Puerto Rico: The Economics of Status

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Abstract

This paper attempts to present an analysis of the economic and fiscal dimensions of Puerto Rican status. The status debate in Puerto Rico has, historically, been heavily concentrated in *political* analysis of the status options: commonwealth, statehood and independence.

The document's key conclusion is that status has fundamental economic and fiscal implications for the island and for the United States. Statehood would stimulate greater investment and more rapid economic growth through full integration with the U.S. economy and a more stable investment climate. An Analysis of Puerto Rico's potential for convergence in growth of income to that of the US indicates that the economic policies improved by statehood would spur faster growth through full integration with the U.S. economy. The present Commonwealth status, in addition to promoting dependence -oriented development, has kept Puerto Rico from catching up with the rest of the U.S.

In terms its fiscal implications, statehood would actually have been a net benefit to the U.S. Treasury, by imposing income taxes on firms and individuals who now do not paid. Puerto Rico and U.S. citizens living there would benefit from statehood through increased federal transfers and being brought into equality with counterparts on the mainland. Additional transfers to Puerto Rico under statehood would have been outweighed by increased tax revenues.

Statehood would eliminate Puerto Rico's nebulous and uncertain political status which will continue to hinder investment in a future of increasing globalization. Statehood would clearly define Puerto Rico as a "domestic" rather than "foreign" location in the eyes of investors, and distinguish it from other developing countries in the region as competition for investment intensifies.

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Table of Contents

I. BACKGROUND 2

A. Political Status 2
B. A History of "New Deal," Government-Led Development 3
C. Section 936 Tax Credits 7
D. The 1990 Congressional Budget Office Report on Puerto Rico 8
E. Recent Changes and Ideas 9

II. PUERTO RICO AND MODERN ECONOMIC GROWTH ANALYSIS 11

A. A New Perspective 11
B. Convergence theory and political status 11
1. Evidence for Convergence in the United States 12
2. Evidence for Convergence in the European Union 13
C. Hawaiian Convergence under Statehood 13
D. Commonwealth as a Block to Puerto Rico's Convergence with the U.S. 15
E. Summary 20

III. THE FISCAL COSTS OF COMMONWEALTH FOR THE UNITED STATES 21

A. Forfeited Tax Revenues 21
B. Federal Transfers 22
1. Payments to Individuals ($5 billion) 22
2. Grants to State and Local Governments ($2.4 billion) 22
3. Food Stamps ($1.1 billion) 23
C. Wages and Salaries ($535 million) 23
D. Summary 23

IV. THE FISCAL IMPACT OF STATEHOOD 24

A. Introduction 24
B. Possible Changes in Federal Expenditures 24
1. Transfer Payments for Federal Programs 24
2. Wages and Salaries ($60 million) 25
3. Procurements (to be determined) 26
4. Total Changes in Federal Funding 26
C. Net Fiscal Impact 27
1. Impact on the Federal Budget 27
2. Impact of Statehood on Puerto Rico 29

V. REALIZING POTENTIAL FOR GROWTH THROUGH ECONOMIC REFORM 31

A. Puerto Rico's Economic Potential 31
B. Privatization of Public Corporations 31
C. Private Sector Infrastructure Initiatives 32
D. Government Efficiency Reform 32
E. Protecting and Capitalizing on Puerto Rico's Natural Advantages 33
F. Potential Tax Initiatives 33
1. Consumption Tax 33
2. Tax on Public Corporations 34
3. Income Tax Structure 35
G. Summary 35

VI. THE EFFECT OF STATEHOOD ON INVESTMENT IN PUERTO RICO 36

A. Statehood would make Puerto Rico a "domestic" not "foreign" investment location......36
B. Uncertainty discourages investment 37
C. Sources of investment in Puerto Rico 38
1. Puerto Rican investors......38
2. External Investors......39
D. Summary......40

VII. Conclusions......41

APPENDIX I: CORRECTING THE 1990 CBO REPORT.....ERROR! BOOKMARK NOT DEFINED.

A. Drawbacks of the CBO Model ......**Error! Bookmark not defined.**
B. Benefits of the Computable General Equilibrium (CGE) Model**Error! Bookmark not defined.**
C. The Impact of Statehood: Comparing Results ......**Error! Bookmark not defined.**

APPENDIX II: RECENT DEVELOPMENTS IN PUERTO RICOERROR! BOOKMARK NOT DEFINED.

A. Privatization of Public Corporations......**Error! Bookmark not defined.**
B. Investment ......**Error! Bookmark not defined.**
C. Government Efficiency Reform......**Error! Bookmark not defined.**
D. Tax Structure Reform ......**Error! Bookmark not defined.**

BIBLIOGRAPHY 44

Figures

1	Investment as a Share of GDP in Puerto Rico	9
2	Hawaiian Personal Income	18
3	Puerto Rico’s Economic Performance Relative to the United States	20
3a	Puerto Rico and the U.S. Convergence Frontier	21
4	Per Capita Income in Puerto Rico: Two Stories	22
5	Projected Economic Benefits from Statehood, 1994 to 2025	24
6	Net Fiscal Impact of Statehood on the Federal Budget, 1995	32
7	Net Fiscal Impact of Statehood on Puerto Rico, 1995	34

Tables

1	Benefits of Statehood Assuming 3.5% Convergence Rate	23
2	Current Costs of Commonwealth to the U.S. Treasury	27
3	Potential Increased Federal Transfers to Puerto under Statehood	30
4	Net Impact of Statehood on the Federal Budget, 1995	31
5	Estimate of Net Impact of Statehood on Puerto Rico, 1995	33

Puerto Rico: The Economic Implications of Status

Abstract

This paper attempts to present an analysis of the economic and fiscal dimensions of Puerto Rican status. The status debate in Puerto Rico has, historically, been heavily concentrated in *political* analysis of the status options: commonwealth, statehood and independence.

The document's key conclusion is that status has fundamental economic and fiscal implications for the island and for the United States. Statehood would stimulate greater investment and more rapid economic growth through full integration with the U.S. economy and a more stable investment climate. Further, statehood would actually have been a net *benefit* over commonwealth for the U.S. Treasury. From a strategic perspective, statehood would eliminate the possibility of additional costly and ineffective subsidies and tax breaks which would continue to drain the U.S. Treasury.

An Analysis of Puerto Rico's potential for convergence in growth of income to that of the US indicates that the economic policies improved by statehood would spur faster growth through full integration with the U.S. economy. The present Commonwealth status, in addition to promoting dependence - oriented development, has kept Puerto Rico from catching up with the rest of the U.S.

In terms its fiscal implications, statehood would actually have been a net benefit to the U.S. Treasury, by imposing income taxes on firms and individuals who now do not paid. Puerto Rico and U.S. citizens living there would benefit from statehood through increased federal transfers and being brought into equality with counterparts on the mainland. Additional transfers to Puerto Rico under statehood would have been outweighed by increased tax revenues.

Statehood would eliminate Puerto Rico's nebulous and uncertain political status which will continue to hinder investment in a future of increasing globalization. Statehood would clearly define Puerto Rico as a "domestic" rather than "foreign" location in the eyes of investors, and distinguish it from other developing countries in the region as competition for investment intensifies.

I. Background

A. Political Status

Puerto Rico became an unincorporated territory of the United States in 1898 at the end of the Spanish-American War. An unincorporated territory is one to which all provisions of the Constitution had not been expressly extended. In 1952, the island became one of three "commonwealth" territories in recent U.S. history. The Philippines and Northern Marianas were also given "commonwealth status" as territories.

Commonwealth status has involved self-government in internal affairs for Puerto Rico, although the U.S Congress retains full authority to determine the status of the territory and apply federal law as it deems appropriate. In the Jones Act of 1917, Puerto Ricans became citizens of the United States. While they are U.S. citizens, Puerto Ricans cannot participate in U.S. elections. They have no vote in presidential elections and their representative in the Congress is a Resident Commissioner with a voice, but no vote.

As a territory of the United States, Puerto Rico operates under the U.S. judicial, monetary, and tariff systems, and is profoundly affected by, yet largely excluded from, the U.S. income tax system.[1] Puerto Ricans do not pay federal income tax, and corporations based in Puerto Rico do not pay federal corporate tax. Commonwealth status implies that, like any U.S. state, important determinations can be made by Puerto Rico's local legislature though many vital decisions, particularly concerning the economy, remain with the U.S. Congress. For instance, the operation of educational institutions and the election of a Governor are under local Puerto Rican jurisdiction, but federal tax credits and federal transfers are under the domain of the U.S. Congress, in which Puerto Rico has no vote.

Discussions of Puerto Rico's political status have involved two options in addition to commonwealth: independence and statehood. Under independence, Puerto Rico would become a fully sovereign nation with jurisdiction over its internal affairs and external relations. Independence would involve a termination of U.S. citizenship for persons born in a new Puerto Rican nation, and an election between U.S. or Puerto Rican citizenship for those now living. Under statehood, Puerto Rico would become the 51st state of the Union and would be subject to the same statutes as current U.S. states, with birthright citizenship for Puerto Rican residents. The transition to statehood would have to be defined through both Congressional and Puerto Rican legislation. Statehood would extend all constitutional guarantees to Puerto Ricans, as well as the right to vote in federal elections and the obligation to pay federal income taxes.

[1] Eliezer Curet, "Puerto Rico: Development by Integration to the U.S." 1986, *Editorial Cultural*, Puerto Rico, page 35.

Puerto Ricans have recently had the opportunity to express their preferences for the island's status through popular plebiscites. In 1967, commonwealth won 60 percent of the vote and statehood 39%, although low voter turn-out and a boycott by some supporters of the independence and statehood options may have underestimated support for statehood. The most recent plebiscite was held in November of 1993 when commonwealth won 48 percent of the vote and statehood garnered 46 percent.[2] As these statistics indicate, popular support for each of the status options has varied across time, although showing an increasing trend towards statehood.

B. A History of "New Deal," Government-Led Development

Understanding the current economic dynamics in Puerto Rico requires some knowledge of the island's post WWII history. In 1950, Puerto Rico had just come through a decade of agricultural primacy in its economy and "Operation Bootstrap" was in full gear. "Operation Bootstrap" was a new economic development strategy for Puerto Rico which focused on "the promotion of direct private capital investment and the establishment of private manufacturing enterprises for export to the U.S."[3] Under "Operation Bootstrap," the focus of development was on external, mainly U.S., investment that would, it was hoped, stimulate Puerto Rico's economy, increase employment and boost personal incomes.

Consistent with the development strategies of this time, it was thought that Puerto Rico's public sector should lead and support its private sector. Thus, Puerto Rico's economic strategy in the 1950's was based on the creation of government development agencies and a public sector with broad jurisdiction over goods and services typically provided by the private sector in more developed countries. First, the government development agency Fomento (meaning "promotion" in Spanish) actively recruited industry to locate in Puerto Rico. Fomento used the incentives of inexpensive labor,[4] industrial parks, and tax incentives from the U.S. to attract manufacturing firms. Fomento was quite successful in effecting the type of centralized planning advocated by 1950's and 1960's development economics.

Second, public corporations were allowed to develop and serve government and quasi-government functions with greater financing and management flexibility than traditional government agencies. Most public corporations were intended to collect some of their operating expenses from charges for their services and products, although public corporations have indeed relied upon Puerto Rico's general fund for appropriations.

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2 Robert Friedman, "Young bill clears another hurdle," *The San Juan Star*, May 22, 1997.

3 Eliezer Curet, "Puerto Rico: Development by Integration to the U.S." *Editorial Cultural,* Puerto Rico, 1986, page 38.

4 Puerto Rican average wages were 30 percent of American wages in 1955. Fernando Lefort, "Is Puerto Rico Converging to the United States?" Working Paper 1003, International Tax Program, Harvard University, November 1997.

Puerto Rico's economy experienced healthy growth during this transition from an agriculture-based economy to a manufacturing-based economy. Between 1950 and 1958, Puerto Rico experienced a 4.6 percent average annual growth rate in real GNP. From 1959 to 1974, real GNP expanded at an average annual rate of 6.5 percent. Productivity, measured by average real GDP per person employed, grew at 5.6 percent between 1950 and 1958, then by 5.2 percent between 1959 and 1974.[5] The island was perceived to be a development success.

