Political Status as an Economic Issue:

Puerto Rico's Failure to Converge with the US under Commonwealth Status

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- Why Puerto Rico has not Converged with the U.S.
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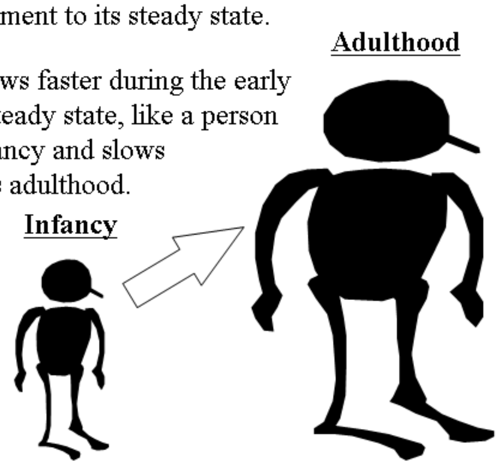
Convergence Theory: An Overview

- *An analogy*: An economy's steady state is like the final height to which a person grows. Convergence is the speed of an economy's movement to its steady state.
- An economy grows faster during the early transition to its steady state, like a person grows fast in infancy and slows as he/she reaches adulthood.



Convergence Theory: Evidence from the U.S.

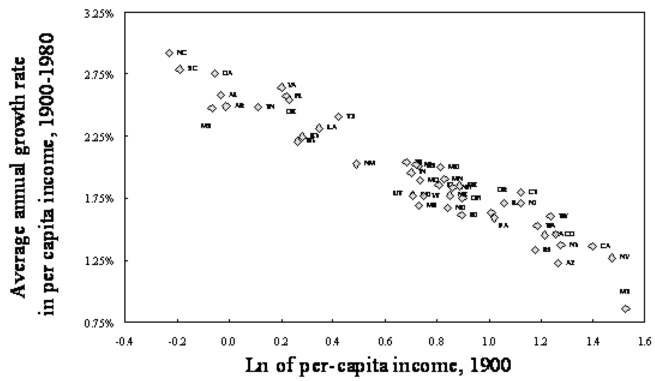
- Barro and Sala-I-Martin (1992) analyzed economic growth in the 48 states from 1900 to 1980 and found a rate of convergence of **2 percent a year**.

Key finding: The poorest states in 1900 have grown **twice as fast** as the wealthier states, and have caught up over time.

For example: South Carolina was the poorest state in 1929, and had only 22.4% of the per capita income of New York. Through faster growth, this ratio had increased to 71.8% by 1990.

Convergence Among U.S. States, 1900-1980

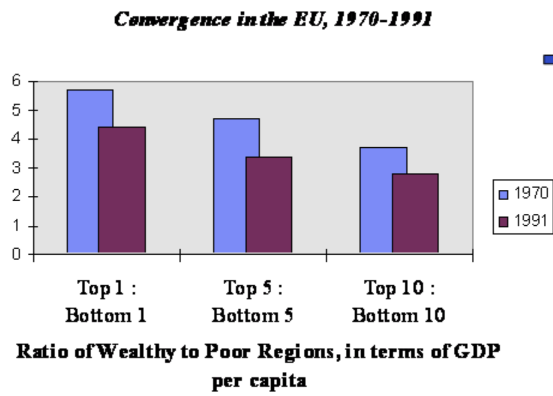
In the U.S., poorer states have grown faster than wealthier ones and catch up with the rest of the economy over time.



Source: Barro and Sali-I-Martin (1992), “Convergence,” *Journal of Political Economy,* 100 (April): 223-251.

Convergence Theory: Evidence from Europe

- Integration in the European Union has closed the gap between the least developed regions and the most developed regions.



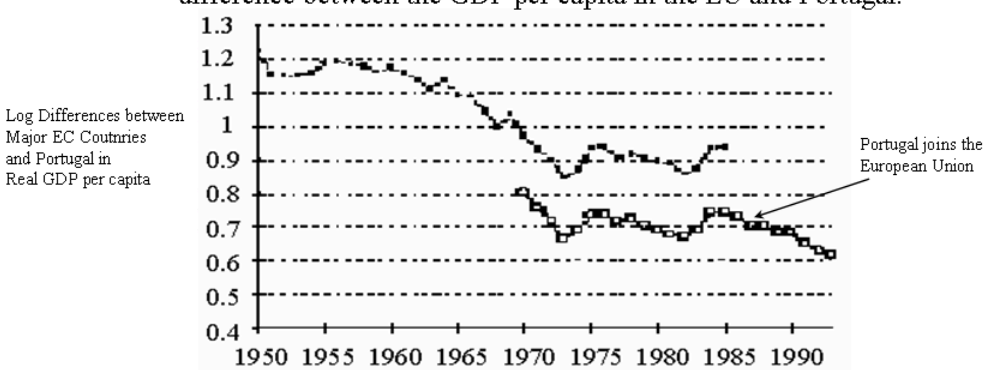
- The difference between the per capita income of the wealthiest EU regions and the poorest has declined since 1970.

