

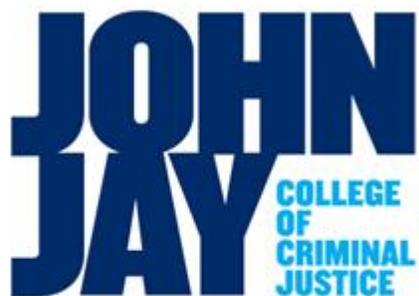
DEPARTMENT OF ECONOMICS

Working Paper

Wealth Extraction, Governmental Servitude, and Social Disintegration in Colonial Puerto Rico

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I) Introduction

After ten years of economic contraction many of the citizens of Puerto Rico find themselves watching the secular decomposition of a reality that in its heyday was painted by many as one of relative socio-economic welfare. The latest economic downturn of the island, which predated the so-called global “great recession” by two years, has confirmed that the current colonial economy could not achieve certain objectives of the economically more advanced economies.

When compared to its own historical record and that of the United States, the performance of the economy of Puerto Rico is not an example of socio-economic convergence or of a process leading to “developed capitalism”:

- A secular decline in economic growth capacity. Compared with the so called golden period of 1947-1973 when growth averaged 6% per year, after the first oil shock during fiscal years 1976-2014 growth averaged 1.6%. Since the beginning of 21st century to date is -0.5% and with the onset of the current crisis in 2006 average economic growth is at -1.5%. Preliminary estimates and forecasts for fiscal years 2015, 2016 and 2017 are negative. The length and depth of the downturn are those of a depression and not a simple cycle.
- Dramatic decline in job creation capacity. Even during the golden years period full employment was never attained. Minimum unemployment of 10.3% during 1969-1970 was the lowest yearly average since 1947 to date. Currently, participation rate is around 40%, more than 20 percentage points lower than in the United States. Unemployment hovers around 12%, while the state with the highest unemployment, West Virginia, experiences 7% unemployment. Employment rate stands at 36%.
- Median household income, in 2013 inflation-adjusted dollars, was 37% of US median household income (\$19,183 versus \$52,250) Per capita income in Puerto Rico is almost half of Mississippi, the poorest state. Around 46% of the population lives in poverty, whereas in the United States it is close to 15%. Puerto Rico is second to none of the 50 states regarding inequality of income distribution. With a Gini index of 0.547 in 2013, it is higher than Washington D. C. (0.532) and New York (0.510). US average is at 0.481.

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- Emigration to the United States is reaching record levels. Between 2010 and 2014, the average number of people leaving the island was 53,020. For the period between April of 2014 and March of 2015, the number reached 86,654 (during the first massive waves of emigration of the 1950s, the yearly average was 47,400). Combined with lower birth rates, this has led to a significant decrease and aging of population.
- A fiscal crisis of major proportions, with a total public debt over 100% of GNP (\$72Bn), not counting net liabilities with the public pension system at \$43.4 billion. Increasing debt service burden, liquidity crisis, creeping default and all tax-backed bonds at near default status.
- Nine years of austerity policy, increased tax burden on consumption, attrition and firing of thousands of government employees with reduction of fringe benefits for those remaining, big privatization projects and market liberalization policies

The roots of this unfolding drama are found in an obsolete economic model once thought of as successful and which the two major political administrations insist on perpetuating, albeit with differences in tonalities. A failed model, which combined with regressive neoliberal structural reforms imposed by both administrations, intensifies the economic depression and fiscal crisis, securing Puerto Rico's membership within a group of countries squeezed and looted by austerity policies. While the cost of the adjustment is shared by working class members, poor people and many small business, the share of the pie going to the top of our society and external partners increases with the crisis and the adjustments vainly imposed to appease global financial capital and local intermediaries' thirst for more. No wonder some consider the country as the Greece of the Caribbean.

