THE ECONOMIC CONSEQUENCES OF PUERTO RICAN STATEHOOD

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EXECUTIVE SUMMARY

Background

This study addresses the economic questions that have been posed about statehood for Puerto Rico. It is funded by the New Progressive Party of Puerto Rico, the statehood party, in the context of debate over S.712. The bill would establish a 1991 plebiscite in which the people of Puerto Rico could decide whether they wished to become the 51st state of the union, gain their political independence, or continue in their current dependent, territorial status as a "commonwealth." As a study that concerns itself with the question of economic development, it is largely accessible to the educated lay reader because economic development is not, in the end, simply a matter of manipulating arcane mathematical models. It is a matter of common sense.

The most critical issues raised by the choice of status are in fact beyond the scope of this study--they concern individual dignity and vision, not economic issues. Residents of the island have been U.S. citizens since 1917, and their wartime sacrifices--disproportional to the size of the island's population--are but one indication of the ways Puerto Rico's residents have met their obligations as U.S. citizens. But island residents cannot vote for Congress and the President. This invidious discrimination is not aimed at the Puerto Rican people, who enjoy the full rights and privileges of their citizenship upon emigration to the mainland states. Rather, the discrimination is geographical in nature, aimed at the island itself. As a matter of simple justice, this discrimination against a place, a part of the United States and the home of many of its citizens, is capricious and arbitrary--if not immoral and absurd.

Historically, the test of economic readiness for statehood was simply a test of whether the candidate state was able to support a state government and contribute its fair share to the operation of the federal government. Chapter I of this study documents in detail that the island of Puerto Rico more than meets the historical standard. For 40 years it has supported the equivalent of a state government and more, and every official budget estimate shows it making a fair contribution to the federal system should it become a state, and returning a budget surplus compared to continued commonwealth once new spending and taxes are fully phased in. Indeed, the island is much more economically advanced than most territories were when they became states. This is so in income, but it is also true in the more fundamental sense that the island's people, though on average still poorer than those in mainland states, are educated, skilled, and economically experienced to the extent of being a modern developed country.

The Economic Issue: Statehood Versus Tax-Haven

In purely economic terms, apart from questions of political power, the debate is also fundamentally a debate about the power of tax avoidance to foster economic development. Because the preservation and exploitation of tax haven status under Section 931 and, more recently, Section 936, of the Internal Revenue Code have so long been the guiding force of island economic policy, the absence of tax haven status seems to promise a void.

The true size of that void and alternatives to it are discussed in Chapters II and III. Chapter II provides the economic thesis of statehood: We conclude statehood itself is a more than adequate replacement for the tax haven, because statehood integrates the island into Americans' map of their country.

The conventional wisdom is that Puerto Rico is now a developed economy because of its forceful exploitation of tax haven status, a position this report tentatively accepts. Yet there remains a lingering doubt: In 1980 Puerto Rico had half the income of Mississippi. The same was true in 1970, 1960, and 1950, when exploitation of this status began in earnest. For this reason, the suspicion lingers that perhaps tax haven status has been nothing more than a weak replacement for statehood all along; that the primary determinant of the <u>pace</u> of development has been integration of the island into the mainland economy, while the particular industrial composition of growth has been twisted by tax avoidance.

Whichever is true, what cannot be denied is that Puerto Rico, defying its "West Side Story" image, made its tax haven status a success. Many poor countries have benefitted from the generosity of the U.S. Treasury. Excepting Europe under the Marshall Plan--a place that was, after all, only temporarily poor--no place can be said to have used that money as wisely and as well as Puerto Rico. From the "poorhouse of the Caribbean," it is now the highest income location in all of the Caribbean and Latin America, excepting the Bahamas. The gift of money does not guarantee the wisdom of its use, and the island's residents and elected leaders must be honored and respected for what they have achieved. Moreover, Federal largesse has funded not merely an industrial establishment. Much more important, it has funded the education of an entire people to integrate them into the modern industrial world. Not even the Marshall plan can claim this.

Still, today the benefits of 936 are simply not all that large to the island economy. Section 936 neither buoys the island economy in recession, nor provides an engine of job creation that fuels the long-term growth of the island economy as a manufacturing center. In the last recession, jobs in manufacturing fell 10 percent, jobs in the remainder of the private sector fell by a significantly smaller proportion. Moreover, over the whole business cycle, the manufacturing sector has added but 1,000 jobs, while the remainder of the private sector has added over 90,000. (Meanwhile, the 936 jobs are very expensive to the U.S. taxpayer--$1 million per net new job over the past decade.)

But, regardless of this, what will the island do when statehood replaces the tax haven? It is obvious--say the acolytes of tax haven--that the island has nothing to offer investors but tax avoidance. They say that every study has shown the island economy cannot survive unless it is a home to tax avoidance.

This argument suffers two flaws: its own numbers show no disaster, and those numbers, in any case, assume that what now exists, must be. Because the island's manufacturing sector is now populated by multinational companies exploiting the tax haven, it appears as if that must be the island's destiny. And the fact that these companies are increasingly hard to come by, and benefit the island less when they come because they are there not to employ people, but to avoid taxes, seems inevitable.

But the fact is, the companies who come to Puerto Rico are special companies. If the standard they applied to investments in Puerto Rico also applied to the states, the existing states would have no investments, no companies, and no jobs. (Some may feel this close to the truth, but only because they have lost sight of the powerful effect the Federal budget deficit and value of the dollar had on mainland experience in the 1980s.) The companies upon whom the tax haven's success has depended are multinational companies, located in many countries, and free of the natural preference for home that drives most companies, most of the time.

Most companies instead prefer to be at home, and Puerto Rico is not "home" to American companies. It is a foreign location to these companies. Until they are so big and so widespread that they are accustomed to seeing the whole world as their apple, those companies prefer to invest at home and export abroad. These everyday companies view investments abroad with reluctance, as an ultimate strategic necessity, but only when the firm has no better opportunities at home and is ready for the big step. Quite simply, statehood moves Puerto Rico out of the foreign category and into the domestic category. It changes the mainland investor's and citizen's map of his country. In so doing, it vastly expands the pool of potential investment available to the island. The island need not get an overwhelming or miraculous share of this pool to do well indeed--at least as well ultimately as Mississippi, for example.

As a state, the island has advantages and disadvantages, like every other state. Its particular advantage today is its inexpensive skilled labor force and managerial pool. These are important, but their cheapness will pass as the state's economy advances. However, the island has more important long term advantages that are unique and irreproducible. The most important of these is the island's unique history and culture that makes it the single most appropriate commercial bridge between Anglo North America and the Caribbean and South America. This is a function South Florida and parts of South Texas now serve, but there is room for Puerto Rico. We would be foolishly shortsighted to judge the economic potential of Latin America by its recent economic history. The island's second permanent advantage is its people, now educated for, and experienced in, the world of modern commerce. This advantage makes them no better than those in existing states, but it also makes them no worse.

The Statehood Economy

Building on these advantages, Puerto Rico can strengthen and diversify its economy in four areas. These are documented in Chapter III. Although the commonwealth party asserts from time to time that it too is pursuing these same lines, the ironic fact is that to the extent they are successful, tax haven status is that much less significant, and that much easier to abolish. But in any case, statehood gives the island a leg up in pursuing these goals.

First, in manufacturing it can compete for domestic investment on the basis of its inexpensive skilled labor force and managerial pool, particularly as an export bridge to the Caribbean and Latin America and, conversely, as a bridge into the U.S. for foreign investors seeking an inexpensive U.S. location. (In addition, unlike now, it will have a complement of real representatives, not merely lobbyists in Washington. The importance of this fact to foreign investors should not be underestimated.) Although the tax haven advocates have insisted that companies now brought to the island will leave when they are taxed, many, and perhaps most, now have sufficient investments in going concerns to make such a step unprofitable. Some have admitted as much.

Second, in the service sector the island can build on its existing advantages as the hispanic population most educated and prepared for modern commerce. In particular, the island now serves as a focal point for marketing, sales, distribution, and servicing throughout the Caribbean and Latin America. It has added potential as a regional banking, publishing, and advertising center. Given the work force's experience and training in high technology areas, the island should serve as a regional center in services stemming from the information revolution.

Third, in tourism the advent of statehood can be expected to provide vast new exposure and familiarity with the island to the millions of Americans who prefer to see America first, and who view foreign travel, particularly to the Latin America in which Puerto Rico is now seen as a part, as a matter of danger and discomfort.

Finally, statehood will break the narrow vision of development-as-industrialization that has kept island agriculture from its rightful position in the economy. That the island has great potential in the new commercial agriculture of tropical products has been documented, what has been lacking is the vision and the will to act.

In addition to these four seeds of expansion in the private sector, the island will participate as a full member in the federal system. This means that the island will receive a share of the federal administrative structure and federally sponsored work now denied it because of its lack of full political representation. The income from these will, in turn, further augment the island's income and act as a further stimulus to domestic investment.

While all of these specific developments can be expected, they are not the reason for adopting statehood. Economists--like everyone else--are incapable of foretelling what the shape and contours of the world economy will be from decade to decade. Who would have foreseen the technological developments of the 1980s? For that matter, California was admitted to the union because of its gold. Instead, the driving reason is that statehood will provide a more solid and healthy basis for economic development for decades--and centuries--to come than will hopeful dependence on a slender tax provision in someone else's control.

Quantifying the Economic Impacts of Statehood

It is difficult to quantify the near term gains from statehood in the simple numerical terms to which the political process has become ceremonially accustomed. This is so because statehood is a fundamental change in the institutional basis of the island's economic relationships and in the mainland's perceptions of the island rather than a mere extrapolation of current arrangements. In this "structural change," the sort of economic inertial relationships economists use to quantify routine economic changes are broken. History serves as no fine statistical guide. Thus, quantifying the economic impacts of statehood requires judgement.

For that matter, so does quantifying the effects of removing tax haven status, which in the case of Puerto Rico is also a structural change without historical precedent. For many years, those who would preserve Section 936 have sponsored studies showing the putative economic collapse that would inevitably attend the demise of the tax haven. Yet buried among the numbers in those studies are always two surprises.

First, the basic answer is a matter of judgement all along: who will "leave," what does "leaving" mean, why will they leave, and how many will leave--all are simply matters of assertion based on more or less reasonable assumptions. Sometimes, the analyst's assumptions in these matters have flatly contradicted other analyst's assumptions. Second, once these basic assumptions have been turned into numbers and passed through the economic models, the answer that always returns is "no collapse." Of course, because the studies look only at the negative, the results are necessarily negative. They typically show the economy without Section 936 as performing worse than the economy with 936, but not forever. Over a period of several years, investment in manufacturing is lower than it otherwise would have been as the relative size of the manufacturing sector declines until a new manufacturing sector emerges that is free of firms driven solely by tax avoidance. Once this transition is past, the economy resumes its normal growth. Again, there is no economic Armageddon, only a transition.

The most recent study, that by the Congressional Budget Office, is different from earlier studies primarily in being free of the taint of financing by tax haven advocates. Although the study acknowledges that statehood has its positive sides, CBO does not attempt to quantify these. It does add the federal fiscal changes accompanying statehood, and in so doing estimates the prospects of the commonwealth with full fiscal parity to the states.

But it is not difficult to gain an understanding of what the positive effects of statehood might imply. We estimate the consequences of three very conservative assumptions about the new state's economic development: (1) that it gets only 25 percent of the average per capita direct foreign investment recently experienced in the mainland states; (2) that its tourism industry gains from statehood to the tune of only 25 percent of the boom experienced by Hawaii after statehood; and (3) that, in terms of federal contracting and employment, it rises to the bottom of the list of states.

These three assumptions alone--with no tourism "miracle," no new industries, no rapidly expanding service sector outside of tourism, no compensating wave of return investment from the main land or surprise decision of 936 companies to invest more than in CBO's calculations--just these three assumptions are enough to more than compensate for most of the ill effects calculated by CBO. Even in CBO's worst case for statehood (at least compared to commonwealth) these conservative assumptions make up all of the jobs lost and well more than half the difference in income.

The reasons even conservative assumptions on the benefits of statehood lead to improved performance compared to commonwealth are twofold. First, the island has a small economy, so that changes in mainland views of the island and activities towards it that are small by mainland standards can have sizable impacts on the island. Second, as we have shown, the benefits of 936 are simply not all that large to the island economy, and are therefore not all that difficult to make up. And the fact is, Puerto Rico does not now get what a state does.

Building a State Government

Opponents of statehood argue that the island government is now so large and so expensive that adding the federal burden to the commonwealth-state burden would prove so expensive as to scare away both investors and residents. Nor could this government be reformed, they add, without massive disruption.

This is simply false. What matters is the burden on the taxpayer, which is in fact larger today than that of any state, but not so much larger as to require traumatic surgery for its remedy.

The island government now appears quite large because it owns a number of public enterprises not commonly found among state assets--in sugar, shipping, telephones, and electric power, to name a few. Whether the functions these public enterprises perform could best be served by privatization is a productive question to ask, and the answer is almost surely in the affirmative. Privatization would also provide funds from the sales that might be used for improvement of the island's infrastructure, including education, as is the plan with the current privatization of the telephone company.

But these enterprises are not a drag on the taxpayer except to the extent of subsidies, subsidies that now run in the neighborhood of $0.2 to $0.5 billion per year. Some or all of these subsidies could, and must, be cut to bring the new state's tax burden in line in with those of other states.

A second source of budget saving will arise from the replacement of tax support now given to the island's comprehensive public health service, which is the major source of medical care for the island's poor. The introduction of full medicare and medicaid, as well as the remaining full range of federal entitlements to the poor, will make island taxpayer support of the medical system unnecessary. Once the public service is free to charge the cost of its services, whether it continues as a public undertaking or converts to the private sector, the current $0.4 to $0.5 billion annual budget cost will be unnecessary.

These two sources of budget saving alone--elimination of subsidies to public enterprises and of support to the public medical service--will suffice to bring Puerto Rico's tax requirements into line with those of other states. The ensuing cut in the tax burden may be tilted, to the degree felt appropriate, to reducing personal and business income taxes. Some reallocation of tax revenues may also be made toward heavier reliance on the property tax, though this is a matter of form and requires no overall tax increase. Most research shows that businesses take into account both income and property taxes in their location decisions.

Caring for the Poor

Statehood would require the extension of full federal entitlement benefits to the island's residents, who now receive such benefits in limited form. Opponents of statehood argue that this would create a climate of welfare dependency, though they also request the same treatment under continued commonwealth.

But the major sources--$2.3 billion of the $3.0 billion currently projected by CBO for 1995--of new entitlement spending are, by and large, removed from those programs usually thought of as causes of welfare malaise. They are SSI, which is for the aged, blind and disabled, and the medical care programs discussed earlier (which will replace medical services already funded by the island). There is little reason to believe these programs will discourage work, while they will greatly ease the burden of those least able to work.

The remaining additions to entitlement benefits in AFDC and food stamps represent enhancements to programs already operating on the island. These programs have been redesigned in recent years to reduce their adverse incentive effects. Moreover, a historical review of the evidence on island resident's work experience shows no significant ill effects from these programs. Rather, to the extent island residents cannot work, it is largely due to a shortage of jobs, a shortage that can be laid at the foot of the island's reliance on Section 936.

THE ECONOMIC CONSEQUENCES OF PUERTO RICAN STATEHOOD

Introduction: The Context of the Analysis

This study accompanies discussions of Senate Bill S.712 providing for a plebiscite on the political status of Puerto Rico. In the plebiscite, the residents of Puerto Rico would decide on the future status of the island among statehood, independence, or an "enhanced" commonwealth. The bill contains provisions necessary to effect the chosen status.

The study concludes that statehood is a desirable option with potential economic benefits both to the island and to the nation. Ultimately, if such a bill becomes law, the viability of statehood will justly be a matter for the people of Puerto Rico to decide.

But the granting of statehood is not primarily an economic issue; rather, it is a political issue involving the fundamental values of the American Republic--a fact that has been prominently recognized in the admission of other states. Membership in the union is not, at heart, merely another subject for the economist's sharp pencil. Rather, the primary question is whether residents of Puerto Rico--who have been United States citizens since 1917--will have the full range of rights, privileges, and duties commensurate with their citizenship. They are now automatically entitled to these rights and privileges upon immigration to a state, and many of the current population of the island have resided on the U.S. mainland at one time.[1] The loyal service of many Puerto Ricans in wartime has amply demonstrated their willingness to accept the duties.

The primary <u>economic</u> test in the admission of states has been, in the words of the Senate:

> That the proposed new state has sufficient population and resources to support a state government, and to provide its share of the costs of the federal government.[2]

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[1]Although neither current statistics nor tabulations of the total number of residents who have lived on the mainland appear to be available, it is suggestive that in the 1980 Census, about 5 percent of island residents over the age of five had been living on the mainland five years earlier.

[2]U.S. General Accounting Office, <u>Experiences of Past Territories Can Assist Puerto Rico Status Deliberations</u>, Report to the Congress by the Comptroller General, March 7, 1980, GGD-80-26, p. ii. The GAO attributes the quotation to the Senate Committee Report accompanying the most recent admission act. No more precise citation is given. See the interesting discussion concerning "The Three Jeffersonian Guidelines for Statehood" in <u>Breakthrough from Colonialism: An Interdisciplinary Study of Statehood</u> by the Grupo de Investigadores Puertoriquenos (Ediorial del la Universidad de Puerto Rico, 1984) at 1115 ff.

Given Puerto Rico's level of economic development, its existing government, and federal revenue projections from official sources, there can be little doubt that Puerto Rico meets these tests, a matter discussed in the first chapter of this study.

But Puerto Rico is less developed economically than the existing states. This has raised the concern that permitting Puerto Rico to become a state would have adverse consequences both for the island and for the mainland. In particular, the island's economic development has long been keyed to tax advantages for subsidiaries of U.S. corporations that locate on the island under Section 936 of the Internal Revenue Code.[3] Opponents of statehood argue that removing this tax benefit, as would ultimately be necessary with statehood, would cause a flight of business from the island. They argue that statehood itself would result in no offsetting advantages and Puerto Rico itself has no special advantages. Thus, opponents of statehood believe that Puerto Rico would again become the "poorhouse of the Caribbean," as it was in the late-1940s.

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[3]Section 936, like its predecessor Section 931, in essence provides tax exemption for the subsidiaries of mainland corporations operating in Puerto Rico and other possessions. This is admittedly a simple statement of the workings of the provisions. The provisions were and are complex, and some of the complexities are discussed later in the text.

This horror story continues with two further observations. The first is that island residents, including businesses, would have to pay federal taxes on island income (from which they are now exempt), together with island income taxes that are already as high as federal income taxes. These alone, opponents say, would serve as further cause to abandon Puerto Rico. But with "936 companies" fleeing the island, island incomes would fall, requiring yet higher tax rates as well as cuts in public spending and employment. This downward spiral would further reinforce the supposed damage done by the end of Section 936.

The second observation is that island residents would, for the first time, receive full federal social benefits which, opponents of statehood argue based on present budget estimates, would provide sizable incentive to become, and remain, unemployed. The end of statehood, according to its opponents, would be an economic wasteland surviving only as a welfare state--posing a constant, limitless fiscal drain on the mainland.

The remainder of this study (Chapters II-VI) dissects and repudiates this horror story point by point. In addressing these issues, it is important to remember two key facts. First, virtually every state has been "underdeveloped" when admitted to the union--as indeed, the first states were mere backwoods colonies. This did not mean that these states did not meet the basic economic test for statehood discussed above, as does Puerto Rico. Nor did it mean that statehood was not a good decision for both the territories and the existing states, as it would be with Puerto Rico.

Second, it is not the uniformity of the states, but rather their diversity, that is key to America's economic well-being. The economic strength of the union has come from the unification of diverse areas with different strengths and weaknesses. Each unique area then augments and reinforces the strengths of the others, while lessening the importance of each region's weaknesses.

For this reason, it is necessary in Chapter II to examine the development question: What will replace Section 936 as an incentive to create jobs and income on the island? Commonwealth advocates tend to argue that, compared to other foreign locations, Puerto Rico has little to offer except 936. This is simply not true, but to the extent it may contain any truth, the truth stems not from the fact that Puerto Rico has little to offer by comparison with other states, but from the fact that Puerto Rico is a foreign location. Investors view foreign investment differently than domestic investment, and apply much narrower criteria as to what is important. They also demand a higher return from foreign locations. The same is true for most Americans, whether they might come as tourists or as new residents.

Statehood removes Puerto Rico from the shadow of uncertainty over its institutional future and the limbo of ignorance that accompanies its present ambiguous status. It moves Puerto Rico from the "foreign" column to the "domestic" column in the roster of places, and into American investors' and tourists' perceptions of their country. Compared to other states, the island has much to offer. The consequence should be an increased willingness to visit and to locate in Puerto Rico to take advantage of its natural strong points--its climate, its strategic location vis-a-vis Latin America and the Caribbean, and its educated, skilled, and able population. The same strengths should likewise induce foreign firms to locate there when they look to establish themselves in the U.S.

Statehood should also turn the commonwealth's efforts at economic development from an unhealthy obeisance to a single principle--tax haven dependency on Section 936--to more diversified efforts. To some extent, the continuing threats to 936 have served to encourage such efforts already. In the end, the existing commonwealth's prime weapon in attracting new investors--Section 936--is something they neither own nor control.

In Chapter III, we discuss what this might mean for the island's further development in terms of sectors and industries, development based more naturally on the island's strengths than is the case under Section 936. We see a continuing role for manufacturing, scope for expansion of services, particularly in the regional context, enhanced tourism, and a rebuilding of agriculture on a new foundation. At the same time, it is well to remember that the judgments registered here rest on a knowledge of today's economy, not the future economy. But speculating on the specifics of the future is more risky--and much less important--than providing the fundamental basis for new activity in whatever economy the future brings. After all, California was admitted to the union because of its gold deposits.

In Chapter IV, we review the quantification of statehood provided by others and use the recently developed CBO[4] model of the island economy to examine the impacts of potential changes under statehood. From this it is clear that statehood can easily

[4]Congressional Budget Office, "Potential Economic Impacts of Changes in Puerto Rico's Status Under S.712," CBO Papers, Washington DC, April 1990.

improve upon the economic performance of the current commonwealth relationship.

Having addressed the jobs issue, the prime mover of the horror story, we turn in Chapter V to the question of governance. Why is the island's government so large; how can it be made smaller; and won't this, in turn, cause grave dislocation? The answer lies in its history, different from the mainland. This difference is not immutable, and the Chapter shows that the necessary steps can be taken with a modicum of sacrifice and no dislocation.

As the final piece of the horror story, we turn in Chapter VI to the question of welfare benefits. We ask whether the new federal benefits, apparently so large, will turn Puerto Rico into a welfare state. Again, the answer is encouraging, primarily because the additional benefits are targeted to the aged, blind, disabled, and to children. All of these are admittedly deserving, and the added benefits run little risk of discouraging work--as CBO itself has recently acknowledged. Nor does history offer any evidence that existing entitlement benefits have had perverse effects on the island's residents.

It may appear natural that this study, presented as it is on behalf of statehood and sponsored by the statehood party, should provide a defense of the island's future under statehood. And it does so. But before dismissing it on these grounds, the reader is cautioned to examine the analysis. The economic future of the island is a question of economic development, about which economists have little to offer that is not typically a product of common sense. For this reason, the bulk of the study does not rest on obscure theorizing or the ceremonies of economic arcana that are ill equipped to quantify the effects of institutional changes on newly developing economies. Both its analysis and its conclusions are, therefore, by and large accessible to the concerned and literate citizen.

I. PUERTO RICO SATISFIES TRADITIONAL ECONOMIC REQUIREMENTS FOR ADMISSION AS A STATE

A. The Traditional Economic Criterion for Admission as a State is the Ability to Support State and Federal Governments

As cited earlier, the key economic condition for statehood has been the potential of a new state to support the apparatus of state and federal government. The need for this condition stemmed naturally from the fact that candidate territories were typically backwoods areas with limited settlement and economic bases. From an economic point of view, imposing a low hurdle to admission was appropriate because once territories reached a certain minimal level of economic development, they could develop further to the level of existing states as part of the union by supplementing and complementing the existing national economy.[5] Indeed, economic development in Puerto Rico, because it has not taken place this way, may have been increasingly distorted.

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[5]A review of such documents as the 1980 GAO report and the comprehensive Breakthrough from Colonialism makes this development clear. Although opponents of statehood in many cases raised concerns about the level of development, such arguments ultimately proved futile. For example, one argument levied against the admission of this author's home state, Illinois, was that its citizens were "ignorant." (Breakthrough From Colonialism, Vol. II at 1265.)

A territory seeking admission was not required to provide a state government whose level of taxes and spending met some comparability with existing states that were at a higher level of development and had more advanced economies. Rather, it was required to have the population and resources to support a state government. Indeed, many new states were endowed upon admission with federal lands and resources precisely to endow the state government so that it could perform its functions.[6]

Similarly, and although all previously admitted territories, unlike Puerto Rico, were already part of the federal tax system, the test was whether the candidate had sufficient population and resources to pay a share of the cost of federal government. But the magnitude of this share was not addressed, nor would it be appropriate today to set a formula for such a test. Currently, states vary widely in the ratio of their receipts from the federal government to their contributions to it, with many states being net recipients by wide margins.[7] It is possible that Puerto Rico would remain a net recipient for many years--as are

[6]See Breakthrough From Colonialism at 1148-1156 for an enumeration of these endowments.

[7]In 1988, 28 states received more in federal funds than their residents paid in federal taxes, according to the Congressional Research Service. L. Rymarowicz, "CRS Report for Congress: Federal Tax Payments by State Residents and Federal Expenditures in Individual States, Fiscal Year 1988," U.S. Congressional Research Service, January 23, 1990.

