Article

Puerto Rico's 21st Century Great Depression: Causes and Policy Implications

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Abstract

This article highlights the importance of class processes in the ongoing economic crisis in Puerto Rico and assesses trends in productivity and worker compensation across industrial sectors. Puerto Rico's worker compensation and productivity have both decreased since the 1980s in most industrial sectors, with compensation falling faster than productivity. The primary deviation from this pattern is finance, insurance and real estate ("FIRE"). Even though productivity has risen in this sector, worker compensation has dropped. The discussion suggests FIRE is the sector where most rent-seeking takes place, and where many have already been effective in obtaining an upward distribution of income. The government should focus on taxing industries such as these, while developing an industrial policy program aimed at strengthening industries with higher potential impact in the economy. The article also argues this should be combined with policies aimed at strengthening the labor movement.

Key Words: Puerto Rico, Economic Development, Class Analysis

JEL classifications: O54, O20, B50

1. Introduction

The issue of Puerto Rico's economic and debt crisis has recently received considerable attention. The island's economy contracted 15.9% from 2006 to 2016, while total employment has fallen in 20.9% and gross public debt reached 97.8% of GNP in 2014 (Puerto Rico Planning Board, 2017). As a result, U.S. Congress established an unelected oversight board, also referred to as a Fiscal Control Board, to oversee debt restructuring in 2016. The Puerto Rican people and the aftermath of their crisis are an important cause for concern. However, the case of Puerto Rico has been substantially understudied within the field of economics during the past decade. In addition, the scant research on the island's economy has various deficiencies. The most notable include an excessive emphasis on one of two factors as the sole or primary cause of the Puerto Rican crisis. The most common account argues the Clinton administration's decision to gradually eliminate the corporate tax breaks for U.S. firms operating in Puerto Rico between 1996 and 2006, commonly referred to as "Section 936," sparked the ongoing in crisis. The other view argues the political straightjacket associated with being a territory that belongs to the U.S. (with no representation in any branch of U.S. government, and prohibited to enact tariffs or negotiate economic treaties) ultimately blocks the possibility for economic and human development in Puerto Rico. While both processes were fundamental, this article argues neither explanation is sufficient independently, and a deeper analysis is required to understand the island's crisis. Furthermore, it intends to contribute to the study of the Puerto Rican economy by assessing the island's class structure, along with its trends in productivity growth and worker compensation across industrial sectors.

2. Research within Economics on the case of Puerto Rico

As was previously noted, scholarly work within Economics focusing on Puerto Rico's ongoing crisis is scarce. Being under the jurisdiction of the Federal Reserve Bank of New York, it is not surprising a substantial amount of the research that has been conducted on the crisis has been by said institution. In 2008, two years after the onset of the Puerto Rican recession, the Federal Reserve Bank of New York published an article that argued the repeal of section 936 put "further drag on the island's economy," and warned prospects for recovery were limited due to increasing competition from emerging Latin American neighbors (Bram, Martínez, & Stendeil, 2008).

In 2014, the Federal Reserve Bank of New York published research that found "Puerto Rico's out-migrants tend to be from younger and, in recent years, less-educated segments of the population" (Abel & Deitz, 2014). The Puerto Rican crisis has led to a massive wave of migration to the U.S mainland. In 2016, prior to the strike of hurricanes Irma and María, Puerto Rico was already among the top twenty nations with the highest net migration rate, with migration patterns similar to the world's least developed nations or with countries suffering humanitarian crises (Central Intelligence Agency, 2017). In 2017, after the devastation caused by the hurricanes, Puerto Rico became the nation with the fifth highest net migration rate in the world (Central Intelligence Agency, 2018).

Finally, in 2016, the Federal Reserve Bank of New York published a transcript of a presentation given in Puerto Rico by its sitting president, William C. Dudley. Dudley (2016) defends the presence of the unelected Fiscal Control Board imposed by U.S. Congress arguing that in situations like that of Puerto Rico, "the record suggests that it can be extremely helpful to have some kind of independent fiscal monitor in place on an ongoing basis." Dudley (2016) also stresses the importance of reducing business costs through policies such as providing Puerto Rico with minimum wage policy autonomy (i.e. allowing the island to set its minimum wage *below* the U.S. Federal minimum). His presentation also lists policies that he argues might benefit the island's recovery, such as extending the Earned Income Tax Credit to Puerto Rico and improving the quality of public education (Dudley, 2016).

