Unlocking the Golden Handcuffs: Prospects for Improving the Performance of the Puerto Rican Economy

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While the standard of living in Puerto Rico compares favorably with its regional counterparts, since 1980 the disparity between living standards on the US mainland and Puerto Rico has widened in contrast to the trend from 1950-80. By implication, economic growth in Puerto Rico over this interval has lagged that on the mainland. A recently released major study of this issue concludes that the cause of this reversal of trend is the result of policy failures (including tax, labor market, and industrial policies) by both the Territorial and the US governments. This paper argues that many of these cited policy distortions -- given Puerto Rico's constraints resulting from its political status -- can be remedied only after Puerto Rican's can decisively settle their long-standing "existential" problem: continued territorial status or full statehood.

INTRODUCTION

Over the last two years, in addition to the publication of routinely scheduled country reports and profiles by consultancies such as The Economist Intelligence Unit (2006a, 2006b), a flurry of US government reports on Puerto Rico (Task Force Report, 2005; CRS, 2005; GAO, 2006; and JCT, 2006) were issued around the same time as the release of an important study carried out by an independently-funded research project underwritten by the Brookings Institution in Washington and the Center for the New Economy in San Juan (B/C) that focused on the recent past performance of the Puerto Rican economy and, more importantly, on recommendations for comprehensive policy changes to improve the performance of the Puerto Rican economy over the next decade and beyond (Collins, Bosworth and Soto-Class, 2006). On issues concerning economics and politics, the successive release of government committee and "think-tank" reports within such close proximity usually signals the existence of "problems". Judging by the contents of the above-cited reports, in the case of Puerto Rico, this appears to be the case.

No matter how big or small, how advanced or backward, how old or new, every country has a "story" to tell – a defining characteristic (or set of characteristics) that anchor(s) its position on the world's political and economic stage. Often these defining characteristics have their roots in historical, geological, geophysical, demographic, or political "facts" and sometimes in a combination of all of these and others.

As we shall see below, the single most important determinant of the performance of the Puerto Rican economy, including the material well-being of its residents, is the often strained (and sometimes tortured) unique relationship and status that the island has with the United States. As we will argue below, this unique relationship is the dominant reason why Puerto Rico enjoys one of the highest levels of economic well-being in the region, i.e., measured by income per capita (EIU, 2006b). Nevertheless, according to the B/C study cited above, even though the economy grew at an annual rate of 3.9% from 1975-2004, since 1980 there has been a growing divergence in the standard of living on the island and living standards on the US mainland when measured by the per capita GDP. This is the case because, according to the B/C report, Puerto Rico's official statistics overstate the value of goods and services produced on the island due to section 936 (of the US tax code) benefits which provided -- before its recent expiration in early 2006 -- strong incentives to use transfer pricing to shift reported income to Puerto Rico because profits were effectively exempt from US taxation from 1976-2005. Once adjusted, the data highlight the poor performance of the Puerto Rican economy, relative to the US mainland, over this time interval.

Part 1 of the paper provides a review of Puerto Rico's vital statistics, its political landscape, and some recent economic highlights. Because the Puerto Rican economy is already so highly integrated into the global economy it is useful to describe the territorial, regional, and global constraints to which the Puerto Rican economy must conform. This is provided in Part 2. Part 3 presents a description and analysis of the strengths and weaknesses of the Puerto Rican economy when viewed through the prism of the World Bank's "recipe for success" that is presented in Part 2. In addition, throughout this section, the reader is repeatedly reminded of the additional constraints that are imposed on Puerto Rico's policy-makers and -- as so often is the case -- the economic benefits that accrue to Puerto Rican residents from the island's unique political status with the world's pre-eminent economic power.

VITAL STATISTICS, THE POLITICAL LANDSCAPE, AND RECENT ECONOMIC HIGHLIGHTS

Puerto Rico, a Caribbean island that is approximately 110 miles long and 50 miles wide at its longest and widest points, respectively (with a total surface area of about 5500 sq miles or 9000 sq km), is roughly the size of Cyprus. The island is located between the Dominican Republic on the west and the Leeward Islands (the US Virgin Islands, the British West Indies, etc.) on the east, and lies about 1000 miles southeast of Florida.