28 states today. But this is not a bad fiscal deal for the 50 existing states. Continued commonwealth means a larger--perpetual--drain from the federal government, with no contribution to tax revenues.[8] As is shown in Figure 1, the change is marked.[9]

B. Puerto Rico has the Population and Resources to Meet and Exceed the Requirement

In the case of Puerto Rico, the economic threshold for statehood is obviously exceeded. Though the breadth of its resources and potential are discussed in Chapters II and III, it

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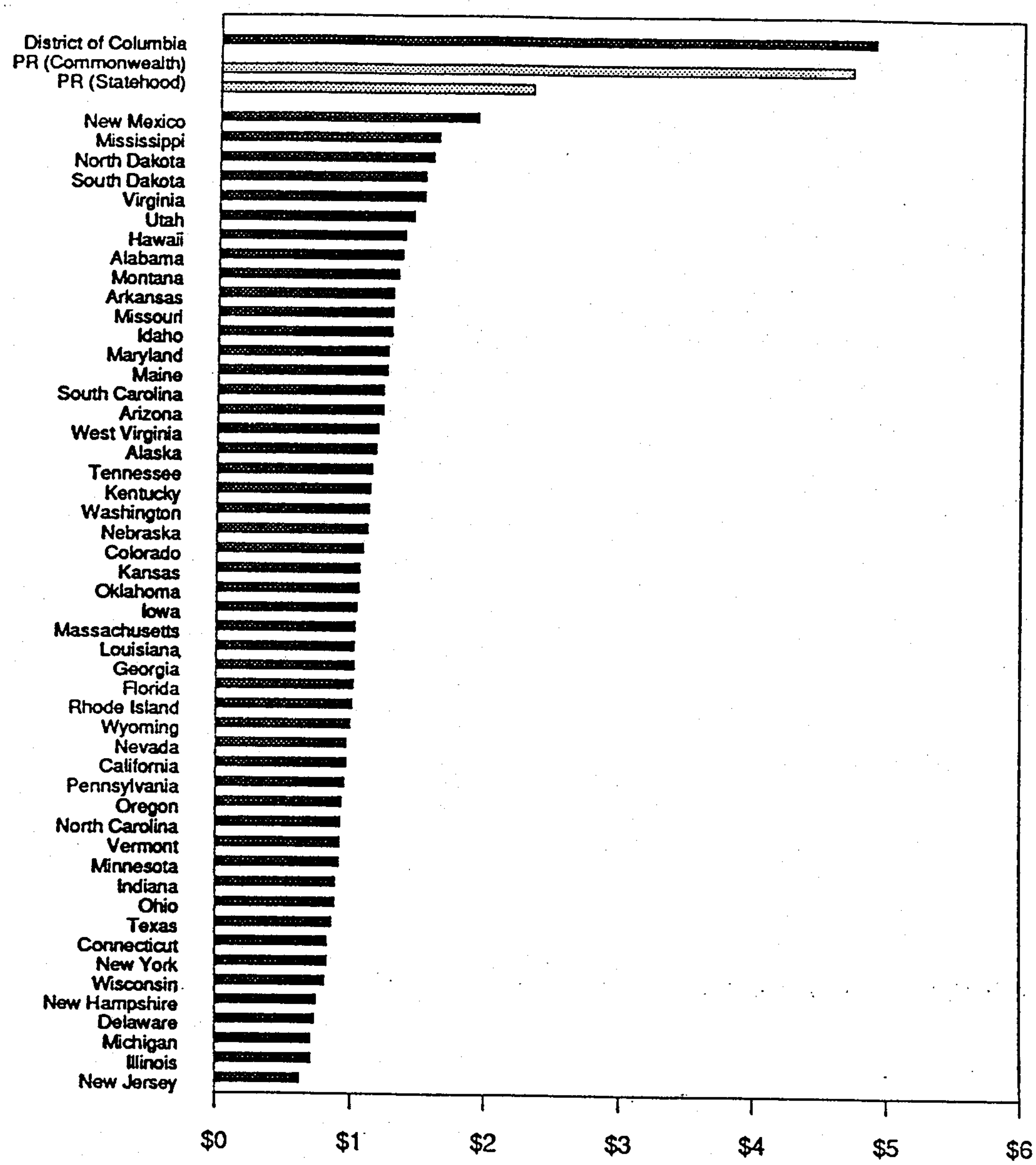
[8]CBO cites Bureau of the Census data showing $6.2 billion of federal spending in Puerto Rico in 1988. In addition, revenue losses from Section 936 were equivalent to outlays of $2.7 billion in that year. Meanwhile, for approximately the same period, residents of Puerto Rico paid about $1.5 billion in contributions for social security and related programs such as civil service retirement. Island residents paid no U.S. income taxes on island incomes. (CBO, "Background Materials on the Costs of the Puerto Rico Status Referendum Act," prepared for the Committee on Finance, United States Senate, November 15, 1989; U.S. Executive Office of the President, Special Analyses; Budget of the United States; Fiscal Year 1989, Special Analysis G, at G-40; and Junta de Planification de Puerto Rico, Apendice Estadistico, Informe Economico al Gobernador 1989. Table 21, Data for Puerto Rico's Fiscal Year, July 1, 1987-June 30, 1988.)

[9]The computations in Figure 1 are based on information provided in Kiefer, D.W., "Treating Puerto Rico as a State Under Federal Tax and Expenditure Programs: A Preliminary Economic Analysis," Congressional Research Service, September 7, 1977, together with income and demographic data for 1987. Note Residents of Puerto Rico now make payroll contributions to social security and other social insurance funds, but pay no other federal tax.

Figure 1
Dollars of Federal Expenditure per One Dollar of Revenue, FY1987



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is worth noting that Puerto Rico's population currently exceeds that of 23 states.[10] The island is one of the most densely populated areas in the world, with almost 950 persons per square mile in 1987; this is 14 times greater than that of the United States as a whole and is comparable to Rhode Island, which has a population density of 935 persons per square mile.[11] The population inhabits an island roughly two-thirds the size of Connecticut.

Puerto Rico has an increasingly experienced and educated work force, and a unique culture reflecting both its nearly 500 years of Hispanic heritage and its long-held ties with the United States.[12]

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[10] U.S. Bureau of Census, Statistical Abstract of the United States: 1989 (109th edition), Washington, DC 12988.

[11] The Economist Intelligence Unit, Country Profile: Puerto Rico, 1988-1989, p. 43; Statistical Abstract of the United States, pp. 18-19.

[12] In a number of studies, groups advocating the retention of Section 936 have repeatedly praised the level of skills, productivity, and work attitude of the island's work force, even though such praise was largely beside the point of their studies. Such studies report, inter alia, that island subsidiaries do not merely employ island residents, they are also largely managed by native islanders. See Impact of Repeal of Section 936 on Puerto Rico's Economy, Booz, Allen & Hamilton Inc. for the Puerto Rico Manufacturer's Association (May 1985) for one such study.

As befits a small but densely populated island economy with no significant mineral resources, its population is its greatest resource. Their education and training, then, is the island's most important task, and its success in that task--together with enhancing the health of its population--has been the measure of the economy's advance:

- In 1950, of the population age 25 and older, 8.3 percent had completed high school and 3.4 percent had completed college. By 1980, 33.8 percent had completed high school and 18.5 percent had completed college--and 42.5 percent of the population was bilingual in English and Spanish.[13]

- From 1970 to 1987, the percentage of persons aged 18-24 attending college more than doubled from 17 percent to 40 percent.[14] At present, over 25 percent of the population over age 25 has completed college.[15]

- Puerto Rico has 18 United States accredited universities, the oldest founded in 1903.[16]

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[13]U.S. Department of Commerce, "General Social and Economic Characteristics: Puerto Rico," Census of the Population, 1960, 1980. The question of bilinguality, and the accuracy of its measurement, are addressed further in Chapter III.

[14]U.S. General Accounting Office, Puerto Rico: Information for Status Deliberations, Briefing Notebook for the Senate Committee on Energy and Natural Resources, June 15, 1989, pp. 7-14.

[15]Booz, Allen & Hamilton, p. II-2.

[16]Profiles of American Colleges (New York: Barron's Educational Series, 1988), pp. 1048-1060. Liebman, A., The Politics of Puerto Rican University Students (Austin: University of Texas Press, 1970) p. 9.

Thus, although Puerto Rico is admittedly less developed economically than the mainland states, it is hardly a backwoods settlement. Furthermore, not only is its per capita gross domestic product (GDP)[17] higher than that of any other sovereign nation in the Caribbean and Latin America, except the Bahamas,[18] it is also as high as those of several nations that are members of the Organization for Economic Cooperation and Development (OECD).[19] In 1987, GDP per capita in Puerto Rico was $7,214 compared to Portugal at $6,300, Greece at $6,365, Ireland at $7,546 and Spain at $8,677.[20] In this light, it is more accurate

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[17]Gross domestic product is the market value of production within the domestic boundaries. In contrast, gross national product (GNP) is the market value of production by domestic nationals, wherever located. For the U.S. as a whole, the two measures are quite close. For smaller and more open economies, the two may be quite different, as is the case for Puerto Rico, where a significant portion of the value of production (GDP) on the island flows as income to mainland nationals (U.S., but not Puerto Rican, GNP).

[18]Statistical Abstract of Latin America, Vol. 27 p. 991.

[19]The OECD is the international economic treaty organization of democratic, industrialized nations. It is often referred to in the popular press as "the Rich Man's Club." The income level in Puerto Rico also exceeds that of the non-OECD countries, Taiwan and South Korea, recently viewed as "Newly Industrialized Countries."

[20]These comparisons are based on purchasing power parity exchange rates to more accurately reflect longer-term dollar values; use of current exchange rates would not fundamentally change the comparison but would slightly alter the ranking of countries and the levels of GDP in dollars. OECD, National Accounts, Main Aggregates, 1960-1987, February 1989, pp. 130-31, 153.

to think of Puerto Rico as quantitatively behind the present condition of the mainland states, but not qualitatively at a different level of development. This is much the same way as the poorer nations mentioned above are viewed by others, including the United States, in the context of the OECD.

C. Puerto Rico's Commonwealth Government is Already Indistinguishable From a State Government in Most Relevant Respects

For roughly 40 years, Puerto Rico has supported a democratically elected government that performs all of the functions of a state, in addition to its earlier experience with more limited self-government under both the U.S. and Spanish flags.[21] In 1989, residents of Puerto Rico paid about $1,000 per capita in income, sales and property taxes, a number roughly comparable to those for Iowa, Virginia, and North Carolina.[22]

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[21] Little known to the mainland is the fact that Puerto Rico achieved autonomy and extensive self government prior to the commonwealth era. In 1898, after more than 100 years of "status politics," as they are called today, Spain granted a charter of self-government, which also gave the island full representation in the Spanish Cortes. Eight days after the island's legislature opened, the U.S. invaded Puerto Rico. (J.L. Dietz, Economic History of Puerto Rico; Institutional Change and Capitalist Development, Princeton University Press 1986, p. 76.)

[22] Comparative figures on commonwealth government finances are available in U.S. General Accounting Office, Puerto Rico: Information for Status Deliberations; Briefing Notebook for the Committee on Energy and Natural Resources, U.S. Senate, June 15, 1989, p. 6-5. See especially Chapters 5 and 6. The Notebook

The commonwealth government received about the same amount, per capita, in federal grants and intergovernmental transfers as the average state.[23] On the broadest measure of revenues per capita, the commonwealth at $3,168 is roughly comparable to the $3,462 average of the states, notwithstanding the much lower income level on the island.[24]

These indicators are important because they demonstrate that Puerto Rico, although admittedly less economically developed than the states, is far in advance of what has been expected from a new state in the past. For many years, Puerto Rico has supported a government equivalent to that of a modern state, with all of the obligations and services that implies.

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used the most recent figures available at the time that document was prepared--1987 for the United States and 1989 for Puerto Rico. More recent final figures for 1989 are available for the island in Apendice Estadistico of the Informe Economico al Gobernador 1989, Junta de Planification de Puerto Rico. The figures for other states are for 1988 and are from U.S. Bureau of the Census, State Government Finances in 1988, December 1989.

[23]Excluding federal government payments to public corporations such as electric power, telephone service, various credit corporations, and sugar marketing, the figure for Puerto Rico is $341 against an average of $472. If public corporations are included, the numbers are $536 and $472 respectively.

[24]The use of the bottom line to Table 6.2 of the GAO notebook is problematic (as pointed out in the Notebook) because of differences in the classification of state revenues from the sale of goods and services. As mentioned later in the text, the commonwealth government owns such services as electric power and telephone, a factor which distorts comparisons.

Although these services are not always, in some respects, up to the level of current states on average, they are typically comparable to the poorest states and often exceed them. Indeed, the commonwealth itself is responsible for a number of government enterprises once thought particularly progressive, such as electric power, agricultural marketing (sugar), telephone services, and shipping.[25] Moreover, the commonwealth has long been involved in developmental credit provision, a role only recently added to the portfolio of governmental activity in a number of states.[26] Overall, the commonwealth government spends roughly the same per capita as the average of all states.[27] Hence, notwithstanding Puerto Rico's level and structure of economic development, its government is even now largely equivalent to that of a state.

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[25] In important respects, some of the functions undertaken by the commonwealth government are a historical legacy of the New Deal era. These activities, which mirror some types of functions once undertaken by the federal government on the mainland, played an important positive role in fostering island development. Their adequacy to present day economic needs is a topic of debate there just as such activities have been on the mainland--and in other countries around the world. These matters are discussed in Chapter V.

[26] National Association of State Development Agencies, Directory of Incentives for Business Investment and Development in the United States (The Urban Institute Press: Washington, DC, 1986).

[27] U.S. General Accounting Office, 1980, p. 6-7.

D. Under Statehood, Puerto Rico Will Make a Fair Contribution to the Federal Fisc

Attention has been focused on the fact that federal expenditures will increase under statehood--relative to commonwealth--because statehood would require that U.S. citizens resident in Puerto Rico receive full federal entitlement benefits, which they do not now receive. Reasonable estimates of these additional outlays entail added federal spending by the year 2000 of about $3-4 billion annually, and cumulative totals from 1992 to 2000 of about $22 to $30 billion.

Even if this were all the story--and it is not--it would not imply that statehood would be inappropriate. The test of statehood has been that of a "fair contribution," and many states receive more in benefits from the federal government than they pay in taxes. The same estimates also show island residents paying over $2 billion per year in federal taxes by 2000, taxes of a type they do not now pay.

But omitted from the foregoing estimates are the additional tax revenues the federal government will receive from possessions corporations--island subsidiaries of U.S. corporations currently exempted from tax under Section 936. These newly taxable companies will, after a phase-out period for 936, be paying about $4 billion per year by the end of the century.

In consequence, the full effect of statehood is to turn an annual surplus for the Treasury--again compared to continued commonwealth--beginning in 1996 or 1997, depending on the estimate. **By the Treasury's own estimates of the current proposal for transition, the cumulative impact of statehood up to the year 2000 is a surplus for the Treasury of $1.7 billion.**[28]

This raises a question as to whether the transition provisions of S. 712 are adequate to their purpose. The transition ought to be designed to minimize any adverse impact arising from the change in institutions. Recent estimates of the economic impact of statehood by CBO, discussed later in this study, raise a question as to whether, rather than turn a surplus, the transition budget impact ought to be at least as generous as for continued commonwealth. In every prior admission

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[28]These estimates are based on preliminary data circulated by the relevant agencies in the context of discussions over S. 712. Naturally, they are likely to be revised, but it is unlikely that the qualitative result will be altered in later estimates. In any case, given the economic uncertainty surrounding transition to statehood, as discussed later in this report, no precise estimates can be made. However, the key point here is not the precise size of the contribution to federal receipts, but that the new state of Puerto Rico would, under any realistic scenario, make a fair contribution to the federal government.

of a new state, similar transitional aid--and often more generous--has been given in the form of grants, particularly of valuable land.[29] These monies today, when remembered at all, are seen to have been well spent. Puerto Rico should be no different, but the amount of land available for grant is negligible.

Once a state, Puerto Rico will remain a state for our children and our children's children. A reasonable test, then, is whether it is likely that, from the point of view of the fisc, the transition "deficit" will roughly balance or turn positive in a reasonable amount of time, rather then be a tax burden on our children. It is on this fact that the revenue and outlay estimates tend to be reassuring: The balance turns positive in a few short years, and remains positive thereafter.

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[29]See Breakthrough from Colonialism, op. cit.

II. THE ECONOMIC THESIS OF STATEHOOD: BECOMING A STATE WILL MAKE A FAVORABLE DIFFERENCE TO INVESTORS

Although the primary impetus to the desire of Puerto Ricans for statehood is dignity--the desire of island residents to be equal in rights and duties to every other American citizen--the impetus also has a secondary component that is economic. This component is the thesis that Puerto Rico exists in an economic limbo parallel to its political limbo, neither "foreign" nor "domestic" to the U.S. Because it is a "commonwealth," a territorial relationship unfamiliar at best--and, more commonly, simply unknown--to most Americans, and because of the island's unique mix of Hispanic and North American culture, it projects an aura of the foreign. Yet in laws and governance it is domestic--with exceptions and footnotes.

It is further saddled with the reputation of its earliest immigrants to the mainland: Immigrants unskilled, uneducated, untutored in English, were unprepared for life in a modern industrial country. Having settled in New York City, and later a few other major cities, many formed their own protective ghettos, and were caught--for reasons of language, color, and custom--in the cycle of urban poverty in which a number of their descendants still struggle.[30] Thus, island residents, though now different in essential ways from those immigrants and their children, must still overcome the image of West Side Story.

Finally, the island is ensnared by the program that gave it economic life. The wonder of Operation Bootstrap, which made Puerto Rico the first industrialized tropical island, now serves as a political and economic trap. This velvet trap--relatively well furnished but nonetheless a trap--has created powerful political and economic interests for whom the maintenance of their privileges is more important than the political dignity of the island's citizens. Moreover, it has ensnared the authorities' policies in a view of economic development keyed solely to tax avoidance, rather than to the broad fundamentals upon which sustainable economic development has been shown to rest.

It is the economic thesis of statehood advocates that admission to statehood can help to break these three entangled chains that hold the island's economy prisoner. By putting the

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[30]The National Commission for Employment Policy, a federal bureau, has studied the experience of Puerto Rican migrants to the mainland. Their analyses may be found in Hispanics and Jobs: Barriers to Progress, 1982 and in Carol J. Romero, "Services to Hispanics in JTPA: Implications for the System," U.S. NCEP, April 1989.

island squarely in the ranks of the "domestic," its foreignness will be recognized as another panel in America's colorful quilt, rather than a vacuum, an ambiguity, or a danger to be overcome with tax incentives. The enhanced awareness of the island can also help to overcome the ghetto image that haunts its people. Finally, in breaking the ties of tax privilege, statehood will force the island from the cage of corporate welfare and free it to devote its resources and political efforts to their best natural advantage. Among those resources will be political power long denied it, power which also has an economic reward. The remainder of this chapter examines this basic economic thesis of statehood.

A. The Fading Miracle of Operation Bootstrap

Beginning with the introduction of "Operation Bootstrap" in 1948, Puerto Rico commenced its rapid industrialization. The program itself was, in the circumstances of its time, an act of genius. Whereas aid given to most less-developed countries has tended to yield only marginal success, Puerto Rico's development program was for many years an unqualified success.[31]

[31] A summary of Operation Bootstrap is provided in every economic study and economic history of Puerto Rico, and the one given here accepts the conventional wisdom as it applies to history. However, not all data uniformly support the conventional wisdom. As of the 1980 Census, income in Puerto

Prior to the 1950s, Puerto Rico was predominantly a poor agrarian society. In 1950, 44.6 percent of the work force was located in agriculture or home needlework, while only 9 percent was in manufacturing. Per capita personal income was $296. Wages on the island were far more comparable to those in less developed countries than to those on the mainland.

The program built on the base of Section 931 of the Internal Revenue Code, the predecessor of Section 936, which exempted U.S. corporations from tax on income earned in U.S. possessions. The provision had been adopted to give U.S. corporations in the

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Rico was roughly half that of Mississippi. The same was also true in 1970, 1960, and 1950. This suggests that the main effect of Operation Bootstrap may have been to tilt the development of the island away from its natural advantages and toward less appropriate industries while leaving the level and speed of development relatively unaffected. Under this alternative hypothesis, the level and pace of development were determined not by the tax benefits, but by the progressive integration of the island into the mainland economy through trade, travel, common customs barriers, monetary union, and the increasing skill level of its work force. The consequence would have been to pull the island's economy up at the same pace other poor regions were also pulled up by the mainland engine. This is not to deny the genuine hard work, thoughtfulness, and energy of island residents that went into the success of Operation Bootstrap. What is of greater import from the perspective of economic development is that the income generated by industrialization has gone toward the education of the island's population.

Philippines parity with the tax treatment of corporations from other nations active there.[32]

The native genius of Puerto Rico's program was to augment Section 931 with local tax exemptions, with pro-development programs that further enhanced these effects by providing infrastructure, inexpensive factory space, a cooperative government, and skill training for workers, and with an active program of marketing and promotion.

The success of the program, though evident today, should not be taken for granted. It rested on the idea that incentives for private investment, and the results of that investment, could be more effective in enhancing economic growth than could the more centralized planning model it supplanted--and that was common throughout the developing world until very recently.[33] Though

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[32]The main difficulty with Section 931 was the disruption caused by its failure to exempt dividend remissions excepting the return of capital when a subsidiary was liquidated. This led companies to terminate subsidiaries when they wished to repatriate dividends, then to open another subsidiary. The disruptive effect of this lacuna was remedied by the replacement of Section 931 with the present Section 936 in 1976.

[33]The past decade has witnessed a crisis in many less developed countries caused variously by the worldwide recession and disinflation of the early-1980s, the ensuing debt crisis, and later deep falls in oil and other commodity prices. This has led to a renewed interest in development models based on expansion of the private sector, which goes under the name of "structural adjustment." See, for example, recent annual issues of the World

remnants of planning and its intellectual inheritance still remain, the enlightened vision of Puerto Rico's leaders--Munoz-Marin and Moscoso in particular--and the effectiveness of the people of Puerto Rico who executed the vision, cannot but be admired.

The effectiveness of the program--at least until recent years, can be measured by the leading role that manufacturing played in the development of the island's economy. For make no mistake, the original vision was to turn Puerto Rico into an industrialized economy, a vision then typically associated with development. Figure 2 shows the evolution of manufacturing's share of gross national product and of the share of manufacturing employment in total employment through 1989.

The limits to this basis for development have only begun to show itself in recent decades. The program has become

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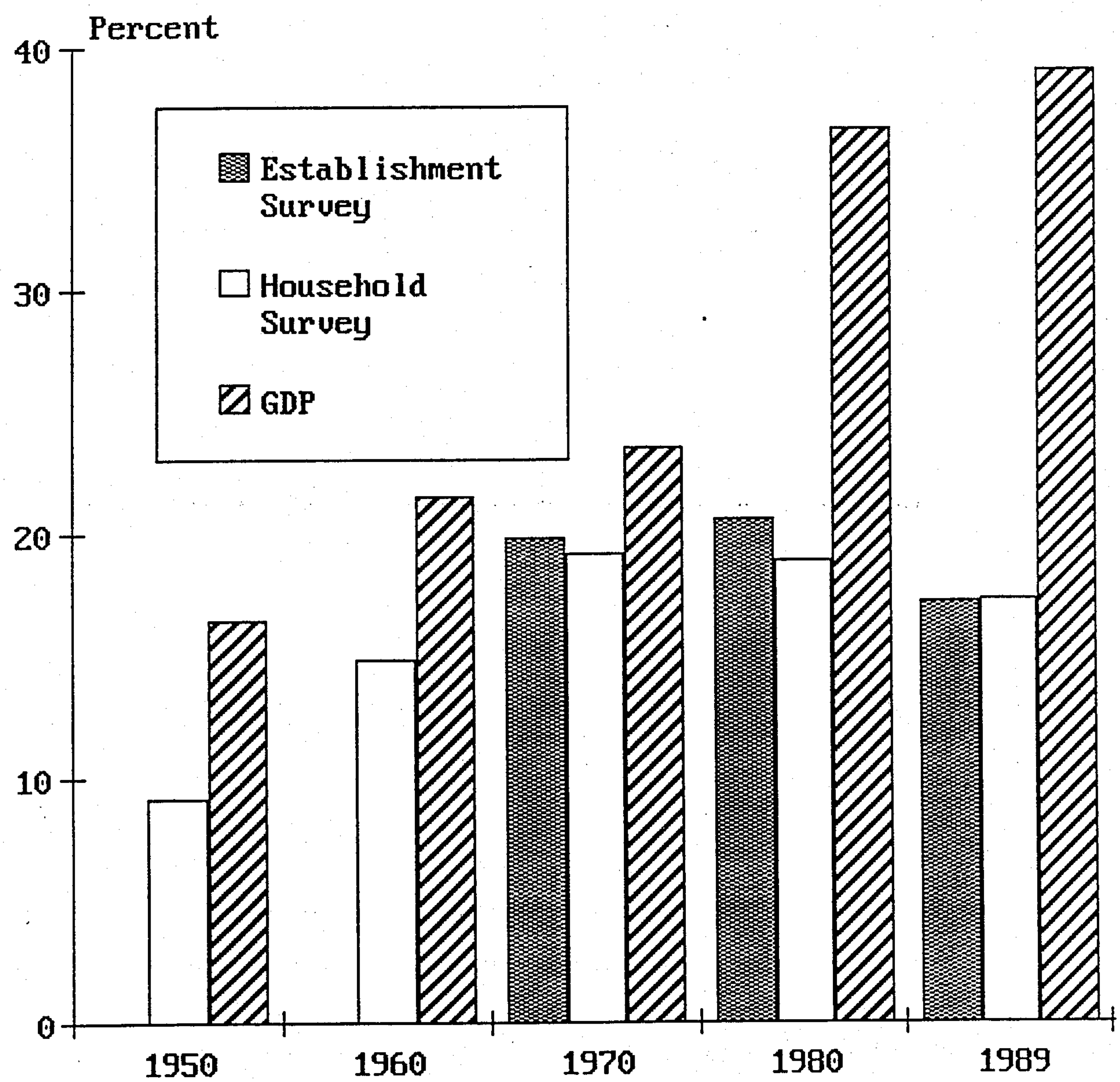
Bank's <u>World Development Report</u>, as well as, for developed countries, the OECD Secretary General's 1987 report <u>Structural Adjustment and Economic Performance</u>.