In this article we provide a general overview of how the decade-long depression in Puerto Rico is connected to the enforcement of an outdated economic model and structural adjustment policies with regressive and procyclical consequences. The search for a new way to organize economic activity is not a technical issue for well-paid advisors; it is a power relation affair.

In the first section, we examine the characteristics of an *obsolete* economic model that outlived its "successful" period by four decades. We then explore how the crisis of 1974-75 was tackled and use that context to then analyze the current decade-long depression, one that to a certain extent is structural and self-inflicted. Finally, we provide a conclusion of the path to where we think our analysis leads in order to tackle the crisis and possible solutions.

II) An outdated economic model

Puerto Rico's current economic model has its roots in the post war transition from a rural and agricultural economy to an urban and industrial one. This transformation was based on export-led industrialization dependent on foreign, primarily U.S., direct investment which was attracted by a host of economic, legal and political incentives to operate in the island. This process involved various phases of industrialization, from light industries (clothing and apparel), heavy industries (refineries and petrochemicals), and then to the current high tech sector (pharmaceutical and electronics). Throughout this process the basic characteristics of the development model have remained unchanged, namely:

- 1) An ideology based on the notion that Puerto Rico's lack of development capacity is due to its small size, overpopulation, absence of natural resources and very low income therefore requiring external capital flows and export led industrialization and now services.
- 2) A fundamental role for government promoting economic activity in an ad-hoc fashion. Attracting foreign investment with various incentives and no clear objectives attached to them, e.g. multiple tax credits and exemptions; environmental subsidies; subsidized public utilities; abundant, educated and cheap labor force; and industrial peace with anti-union policy.
- 3) The contradictory goal of maintaining low absolute costs of doing business for investment attraction, regardless of productivity gains and expected personal income gains from growth and development processes.

Between 1947 and 1973, Operation Bootstrap and the ensuing industrialization process promoted relatively high growth rates averaging 6% yearly. However, economic growth was unable to lower unemployment rates to single digits or to increase labor participation rates to first world standards. Migration to the United States was substantial, yet poverty remained extremely high, encompassing 62.8% of the population in 1970. Whatever room for maneuver the Puerto Rican government had for negotiating better terms for the country was lost as the general attitude of industrialization promoters was based on the impossibility of endogenous development and a primeval belief in a sort of trickle down effect. In essence, Operation Bootstrap was a neoliberal endeavor since its inception. When the crisis struck and options were discussed in the new scenario of economic liberalism's rebirth, public strategists were out of options.

III) Flawed historical responses

With the onset of the early 1970's crisis, oil refineries and petrochemical complexes expansion came to an abrupt halt. The onset of neoliberal globalization brought new Third World competitors into the world economy. It was clear that Puerto Rico had lost attractiveness for certain fractions of capital. Competing against low costs and newly industrializing countries was not an option as they gained more access to US and global markets within the new international division of labor. Instead of changing the model in place since 1947, it was preserved and more aggressive subsidies were offered, specially tax breaks, low real wages, cheap infrastructure and environmental laxity. Vested interests resistance to change, lack of institutional agility and determination were the order of the day. Dependency was to remain untouched and growing.

To start the chronology of the early 1970's crisis with the oil embargo and its consequences for the Puerto Rican economy obscures the fact that signs of exhaustion of the economic model were present before that event. Economic growth in the late sixties and early seventies was maintained with expansionary fiscal policy. Public debt increased by around 90% during 1969-1973. Debt financing grew larger as the government increased its public spending to create 40% of new jobs in those years.

The process of industrialization, supposed to be the main driver of growth and development, had and still has major flaws. First there is the problem of *improvisation*, i.e. the absence of a development strategy and corresponding Industrial policy resulted on "taking advantage" of conjunctural opportunities without a long-term, integral, and dynamic vision of the economy, the relationship among its sectors and major development goals. This led to the formation of an industrial enclave dominated by subsidiaries of multinational firms, with no substantial connection with the rest of the economy, a policy that used the country as an assembly platform for the export of goods and global money laundering. This enclave model limited the benefits usually associated with industrialization, such as an increase in employment and income, transfer of technology, endogenous capital formation, domestic entrepreneurial development, etc. This also applies to other industrial sector like tourism with the proliferation of resorts and cruise ship activity poorly integrated with the rest of the economy.