Similar to the Federal Reserve Bank of New York, Jenkins et al (2016a) mention the potential benefits of extending the Earned Income Tax Credit to Puerto Rico; however, these researchers also stress the urgency of increasing public investment on the island. Jenkins et al (2016a) add that the Puerto Rican government's tax incentives, "which are, in essence, corporate welfare, cannot be a prime building block for economic development" (Jenkins et al, 2016a). This appraisal of the government's tax policy is in line with that of other recent publications that have also highlighted this problem. For example, Fuentes-Ramírez (2017) similarly argues the Puerto Rican government has become notorious for its excessive and/or exclusive use of tax credits as the primary development policy. Also consistent with scholarly work on Puerto Rico from previous periods (see Dietz 1986; Dietz 2003), Jenkins et al (2016b) argue:

> rather than yearning for the return of 936, Puerto Rico would do well to abandon of the 936 myth. This recognition of reality could be one important step in laying the foundation for a new era of economic development for Puerto Rico. Secondly, Section 936 has ceased to be an efficient means of attaining employment-producing investments in Puerto Rico and other U.S. territory. While the initial rationale for the credit was the creation of jobs and the stimulation of economic activity in the territory, the outcome has been far different.

On the other hand, Jenkins et al (2016a) argue the main reason for Puerto Rico's slow development and present crisis is the "non-resolution of its political status." The authors contend Puerto Rico "diverged rather than converged with the 50 states, and after consideration of the conventional variables, it's not being a state appeared to be the main reason" (Jenkins et al, 2016a).

Uneven economic development is profoundly shaped by various socioeconomic processes that transcend the political status of a nation or economy. For example, scholars have historically stressed the similarities between Puerto Rico's structural problems and those of other developing or peripheral nations (see Irizarry Mora, 2001). Not being annexed to an advanced nation is certainly not the main reason why peripheral nations diverged rather than converged with advanced nations. Scholars defending the "political status argument" would need to show Puerto Rico's structural problems are substantially different from those of other peripheral nations; however, as was previously mentioned, most scholarly work from previous decades suggests the opposite.

In sum, it is highly problematic to stress the island's territorial status as the determinant or primary cause of Puerto Rico's difficulties. Jenkins et al (2016a) go even further, arguing it is particularly statehood (not independence) which will ultimately open Puerto Rico to the possibility of economic development. In addition to eligibility for federal programs such as Earned Income Tax Credit or total eligibility for the Child Tax Credit, it is unclear what other economic benefits statehood would imply. If the vast structural and historical problems of Puerto Rico's economy go unaddressed if the island becomes a state, the crisis would most likely continue. While resolving the island's status is a necessary condition for long run growth and development, there is little evidence that only the statehood option is a feasible route for this process. Independence, for instance, would grant Puerto Rico the political power to employ monetary policies according to its own conditions, or effectively combine trade and industrial policy. Most importantly, as this article will argue, internal class processes are at least as significant as those processes related to the island's territorial status.

It should be clarified this article is *not* arguing the political status of the island has *not* fettered growth and development. The point being made is that arguing the status of the island is *ultimately* at the root of *all* problems is deterministic and problematic.

This excessive emphasis on the island's territorial status can also be found in Hexner & MacEwan (2017). Nevertheless, the authors highlight in their discussion fundamental aspects often overlooked in the Puerto Rican case. For example, Hexner & MacEwan (2017) correctly note that the 2006 recession is not a singular crisis, but part of a process of long-run decline that was already underway during the late 1970s. Similarly, their article is an important contribution for highlighting that:

> The popular belief that Puerto Rico receives "generous" treatment from Washington is belied by the data. Moreover, while many observers viewed Puerto Rico as an economic success story during the late 1900s, this view erred in measuring success by the growth of GDP instead of GNP, the former including the profits of firms based off the island (mainly in the U.S.) and not providing a measure of economic conditions of Puerto Rican people of firms (Hexner & MacEwan, 2017).