According to a mid-2004 US Census estimate (EIU, 2006b), the island's population was approximately 3.91 million people, about the same as Singapore, and according to the World Bank (2005), Puerto Rico, in 2003, had an annual population growth rate of 0.8%, some 0.3% per year below that of the US mainland. (Part of the slowdown in the island's population growth rate over time is, of course, due to the extensive and unrestricted immigration to the US mainland.) In 2002 life expectancy at birth in Puerto Rico was the same, 77 years, as in the United States, and both the total and the female literacy rates (for those 15 years and older) were 94%. Per capita gross national income (on a purchasing power parity basis), in 2003, was

$16,300, less than half that reported for the US mainland (World Bank, 2005), while per capita GNP in 2005, according to the Puerto Pico Planning Board, was $13,700 (EIU, 2006b). [1]

The recently published B/C study, mentioned above, cited data that indicate that the standard of living in Puerto Rico -- measured by annual income per capita -- in 2004, was less than half that of Mississippi, the US's poorest state. In addition, according to the same study, more than 48% of the island's residents lived below the federally defined poverty line, nearly four times the US national rate.

Furthermore, while the gap in living standards (measured by GDP per person) between Puerto Rico and the US mainland narrowed between 1950 (around the time when the island's Commonwealth status began) and 1970 -- GDP per person in Puerto Rico in 1950 was 20% of GDP per person in the US in 1950 and 45% per cent in 1970 --over the last three decades that gap has steadily widened with GDP per person, in 2000, estimated at only 35% of GDP per person on the US mainland (The Economist, 2006). In addition to an unusually low <u>employment</u> rate (see Part 3, below), the official unemployment rate on the island is 2.5 times the rate on the mainland. Also, almost 50% of the island's population participates in the US government's "food stamp" program, which provides monthly cash (in the form of script) to means-tested poor people to purchase basic food items. These official statistics should be qualified because of the significant size of the "informal" economy on the island, estimated at approximately 23.3% of GDP in 2002 (Department of Labor and Human Resources, 2004). After including the contribution of the "informal economy" Puerto Rican living standards, relative to those on the US mainland, are estimated (by us) to increase to 45%.

With regard to value-added, the agricultural sector contributes about 1%, manufacturing about 43%, and services (that includes tourism) approximately 56% to GDP, percentages that have changed little since 1990. Efforts were made in the 1990s to reduce the importance of manufacturing in the economy because of international competitive pressures, but this has not materialized. (More about this below).

The island, which was an autonomous province of Spain in the 1890s, was invaded by US troops during the 15 month-long Spanish-American War that ended in 1898. Since then Puerto Rico has been governed by a US military governor (until 1900), followed by a civilian government with a governor and executive council appointed by the President of the United States (the Foraker Act), and in 1917, the Jones-Shafroth Act established the island as an "organized but unincorporated" territory of the United States. Since 1917, Puerto Ricans have been US citizens though they don't vote in national elections nor are they subject to federal income taxes. In 1947 the US Congress approved a law allowing the election of the island's governor by the people of Puerto Rico, and in 1950 Congress passed the Puerto Rican Federal Relations Act giving Puerto Rico the right to establish a government and a constitution for the internal administration of the Puerto Rican government and "on matters of purely local concern" (Task Force Report, 2005). In a 1952 referendum, the island's residents voted for Commonwealth status that recognizes the powers of self-government that Congress has permitted. In addition, in 1952 Congress approved Puerto Rico's Constitution, subject to some amendments, which took effect in 1953.

This flurry of status-related activities may have been a response by the island's residents to the actions of a fringe group, the Nacionalistas, who advocated independence from the United States and full national sovereignty. In the 1950s they carried out a series of violent actions to

[1] Because of the large outflow of profit remittances to US parent companies from their Puerto Rican subsidiaries, GNP is substantially lower than GDP.

support their cause including an attempt to assassinate US President Harry Truman and shooting five US Congressmen in the US House of representatives in 1954.