Furthermore, during the early 1970s a widening gap between Gross National Product and Gross Domestic Product started, one that has grown currently to the equivalent of 50% or more of GNP³. The collapse of Bretton Woods opened the gates for the thus far

³ Gross National Product refers to the total value of the goods and services produced in one year by the residents of a country within the borders of that same country or others, while the Gross Domestic Product refers to the total value of goods and services produced within a country by both nationals and foreigners in that country.

restricted flow of financial capital worldwide. Puerto Rico became a focal point for investors' global financial strategy when section 931 of the internal revenue code was substituted by section 936 providing greater flexibility to capital flows. Numerous tax breaks and the use of transfer pricing for income shifting around the world allowed for a substantial amount of money—over \$30 billion in total and more than 75% of manufacturing's GDP currently—to be transferred out of Puerto Rico yearly, limiting capital formation and enhanced economic activity.

The government budget experienced its first (unconstitutional) deficit and public in 1974 and debt rose to 74% of GNP in 1976. Risk classification of government's general obligations was downgraded and the first contemporary fiscal crisis was born. The Commonwealth of Puerto Rico commissioned a study about the country's public finances in 1974, often referred to as the Tobin Report (1975), named for economist James Tobin.

Tobin's report emphasized the problems of poverty, inequality, and dependence, and highlighted the erosion of Puerto Rico's attractiveness to foreign capital, but it also put forward a series of recommendations, many of them typical of neoliberal adjustment programs imposed by the International Monetary Fund principally in Third World countries from the 1970's onwards. Among its recommendations were: limiting public expenditures; freezing salaries of the central government, public corporations and private sector; delaying congressional federal minimum wage increments; reduce minimum wages for workers under twenty years; eliminating fringe benefits that increased labor cost; direct industrial incentives to firms that invest and create employment in Puerto Rico; responsible marketing of government bonds.

IV) Current Political and Economic Crisis

From the time of the Tobin report until 2006, the economy of Puerto Rico had undergone an intermittent structural adjustment process with varying degrees of intensity. A detailed account of more than three decades of on-and-off structural adjustment is beyond the scope of this essay. However, as affirmed by Tobin, the early 1970s crisis was not merely a conjunctural problem to be solved by a repertoire of anti-cyclical policies. It was a structural problem that required more fundamental responses.

The disastrous effects of the first post-war crisis in 1974 and the second great recession of the early 1980's, when unemployment in Puerto Rico surpassed 20%, were contained through a sizable increase in the flow of federal funds and migration. However, Operation Bootstrap remained unchanged. Thus, the problems of 40 years ago remained latent and made their reappearance in 2006.

Puerto Rico's economy never regained capacity for growth comparable to that of the 1947-73 period. Public indebtedness remained at 60% of GNP during 1977-2000. The labor market continued its mediocre performance, and migration and federal transfers maintained conflicts and tensions at bay. After the 2001 recession, growth capacity further weakened and public debt picked up again. Risk assessment of Puerto Rico's public debt was a notch below non-investment grade (Baa3) in 2006 according to Moody's assessment. At play were the combined effects of an outdated economic structure, the lack of an industrial policy, and new federally mandated parameters—higher minimum wage and changes in the IRS code affecting Puerto Rico— in a more competitive and globalized economy.

This is the context in which the two governmental administrations, the Popular Democratic Party and the New Progressive Party, have governed during the last decade of depression and fiscal crisis, applying structural reforms without questioning how this context came to be. The neoliberal discourse adopted by ruling extractive elites in Puerto Rico has had four main components: the excessive size of government; living beyond our means; the need for an adjustment in which all sectors of society must sacrifice; and the need to keep costs of doing business low in order to maintain competitiveness.

