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Myths and Reality of the Puerto Rican Economy

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Foreword

Why has the case method of teaching been so widely adopted? Because students learn to think for themselves and discover that trusted decision makers should not rely upon second hand information. Yet, it would appear that too many pundits succumb to the temptation of only half-listening and not sincerely looking below the surface of myths masquerading as facts.

The supposed impact of section 936 of the IRS code on Puerto Rico is a case study of the continuing dominance and damage of a mythical policy. For example, *New York Times* columnist and Nobel Prize winner Paul Krugman began his explanation of the current crisis asserting: “There was a time when the island did quite well as a manufacturing center, boosted in part by a special federal tax break. But that tax break expired in 2006, and in any case changes in the world economy have worked against Puerto Rico.” Even this Nobel Prize winner who consistently calls out those who shun any facts that disprove their beliefs was taken in by the myth.

It’s time to clear things up.

The Puerto Rican economy did not do well under Section 936, and the current, long-lasting recession cannot be attributed to the termination of 936.

Some facts:

- During the era of 936, the Puerto Rican economy fell further and further behind the U.S. economy in terms of gross national product (GNP). Section 936 was established in 1976. Between 1980 and 2000, while the mainland’s GNP rose by 90%, GNP rose by only 60% on the island. (And, ironically, immediately after 1996, when the termination of 936 began, the Puerto Rican economy rose slightly more rapidly than in previous years.)

- As 936 was coming to an end, the U.S.-based firms that had obtained the tax advantage of this regulation switched their status to Controlled Foreign Corporations (CFCs), and thus retained essentially the same tax advantage they had had with 936.

- Employment on the island in manufacturing did fall substantially from 1996 to 2006, dropping from 157.7 thousand to 109.8 thousand. However, for the four industries where 936 played a major role—pharmaceuticals and medicine, chemicals, computers and electrical goods, and medical equipment and supplies—employment only fell from 82.2 thousand to 80.3 thousand.

The Heller school has had a long-standing interest in Puerto Rico and there are several reasons why this paper fits with issues of exclusion and inequality in the Heller School and in the Center for Global Development and Sustainability. First, in the winter of 2001 SID decided to offer a course on Puerto Rico as part of its Country Development Studies Program. The idea of the Country Development Studies Program was to examine a broad range of topics—social, political, cultural, economic—that affected the development of a country or region. The current paper updates some of the findings from SID's early work on Puerto Rico. Second, though part of the USA, the commonwealth of Puerto Rico displays many of the attributes of a developing nation—low income, high unemployment, migration, brain drain, and linguistic and cultural barriers—that make it hard for Puerto Rico to achieve the quality of life that one might expect from a region in the USA. Like other excluded regions and groups of interest to the Center for Global Development and Sustainability, Puerto Rico is a region that has been excluded from development by its better-off neighbors. Puerto Rico illustrates in a microcosm many of the larger themes central to international economic development. Third, Puerto Rico has remained the poorest region of the United States since the Spanish-American War, 1898, with no signs that it is converging to the standard of living in the mainland of the USA. Exclusion tends to persist, unless these myths about what is best for Puerto Rico’s economy are exposed. Last, the paper matters because it redresses the shortage of information about Puerto Rico in the media and in academia.

Ricardo Godoy

Myths and Reality of the Puerto Rican Economy[*]

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Inside and outside of Puerto Rico, the severe decline in the island's economy—and the equally severe debt crisis—is widely attributed to the termination of the special tax advantages that were provided to firms under Section 936 of the U.S. tax code. According to this common scenario, after Section 936 was put in place, the Puerto Rican economy did well, led by the manufacturing firms that benefited from this tax break (as well as from additional tax breaks provided by the Puerto Rican government). Then, starting in 1996, 936 was phased out over ten years and ceased to exist in 2006. According to the island's Secretary of Economic Development, Alberto Bacó Bagué, once the island's tax exemption expired, "we kind of disappeared from the map."[†]

In the states, the Nobel Prize winner and *New York Times* columnist, Paul Krugman, began his explanation of the current crisis asserting: "There was a time when the island did quite well as a manufacturing center, boosted in part by a special federal tax break. But that tax break expired in 2006, and in any case changes in the world economy have worked against Puerto Rico."[‡]

Yet, this common scenario is a myth. The Puerto Rican economy did not do well under Section 936, and the current, long-lasting recession cannot be attributed to the termination of 936. The roots of both the long-term weakness of the economy and the current debacle lie in the economic structures that have been created by Puerto Rico's political status as a territory of the United States.