The successor group to those advocating independence from the US now constitutes only a small minority on the island. In the most recent plebiscite on the issue of the future political status of the island, held in 1998, those voting for independence captured only 2.5% of the votes cast. Especially since the early 1960s – after Alaska and Hawaii became states in 1958-9 – the population has been equally divided between those supporting full statehood for Puerto Rico and those wishing to maintain the status quo, that is, remaining a commonwealth territory of the US. A 1967 plebiscite on the question reaffirmed the latter position by a 60% to 40% vote, but in local elections a year later the candidate of the party advocating statehood won the governor's race for the first time. Another plebiscite on the issue in 1993 again indicated that a majority of those voting still desired the current association with the US, although the margin of victory over those supporting statehood narrowed to 3% of the vote. And yet again, the 1998 plebiscite on the political status of the island -- by a 4% margin -- supported the status quo even though those preferring this status, because of the ballot wording, were advised to cast their votes for the option marked "none of the above", which received a majority 50.3% of all votes cast (Task Force Report, 2005).

The principal objectives of this paper are to describe the medium- and long-term structural weaknesses and strengths of the Puerto Rican economy and to identify the changes that can be adopted to overcome the island's weaknesses during the next decade in order to address the income-, employment- and poverty-related problems enumerated above, to the end of improving the future performance of the economy and the economic well-being of the island's population.

To be sure, as will be argued below, a large part of Puerto Rico's troubles are the result of an inability and/or unwillingness on the part of the political class (and its residents) to decisively settle their longstanding status question. In fact, the unrelenting tensions between the island's two main political parties -- the Popular Democratic Party, which favors a continuation of the island's commonwealth status, and the Progressive Party, which advocates statehood for Puerto Rico -- paralyzed the local economy during a recent budget impasse that resulted in a partial shutdown of the public sector that closed schools and 43 government agencies, idling half of the island's 200,000 civil servants, who represent about 15% of the island's labor force. (The government is the largest employer in Puerto Rico). The island's governor, Aníbal Acevedo-Vilá, from the Popular Democratic Party, and the legislature, which is controlled by the Progressive Party, were unable to agree on a budget since 2004. With public sector spending rising faster than revenue, the shortfall has been bridged by borrowing. With the island's borrowing limit already reached, before additional funds could be borrowed in the capital markets an agreement was needed on how to pay for the borrowed funds. The resolution of the crisis came with an agreement to introduce a sales tax for the first time in the island's history. Nevertheless, most analysts agree that this fiscal crisis was "nothing but a big power struggle between the two parties" (Lyman, 2006).

As we shall see throughout this study the strained political environment, the result, in part, of the inability or unwillingness of the Puerto Rican people to clarify definitively their preference for the island's future political status, is at the core of many of the island's structural problems. Before examining them in Section 3, below, it is useful to describe the contours -- the territorial, regional and global constraints -- within which the Puerto Rican economy must operate over the next decade.

THE METHODOLOGICAL FRAMEWORK

A. A Digression on Puerto Rican-American Civics

Despite its “special status” that has been evolving over its more than century-long association with the US (CRS, 2005), it is important to recognize that from the constitutional point of view of the United States, Puerto Rico is a territory, and, therefore, under the US Constitution’s Territory Clause, the island is subject to Congress’s authority “to make all needful Rules and Regulations” (US Constitution, Article IV, section 3, clause 2). By extension, the current territorial status enjoyed by Puerto Rico can continue as long as the US Congress desires, and any change to a non-territorial status, again, must be derived from the US Congress.

Furthermore, according to the President’s Task Force Report on Puerto Rico’s Status (December 2005), “there are only two non-territorial options recognized by the US Constitution that establish a permanent status between the people of Puerto Rico and the Government of the Unites States”: statehood or independence. Needless to say, any movement towards a non-territorial status – statehood or independence – should begin with an unambiguous expression of desire for a change in status from the people of Puerto Rico, before the matter is deliberated, and ultimately acted on, by Congress. To this end, the 2005 Report of the President’s Task Force recommends that “the popular will of the people (of Puerto Rico) should be ascertained in a way that provides clear guidance for future action by Congress”. The task force suggests that gauging the “popular will of the people”, either to maintain the current territorial status, or to choose one of the two available permanent, non-territorial options, should be carried out through periodic plebiscites on the issue (page 10 of the Report).