The size and role of the government has become one of the principal issues of the debate with various groups offering a variety of often contrasting views on the subject. Both governing parties have adopted the excessive size of government as one of the main reasons for the Puerto Rican economy's woes. While standard economic measurements do not support the thesis that Puerto Rico's government is too "big", the recent history of the island puts the role of the government at center stage, particularly regarding US - PR relations, the origin of the crisis as well as local government capacity to negotiate with the federal government possible crisis solution strategies.

However, denying the relative fiscal autonomy of the Commonwealth of Puerto Rico is a grave mistake. It can be argued that much of the crisis is *self-inflicted*. The lack of an industrial policy with effective oversight and the extension of subsidies to most of the foreign investment in sectors other than manufacturing, as well as to local capitalists, has eroded the tax base, contributed to depressed salaries, wealth and income inequality, poverty, environmental degradation, and the expansion of the informal economy. Despite the fiscal crisis and the lack of evidence supporting the effectiveness of the multitude of subsidies, both governing parties continued granting tax exemption, wage subsidies and other inducements for business to invest. In 2004 there were 40 tax exemption laws. As we write, the number of these laws exceeds 80. Furthermore, every instance of tax reform from mid 1980's until 2010 involved lowering taxes in order to

promote economic growth—a failed supply-side strategy for growth but a very effective tool for income and wealth redistribution to the top.

Intensive and indiscriminate use of tax exemption has made of Puerto Rico a free-for-all fiscal paradise, eroding the tax ethic and tax base of the system. A growing sense of unfairness permeates public opinion. Some events that highlight Puerto Rico's lack of fiscal control are:

- Over 20,000 businesses did not submit their income tax reports on April of 2014, which meant a loss of revenues in the order of \$400 million.
- Big businesses in manufacturing, retail and other sectors report minimum profits, losses or break-even, hiding their revenues through “profit-stripping” strategies with transfer pricing and income shifting.
- Real estate investment trusts siphoning hundred of millions out of Puerto Rico without paying taxes or being authorized to do business in the island.
- Government bailout payments for debt service of luxury hotels amounting to \$400 million during 2012 and 2013.
- Four billion dollars in uncollected tax debts in 2015.
- An overall rate of evasion close to 30% of potential revenues
- Eighty tax exemption laws that cost over a \$1 billion in lost revenues yearly
- Dwindling resources at the Treasury Department for tax enforcement, leading to the loss of personnel, intellectual expertise and technological know-how.
- Tax subsidies at municipal level, granted by central government, resulting in \$850 million in revenue losses per year for cash strapped towns
- Waste of public funds amounting to 10% of budget according to past comptrollers (Equivalent to \$900M of general fund backed budget and \$2,900M of consolidated budget). Corruption, mounting to almost \$900 million of public funds per year according to FBI figures.

All of these examples of contradictory economic behavior and more happen amidst a major fiscal crisis and depression. This is precisely why we see this crisis as self-inflicted and also question the discourse of sharing the burden of adjustment by all. So far the burden of the adjustment has been falling on the working class, the poor and many small businesses. The tax system—with its complexity, lack of integral connection and regressive bias—and the use of public funds—reflecting lack of planning, absence of controls, corruption, political cycles, and politicians' whims—are both common problems in the allocation of resources that are *locally determined*.

Although budget deficits are explicitly forbidden by Puerto Rico's constitution, using public debt to finance recurrent expenditures, declaring certain amounts of debt as “extra constitutional,” and issuing debt without specific sources for its service were

common practices. However, as the imbalance grows, the economy contracts, and less revenues accrue to the treasury, solvency is compromised and risk assessment becomes increasingly negative. As this vicious cycle continues a cash-flow crisis emerges with incremental default taking place.