Figure 2

Manufacturing as a Share of Total Employment and GDP



Sources: Puerto Rico Planning Board,
Puerto Rico Bureau of Labor Statistics

increasingly ineffective in promoting manufacturing employment[34], even as the rest of the economy continued to grow.

One can identify two reasons for this evolution. The first of these is that the economic environment has changed, both in terms of the institutional forces that made the program effective and in terms of the overall thrust of economic advance. The second is that, in the context of this changing environment, tax avoidance has become a driving force for firms moving to the island.

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[34]The figure shows two bars for the employment share beginning in 1950. The bar appearing in each year is from a survey of households, which would normally be expected to provide a relatively accurate picture of total employment and of employment in certain small sectors such as retailing, wholesaling, and sectors in which self-employment is important. The second bar, available since 1970, is based on an annual census of manufactures in 1970 and a survey of establishments thereafter. The established survey tends to give a more accurate picture of employment in sectors where larger establishments are present, such as in manufacturing. This accuracy is enhanced by the more frequent redrawing of the sample of establishments than of households. Discrepancies between estimates for manufacturing employment in the early-1980s suggest the household survey should be distrusted during that period. The household survey at that time, based on a decennial census from 1970, most likely fell prey to population movements and migration connected to the economic shocks of the 1970s. By 1989, the manufacturing data for the two samples was again quite close. On the accuracy of the several data sources, see Miguel A. Prospero Altiery, Director, Negociado de Estadisticas del Trabado, "Differencias Entre los Estimados de Empleo en la Manufactura Derivados de la Encuesta de Hogares y de la Encuesta de Establecimientos," Negociado de Estadisticas del Trabajo, Departamento del Trabajo, Estado Libre Associado de Puerto Rico, Octubre 1974.

In the earliest years of the program, Puerto Rico had a vast reserve of inexpensive unskilled labor, like many other less developed countries. U.S. firms in those years, broadly speaking, were less global in their orientation. Firms in such labor intensive industries as apparel and shoes, and those with simple assembly operations found that they could use Puerto Rico as a nearby manufacturing base within the legal structure and tariff walls of the United States. Investment requirements were minimal and largely provided by the commonwealth. Marginal tax rates to be avoided were quite high--52 percent between 1952 and 1964.

But in recent years these fundamentals have changed. With the gradual introduction of mainland minimum wages, unskilled labor became as expensive as mainland unskilled labor. At the same time, improvements in transportation and communication, increased security for private enterprise in a number of less developed countries, and the general globalization of the vision of large American companies made the use of cheaper unskilled labor in Asia much more acceptable, secure and profitable. Both mainland tariff and tax rates have come down in recent years, lessening the tax incentive to location in Puerto Rico. Other countries began to offer favorable tax havens, Ireland in particular.[35] These effects were temporarily fortified by the period of the high dollar in the early and mid-1980s.

As these events occurred, a different type of company began to come to Puerto Rico to take advantage of Section 936, which replaced Section 931 in 1976. These companies tended largely (though by no means exclusively), to be outcomes of the high-tech era--electronics, pharmaceuticals, and medical equipment, to name just a few. The evolution was gradual. It rested on both real and tax-related advantages. The real advantages were that Puerto Rico had, over the years, established a relatively modern infrastructure, including transportation and communication

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[35] It may not come as a surprise that Ireland finds itself in similar circumstances to Puerto Rico. In 1950, the Irish Republic adopted a program similar to Operation Bootstrap, with guaranteed tax holidays for high-value-added manufactures, reinforced by infrastructure and investment grants and employment training. It now finds itself in the position of being a "dual economy" in the words of one OECD study, with a sophisticated expatriate manufacturing sector producing few jobs, and a less developed sector producing less but employing many more, high unemployment and significant emigration of skilled workers. The difficulty there, as in Puerto Rico, is compounded by the reduction of the domestic tax base stemming from the tax exemption for foreign manufacturers, who require public spending for the provision of infrastructure, capital grants, and subsidized facilities. The implicit revenue loss must be made up by high taxation on domestic residents and domestic businesses, further encouraging emigration, making labor expensive (given the high <u>nonwage</u> labor costs), and discouraging capital accumulation by potential domestic entrepreneurs. (OECD, <u>Economic Survey of Ireland</u>, 1984/85, p. 43.) (Unfortunately, much critical analysis of the Irish economic program undertaken by the OECD is not available to the public.)

systems. By 1980, its younger population had education equivalent to that on the mainland, offering a pool of skilled labor and a cadre of business managers that were available at much lower wage levels than on the mainland. This provided an environment for more capital intensive firms.

Section 936 provided an incentive to utilize the environment. The incentive encourages the sourcing of profits in Puerto Rico, not the provision of jobs or income to island residents. The last are merely felicitous byproducts of Section 936. The introduction of more capital-intensive firms meant the introduction of firms with higher profit rates--that is, for whom the tax credit was more valuable. These firms provide fewer jobs, but they hire more skilled workers.

Section 936 also provided an incentive to move intangible income to Puerto Rico. In simple terms, this has meant that U.S. companies transfer their patents and other intangible assets to their island subsidiaries. Thus, a pharmaceutical house could freely transfer a patent to the island (having deducted the development cost on the mainland). It could then sell the drug, manufactured on the island, back to its parent at prices that reflected not just manufacturing cost, but also the value of the patent.

As this avenue of avoidance became more commonplace, the tax code was changed to limit it. But these limitations--together with the lowering of tax and tariff rates and other factors mentioned earlier--have served to discourage further expansions of 936 employment on the island.[36] Between 1980, the last business cycle peak, and 1989, which follows six successive years of recovery, the entire manufacturing sector of Puerto Rico

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[36]A secondary feature of the 936 "program" has been its use of tax incentives, including the "tollgate tax," to "trap" the profits of 936 companies in the island economy for an extended period before they are remitted as dividends. While there, they are intended to be devoted to various development ends, if only to making island credit cheaper. The pool of "936 funds" grew rapidly in the early-1980s, but has not increased at all since 1986, a change apparently due to mainland tax reform and tightened regulation of the pool. In the past year, the commonwealth government appears to have attempted to raise revenue to close its deficit by encouraging profit remission from the pool at reduced tollgate tax rates.

There is little indication that the program was effective, largely because the island's otherwise open financial markets provided incentive for non-936 funds to leave the island to earn higher yields and for 936 funds themselves to be arbitraged off the island where possible. Most of the pool itself was channeled into government debt (providing an incentive for the commonwealth government to borrow excessively) and into CDs and other short-term instruments unsuited to supporting long-term investment or development projects. The latest Caribbean Basin Initiative (CBI) program makes the pool available to borrowers in the CBI islands. (U.S. Treasury Department, <u>The Operation and Effect of the Rossessions Corporation System of Taxation; Sixth Report</u>, March 1989, Chapter 6 especially at 80, Robert R. Nathan and Associates, Inc., <u>A Profile of the Puerto Rico Financial System</u>, Prepared for the Puerto Rico, USA Foundation, June 1989, especially Table B-6, and Alexander F. Diaz, "936 Repatriations Boom in 1990; Outflow Blamed on Agreements Between Hacienda, 936 Companies Designed to Help Reduce commonwealth Budget Deficit," <u>Caribbean Business</u>, May 17, 1990.)

increased by an annual average of only 1,000 jobs, while in other sectors of the economy growth exceeded 140,000 jobs.[37]

No separate data on 936 firms are available on a timely basis. Thus, it is impossible to tell to what extent incremental new jobs in 936 firms contributed to the gain in manufacturing employment, as it is also impossible to identify precisely the impetus to investment spending on the island provided by these firms.

Underlying the weak job performance in manufacturing is the fact that Section 936 firms that are dependent on inexpensive labor have been leaving the island for some time, and will continue to do so.[38] This process is now further encouraged by the use of Section 936 as a tool within the Caribbean Basin

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[37]Because of the obvious inaccuracy of the household survey of employment at the beginning of this period, we have used the establishment survey. The household survey would show an increase of 154,000, of which 15,000 are in manufacturing. However, Puerto Rico conducts a complete census of manufacturing every year, the results of which support the accuracy of the data in the establishment survey. The major discrepancy between household and establishment surveys, it should be noted, casts doubt on the accuracy of a number of fundamental economic statistics derived from the household survey for the period from roughly 1975 to about 1985. Among these dubious statistics are labor force participation rates, and unemployment and employment rates.

[38]CBO reports an attrition rate of about 2.5 percent per year. (BO Papers, April 1990 at 20.)

Initiative, an arrangement permitting "twin plants." For example, a firm can set up labor intensive operations in such cheap-labor locations as the Dominican Republic, and higher value-added operations (with lesser labor requirements) on Puerto Rico. The whole of the operation acquires 936 exemption.[39]

The critical consequence of these developments for the 936 program in Puerto Rico is to give it less "bang for the buck." That is, in labor intensive operations with low profit margins, the U.S. Treasury realizes a relatively small revenue loss per job created. In capital intensive operations the cost per job is significantly higher, though the island also benefits during the initial stage to the extent investment in plant and equipment require island-based inputs. In intangible-intensive operations, the cost per job is much higher still, and the island benefits

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[39]For a recent summary, see commonwealth of Puerto Rico, Economic Development Administration, "Puerto Rico's Caribbean Development Program; An Update," July 6, 1989. The document attributes 61 projects to the program, projects providing 3,832 jobs in Puerto Rico and 10,284 jobs elsewhere in the islands. Because these are "jobs promoted" according to FOMENTO's definition, their realization remains open to question. Indeed, the accuracy of these statistics have been questioned in oversight hearings according to "Congress Asks Why Section 936 Funds Are Not Reaching the Caribbean," Tax Notes, April 9, 1990, at 133-135. (See also Jeff Lazo, "Baxter Reshuffle Bodes Well for Costa Rica; Company Restructuring Forces 10 Percent Reduction in World Work Force, Toa Alta-Produced Pharmaseal Products to be Moved to San Jose," Caribbean Business, April 12, 1990; "Searle Will Give Costa Rica a Boost; Twin-Plant Contest Heating Up Among CBI Countries Since Dominican Republic's Approval of Tax Treaty," December 28, 1989.)

from the intangibles neither through research and development spending nor through investment spending on tangible capital goods, though it acquires some familiarity with operations in the most technologically advanced sectors. Here, the revenue loss is very large per job created. For example, the most recent Treasury Report on the operations of companies enjoying 936 benefits showed the average cost per 936 job, as measured by lost tax revenues, at $18,523 in 1983, but at $57,761 in the pharmaceutical sector. These represent, respectively, approximately 125 percent and 265 percent of payrolls.[40]

The decline in the effectiveness of Section 936 can be measured by the revenue loss per incremental job which, in raw dollar terms, is about $1 million annually per net new job created between 1980 and 1989. Adjusted for inflation, the figure is $576,000 in 1989 dollars.[41]

This figure is computed from the last cyclical peak in manufacturing employment, which should again be near its peak today. If one instead goes back to 1973, the peak before 1980,

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[40]Treasury Department, Sixth Report, at 47.

[41]Data on revenue losses may be found in U.S. Office of Management and Budget, Budget of the United States; Special Analysis G, for the years 1982 and 1990. Employment statistics are from the island's establishment survey, discussed earlier.

one sees that manufacturing has added only about 500 jobs per year in the ensuing 16 years, most of which was obviously prior to 1980.

It is possible to argue with these figures, but the arguments have little merit. One can pick a more recent period to find greater job increases, but these represent the usual results of a cyclical upturn, and the rest of the private sector shows more dynamic growth. Nor can 936 manufacturing be said either to represent a cushion that somehow buoys the island economy during recession or a starting motor to bring the economy out of a dip. During the recession of the early-1980s, manufacturing employment fell by 10 percent, shedding 15,000 jobs between the 1980 peak and the 1983 trough, before commencing a slow return to its original level, a level not much below where it stands today. In contrast, other <u>private sector employment</u> fell only about 7 percent from its peak to its trough, and total public service employment, including public enterprises such as power, telephones, and shipping, fell by 6 percent. Over the whole cycle, when manufacturing added just 1,000 jobs, the rest of the private sector added 94,000 jobs and public employment added 53,000. This pattern is consistent with the usual cyclical volatility of manufacturing, and points up the fact that most investment and employment in island manufacturing now is an integral part of the mainland manufacturing sector, with the role of 936 now limited to providing one incremental incentive to attract new firms to the island. Meanwhile, job growth lies overwhelmingly outside the manufacturing sector.

Instead of a selective use of data from the business cycle recovery, one could argue that had policies been more favorable, or events more favorable, more jobs would have been created.[42] But to argue these misses the two crucial points: Over the long haul, in good times and bad, 936 has been ineffective in achieving its presumed function--being the engine of employment for growth of an island-based manufacturing sector; and the cost per jobs, even had there been more jobs, would have been no smaller.

The ensuing distortion in the economy--and unavoidably in the politics of its status--can be measured in several ways. First, although only 17 percent of all island jobs were in manufacturing in 1989, manufacturing provides about 40 percent of

[42]One can also pick a different data source, the household survey of employment. But that survey is widely recognized as inferior to the basis of the figures used here, the establishment survey. The establishment survey, a survey of business payrolls, is "benchmarked" annually for manufacturing to the island's complete annual census of manufacturing. In contrast, the household survey is based on a survey of households drawn from the decennial census, which was ten years old by 1980.

the value of production on the island.[43] Second, the share of profits in manufacturing value added was 65 percent in 1980 and had risen to 73 percent by 1989. The comparable share for mainland manufacturing corporations was a little under 20 percent, an indicator of the likely share in Puerto Rico were it not for the 936 companies' excessive reliance on income from intangibles.[44] Finally, the total wage bill in island manufacturing rose by 65 percent between 1980 and 1989, about 1.4 percent per year in real terms using the GNP deflator. Meanwhile, profits rose by 142 percent, or about 7.4 percent annually in real terms. Island residents get the wages but not the profits: Most of the benefits accrue on the mainland.

It is possible to argue that, but for 936, there would have been significant job loss in manufacturing. But this is to miss the point because most of the jobs now being lost are in 936

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[43]Manufacturing's share in island residents' income (island GNP) is much smaller--perhaps about 20 percent. Commonwealth proponents sometimes use a number like 60 percent rather than 20 percent, but this is due to the misleading way in which the data are presented in the relevant table in the national accounts--profit remissions to foreigners are subtracted, but not on a sector-by-sector basis so as to properly attribute the remission to the sector. Thus, profit remissions are made to come from the atmosphere hovering over the island, rather than from specific industries.

[44]U.S. Department of Commerce, Survey of Current Business, "The U.S. National Income and Product Accounts, Tables," July 1989 at 78-79.

companies. The interaction of economic fundamentals with the tax incentives has caused the substitution of one kind of company for another. As a consequence, a few skilled jobs are replacing many unskilled jobs. Although these skilled jobs are in their own right good, they are too few, very expensive to the American public, and narrowly concentrated in manufacturing.

These facts all lead to the inescapable conclusion that Section 936 is relatively ineffective--it has played itself out--and it is very expensive to the federal treasury. This last has not gone unnoticed in Washington, and has led to several assaults on the provision.[45] Still, in the absence of a viable alternative, it has been preserved--in less generous form--as part of a continuing commitment to the island's residents.

The future of the provision remains shaky, and consequently significant amounts of money and political effort are concentrated on maintaining it. As part of this process, advocates of its retention, including the commonwealth party, must convince its own citizens, and the Congress, that Puerto Rico is a poor unfortunate place that can survive only with the

[45]Most recently, in testimony before the Senate Finance Committee on April 26, 1990, Treasury declined to guarantee support for permanent continuation of Section 936 even if island residents were to opt for continued commonwealth in the plebiscite envisioned in S.712.

largesse of 936. This feeds whatever insecurity and lack of self-respect may be endemic to the island's status as the world's oldest colony. It also feeds outside investors' views that the island is a foreign and less developed economy.

B. Statehood is a Substitute for Section 936

Past discussions of the elimination of the Section 936 have taken place in the context of simply eliminating the provision, but not of fundamentally altering Puerto Rico's political status at the same time. Statehood would require the ultimate elimination of Section 936, and S.712 accordingly includes a phaseout of the provision from 1994 through 1998.

Proponents of statehood view that change in status as, in large measure, a replacement for Section 936. They see 936 in the current island context, which is that of a low-income but developed economy, as largely a means to overcome investor reluctance and antipathy to investing abroad, especially to serve their home market, the mainland U.S. Thus, it is the fact of 936's success, and the ensuing development, that have made the provision an anachronism. Yet so long as Puerto Rico remains "foreign," the provision remains a helpful anachronism.

It is easy to misunderstand the proposition that the two are substitutes because the two--statehood and tax exemption--are obviously different in character. Moreover, the positive supply-side impacts of statehood are not as readily measurable as federal revenue losses, corporate profits on the island, and manufacturing jobs. For this reason, the impacts have been labeled fantasies by opponents of statehood.

But the view of statehood advocates is that the island, when compared to other states rather than to alternative locations for <u>foreign</u> investment, has natural advantages and disadvantages on a par with other states. Placed in the context of states, then, rather than viewed as a foreign location, the island can attract a diverse range of domestic U.S. investments that will rely on these advantages. The increase in investment need not be of miraculous proportions in order to support and enhance the island's further development, or to replace the weak reed of Section 936. Furthermore, by focusing attention and policy on a broad range of sectors and activities, rather than simply attempting to pile factory on factory, the island will build a healthier economy less dependent on policy attention to a single sector and the vagaries of a single tax incentive. Yet none of this is to assert that a miracle will occur and the island will be transformed overnight. Rather, like all economic development in more mature economies, statehood will provide a climate in which the island can, over time, achieve its natural economic potential.

C. How Commonwealth Status Discourages Investment[46]

Commonwealth advocates assert that without Section 936 there is no reason to invest in Puerto Rico; that Puerto Rico is a small market with expensive labor, expensive power, and long and expensive transportation hauls to market.[47] But this assertion overlooks a fundamental fact that, most forcefully put, can be summed up by stating the obvious--this is also true in greater or lesser degree of many states. Why would investors choose to locate in those states but be more reluctant to invest in the commonwealth of Puerto Rico?

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[46]Throughout this study, the terms "investors" and "investments" should be understood to be direct investments in tangible and intangible property; that is, plant, equipment, warehouses, offices, hardware and software, and so on. In contrast, when we discuss financial investments, we will identify these investments as such.

[47]For a recent and representative example, see "Statement of Jose Berrocal, Counsellor to the Governor of the Commonwealth of Puerto Rico before the Senate Committee on Finance," April 26, 1990 at 5-7. In their advertising for investors, commonwealth representatives argue quite differently, as we shall see.

A very significant--perhaps the most important--reason is that investors in every nation draw a distinction between "domestic" and "foreign." Although there are, of course, firms for whom this distinction is moot because they have become so large as to be truly supra-national, it is basic for most investing firms. These firms make investment decisions in the two spheres on different terms. To invest abroad requires a firm to be, or become, a multinational firm, a step that typically occurs in the growth of the firm only after its management feels it has sufficiently mastered the home market. Even then, locating abroad is a substitute for exporting from the home market.

Statehood moves Puerto Rico from a "foreign" location (or limbo), as seen from the U.S., to a "domestic" location, as seen by U.S. investors. Domestic locations are, in fundamental ways, known quantities. The domestic investor feels more comfortable and certain with the laws, traditions, work place culture, and business practices and knows, from long experience, what he can expect "at home." In contrast, he does not know this of a foreign place, but must rely on advisors and agents who may themselves be foreign to him in their culture and folkways. For this reason, firms tend first to seek out investment opportunities at home; after these seem fully exploited, firms go abroad. Even then, they tend first to go to countries that resemble their home in institutional and cultural ways.[48]

It is oftentimes mistakenly assumed that the dichotomy between "domestic" and "foreign" is simply a matter of what financial investors term "sovereign risk." That is, in the global markets for liquid financial investments, yields on paper assets from different countries bear "premia," implicit surcharges or discounts from secure financial investments--such as U.S. Treasury issues. These premia encapsulate the financial markets' overall judgment on the riskiness of financial assets in each country. On this point, Puerto Rico scores well as part of the United States.[49]

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[48]See, for example, Richard E. Caves, Multinational Enterprise and Economic Analysis, Cambridge Surveys of Economic Literature (Cambridge University Press, 1982) p. 12 ff. and especially at 12-13: "Each person is normally a citizen of some particular country and brings to his business a general knowledge of the legal and social system, the 'ways of doing things,' particular to that nation. The business firm, unless already a mature [multinational enterprise], has a clear-cut national base and identity, with its internal planning and decision making carried out in the context of that nation's legal and cultural framework."

[49]Unfortunately, it is impossible to measure the degree of sovereign risk in commonwealth issues because of the subsidies provided by U.S. tax exemption and the requirement that profits retained in Puerto Rico by domestic subsidiaries in order to earn tax exempt passive returns must be invested in acceptable assets, among which are commonwealth paper.

· extra investment in PR paper issues
· ~~[illegible]~~- adjust surely?

Yet simply scoring well, even very well, is not particularly relevant because direct investments, for which there is no developed "secondary" market, cannot readily be sold. Even on the mainland, there are ranges of financial risk premia that can vary from virtually zero--for Treasury Bills--to several percentage points--for financial assets from large corporations. When one goes further to look at risk premia for factories, business establishments, or companies that are not publicly held--and therefore not readily marketable just as offshore direct investments are not easily marketable--the risk premia can range from 25 percent to 50 percent and up.[50]

The analogy to financial markets carries a second mistake. Financial investment carries much less of an information burden, in part another aspect of risk, than does direct investment. Financial assets can be made in small doses, and the investor can devote proportional attention to each small investment, while diversifying the investment across a range of various assets and risks. In contrast, direct investments are "lumpy;" they require the investor--typically a business--to entangle itself in a large operation and its day-to-day management, including the local

[50]See, for example, I.L. Blackman, The Valuation of Closely Held Businesses; State-of-the-Art Techniques for Buyers, Sellers, and Their Advisors (Probus Publishing, Chicago, 1986) and S.P. Pratt, Valuing a Business; The Analysis and Appraisal of Closely Held Companies, Second Edition (Dow Jones Irwin, Homewood, 1989).

political and business environment that affects the investment on a daily basis. For very large companies, such direct investments represent a proportionally smaller piece of the company's portfolio than it does for smaller companies. Yet even a firm with 10 or 20 foreign direct investments has a substantial proportion of its portfolio in each one. On this scale, "small" may be quite large from the perspective of the ordinary citizen.

The point we are making is frequently confused with another, related point. The related point is that statehood would resolve investor's uncertainty over the island's status. This is true, but typically misunderstood. Although there is in the eyes of investors, we believe, some risk that Puerto Rico might become independent and, in so doing, a less favorable location for foreign investment, the more important status-uncertainty concerns the island's tax haven status. This riskiness does not come from the specific uncertainty surrounding Section 936; rather, it is a generic risk associated with tax havens. All tax haven situations are inherently risky because the haven exists at the mercy of legislators and administrations who--like Congress--are not immune from budget pressures. Thus, building an economy on tax haven status requires rowing against the current--firms typically do not want to commit themselves irrevocably to gain such a temporary benefit. Puerto Rico, like other tax havens, must have other advantages of a more permanent nature. Ireland, as another example where relatively more permanent investment has been undertaken, promises entry into the European Common Market as well as an educated and trained labor force with certain high-tech skills (computer programming, for example) and additional government support. Still, far from every multinational finds these enticements sufficient.

The effective dichotomy between domestic and foreign investment has not been explicitly addressed in economic theory--it has not really been what economists would consider a topic for theoretical analysis because it rests on cognition and "psychological factors."[51],[52] Rather, and reflecting the

[51]There is an extensive literature on why firms become mutinationals and what they do when they become multinationals, reviewed by Caves, op. cit.

[52]Economic theory, which assumes that the more one invests in a place, the lower will be the marginal return, only gives the general guidance that firms will try to equalize their returns from all different locations. If returns were not equal, one could reduce investment in the least profitable spot by one dollar and add the dollar to investment in the most profitable spot. The result would be to raise the total return.

This is a helpful insight, but offers little practical guidance for deciding between investing in two specific places where the expected returns may be the same, but information, understanding, institutions, and the subjective evaluation of risks may differ. Moreover, the theory offers an assumed spectrum of investments without the local color and complications that make direct investment in the real world such a gamble.

Perhaps not surprisingly then, the simple theory is at dichotomy, empirical economic analysis has simply treated the two spheres of investment as separate topics.

Foreign investment decisions tend to be driven by one of only three factors: proximity to essential natural resources, typically minerals; proximity to major potential markets; and availability of significant cost advantages.[53] Given the "risks" (in the broadest sense) of foreign direct investment, the last category of these is typically not seen as durable enough--however large--to warrant major investments. For this reason, firms seeking cheap labor rarely commit themselves to major tangible investments. This was formerly also true of Puerto Rico, where the government, under Operation Bootstrap, provided inexpensive plants for lease. Only in recent years have the "new types of firms" tended to make more significant tangible

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variance with the facts. (Caves, op. cit. at 32-33.) Notwithstanding this, the Congressional Budget Office appears to have adhered to the simple theory in its analysis of statehood: "Theory suggests that firms will make investments in all feasible locations until the after-tax rates of return of the last investment in each location are all equal." (Congressional Budget Office, op. cit. at 8.)