Source: Robert Leonardi, (1996) *Covergence, Cohesion and Integration in the European Union*, Table 4.1, page 91

Portugese Convergence with the European Union

Portugese Convergence with the European Union

- Since 1950, Portugal has closed the gap with the EU, measured in the difference between the GDP per capita in the EU and Portugal.



- Convergence has been particularly quick since Portugal became a member of the EU in 1986.

Source: Barros and Garoupa (1996), "Portugal-European Union Convergence: Some Evidence," *European Journal of Political Economy*, 12(1996): 545-553, Figure 1, drawing on data from the OECD and Summers and Heston (1992).

Evaluating Puerto Rico's Economic Performance

Question: *Has Puerto Rico been converging (closing the income gap) with the United States as neoclassical growth theory predicts?*

Evaluating Puerto Rico's Economic Performance

***Answer**: No. Puerto Rico grew slower than predicted by its initial income level, even after controlling for other relevant factors.*

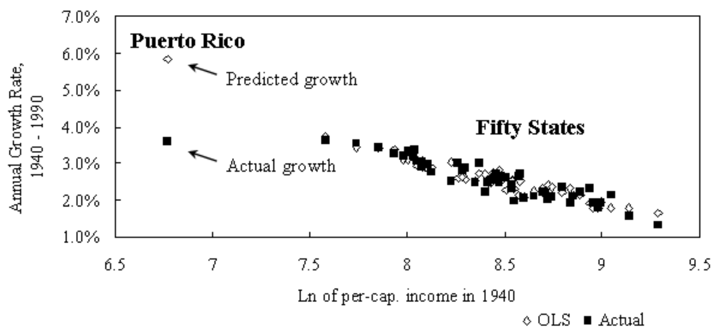
Evaluating Puerto Rico’s Economic Performance

***Methodology**: “Panel Data Regressions” with a sample of the 48 mainland United States plus Puerto Rico and Hawaii for the period 1940 - 1990.*

(*Source:* Statistical Abstract of the U.S., figures net of federal transfers)

Puerto Rico and the U.S. Convergence Frontier

➡ Puerto Rico's actual growth was *almost 3 percentage points less* than the predicted growth rate of 6.0%, given its income level in 1940.



Source: Statistical Abstract of the United States, net of federal transfers.

Why has Puerto Rico *not* Converged with the U.S.?

1. Lower education level?

2. Government's higher share of income?

3. Lower level of federal transfers per capita?
- *All three controlled for in analysis, and can not explain lack of convergence.*

4. Difference in technology in Puerto Rico?
- *Unlikely given strong economic integration with U.S.*

Commonwealth Status Has Kept Puerto Rico from Converging with the U.S.

Hypothesis: *Statehood really makes a difference.*

Commonwealth status has prevented convergence through

(1) uncertainty over "rules of the game" for investors,

(2) incomplete integration with the U.S. As a result, mainland investors, corporations, and ratings agencies, consider Puerto Rico a "foreign" rather than "domestic" location.

(3) making "tax incentives" the prime rationale for economic strategy and investment.

Testing the Effect of Statehood on Growth in the U.S.

Methodology: Compare the historical economic growth of U.S. territories with states to determine whether statehood matters.

"Growth Panel Regression Analysis" of the economic growth of all U.S. states **and** territories, from 1880 to 1940.[1]

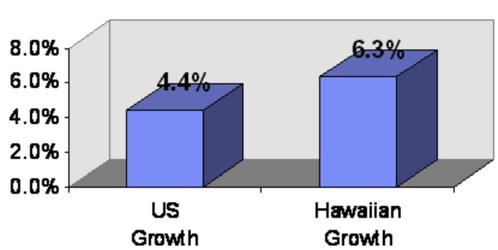
Results: Statehood does matter. The economies of U.S states grew fully **2 percentage points faster** than territories.

[1] Data series from Barro and Sali-I-Martin (1992), "Convergence," *Journal of Political Economy*, 100: 223-251.

Hawaii: Statehood and Convergence with the U.S. Economy

- *After statehood,* the Hawaiian economy began to converge with the U.S., grew almost 2% faster than, and began to catch up with, the more affluent U.S. economy.

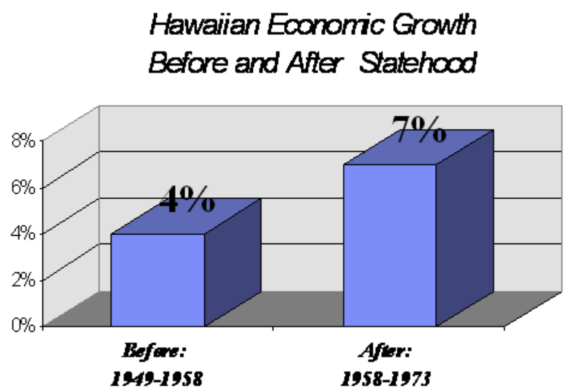
US vs. Hawaiian Economic Growth Rates, 1959-1973



Note: As measured by average real annual growth in gross national product, U.S., and gross state product, Hawaii, during the period, 1959 -1973.