3. From 19th century colonialism to Puerto Rico's 21st Century Great Depression

During the late 19th century and early 20th century, whatever market for manufactured goods emerged in Puerto Rico did not become the internal market of the island. Instead, it could be better described as an appendage of the internal market of the U.S. After the U.S. military invasion in 1898, processes including the forced dollarization of the Puerto Rican economy, the impossibility of any type of protections for key local industries, and the complete exclusion of Puerto Rican economic elites from political power hindered the development of an internal market on the island. In these conditions, imported U.S. goods, from food to manufactured products, increasingly flooded the island (Ayala & Bernabe, 2009; Dietz, 1986; González Díaz, 1991).

During the first half of the 20th century, many U.S. firms set up manufacturing operations on the island, producing goods destined to the U.S. market. Incipient Puerto Rican manufacturing could not compete with U.S. goods, and focusing on exports was even less feasible. At a point when protection of Puerto Rico's infant industries was perhaps most needed, they were essentially obliterated, and this process influenced its subsequent development (Dietz, 1986; Irizarry Mora, 2001).

After the Puerto Rican government was granted limited autonomy in 1952, it decided to try to promote manufacturing within the island by focusing on exporting to the U.S. However, it was U.S. firms, not Puerto Rican firms, who were expected to engage in these activities. The government believed this foreign-owned manufacturing sector would spark growth for the entire economy. While economic growth was temporarily achieved, more than half of the population remained in poverty, and unemployment never fell below 10% (Irizarry Mora, 2001). A key problem was the government did not seem to account for the possibility that the foreign firms arriving would not necessarily be sufficiently labor-intensive to have a substantial effect on employment. Similarly, while the importance of establishing linkages between the foreign manufacturing sector and Puerto Rican firms was occasionally discussed by policy makers and economists alike, the government did very little to ensure this process took place (Dietz, 1986; Irizarry Mora, 2001). With the recession of 1974-1975, the Puerto Rican economy initiated its slow but steady collapse.

While Puerto Rican elites were unable to compete against U.S. firms, they did not simply disappear during the early 20th century. As has been noted is characteristic of many developing economies (see Baran, 1957), a significant part of Puerto Rican capitalists focus on areas such as commerce and finance rather than manufacturing. For example, the most comprehensive data on Puerto Rican capitalists is found in the "Caribbean Business Book of Lists," an annual report published by Puerto Rico's main business newspaper *Caribbean Business*. The report highlights the Top 400 Puerto Rican firms each year. In 2015, financial institutions, trade, and insurance generated 65.91% of total revenue among the top

400 Puerto Rican firms. Of the top ten Puerto Rican firms, eight are related to either insurance or to the distribution of imported products. Conversely, manufacture plays a small role in the local private sector. Only 42 manufacturing companies made it to the "Top 400" list, generating 5.27% of total revenue. Social scientists outside Economics, such as Ayala & Bernabe (2009, 270), have similarly argued the Puerto Rican capitalist class largely acts as "intermediaries or representatives of U.S. producers (as importers, dealers- distributors, wholesalers-retailers, or providers of financial or transportation services)," and it is a "dependent, subordinated stratum, a modern-day version of the comprador bourgeoisie."

In sum, most of the island's capitalists have gravitated towards sectors, which at least in Puerto Rico, have had relatively poor impact in the creation of employment or in stimulating growth in other sectors. Furthermore, after the 1970s, U.S. firms have set up mainly knowledge or capital-intensive operations (e.g. factories producing medications, fine chemicals, or advanced electronics) that have created relatively little employment or linkages to the local economy. For instance, according to Caribbean Business (2017), Puerto Rico's top private employers as of November 2016 were Walmart (13,295 employees), Popular, Inc (the island's largest bank and publicly traded company, with 7,215 employees), local supermarket chain Econo (6,550 employees), local hospital systems Metro-Pavia and Grupo Hima-San Pablo (4,956 and 4,875 employees respectively), and U.S. drugstore chain Walgreens (4,500 employees).