[53]See Caves, op. cit., Chapters 1, 2 and 6, as well as the contributions by Kogut, Krugman, and Reed in C. Kindleberger and D. Audretsch, The Multinational Corporation in the 1980s (MIT Press, 1983.) An appraisal by business executives is offered in Tax Reform Hearings (1985) before the House Committee on Ways and Means; June 11, 12, and 17, 1985 at pp. 4742 ff.

commitments, developments also paralleled to some extent in Ireland.

Whatever its territorial status, U.S. investors by and large regard Puerto Rico as a foreign location. This is encouraged and revealed by institutional treatment; for example, such diverse administrative arms as the tax law and the CIA[54] regard the island as foreign. It is also revealed in the anecdotes of island professionals--outside auditors from major accounting firms and local attorneys have reported to this author that even parents of long-time 936 firms ask annually how the subsidiary has made its foreign exchange translation from the island currency and whether the FASB rules for auditing foreign companies have been observed.[55]

It is also noticed in a host of small ways that, cumulatively, suggest a qualitative difference of significant magnitude. For example:

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[54]The CIA World Factbook 1989 at 245-246 treats the island along with other foreign countries. It describes the "type of government" as "commonwealth associated with the U.S." It states that the "indigenous inhabitants are U.S. citizens" and, under the heading currency, tells us that "U.S. currency is used." It also notes that "Defense is the responsibility of the U.S."

[55]The FASB rules explicitly define Puerto Rico as a domestic U.S. location.

- Maps of the U.S. for business readers omit the island, though the impact of its purchasing power on the U.S., and of U.S. economic conditions on the island, are sizable and on the same scale as that of many other states--See Figure 3.

- Maps of the island identify it, parenthetically, as part of the U.S., an identification that would hardly be needed for a map of Hawaii--See Figure 4.

- Common books on the advantages of living and working in different U.S. locations--a tool for managers and professionals considering personal or business moves--omit the island[56]

- The American Automobile Association (AAA) treats it as a foreign location and provides little information on travel to it.[57]

- Major airlines consider it a foreign destination.

- Federal Express considers it a foreign address; packages (including business documents) are required to carry the foreign manifest and customs documentation; there is no weekend delivery.

- The island's financial institutions are "governed" at great distance within the Federal Reserve System by the Federal Reserve Bank of New York rather than being more reasonably incorporated with Florida in the Atlanta district. In the best of times, the New York Fed might have one junior economist responsible for knowing about Puerto Rico.

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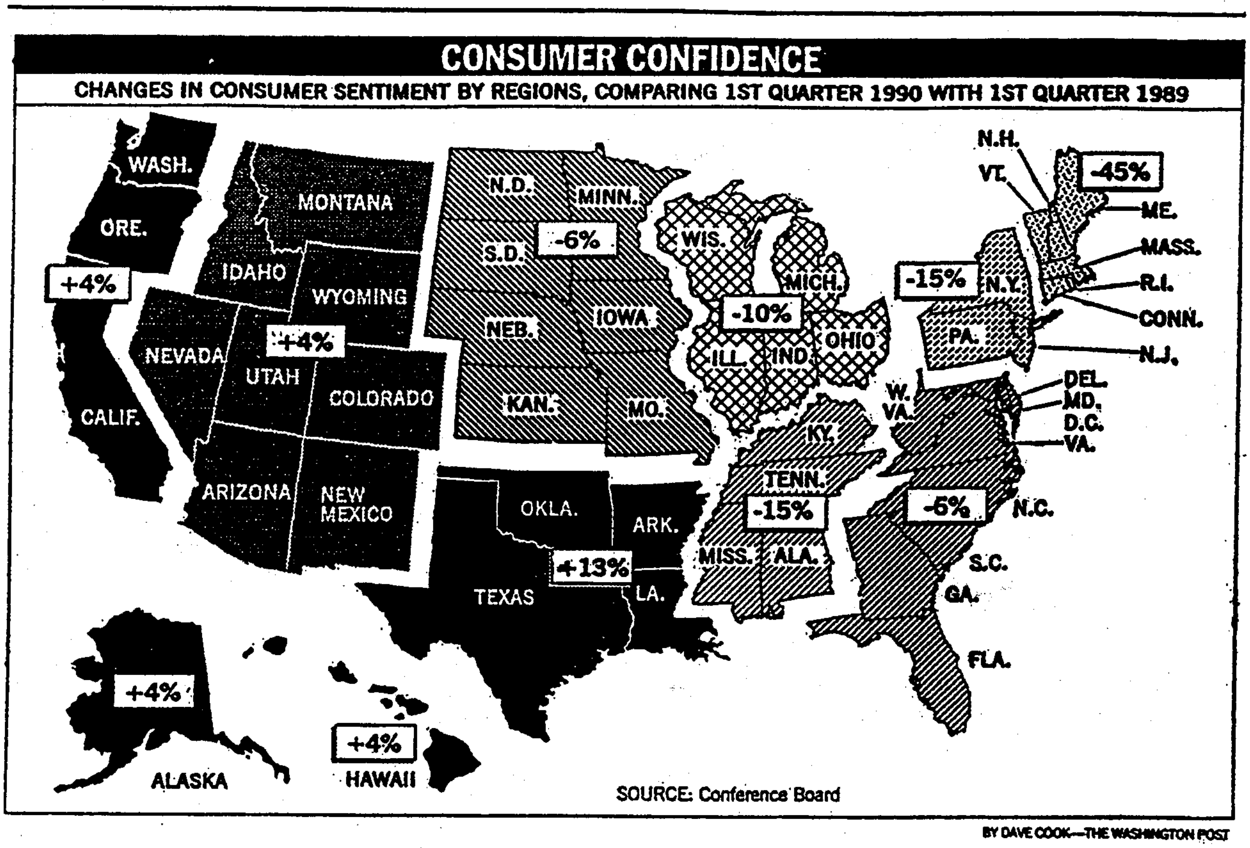
[56]R. Boyer and D. Savageau, Places Rated Almanac; Your Guide to Finding the Best Places to Live in America. (Prentice Hall, New York, 1989.)

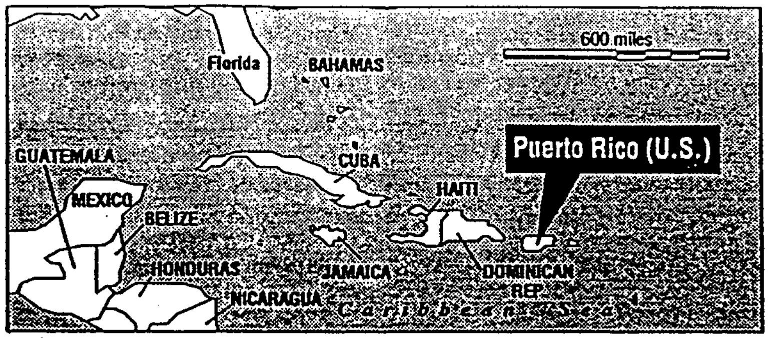
[57]The only reference or relevant document in the Washington Office of the AAA was located in the foreign travel department, a slim guide entitled Travel Guide; Bahamas, Bermuda, Caribbean.

FIGURE 3



Source: The Washington Post

FIGURE 4



PUERTO RICO AT A GLANCE

Source: <u>The Washington Times</u>

So long as U.S. investors continue to regard the island as a foreign location, there will be some truth in the proposition that without Section 936, there may be little reason for companies to come to the island. Even this, though, is an overstatement for two reasons. The first is that, in those cases where firms have come in part to be near a major foreign market--not the island itself, but the Caribbean and Latin American region--the motive will remain valid.[58] In these decisions, like domestic investment decisions to be discussed below, other factors beyond the narrowly economic, including culture and quality of life, play a role.[59] The second reason is that, in industries that rely importantly on the existence of industry-specific plant, labor skills, and the organization that goes with them, the costs of moving or setting up new operations may be prohibitive. An extreme example of this is provided by the auto industry, which remains even today in Detroit, albeit in

[58]A number of firms have major production, servicing, and distribution centers for the Caribbean and Latin America (CLA) region in Puerto Rico; among them are Citibank, Exxon, Upjohn, Sterling, Eli Lilly, Parke Davis, Sterling, Kodak, H.B. Fuller, and Everready. Note that there is no necessary reason for firms with manufacturing plants in Puerto Rico *ipso facto* to use the island as a sales, service, or marketing base for the region.

[59]Indeed, it should be apparent that the distinction we are making between domestic and foreign investments is one of priority and emphasis, rather than of absolute difference. Firms tend to make domestic investments before foreign ones, and tend in the latter to be *driven* more by the three factors we have enumerated.

attenuated form, because there remains a pool of human and organizational skills there. It is likely that a significant portion of the island's high-tech firms will continue in place, and be augmented by other firms requiring the same skills and organization.[60]

With these observations from economic theory as background, it is clear that Puerto Rico now poses a twofold conundrum. First, it is a "foreign" location that serves the mainland. Given the effective dichotomy between "foreign" and "domestic," most domestic firms would not look "abroad" for a place to source the domestic market unless it offered sizeable cost advantages. When the company did so, it would typically prefer not to make substantial direct investments, but to keep itself relatively liquid and mobile. Apart from the incentive to shelter profits provided by 936, Puerto Rico offers relatively small advantage as a foreign location serving the home market. But the incentive to shelter profits is only effective for firms requiring a more substantial presence than would be preferred by low-margin

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[60]In late May, Eli Lilly announced its intention to remain in Puerto Rico after statehood and--perhaps more important--to continue with its expansion plans there. As reasons for continuing, the company cited its costly investment and large skilled labor force. (Manny Suarez, "Eli Lilly Says It Won't Abandon P.R. Under Statehood," The San Juan Star, May 17, 1990.)

endeavors that wish to stay mobile. Hence, the latter firms have been leaving the island for some time.

This leaves only firms for whom the profits to be sheltered are large, who are armed with advisors to guide them in sheltering those profits, and who require substantial investment--tangible or intangible--to make those profits. These are largely the firms that have come to the island in recent years. They are typically large enough--the Fortune lists--to view direct foreign investment in the island as a small part of a global strategy--a way to serve the home market very cheaply. They are expensive for the Treasury to support.

D. The Investment Decision in Domestic Puerto Rico

In contrast to the fairly short list of goals driving foreign direct investment, the economic literature on location decisions for domestic investment in the states has identified a broad range of motives.[61] To be sure, these include motives with

[61] Much of the economics literature has focused on the effect of taxes on location, a focus arising from the apparently puzzling fact that they do not seem to have much of an effect. However, the literature is as broad as the range of parties interested in location analysis. A selected list of recent interesting studies would include: T.J. Bartik, "Business Location Decisions in the United States: Estimates of the Effects of Unionization, Taxes, and Other Characteristics of States," Journal of Business and Economic Statistics, January

effects that might be quantifiable on the bottom line--costs of labor, energy, and materials; nearness or transportation costs to markets; costs of providing necessary infrastructure for investment; and cost of investment, which may include costs of addressing local regulatory issues as well as the costs of construction and availability of financing (when the firm is dependent upon local financing). Taxes and the possibilities of favorable tax treatment also play a role, but these can be more than offset by the uses to which government is seen to put the funds.

The list of motives also includes those that have only indirect effects on the bottom line, being more in the nature of

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1985; R. W. Schmenner, J.C. Huber, and R.L. Cook, "Geographic Differences and the Location of New Manufacturing Facilities," Fuqua School of Business, Duke University, December 1984 (processed); M. Wasylenko and T. McGuire, "Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates," National Tax Journal, December 1985 at 497-511; J. Papke and L. Papke, "Measuring Differential State-Local Tax Liabilities and their Implications for Business Investment Location," National Tax Journal, Vol. XXXIX No. 3 at 357-366; T. McGuire, "Interstate Tax Differentials, Tax Competition, and Tax Policy," National Tax Journal, Vol. XXXIX, No. 3 at 367-373; Yankelovich, Skelly and White, Inc., The Business Climate in Wisconsin, Executive Summary of Comprehensive Research Program Prepared for the Department of Development, The State of Wisconsin, May, 1984; Dick Netzer, "What Should Governors Do When Economists Tell Them That Nothing Works?" New York Affairs, Vol. 9, No. 3, 1986 at 19-36; P. Warner, "Business Climate, Taxes, and Economic Development," Economic Development Quarterly, Vol. 1, No. 4, 1987 at 383-390; and Julien J. Studley, Inc., "The Comparative Costs of Doing Business in Seven Cities," October 1983 (processed).

risks or opportunities, as well as those that have no discernible effect on the bottom line. Among the former particularly are questions about the labor force--its education, skill level, experience, and reputation for work place discipline--and about the attitudes of the local and regional governments towards business. All of these are important when the economic climate changes for better or worse, or when the firm or its operations change. Among those having no discernible effect on the bottom line but still critical are the "quality of life" motives, climate, recreational opportunities, quality of education for children or nearness to scientific and educational resources, cultural life, cleanliness and safety.

Of all these motives, none has been found to be overwhelmingly dominant. Perhaps this should not come as a surprise, the variety of decisions is as wide as the variety and motives of investing firms and the kinds of establishments they wish to create. Some decisions will echo with greater or less faithfulness the set of motives driving multinational's foreign investment--raw materials, nearness to markets, or cost advantages. But in a national economy the size of the United States, and with the possible exception of certain very specific agricultural or natural resource products, the mix of all the variables available from place to place provides a continuum of alternative choices in which no one or a few places will predominate for long. Effects on the bottom line will not provide the unique determinant.

An example, familiar to this author, nicely sums up the complexity. A major financial services firm wanted to move its "back office" processing center from Manhattan, where its annual operating costs ran to about $13 million per year. A location expert recommended a less expensive site in New Jersey, where cost savings were on the order of $2 million per year--more than 15 percent--but the firm found these savings insufficient. Eventually, the firm moved to a western city where cost savings were estimated at $3.8 million, 28 percent. But this city was not the location of maximum estimated saving, a location that offered savings of $5 million below Manhattan costs. Rather, the western city was selected because the firm expected the labor force there to give better quality service with less likelihood of labor-management strife.

Moving Puerto Rico from a "foreign" to a "domestic" location will increase the readiness of U.S. investors to invest in Puerto Rico, and broaden the range of motives that guide them to do so. In a technical sense, this means that the risk premium, hence the required rate of return from direct investments in Puerto Rico will be lower. But the true meaning is somewhat broader than this, since factors other than the rate of return can play a role. For example, to the extent the island now serves as a sales and service entrepot for U.S. firms serving the Caribbean and Latin America, it is disadvantaged in doing so compared to rival locations, Miami for example, by its foreignness. This would be the case even if the expected return from the two locations were the same. Statehood can help to eliminate this discrimination.

But statehood can also have a favorable impact on investment in Puerto Rico by truly foreign--that is, non-U.S.--investors by including it within the U.S. Currently, Puerto Rico offers non-U.S. investors little that the U.S. categorically does not also offer except lower priced skilled labor and tropical locations for tourism. Many potential foreign investors do not have the option of benefitting from Section 936. And in return for investing in Puerto Rico, foreigners gain no political clout in Washington, a matter that can be very important in times in which foreign investment is a politically sensitive issue nationwide. The inclusion of Puerto Rico within the domestic U.S. economy, by providing a political voice for foreign investors commensurate with that which they would have in other states, will permit those investors to more carefully weigh Puerto Rico's other relative advantages. We now turn to a discussion of those advantages and the state economy they can help to create.

III. THE ECONOMY OF THE 51ST STATE

Looked at in its entirety, Puerto Rico presently offers the basis for further economic development along four major lines: (1) continuation and enhancement of some areas of manufacturing; (2) services; (3) tourism; and (4) agriculture. In recent years, services have grown remarkably quickly of their own accord. Tourism has been relatively underdeveloped given its potential. Finally, agriculture has been largely neglected since the beginning of Operation Bootstrap.

An island economy developing further along these four lines would be a much more diversified and resilient economy than one solely devoted to Section 936. It is reported that the commonwealth government has begun to recognize this and is developing a strategy to help diversify the economy's base.[62] Ironically, such diversification would make Section 936 and its political stepchild, the commonwealth arrangement, unnecessary: To the extent Section 936 manufacturing becomes less important, its removal carries less risk.

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[62] See statement of Berrocal, op. cit. at 18, for a brief mention of this as a "long-term goal."

In addition to the major lines of private development, a further supplement to island incomes and development would be provided by the enhanced presence of the federal government on the island. A good bit of attention has focused on the allegedly adverse role that provision of full federal entitlement benefits would have on the new state, a matter addressed in the Chapter VI. But it is often overlooked that spending this income creates real jobs. More importantly, Puerto Rico now contains enough U.S. citizens to be 28th in population among states. Yet it receives a disproportionately small share of the ordinary spending of the federal government devoted to productive activities or to infrastructure development because it has no representation in Congress. There is disproportionately little federal employment. This is not to say that it does not get its fair share. But, as Section 936 tax benefits, most of the federal largesse merely passes through the island on the way to mainland corporations.

A. Manufacturing in the 51st State

Viewed as a domestic location for direct investment--in comparison with other states--Puerto Rico offers the advantages of an inexpensive skilled labor force and a strategic location vis-a-vis the Caribbean and Latin America. Its relatively well developed infrastructure and modern transportation and communication networks are even now cited as strong reasons for "foreign" investors to come to the island. When seen especially as a commercial bridge with Latin America, its fortuitous mix of cultures and bilingualism, together with identification as an American state, would give it unique advantages. In contrast, the island's putative drawbacks, often cited by 936 advocates as the need for expensive ocean transportation, reliance on high-priced imported oil, and shortage of industrial water, are in the main more illusory than real.

The island's productive abilities are touted by the Economic Development Administration's ("Fomento's") own advertising, which emphasizes:

> [a work force of] well-educated, highly skilled bilingual U.S. citizens whose output per dollar of production wages is double that of the U.S. mainland. And whose managerial abilities are reflected by the fact that 98 percent of all plant managers in Puerto Rico are Puerto Ricans...[The island's] communications systems are state of the art. And [its] highly developed shipping and air cargo networks provide easy access to overseas and U.S. markets.[63]

Although the commonwealth party, in its political presentations to the Congress and its information packets for the

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[63]Advertisement appearing recently in Caribbean Business.

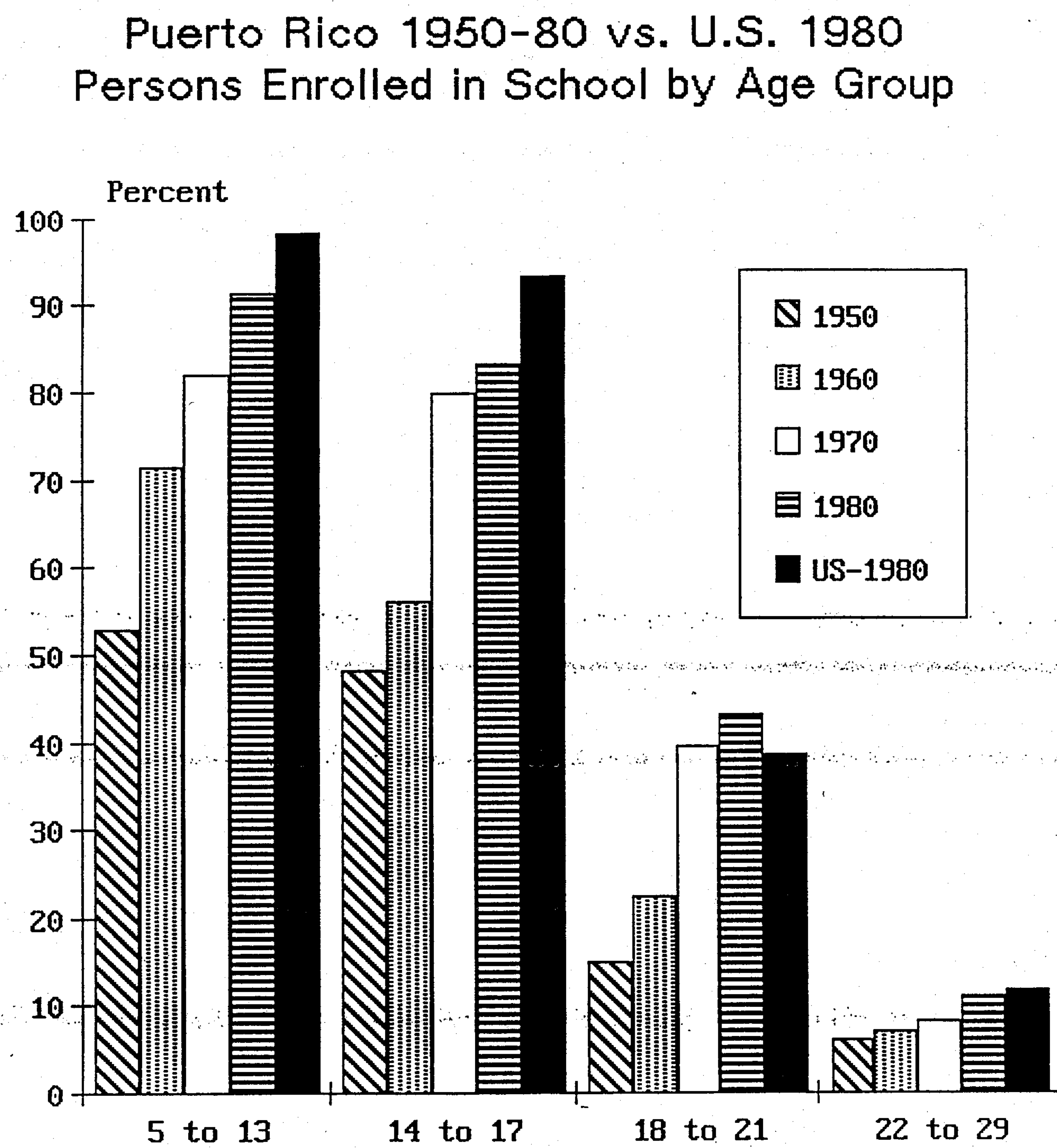
media, has emphasized island residents' lack of education and English, Fomento's presentation is closer to the truth.

That the opposite can be maintained is due to adroit use of statistics. Because Puerto Rico has developed rapidly over just 40 years, many are alive today who grew up when education was rare. Middle-aged people grew up in a developing economy, while today's youth are growing up in a developed economy. When one goes back to 1980, as one must to get good economic data on the population, one faces the problem that averages of the whole population may mask advances only visible in the younger populations. Two examples relevant to the current discussion are useful:

- In the successive census years of 1950, 1960, 1970, and 1980, the median school attainment level of adults rose steadily from 3.7 years in 1950, to 4.6, then to 6.9, and finally, in 1980 to 9.2. But this could be interpreted with the statement, "In 1980, the average adult only had 9 years of schooling." But behind these statistics was a steady "universalization" of education--pictured in Figure 5--until, by 1980, attendance in most levels of schooling were close to those on the mainland. Moreover, college attendance exceeded that on the mainland.

- In successive census years up to 1970, ability to use English increased, but has declined slightly since that time among the young, as can be seen in Figure 6. But one can

Figure 5

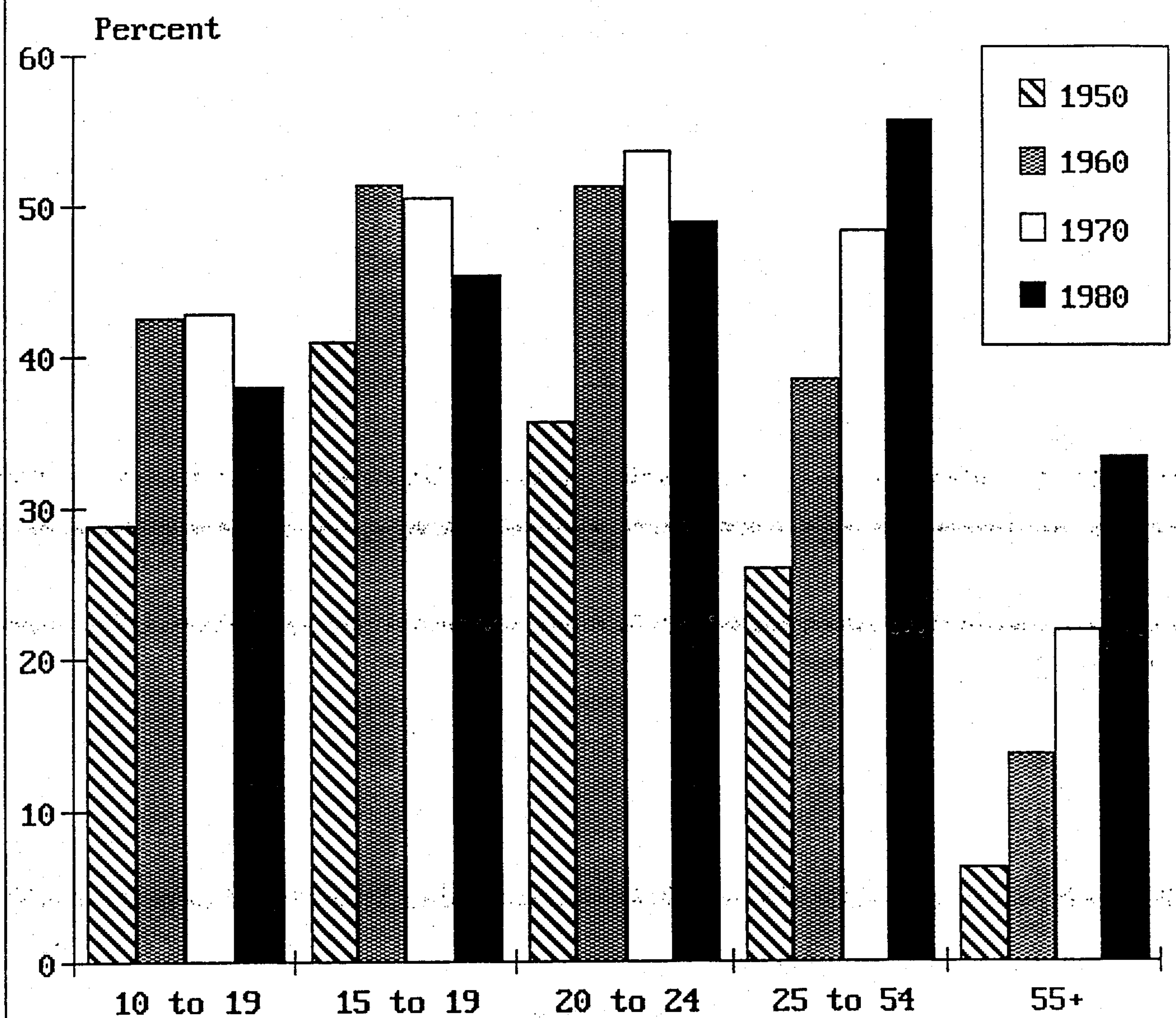


Source: United States Census

DRAFT

Figure 6

Puerto Rico
Ability to Speak English by Age Group



Note: 1980 10-24 Age Groups Adjusted by QFA
Source: United States Census

summarize the 1980 census data as saying that only 42 percent of the population had some conversational ability in English.[64]

Two further remarks about the data on English usage are important. The first is that, as a political matter, the commonwealth party has long de-emphasized English teaching in the public schools; though, even then, school children receive an hour each day of English instruction through primary and secondary school. The ambivalence reflects association of the English language with colonialism, and with its required usage during the early years under the U.S. flag. More recently, English has been a political football, associated with the statehood party and therefore attacked by the commonwealth party. Thus, the peculiarities of the commonwealth relationship have forced it to handicap its children. In other countries--even Cuba, for example, where the U.S. is hardly loved--knowledge of English is recognized as an essential skill for success in the modern world economy.