The record of economic performance did not continue, although its reputation as a model for development persisted. For all intents and purposes, Puerto Rico has continued under the "Operation Bootstrap" mode of development to the present. As economies around the world grew and began applying new lessons, development policy for Puerto Rico continued to rely on government-led initiatives. That is, even after other countries had learned that private sector-driven, market-based economies produced deeper and more sustainable growth, Puerto Rico continued in the "New Deal" tradition. If anything, the Puerto Rican government intruded even further into the economy, adopting a concerted program of government intervention which included the take-over of the telephone company, a shipping line, and the creation of a centralized purchasing entity.

In retrospect, Puerto Rico's economic development strategy appears to have been blind to reality. Low labor costs were no longer an incentive to invest in Puerto Rico. Public sector corporations thoughout the world proved mediocre performers at best. Finally, the reliance on, and hope for, federal tax incentives generated a corporate welfare dependence which still exists today.

From the mid-1970s, Puerto Rico's economy began to experience stagnation, in striking contrast to the growth of the previous two decades. Real GNP growth, for example, slowed to an annual rate of only 1.7 percent between 1975 and 1984.[6] While the U.S. recovered from the oil shock in 1973, Puerto Rico did not. Further, Puerto Rico stopped converging with the U.S. and began to converge with the developing economies of Latin America and the Caribbean. In Section IV it is observed that Puerto Rico's commonwealth status hindered growth and kept it from converging with the U.S. economy.

Investment in the Puerto Rican economy also dropped sharply during the early 1970's, as measured in the investment share of GDP. While it was hoped that domestic capital would replace the initial burst of external investment encouraged by "Operation Bootstrap," the domestic replacement never materialized and the commonwealth came to rely on tax induced, external investment. Figure 1 indicates that investment dropped from 29% of GDP during the period 1955 to 1972, to 14% in 1994.[7]

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5 Eliezer Curet, "Puerto Rico: Development by Integration to the U.S." *Editorial Cultural*, Puerto Rico, 1986, pp. 44, 49-50.

6 In Puerto Rico, there is a significant difference between GDP and gross product (GP), which is similar to GNP for independent nations. The difference is due to the inclusion in GDP of section 936 profits that are repatriated to the mainland. Thus, GP will be used in most cases to assess the economy of Puerto Rico.

7 Fernando Lefort, "Is Puerto Rico Converging with the United States," Working Paper 1003, International Tax Program, Harvard Law School, November 1997, page 22.

Figure 1
Investment as a Share of GDP in Puerto Rico

Although the island seemed a successful example of economic development in the first phase of its transition, the Puerto Rican economy in the 1970's and 1980's languished with low growth rates and unemployment rates ranging from 10 to over 22 percent.[8] It became clear that the development strategy which had worked for Puerto Rico in the 1950's was no longer effective in the 1970's. As slow growth persisted through the 1970's, 1980's and into the 1990's, the island's continued reliance on an outdated development model adopted in the 1950's became even more obviously inadequate.

Over time, private sector capacity indeed developed on the island with the establishment of sophisticated financial institutions, world-class hotels, and a mature services sector. Many of the public corporations and government development agencies, which had originally been charged with the provision of goods and services, had become superfluous with the growth of the private sector. The Puerto Rican government apparatus, it seemed, had stepped over the line from being a facilitator of growth to an impediment to growth.

[8] Ibid. at page 52, table 7.

Nevertheless, largely because Puerto Rico's economy receives limited exposure on the mainland, its 1950's reputation as a model for stimulating and achieving economic growth continued in the minds of most Americans. This reputation has been reinforced by the lobbying efforts of major electronics and pharmaceutical corporations, who have benefited from costly tax breaks for U.S. companies operating on the island.[9]

Puerto Rican economic success looks good when it is compared with other Caribbean islands and Latin America, instead of with the fifty states. Indeed, in comparison with these countries, Puerto Rico has been economically vibrant. Of 22 Latin American and Caribbean countries on which the World Bank reported data, Puerto Rico's per capita GNP of $3479 ranked third in 1980. Its real annual growth rate in GNP between 1960 and 1970 of 3.7 percent also ranked third highest among these countries. However, Puerto Rico's GDP growth rate during 1970-1980 dropped to almost half its level during 1960-1970; during the period 1970 to 1980, eleven Latin American and Caribbean countries outperformed Puerto Rico.[10]

It must be remembered, however, that the residents of Puerto Rico are US citizens with rights to unrestricted travel to and from the mainland, and the economy of Puerto Rico is virtually integrated with the United States. Accordingly, Puerto Rico's economic performance should be compared with the 50 U.S. states rather than with the economies of the Caribbean and Latin America, or with any other developing nation. The result of the Puerto Rico-United States comparison reveals the paucity of economic progress on the island. The island's 1995 per capita personal income of $7296 was *less than half* of Mississippi's, the poorest U.S. state, with per capita personal income of $18,352 in the same year.[11]

To appreciate the sensitivity of the Puerto Rican economy to the U.S. Congress and federal agencies, the reader should be aware of the tax breaks provided to U.S. corporations under Section 936 of the Internal Revenue Code and the 1990 Congressional Budget Office report,[12] which are described below.

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9 *See* William J. Baumol and Edward N. Wolff, "Catching up in the postwar period: Puerto Rico as the fifth 'tiger,'" *World Development* 24(5): p 869(17), 1996.

10 World Bank, *World Development Report 1982*, New York: Oxford University Press, 1982, Tables 1,2,3; and Puerto Rico Planning Board, *Economic Report to the Governor, 1984*, San Juan: Puerto Rico Planning Board, 1985, Table 1. Both cited in Eliezer Curet, "Puerto Rico: Development by Integration to the U.S." *Editorial Cultural*, Puerto Rico, 1986, page 84.

11 Puerto Rico figures listed in Government of Puerto Rico, Planning Office, "Economic Report to the Governor, 1995." Mississippi figures listed in Moynihan, Daniel Patrick, et al., "The Federal Budget and the States, FY 1995," Cambridge, MA: Taubman Center for State and Local Government, John F. Kennedy School of Government, Harvard University and the Office of Senator Daniel Patrick Moynihan, U.S. Senate, 1996.

12 U.S. Congressional Budget Office, "Potential Economic Impacts of Changes in Puerto Rico's Status under S. 712", prepared for the Senate Finance Committee, April 1990

C. Section 936 Tax Credits

Tax incentives played a central role in the original post-World War II development of Puerto Rico. The tax subsidy found in Section 936 of the federal Internal Revenue Code has been in effect on the island, in some form, since 1921, though its significance as a development tool increased in the post-war period. Section 936 and its forerunners have largely exempted U.S. corporations from paying federal tax on income earned by their Puerto Rican subsidiaries. Puerto Rico has a parallel tax subsidy program effectively exempting 936 corporations from Puerto Rican income taxes as well.

With respect to Puerto Rico, section 936 and its predecessors were intended to spur development of *labor*-intensive industries in Puerto Rico and improve the island's high unemployment rates. This made some sense because, from 1950 to 1960, Puerto Rico was a source of inexpensive labor relative to the mainland and was attractive to mainland manufacturers. After 1960, however, countries such as South Korea, the Dominican Republic and Taiwan replaced Puerto Rico as centers for manufacturing, largely by offering cheaper labor.

However, the tax counsel of various Fortune 500 corporations identified a tremendous bottom-line bonanza in section 936. They realized that section 936 made Puerto Rico a tax haven for capital intensive manufacturing, particularly of proprietary products. Thus, contrary to its original purpose, section 936 and its predecessors ultimately attracted *capital*-intensive manufacturers of pharmaceuticals, electronics, and apparel. A skewed economic composition has resulted, in which profits from manufacturing comprise a larger part of Puerto Rico's GDP than in any other U.S. state.[13] Given the original intention of improving employment prospects through fostering labor-intensive industries, the opposite results were actually achieved.

Even for historical purposes it is worth examining how costly and ineffective section 936 proved to be. In 1989, section 936 cost the US Treasury $2.37 billion, or $22,375 per 936 employee. Because the average annual wage in a corporation receiving section 936 credits was only $20,540 in 1989, the *U.S. Treasury was paying $1835 more per employee in tax losses than the employee received in salary from his or her employment*.[14] The pharmaceutical industry received even more in tax benefits for each job. A 1992 General Accounting Office Report found that drug companies with manufacturing operations in Puerto Rico received tax benefits worth *$72,788* for each job paying an average of *$26,471*.[15]

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[13] In 1995, the manufacturing sector made up 41.8 percent of Puerto Rico's GDP. Puerto Rico Planning Board, *Economic Report to the Governor, 1995*. In 1992, the most recent year for which the data is available, the manufacturing sector comprised 30.6 percent of the gross state product. No other state's manufacturing sector was as large relative to its gross state product. *Statistical Abstract of the U.S., 1996*, Table 690, page 447.

[14] Hexner et al., "Puerto Rican Statehood: A Precondition to Sound Economic Growth," 1993.

[15] Figures for 1987. For more information, *see* 6 *Tax Notes International* 519, March 1, 1993.

Section 936 indeed proved to be a perverse economic tool. It created a development strategy founded on the hypothesis that if section 936 were to be eliminated, which would occur under statehood, the Puerto Rican economy would collapse. However, the U.S. Congress did act to repeal section 936 over time, and the economy is now performing even better.

In 1993, bipartisan concern over corporate welfare and the budget deficit renewed interest in the political status of Puerto Rico and lawmakers voted to reduce and later to phase out so-called "section 936" tax breaks to U.S. corporations which cost the Treasury over $3.8 billion by 1994. The repeal of subsidies which had been considered sacrosanct necessitated a change in economic thinking about the status of Puerto Rico, and has created the opportunity to analyze statehood in a new light.

D. The 1990 Congressional Budget Office Report on Puerto Rico

The notion that the Puerto Rican economy would virtually collapse without section 936 was reinforced by the 1990 release of a Congressional Budget Office (CBO) report that assessed the impact of statehood on the Puerto Rican economy. The CBO report was initiated in response to Senate Bill S. 712 which would have made binding the results of a 1991 referendum to determine the island's political status. The CBO was asked "to estimate how a change in Puerto Rico's status, if it were made under the stipulations of the [then] current version of S. 712, would affect the island economy over the remainder of the decade."[16]

The CBO's concept of Puerto Rico's economy under statehood was based primarily on the removal of section 936 tax benefits and changes in federal transfers to the island. However, the assumptions underlying the CBO's projections are unrealistic in several key respects. The model made no allowance for the prospect that the Puerto Rican government could alter its economic strategy to compensate for the termination of 936. It also failed to take account of investors' changed perceptions of Puerto Rico as a state both fully integrated politically and economically with the United States.

The results of the CBO experiment indicated that, under statehood, real gross product would decrease by 10 to 15 percent, and that investments claiming 936 benefits would drop by 62 to 73 percent points. Additionally, they estimated an increase in the unemployment rate of 4 to 7 percentage points.[17] The extremity of the results is due not only to unrealistic assumptions, but to the specifications of the macro-econometric model which the CBO employed.

[16] U.S. Congressional Budget Office, "Potential Economic Impacts of Changes in Puerto Rico's Status under S. 712," prepared for the Senate Finance Committee, April 1990.
[17] Diagnostic Policy Center, "Economic Policy Analysis for Puerto Rico Using a General Equilibrium Model," March 1997.

When the identical scenario is simulated using a computable general equilibrium (CGE) model more sensitive to and appropriate for the realities of Puerto Rico's economy,[18] the economic impact is much less dramatic. Without taking account of any adjustments in economic policy or investment, the identical scenario conducted on the CGE model finds that real gross product drops by 5.6 percent, instead of the CBO's 10 to 15 percent.[19] Section 936 investments drop by 63.3 percent under the CGE model, which is congruous with the CBO's result.[20] Employment is decrease by 2.3 percentage points,[21] significantly less than the CBO's 4 to 7 percentage point increase in the unemployment rate.

While the CGE simulations still yield negative impacts, the results are much more modest than those generated by the CBO's macro-econometric model.[22] They indicate a resiliency and capacity in the Puerto Rican economy which would not crumble with the removal of section 936. In fact, the CGE model suggests that sensible policy measures by the Puerto Rican government could readily compensate for the loss of section 936.