According to the Puerto Rico Planning Board, unemployment has been on average 15% since 1970. During the same period, the labor participation rate has been on average 45%, falling to a historic low of 39.7% in 2015 (the island is consistently among the world's five lowest labor participation rates). This has fueled typical conservative rhetoric on "lazy workers" in Puerto Rico. The sum of the population outside the formal labor force and the unemployed has represented on average 60% of the working-age population since 1970. Furthermore, according to the Puerto Rican Department of Labor and Human Resources, only 9.97% of Puerto Rican workers were unionized in 2014. The previously discussed migration rates and the present weakness of the Puerto Rican working class suggest the island's low labor participation rate is more likely to be related to a "discouraged worker" dynamic than with stronger preferences for leisure in Puerto Ricans.

In this context, the Puerto Rican government has historically favored "supply-side" policies, consistently lowering taxes for firms and in many cases not taxing U.S. firms at all. This has resulted in severe fiscal constraints for the government, pushing it to issue debt as a short-run solution (Dietz, 1986; Ayala & Bernabe, 2009). Throughout the 1980s and the early 2000s, the Puerto Rican government continued within the same ineffective policy framework. However, the development strategy's deficiencies were ameliorated by federal transfer payments, outward migration, and debt-financed spending (Dietz, 2003; Ayala & Bernabe, 2009). Despite these counteracting processes, the island's growth rates continued faltering until the onset of the 2006 recession.

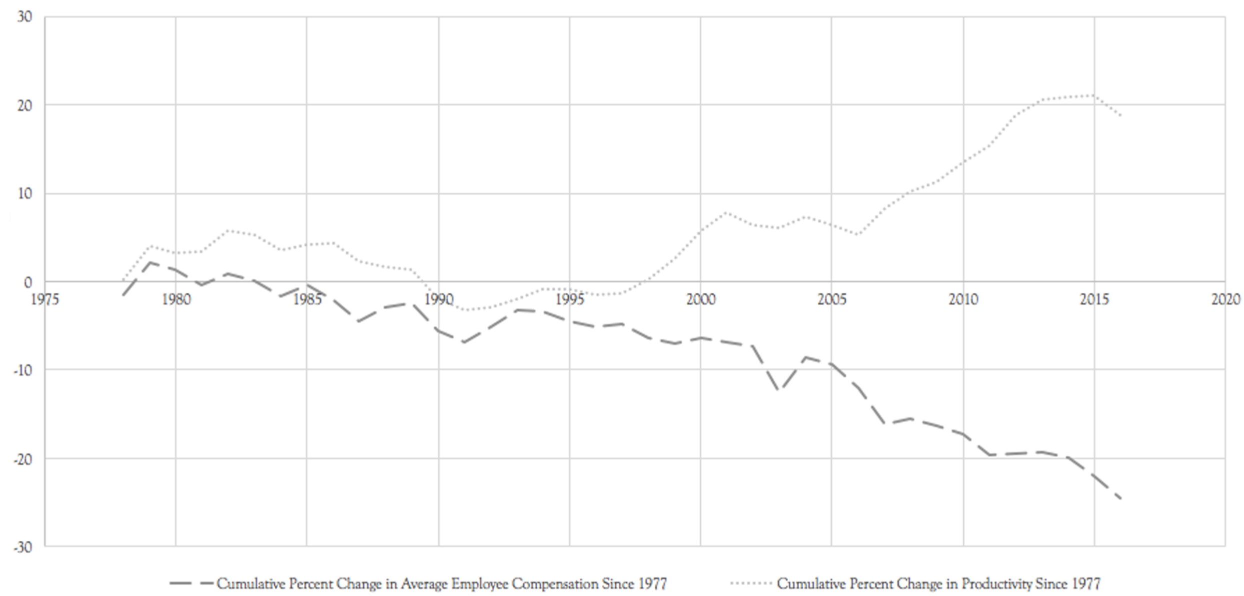
It is also worth noting Puerto Rico has become one of the most unequal economies in the world. According to U.S. Census Bureau data, when utilizing the GINI coefficient measure of inequality, Puerto Rico has remained among the top ten most unequal nations during the past ten years. Income inequality in Puerto Rico has been substantially shaped by the functional distribution of income. Previous research has noted how after the 1970s, Puerto Rico has experienced a substantial rise in the profit-share/fall in the wage-share (Irizarry Mora, 2002). However, to date, no work has incorporated changes in productivity growth to examine income distribution between property-owners and wage earners in Puerto Rico.

