A Slant on Puerto Rico's Economic Situation

Remove the Smoke and Mirrors

The major obfuscation involves two perennial fallacies:

- Puerto Rico as the model of economic development, and
- Puerto Rico requires tax breaks to survive.

How can a model economy require a jump-start for 46 years (since WW II)? Yet, reputable consulting firms, accounting firms, academics, and policy makers still today back this position. Strange?

Some Data Highlights

The attached table attempts to quantify the situation. What numbers hit home? At 11%, unemployment is more than twice that of the mainland (and has been more than 10% for generations). About one third of employment is in the public sector, twice that of the mainland economy. Since 1940, fast growth has helped Mississippi and other poorer states close the gap with rest of the country (from ¼ of the richest state to 50% in 1990)**.** Thanks to paltry growth since the early 1970's,[1] Puerto Rico's per capita GNP (now $9,947) has been stuck at less than a third of the U.S. ($33,646) for decades. Interestingly had Puerto Rico been an actual state in the US the economy would have grown 3% faster, and per capita income would now be about $7,000 higher and closer to the U.S. average.

Inflated by heavily subsidized manufacturing production, Puerto Rico's GDP (gross domestic product) exceeds its GNP (gross national product) by about 50%. Touted by island boosters, Puerto Rico's GDP is propped up by federal credits and overstates the strength of the economy, worker earnings and output benefiting the local economy.

In an economy in desperate need of investment, local capital continues to flee the island for better investment opportunities on the U.S. mainland. For an economy known as a prime investment spot, it is ironic that between 1980 and 1994, over $2.2 billion more in investment capital flowed out than came in.

With subsidized pharmaceuticals and electronics firms "dominating" the economy at least a bit of R&D would be expected. The reality is close to nothing; at an estimated 0.3% of GDP, or $144 million annually, Puerto Rico invests about nine times less than the U.S. as a whole, 2.61%.[2] South Carolina, the state closest in population to Puerto Rico, invests $996 million on R&D annually, almost seven times as much. In fact, until the R&D tax credit was extended to PR in 2000, the very firms attracted to PR by the tax

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[1] Average of 1.1% real annual GNP growth from 1975 to 1995.
[2] Based on most recently available 1997 figures.

breaks had a tax disincentive to do R&D in PR, to the tune of $130,000 per $1 million of R&D expenditures. The pathetic number of patents issued in PR over the past 23 years best tells the sorry story. 499 total, or 52 times fewer per capita than in the U.S. as a whole).

Puerto Rico's tourist industry cannot pick up the slack. Annual visitors to the island have actually decreased since 1998, by 2.2%, while Hawaii (5.8%), Mexico (6.2%), and the Dominican Republic (28.7%) have continued to grow. Even phenomenal growth in such a relatively tiny sector couldn't begin to supply the needed jobs; tourism employs only 1% of the workforce and contributes about 1% of the economy.

Puerto Rico's cost to the US taxpayer should not be overlooked. Even as a territory, Puerto Rico receives $12.3 billion in federal spending (more than 23 states), and benefits from about $3.5 billion in tax credits annually (compared with total Commonwealth revenues of $6.7 billion). Since 1972, mainland firms operating in Puerto Rico have reaped huge profits free of federal tax that have cost the U.S. Treasury over $115 billion since 1972.[i] Also not to be disregarded is the unrestricted movement between the island and the mainland, where one can instantly earn 33% more and where the next generation rises roughly to the US average.

The Immense Political Deterrent to Economic Growth

Puerto Rico is stuck - the financial and political incentives to maintain the status quo are immense. The Fortune 500's enjoy having the tax breaks under the protection of the American flag. Both political parties enjoy the patronage from the large government, and the Commonwealth Party benefits from the large US corporate contributions. Neither US political party is keen on the congressional implications of the 51st star. Senator Kennedy, who favors Commonwealth status because those were the views and friends of President Kennedy, depicts the weirdness of the scene.

What are the repercussions on the economy and sensible economic policy? First, the smoke and mirrors become the prime mover. Washington is told that tax incentives are necessary and the island is told you can have your cake and eat it too - federal benefits and no federal taxes, and statehood would bring an end to this nirvana. Second, it fosters actions that inhibit growth. For example, English is poorly taught and its teaching is frequently opposed on political grounds. In this global economy does such a position make sense?

Puerto Rico's excise tax is cumbersome, corrupt and inefficient. A modest sales tax would increase revenues by about 18%, and the amount would be even greater when one accounts for the spending of the underground economy, which is estimated at 20% and would be captured under a sales tax.

The sad conclusion is that the battles over status have overwhelmed economic policy. Sensible economic policy could be carried forward under the current status, and that is actually the beauty of the Kemp Challenge, which makes the choices clear.

The Kemp Tax Reform Challenge

The Kemp tax reform challenge would simply throw down the gauntlet. For a finite period, 4 to 7 years, Congress will make $3.5 billion available to Puerto Rico to reform its taxes and essentially to restructure its economy. While it is true, it may not even be necessary to say that the last 25 years have been a failure. What should be said is that the $3.5 billion will annually be injected directly into the economy not via a corporate balance sheet.

The challenge to the challenge will be setting up the system, the milestones, and the measures of performance. The setting up of the initiative is a doable task, but it remains to be done.

The Last Word

Sweeping Puerto Rico under the rug represents a menace for the United States. The smokescreen and the vested interests that prevail are thick and powerful. The Kemp tax reform challenge cuts through the smoke and rises above the interests to present a clean choice for action. Taking on the challenge would be the only route to take.

Puerto Rico in Numbers

	Puerto Rico		U.S.
Per capita income (1999)	**$9,947** 3.4X less		**$33,646**
Unemployment rate (2000)	**11.0%** 2.4X higher		**4.5%**
Public sector employment (% of total)	**32.0%** 2.0X higher		**16.0%**
Real growth rate (GNP) (1975 to 1995)	**1.1%** 2.7X less		**3.0%**
Patents per capita	**8.5** 50.5X less		**344.54**
Spending on R&D as % of GDP (1997)	**0.3%** 8.7X less		**2.61%**

Federal spending in PR (2000)	**$12.3 billion**
Annual cost of Section 936 (2000)	**$4.0 billion**
Tourism as % of GDP (2000)	**0.97%**
Tourism as % of GNP (2000)	**1.5%**
Tourism as % of Employment (1999)	**1.1%**

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[i] Present cost valuation using 8% discount rate.