Second, though, the data--particularly for youth--need to be taken with some latitude. Anyone with a knowledge of another

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[64] In a recent press packet, commonwealth advocates highlighted this as the only 'boxed' datum in the material. See "Puerto Rico, A Brief Introduction," prepared by the Puerto Rico Federal Affairs Administration and the Puerto Rico Economic Development Administration, March 1990, at 7.

language recognizes that no degree of book knowledge is a substitute for active speech. Thus, youth with some fundamental knowledge of the language, who would not consider themselves to have a command of the language, may find themselves more proficient speakers after some continuous usage in the work place. This idea is supported by the relatively stronger English proficiency of the working age population. The proficiency of all age groups is likely to increase with the recent widespread availability of English language television.

In addition to being educated and bilingual, Puerto Rican workers are reported to be skilled and highly productive, with extremely low turnover rates. It is difficult to find accurate statistics on this score because productivity data include the value of intangibles in output. Fomento has published brochures in which mainland company executives offer testimony to these statements, and they appear to be common wisdom on the island. As noted earlier, one finds supporting testimony of this in places where the testimony is unnecessary.[65] Moreover, the wisdom appears credible in the light of the work place discipline one would expect to be felt in an economy with high unemployment rates.

[65] See Chapter I.

That skilled labor is relatively inexpensive is easy to document. Table 1 shows the average hourly wage for production workers in major manufacturing industries in both the U.S. and Puerto Rico. These are production line workers, not technicians, managers, or other types of white collar employees, so it may be expected that the skill levels should be about the same. Instead, given especially the pool of unemployed and willing workers on the island and the modest standard of living to which they are accustomed, wages are significantly below those on the mainland. Table 2 shows average wage levels for three types of workers in major urban areas with the lowest mainland wages. This demonstrates that island wages, particularly for the skilled, are at the bottom of mainland levels.[66]

In contrast to these, the island has been argued to be disadvantaged by the fact that, as a Caribbean island without mineral resources, it must depend upon expensive imported petroleum for electric power and on high-priced ocean shipping. The importance of these factors is, however, easily overestimated.

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[66]Notice that the low wage levels on the island are one key contributing factor to the island's measured poverty.

Table 1

Puerto Rico vs. United States
Average Hourly Earnings of Production Workers
By Manufacturing Industry
1988

Industrial Group	Puerto Rico (dollars)	United States (dollars)
All Manufacturing	5.46	10.18
Nondurable goods	5.31	9.43
Food and kindred products	5.53	9.10
Alcoholic beverages	6.54	16.89
Soft drinks	8.08	9.68
Tobacco manufactures	5.84	14.68
Textile mill products	4.52	7.37
Apparel and other textiles	4.03	6.12
Paper and allied products/	5.67	11.65
Printing and publishing	N/A	10.52
Chemicals and allied products	8.14	12.67
Drugs	8.41	12.07
Petroleum and coal products/	5.75	14.98
Rubber and miscellaneous plastics	N/A	9.14
Leather and leather products	4.15	6.27
Durable goods	5.71	10.71
Lumber and wood products/	4.04	8.61
Furniture and fixtures	N/A	7.94
Stone, clay and glass products	5.85	10.47
Primary metal industries/	6.25	12.15
Fabricated metal products	4.42	10.26
Machinery, except electrical	5.70	11.01
Electric and electronic equipment	5.88	10.13
Transportation equipment	4.76	13.31
Instruments and related products	5.94	9.98
Miscellaneous manufactures	5.20	8.01

Source: Puerto Rico Department of Labor

Table 2

Puerto Rico
Relative Pay Levels by Occupational Groups
(Average pay level for each group)
1987

Area	Office Clerical
Puerto Rico	71
McAllen-Edinburg-Mission Brownsville-Harlingen, TX	72
Lower Eastern Shore, MD-VA-DE	75
Clarksville-Hopkinsville, TN-KY	76
Columbus, GA-AL	76
New Bern-Jacksonville, NC	76

Area	Skilled Maintenance
Puerto Rico	60
McAllen-Edinburg-Mission Brownsville-Harlingen, TX	55
Lower Eastern Shore, MD-VA-DE	68
Columbus, GA-AL	73
Montgomery, AL	75
Greenville-Spartanburg, SC	76

Area	Unskilled Plant
Puerto Rico	68
McAllen-Edinburg-Mission Brownsville-Harlingen, TX	69
El Paso-Alamogordo-Las Cruces, TX-NM	69
Tucson-Douglas, AZ	69
Little Rock-North Little Rock, AR	72

Source: United States Department of Labor, Bureau of Labor Statistics

Puerto Rico appears to have suffered a larger increase in oil prices than did the mainland during the oil shocks of the 1970s because, prior to that time, U.S. regulations had allowed the island to obtain oil cheaper than on the mainland. The consequence was that the island suffered more gravely from the price increases. But the increases are of no economic relevance today; rather, it is the cost of fuel today that matters. The fact is that many states and localities on the mainland rely on oil. The price of oil, whether domestic or foreign, is now determined in world markets, and domestic oil is priced comparably to foreign oil--everywhere in the U.S. Imported oil is also shipped into the mainland, and some passes by the island on its way to the mainland.

The same, for that matter, is true of a number of products shipped from the orient to the east coast, from Europe to the west coast, or from coast to coast through the Panama Canal. Shipping to New York from Puerto Rico is reported even now to be less expensive than overland freight from the west and southwest to New York City.

Still, there are two kernels of truth here. The first is that the island is not a suitable locale for manufacturing that relies on massive quantities of inexpensive electric power--

steel making or aluminum refining, for example.[67] The second is that ocean freight charges are higher than they would otherwise be for shipments to the mainland because of Jones Act regulations requiring intra-coastal shipping on American bottoms--and the island in recent years did win specific exemption from the Act for cruise ships. The Jones Act is offered by many supporters of 936 as a source of significant adverse effects on the island's economy, and to be a major reason why 936 is needed to compensate for locating there.[68] Yet despite the arguably adverse impact of this policy, the island has no direct voice in its design or application. This is a policy the federal government could change that might significantly benefit the island's economy with no budget impact whatsoever.

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[67]Though without precise data, one can never be sure. A recent issue of Forbes reported that a new copper mining venture in Butte, Montana, found it cheaper to ship ore to Japan for processing and returned to the U.S. than to have the same work done in the southwest U.S. This contravened the obviously more expensive shipping and the fact that Japan is also completely dependent on imported oil. But the Japanese have overcome these disadvantages by more efficient processing. See J. Cook, "New Hope for the Dead," Forbes, September 8, 1986.

[68]See Booz Allen and Hamilton, op. cit.; U.S. Commerce Department, December 1979, Volume II at 392-405 and 443-489. The latter report argued that even in the absence of the Jones Act, shipping costs would be high--just as everywhere else--because of cartelization in shipping--the formation of "liner conferences." A more likely reason for the expense of shipping to Puerto Rico is that southbound ships are full, and northbound ships relatively empty because, in the latter case, the island's products are not bulky. This means that the price of southbound freight must cover the round trip.

While the foregoing touch on the island's current advantages relative to the mainland, these advantages are not permanent because as the island's economy grows, wage rates should approach mainland levels. A more permanent advantage is provided by the island's location and cultural history, which make it a perfect commercial bridge between the United States and Latin America. The role of commercial bridge is currently played primarily by Miami, with some of the functions performed vis-a-vis Mexico through Texas cities such as El Paso.[69] But there is room for Puerto Rico to serve this function as well, and will be more room as Latin America returns to its former growth.

On this score Puerto Rico is especially--and permanently--well suited because of its Hispanic heritage and North American citizenship. It is even now an entrepot for many U.S. companies operating in the Caribbean and Latin America. It can likewise be expected to become the perfect U.S. foothold of Latin American businesses.

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[69] In addition to their "bridge" functions, the Texas cities have played host to twin plants like those now beginning under the CBI with Puerto Rico as the domestic "twin." There is every reason for this development to continue and expand more rapidly under Puerto Rican statehood.

B. Services

The island is well suited as a commercial bridge for the provision of services to the Caribbean and Latin America. The island's residents are now possibly the best educated Hispanic population in the world, and are surely the best educated in matters relating to technology and modern business. As mentioned, the island provides management for local and 936 manufacturing concerns; it also has an active segment of the sector servicing those companies in ways from accounting and legal matters to advertising, marketing, and shipping. It also has start-up companies as diverse as one providing Spanish language court decisions on CD-ROM for Latin American judicial systems, to one providing advertising in Spanish for American companies throughout Latin America. As noted before, the island has numerous concerns that use the island as a regional servicing, marketing and distribution center.

One area in which the island's economy has not performed up to expectations has been in international finance. Notwithstanding the favorable tax situation, the presence of a modern financial sector with the associated infrastructure and expertise, and commonwealth government efforts to achieve the goal, the island has not become a major financial center for the region. However, the island has been attempting to compete with other offshore financial centers offering similar tax advantages and a more favorable regulatory environment. Meanwhile, Miami has become, by default, the major regional banking center while offering neither tax nor regulatory advantages--but the absolute certainty of the U.S. shore. It appears certain in this regard that Puerto Rico would offer more effective competition for regional financial activity as a state.

All of these service activities have several attributes that make them especially appropriate for island development. They make use of the island's natural advantages: its location, culture, human capital, and developed infrastructure. They avoid reliance on the island's relative disadvantages: its distance from the mainland, its limited water and natural resource base, and the limited scope of its environment to accept industrial discharge. The activities are labor- and skill-intensive; they are not capital intensive. Like manufactures, they can be exported.

C. Tourism--The Hawaii Debate

Perhaps the most often rehearsed element of the economic debate on statehood is the potential for tourism. Advocates of statehood have maintained for some years that Puerto Rico's tourism industry has suffered because the island is not a state, and they offer Hawaii as the model that proves their point. Opponents believe Hawaii to have been a special case, and offer several reasons to support their view. Where does the likely truth lie?

In 1959, Hawaii had 243,000 "visitor arrivals" in 1965 that number was 687,000, and by 1970 it was 1.7 million. In recent years it has been over 5.5 million.[70] The number of hotel rooms tells a similar story, roughly trebling from 9,200 between 1960 and 1970, and exceeding 66,000 in recent years. Hawaii had 31,000 hotel employees in 1987, about 7 percent of employment; local authorities grant the industry responsibility for 196,000 jobs in total, about 43 percent of employment.

In comparison, Puerto Rico hosted 3.2 million visitors in 1989, but only 700,000 stayed in hotel rooms. Another 800,000 came on cruise ships, while 1.8 million did not register as guests and must be presumed to be largely Puerto Rican visitors from the mainland or, perhaps, changing planes at San Juan

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[70]These and other data on Hawaii are from The State of Hawaii Data Book, various years, published by the Hawaii Department of Business and Economic Development. Also see Hawaii, Facts and Figures, a publication of the same organization.

airport. There are only about 5000 hotel rooms on the island, and about 9,000 hotel employees.

While advocates of statehood argue that, on its face, the hospitality and untapped tourism potential of Puerto Rico merely need the awakening of statehood, opponents argue that Hawaii enjoyed historical advantages Puerto Rico does not share--culture and language closer to the mainland, isolation that made it a perfect stopover for transpacific travel and meant there was no competition, and a military buildup. Significantly, opponents observe, Hawaiian statehood and the commercial jetliner arrived almost simultaneously.[71]

This exchange, which has been practiced among advocates of the status options for so many years that all participants know it by heart, may have suffered by repetition. There are really three separate questions being addressed: (1) Did statehood make a difference to Hawaii's economy? (2) Did it make a difference to tourism in Hawaii? (3) Do either of these matter for Puerto Rican statehood?

[71] Of course, the jet airplane also came to Puerto Rico at the same time.

The answer to the first of these appears to be yes, supported by statistical evidence.[72] But the one book that might have fully answered the question will never be finished. Thomas Hitch, the author and long-time chief economist for First Hawaiian Bank, died with the book in draft.[73] Because of its resonance in the current debate, it is worth quoting at length. In reading the excerpt, it is well to remember that Hawaii's small population, about one-third that of Puerto Rico, and its much greater isolation, make it inherently a less attractive market than Puerto Rico:

> From 1958 to 1973 the Hawaiian economy was, primarily as a result of statehood, the coming of the jet airplane, and the buildup of the defense establishment during the Vietnam War, in a state of great economic boom.
>
> First, consider the tremendous economic importance of statehood. Before statehood in 1959 most businessmen on the mainland knew nothing about Hawaii. Let me cite three personal examples to get this important point across. In the early-1950s I wanted to make a change in one of my life insurance policies so I wrote to the head office of the insurance company in New York with my request. I was told

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[72]Ghali and Rose (1977) find statistically significant support for the proposition that statehood raised Hawaii's rate of income growth by about 2.6 percent per year, as well as increasing immigration.

[73]Islands in Transition: The Past, Present, and Future of Hawaii's Economy, copyright First Hawaiian Bank, processed, 1989. We were kindly provided relevant sections from the draft through the intervention of the Bank and the University of Hawaii Press. The book was recommended by James Mak, Professor of Economics at the University of Hawaii, as being the most complete telling of Hawaii's economic history.

that I would have to get a physical examination and that I would have to use a doctor recommended by the American Consul in Honolulu! Then in the mid-1950s I had some correspondence with my old friend Steve Saulnier who at that time was Chairman of the President's Council of Economic Advisers under President Eisenhower. His letters came to me out of the White House mail room and all had foreign postage on them![[74]] Finally, one time in the late-1950s I was in Boston giving a talk about the growth possibilities of Hawaii and an old friend in the audience who knew Hawaii quite well told me, sarcastically, that there was no need for me to come back to Boston to tell the businessmen and investors there about Hawaii. Most of them had been down to one or more of the Caribbean islands and they already knew how natives on small islands live.

This ignorance about Hawaii permeated most U.S. businesses. If they were engaged in any overseas trade of any kind they almost universally put the Hawaii market in their foreign trade department. Even the U.S. Department of Commerce treated Hawaii as a foreign area until 1947 in that it required all shipments to Hawaii from the mainland to be reported by item, quantity and value just like foreign shipments had to be reported. Of course no such requirement existed for shipments between the states.

The point is that statehood was worth a billion dollars of advertising and promotion for Hawaii. Suddenly we were the 50th 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.]

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[74] During preparation of this study on Puerto Rican statehood, a temporary secretary asked what the postage was to Puerto Rico. The secretary, who is fluent in Spanish and Portuguese and has lived in Brazil and Chile, was working as a temp because she and her husband, who is a foreign service officer, had just been expelled from Nicaragua in return for the U.S. military's forced entry into the Nicaraguan embassy in Panama. She, more than the average citizen or investor, ought to have known that Puerto Rico is a part of the U.S. postal system.

> In 1971 I spent a day briefing the Board of Governors of the Federal Reserve Bank of San Francisco on economic conditions in Hawaii. In preparation I made a count of the "foreign" (i.e., overseas, mainly mainland U.S.) business firms that were doing business in Hawaii. As of 1955 there were only 311 of them. By 1971 this number had increased to 1916--a better than six-fold increase that, without statehood, would probably have taken at least a generation or two to achieve...This was such a far cry from pre-war Hawaii, even from pre-statehood Hawaii, that I told the Board of Governors that Hawaii's economy had come to represent a wide spectrum of big, medium and small businesses, some local, some mainland and some foreign, no one of which or group of which could be said to be dominant in any sense of the word. Hawaii had become a modern, diversified, pluralistic economy.
>
> Both statehood and the jet airplane came to Hawaii at the same time in 1959. Between the two of them they gave Hawaii's tourism a tremendous boost--statehood because it brought Hawaii to the attention of the traveling public as no other event could have, and the jet because it made flying long distances faster, more comfortable, and most importantly much cheaper...[75]

This last paragraph also suggests an affirmative answer to the second question--did statehood promote Hawaiian tourism. And the excerpt also suggests that statehood will make a difference for Puerto Rico.

But will statehood cause a tourism boom in Puerto Rico? We believe it will, though the boom may be modest compared to Hawaii's. Although we know of no surveys that would prove the point, our impression is that Puerto Rico suffers from a poor

[75] Hitch, op. cit., pp. 478-481.

image among potential mainland tourists as a hispanic third world country--a reflection both of the "West Side Story" image and of the long-time reputation of Latin America among many Americans as a dangerous and uncomfortable place to visit.[76] This is to be distinguished from merely being a poor country, as many more favored destinations in the Caribbean are poorer. It is for this reason that we believe the increased exposure of the island and the favorable publicity that would be provided by statehood would ensure a qualitative change in tourism. It would reassure less widely traveled Americans that the island, though different, is also American. If one believes in seeing America first, as do many Americans, the 51st state can be a powerful attraction.

D. Tropical Agriculture

Until Operation Bootstrap, Puerto Rico was an agricultural economy dependent on sugar, coffee, and cigar tobacco for commerce and tropical staples--beans and root crops, for example--for subsistence. Industrialization, and the attractions

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[76]These observations also reflect this author's former view of the island before visiting, as well as the view of many with whom he has spoken in the course of this study. On visiting, the author was struck not by the poverty or danger of the island, but by its beauty, the hospitality of its people, and the untapped potential it offers. The author is well traveled by most American standards.

of the manufacturing centers caused immense dislocation in agriculture, as it has done in other developing countries.[77]

The decline in agriculture continued through the 1960s and 1970s, levelling out in the latter half of that decade. But most of that which was left, apart from the remnants of the sugar economy, was not geared to world markets. In the meantime, world demand for what were once viewed as obscure tropical products has expanded significantly. Hawaii, parts of California, and south Florida, as well as Israel and a number of African countries have found the export of such tropical products to be important sources of income in world markets.

Efforts to develop a new agricultural base on the island appear not to have been undertaken, except in the most minor way, in the last decade. This has been the case despite studies showing that a significant payoff could be expected from expanding tropical agriculture on the island.[78] One must presume that the reason bolder steps have not been taken has lain mainly

[77]It is sometimes mistakenly asserted that the introduction of food stamps was the culprit behind the decline in agriculture, but this supposition is clearly refuted by the data, as we show in Chapter VI.

[78]See R. Weisskoff, <u>Factories and Foodstamps</u>, Johns Hopkins, 1985, especially Chapter 17.

in the past devotion of all parties to the ideal of Puerto Rico as a manufacturing base, "a little England, a New World Belgium."[79]

[79]Weisskoff, op. cit. at 128.

IV. QUANTIFYING THE ECONOMIC IMPACT OF STATEHOOD

Statehood can be expected to increase investment in the island, both from the mainland and from foreign shores. It would also be no surprise to see more, and more diverse, entrepreneurial efforts on the island once the crutch of 936 is removed and the uncertainty and psychological dependence of territorial status is eliminated. A range of estimates of the island's potential is possible, and we provide some estimates showing that even a modest advantage gained from statehood is likely to be sufficient to cause economic performance of the new state to exceed that of continued commonwealth.

Like all estimates of future performance, those given here rest ultimately on judgment. It may be thought that this is unusual, given the apparent rigor with which economists customarily appear to approach such tasks. But in all such exercises, including certainly those of statehood opponents, judgment ultimately drives the magnitude--even the direction--of the final results. To understand the context in which our judgments are made, it is therefore useful to discuss first how economists project in situations like that represented by statehood, then about how projections concerning Puerto Rico have been made in other studies. With these as background, we can then discuss our estimates of the effect of statehood.

A. Projecting the Consequences of Structural Change

The set of institutional changes surrounding Puerto Rican statehood represent unusual events; that is, they are events for which no quantified history exists. Although 50 states have previously been admitted, 48 of these occurred before comprehensive statistical records were kept. The experience of Hawaii and Alaska are suggestive but do not yield statistically acceptable quantitative answers to the question we would like to ask: What will statehood do to the Puerto Rican economy?[80]

To project the future of an economy, economists typically use quantitative models of the economy--"macroeconomic models" like that CBO has recently developed for Puerto Rico. By the models' nature and the technique of their construction, the forms

[80] To understand this, one need merely ask oneself whether Dr. Hitch's testimony on statehood in Hawaii conclusively proves the case for statehood in Puerto Rico. The answer must be no, because however illuminating or convincing his arguments might be, there exists the statistical possibility that they may simply not be relevant to Puerto Rico. They could be two separate cases. But this is a fundamental problem that no volume of numbers and statistical manipulation can overcome. And ultimately this unavoidable fact pervades all statements about the future of 936 companies and the gains from statehood.

and values in the models' equations are the product of the history of the economy itself. They rest on historical data and represent quantifiable historical relationships. That is, economic models represent the past. To project the future with a mechanical application of the model requires that the economist believe that the future economy will be like the past. Of course, this is never true, so economists judgmentally adjust their models to make every projection.[81]

Though judgmental adjustments must be made in every projection, these adjustments are typically aimed to calibrate the automation to the superior knowledge of its user, superior knowledge because the user knows what is "reasonable" and the model does not. Such adjustments are typically rather small in the case of a major industrial economy because the economy is large and does not change its properties markedly over a short period.

There are exceptions of course--the oil shocks were exceptional periods because the history incorporated in the models did not contain experiences like them. In this respect,

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[81]In addition, the models, based as they are on approximations, a selective view of what is important, and on the average of history, typically do not "forecast" the present very well. This is another reason to make adjustments.

they were "structural" changes because they caused the economy to behave in ways different from its past functioning. Furthermore, they caused institutional changes that further deviated from the models' sense of history. But they also were new to the models' masters. Although this did not prevent economists from making projections, it meant that there was unusually wide leeway for judgment.[82]

Parenthetically, there are other sorts of models that economists use. One type of model relevant to the present case is the "tax model" of the type used in Peat Marwick's recent study of statehood, also discussed below. Tax models are really quite different from macroeconomic models. In fact, they are little more than elaborate electronic versions of the tax code. That is, they are "Andrew Tobias" writ large. They are computer programs that read data about (anonymous) taxpayers--typically taken from tax returns--calculate the tax liabilities of each taxpayer, and add up the result. They may be enhanced by data on the taxpayer taken from other sources. Also, because they are computer programs, they can be changed to contain new provisions of the tax law--so long as the data on taxpayers also contain information that will allow the results of the new tax provision

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[82]The results, in terms of forecasting accurately the future, were also not particularly good.

to be quantified. These models are useful. But they tell us nothing about how taxpayers will actually behave or an economy will likely perform. They calculate tax liabilities only after the economy is "given" to them in terms of taxpayers' incomes and other relevant information. But then, in these models, the given changes in incomes and in the tax law are "structural changes." For this reason, even the best revenue estimates of new provisions must ultimately be little more than the consequence of modestly informed judgment.

Statehood and the attendant removal of Section 936 are structural changes par excellence. Because Puerto Rico has never been a state and, for all practical purposes has always had unique federal tax treatment, any projection of the consequences of these changes must ultimately rest on conjecture. The first task in evaluating a projection when the structural changes are so massive is to discover what assumptions are key to the results. Then one must evaluate the reasonableness of those assumptions. Having done so, one may then ask whether the master has properly used the model to compute the consequences of the judgment. But in this case, the latitude for judgment is particularly wide.

This can be seen in reviewing previous studies, but at the same time one must be careful to separate the public relations "spin" that has been put on the results from the results themselves.