E. Recent Changes and Ideas

As in the past, much of what is now happening in the Puerto Rican economy has its roots in events on the U.S. mainland. The push for a balanced budget in the 1990's made the $3.8 billion tax credit under section 936 a logical target in the U.S. Congress.[23] In spite of substantial efforts to persuade lawmakers that reducing or repealing section 936 subsidies would destroy the Puerto Rican economy, Congress took the first steps in 1993 to limit the amount of tax credit that U.S. corporations could claim under section 936. Then, in the 1996 Small Business Job Protection Act, Congress fully eliminated 936 benefits for new claimants and phased out benefits for existing recipients over the next 10 years.[24]

Puerto Rico's economy has not been devastated by the section 936 repeal and phase-out. Key economic indicators point to the resiliency of the Puerto Rican economy. Total employment increased 3.9 percent from FY 1995 to FY 1996, and total employment during the first seven months of FY 1997 increased 3.7 percent over the same period of FY 1996. Real gross product increased by 3.4 percent from 1994 to 1995, by 3.1 percent from 1995 to 1996, and by a projected 2.8 percent from 1996 to 1997. The fact is that section 936 is in the process of phase-out and, although the grand-fathering

[18] A CGE model allows for sectoral disaggregation, incorporates income expenditure relationships, and allows prices to be flexible. The sectoral disaggregation feature is especially important for analysis of Puerto Rico's economy since it is led by the manufacturing sector, which responds differently than do smaller sectors to stimuli in the economic environment. See Appendix I for greater detail.

[19] Diagnostic Policy Center, "An Economic Policy Model (CGE) for Puerto Rico: Results from Three Simulations," April 1996, page 60

[20] Ibid.

[21] Ibid. at 59.

[22] Ibid.

[23] The figure given is for 1994. U.S. Department of Treasury, *Statistics of Income Bulletin*, Spring 1997, page 204.

[24] That is, there are now no new investments under section 936 although existing 936 investment will continue to be eligible for the tax credit over the 10 year phase-out period.

period is not yet complete, Puerto Rico remains economically intact. Section 936 has been repealed, and CBO's projections of its impact now appear to be exaggerated in light of Puerto Rico's economic performance.

The current tone of economic discourse on the island is a start down a promising path, which is confirmed in more frequent calls for the Puerto Rican government to change its role from a provider of services and regulator of industry to a facilitator of private sector development.[25] Although this rhetoric is commendable, the past lack of action surrounding new ideas is notable. Several initiatives have actually gone beyond the level of rhetoric and been put into practice, because of efforts both on the mainland and in Puerto Rico. These efforts include:

- the U.S. Congress' action on section 936 of the Internal Revenue Code, repealing the credit for new investments and phasing it out over 10 years for existing investments,

- the Governor of Puerto Rico's measures to improve the tax structure, reform the public sector, and encourage investment in tourism, and

- the Governor of Puerto Rico's initiation of privatization in management and ownership of some public corporations.

[25] "A Strategy for the Development, Administration, and Financing of Infrastructure Investment in Puerto Rico," Council on Planning Strategy for the Private Sector in Puerto Rico and the Government Promotion Bank for Puerto Rico. Phase 1, Volume 1. April 1994. W. Lockwood Benet & Associates.

II. Puerto Rico and Modern Economic Growth Analysis

A. A New Perspective

The convergence theory of economic growth predicts that the rate at which an economy grows during its transition to the steady state is proportional to its distance from that steady state - the further the distance, the faster the growth, and vice versa. Considering that the US is the largest and wealthiest economy in the world, it is not surprising that during the post war period Puerto Rico linked itself with the US and outperformed other economies with lower steady state levels of per capita income.

The principal conclusion of this research is that the economy of Puerto Rico is no longer converging to the steady state level of per capita income of the United States. A recent paper by Fernando Lefort uses econometric analysis to demonstrate that Puerto Rico's economy has been diverging away from the U.S. and shows no signs of catching up.[26] Three other significant results from the research are:

- The integrating effect of statehood is actually a vital economic, and not just political, variable. In fact, states grow faster than territories because of their complete economic integration with the U.S. economy. Puerto Rico's commonwealth status explains why it has failed to converge towards the U.S.

- Without statehood, Puerto Rico will never evolve sufficient economic strength to converge with the mainland economy. Because of the lack of economic convergence, statehood is, economically, a sink or swim matter.

- Commonwealth has exacted an enormous cost for the Puerto Rican people. In 1994, the average Puerto Rican would have been making $6000 more per year had Puerto Rico been converging to the US economy like the other low-income states. Rather than asking about the costs of statehood, modern growth analysis demonstrates that the opposite question should be asked: what has been the *cost* of commonwealth.

B. Convergence theory and political status

The ideas forming our assessment of the cost of commonwealth to Puerto Rico are known as convergence growth theory.[27] Applied to Puerto Rico, these ideas help formulate an answer to our question about the opportunity costs of commonwealth to Puerto Rico. Historically, U.S. states have experienced growth rates 2% higher than

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[26] Fernando Lefort, "Is Puerto Rico Converging to the United States," Working Paper No. 1003, International Tax Program, Harvard Law School, Harvard University, November, 1997.

[27] For more on convergence theory, see Robert Barro & Xavier Salai-I-Martin (1992) "Convergence," *Journal of Political Economy*, 100 (April): 223-251 and G. Mankiw, D. Romer, and D.N. Weil (1992) "A Contribution to the Empirics of Growth," *Quarterly Journal of Economics*, 108: 407-437.

territories.[28] This faster growth occurs because the economies of U.S. states are sufficiently integrated that they share similar growth frontiers. That is, U.S. states are converging to a similar endpoint. When a territory becomes a state, its economy becomes much more integrated with the other states than it could have been as a territory. Thus, in addition to the growth a territory is already experiencing on its own, it can expect additional economic expansion on the basis of becoming a state.

As one economy begins to converge toward another wealthier economy, it will initially experience higher growth rates as it "catches up" and lessens the gap in per capita income levels between itself and the more developed economy. For this reason, a 3.5 percent higher growth rate is an appropriate estimate of the additional growth that a territory would at first experience as a result of its economic integration with the other U.S. states.[29]

1. Evidence for Convergence in the United States

There is strong evidence for convergence among the regions of the U.S. States with lower initial incomes have grown faster than wealthier states. Lefort reviews the strong statistical evidence for convergence among the U.S. states over time and cites some examples:[30]

> South Carolina, the poorest state, had 22.4 percent of the per capita income of New York in 1929, [though] by 1990 this ratio had become 71.8 percent. Mississippi was the poorest state in 1940. It had 22 percent of the per capita income of Delaware, then the wealthiest state in America. By 1990, Mississippi, still the poorest state, already had 50 percent of the income of the wealthiest state, now Connecticut. In 50 years, Mississippi has been able to reduce by half the distance that separates it from the wealthiest states. Given the degree of cultural and economic integration among the different states, the convergence effect must be the main reason that Mississippi grew at a rate twice as high, on average, as that of the much wealthier Northeastern states during the last 50 years.

[28] Fernando Lefort, "Is Puerto Rico Converging to the United States," Working Paper No. 1003, International Tax Program, Harvard Law School, Harvard University, November 1997.
[29] Ibid. at page 18.
[30] Ibid.

2. Evidence for Convergence in the European Union

There is also growing evidence for convergence among the countries of Europe. Market reform and the political and economic integration effected by the European Union have helped to narrow the gap between more and less developed nations. Analysis of regions within the EU also shows a decline in inequality over time.

A combination of market reforms and integration in the EEC have enabled Spain and Portugal to grow faster than their wealthier European counterparts over the past ten to fifteen years.[31] A recent analysis of Portugese economic growth indicates that Portugal has been catching up with the EU since the early 1950's, with more rapid convergence occurring after 1986 when the country became a full EU member.[32] A review of economic growth data by European region by Robert Leonardi of the London School of Economics found evidence for "four decades of convergence" since the 1950's.[33] Leonardi finds a consistent pattern of reduction in inequality between the core and peripheral regions in the EU over time.

C. Hawaiian Convergence under Statehood

The economic performance of Hawaii, one of the most recent states, provides a demonstration of the benefits of statehood. The Hawaiian economy grew significantly faster under statehood than as a territory, as it began to integrate with the larger and more developed U.S. economy. Annual increases in real gross state product jumped from 4% during the period 1949 to 1958, to almost 7% in the "Great Hawaiian Boom" from 1958 to 1973, coinciding with the move to statehood.[34] As Thomas Kemper Hitch notes in his economic history of Hawaii, this "probably set an all-time record for sustained high-level expansion for any state or region in the nation."[35] Figure 2 below illustrates the rapid growth which Hawaii experienced after statehood.[36]

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[31] Larre, B. and R. Torres, "Is Convergence a Spontaneous Process? The Experience of Spain, Portugal, and Greece," *OECD Economic Studies*, 16, 1991.

[32] Barros, Pedro Pita, and Nuno Groupa, "Portugal-European Union Convergence: Some Evidence," *European Journal of Political Economy*, 12(1996): 545-553.

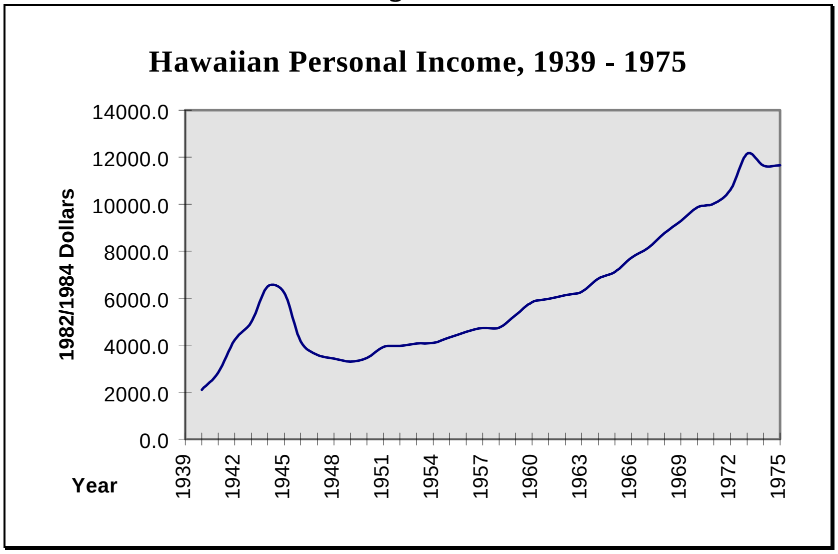
[33] Leonardi, Robert, *Convergence, Cohesion, and Integration in the European Union*, London: St. Martins Press, 1996, p. 87.

[34] Hawaiian growth figures cited in Thomas Kemper Hitch (1992), *Islands in Transition: The Past, Present, and Future of Hawaii's Economy*, pp. 171-172.

[35] Ibid. at page 171.

[36] Personal income figures in 1982/1984 dollars using Honolulu Consumer Price Index, from Robert C. Schmitt, *Historical Statistics of Hawaii*, The University Press of Hawaii: Honolulu, 1977, page 167, Table 6.3, "Personal Income and Disposable Income, Total and Per Capita, 1939-1975."

Figure 2



Hawaiian growth, as expected, increased faster than the United States as it caught up with the more affluent economy. Real growth rates in Hawaii averaged 6.31% during the period after the move to statehood, 1958 to 1973, far exceeding the still impressive U.S. growth rate during the same period of 4.4%.[37]

External investment in Hawaii soared after statehood. The number of firms doing business in Hawaii increased *sixfold* from 311 in 1955 to 1,916 in 1971. Hawaii's best known business economist, Hitch writes that this increase without statehood "would have taken a generation or two to achieve."[38] Tourism received a similar boost from statehood: yearly visitors to Hawaii increased *fifteenfold* between 1958 and 1973, from 171,000 to 2,631,000, and averaged a 20 percent per year increase for 15 years.[39] Tourism spending in Hawaii expanded at a real annual growth rate of 15.1% during the same period, increasing from 5.8% of the economy before statehood to 19% in 1973.[40] Tourism presently comprises approximately 23% of the Hawaiian economy.[41]

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37 Real GDP in the United States expanded at an average annual rate of 4.4% during the period 1959 to 1973. Figures from National Bureau of Economic Analysis, *Survey of Current Business*, August 1997, Summary of National Income and Product Series, 1929-1996, Table 2a. Hawaiian growth figures cited in Thomas Kemper Hitch (1992), *Islands in Transition: The Past, Present, and Future of Hawaii's Economy*, p. 172, based on gross product figures from Robert Schmitt, *Historical Statistics of Hawaii*, p. 164, Table 6.1.

38 Hitch, *Islands in Transition: The Past, Present, and Future of Hawaii's Economy*, p. 182.

39 Ibid. at page 183.

40 Hawaii Visitors Bureau, *1986 Annual Research Report*, page 1, and records. Listed in *State of Hawaii Data Book, 1996*, Table 7.21, "Estimated Visitor Expenditures: 1951-1995," and available on the World Wide Web at http:/www.hawaii.gov/dbedt/db96/sec7.html.