The different adjustment programs implemented since 2006, starting with Acevedo Vilá's governorship with reform imposing Puerto Rico's first sale tax and public employment attrition, to Fortuño's plan and its iconic Law Number 7 of 2009 firing over 20,000 public employees, and García Padilla's Law Number 66 of 2014 that reduces the budgets of public agencies, consolidates some of them and maintains public employment attrition, have all targeted the size of government, its labor force, and their fringe benefits. The number of public employees has decreased significantly and so has the cost of public sector labor force. Since the crisis began in 2006, and up till September 2015, average government employment has experienced a reduction of 69,000 jobs. The negative multiplier effect of public employment downsizing is considerable contributing to private sector activity decline on top of the downturn. Total non-farm wage employment dropped 137,000 during the same period, deepening the depression, the fiscal crisis, and the precarious state of public retirement systems.

Regressive taxation has also been the order of the day. More taxes on consumption are imposed in a desperate move to shore up liquidity crisis, big scale privatization projects are undertaken by both administrations (Fortuño and García Padilla) and more are waiting with Public Private Partnerships (P3) initiatives that bring lump sums of cash to the government in exchange for the transfer of productive public assets to private hands for 40 to 50 years. Finally, more pro business laws are still approved, business permits reform was undertaken, commercial sector operating hours expanded, and sunday wages were slashed, while vast amounts of internal and external funds were injected into the economy. Notwithstanding, and with growth still nowhere in sight, government faces a liquidity crisis while gradual default already began and most of its debt is close to default status.

The Puerto Rican economy is like a punctured tire tube: you can pump vast amounts of resources into it and it will not grow. Since 2006, and up until 2015, close to \$40 billion were injected into the system, e.g. sales tax backed bonds; Bush's 2008 stimulus; bond emissions by central government, public enterprises and municipalities; American Recovery and Reinvestment Act funds; Federal Deposit Insurance Commission funds for bank consolidations; Toxic Asset Relief Program; and Affordable Healthcare Act funds.

In spite of this considerable injection, the only positive growth value since 2007 to the present was a meager 0.5% in fiscal year 2012. During 2000-2005, right before the

onset of the crisis, average growth was just 1.82%. From the beginning of the century to 2014 average growth has been 0.15%. With the crisis of 2006 till present average growth it's at -1.5%. According to official estimates and forecasts, growth will remain negative during 2015 and 2016. As it is structured, the Puerto Rican economy lost capacity for growth.

The problems of the Puerto Rican economy are certainly structural but the necessary adjustment to solve them is not the classic IMF neoliberal package. Perfect mobility of labor is an effective escape valve whereby some, especially the young, can dodge draconian austerity policies by leaving the island. Dominant groups take advantage of the crisis to advance their own interests, lowering taxes, liberalizing markets, privatizing at a discount, claiming more subsidies and so on. An enormous informal economy with both legal and illegal activities wraps the island. To think that the remedy lies in more taxes, privatizations, budget cuts and liberalization of markets is to deny major institutional problems not addressed by this neoliberal strategy. After nine years of structural reforms and massive injections the Puerto Rican economy continues its downward march towards depression and default.

V) Conclusion: Race to the Bottom, Default, and Change

The *double whip* of the fiscal crisis and the economic recession that the economy of Puerto Rico faces shows no sign of abatement: growth is nowhere in sight and government faces a cash flow crisis with gradual default already in motion. With access to financial markets severely restrained, room for fiscal maneuver is very limited in the context just described.

The demographic situation runs counter possible future growth and development as the population growth rate diminishes and net out migration is reaching record levels, perhaps even greater than those of the 1950s. Puerto Rico's total population is decreasing and aging fast. Furthermore, a sort of population swap is taking place with mostly the young population leaving (82% of migrants are 24 or less years old) while Law 22 of 2012 (Millionaire's Law) is attracting hundreds of well of Americans to this fiscal paradise. Lack of opportunities has led to the growth of a sizable informal economy, which further erodes the tax base. Inequality, poverty and social tensions are up in this deteriorated scenario.