B. Regional and Global Constraints

In its 1991 World Development Report (World Bank, 1991), the World Bank articulated four broad requirements that would have to be met in order to characterize a national economy as "battle ready" to meet the challenges of the fiercely competitive world economy on the eve of the 21st century. They include:

A. a stable macro-economy characterized by both fiscal and external balance and low and stable inflation;
B. the adoption of a competitive micro-economy that includes a substantial reduction in state ownership and management of productive assets and the elimination of price distorting subsidies and taxes;
C. strong global linkages that include adherence to GATT (now the WTO), low and uniform tariff rates, absence of non-tariff barriers, a uniform and market-determined exchange rate, a liberalization of the rules governing capital flows and direct foreign investment, and;
D. an active government policy that promotes social and economic investment, especially in the areas of education, infrastructure, and health.

The World Bank, in its 1997 World Development Report (World Bank, 1997), expanded the reach of the fourth requirement to include the promotion and enforcement of property rights, reducing the level of corruption in the country, and ensuring a reliable legal system—some of the so-called “second tier” reforms.

The global economy is imposing strict discipline on the range of acceptable economic and financial policies that can be prescribed in developed and developing countries alike. The December 1994 Mexican debacle, the Asian meltdown in 1997, the Russian collapse in 1998, the Brazilian devaluation in January 1999, the Turkish crisis in 2001, the debt default in Argentina in late 2001, and the threat of a Brazilian default in 2002 all serve as frightening reminders of the dangers of macro and microeconomic imbalances and institutional weaknesses in a world of free capital movements. Nevertheless, in the first decade of the 21st century there is compelling evidence to demonstrate that a necessary, though not sufficient, condition for sustained improvements in material life can be realized only by constant exposure to, and continued rationalization with, the ever-widening global economy (Fischer, 2003).

As ever in economics, a decision in favor of global integration involves a trade-off: enhanced opportunities for future economic growth and improved living standards on the one hand, accompanied, on the other, with considerable short- (and often medium-) term economic pain, along with the risk and responsibility of continuously adjusting the national economy to the increasingly demanding dictates of the global economy.

To be sure, despite its very unique political status, the tough constraints being imposed on the policy-makers of most globalizing national economies are very much a part of the normal operating constraints faced by Puerto Rico, even though strictly speaking, it would be wrong to refer to the island's economy as a "national" economy because of its very special political status with the US. Nevertheless, Puerto Rico must still comply with most of the requirements cited in the World Bank report. For example, the island must comply with Article C, above, regarding global linkages, only because of the agreements the US has already made with the World Trade Organization and other multilateral institutions.

Furthermore, most of the so-called "second-tier" reforms enumerated in the Bank's 1997 Report (see above) are, likewise, already in place because the island shares the US legal code. It is important to stress that embedding US legal, accounting, labor, safety. environmental, and commercial codes into Puerto Rican society has trade-offs. In a highly globalized world economy, it can (and does) harm Puerto Rico's competitive advantage vis-à-vis its neighbors in the region, while on the other hand, the adoption of America's legal system (and the protections it offers for private property, contracts, and patents) facilitates inward investment, even without the generous array of tax and other incentives that have been so much a part of the investment equation for private sector firms doing business in Puerto Rico over the recent decades. Also, not to be dismissed is the important "escape valve" for reducing unemployment on the island, which is the right of unrestricted migration to the US mainland by Puerto Rican residents if there is a perception of the existence of better economic opportunities off the island.

To summarize, just as the island's policy options are forged with the Commonwealth-Statehood political stalemate in mind, the economic and financial strengths and weaknesses are similarly influenced by the array of constraints and opportunities that accompany its special political status.

STRENGTHS AND WEAKNESSES OF THE PUERTO RICAN ECONOMY

A. A Stable Macro-Economic Environment

Long-term growth prospects are enhanced by disciplined short- and medium-term macro-economic policies. The requirements for short- and medium-term stability in the principal macro-economic variables include fiscal and external discipline and stable (and low) inflation while longer-term growth conditions require low rates of unemployment, acceptable labor participation rates, and, of course, continuing productivity growth. In recent years Puerto Rico's fiscal imbalances have contributed to a deterioration in the public finances to such a degree that two credit agencies, Standard and Poor's and Moody's, in June 2005, lowered their ratings on Puerto Rico's bonds to one notch above investment grade (EIU, 2006a). The island's fiscal deficits are also being compounded by growing unfunded pension liabilities. A full-blown fiscal crisis that erupted in May 2006 over the inability of the executive and the legislative branches of the territorial government, which are controlled by different political parties, to agree on the rate of a new sales tax to confront the chronic budget deficits that, over the last 12 years, have led to a ballooning of the public debt to GNP ratio of approximately 70% (EIU, 2006b). The May crisis resulted in a brief partial shutdown of the public sector and an additional downgrade of Puerto Rico's bonds to "junk" status. The resulting 2006/07 budget agreement, reached in the last quarter of 2006, will lead to the introduction of a 5.5% Commonwealth-wide sales tax (and a 1.0-1.5% sales tax for municipalities) to be assessed on most categories of goods and services.