41 "The Economic Impact of Tourism in Hawaii: An Application of The Hawaii Input -Output Model," *Hawaii's Economy: A Quarterly Report from the Department of Business, Economic Development & Tourism*, First Quarter 1996, Table 3, page 7. Data derived from the Department's Input-Output Model of the Hawaiian Economy.

Hitch concludes that statehood was one of the key drivers of the Great Hawaiian Boom. He notes that, prior to statehood, “most people knew little about the islands” and “ignorance about Hawaii permeated most American businesses.”[i] Hitch observes that statehood created invaluable exposure for the islands on the U.S. mainland:

> **Statehood was worth a billion dollars of advertising and promotion for Hawaii**. Suddenly we were the fiftieth state, and thousands upon thousands of national business firms with activities all over the country began asking themselves why they weren’t doing business in Hawaii. Those who were already doing such business generally transferred the Hawaii market program out of the foreign department and put it in the domestic department. [emphasis added.][42]

D. Commonwealth as a Block to Puerto Rico’s Convergence with the U.S.

The projections of convergence theory provide a framework for dismantling the false tenets of conventional wisdom. One aspect of this conventional wisdom has held that Puerto Rico’s success relative to other Caribbean islands was primarily attributable to its commonwealth status, which was considered to confer significant economic benefits. A second aspect of the conventional wisdom on Puerto Rico contends that Puerto Rico would eventually "catch up" with the United States economically before being admitted as a state, with commonwealth as a temporary status serving to transition the island into statehood.

Puerto Rico is, indeed, relatively successful in comparison to the Caribbean islands and Latin America. However, given its close economic, geographic, and political association with the United States, Puerto Rico should be converging to the United States, instead of to the less developed economies of the Caribbean and Latin America. Evidence clearly shows that Puerto Rico is *not* converging to the same end point as the United States; and is instead *diverging* away from the United States towards a lower end point. These data imply that commonwealth has not been the economic “saving grace” that it was thought to be and that Puerto Rico will not “catch up” to the U.S. as a commonwealth.

Figure 3 clearly indicates that Puerto Rico has failed to converge, or catch up with the US economy since 1972.[43] The graph shows Puerto Rican per capita GDP and GNP expressed as a percentage of the same US figures. From 1955 to 1972, the island economy grew faster relative to the US, in terms of both GNP and GDP. However, since 1972, Puerto Rico has under-performed the US economy, making only a minimal gain in terms of GDP and falling further behind in GNP.

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[42] Hitch, *Islands in Transition*, at page 181.
[43] Lefort, “Is Puerto Rico Converging with the US?” Figure 3a, page 10.

Figure 3

Relative Performance of Puerto Rico:
Ratio of per-capita output to U.S. output

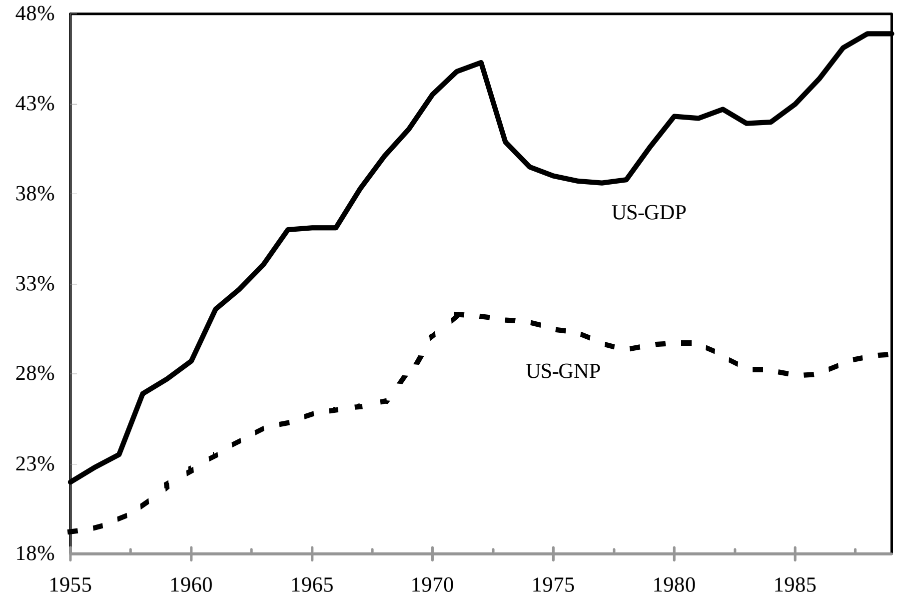


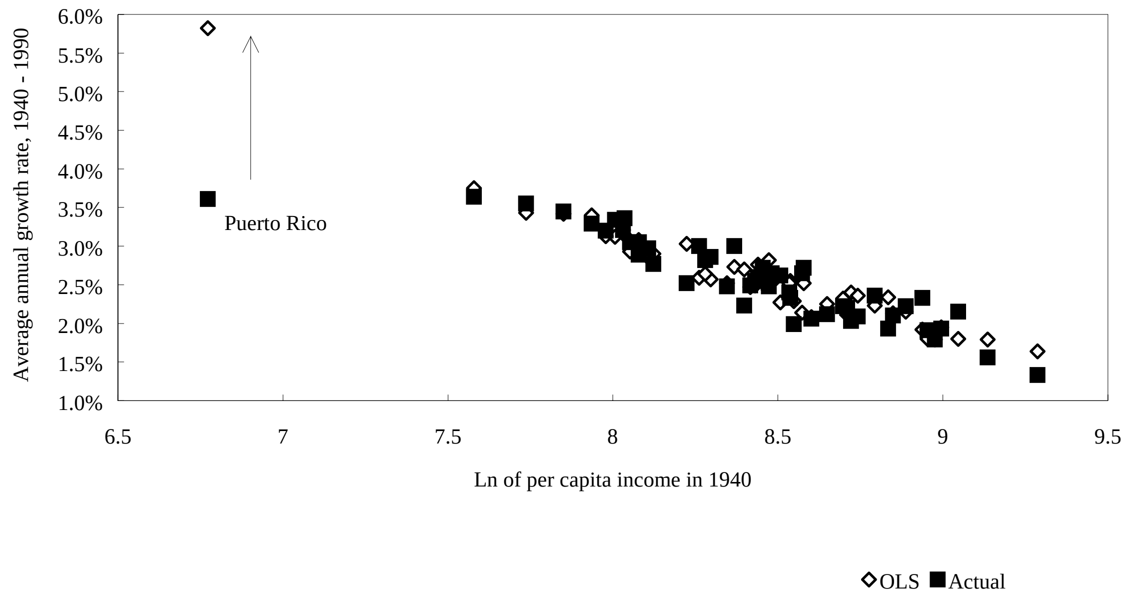
Figure 3a provides further illustration of Puerto Rico's divergence from the mainland economy.[44] The graph plots the average annual growth rates of Puerto Rico and the U.S. States from 1940 to 1990, given their per capita income in 1940. The slant of the plotted points clearly indicates that poorer states in the U.S. have been catching up with more affluent states through faster growth.

The chart shows that Puerto Rico has *not* converged with the mainland economy, as per capita income would predict. The filled square marker shows Puerto Rico's actual growth rate, and the diamond shaped marker shows what its growth rate would have been had it been converging as a state with the U.S. economy. The vertical distance between these two markers is a graphic illustration of the cost of commonwealth in terms of lost growth.

[44] The convergence frontier in Figure 1 is obtained through ordinary least squares (OLS) regression methodology. Fernando Lefort, "Is Puerto Rico Converging with the U.S.?" Working Paper 1003, International Tax Program, Harvard Law School, November, 1997, page 13.

Figure 3a

Puerto Rico and the U.S. Convergence Frontier



The “income gap [between Puerto Rico and the United States] will not be closed just by waiting for it to happen.”[45] Without being a state, *no* territory can "catch up" to the states. It is only through becoming a state that a territory's economy has the ability to reach the economic level of the U.S. This applies equally to Puerto Rico and other territories: Puerto Rico will not grow to the U.S. level without statehood.

Figure 4 provides graphic illustration of the more rapid growth which Puerto Rico would have experienced had it become a state instead of a commonwealth. The graph contrasts historical growth as a commonwealth with the faster expansion which total integration under statehood would have stimulated.

[45] Fernando Lefort, “Is Puerto Rico Converging to the United States?” Working Paper 1003, International Tax Program, Harvard Law School, November, 1997.

Figure 4

Per Capita Income in Puerto Rico: Two Stories

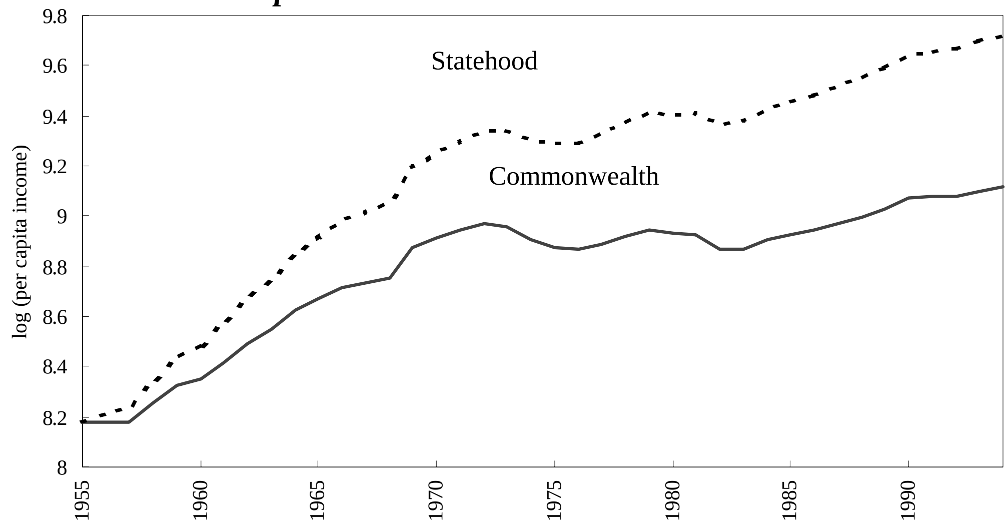


Figure 3, 3a, and 4 graphically illustrate that commonwealth has imposed a significant opportunity cost on the Puerto Rican people and their economy. Because fully integrated economies grow together towards a common endpoint, Puerto Rico would have grown significantly faster as a state. In fact, *U.S. citizens living in Puerto Rico would have been making $6000 more per year* in 1994 if the island had become a state in 1955 instead of a commonwealth, and converged the lower income U.S. states.

Table 1 below projects the incremental benefits of Puerto Rico becoming a state in 1994 in terms of per capita income. These changes are benefits which would occur as a result of statehood, and in addition to growth under current status. The table indicates that if Puerto Rico had become a state in 1994, *real per capita income would be $1343 more in the year 2000 than under current status.*[46]

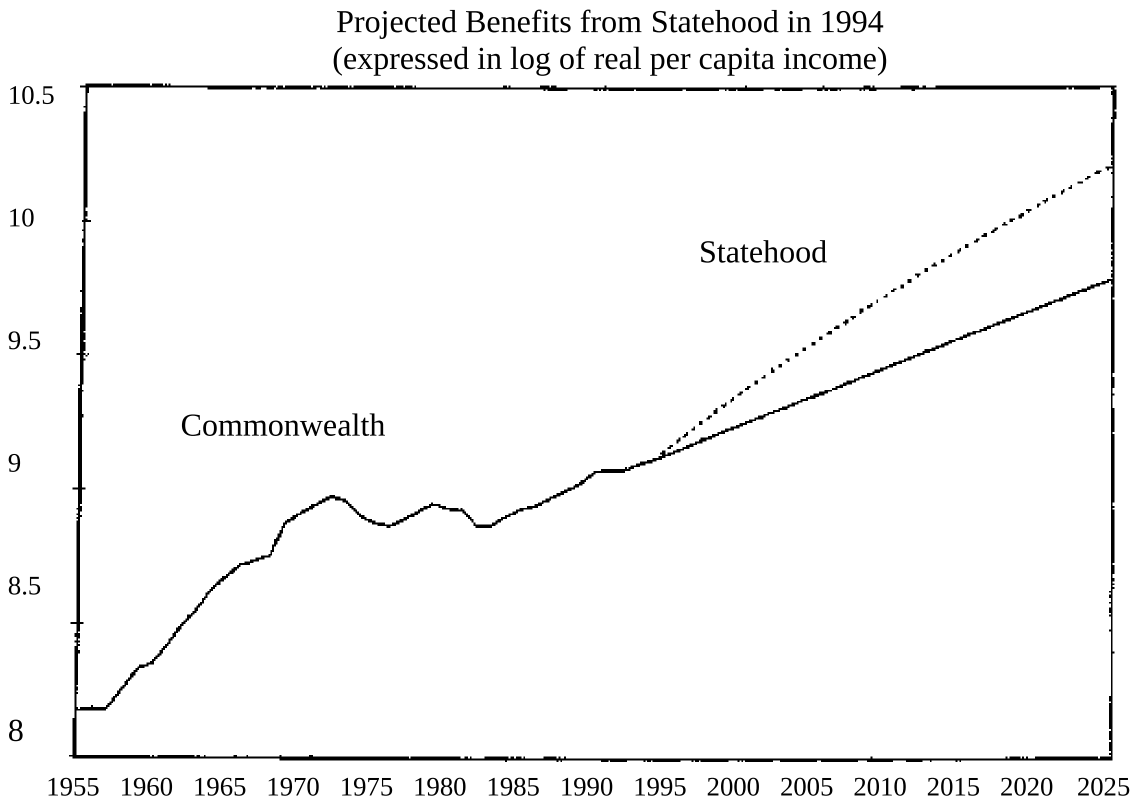
Table 1
Benefits of Statehood (if achieved in 1994)
(assuming a convergence rate of 3.5%)

Year	**Change in per capita income under statehood**
2000	$1343.70
2005	$2641.00
2010	$4095.70
2020	$5706.60
2025	$9405.40

Figure 5 illustrates the impact of statehood on per capita income projected over time. The perforated line represents the projection of increased growth under statehood and the solid line representing historical and expected growth under Puerto Rico's current commonwealth status.