A "Fiscal Stabilization and Economic Growth Plan" was presented by the current administration in September 2015. According to it, by the end of 2015 the government would have run out of cash and it estimates an aggregate public financing gap of \$27.8 billion over the next five years. The plan proposes a garden variety of neoliberal

prescriptions dating from the time of Tobin's report while adding some new ones. Most important of all are negotiating debt restructuring with bondholders, obtaining substantial concessions from the federal government with more Medicaid and Medicare allocations, control over minimum wages, and exemption from cabotage laws. The plan also proposes revising labor laws in order to strip the working class of many acquired benefits for the sake of competitiveness. It also proposes a local fiscal oversight board with powers not clearly limited. However, the proposal states that even with a 100% success rate in its implementation, only half of the public finance gap (\$14 billion) could be closed by 2020.

The Puerto Rican economy has become a model of extreme capitalist wealth extraction, with over \$30 billion in profits repatriated every year. Meanwhile the share of profits and interests going to local extractive elites, mostly intermediaries of global financial capital and other fractions of capital, increased 70% during 2005-2014, according to the functional distribution of net national income. Workers share of net national income increased only 1.3% during the same period. Thus, all groups and classes of society do not equally share the crisis.

As the NY Fed's report "An Update on the Competitiveness of Puerto Rico's Economy" (2014) clearly stated, "the island appears to face two alternatives: either manage its own economic adjustment and put the Commonwealth on a secure fiscal basis, or wait for outmigration and the discipline of the market to force an even more painful adjustment, particularly for those unable or unwilling to leave the Island."

Among the citizenry more awareness exists on how both major governing parties are responsible for the crisis and therefore incapable of adopting other approaches to the crisis than the socially disruptive structural adjustments they have imposed so far. Average citizens cannot relate with the discourse of having lived beyond their means as the burden and hardship of daily life keeps growing upon a population already impoverished before the crisis and the adjustments. Rationing of basic public services and lack of opportunities, increasing poverty, inequality, and migration constitute major challenges faced by working people and the poor. How much more can be asked from them to contribute for the solution of the crisis? In spite of this, status preferences blur the shared class nature of the main political parties and therefore their resistance to structural change within, and potentially outside, colonial capitalism.

However, talking about any future lineages of Puerto Rican economy and society is purely speculative at the moment. A far-reaching social restructuring process is taking place and no significant resistance appears to coalesce in order to restrain it and lead it in a different direction. In Puerto Rico and among Puerto Ricans in the USA, much effort is being mustered for some form of bailout, bankruptcy law or federal oversight board of

the troubled economy. Regardless of the mechanisms and amount of funds that a possible federal intervention could allocate or impose to Puerto Rico's economy, growth will not restart and public debt obligations will last forever if the model based on vast subsidies for capital in exchange for crumbs for the Puerto Rican people is not substantially changed.

Building a new economy and society with more equitable wealth and power distribution in a colonial setting will not be possible without major political struggles as the examples of sovereign Greece and Argentina show. In the limit, the terminal crisis of Puerto Rico's socio-economic model poses imperative challenges that must be addressed head on if future sustainable development is to be considered attainable. The ways and manners this struggle will take depend on people's capacity to organize and transform a political system plagued with political investment, closed entry into the electoral arena for new parties, and centuries old fears of grasping power and control of our own existence. This represents a formidable challenge as the groups and alliances of local and international classes extracting wealth from the island will do all that is possible to prevent change. However, as this extractive model reaches its extensive and intensive margins, incapable of growing, drained of its productive population, fiscally broke with systemic limits to budget cuts and more taxes, a compromise must come. A broad coalition of progressive forces in Puerto Rico and the United States, capable of cutting the Gordian knot of extractive class domination, pushing for institutional changes in Puerto Rico while claiming for the island a fair share of the surplus extracted and sent to the US during the last 117 years would be a good start.