Using Puerto Rico Planning Board data, this article evaluates trends in real average employee compensation and productivity growth (growth of real Net Product per employed worker) across the industrial sectors defined in the national accounts system. Results are shown in Table 1. Change in manufacturing productivity was excluded because transfer pricing practices of U.S firms on the island result in a serious overestimation of manufacturing income and output in Puerto Rico's national accounts. Multinational firms frequently set prices in the transactions between their subsidiaries or affiliates with the objective of shifting income from high-tax jurisdictions to low-tax jurisdictions like Puerto Rico. As a result, official figures for manufacturing are overestimated due to the inclusion of what are essentially "paper transactions" between affiliates or subsidiaries of U.S. firms seeking to avoid paying taxes elsewhere. Estimates place actual manufacturing output of U.S. firms in Puerto Rico from 45% to 72% lower than official figures (Collins, Bosworth, & Soto-Class, 2006, 27-28). It would certainly be worthwhile to assess trends in productivity and compensation in Puerto Rican manufacturing firms, as well as in U.S. manufacturing firms operating in Puerto Rico. Nevertheless, the exclusion of changes in manufacturing productivity is not problematic for this article's objectives.

Table 1

Industrial Sector	Change in productivity 1977-2016	Change in real average employee compensation 1977-2016	Share of Total Employment in 2016
Trade	-35%	-35%	23.8%
Agriculture	930.5%	1,310%	1.6%
Manufacturing	•	-5%	8.5%
Construction & Mining	-36.6%	-47%	3.4%
Transportation & Public Services	-66.6%	-61.8%	23.3%
Finance, Insurance, and Real Estate	63.6%	-31.7%	4.3%
Services	-19.7%	-20.1%	35.1%
Puerto Rico	18.9%	-24.4%	100%

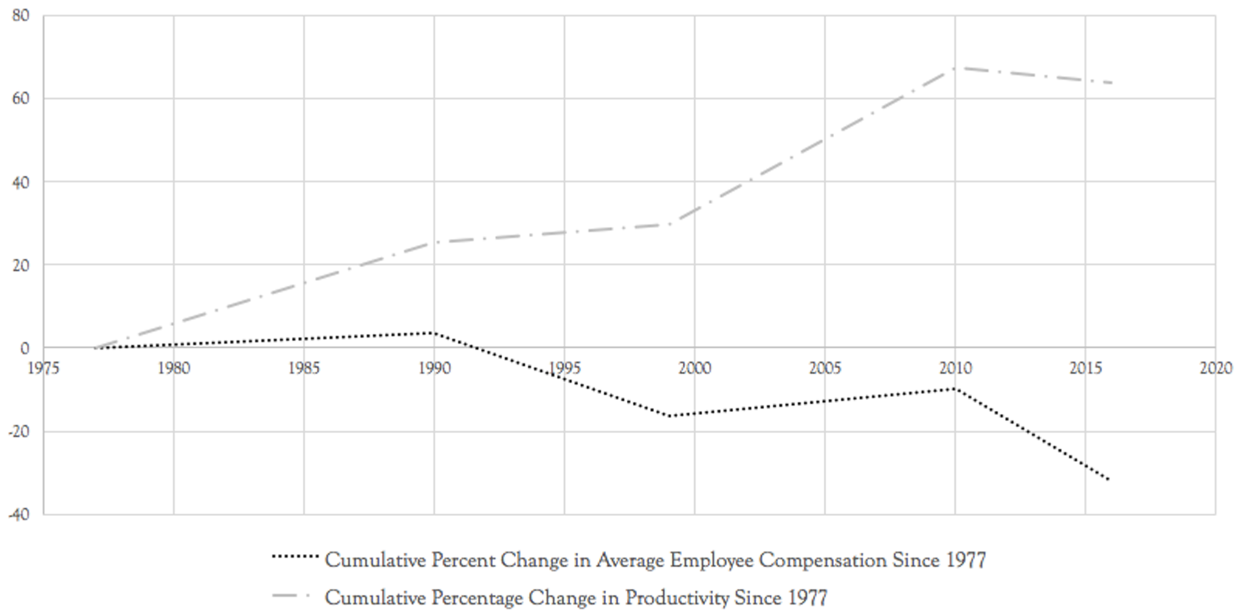
Figure 1. Productivity growth and Average Employee Compensation growth in Puerto Rico 1977-2016
(at constant prices) (Source: Puerto Planning Board)