It is important to note that before the introduction of the sales tax, Commonwealth taxes (from all sources) were sufficient to cover only about 60% of annual territorial government expenditures, with 30% of Commonwealth expenditures funded by US government grants and transfers, and the remaining annual expenditures were financed by new borrowing. As a result, in recent years most new debt has been issued to finance current expenditures rather than capital projects.

In contrast to many Latin American countries who experienced both high and unstable rates of inflation during the 1980s, which was responsible, at least in part, to the poor performance of their national economies during the "lost decade", Puerto Rico's rate of inflation until 2000 has been relatively low and stable, though in recent years official inflation has been relatively high and more unstable, exceeding 15.0% in 2006, a rate that was strongly influenced by increases in food, energy and transport prices (EIU, 2006a; p.15). Part of the reason for the high official inflation rate in the last few years is widely acknowledged to be a technical bias that over-states the true inflation rate. The official inflation index is being adjusted to eliminate this upward bias (EIU, 2006a; p.18).

With respect to the employment and unemployment rates, and the structure of employment, in 2005 Puerto Rico's labor force was estimated at 1.422m people, with an official unemployment rate of 11.4%, more than twice the rate of unemployment on the US mainland. The government is the largest employer on the island (approximately 22% of total employment), followed by commercial services at 21%, manufacturing at 11%, and the agricultural sector, absorbing only 2% of total employment. Puerto Rico's tourism sector -- directly and indirectly -- employed about 60,000 people, about 5% of total employment. One statistic that is highlighted by the B/C study was the very low employment rate (40.6% in 2002) on the island relative to the rate on the US mainland (61%) (Burtless and Sotomayor, 2006; p. 83). In particular, for males, the participation rate for the 16-19-age bracket was 20.3%, and for the 20-24-age bracket the participation rate was 21.0% (Department of Labor, 2006).

The large informal sector absorbs many of the "jobless" males who would not be captured in the official unemployment rate but who are represented in the employment rate, that is, in the denominator of the fraction. Again it is important to emphasize that many of the factors that affect employment are controlled by the US government, for example, the benefit levels and eligibility requirements of the social security system, the federal minimum wage, federal tax incentives, transfer payments to the poor, and, of course, immigration policy.

The ratio of employment to working age population in Puerto Rico is only 2/3 the US level, and, according to the B/C study, one of the alleged primary reasons for the growing wedge between living standards in Puerto Rico and the mainland is attributed to the differences between the employment rates in the two economies.

To conclude this section on the key variables that influence the stability of the macro-economic environment (and provide the ingredients for sustainable and stable future growth), it is important to highlight the dominating influence exerted by the US economy on the Commonwealth economy that goes beyond the federal transfers for social programs, which rose steeply in the 1970s and 1980s. According to (Chapter 2 of B/C, 2006), since 1990 federal transfer benefits have provided 25-28% of Puerto Rico's personal income, about twice the percentage that goes to US states. The five principal benefit programs are: the Nutritional Assistance Program (PAN), the equivalent of the mainland's food stamp program, unemployment insurance, social security retirement and disability benefits, government provided health insurance, and the program of temporary assistance for needy families. These other benefits include the recently phased-out US tax incentives for private sector industrial investment on the island (activities spawned by section 936 and the more prescribed section 30A of the US tax code), and the very large percentage of American tourists as a percentage of the total (about 75%) whose visits are influenced, at least in part, by the state of the US economy. Just the uncertainty generated by the debate over the future of the section 936 tax incentives reduced the growth in Puerto Rico's exports during the 1990s, resulting in the loss of more than 10,000 manufacturing jobs by 2000 (EIU, 2006b). To be sure, the impending phase-out of the Multi-Fiber Agreement in 2005, and the expected accession of China into the World Trade Organization in 2001, also contributed to this.