B. Previous Studies

When one looks at the actual numbers produced by previous studies--and not the spin--even under the most pessimistic assumptions the negative impacts of losing 936 are limited. And, as will be seen, even these negative effects are often produced by biased or flawed judgments. In reviewing the studies, three features of the results are significant:

- No previous study includes any assumption about the positive benefits of statehood.
- Studies prepared by those trying to show the negative impacts of losing 936, as well as the recent Congressional Budget Office study, overstate the negative impacts due to various judgmental and/or technical flaws.
- Even these overstated negative impacts are limited--they do not show the island's economy reversing course and sinking into the sea. Rather, they picture a transition shock in which that relatively small part of future growth that would have been contributed by 936 companies does not occur. Growth is lower than it would otherwise have been--for some limited period--and then resumes.

Although advocates of the commonwealth party are fond of stating that every study that has ever been done has shown that removing Section 936 would be a disaster for the island, there is less to be made from this than the rhetoric suggests. In fact, excepting two early studies and the recent Congressional Budget Office study, all seem to have been written as justifications for the maintenance of Section 936 and paid for by its beneficiaries. The two early exceptions make an interesting contrast because, in fact, neither really confronted the issue.

1. The "Tobin Report"

The first such study was that done by "The Committee to Study Puerto Rico's Finances," called the "Tobin Commission Report" after the noted economist who headed it. The study was commissioned by the commonwealth (under then-Governor Hernandez-Colon) to help it cope with the fiscal crisis induced by the first oil shock and ensuing recession. It took the presence of then-Section 931 for granted, though it warned that the island's most important resource lay in its people, and that 931 together with the island's tax exemptions were even at that time bringing to the island firms that provided few jobs, firms that were not particularly appropriate to the island however welcome their jobs might be.[83]

2. The "Kreps Report"

The second study was the Department of Commerce's 1979 Economic Study of Puerto Rico, often called the "Kreps Report" after then Secretary of Commerce Juanita Kreps.[84] It was requested by then-Governor Carlos Romero Barcelo. The study, in two volumes, represented the output of a broad interagency task force assigned to study both the state of the island's economy and the effect of federal programs on the island.[85] The interagency task force expressly avoided any evaluation of changes in the island's status, and assumed that 936 would continue to be the main development tool available to the island. Thus, once again, no attempt was made to evaluate the impact of removing the provision, or of replacing it with statehood.

[83]Report to The Governor: The Committee to Study Puerto Rico's Finances, December 11, 1979. See, for example, pp. 22-24.

[84]U.S. Department of Commerce, Economic Study of Puerto Rico, Two Volumes, December 1979.

[85]When Puerto Rico is admitted as a state, a reprise of the Kreps Report would provide a firm basis for refining the economic transition to statehood.

Since these studies were done, the past decade has witnessed several legislative attacks on the largesse of 936, and its beneficiaries have responded with studies designed to show the dependence of the island on the provision and, therefore, the need to retain 936.[86] Prior to the recent study by Peat Marwick, these have analyzed the repeal of 936 alone, but Peat Marwick's as well incorporates no gains from statehood and is therefore not materially different in its analytical goal from the studies that preceded it.

3. Booz Allen & Hamilton

Representative of the earlier studies is that by Booz Allen & Hamilton (Booz-Allen) reported in May, 1985 and paid for by the Puerto Rico Manufacturer's Association.[87] At that time, Treasury had suggested repealing 936 and replacing it with a wage credit to stimulate job-intensive investments on the island. The main content of the study is in two parts: a strategic analysis and a model-based computation of economic impacts. The first attempts

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[86] In addition to the Booz Allen Study noted earlier, there have been several studies by Robert R. Nathan and Associates, the most general of which is "Section 936 and Economic Development of Puerto Rico," Prepared for the Puerto Rico, U.S.A. Foundation, August 1987. We also understand there to have been a study by ICF, Inc. in about 1985, though we have been unable to obtain a copy.

[87] op. cit.

to determine which industries will "leave the island,"[88] the second to determine what the consequences of the ensuing moves are for the island's economy.

In the "strategic analysis," Booz Allen evaluated the advantages of Puerto Rico and alternative locations, with and without Section 936 in Puerto Rico, to determine the island's competitive advantage for each industry. The analysis was based on interviews with executives in the parents of 936 companies, on comparisons of advantages and disadvantages of alternative locations, and on the judgments of the analysts. The results are presented as tables of likely growth in each island industry where 936 companies are active, with and without 936, for a five year period, assuming 936 were to have been repealed in 1985. The period was chosen as long enough to capture the vast majority of the effects of removing 936. No formal quantification of

[88] Although studies like these often use the term "move" or "leave" the island, these terms are simplifications that misrepresent what might happen if 936 were repealed--with or without statehood. If firms close, or move their operations elsewhere, the terms "move" and "leave" are appropriate. If the firms cease investing, or expand elsewhere rather than on the island, "moving" and "leaving" imply an economic disruption that would not occur--the island's economy would simply grow more slowly, other things being equal. Firms expand elsewhere all the time. In simple comparisons, such as Booz Allen's and Peat Marwick's, in which the island is compared "with" and "without" 936, no distinction is made between true departures and reduced expansion below what might have occurred, though these have very different human consequences.

bottom-line impacts on company profitability of the removal of 936 is given; that is, the entire strategic analysis consists of the consultant's judgment.

Two features of the consultant's judgment are of interest. The first was that labor intensive industries, such as apparel, are leaving the island because of high labor costs, and that this move would accelerate if 936 were repealed. Although the view seems sensible, it conflicts with recent history: Employment in the apparel sector, for example, grew by about 12 percent between 1985 and 1988, the most recent year for which data are available. This growth returned apparel employment to its 1980 level, thereby roughly paralleling growth for the manufacturing sector as a whole. The second judgment was that companies with higher tangible capital commitments on the island--pharmaceuticals and hospital supplies, would be less likely to reduce their commitment than would those with low commitments, such as apparel.

The analysts from Booz Allen then fed these "strategic impacts" through a macroeconomic model of Puerto Rico to calculate the broader consequences for the island's economy. In the base case, with continued 936, they projected real GNP on the island growing at an average annual rate of 4.5 percent between

1985 and 1990. (Actual growth through 1989 has averaged about 3.9 percent.) In the "repeal" projection, growth virtually stopped for the first year (turning in 0.1 percent growth), then picked up to 2.3 percent for the remainder of the period, a rate equal to mainland U.S. growth. At the end of the period, growth returns to the average rate experienced between 1973 and 1989. Compared to the base case, the level of real GNP was about 12 percent lower by the end of the period.

Thus, the effect of removing 936 is to reduce a part of the economy, over time, while the rest of the economy continues to grow. Once the 936 sector has been cut back, the slowdown is over. Most important, and contrary to the spin the opponents of statehood have put on such results, the island economy does not tip over into a permanent decline. Rather, the non-936 sector continues to grow, and with it the whole economy.

4. Peat Marwick

In the past few months, Peat Marwick has released a study of the impact of statehood financed by the commonwealth party.[89] This study takes a quite different methodological approach from

[89]KPMG Peat Marwick Policy Economics Group, "Economic and Fiscal Impacts of Puerto Rican Statehood," February 1990.

the Booz Allen study. Peat Marwick uses a tax model--as discussed earlier--to calculate the increase in tax liabilities of 936 companies that would be caused by repeal of 936. The model is calculated on incomes projected by the Puerto Rico Planning Board for 1992. It then assumes that those firms with the largest tax increases would be "subject to relocation."[90] It assumes alternately that firms suffering a reduction in their after-tax return of more than 5 percentage points or more than 11

[90]Although the report ostensibly concerns statehood, no offsetting effects to the removal of 936 are assumed to stem from statehood. Indeed, tax impacts for purposes of the study's analysis are the sole determinant of location notwithstanding the following observation:

> Business location decisions are affected by a number of factors: land costs, labor costs, environmental and regulatory costs, transportation costs, taxes, tariffs and other trade barriers, costs of raw materials and finished products, and noneconomic factors such as relative political stability. The desirability of Puerto Rico under statehood relative to the mainland and alternative foreign sites is based on the net effects of all such factors.
>
> It is not possible to replicate all of these factors which influence decisions concerning location, to enter, stay, or leave. It is possible, however, to analyze, in the case of Puerto Rico, the bottom line effects of increased taxes resulting from a move to statehood and to compare the resulting bottom-line to that available in alternative sites. (Peat Marwick at vi.)

Unfortunately, in so doing, Peat Marwick overlooks other changes to the bottom line that would occur if the firm relocated. Nor, contrary to the text, does the study (nor did its authors during the course of their study) identify alternative locations where the "resulting bottom-line" would in fact be "available."

percentage points would "move."[91] It does so by assuming the existence of locations where returns would be high enough to equal or exceed this loss in after-tax return; though it performs no analysis to determine whether such places exist and would be suitable for the firms assumed to "leave" Puerto Rico.[92]

Although it does not say so, firms suffering an 11 percentage point or greater reduction in after tax returns would now be enjoying pre- and post-tax returns in excess of 25 percent. Indeed, nearly two-thirds of the income of the 936 firms is in companies that would suffer reductions of earnings in excess of 15 percentage points, and these businesses must be earning pre-tax returns in excess of 50 percent. After elimination of Section 936 and the imposition of federal taxes,

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[91]They observe that some companies would relocate and some would curtail new investments, but they make no judgment as to the mix or the timing of the assumed cutback in the sector.

[92]The existence of such places cannot be taken for granted. For example, skill-intensive operations cannot simply be moved; the new location must provide the proper mix of skills. Likewise, the infrastructure must be available to support capital intensive operations, if these are being moved, and the new location must have acceptable political stability to warrant direct investment on a large scale. At a presentation of the results to Senate staff, one representative of Peat Marwick cited Guatemala as a likely destination for 936 companies because of its cheap labor. Yet the firms envisaged as moving by the Peat Marwick study are not firms using cheap labor; rather, as is discussed in the text, they are the high-profit firms requiring skilled labor and a developed infrastructure, making Guatemala an unlikely destination.

their returns would still exceed 33 percent. According to the Treasury,[93] the 936 companies earned average profits roughly equal to 30 percent of sales in 1983; in the pharmaceutical industry the profit rate was closer to 50 percent, and these firms alone account for nearly half the tax benefits from the provision (while employing only 8 percent of the manufacturing work force.)

Thus, the greater the percentage point fall in the firm's after-tax profit in Peat Marwick's calculations, the higher is the firm's current pre-tax return, and the higher is that firm's after-tax return when 936 is removed. Given the known profile of 936 firms, this implies that Peat Marwick assumes that those firms that have the highest profits and more intangible assets are those most likely to relocate. These firms also have the smallest employment. This stands in direct contradiction to Booz Allen's judgment, based on interviews with the parent firms' executives, that these are the firms less likely to relocate.[94]

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[93]Treasury, <u>Sixth Report</u> at 41 and 47. Data are for firms not electing the profit split method. Total manufacturing employment is from the Puerto Rico Census of Manufactures.

[94]As discussed earlier, firms with such a large going concern value would have reason to continue and even expand in the new state so long as operations there meet world standards, as they are generally reported to do. Eli Lilly, which has announced its plans to stay, is such a firm.

A second feature of the Peat Marwick computations is that they assume that the parent firms do not care about dividend remissions.[95] Currently, 936 companies may remit profits to the parent corporation free of U.S. tax, paying only a "tollgate tax" to Puerto Rico of 10 percent, or 5 percent if the profits are invested in Puerto Rico for a few years prior to remission--a tax which most observers dismiss as unimportant. In contrast, profits remitted from alternative locations are taxed by the U.S. and, if they accumulate overseas, can eventually be taxed without remission under certain other provisions of the tax code. On this matter, Booz Allen insists that dividend remissions are very important to U.S. parent companies that do extensive R&D because the dividends can help finance research.[96] It is precisely these companies that are assumed to be "subject to relocation" by Peat Marwick, and whose tax costs in the alternative locations are ignored.

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[95]The report states at footnote 1, page I-5:

The discussion does not give weight to the fact that a foreign affiliate cannot necessarily repatriate its low taxed earnings to the U.S. (e.g. as a dividend) without a payment of U.S. tax, while a 936 corporation can, because most U.S. corporations owning foreign affiliates have discovered that the economic cost of not repatriating their income is low.

[96]Booz Allen at III-13

Because the firms that Peat Marwick assumes will leave the island are extraordinarily profitable and capital intensive by any standard, the tabulations Peat Marwick provides of these firms include impressively large numbers. However, the impact of these departures is quite small compared to those foreseen by Booz Allen, in part because of the extension of federal entitlement benefits to the island. In its worst case (the "five percentage point scenario"), GNP is only 5 percentage points lower in the year 2000; in the "11 percentage point scenario," GNP is only 0.4 percent smaller. Although Peat Marwick presents no formal model undergirding these calculations, they would suggest average annual growth at worst perhaps 1 percent lower during the latter half of the 1990s. Thus, despite dramatic public relations spin, the quantitative effect projected for the island is quite small, even with no gains from statehood.

Peat Marwick minimizes this last by pointing to the dramatic loss of capital and jobs that would result from the departure of 936 companies, and they offer estimated job losses of 80,000 to 145,000 to bolster their case. However, these estimates are inconsistent with their estimates of the impacts on GNP, apparently in part because they do not recognize offsetting gains elsewhere in the economy. Here it is important to remember that only 17 percent of the island work force currently labors in manufacturing,[97] and a similar percentage of the island's income originates in this sector. In contrast, "foreign" profits from manufacturing are roughly three times the size of island income from the sector, and it is here that the elimination of Section 936 would hit hardest--in profits but not island jobs.[98]

5. The Congressional Budget Office

In its recent study of the economic consequences of S.712, CBO first judgmentally derives estimates of the reduction in 936 investment and exports between 1991 and 2000, then feeds these through a macroeconomic model of the Puerto Rico economy built for the purpose. The model projections also incorporate impacts stemming from full implementation of federal entitlement benefits and federal taxation on the island. CBO acknowledges that a range of offsetting beneficial impacts might occur as a result of statehood, but does not quantify them. Thus, like Peat Marwick, CBO quantifies "statehood" as being identical to the current commonwealth arrangement except for federal fiscal treatment as a

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[97]According to Treasury, only 12 percent of the work force is employed by 936 companies. (Testimony of Philip D. Morrison, International Tax Counsel, Department of the Treasury, Before the Senate Finance Committee, April 26, 1990.)

[98]Peat Marwick also estimates the impact of statehood on the island government's budget and on the federal budget, both of which topics are taken up in later chapters of this study.

state; this is, of course, nothing other than the treatment historically afforded to incorporated territories (but ignoring any benefit the latter might have obtained from being "intended" for statehood.)

CBO's analysis starts with the construction of two "baseline scenarios," one with high growth under Section 936, the other with low growth. It is important to recognize that these scenarios do not represent forecasts, though this has been overlooked by many. Each of the projections represent deviations from the trend rate of growth in Puerto Rico since 1973. Each baseline is roughly two "standard deviations" from this trend, so the baselines are extremes of the plausible range--with, in a mechanical sense, roughly 5 percent probability that the economy might perform outside the range.

We use the term "mechanical sense" because the range is derived without an analysis of economic fundamentals that would tend to drive the island economy's performance toward one or the other extreme. Yet the trend growth in GNP from 1973 to 1989 was about 2.1 percent per year, and about 1.9 percent per year from 1980 to 1989. Moreover, the underlying growth of the U.S. economy--the key driving force of the island economy--has slowed since 1973, and the incentives provided by 936 have been sharply curtailed in the last decade. Thus, unless there is a spontaneous upswing from an unknown source, the island's economy is likely to lie near the low base projection of 1.5 percent annual growth in GNP when measured over a period as long as a decade. In contrast, achievement of the high base growth rate of 3.3 percent would appear to require 15 consecutive years (starting in the middle 1980s) without a recession either on the island or the mainland, as well as a return of Section 936 incentive impacts toward the golden age of growth in the 1950s and 1960s. This is most unlikely.

Statehood is then assumed to depart from these base cases because 936 investment is lower, causing exports to be reduced in turn. In each case, the present-day attrition of firms is assumed to continue, while investment by remaining firms is assumed to be sufficient only to maintain their current level of operations.[99] CBO has no underlying quantifiable reason for arriving at this particular outcome, but assumes it to be a reasonable magnitude of response to the elimination of tax incentives. The ultimate size of the reduction in 936 companies' capital stock, 47 percent, lies about halfway between Peat Marwick's worst- and best-case scenarios for operating assets, a

[99]Because 936 investment in the base case is given, it is assumed to be investment net of attrition, making it all the more remarkable in the high base case.

fact that may have accounted for the choice of assumption since Peat Marwick's study was completed as the CBO report was being prepared.

The implied reductions in 936 investment and exports--together with changes in federal taxes and spending on the island are then run through CBO's model to get estimates of the overall impacts on the economy. The key result is a slowing in the average rate of growth of GNP over the period of between 1.8 percentage points (high base) and 1.0 percentage points (low base). By 2000, GNP is computed to lie between 10 (low base) and 15 (high base) percent lower than in the respective base, numbers roughly akin to those of Booz Allen and larger than those of Peat Marwick.[100] In the process, the economy is projected to create between 50,000 (low base) and 100,000 (high base) fewer jobs than

[100]CBO's results are extremely sensitive to a single assumption concerning the pace of reinvestment of 936 companies' profits in the so-called "pool" of 936 funds retained in island financial institutions to incur a reduced "tollgate" tax burden. This pool of funds grew rapidly up to 1986, but has remained roughly constant since the first quarter of 1986, apparently as a consequence of a number of changes in the regulatory environment induced by federal tax reform. CBO appears to have been unaware of recent years' developments, and CBO projected reinvestment in the pool continuing to accelerate at pre-1986 rates through the year 2000. Had they instead assumed that the pool has ceased to grow, the projected adverse impact of statehood would have been only about 25 percent as large as their published projection. That is, the single overwhelming source of their adverse projections for statehood appears to have resulted from a lack of current information about the actual operation of what is--by all accounts--a secondary aspect of the 936 program.

in the base cases, which have employment in the year 2000 of roughly 1.3 million and 1.1 million, compared to today's 900,000. Thus, employment in the new state continues to rise over the decade even under the most adverse assumptions.

As with the other studies, CBO foresees a recovery in growth after the transition period. Thus, once again and despite relatively pessimistic assumptions, the island economy does not enter the economic free-fall postulated by statehood opponents. Rather, the economy is assumed to pay a price for its present excessive dependence on the tax advantages embodied in Section 936, but to recover its own natural growth after the adjustment period has been completed. At no point, except in the last years of the low base, where growth is already limited under commonwealth, does CBO--or any other analyst--foresee even a mild recession.[101]

[101]The low growth case shows GNP declining about 0.9 percent per year between 1995 and 1999, after which it once more picks up. This appears to be a result of the current transition path, which boosts GNP somewhat artificially, though for good reason--the provision of entitlements to the needy--early in the transition period. The downturn is mild, and could be avoided with a more appropriate transition path. Under current provisions, Treasury estimates statehood to return a $1.7 billion surplus to the federal government over the transition period compared to continued commonwealth. This money could be "covered over" to the island to help avoid any downturn while maintaining budget neutrality for the Treasury.

C. Estimates of the Gains from Statehood

While informative, CBO's results do not come to grips with the essential feature of statehood, the institutional changes that fully integrate the island into the United States. Rather, by avoiding any attempt to quantify these effects, CBO is left with estimates of the impact of the quantifiable fiscal changes on today's commonwealth. The consequence is, then, not an estimate of statehood, but rather of the commonwealth with full fiscal parity to the states. That the impact is to reduce the commonwealth's economic growth suggests that the current arrangement gives the island a free ride that not even the poorest states enjoy.

But as we have discussed in Chapters II and III, statehood will open the island economy to a range of economic possibilities now closed to it because of its limited appeal to firms other than multinationals willing to serve the U.S. market from offshore in exchange for tax savings. Although some 936 investment that might have occurred may be lost, other U.S. manufacturing firms that are not major multinational companies will find Puerto Rico an attractive location, particularly as a bridge for exports into the Caribbean and Latin America. Moreover, foreign firms will also be attracted. Significant investments should also take place in the tourist and services industries and in agriculture. Finally, in joining the union, the island will be able to command a share of federal employment and activity commensurate with its population of U.S. citizens.

All of these together present a very large potential pool of economic activity for the island, and one therefore need not reach for economic miracles to find new economic activity that can materially supplant the loss of Section 936. It is possible to quantify reasonable magnitudes for these variables, and we have done so. On the basis of our judgment, at the <u>minimum</u> we believe it plausible to expect an outcome resembling the following:

- New foreign investment growing to about 25 percent of the national per capita average by the year 2000;[102]

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[102]Estimates are based on annual reporting of direct foreign investment by state (but including Puerto Rico) from the U.S. Department of Commerce, and use an average of the most recent years available: 1986, 1987, and 1988. The per capita average for the U.S. is $205 in dollars of 1987 purchasing power, with state experience ranging from zero for Idaho and South Dakota to $791 for Ohio, $976 for Hawaii, and $1,118 for Delaware (which may be a reporting error based on the registration of corporate headquarters). Achieving investment at 25 percent of the national per capita average would put Puerto Rico in the league of Maryland ($44), Colorado ($50), South Carolina ($55), and Michigan ($65), well below Florida ($122) and Georgia ($151).

Investment is assumed to grow linearly beginning in 1992, and to generate island income from exports using relationships

- Additional tourism representing approximately 25 percent of the gain experienced by Hawaii after statehood;[103] and

- Enhanced federal presence in terms of contracts and federal employment that would put Puerto Rico _up_ among the states receiving the _smallest_ amount of both of these.[104]

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implicit in the CBO experiments, as well as the necessary return to foreign investment.

For a different set of estimates see "Statement of Nelson Soto-Velasquez Before the United States Senate Finance Committee," April 26, 1990.

[103]The projection envisages expansion of the number of hotel rooms by about 45 percent through the year 2000, with a concomitant increase in visitors of about 1.6 million annually by the end of the decade. No increase in real per capita visitors expenditures is projected. Again, new investment and added tourist visitors are phased in linearly between 1992 and 2000.

For different sets of estimates, see Soto-Velasquez, _op. cit._ and "Statement of Professor Jose R. Oyola before the U.S. Senate Finance Committee, April, 1990."

[104]The estimate of government contracts is based on Department of Defense Military Prime Contract Awards (MPCA), only one category of government contracting, for the years 1986 and 1987. Puerto Rico is assumed to receive federal contracts in the approximate amount of $100 per capita (in dollars of 1987 purchasing power) by the year 2000. The U.S. average for MPCA alone was $544, and the states with the smallest per capita amounts were, in ascending order, Montana ($19), West Virginia ($71), Idaho ($89), Oregon ($121), South Dakota ($138), and Kentucky ($144). The six highest states (Maryland, Alaska, Virginia, Missouri, Massachusetts, and Connecticut) had per capita contract values between $1000 and $1750.

Federal employment and payrolls were assumed to grow until equal, on a per capita basis, to those for Wisconsin which, at 56.4 federal employees per 10,000 inhabitants (in 1986), was the lowest federal employment intensity of all states. (_Statistical Abstract of the United States_, Table 517.)

The projections stemming from only these assumptions are quite conservative. They include no offsetting increases in investment from the mainland except those in the tourism sector; they include no new manufacturing or service industries or employment. They build on CBO's pessimistic assumptions concerning 936 investment. Finally, they include only the smallest reasonable estimates for federal presence, notwithstanding the fact that the island will become the 28th largest state, with a congressional representation to match.

Yet these gains alone, when factored into the CBO model, would increase the island's real income by three quarter's of the projected loss in CBO's high base case, itself an extremely pessimistic outcome for statehood (relative to continued commonwealth)--and one far out of line with commonwealth's recent history. When compared to CBO's more realistic low base case, these gains would wipe out any statehood "economic deficit." Indeed, real GNP under statehood would stand some 5 percent higher by the end of the century under statehood than under continued commonwealth.

In addition, and likewise estimated conservatively, the projections more than eliminate any putative job loss under statehood under both cases. That is, because new investment and employment takes place in sectors that are much more labor intensive than manufacturing--which employs relatively few--the number of new jobs in the state exceeds that under CBO's estimates of continued commonwealth. If the new pattern of growth merely reflected the labor-intensity of the current non-936 sector, statehood would create the same number of jobs as in the high base case, and 50,000 more than commonwealth under the low base case. However, given the new state's more appropriate concentration in services, including some federal employment, as well as some improvement in construction, these estimates are on the low side.

Why do such conservative assumptions have such a large impact on the island's economy? The simple answer is that the island's economy is not very large, so that small changes in patterns of mainland or foreign investment towards the island, or in federal presence, make a big difference to the economy--the same is true of many states. That the outcome seems surprising may be attributed solely to the island's historical focus on the difficult task of industrializing the island by luring "foreign" investors with tax incentives. Although this strategy could work for a while, when there were no such companies on the island and a potential pool of takers, today the potential pool of such newcomers is all but exhausted. Thus, what is lacking is not island attractiveness, but a supply of new "foreign" investors for whom taxes are the driving motive.

V. SHAPING A STATE GOVERNMENT

The current commonwealth government of Puerto Rico is, by some measures, considerably larger than the usual state government. Its income tax rate schedule is roughly on a par with the federal rate schedule, while income tax rates in the fifty states are normally much lower. Opponents of statehood have therefore questioned whether imposing the federal system on top of a commonwealth-sized state government might be disastrous: Businesses and individuals would leave to avoid the high income tax rates; to ameliorate this would require massive cutbacks in employment where government employs roughly one-third of the population, at least by some measures.

This adverse scenario is badly overdrawn, and this chapter demonstrates why. Much of the apparent size of government arises from the fact that the commonwealth now owns a number of corporations and utilities. Some of these can and should be privatized, though this is a matter of good public management rather than budget. Others, however, draw on the budget to the extent of subsidies from general tax revenues. These subsidies can be eliminated without substantial adverse repercussions on the economy. Elimination of the subsidies can help provide the needed financial scope for realigning the island's tax structure.

