

ECONOMY

Businesses should operate with recommended surpluses while aiming at financial transformation



THINK STRATEGICALLY:

The Teachings of History

BY FRANCISCO RODRÍGUEZ-CASTRO | frc@birlingcapital.com

Was the 1976 Tobin Report Largely Ignored?

Some of us have heard of the Tobin Report, which contained a formula that would have prevented a good portion of the troubles Puerto Rico is facing.

James Tobin was an American economist who served on the Council of Economic Advisers and consulted with the Board of Governors of the Federal Reserve System and taught at Harvard and Yale universities. Tobin received the Nobel Prize in Economic Sciences in 1981 for his “extensive and creative work on analyzing financial markets and their relationships to spending, employment, production and price decisions.”

The Committee for the Study of the Finances of Puerto Rico was appointed by Gov. Rafael Hernández Colón in March 1974. Its members were:

- Chairman James Tobin, Sterling Professor of Economics at Yale University
- William Donaldson, Dean & Founder of the Yale University School of

Management

- Kermit Gordon, President, The Brookings Institution
- Wilfred Lewis, Executive Director, National Planning Association
- Sidney Robbins, Professor of Finance, Columbia University

In its letter to Hernández Colón, the committee stated: “The economic development and fiscal problems of Puerto Rico have increased since 1969. Although some of the current issues facing the Commonwealth are outside of their control, the current trend of the government expenses, the accumulation of deficits by public corporations, and public debt and production costs will not be sustainable even under the most favorable economic conditions.”

The committee found that the need for an austerity program was evident and made the following recommendations:

Limitation of Government Expenses and Salary increases: Puerto Rico may be unable to access the debt markets, so it must create savings to finance the

island’s economic growth adequately. The government budget must be right-sized to begin creating surplus.

Tax Increases: The committee recommends critical changes to the commonwealth’s tax structure.

Property Tax: The property tax assessment must be made considering certified appraisals and must eliminate the taxpayer primary residence’s current substantial exemption. We still use the byzantine 1954 formula.

Income Tax: A comprehensive tax reform must be implemented, as well as better adoption processes.

Special Tax on Durable Luxury Goods: this would include automobiles with an ascending tax rate according to their cost.

Public Corporations Must Have a Surplus: All public corporations must right-size their operations and eliminate the reliance on issuing debt to finance large-scale projects. They must operate financially with the recommended surpluses while seeking to achieve a complete financial transformation.

Responsible Marketing of Puerto Rico Bonds: The only real protection for Puerto Rico’s credit is limiting debt issuance. Those specific policies are adopted to guarantee that Puerto Rico can meet its debt obligations.

Specific Measures to Train and Employ the Younger Generations: There are critical federal programs to solve the dire situation of unemployment in Puerto Rico. Key examples include trade schools, direct training in jobs and government projects. The committee recommended that the government seeks a waiver in Congress of the federal minimum salary for those younger than 20 years old.

General Limitations of Salaries: a broad freeze to all pay scales and salaries of government employees and public corporations.

Incentives for Investment and Job Creation of Exempted Corporations: the committee recommended that a system be created to grant tax credits to those corporations that generate employment and reinvest.

Investments to Generate More Private Sector Jobs: the committee

recommends that the governor seek out the largest corporations in Puerto Rico and ask them to begin new investments and projects.

A very revealing fact in the Tobin Report is that most of the recommendations it makes are similar to the ones made by the Financial Oversight and Management Board (FOMB) in its fiscal plan, and now as the FOMB is on the cusp of renegotiating all of Puerto Rico’s public debt, it makes more sense than ever to understand that if we had paid attention and executed only 50 percent of what was recommended in these and other similar plans, Puerto Rico would be in a completely different economic and financial position.

The sad conclusion is that what ails us as a nation is the political unwillingness to effect transformative changes with a once and done approach. As the FOMB and the Government of Puerto Rico embark toward the normalization of Puerto Rico’s debt structure and the adoption of strict measures to achieve the needed four consecutive years of balanced budgets, our politicians need to understand that the best way to help Puerto Rico is to profoundly understand the actions we must take to fix our fiscal imprudence of years past and position the island towards economic growth.

Every political leader must become part of the solution to allow Puerto Rico to transform the way the government conducts its processes and allow the FOMB to steer through the process of change.

There is no better quote than this one from President Theodore Roosevelt, who in 1910 said: “It is not the critic who counts; not the man who points out how the strong man stumbles or where the doer of deeds could have done better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood, who strives valiantly, who errs and comes up short again and again, because there is no effort without error or shortcoming, but who knows the great enthusiasms, the great devotions, who spends himself for a worthy cause; who, at the best, knows, in the end the triumph of high achievement,

and who, at the worst, if he fails, at least he fails while daring greatly, so that his place shall never be with those cold and timid souls who knew neither victory nor defeat.”

Week in Markets: \$1.9 Trillion Stimulus Coming; Wall Street Received \$71.1 Billion in New Inflows

The U.S. stock market ended the week with timid gains, as the parade of upbeat corporate earnings and the probability of the \$1.9 trillion fiscal stimulus bazooka getting approved soon kept investors focused.

Another development that has maintained investors’ optimism is that the vaccine distribution has improved dramatically, and President Biden has committed to purchasing an additional 200 million vaccines.

Not all economic news was positive; job growth has fallen below expectations, as the economy has slowed. Additionally, the labor department reported that Initial Claims for Unemployment Insurance fell to 793,000, down from 812,000 last week, a change of minus-2.34 percent from the previous week and 294.5 percent from one year ago, quite far from pre-pandemic levels. The most affected sectors are the restaurant, tourism and entertainment industries, which are mostly in a holding pattern until the vaccine levels reach herd immunity levels.

Wall Street achieved another record this week as the market received \$71.1 billion in net inflows from investors into both stock funds, which netted \$58 billion, and bond funds, which netted \$13.1 billion, all from investors’ cash reserves.

Investors are also carefully examining the corporate earnings results. So far, more than 80 percent of the companies have reported 4Q2020 results that have surpassed analysts’ expectations. Meanwhile, there are projections that for 2021, corporate earnings growth is pegged to increase by 20 percent.

Francisco Rodríguez-Castro is president and CEO of Birling Capital LLC. Think Strategically© is a publication by Birling Capital LLC that summarizes recent geopolitical, economic, market and other developments. This report is intended for general information purposes only and does not represent investment, legal, regulatory, or tax advice. Recipients are cautioned to seek appropriate professional counsel regarding any of the matters discussed.

Weekly Market Close Comparison	2/12/21	2/5/21	Return	YTD
Dow Jones Industrial Average	31,458.40	31,148.11	1.00%	2.78%
Standard & Poor’s 500	3,934.83	3,886.80	1.24%	4.76%
Nasdaq	14,095.47	13,856.30	1.73%	9.37%
Birling Puerto Rico Stock Index	2,152.75	2,110.41	2.01%	5.27%
U.S. Treasury 10-Year Note	1.20%	1.19%	0.84%	0.30%
U.S. Treasury 2-Year Note	0.11%	0.09%	22.22%	0.50%