[46] Fernando Lefort, "Presentation on Convergence Theory," Diagnostic Policy Center, 1997. This growth would occur in addition to 1994 per capita income of approximately $7000. Puerto Rican Planning Board, *Economic Report to the Governor, 1995,* Table 9.

Figure 5



E. Summary

Convergence theory and modern growth analysis help to provide quantification of the economic impact of political status for Puerto Rico. Analysis indicates that Puerto Rico has not been converging with the United States as a commonwealth, resulting in a growth rate about 2.5% less than would be expected given its initial income level and a steady state like the U.S. The failure to converge has imposed a significant opportunity cost on U.S. citizens in Puerto Rico: per capita income, as indicated in Figure 4, would have been almost double its actual value by 1994.[47]

Statehood plays a critical role in convergence in the U.S.; no full states have experienced the same failure to converge as Puerto Rico did under commonwealth status. In fact, statehood has a demonstrable impact on growth: the economies of U.S. states have grown 2 percentage points faster than those of territories. Most recently, Hawaii experienced significantly faster growth as a state than as a territory.

[47] Had it been converging with the steady state income level of Mississippi since 1955.

III The Fiscal Costs of Commonwealth for the United States

A. *Forfeited Tax Revenues*

Without Puerto Rico integrated into the federal income tax system, the U.S. Treasury is forfeiting tax dollars that it would collect from individuals and corporations in Puerto Rico. The most glaring loss of revenue, however, is from corporations benefiting from section 936 of the Internal Revenue Code. As of 1989, the present value of tax losses was *over $52 billion*.[48] While the tax breaks are being phased out, section 936 still costs the federal government over $3.8 billion in lost revenues, as of 1994,[49] up from $2.8 billion in 1989.[50]

Even with the phase-out of section 936 in progress, the U.S. Treasury has the expense of 936 for the remainder of the 10-year grand-fathering period. Government reports estimate that the ten year phase-out will cost the government another $25 billion in lost revenues for a program which has been proven to be ineffective (see section II for a review of studies on section 936).

As long as Puerto Rico is a commonwealth, there remains the possibility of tax subsidies which would place a continued drain on the U.S. Treasury and do little to improve the living conditions on the island. Despite improvements in economic policies, there will remain political interests supportive of additional costly and enduring corporate welfare programs. Statehood would eliminate the possibility of further costly subsidies and the dependence mentality which they foster.

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48 U.S. Department of Treasury, "The Operations and Effect of the Possessions Corporation System of Taxation, Sixth Report," 1989, Table 4-11. Figures for 1984 and 1986 were imputed by taking the mean between available data for 1985 and 1987. The discount rate used was 8%.

49 U.S. Department of Treasury, *Statistics of Income Bulletin*, Spring 1997, page 204.

50 U.S. Department of Treasury, "U.S. Possessions Corporations Returns, 1989," *Statistics of Income Bulletin*, 1993, p. 99.

B. Federal Transfers[51]

Both the Government of Puerto Rico and the US citizens residing in Puerto Rico receive transfers from the federal Government. In FY 1995 Puerto Rico received $9.7 billion in federal outlays, or approximately $2,620 for every person living on the island, which is approximately half of the federal spending distributed to the average state. These funds are spread across various major programs as follows:

1. Payments to Individuals *($5 billion)*

The largest share of federal spending in Puerto Rico is in the form of direct federal transfer payments, referred to as "Payments to Individuals" and totalling $5 billion in Puerto Rico in FY 1995. In order of importance to Puerto Rico, the programs include social security payments ($3 billion), Medicare ($775 million),[52] unemployment compensation ($390 million), federal retirement and disability ($200 million), and veterans benefits ($360 million). Under current status, these programs apply to Puerto Rican Residents in essentially the same way as to mainland residents, with a few minor exceptions.

2. Grants to State and Local Governments *($2.4 billion)*

The $2.4 billion sent to Puerto Rico as "Grants to State and Local Governments" is the next major component of federal spending on the island. Fully 25 percent of federal spending in Puerto Rico (compared to 19 percent in the average state) is through these intergovernmental grants. The main programs funded in Puerto Rico are community development and housing subsidies ($570 million), Department of Education programs ($380 million), Customs Bureau rebates ($340 million), and social services and welfare ($320 million). Medicaid, which is the largest intergovernmental transfer program to the states, where spending was $340 per capita in FY 1995, was capped at $112 million or $30 per capita in Puerto Rico in FY 1995.

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[51] All of the information in this section on federal transfers is drawn from an unpublished report by Monica Friar at the Kennedy School of Government, Harvard University. The report is entitled "Federal Transfers and Puerto Rico," 1997.

[52] The Monica Friar report "Federal Transfers and Puerto Rico" replaced the Census' gross Medicare obligations figures with the Health Care Finance Administration's Medicare expenditures net premiums figure, which more accurately mirrors the Medicare numbers in the President's Budget.

3. Food Stamps *($1.1 billion)*

The Food Stamp program is a block grant administered by the Puerto Rican government and called the Nutrition Assistance Program (NAP). Although federal spending in FY 1995 was capped at $1.1 billion, or about $300 per capita, it is the single largest program subsidy from the federal government to Puerto Rico. In FY 1995 Puerto Rico received $810 per year per recipient.

C. Wages and Salaries ($535 million)

This category includes federal spending for the personnel needed to administer federal programs, distribute benefits and ensure the national defense. In FY 1995, federal salaries and wages in Puerto Rico totalled $535 million, or $145 per capita. The primary agencies responsible for these federal personnel in Puerto Rico are the Department of Defense, Veterans Administration, the Justice Department, the Department of Transportation, the Department of the Treasury, and the Agriculture Department.

D. Summary

Puerto Rico as a commonwealth presently costs the federal government approximately $9.7 billion, based on fiscal year 1995 data. Table 2 below summarizes the current costs of commonwealth to the U.S. Treasury in terms of both direct expenditures and lost revenues as a result of tax breaks. Under the current status, expenditures would continue without the receipt of any taxes from Puerto Rican corporations or individuals.

Table 2
Current Costs of Commonwealth

Payments to Individuals	$5.0 billion
Lost tax revenues	$3.8 billion
Intergovernmental Transfers	$2.4 billion
Food Stamps	$1.1 billion
Wages and Salaries	$535 million
TOTAL	**$12.84 billion**

IV. The Fiscal Impact of Statehood

A. Introduction

This section examines the fiscal impact of statehood from several key perspectives. We evaluate the fiscal impact of statehood on the federal budget and on Puerto Rico, by calculating the incremental effect on each party had Puerto Rico been a state in 1995. Contrary to fears that Puerto Rico would be a drain on the federal budget, this analysis demonstrates that statehood would actually have cost *less* than commonwealth. Tax revenues from individuals and corporations would have exceeded any increases in federal transfers to Puerto Rico. Statehood would also have been a net fiscal benefit for Puerto Rico.

B. Possible Changes in Federal Expenditures

1. Transfer Payments for Federal Programs[53]

As detailed above in section III, Puerto Rico received $9.7 billion in 1995 from the federal government. Although some of these programs are already funded for Puerto Rican residents in the same way that they are for mainland residents, funding for some programs may change under statehood. Regardless of status, changes to reduce the disparity in funding levels between U.S. citizens in Puerto Rico and on the mainland are possible in the future.

a. Payments to Individuals ($740 million)

Puerto Ricans are already receiving most federal individual transfer payments on the same basis as mainland residents. U.S. citizens in Puerto Rico are not, however, currently eligible for Supplemental Security Insurance (SSI) benefits for the aged, blind, and disabled. Without detailed statistics on its eligible population, it is difficult to predict the cost of administering SSI in Puerto Rico. Mississippi, the poorest state in the U.S. in 1995, received $195 in SSI payments per capita. If Puerto Rico were to have a similar incidence of SSI payments as a state in 1995, U.S. citizens would have received a total of $740 million.

b. Grants to State and Local Governments ($440 million)

According to the Puerto Rico Federal Affairs Administration, the $122 million in federal funding that the island currently receives covered only 18 percent of the Puerto Rican government's Medicaid-related program costs. Were it to operate under the same rules as the states, Puerto Rico would be eligible for the highest federal reimbursement

[53] All of the information in this sub-section of part B is taken from Monica Friar's report, "Federal Transfers and Puerto Rico."

rate of 83 percent. This would have resulted in an additional $440 million over and above the $122 million cap for Puerto Rico in 1995, holding constant participation / eligibility rates from pre- and post-statehood periods.

c. Food Stamps ($151 million)

U.S. citizens receiving food stamps in Puerto Rico currently receive $810 per year under the Nutrition Assistance Program grant, compared to $919 per Food Stamp recipient in the states. Under statehood, Puerto Ricans would be eligible for Food Stamps just as are mainland residents, which would result in the termination of the NAP grant and the full extension of the federal Food Stamp program to the island. With no projected increased participation in the program were Puerto Rico to be a state and federal reimbursement of the additional $109 per recipient that states receive, the island would have drawn another $151 million under statehood in 1995.

2. Wages and Salaries ($60 million)

Because the federal government is, to a large extent, already established in Puerto Rico, statehood would not require a major installation of federal agencies as if the island were completely new to the federal system. However, under statehood, the need for federal personnel on the island would likely increase by a slight degree. Additional personnel would be required, but only as a supplement to the federal employees already in Puerto Rico.

The precise extent to which federal personnel in Puerto Rico would increase is unknown. In order to offer a reasonable estimate, we have taken the average of the five states with the lowest 1995 per capita levels of wage/salary receipts from the federal government: Wisconsin, Michigan, Iowa, New Hampshire, and New York.[54] This method yields a lower-bound estimate and is appropriate for Puerto Rico because the existing federal establishment on the island indicates that further expansion would be minimal. The resulting approximation is $161 per capita, or $595 million aggregate, in federal wages/salaries which Puerto Rico might have expected under statehood in 1995. Since the island's actual 1995 level was $145 per capita, or $535 million aggregate, the estimated increase under statehood is approximately $16 per capita, or $60 million in the aggregate.

[54] Moynihan, Daniel Patrick et al., "The Federal Budget and the States, FY 1995," Cambridge, MA: Taubman Center for State and Local Government, John F. Kennedy School of Government, Harvard University and Office of Senator Daniel Patrick Moynihan, U.S. Senate, 1996

3. Procurements (to be determined)

Most procurement spending is determined through a competitive bidding process, although much is at the direct discretion of the Executive Branch.[55] These federal dollars will be spent, regardless; the only question is *where* they will be spent. That is, federal procurement dollars spent in State A would have been spent in State B if State A had not been chosen. A substantial portion of federal procurement spending is for national defense. While statehood would solidify Puerto Rico's strategic importance, the commonwealth already receives defense procurement dollars for military bases on the island which would not significantly increase under statehood. Procurement dollars represent no spending increase for the federal government, nor are they a direct benefit to Puerto Rico as real goods and services must be given up in exchange for the payments received.