On top of these budget savings, significant additional savings will become available as a consequence of the extension of full federal entitlement benefits to the island. The largest of these is in the area of medical care.

These cutbacks would be of a sufficient order of magnitude to permit a reconstruction of the tax system to fit nicely within the usual outline of federal-state-local relationships. Doing so requires no extensive cuts of employment, though it may involve shifting employment out of the public sector through privatization. This last would have the side benefit of presenting the new state with revenues from the sales of public corporations that may be used for public capital improvements, including improvements in education. At the same time, no major cuts in employment in general government activities is necessary, nor should it be.

A. Revenue Shortfall Illusion

It is sometimes asserted that statehood will bring two revenue problems to the island:[105] (1) tax revenues would decrease because of weaker economic growth, and (2) the new state's tax rates will have to be reduced to be more in line with

[105] Peat Marwick at III-19, for example.

the tax systems of other states. The first of these might be called the "revenue shortfall" problem, the second the "revenue reform" problem. However, the revenue shortfall problem is really an illusion arising from a misunderstanding of the kind of analyses in which the shortfall arises. As a matter of government policy, the revenue shortfall problem is not unique to statehood and has no special adverse consequences for the statehood economy, as we shall explain. In contrast, the revenue reform problem is an issue that needs to be addressed, and to do so requires a calculation of the magnitude of spending cuts and/or tax structure reform needed to bring the desired realignment.

The revenue shortfall illusion is an artifice of certain kinds of studies. Studies like Peat Marwick's that compare two alternative futures at a point in time--for example, statehood versus commonwealth in the year 2000--may mislead the reader as to the choices to be faced. Such studies presume, for example, that the statehood economy will grow less rapidly than the commonwealth economy, so that the statehood economy will be smaller than the commonwealth economy in the year 2000. (As we discussed, these alternative growth paths are assumptions based on judgment, not rigorous forecasts--and we believe them to be wrong.) They then imply that going from commonwealth to statehood will, for this reason, lead to revenue losses that must be made up in tax increases or spending cuts.

The fact is, if an administration is not guilty of mismanagement, the size of government spending grows roughly in line with the economy, whether the economy grows slowly or quickly. Thus, if the statehood economy were to grow more slowly than would have occurred under commonwealth, government spending, properly managed, would be smaller at the end of the period, and no cuts would be required. This linkage of the public sector to the economy is precisely the experience of the past decade, which had periods of both slow and rapid growth. If, however, the government is ill managed, or if a slowdown is sudden or unexpected, the government may find itself overcommitted and cuts will indeed be required. Otherwise, government spending will grow more slowly, just as the economy does.

Of course, if the current commonwealth party administration has overcommitted its resources, any period of slower growth--from whatever source--following the current business cycle recovery will require action. But the actions required in that circumstance would be no different than would be required from assumed slower growth under statehood after a period of overcommitment. Indeed, slower growth under statehood may pose less of a difficulty because, if the pessimistic scenarios are correct, the part of the economy that is growing less rapidly--the 936 sector--is precisely the sector that pays few taxes. Still, issues of managing government taxes and spending over the business cycle are issues common to governments everywhere and pose no unfamiliar challenge.

B. The Need for Fiscal Reform

The only issue, then, is whether spending cuts and a reallocation of revenues among tax sources will be required to adjust the structure of government and the level of taxation because the commonwealth government is presently bigger than a state government would need to be and its pattern of taxation differs from those of the states. This is the revenue reform problem. On its face, the current commonwealth government, including municipalities,[106] is quite large by mainland standards; but it is also quite different, making simple comparisons misleading.[107] In its fiscal 1989, the commonwealth (excluding municipalities) was budgeted to spend about $9.8 billion, or

[106]The present island government is substantially more centralized than most state governments, with most functions residing in the central government.

[107]For another discussion of this, see the General Accounting Office, Briefing Notebook, Chapters 5 and 6.

about 49 percent of island income (GNP) and 35 percent of the value of production on the island (GDP).[108] According to the island's GNP accounts, however, commonwealth government spending was about $4.7 billion, and municipal spending another $0.8 billion--a total of 27 percent of GNP or 20 percent of GDP.[109]

The large discrepancy in island government accounting is, first of all, the consequence of the commonwealth's owning a large number of public enterprises, public utilities, and other commercial activities undertaken by the commonwealth government but not common to state and local governments on the mainland. This arrangement stems in large measure from the active role the island government has taken in economic development. Its commercial activities include the sugar industry, operation of a large shipping company (acquired in 1975 when several privately owned lines threatened to cease servicing the island as a consequence of financial difficulties), the electric power authority, the telephone company, and several government-operated credit institutions. Altogether, the island operates some 52

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[108]Remember that the primary difference between Puerto Rico GDP and GNP is that remissions of foreign profits are subtracted from GDP to get GNP. These remissions arise primarily in the 936 sector. They accounted for roughly 31 percent of GDP in 1989, so that island GNP was only about 70 percent of island GDP.

[109]This includes spending from federal funds as well as from tax and other revenues.

public enterprises.[110] The revenues and expenditures of these operations are all included in the island budget, though the large majority of revenues are from sales of services, and the expenditures are normal business expenditures. These business-type activities are not included in the GNP accounts' definition of government. Hence, the smaller budget numbers are the appropriate ones to use in evaluating spending and tax cuts.

A number of the government-run businesses operate with continuing deficits, which may be the result of inefficient management or the consequence of pricing policies explicitly aimed at subsidizing one group or another, either the poor, the consumer, or private businesses being promoted for development reasons. These subsidies are paid for by taxpayers, so that one of the first steps in reducing the size of the island government to that of a state would involve decisions either to privatize the firms or, equivalently from the point of view of taxpayers, to terminate the subsidies. To the extent the subsidies had been directed or intended to benefit the poor, implementation of full federal entitlement benefits on the island (discussed in the next chapter), would reduce or eliminate this need for below-market prices. Privatization would have the additional benefit of

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[110] U.S. General Accounting Office, Briefing Notebook at 5-10.

placing funds at the disposal of the state government for investment in education, infrastructure, and alternative development activities, and to reduce outstanding debt.

As a general matter, these steps should not be controversial, though individual political personalities and circumstances will always be such as to generate political debate in decisions of this magnitude. The commonwealth government is currently privatizing the telephone company, with the payment to serve as a fund to support education on the island. The statehood party has traditionally opposed public enterprises and supported privatization, though the current sale has generated some opposition concerning the manner in which it is being carried out. The stance of supporters of independence, which includes a broader spectrum of views on the role of government in the economy, is less uniform in its support of privatization.

Given the recondite nature of government accounting in general, and of the commonwealth's accounting in particular, it is difficult to put an exact measure on the gains from eliminating subsidies to public enterprises.[111] In the FY 1990 budget, total government spending is budgeted at $11.1 billion,

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[111]Oficina de Presupuesto y Gerencia, Oficina del Gobernador, Estado Libre Asociado de Puerto Rico, <u>Presupuesto Para el Ano Fiscal 1989-90</u>, Marzo, 1989.

of which $4.4 billion is from the sales of services, $0.8 billion from loan and bond revenues (some of which supports commercial activities and some of which does not), and $1.5 billion from federal funds. This leaves about $4.4 billion to be funded from tax revenues. Subsidies to the sugar corporation alone were budgeted at $121 million. Given the number and scope of enterprises represented in the budget, cuts of $0.2 to $0.5 billion are feasible, and more is possible.[112]

The issue here in selecting a number is not one of feasibility in any economic sense, and none of the cuts require job losses except to the extent of current overmanning. Rather, the issue is one of policy choice: Some, and perhaps many, of the enterprises serve goals that the state government ought to be seeking to fulfill--the tourism corporation, for example, or support for agricultural development. These may require more or fewer resources than are currently budgeted, and may require the same or a different administrative structure to better achieve the goal. It is not the purpose of this study to choose directions for the future state. Rather, it suffices to note

[112]There are doubtless also a range of hidden subsidies in the commonwealth's budget, as in any government budget. But knowledge of those requires knowledge of the inner workings of the current administration, to which we are not privy. It should be noted that we have explicitly omitted the University of Puerto Rico system, a public corporation, from the above estimate of subsidies.

that $0.2 to $0.5 billion of the current budget's subsidies could be eliminated at virtually no loss to the commonwealth economy while retaining sufficient amounts of budgeted subsidies to permit a reordering of priorities.

A second major area of budget rearrangement is provided by the public health services, which are expected to receive about $0.4-$0.5 billion in subsidies from the general fund. Historically, given the sharp limits on medicare and medicaid funding available for servicing the medical needs of the island's poor, the commonwealth has operated a comprehensive public medical service, including primary, secondary, and tertiary care centers; that is, centers ranging from local public physicians and paramedical professionals to fully staffed major hospitals with full service. The resources of this service are strained; professionals are underpaid and sometimes below mainland professional standards, and medical care may be rationed.

The extension of full federal medical funding to the island will make the commonwealth's subsidies unnecessary, and at the same time provide the poor with freedom of choice of providers, which they do not now have, being required to utilize the public health service. Given these facts, two alternative scenarios are possible. One would involve the privatization of the public health service; the other would permit the continuation of the service in competition with a more active private sector. Either of these is feasible, and the choice is a matter for the new state government. Privatization would permit a gain of several hundred million dollars from the sale of assets which could be applied, as in the case of other public corporations, to other public investment projects for the new state. Continuation of the public health service would still permit it to charge competitive prices for medical care to those supported by medicare and medicaid, eliminating the need for subsidies from general tax revenues.

In sum, these two sets of items alone would permit a reduction in tax levies of anywhere from $0.6 to $1.0 billion in 1990 dollars, reducing spending by about 3 to 5 percent of GNP. Although we proceed immediately to examine the needed adjustment of the tax structure, it is worth noting that collections of individual tax revenues in the 1990 budget were budgeted at about $0.9 billion[113] and corporate taxes, including tollgate tax receipts, at about $1.0 billion. Thus, the identified budget cuts alone, if devoted to individual and corporate income tax

[113]This includes certain withholding regimes for nonresidents and for certain types of interest income.

reduction, could fund a substantial reduction in income tax rates.

C. Reforming the Tax Structure

Reforming the tax system requires two steps. The first is to bring the overall state and local tax burden on the island into line with tax burdens in the states by cutting spending as identified above; the second is to reallocate the burden among tax sources, assuming income taxes are currently too high, to reduce the relative share of the burden accounted for by income taxes.

There is no absolute standard by which to compare the size of tax burdens in different economies. The usual measures of tax burden compare tax liabilities for the economy to measures of the ability of the economy to pay--GNP (the value of income received from production by island residents), GDP (the value of production on the island), or personal income.[114] In 1989, the total tax burden on the island came to about 17.6 percent of GNP, 12.6 percent of GDP, and 19 percent of personal income. In comparison, the state average for these was 11 percent of GNP and

[114]Peat Marwick, for example, suggests that the ratio to GDP is the appropriate measure. (Peat Marwick at III-14.)

GDP and 13.2 percent of personal income.[115] From these, one can compute needed reductions in 1990 tax revenues on the order of $0.5 billion to $1.4 billion if the state government were to aim at the average tax burden of existing states relative to their economies.

The spending cuts identified earlier--$0.6 to $1.0 billion--fall well within the range of needed spending reductions. If the new state government were content to remain among the more highly taxed states, these cuts would be more than adequate. If, on the other hand, additional cuts were felt to be desirable, these would not need to be particularly large and could be spread out over a number of years. Just as an indicator of the relevant magnitudes at the extreme, spending from general fund sources currently grows on the order of $0.2 billion per year. Thus, a one-year spending freeze would allow an additional tax cut of $0.2 billion. Although we do not recommend undifferentiated spending freezes as sensible policy, this does indicate that even the additional amounts needed if one were to require the maximum cut indicated above--$1.4 billion in 1990 dollars--and decided to eliminate only the smallest amount of subsidies--$0.6 billion--could be achieved in four years without

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[115]We include in the tax burden such "nontax" receipts as lottery profits, but exclude federal funds and contributions to pension funds.

reducing spending below its current nominal level. Moreover, those who might normally be considered most at risk in such an extreme cases, the poor, would still find themselves better off as a result of the extension of the federal safety net.

But we believe the identified cuts are sufficient to achieve the goal of bringing the new state's tax burden in line with burdens in existing states. From this it necessarily follows that the identified cuts, together with existing revenues, may be rearranged in such a way as to allow the corporate and individual income taxes on the island to be brought in line with those of existing states.

As can be seen from a review of commonwealth tax revenues, the structure of commonwealth receipts is different in important ways from that of the states. Simply confining the analysis to the four major types of taxes, individual, corporate, sales, and property, the proportions accounted for by the commonwealth and by the state average are as follows:[116]

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[116]The data for the commonwealth are for 1989 and for the states, for 1987. We have eliminated revenues from goods and services, which accounts for 6 percent of total state revenues but 36 percent of commonwealth revenues due to the prevalence of sales from public corporations on the islands. We have also eliminated "all other revenue sources," which are only 16 percent of island government revenues but 36 percent of state revenues, some of the latter of which includes revenues from the sales of goods and services. In addition, we have excluded federal funds,

Table 3

Percentage of Government Revenue

	Commonwealth (1989)[117]	States (1987)
Individual Income Tax	27.5	23.4
Corporate Income Tax	31.9	6.4
Sales Tax	31.9	38.3
Property Tax	8.7	31.9

Based on these data, the second goal of the needed tax reform--in addition to lowering the overall tax burden--would be to restructure the tax system to reduce corporate and individual taxes, while raising sales and property tax collections. The increase in sales taxes is of a relatively minor order--about $0.2 billion. Raising property tax collections, which are low because the system is relatively underutilized, would be a more significant political undertaking. At the same time, it should be remembered that the increases in these taxes would be taking

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which are a larger percentage of commonwealth receipts (24 percent) than of states (14 percent), but are much larger in per capita terms for the states ($472 for the states in 1987 versus $341 for the island in 1989). See GAO Briefing Book, Chapter 6.

[117]The commonwealth had projected to undertake the last phase of its staged tax reform in fiscal 1990. This would have lowered individual taxes somewhat and raised business taxes by a slightly larger amount, thus changing the relative shares. However, the commonwealth, like many states, has found itself in deficit this year, so that delay of the most recent stage of tax reform is a topic of debate. For this reason, we will use the 1989 tax shares as sufficiently accurate for the purposes of the current study, though our computations are for 1990.

place in the context of a general tax reduction, as well as of a focused reduction in income taxes. On net, taxes in total would be cut by $0.6 to $1.0 billion.

The restructuring of the tax system does raise an economic point worth considering, which is whether the game of restructuring is worth the political candle. Although the general reduction in the tax burden benefits all taxpayers, the restructuring of the system will benefit some and harm others. The only clear reason for undertaking such a reform is to bring the outline of the system as a whole into accord with the state systems on the mainland. In these systems, property taxes have historically played a major role because they are used to fund local government and because they pre-dated income taxes.

Yet whether a relatively greater reliance on property taxes is better for the economy is a matter open to debate. Economists generally feel that property taxes, if well designed, have less severe, adverse consequences for work and saving than do income taxes.[118] However, both, as customarily applied, serve as disincentives to capital formation. Income taxes may be better

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[118]This is merely the well-known observation that taxes on pure land "rents," the part of the value of real property stemming from its locational scarcity, do not alter economic efficiency, a point publicized by Henry George.

utilized to redistributive ends than property taxes, but even here the final judgment must depend on the distribution of the economy's wealth and income. Moreover, and as a practical matter, both potential investors and potential residents may take both, or the total, into account when making decisions about where to locate.[119]

As a practical--and preliminary--judgment, the desirability of a complete restructuring of the new state's tax system to mirror those of existing states may be overvalued. We suspect, though it is a subjective suspicion, that current income tax rates are too high and current property tax rates too low to fit the island's economy comfortably into statehood. However, we do not believe that a complete reallocation is necessary.

In part, the answer to this may lie in the new state's decision about its internal organization. Currently, the commonwealth is much more centralized than the states, with much less power delegated to local levels of government. There are no counties, though increasing population and economic activity may warrant such a devolution of power in the new state. With such a devolution could come a natural devolution of taxing powers which

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[119]This is one conclusion that arises from the voluminous literature on the effect of taxes on business location in the states cited in Chapter II.

may leave the property tax, and the choice of tax rates and property valuation, in regional hands to respond to regional needs.

VI. PROVIDING EQUAL ENTITLEMENTS

Statehood would extend full federal entitlement benefits to the island's residents. Under current federal law and the existing status of the island, residents of Puerto Rico, while they are U.S. citizens, do not participate fully in all social benefit programs.[120]

On the island, residents now participate fully in regular social security (OASD) and unemployment insurance and make contributions to both systems. However, supplemental security income (SSI) is altogether unavailable to the aged blind and disabled. Instead, they receive a limited program partially funded by a block grant from the federal government. They receive medicare, but prospective payments are based on the low cost of hospitalization on the island, which is heavily influenced by the island's comprehensive public health care system. Medicaid is limited. Aid to Families with Dependent Children (AFDC) is available with limitation, and subject to a cap together with aid to the aged, blind and disabled, and

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[120]However, as U.S. citizens they may freely move to any of the fifty states and receive in full any benefits to which the law and their circumstances entitle them.

several other programs. Nutritional assistance is also limited, and is received as cash rather than as food stamps.[121]

CBO has estimated the approximate federal budget costs of the extension of these major programs to the new state to be as follows in 1995:[122]

Current Law (Commonwealth)	$2.1 billion
Increments Due to Statehood:	
Food Stamps	0.7
Medicaid	1.2
Medicare	0.1
Supplemental Security Income	0.9
AFDC	0.1
Total Increase	3.0
Outlays Under Statehood	$5.1 billion

[121]Eligibility for, and operation of, the several entitlement programs is interrelated and complex. We note that these complexities and the absence of data on Puerto Rico's eligible population has resulted in significant divergence between CBO and Administration estimates of the likely costs of several programs.

[122]CBO Papers, op. cit. at Table 5 and Table 7. The added outlays do not represent the net increase in federal funds to the island. Instead, the outlays are partially offset by extension of the federal tax system to island residents which, however, are not, from federal budget scoring, effectively fully phased-in until 1997. By the year 2000, CBO projects added outlays of $3.6 billion, offset by revenues from the island of $2.2 billion.

In addition, the Treasury would receive revenues from operations formerly exempt under Section 936, but not accounted as new revenues from the island itself by CBO. CBO has not made estimates of these revenues, but in Treasury scoring these more than exceed the net deficit on new spending to the island. Thus, the impact of statehood is to return a surplus to the federal budget.

Some opponents of statehood have argued that as a state, Puerto Rico's relatively low income and high unemployment would channel "too much" federal money to the island. This is not an economic argument, and we leave to others the political and legal debate over whether the federal government should vary its social-welfare support for American citizens according to their place of residence.

However, there is a related economic question, one raised by Senator Moynihan and others, which should be joined: Given that the people of Puerto Rico currently have lower incomes on average than residents of any of the 50 states, would statehood provide such high levels of federal social-welfare support as to undermine the work ethic and create an alternate culture of dependency damaging to economic initiative?[123]

Our judgment is that it would not. The reason is that most of the projected increases--medicaid, medicare, and SSI--would be distributed to people who are too ill, or too young, or too old,

[123]From time to time, adherents of the commonwealth party also seem to argue for this view, while at the same time arguing that the commonwealth ought to receive full entitlement benefits in any case--and without paying federal taxes.

replace a smaller existing block-grant program partially funded by the commonwealth. Thus, not all the increase in federal outlays would translate into additional benefits. Still, benefits per recipient would increase substantially, as would the number of eligible recipients. But the incentive effects on Puerto Rico's average able-bodied worker would be minimal: Virtually all who would receive this help cannot work, or are severely limited in their occupational possibilities, regardless of the level of assistance.[125]

Federal costs associated with medicare and medicaid payments are also expected to increase with statehood, with medicaid by far the largest projected increase.[126] But the U.S. Department of Health and Human Services (HHS) projects that the major beneficiaries of this increase will be the hospitals and health

[125] If an SSI beneficiary is "living in the household of another," he/she still receives two-thirds of all benefits under this program, regardless of the income of the rest of the others in that household. Thus, the potential disincentive effects on able-bodied workers in the household are minimal, since the group as a whole is not "taxed" by loss of benefits if members of the group earn more income.

[126] The Administration projects considerably smaller spending increases for medicaid due largely to differences with CBO in judgments about the size of the likely needy population. The Administration has as yet made no estimate of medicare, taking the position that S.712 contains certain ambiguities that render estimates currently impossible to make. However, it must be presumed that the Administration's estimates would not differ qualitatively from those of CBO.

or too disabled to work.[124] For the remaining benefits that could be characterized as potentially eroding the work ethic, the probable increases in total benefits per recipient are much smaller than the aggregate figures suggest, and "work fare" constraints and incentives are being incorporated into the federal programs that would offset some or all the disincentive effects associated with richer benefits. Indeed, there is no evidence that these last programs, to the extent they exist today, have had adverse impacts on the work ethic of island residents.

A. Most New Entitlement Recipients Would Not Be Part of the Potential Work Force

Of the $3.0 billion increase in federal entitlements to the island, $2.2 billion--almost 75 percent--would be for extensions of programs aimed at the aged, blind and disabled and the medically needy: SSI, medicare, and medicaid.

Supplementary Security Income, provides support for elderly, blind and disabled persons who do not receive social security. This program would be 100 percent federally financed and would

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[124]There is also a small incremental amount for outlays under the earned income tax credit, which would come to the island with federal taxes. However, one can only qualify for the earned income tax credit by working.

care providers, not recipients.[127] As discussed in the previous chapter, this will relieve a significant burden from the current island government, and ultimately provide better quality medical care through both public and private providers. This would improve the island's public and private medical and health care systems for both the direct recipients of assistance and the rest of the population, including Puerto Rico's work force. Better health means reduced absenteeism, better productivity and lower unemployment.

To anticipate this improvement in the medical and health care systems, consider first current conditions. Puerto Rico currently spends roughly $500 million from its general funds, 12 percent of its 1990 general fund budget, to provide medical services to a broad segment of the population through an extensive public health service similar to Canada's.[128] While there are also private providers and some patients pay for the services they receive in public facilities, medical care for the poor is already funded by the commonwealth.

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[127]See M.H. Gerry, "Statement before the Committee on Finance, U.S. Senate," April 26, 1990, p. 2.

[128]Total spending on medical care, including spending from federal and other funds, is about $750 million. For a complete description of the system, see A. Pagan-Berlucchi and D.N. Muse, "The Medicaid Program in Puerto Rico: Description, Context and Trends," Health Care Financing Review, Summer 1983, pp. 1-17.

But this system has its problems. Given the budget restraints, medical care must be rationed. Those in need but not receiving prompt service can readily fly to the mainland for treatment at public hospitals, at the expense of mainland care programs. And, the primary care providers--the physicians--are poorly paid by the public system. With such low pay on the island, board-certified physicians have a strong incentive to migrate to the mainland U.S. to achieve mainland compensation levels. Thus, most physicians remaining on the island either are very dedicated or have possibly inferior (not board-certified) training.

When the current system converts to the federal programs, three important changes would take place. First, more resources would be available for medical assistance to the poor. Better assistance and better health would result in more Puerto Ricans ready and able to enter the work force. It would also relieve some of Puerto Rico's budgetary pressures. Second, the federal programs require the poor to have a choice between public and private providers. Private doctors and other health care providers could thus earn an income on the island closer to that available on the mainland. This should result in an increase in qualified private providers available to serve both the poor and the rest of the population.

B. Historical Impacts of Welfare Programs on Work Patterns

Statehood would also provide certain welfare benefits to some able-bodied persons in the same way that such persons receive the benefits in the current 50 states. In this category, we count food stamps and the portion of AFDC and medicaid benefits supporting the parent.[129] The commonwealth, however, already provides some of these benefits. It is difficult to derive from the aggregate outlay figures an estimate of per capita increases, but for most programs the probable increases relative to existing benefits--and, more importantly, to total incomes--is not as dramatic as the aggregate numbers would suggest. This is especially true when one recalls that these benefits are taken into account in calculating eligibility levels and benefits provided in other programs. Hence, increases in food stamps, medicaid and AFDC benefits could be partially offset for many recipients by reductions in the potential benefits from other programs.

[129]HHS estimates that the major increases in medicaid benefits will come from the shift in state/federal cost sharing and in the broader coverage of SSI beneficiaries--neither of which affects the possible benefits for a potentially able-bodied worker. See "Statement by Arnold R. Tomkins Before the Finance Committee, United States Senate" November 15, 1989 at page 9.

Moreover, the new federal approach toward assistance to the poor--as embodied, for example, in the programs under the Family Support Act of 1988--emphasizes parental responsibility and providing to needy families the education, training, employment and employment-related support necessary to break them free of long-term welfare dependence.[130] These reforms, not now incorporated into the commonwealth welfare system, would help to further contain and dilute any disincentive effect of increases in AFDC and nutritional assistance connected with statehood.[131]

1. Has Welfare Discouraged Work in the Past?

It is sometimes argued that labor force participation on the island is low--and unemployment, discussed next, is so high--because of the broad availability of mainland welfare programs that are generous in light of the island's low income. For

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[130]For example, HHS projects that over 85 percent of the increase in federal funding of Puerto Rico's AFDC program (for FY 1995) would be related to the new requirements of the AFDC-Unemployed Parent program mandated by the Family Support Act.