As shown in Figure 1, the Puerto Rican economy's productivity grew in 18.9% from 1977 to 2016, while real average employee compensation *fell* by 24.4%. However, upon evaluation of these trends within each industrial sector, only "Finance, Insurance, and Real Estate" has a similar pattern. Most of the Puerto Rican economy has experienced a drop in both real average employee compensation and productivity since the 1980s, with compensation falling faster than productivity. This suggests employers have squeezed out of workers a larger share of the diminishing surplus during the ongoing recession.

The primary deviation from this pattern is finance, insurance and real estate. In this case, as shown in Figure 2, even though productivity has risen, worker compensation has been falling since the 1990s. This suggests "Finance, Insurance, and Real Estate" is the industrial sector that rent-seeking Puerto Rican capitalists prefer, and where they have already been effective in obtaining upward distribution of income.

Figure 2. Productivity growth and Average Employee Compensation growth in Finance, Insurance, and Real Estate 1977–2016
(at constant prices) (Source: Puerto Planning Board)



This also suggests a significant amount of wealth is available for investment on the island, but it has concentrated within the Puerto Rican industries, or among the Puerto Rican capitalists, that are not necessarily as conducive to economic development. Thus, Puerto Rico can secure funds for both, paying off its accumulated debt and financing development, by transferring economic resources from industries such as finance, trade, real estate, and insurance, to other industries or initiatives more likely to contribute to an upward spiral of economic development (e.g. sustainable energy, agriculture with focus on food sovereignty, industries with high employment multipliers, industries and/or firms with significant potential for establishing linkages with other Puerto Rican firms or with global value chains, etc.). This could be achieved by establishing taxes targeting Puerto Rican sectors such as finance, real estate, wholesale/retail trade, and insurance. Revenue should be channeled to an industrial policy program, and this should also be accompanied by initiatives seeking to increase the island's low union density and improve overall worker rights and benefits. The previous discussion suggests this would improve Puerto Rican labor's bargaining capacity, reduce inequality, and foster economic development.

4. **Concluding Remarks**

This article has argued that explanations that highlight a primary cause for Puerto Rico's economic crisis (e.g. eliminating Section 936 or the island's territorial status) are ultimately inadequate for understanding the situation and/or identifying solutions. It has also argued the class processes underlying what may be considered Puerto Rico's "21st century Great Depression" are among its fundamental aspects. The discussion suggests most of the policy solutions offered as cure-alls for the island's economy (e.g. statehood, equal participation in federal programs, reducing worker compensation and/or corporate taxes, new 936-type credits, etc.) would probably have little, if any, success. Instead, the Puerto Rican government should focus on taxing industries with low impacts on growth or employment, while developing an industrial policy program aimed at strengthening industries with higher potential impact on these variables. This should also be combined with policies aimed at strengthening or fostering the Puerto Rican labor movement. The political landscape on the island does not suggest policies similar to those presented in this article are likely to be adopted soon. The most likely outcome is simply an unprecedented mass exodus of Puerto Ricans to the U.S. mainland. Thus, evaluating how class dynamics might change in this new demographic context would be a beneficial avenue for future research.

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