Some facts:

- During the era of 936, the Puerto Rican economy fell further and further behind the U.S. economy in terms of gross national product (GNP). Section 936 was established in 1976. Between 1980 and 2000, while the mainland's GNP rose by 90%, GNP rose by only 60% on the island.[§] (And,

[*] This paper may be accessed on-line at http://heller.brandeis.edu/gds/eLibrary/working-papers/general-development-studies.html.

[†] Quoted by James Surowiecki, "The Puerto Rican Problem," *The New Yorker*, April 6, 2015, http://www.newyorker.com/magazine/2015/04/06/the-puerto-rican-problem.

[‡] "America's Un-Greek Tragedies in Puerto Rico and Appalachia," *The New York Times*, August 3, 2015, http://www.nytimes.com/2015/08/03/opinion/paul-krugman-americas-un-greek-tragedies-in-puerto-rico-and-appalachia.html?_r=0.

[§] For Puerto Rico, 1980, James L. Dietz, *Economic History of Puerto Rico,* Princeton: Princeton University Press, 1986, Table 5.1, and 2000, Planning Board of Puerto Rico, 2009, *Economic Report to the Governor 2008*. http://www.jp.gobierno.pr/Portal_JP/Default.aspx?tabid=300, Apéndice Estadístico. For the United States, U.S. Department of Commerce, Bureau of Economic ironically, immediately after 1996, when the termination of 936 began, the Puerto Rican economy rose slightly more rapidly than in previous years.)

- As 936 was coming to an end, the U.S.-based firms that had obtained the tax advantage of this regulation switched their status to Controlled Foreign Corporations (CFCs), and thus retained essentially the same tax advantage they had had with 936.

- Employment on the island in manufacturing did fall substantially from 1996 to 2006, dropping from 157.7 thousand to 109.8 thousand. However, for the four industries where 936 played a major role—pharmaceuticals and medicine, chemicals, computers and electrical goods, and medical equipment and supplies—employment only fell from 82.2 thousand to 80.3 thousand.[**]

- After 2006, employment in all manufacturing, including in these four 936 industries, fell off much more, with employment in the four industries standing at only 50.6 thousand in 2013. However, this decline in 936 industries was not due to a loss of tax breaks, but had other causes. The firms kept their tax breaks under the CFC provision, but this provision did not include employment credits as had 936. Exports of pharmaceuticals and medicines, for example, rose substantially as employment fell.[††] Furthermore, the longer term decline of employment in manufacturing was coincident with a similar decline in the states, where manufacturing employment fell by 35% between 1990 and 2010, as compared to a 45% decline in Puerto Rico. This comparison suggests that the combination of global competition and technological change was largely responsible for bringing about the change.

Analysis, https://www.bea.gov/scb/pdf/2011/06%20June/D%20pages/0611dpg_c.pdf. The association of 936 with years of relatively poor economic performance is often obscured by the fact that growth of gross domestic product (GDP) was fairly strong in the 1970 to 2000 period. GDP growth, after all, is the standard by which a country's or a region's economic expansion is usually gauged, and between 1970 and 2000 GDP (inflation adjusted) grew at a 3.8% annual rate. Gross national product (GNP), however, expanded at an annual rate of only 2.7% in this period. By 2000, GDP was almost 50% greater than GNP. This difference was largely, if not entirely, accounted for by the profits of firms based outside of Puerto Rico—mostly in the states. The growth of GNP is a much better measure of the improvement of the Puerto Rican economy—of the well-being of the Puerto Rican people and the condition of firms based in Puerto Rico—than is GDP. This is especially the case because much of the earnings of the firms based outside of Puerto Rico have been a result of the ownership of their patents being located in Puerto Rico and of transfer pricing, both designed to locate profits, but not real activity, in Puerto Rico. For the states, the difference between GNP growth and GDP growth is very small.