Hawaii: Faster Growth as a State than a Territory

- Hawaii grew *significantly* faster as a state than as a territory.

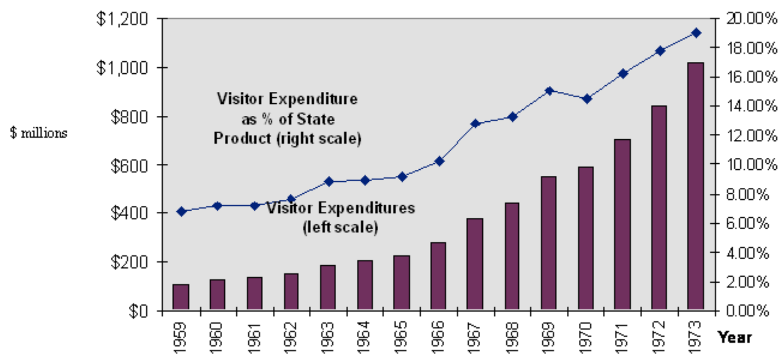


Source: Robert C. Schmitt, *Historical Statistics of Hawaii*, Table 6.1. "Gross State Product: 1901 to 1975" adjusted for inflation using the Honolulu Consumer Price Index.

Hawaii: Expansion of the Tourist Industry under Statehood

- Visitors to Hawaii increased at a 20% annual rate and the tourist industry expanded at a 15% annual rate in the fifteen years following statehood.

Visitor Expenditure in Hawaii, 1959-1973



Source: State of Hawaii Data Book, 1996, Table 7.21, "Estimated Visitor Expenditures: 1951-1995."

The Costs of Commonwealth Status for Puerto Rico

- As a commonwealth, Puerto Rico has experienced slower growth than it would converging to the United States as a full state.

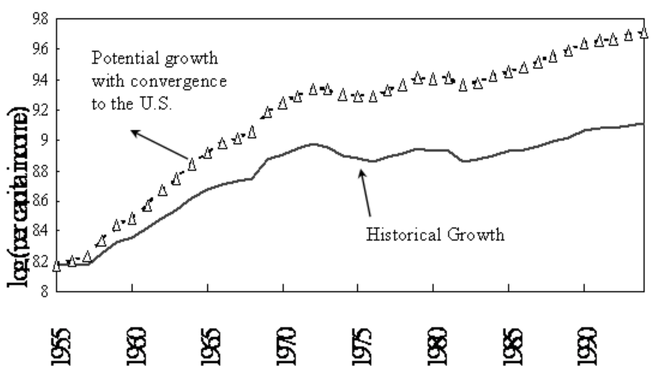
- By preventing convergence, commonwealth has imposed a severe opportunity cost on the average Puerto Rican.

Average Puerto Rican would have earned **$6000 more** per year in 1994.	*and*	He/she would have earned a total of **$111,000** more since 1955

if Puerto Rico had been converging with the U.S. like the 50 states.

Note: Figures assume a conservative 3.7% rate of convergence with Mississippi.

Per Capita Income in Puerto Rico, 1955-1994: The Opportunity Cost of Commonwealth Status



Note: Potential growth with convergence to the U.S. assumes a conservative rate of convergence rate of 3.7% to the steady state of Mississippi.

Conclusions

1. Puerto Rico **has not been converging**, or catching up with the United States as predicted by neoclassical growth theory.

2. Since 1940, Puerto Rico's actual growth rate was *almost 3 percentage points* lower than the predicted growth rate of 6.0%, had it been converging with U.S. states.

3. *Commonwealth status has been a drag on Puerto Rico's full convergence with the U.S. economy*. Incomplete integration, uncertain rules of the game for investors, and the use of tax gimmicks to drive investment and economic strategy have blocked convergence.

Conclusions

4. *Political status does affect economic growth and convergence.* U.S. territories have grown more than 2 percent faster when they became states.

5. *By preventing convergence, statehood has exacted a severe opportunity cost on the U.S. citizens living in Puerto Rico.* If Puerto Rico had become a state instead of a commonwealth, the average Puerto Rican would have earned **$6000 more** per year in 1994.

5. *Statehood will be even more critical to Puerto Rican economic growth in the future*. In this age of globalization, the expansion of NAFTA, and the eventual normalization of relations with Cuba, Puerto Rico's once priveleged trade status is no longer a source of comparative advantage. The island also faces increasingly intense competition for investment

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