[131]Adoption of the federal Food Stamp program would also require a shift from the current cash payment system to the more restrictive coupon operation, with its additional monitoring and redemption restrictions. This loss of financial flexibility and the increase in restrictions also diminish the effective increase in benefits associated with this change.

example, over half the population receives nutritional assistance, the island's variant of the food stamp program.[132]

This apparently plausible argument seems, however, deeply at variance with other data. As shown in Table 4, participation rates throughout Latin America are roughly the same as Puerto Rico's, though for--largely poorer--countries at varying levels of development and with varying degrees of income support.[133]

Second, as Figure 7 shows, the participation rate in Puerto Rico began to drop as development took hold in the 1950s, and participation fell throughout the period of rapid industrialization--well before the availability of federal social welfare benefits. It fell at the time of the mid-1970s recession, recovered, and then slowly fell throughout the late-1970s. It bottomed-out in the recession of the early-1980s, and since then has continuously risen.

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[132] Bloomfield, Richard J., Puerto Rico: The Search for a National Policy (Boulder: Westview Press, 1985), pp. 78-81.

[133] This table is lifted whole--not selectively--from the most recent issue of Statistical Yearbook for Latin America and the Caribbean, 1987. The year of observation varies according to the most recent data available.

Table 4

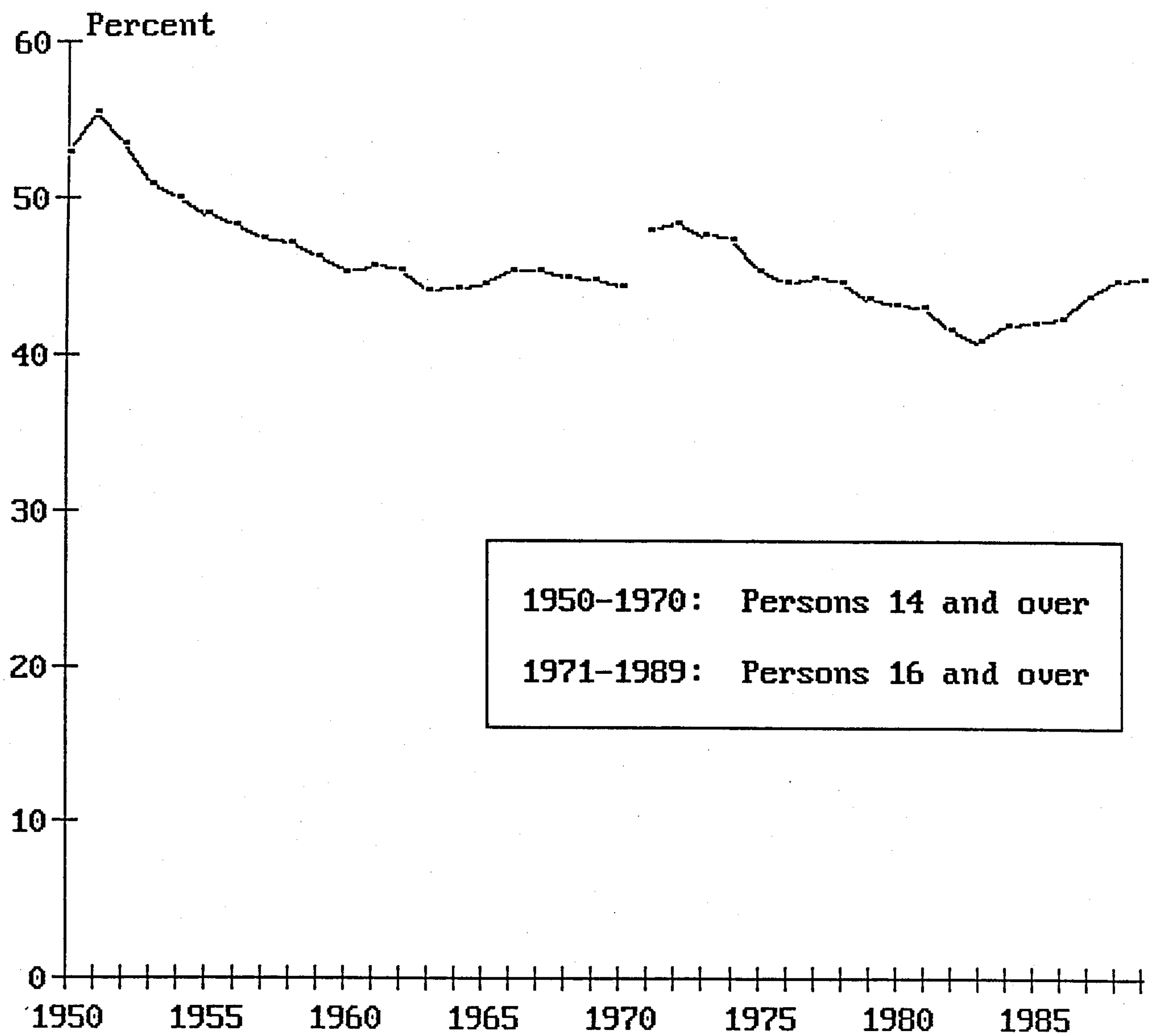
Average Family Size and Labor Force Participation Rates in Selected Latin American Countries

	Latest Information Available	Average Family Size	Participation Rate
Argentina	1980	3.9	46.0
Bolivia	1976	4.3	49.3
Brazil	1980	4.4	49.2
Colombia	1973	6.1	47.6
Costa Rica	1973	5.6	46.7
Cuba	1981	4.0	45.1
Chile	1982	4.5	40.2
Dominican Republic	1970	5.3	42.8
Ecuador	1974	5.4	43.1
El Salvador	1971	5.4	48.9
Guatemala	1973	5.5	41.7
Honduras	1974	5.7	45.0
Mexico	1970	4.9	41.4
Nicaragua	1971	5.9	43.3
Panama	1980	3.7	44.8
Paraguay	1982	5.2	46.6
Peru	1972	4.8	43.3
Uruguay	1975	3.4	48.1
Venezuela	1971	5.8	42.9
* * *			
AVERAGE		4.9	45.1
PUERTO RICO	1989	4.3	45.5
U.S.	1987	3.2	65.6

Source: Statistical Yearbook for Latin America and the Caribbean, 1987, pp. 16-18; Puerto Rico Planning Board, 1989; Statistical Abstract of the United States, 1989, Tables 61 and 622. The U.S. figure for household size is 2.7.

Figure 7

Puerto Rico
Labor Force Participation Rate



Source: Puerto Rico Planning Board

While a comprehensive explanation of these facts would itself require one--and perhaps several--studies, the facts are clearly inconsistent with the argument that welfare payments are at the heart of the matter. What we see instead is, first and foremost, a labor force moving from an agrarian society--in which many work part of the year as agricultural laborers--to a society that, by comparison, can afford to support the extended family without seasonal subsistence work by most family members--as in Latin America. A substantial portion of that support goes to see children, of whom there are relatively more than on the mainland, through school. This schooling further reduces the labor force. Additional support goes for care of aged family members, since there is little in the way of safety net. The recent continued uptrend could suggest--but does not prove--evolution toward the participation rate more common of North America.

More recent developments in the late-1970s and early-1980s also show the typical response of a discouraged labor force to a period of economic adversity. In addition, as will be discussed in the next section, there were two other major changes in the economic environment altering job possibilities.

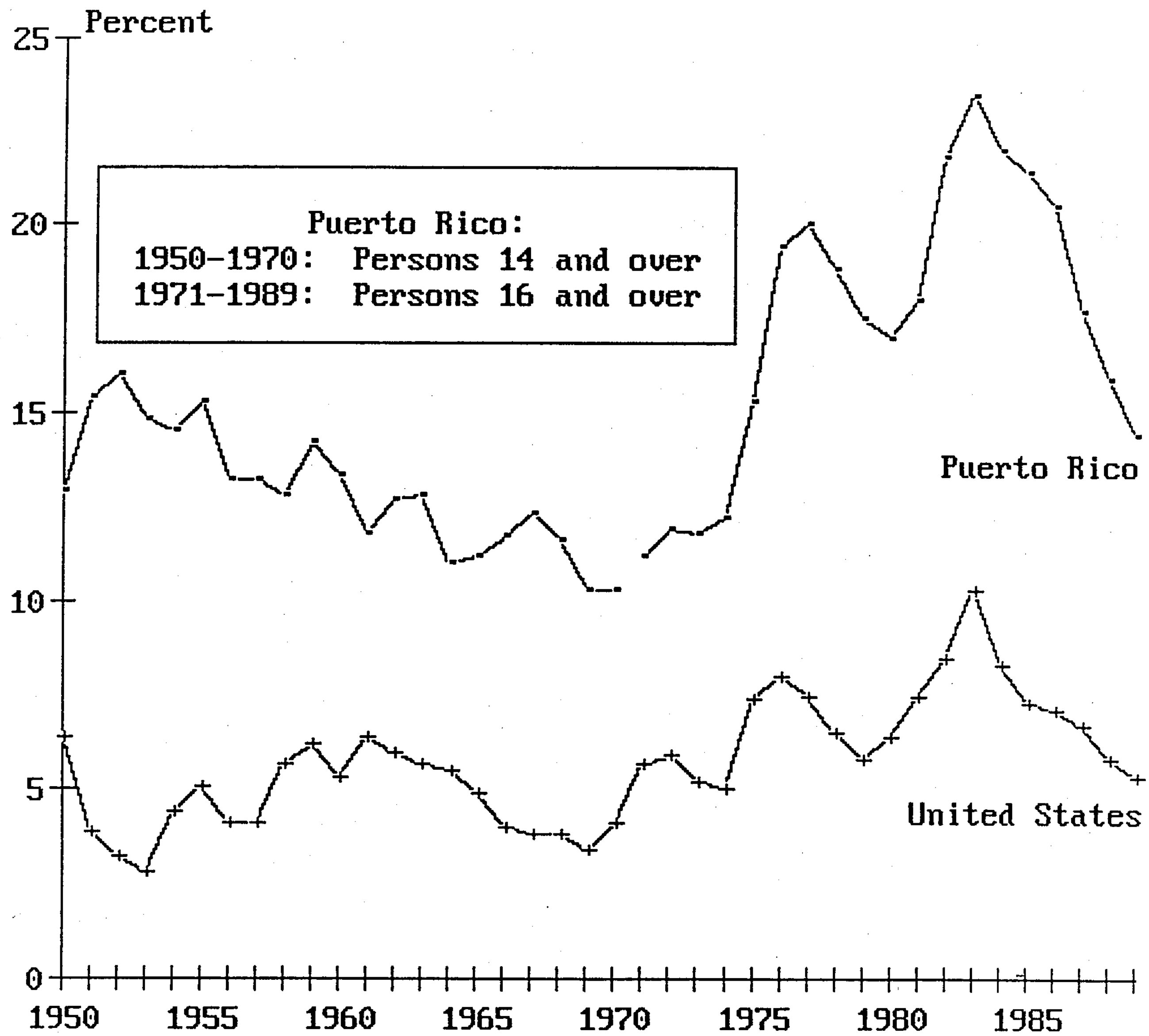
Food stamps were introduced throughout the island beginning in September 1974. Between 1982 and 1984, however, the program was significantly reduced, with aid being cut off to 110,000 families. Yet the generous benefits in the mid-1970s does not appear to have retired workers from the labor force, nor did the later benefit cuts send them back into the labor force. The evolution is much more consistent with a maturation of industrialization at a time of deep recessions. At most, only a small contributing role in this broad sweep can be attributed to welfare payments and, particularly, to nutritional assistance.

2. The Evolution of Unemployment

The unemployment rate in Puerto Rico has raised similar concerns about the impacts of federal assistance programs. Once again, though, as Figure 8 shows, the welfare story is at variance with the data. Three facts stand out from the figure. First, the island unemployment rate mirrors that in the U.S., but amplifies it. The amplification seems to grow larger as the economy grows more dependent upon--cyclical--manufacturing. Second, unemployment peaks with recessions and then drops, notwithstanding changes in nutritional assistance. Third, and finally, there is a wide gap between the island and mainland rates, a gap that is structural, rather than cyclical in nature.

Figure 8

Puerto Rico vs. United States Unemployment Rate



Source: Puerto Rico Planning Board

The history of structural unemployment on the island has a simple pattern--it averaged about 12 percent until about 1975, when it increased to 20 percent. It has only slowly come down from that level. The first part of this is relatively easy to explain.[134] The growth rate of population has exceeded the growth of potential employment. On the population side, growth was historically about 1.7 percent a year, roughly the average for the world, but above the 0.6 percent for the U.S. But, given the focus of development efforts on manufacturing, which employs relatively few workers per unit of output compared to other sectors, the annual addition to new jobs fell far short of increments necessary to employ the potential work force. The consequence was high unemployment, and emigration of the excess population to the mainland.

In the mid-1970s, at about the time food stamps were introduced on the island, the rate of unemployment doubled (as it also did on the mainland between 1969 and 1975). Although it is tempting to ascribe the cause to food stamps, this view was unmistakably refuted in the Kreps Report in 1979. As that study pointed out, there were two major changes to the island economy at that time--in addition to food stamps and the recession

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[134] See U.S. Department of Commerce, Op. Cit., at Volume II, 581-602.

itself. First, construction activity roughly halved between 1973 and 1975, and never recovered its previous level. This put 60,000 construction workers in the street, a number roughly equivalent to the increase in structural unemployment. Construction employment never returned to its previous level. These events can be seen in Figure 9.

The second change was a temporary reversal of migration patterns.[135] Puerto Rican mainland residents returned home, permanently raising the net population in excess of the number of jobs. Although the availability of food stamps may have helped to entice them home, the same time period also saw a parallel,

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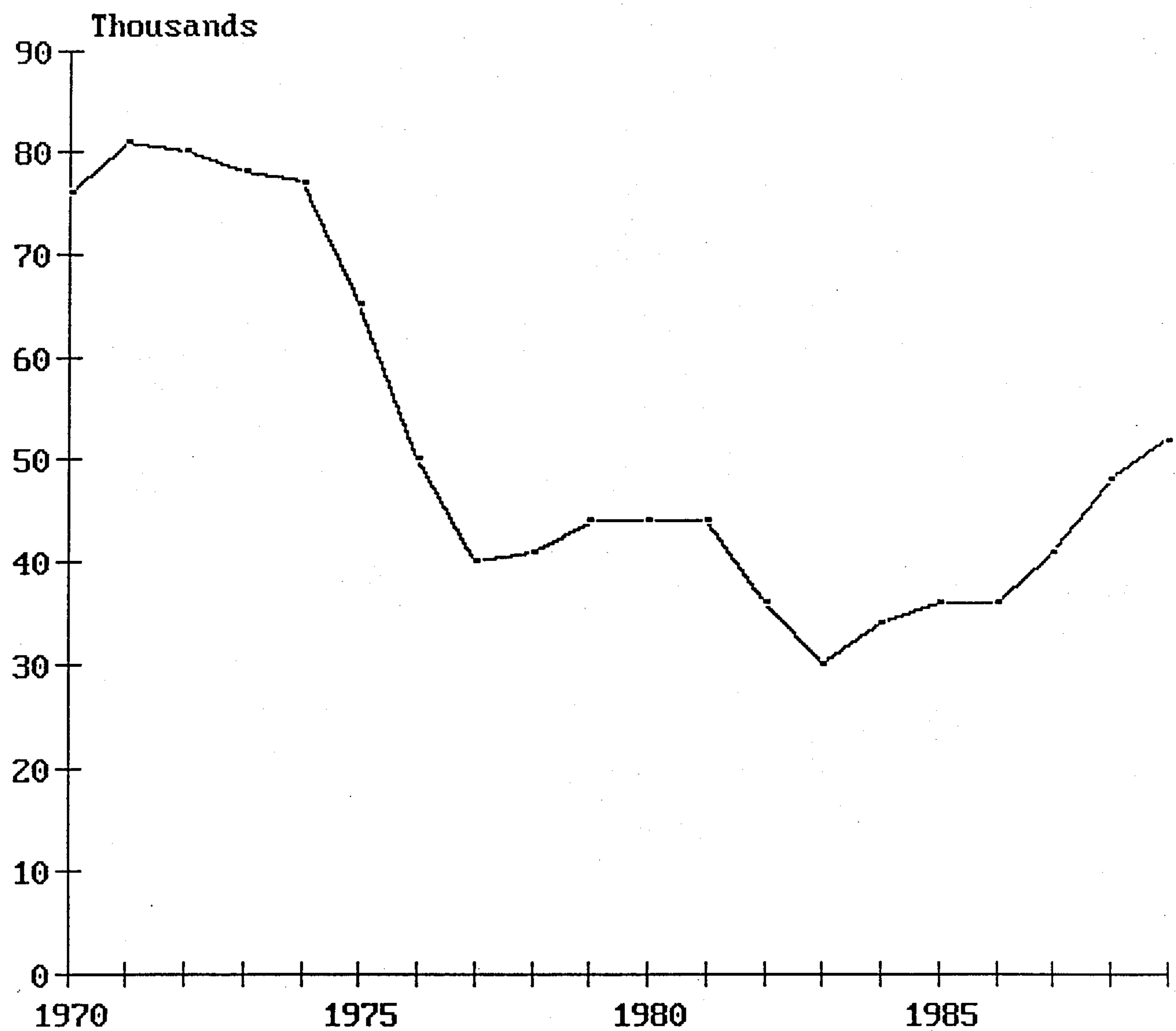
[135]Studies by the National Commission for Employment Policy listed earlier have attempted to document the mainland employment history of hispanic workers, including Puerto Ricans. What these found was that, historically, easy access to the mainland led island residents to come to the mainland seeking work. Keeping in mind that during this period Puerto Rico was relatively early in its development trajectory, these migrants had few skills and spoke little or broken English. They remained largely unemployed here. But they also had easy return access to the island. Thus, their back and forth movements to the island in search of work became a very sensitive indicator of cyclical differences in job prospects between the island and the mainland. (See also R. Maldonado, "The Economic Costs and Benefits of Puerto Rico's Political Alternatives," <u>Southern Economic Journal</u>, Vol. 41, October 1974, pp. 267-282.)

Beginning with the mid-1970s, this relationship changed, as did many potential causes for the change. Economic shocks from 1973 to about 1985 hit the mainland hard; they hit the island harder. Social benefit payments were extended to the island. Though these were less generous than on the mainland, they may have been sufficient to bring home some of the "hard core" unemployed.

Figure 9

Puerto Rico
Construction Employment



Source: Puerto Rico Planning Board

reverse migration of black mainland inner-city residents to their rural origins. The authors of the Kreps Report believed these common developments to have had common causes: the depth of the mainland recession and the increase in inner city violence that accompanied it.[136]

Notwithstanding these explanations, if the extension of food stamps had been a primary cause of the change in unemployment, unemployment would have fallen when the program was cut back in the early-1980s--an occurrence that did not come to pass--unless the brief experience with food stamps permanently changed island residents' willingness to work. There is no reason to believe this. Although island residents may suffer under the "West Side Story" stigma, one of the little known but important features of island unemployment data lie in statistics on the duration of unemployment. Although island unemployment is much larger than on the mainland, the average duration of unemployment has been considerably shorter there: 8.8 weeks compared to 15.8 weeks in 1976, when unemployment on the island stood at nearly 20 percent while the mainland rate was only 7.7 percent.[137] Authors of the Kreps Report argued convincingly that these statistics indicated a strong willingness to work: Rather than accept the prospect of

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[136]Commerce Department, <u>op. cit.</u> at 589-602.

[137]<u>Id.</u> at 595-596.

an extended period of unemployment, even with full food stamps, potential workers migrated to the mainland in search of jobs after a relatively short period of unemployment.

This last impression reinforces one of the striking features of the Puerto Rican work force that comes through in a number of different ways--testimony by employers, migration, statistics on the duration of unemployment, and the active development and success of Operation Bootstrap itself: Perhaps even more than for residents of the mainland, the search for work by island residents is a matter of dignity. If that search has been too often frustrated, it may be because of the limited employment provided by single-minded reliance on manufacturing employment under Section 936 as the sole tool of economic development.

C. Did Food Stamps Destroy Island Agriculture?

Many seem to regard it as conventional wisdom that the introduction of food stamps destroyed the island's agricultural sector. This has been stated most forcefully by Senator Moynihan in his recent statement before the Finance Committee. It has also been stated in a more nuanced fashion by Weisskoff: "The introduction of food stamps hastened agriculture's final demise."[138]

That this thesis needs refinement is clear from the data. Trends in agricultural employment in Figure 10 show that the long-term downward trend in Puerto Rico's agricultural employment mirrors the pattern for the mainland U.S., with no discernible breaks in the patterns associated with the introduction of food stamps in Puerto Rico in 1974-75 nor with the curtailment of benefits in 1982-84. (Note that the decline in Puerto Rico's recorded agricultural employment in the late-1970s is exaggerated because in 1977, the statistical series dropped 14-year olds and 15-year olds.)

In fact, agriculture was largely destroyed by the process of industrialization. Given the backwardness of the cash crop sector--sugar, tobacco, and coffee--also crops with strong worldwide competition, this loss may not be lamented, though the inevitable disruption of the society should be. The real loss is

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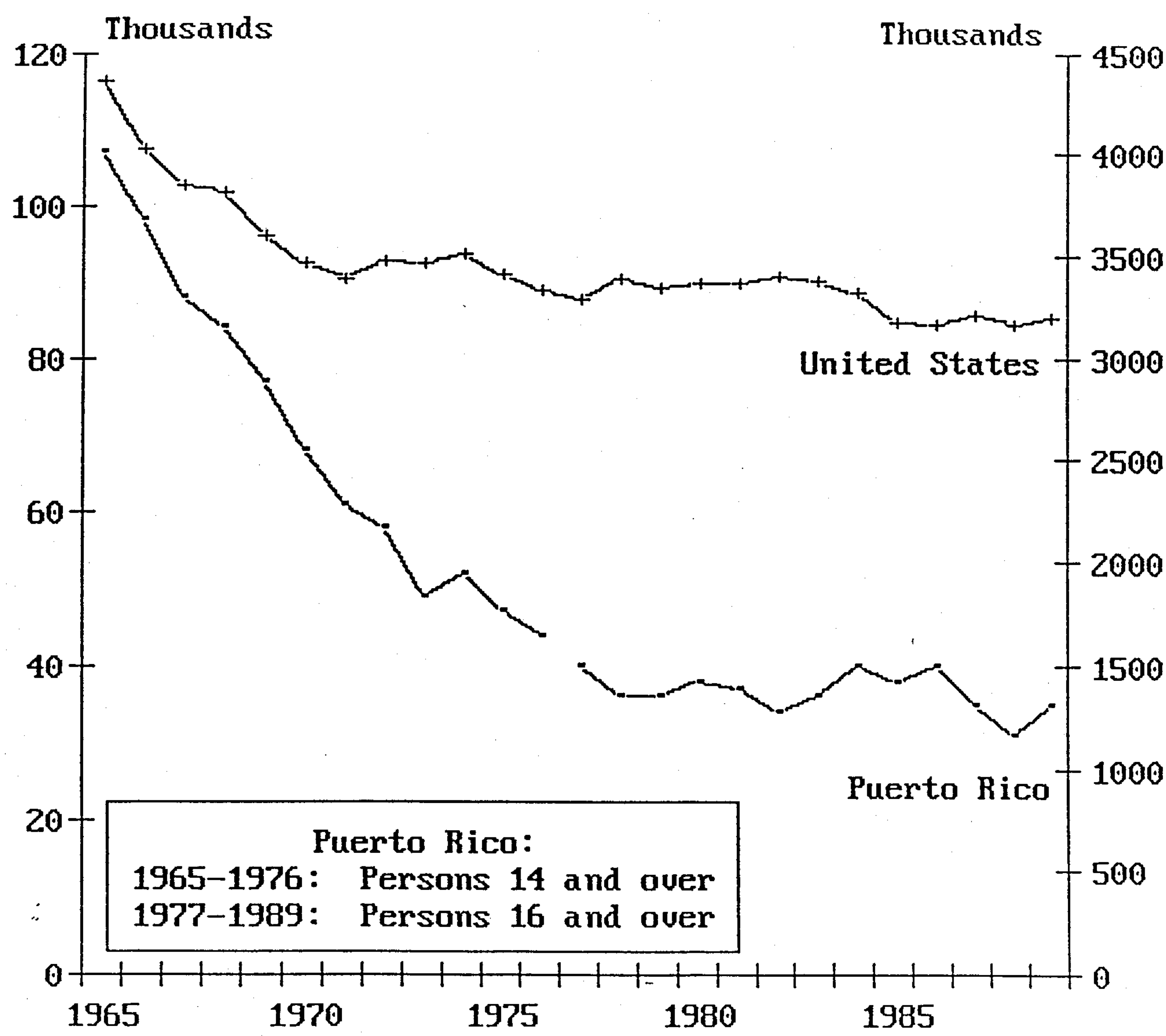
[138] R. Weisskoff, Factories and Food Stamps (The Johns Hopkins University Press, Baltimore and London, 1985), pp. 128. Weisskoff's position is that Puerto Rico's developers associated agriculture with "backward" societies. In promoting manufacturing, they left agriculture to languish. Food stamps, by permitting even the poorest to buy food at the supermarket rather than grow it themselves, severed the last connection to the land of the remaining peasantry.

Figure 10

Puerto Rico vs. United States
Agricultural Employment



Source: Puerto Rico Planning Board

that the island's agricultural sector was not modernized to keep pace with world demand for other crops and products for which the island is suited.

The remainder of agrarian activity lay largely in the production of food crops for local--often home--consumption. Food stamps rendered this activity a luxury rather than a necessity, and this is the sense in which "food stamps destroyed agriculture." The question then, is whether it would have been better to require Puerto Rico to retain an independent peasantry under the economic compulsion of poverty.

Bibliography

[We are harmonizing footnotes and working on a complete bibliography.]