For these reasons, procurements will not be included in our estimate of increased federal spending as a consequence of Puerto Rico becoming a state: procurements represent no net increase in spending for the federal government, existing defense-related spending would not likely change, and they do not represent a dollar for dollar benefit to Puerto Rico as goods and services are sold in exchange for the procurement expenditure.

4. Total Changes in Federal Funding

The total estimated increase, then, is achieved by totalling increases in federal transfer programs and wages/salaries, for a total of approximately $1.4 billion. If Puerto Rico had been a state in 1995, it would have received $1.4 billion more in federal transfers than it actually received in 1995 as a commonwealth. Table 3 summarizes the incremental changes in federal funding that would have accrued to Puerto Rico under statehood in 1995.

Table 3
Increased Federal Transfers to Puerto Rico Under Statehood
FY 1995 Dollars

Food Stamps	$151 million
Medicaid	$440 million
SSI	$740 million
Wages/Salaries	$60 million
TOTAL	**$1,391 million**

55 Procurements are goods and services the federal government directly purchases from a state or territory. Defense, natural resources, and public infrastructure are common examples.

C. Net Fiscal Impact

1. Impact on the Federal Budget

Corporations operating under section 936 in Puerto Rico are subsidiaries of large U.S. corporations with headquarters on the mainland. Although they are located on the island, they are linked to mainland interests. A change in status for Puerto Rico would totally change and significantly increase their tax contribution since under statehood, tax credits like section 936 could not legally exist. Because of the peculiar arrangement of 936 corporations, we have distinguished them for the sake of analysis from Puerto Rican corporations and included their projected tax contributions to the U.S. Treasury under statehood in our calculation of the net fiscal impact of statehood on the U.S. budget.

The aggregate income tax contribution for corporations in Puerto Rico, adding together both 936 and non-936 corporations, under U.S. tax code, is an estimated $3.47 billion to $4.07 billion. When the $49 million in individual income tax and the $3.47 to $4.07 billion in corporate income tax are totalled, the result is an aggregate tax contribution of $3.52 to $4.12 billion. This is our estimate of the aggregate federal individual and corporate taxes associated with Puerto Rico under statehood. Using the 1995 population estimate of 3.7 million people in Puerto Rico, this aggregate tax burden yields per capita taxes of $951 to $1114.

The net fiscal impact of statehood is the difference between the amount that Puerto Rico and 936 corporations would *contribute* to the U.S. Treasury and the amount that would be *transferred* from the U.S. Treasury to Puerto Rico under statehood. Each of these two changes is measured from the baseline of commonwealth. That is, receipts and expenditures to which the federal government and Puerto Rico are already committed under commonwealth are not considered changes due to statehood. To estimate the net fiscal impact of incremental changes due to statehood on the federal budget, a range is given to reflect the intra-governmental disagreement over the cost of section 936. Table 4 shows estimates of the net impact of statehood on the federal government had Puerto Rico been a state in 1995.

Table 4
Upper Bound Estimate of Net Impact of Statehood on Federal Budget in 1995:

Transfers to Puerto Rico from Federal Budget:	$1.40 billion
Tax Revenue from Puerto Rico to Federal Budget:	-$3.52 billion
Net Expenditures from Federal Budget:	-$2.12 billion

Lower Bound Estimate of Net Impact of Statehood on Federal Budget in 1995:

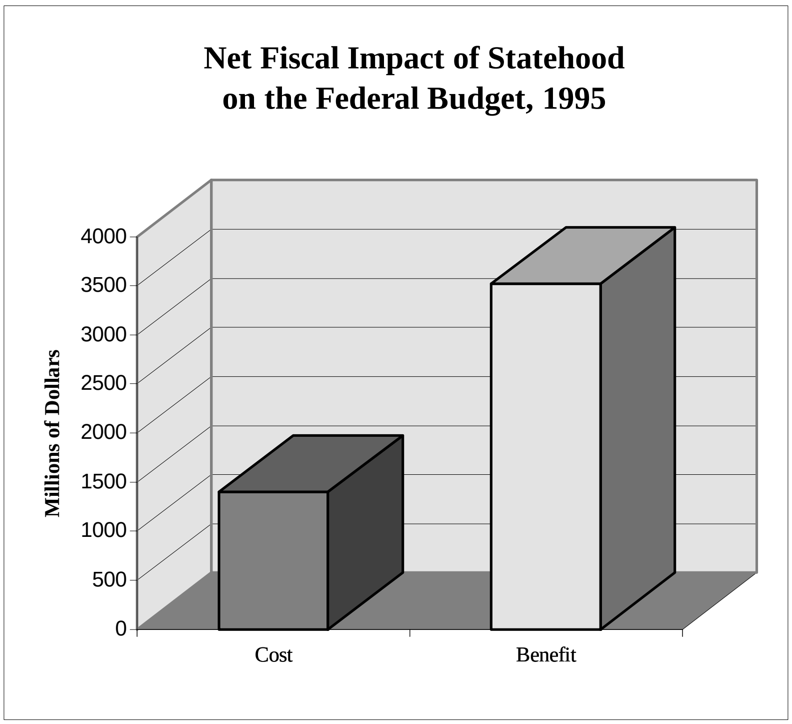
Transfers to Puerto Rico from Federal Budget:	$1.40 billion
Tax Revenue from Puerto Rico to Federal Budget:	-$4.12 billion
Net Expenditures from Federal Budget:	-$2.72 billion

Puerto Rico would more than pay for itself in terms of increased federal transfers due to statehood. That is, federal transfers are expected to increase by $1.4 billion in one year whereas tax revenues from one year are estimated from $3.52 to $4.12 billion. Therefore, $2.12 to $2.72 billion of the tax revenue collected in association with Puerto Rico statehood will be savings to the U.S. Treasury from statehood. Because tax revenues to the federal government outweigh federal expenditures, statehood would be less expensive for the U.S. Treasury than is commonwealth.

It is important to note that there is no statutory requirement that U.S. states contribute as much as they receive to the federal government, or vice versa; there are many states that contribute more than they receive and many that contribute less than they receive. This redistributive power of the federal government to coordinate activity and finances among the states, is part of federalism.

Figure 6 below illustrates the 1995 net savings to the U.S. Treasury from the incremental changes of statehood as compared to commonwealth, using the $3.52 billion estimate of 936 revenues.

Figure 6



2. Impact of Statehood on Puerto Rico

The bottom line of the net fiscal impact calculations above should be interpreted just as it is written, as net expenditures *from the federal budget*, due to statehood. This number should not be thought of as net receipts by Puerto Rico; the existence of 936 corporations has complicated the picture. Since 936 corporations do not represent Puerto Rican assets, but stateside assets, the net receipts by Puerto Rico from statehood are actually higher than these figures indicate. That is, much of the tax revenues from statehood come from 936 corporations, not Puerto Rican residents.

Under statehood, Puerto Rican individuals and corporations would contribute, respectively, $49 million and $671 million to the U.S. Treasury totalling $720 million. Proportionally, the $720 million represents 18 to 21 percent of the total increased revenue to the U.S. Treasury attributable to statehood. When the contributions of section 936 corporation are *excluded* from bottom-line calculations of the net fiscal impacts of statehood, the benefit to Puerto Rico is accentuated. Table 5 below presents the estimated benefit of statehood to Puerto Rico, had the island been a state in 1995.

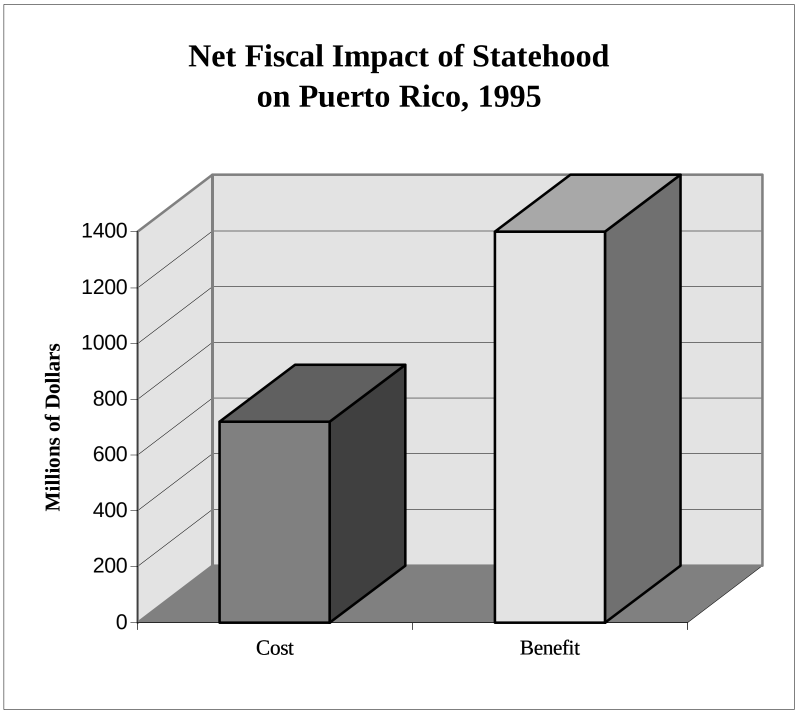
Table 5
Estimate of Net Impact of Statehood
on Puerto Rico in 1995:

Transfers to Puerto Rico from Federal Budget:	$1400 million
Taxes from Puerto Ricans to U.S. Treasury	-$ 720 million
Net Receipts by Puerto Ricans:	$ 680 million

Comparing commonwealth to statehood as presented in table 5, the net fiscal benefit of statehood to Puerto Rico would have been $680 million had Puerto Rico been a state in 1995. The increased revenues accruing to Puerto Rico under statehood would be relatively small in the context of existing transfers under commonwealth of $9.7 billion. Figure 7 depicts the 1995 costs and benefits of statehood over commonwealth for Puerto Rico.

The difference between the bottom line from Table 4 and the bottom line from Table 5 is striking, but logical. It is largely due to Puerto Rico's post-WWII development strategy that favoured "external," U.S. investment and incentives through tax credits. Thus, much of the corporate wealth currently in Puerto Rico is part of mainland U.S. corporations who are not being taxed by the U.S. Treasury on profits earned by their Puerto Rican subsidiaries, due to the section 936 tax credit. That is, the fiscal benefit that Puerto Rico would experience under statehood in relation to the U.S. budget would be financed largely by tax revenues from profits of 936 companies, profits that have gone untaxed since the enactment of section 936.

Figure 7



Although 936 is being phased out over 10 years with Puerto Rico as a commonwealth, there remain political interests, both in the U.S. Congress and among Puerto Rican policy makers, to undo the recent repeal of 936 or to enact other ineffective permanent tax breaks. The very possibility of resuscitating section 936 in essence precludes the formulation of an aggressive private sector development strategy for Puerto Rico and keeps alive the “dependence mentality” which has helped to keep the Puerto Rican economy in stagnation since the 1970’s. A change in status to statehood would permanently repeal section 936, and capture the corporate income of 936 corporations into the U.S. tax system.

V. Realizing Potential for Growth through Economic Reform

A. Puerto Rico's Economic Potential

Among other assets, Puerto Rico possesses a well-trained and productive workforce, a strategic location bridging the U.S. and Latin America, and a well-developed financial infrastructure which will form the solid basis for future growth. The computable general equilibrium (CGE) model replicating the Puerto Rican economy (see section II) provides evidence for resiliency and latent capacity. Modelling additional scenarios using the CGE model indicate that this potential for growth could be realized through modest policy initiatives.[56] Commonwealth status, however, continues to play a critical role in preventing Puerto Rico from realizing its economic potential (see section IV for the findings of modern growth analysis).

B. Privatization of Public Corporations

Privatization alone is not a panacea, but it is a vital component of the updated development strategy that would maximize economic growth in Puerto Rico. Privatization is a means to the end, economic growth, not the end itself and "can best be regarded as . . . a logical complement to a broad strategy of private sector development."[57] First steps toward privatization are under discussion on the island, but only a few public corporations have been proposed. In our opinion, a larger number of public corporations should be under review for prompt privatization, both in terms of ownership and management. We recognize the political difficulties that can accompany privatization initiatives due to the strength of organized labor. Because of this opposition, all attempts at privatization should involve appropriate transition plans and periods.