[**] Unless otherwise indicated, all employment figures here and following are from the U.S. Bureau of Labor Statistics.

[††] The export data are from the Statistical Appendix, *Economic Report to the Governor, 2011*.

- Firms in 936 sectors, particularly in pharmaceuticals, did close down some operations after 2006. However, articles in *Caribbean Business* and on *Pharmtech.com* indicate that the cause was patent issues and technical change:

    - "…the pharmaceutical manufacturing industry in Puerto Rico faces many challenges as many companies have patents on their products that already have or will soon expire, and the number of new drugs in the pipeline are [sic] not enough to replace those with expired patents."[‡‡]

    - "Pfizer will close one of its three manufacturing facilities in Puerto Rico by the end of 2017… because of excess capacity in its manufacturing network created by the achievement of greater efficiencies in manufacturing processes and by the changing global demand, which has resulted from the loss of patent exclusivity."[§§]

It is, then, relatively clear that Section 936 was not responsible for any "good times" of the Puerto Rican economy and its termination cannot explain the current, continuing recession. The problems of the Puerto Rican economy are, in fact, much deeper than any single policy. They lie in the structures that have been created by the island's status as a territory of the United States. These structures can be illustrated by three features of territorial status:

- Policymakers in Puerto Rico have always looked outside the island to find bases for economic growth. Whether it is investment from U.S.-based firms or favors from Washington, policies that would build up the foundations for growth among Puerto Rican have given second rating, if not simply ignored. Efforts to strengthen Puerto Rican based business and build a highly skilled work force have been minimal.

- Territorial status is necessarily uncertain. Not only is there continuing controversy regarding status, and thus the possibility of some major alteration, but, in addition, changes in the nature of territorial status are outside the control of Puerto Ricans. As a consequence, investors (both Puerto Rican and non-Puerto Rican) tend to take a short run approach, not only in their own businesses but in supporting policies that would have long-run positive impacts, especially investment in social and physical

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‡‡ "Manufacturing at a Crossroad," *Caribbean Business*, online at http://www.caribbeanbusinesspr.com/cbdirectory/cb_manufacturing.php?cat_id=11. While undated, it appears to be from late 2011 or 2012.

§§ "Pfizer to Close Manufacturing Plant in Puerto Rico by 2017," Available at http://www.pharmtech.com/pharmtech/News/Pfizer-to-Close-Manufacturing-Plant-in-Puerto-Rico/ArticleStandard/Article/detail/829210?contextCategoryId=35097.

infrastructure. This short-run approach to economic affairs also infects the actions of policymakers.

- Puerto Ricans, though U.S. citizens, have no direct power in Washington, no votes in congress and no votes for president. Among the many ways actions by the federal government provide funds and programs that support states' economies, Puerto Rico is sometimes excluded and sometimes treated unfairly in the distribution of those funds and the implementation of those programs. Examples include the exclusion of Puerto Ricans from the earned income tax credit, substantial exclusion from the child tax credit, limited funding for Medicare and Medicaid, and capped funding for the supplementary nutritional assistance program. It is frequently claimed that Puerto Rico receives "generous" support from the federal government—a claim bolstered by the argument that Puerto Rico gets lots of funds in spite of the fact that Puerto Ricans do not pay federal income taxes. Yet Puerto Ricans are liable for federal payroll taxes, and, in terms of the excess in federal funds each state receives over the amount of federal taxes they pay, measured in per capita terms, many states rank ahead of Puerto Rico. In 2010, for example, the per capita excess (federal expenditures received minus federal taxes paid) received by 17 states was greater than this figure for Puerto Rico.[***] Each of those states, of course, had full congressional representation and votes for president.

These structures of territorial status cannot be the foundation for a strong economy. Weakness, indeed, has been the condition of the Puerto Rican economy for decades: poor growth up to the early 2000s, and then, when set off by particular factors, the continuing recession for the last decade.

Until there is a change in Puerto Rico's political status, its economic conditions will not substantially change.

[***] Data for this statement comes 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