For public corporations that are not suitable for privatization, adjusting fees and charges to reflect more accurately the cost of service provision should be considered. Bringing user fees in line with the cost of service accomplishes two objectives. First, it increases the public corporation's revenues so that it does not have to rely on the government's general funds for operating expenses. Second, it gives residents a sense of investment in the services they receive: "citizens are less likely to waste government services if the costs are more directly understood."[58]

These reforms would reduce the claims on government finances by reducing the number of public corporations being operated publicly and by raising revenues from other sources. This would free up assets in Puerto Rico's general fund for new

[56] Diagnostic Policy Center, "An Economic Policy Model (CGE) for Puerto Rico: Initial Results from Three Simulations," April 1996.

[57] Adam, Christopher, et al. *Adjusting Privatization*, New York: Heinemann, 1997, page 4.

[58] Hexner et al., 1993.

initiatives. The reforms would also stimulate private sector capacity to provide goods and services that it had not provided before due to the operation of public corporations.

C. Private Sector Infrastructure Initiatives

Reliable infrastructure is critical for attracting investment to Puerto Rico. However, Puerto Rico has historically relied on its public sector for carrying out infrastructure development. As public corporations are privatized, more space will be created in the economy for more efficient private sector initiatives. Relying more on the private sector to implement infrastructure programs reduces costs and tax burdens. The pressure to reduce Puerto Rico's tax burden will provide a continuing pressure for the use of the private sector to fund and manage needed infrastructure development.

D. Government Efficiency Reform

Increased government efficiency will help existing investments achieve healthy growth and attract investors looking for sites for new investment. Most attractive to investors is a streamlined government that does not interfere excessively with capital markets and that has sensible, effective policies that help and not hinder the proper functioning of the private sector. In short, ownership and management of currently public enterprises should be privatized to reduce the size of the Puerto Rican government, and the public agencies that remain should be made more efficient.

The ideas that should guide public sector reform, in our estimation, are *one*, that statutes and processes should be simplified and *two*, that government should be converted into a facilitator of private initiatives, not a provider of basic services. Appendix II discusses the current Puerto Rican government's efforts at streamlining the public sector. Progress has been encouraging, yet it represents only a first step in a long and needed process of reform.

It is our opinion that performance-based budgeting should be considered as a means of increasing efficiency in the Puerto Rican public sector, especially in light of the success this type of budgeting has effected in New Zealand and other countries around the world. The benefits are at least three-fold. Performance-based budgeting requires that targets be set, which highlight areas of poor service. For example, if the licensing division has a goal of processing 500 applications a week and consistently processes only 370, energy can be focused on closing the performance gap. Secondly, departments and agencies that fail to justify their existence by failing to produce results can be restructured or dissolved, as deemed appropriate. Eliminating useless or duplicative departments saves public dollars. The final benefit that performance-based budgeting could produce in Puerto Rico is an improvement in the organizational culture of the public sector, particularly in the management ranks. The Revenue Department of New Zealand experienced strong positive results from implementing performance-based budgeting:[59]

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[59] Inland Revenue, "Report of the Controller and Auditor-General, 1990-1993," Department of Tax Administration, New Zealand, pp. 83-84.

> Senior managers have over time seen the benefit of the stated performance measures as critical management tools…The most visible example of this support for performance measurement is the fact that processing centers display their critical performance standards on walls throughout the workplace...Performance standards have also been incorporated in job descriptions and performance contracts, which ensures that staff monitor progress against targets. These actions demonstrate that the achievement of the standards is an integral part of the Department's management process.

E. Protecting and Capitalizing on Puerto Rico's Natural Advantages

Historically, Puerto Rico has failed to capitalize on several key sources of competitive advantage: its human capital, and its natural beauty, climate, and location. Puerto Rico's relatively educated and productive workforce have traditionally drawn investment to the island over other locations. Relative to most Latin American and Caribbean countries, Puerto Rico's education system is good. However, plans for new investment in educational infrastructure and other social infrastructure on the island seem insufficient in light of increasing competition for investment and greater demands for skilled workers.

In FY 1990, for example, education spending accounted for only 18.3 percent of general fund expenditures in Puerto Rico, while expenditures for education by U.S. state and local governments accounted for 35 percent of total expenditures in the same year.[60] While Puerto Rico's workforce is educated to a level that makes it competitive with the Caribbean and Latin America, greater investment would increase this competitive edge and bring the education system more in line with the United States.

Two of Puerto Rico's most important natural advantages are its location and climate. Nevertheless, Puerto Rico's tourist industry remains underdeveloped: only 6% of gross domestic product is generated by tourism. In contrast, tourism in the Caribbean economies as a whole contributes 29.5% of GDP, and tourism in Hawaii contributes 24.3% of the economy.[61] Puerto Rico's climate and natural beauty can be leveraged to generate more tourism through publicity and advertising campaigns strategically targeted at key consumer populations on the mainland and world-wide, particularly in Latin America.

F. Potential Tax Initiatives

1. Consumption Tax

Puerto Rico now has a specific excise tax on alcohol, tobacco, petroleum products, crude oil, vehicles, cement, sugar, horse races, hotel rooms, etc., as well as a

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[60] Hexner et al., 1993

[61] World Travel and Tourism Council, *Travel & Tourism and Hawaii's Economy*, 1997, page 1.

general 5 percent excise tax on other products. This excise tax is collected at the point of sale by the manufacturer or importer, but with substantial tax avoidance. The government of Puerto Rico could collect more of what the law entitles it to, and collect it more efficiently, if the tax were assessed as a consumption tax instead. A consumption tax shifts the point of tax collection from the manufacturer or importer to the point of final sale of the good. According to a 1994 study, in the case of final consumption by business or government, this tax would apply to the selling price, whether the purchase is made from a retailer, a wholesaler, or directly from a manufacturer or importer.[62]

The conventional argument against a consumption tax states that, due to the presence of small, family-run stores in Puerto Rico, there would be substantial seepage of a consumption tax, due to the retailer failing to collect the tax. Thus, potential tax revenue would fall through the cracks. However, it is estimated by those familiar with the business climate in Puerto Rico that over 90 percent of retail transactions take place in larger shopping areas, which are secure reporters of revenue. These are established businesses with standard operating procedures that do many of their sales transactions by credit card. Since the majority of taxed transactions can be accounted for in larger retail centers, a consumption tax would collect more than the present excise tax, even if collection rates were to remain the same.

The conversion from an excise tax to a consumption tax could be accomplished in several ways. A 1994 revenue simulation of the Puerto Rican indirect tax system found that adopting different combinations of tax policy tools could increase indirect tax revenues by up to as much as 33 percent over 1992 levels.[63]

2. Tax on Public Corporations

Another aspect of tax reform is the possibility of extending a minimum tax liability on publicly owned corporations. Government owned corporations currently control large amounts of resources which go completely untaxed. Since they are incorporated as quasi-public entities, it is open to question whether it would make sense to tax them in the same manner as private corporations are taxed. However, extending a small tax to public corporations does two things. First, it would raise revenues for the government's general fund by assessing income and assets that currently go untaxed. Second, it would apply a small amount of pressure to push public corporations into greater efficiency. If their operating budget were cut through a minimal tax obligation, public corporations would be in the position of having to do the same or greater amount of work with fewer resources and thus cut unnecessary activity.

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[62] International Institute for Advanced Study, "A Revenue Simulation Model for the Indirect Tax System in Puerto Rico," prepared for the Department of the Treasury, Puerto Rico, Studies, March 3, 1994, page 4.
[63] Ibid. at pp. 1-2.

3. Income Tax Structure

In 1993, the Puerto Rican government lowered its marginal income tax rates, which is a move in the right direction. It would be beneficial, in our opinion, for the 1999 restructuring to follow the trend of lowering marginal tax rates begun in 1993. The second area of Puerto Rico's income tax structure that we think should be addressed is its complexity. Any moves toward simplification of the tax code and consolidation of tax categories would be welcome.

G. Summary

In order to realize its economic potential, Puerto Rico must depart from its historical reliance on tax incentive development, which has distorted the economy and diverted activity away from areas of competitive advantage. We have suggested several key reforms which have proven effective for stimulating growth in the U.S. and around the world.

Resolution of the lingering status issue, however, will be critical for effective implementation of any economic reforms in Puerto Rico. Puerto Rican politics is dominated by the status issue, and the three major political parties hold out their support of statehood, commonwealth, or independence as central defining characteristics. Statehood would represent a definitive resolution of the status issue, and provide added incentive and support for economic reform.

VI. The Effect of Statehood on Investment in Puerto Rico

Investment is a critical driver of economic growth, and statehood would create a more stable and certain environment for investment in Puerto Rico than is possible under commonwealth status. As a senior banker in Puerto Rico recently observed, "time and stable rules are what investors want."[64] Statehood would put an end to the persistent uncertainty over political structure and tax benefits which has plagued Puerto Rico under commonwealth status.

Statehood would also move Puerto Rico from a "foreign" to a "domestic" location in the eyes of mainland U.S. investors, creating a more favorable environment for investment. Statehood would similarly distinguish Puerto Rico from other developing economies to foreign investors, by making Puerto Rico a clear part of the U.S. In an era of escalating trade liberalization and increasing competition for investment, statehood would set Puerto Rico apart from competing developing economies in the Caribbean and Latin America, and across the globe.

A. Statehood would make Puerto Rico a "domestic" not "foreign" investment location

In the world of advertising, the television viewer is informed that he can rent from Hertz or "not exactly." Puerto Rico presently falls into the "not exactly" category. Investors in the United States analyze potential projects on the basis of whether they are "domestic" or "foreign." Corporations view their operations as domestic or foreign. As it stands, Puerto Rico falls into the "foreign" category which makes investing or establishing operations more complicated and confusing from a U.S. perspective. For example, U.S. rating agencies like Standard and Poors and Moody's Investor Services assess Puerto Rico as an external unit. Maps of the U.S. for business readers do not show the island, and general maps identify it, parenthetically, as part of the U.S., an identification which would hardly be necessary for Hawaii or Alaska. It is also reported that parents of remaining 936 firms still ask how their Puerto Rican subsidiary makes its foreign exchange translation from the island currency, although the Puerto Rico has used the dollar for decades.[65]

A recent lawsuit filed in Europe illustrates that Puerto Rico is not considered a full and proper part of the U.S. abroad either. Wrangler, Ltd. recently filed a lawsuit alleging that the "Made in the U.S.A." label on Puerto Rican goods was "incomplete, inaccurate, and . . . misleading" because the products were produced in Puerto Rico, not

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[64] Jorge Junquera, Senior Vice President of Banco Popular, the largest bank in Puerto Rico, quoted in the *Orlando Sentinel*, September 14, 1997.

[65] Michael McKee, "The Economic Consequences of Puerto Rican Statehood," page 51.

the United States.[66] The suit claimed that the label was misleading because articles manufactured outside the U.S. were often produced in "low-wage countries."

Becoming a state would provide investors with the real McCoy, whereas its nebulous commonwealth status now makes it, in their perception, foreign and "not exactly" part of the U.S. Statehood would make Puerto Rico a "domestic" location and clearly distinguish it from neighboring Caribbean and Latin American economies.

Based on the development experiences of countries around the globe, it is our opinion that Puerto Rico should adopt a sustainable growth strategy free from the investment incentive gimmicks and distortions that were prevalent in earlier stages of Puerto Rico's development and, to a large extent, still prevail on the island. Such a strategy has produced and is producing growth in many parts of the world. The steps that are being taken as part of Puerto Rico's current development strategy are encouraging, but insufficient to solidify serious growth for the Puerto Rican economy.

There are two dimensions of sustainable growth that should be addressed: **one**, attracting stable, substantial investment to the island and **two**, reforming the institutions that either attract or influence the impact of said investment. The concepts and frameworks presented in the previous section are development lessons learned from the experiences of the United States and other countries which have experienced rapid and sustained growth.

B. Uncertainty discourages investment

One of the primary reasons that Puerto Rico's economy has experienced such long-lasting stagnation is that *uncertainty* about the island's future has largely kept investors from serious investment in Puerto Rico. The exception has been investment spurred by section 936 corporate welfare, which has proven an inefficient and ineffective development tool, but which has cost the Puerto Rican taxpayer nothing. To compensate for increased risk, investment on the island has been targeted to short-term, high return projects. Lowering this risk from uncertainty would lead to a greater quantity of investment, in longer-term and less-remunerative projects. It is important to note that this persisting uncertainty has hindered investment by Puerto Rican, as well as external investors, as table 5 illustrates. Uncertainty in Puerto Rico has three sources:

- historical reliance upon tax incentives as a tool for economic development, without the formation of a more comprehensive investment strategy,
- the questionable security of section 936 investments since the tax credit is conditional upon legislative overview by the U.S. Congress, and
- investors' perception that the island's political status is subject to change.

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66 Robert Friedman, "CRB: 'Made in the USA' lawsuit could hurt P.R.," *San Jose Star*, December 3, 1997, p. 4.

The cost of uncertainty, both in terms of opportunity and in growth, has been high for the people of Puerto Rico. Statehood would remove the risk of a change in political status, which continues under commonwealth status, and the inherent risk involved in any tax haven. It would further ensure an end to development strategies like 936 which will only continue to create uncertainty for investors.

C. Sources of investment in Puerto Rico

1. Puerto Rican investors

There are two distinct groups of investors to consider when thinking of investment in Puerto Rico. First are the U.S. citizens residing in Puerto Rico, who have diversified their portfolios (and the location of their investments) and chosen not to invest in Puerto Rico. Many of their investment dollars have gone elsewhere, often to Florida. Table 9 details the inflow/outflow of capital in Puerto Rico during the period 1981 to 1994.

Table 9
External Capital Flows of Puerto Rico
(millions of dollars)

Year	Net inflow of external capital	Net outflow of capital from Puerto Rico	Net movement of capital
1981	1673	458	1215
1982	1834	1441	393
1983	123	2151	-2028
1984	392	2108	-1716
1985	917	2645	-1728
1986	1243	373	870
1987	1697	2393	-696
1988	-768	-2091	1323
1989	1202	1356	-154
1990	734	812	-78
1991	-553	-796	243
1992	2126	2410	-284
1993	278	9	269
1994	1412	1273	139
Total	12,310	14,542	-2232

Table 9 makes it clear that from 1981 to 1994, Puerto Rico actually exported more capital than it imported, contrary to the image of Puerto Rico as a recipient of capital from the mainland.[67] Puerto Rican investors have been diversifying their investments because they perceive the island's economic future to be uncertain. In fact, there has been little or no incentive for Puerto Ricans to invest on the island. Neither the U.S. Congress nor Puerto Rico has broadened the island's investment strategy to encompass more than section 936, which is geared entirely toward "external," or mainland, investment. There has been nothing to attract local Puerto Rican investment to the island or to encourage their medium- to long-term financial commitments there. The result is that practically no Puerto Rican entrepreneurial class has become committed to development on the island.

2. **External Investors**

The second group of investors is from the mainland U.S. and abroad. The conditions under which these entrepreneurs operate, however, are controlled by the U.S. Congress, not by the Puerto Rican government. Statehood would distinguish Puerto Rico as a destination for external investors among multiple possible locations in the area. Under statehood, Puerto Rico would offer permanent advantages which similar locations competing for investment simply cannot match, including complete exemption from U.S. tariffs, use of the U.S. dollar, and protection under the U.S. legal system.

Puerto Rico also faces a future of intense competition for investment, in which its commonwealth status will prove to be even less of an advantage. Before the age of relaxed trade regimes, Puerto Rico was in a relatively advantageous position compared to competing developing countries. However, NAFTA and the GATT have eroded Puerto Rico's comparative advantage by bringing other countries into parity with Puerto Rico in terms of U.S. trade policy. Statehood would set Puerto Rico clearly apart from developing countries in the Caribbean, Latin American, and around the world as a clear part of the United States.

It is also important to note that many of the countries with which Puerto Rico competes for investments have already adopted market-based reforms and private sector-based development strategies which place them, in many respects, "ahead of" Puerto Rico. Puerto Rico continues to rely upon the public sector-driven strategy that it adopted in the 1950's. With its emphasis on self-reliance, resolution of the status issue, and stability and consistency of tax treatment, statehood would act as a catalyst for needed reform.

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[67] Diagnostic Policy Center, "An Economic Policy Model (CGE) for Puerto Rico: Initial Results from Three Simulations," April 1996.

With section 936, U.S. corporations interested in short-term investments have registered good rates of return due to the tax credit. However, external investors wanting to make medium- or long-term investments have often judged, reasonably, that their investments would be more secure in Mexico, Chile, or Ireland than in Puerto Rico. Furthermore, if relations with Cuba are normalized, Cuba could represent an enormous challenge to Puerto Rico's competitiveness. The bottom line is that Puerto Rico is only one location out of many that investors consider when making investment decisions. Thus, Puerto Rico must distinguish itself through statehood in order to experience real growth in its economy.

Puerto Rico's past attraction to investors has been attributable, in large part, to its relationship with the United States: inclusion within the U.S. customs zone, geographical proximity to the U.S. market, use of the U.S. dollar, special treatment under U.S. corporate tax code, relative degree of stability due to its association with the U.S., and inclusion within the U.S. judicial system. However Puerto Rico's relationship with the United States has become less advantageous over time in two important ways.

First, the U.S. minimum wage was extended gradually to Puerto Rico, with all qualifying workers reaching the mainland level of minimum wage coverage by 1981.[68] One effect of the federal minimum wage in Puerto Rico, aside from its positive impacts, was that it eroded the island's competitive position in terms of labor costs, vis-à-vis other countries. Second, with the recent advances in communication technology, Puerto Rico's proximity to the U.S. does not provide as much relative benefit as in previous decades. Thus, the extension of the federal wage to Puerto Rico and the declining advantage of close proximity to the U.S. have both worn away Puerto Rico's competitive advantage for attracting investment.

D. Summary

The availability of investment is a key factor in determining growth in an economy. Statehood would make Puerto Rico a more favorable location for mainland investors by making it a "domestic" rather than "foreign" location, and for foreign investors by making Puerto Rico a clear and full part of the U.S. It would further constitute a definitive elimination of uncertainty regarding political and tax structure, and distinguish the island from other developing economies as trade liberalization through NAFTA, MERCOSUR, and other agreements escalates across the western hemisphere.

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[68] Eliezer Curet, "Puerto Rico: Development by Integration to the U.S." *Editorial Cultural*, Puerto Rico, 1986, page 162.

VII. Conclusions

Puerto Rico's political status has profound economic consequences for the island and for U.S. taxpayers, whether as a state or a commonwealth, a nebulous concept both to investors and mainland U.S. citizens. Contrary to conventional wisdom, commonwealth has been a cost and not a benefit for Puerto Rico and the U.S. Treasury. An economic impact analysis indicates that statehood would stimulate growth and investment on the island and improve living standards for its residents. From a fiscal perspective, bringing in Puerto Rico as the 51st state would result in both a net benefit to the U.S. Treasury and U.S. citizens living in Puerto Rico.

Erroneously, Puerto Rico is still considered by many to be a model of economic development. In fact, the Puerto Rican economy has stagnated since the 1970's after some successful growth in the 1950's and 1960's. Annual growth levels averaged only 1.7% in real terms from 1975 to 1984. Unemployment reached 22% in the 1980's, stabilized at around 15% during the 1990's, and currently stands at double the U.S. rate. In short, the Puerto Rican economy is anything but a case of "if it ain't broke, don't fix it."

It is only through comparing Puerto Rico with developing economies in the Caribbean and Latin America that its economic performance appears favorable. Given that the residents of Puerto Rico are U.S. citizens and its intimate economic, geographic, and political ties to the United States, Puerto Rico should be compared with the fifty states. This comparison reveals the paucity of economic progress on the island. The island's 1995 per capita income of $7296 was *less than half* of Mississippi's, the poorest U.S. state.

Puerto Rico's economy would grow significantly faster as a state for two reasons: modern growth analysis and common sense. "Convergence theory," when reduced to practice and data analysis, shows that the less developed regions of the U.S. economy "catch up" with more affluent parts over time. Since 1940, for example, Mississippi has grown twice as fast as wealthier Northeastern states, and has narrowed the gap with the rest of the U.S. Mississippi now earns 50% rather than 22% as much per capita as the richest state.

Puerto Rico has not converged towards the wealthier U.S. economy like Mississippi, despite close economic, geographic, and political ties to the U.S. In fact, GNP per capita on the island was $7296 in 1995, less than half that of Mississippi, the poorest U.S. state. The gap between the U.S. economy and the Puerto Rican economy has not narrowed because Puerto Rico has not been a full participant in the U.S. economy and political system.

Only the full integration of statehood will narrow the gap. Recent studies on economic growth indicate that states grow 2% faster than territories because of their full integration with the U.S. economy and political system. In Hawaii, *the economic growth rate almost doubled in real terms during the fifteen years after statehood*, expanding by almost 7 percent each year. If Puerto Rico had become a state in 1955, its residents would have been earning fully $6000 more per year by 1994 than under commonwealth status, assuming only a moderate rate of convergence. Alternatively, if Puerto Rico had become a state in 1994, real per capita income would grow $1343 more by the year 2000 than with commonwealth status.

The common sense argument is best represented by the Hertz advertisement on television. Namely, you rent from Hertz, or “not exactly.” From the perspective of an investor, you either invest in a U.S. state or a foreign entity. Because Puerto Rico is not a U.S. state, it is considered by potential investors as a foreign entity and falls in the “not exactly” category. Wrangler’s recent lawsuit alleging that “Made in the USA” labels for Puerto Rican goods are “inaccurate” and “misleading” points to foreign perception of Puerto Rican status.

Puerto Rico’s nebulous and uncertain political status will prove an increasing disadvantage in a world of escalating globalization and expanding free trade. As the competition for investment between developing economies intensifies, statehood will set Puerto Rico apart from other potential locations in the Caribbean, Latin America, and across the world. Statehood will provide the security and stability to attract investment and drive economic growth in Puerto Rico, complete access to the widest market in the world, and an end to the uncertainty facing investors with respect to future rules of the game.

Economic analysis clearly shows that Puerto Rico has the potential to grow. The pace of growth, however, will be driven by Puerto Rico’s political status and economic strategy. A computable general equilibrium (CGE) model replicating the Puerto Rican economy indicates a latent capacity for growth which has not been realized. Puerto Rico has considerable assets which will form the basis for future growth, including a productive and educated workforce, a developed financial infrastructure, and a strategic location.

In fact, concerns that the Puerto Rican economy could not survive the repeal of 936 have been unfounded. To the contrary, real GDP and employment in Puerto Rico have continued to grow since 1994. Government finances have improved and the U.S. rating agency, Standard & Poors revised its outlook this year on Puerto Rico from negative to stable in light of its current budget surplus and improved tax collections. While the economy currently shows promise, only statehood will enable Puerto Rico to optimize its growth potential in the long run.

From the perspective of the American taxpayer and the U.S. Congress, conscious of budget deficits, making Puerto Rico a state would actually cost the federal government *less* and *reduce* the deficit, on the basis of present value and additional savings from increased tax revenues driven by faster economic growth. If Puerto Rico had been a state in 1995, the U.S. Treasury would have saved *at least $2.1 billion*. This finding should not be surprising, given that the U.S. currently collects no taxes from Puerto Rico. Nevertheless, the federal government sent $9.7 billion to Puerto Rico in 1995 alone, and forfeited an additional $3.8 billion in lost tax revenues under section 936.

Puerto Rico itself would benefit from statehood from increased federal funds, as U.S. citizens on the island begin to receive comparable benefits to citizens on the mainland. Estimates indicate that statehood would bring the island an additional $1.4 billion in federal funds and cost $720 million in taxes from non-936 corporations and individuals, leading to a net benefit. It might also be fallacious to consider these increases in federal spending to be costs of statehood in comparison to commonwealth status. It seems unlikely that citizen groups, and Hispanic groups in particular, will allow the large disparity between benefits received by U.S. citizens in Puerto Rico and citizens on the mainland to continue even if the current status were to persist.

In sum, the pace of Puerto Rico's growth hinges on its full integration into the U.S. economy, namely through statehood. Puerto Rico's once privileged trade status is rapidly being eroded by falling tariffs under NAFTA and the GATT. Potential investors from the U.S. and elsewhere will not appreciate Puerto Rico's nebulous political status as a source of economic advantage. Looking towards the 21^{st} century, statehood will set Puerto Rico clearly apart from developing economies in the Caribbean and Latin America and make it an unequivocal part of the United States.

Statehood will drive faster growth through full integration with the U.S. economy and enable Puerto Rico to optimize its significant growth potential. Faster economic growth under statehood will mean higher incomes for U.S. citizens in Puerto Rico, and higher incomes will bring in more tax revenues to the U.S. Treasury.

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