Finally, where the Commonwealth government does have some latitude over its fiscal policy mix -- its tax and expenditure policies -- it is important to highlight the fact that the Commonwealth, because of its political status, does not have a monetary policy that is independent of that of the mainland's. As a result, it is the Federal Reserve Board in Washington that controls credit conditions and short-term interest rates for the island's economy. This, of course, reduces the available policy instruments for short- and medium-term management of the Commonwealth economy.

B. A Competitive Micro-Economy.

The second of the four World Bank requirements for a national economy to be characterized as ready to meet the challenges of the increasingly competitive global economy is the "adoption of a competitive micro-economy that includes a substantial reduction in state ownership and management of productive assets, and the elimination of price distorting subsidies and taxes". This broad group would include the following: tax reform and improved tax administration; deregulation and/or more "market friendly" regulatory regimes; privatization of state-owned assets; banking reform and, more generally, financial sector liberalization.

During the past year there have been a number of significant tax events for Puerto Rico. The first was the termination of the possession tax credit (known as section 936 of the US tax code) after a ten-year phase-out period that began in 1996. The tax credit began in 1976, and provided federal tax credits on earnings generated in Puerto Rico (or any other US possession, for that matter) by US corporations. This tax incentive was designed to encourage investment in Puerto

Rico by US corporations. (In addition, also terminated was the exemption from federal tax on earnings of US firms that were re-invested on the island into income-generating financial investments). Also repealed was the more limited in application, though more directly targeted at Puerto Rico, economic activity credit (section 30A of the US tax code), which permitted tax deductions only on wages paid by US firms already established in Puerto Rico. The section 30A provision also expired at the beginning of 2006. It is important to note that these tax benefits (and their elimination) were, of course, "made in the USA", i.e., Washington, though in close consultation with Commonwealth government officials.

Another major tax event for Puerto Rico is the recent agreement to enact an island-wide sales tax (IVU) of 5.5% on most goods and services, along with a 1.0-1.5% municipal sales tax. This was in response to the intensifying political tensions between the executive and legislative branches of the Commonwealth government. Chronic fiscal deficits over recent years, including repeated under-funding of the island's public-service pension fund, have been undermining the health of the public finances, resulting in a downgrade of Commonwealth debt to "junk" status. The political battle over the 2006/07 budget -- that led to a partial shut-down of the public sector in May 2006 -- was focused on the impasse between the legislature and the government to agree on a rate for the sales tax, the introduction of excise taxes on previously exempted goods, and better enforcement of existing excise taxes. In addition, even though both parties to the dispute were in favor of enacting a sales tax, lowering income taxes, and introducing an Earned Income Tax Credit, the government also advocated an ordinary tax rate of 29% on unearned income, i.e., interest, dividend, and capital gains income, replacing the lower preferential rate of 17% on interest income and 12.5% on dividend and capital gains income with the single higher rate. Furthermore, the government proposed limiting the annual deduction on interest paid on home mortgages to 30% of gross income or a maximum of $15,000.

Among the recommendations included in the recently published joint B/C study was the need to expand the tax base by eliminating most of the distorting tax incentives, diversifying the sources of revenue, reducing the role of the large informal sector in the economy (estimated at 23% of 2002 GNP), lowering the Commonwealth corporate income tax rate to bring it into line with the US corporate tax rate, and rationalizing the distorting exclusions, exemptions and other preferences, which are negotiated between the individual corporation and the government -- both US and foreign-owned firms -- that could, under certain circumstances, result in effective tax rates as low as zero (page 582). Another long-lived distortion in the island's tax base that was highlighted by the B/C study is the "continued reliance on 1958 property values in the determination of property tax assessments" (page 584). On the mainland, property taxes -- at the local level -- play a very stabilizing role in the sources of a local government's annual revenues, and by extension, to annual expenditures. Reform of Puerto Rico's antiquated property tax regime would contribute greatly to a more rational over-all tax system. Also, is the introduction of a consumption tax -- such as the recently introduced sales tax -- that would enhance government revenues, reduce the chronic budget deficit, and help to restore balance in the Commonwealth's public finances.

To conclude the discussion on tax reform, again, it is important to state that a significant part of Puerto Rico's tax policy -- directly or indirectly -- emanates from Washington. In fact many of the new tax proposals outlined in the June 2006 report of the Joint Committee on Taxation on Legislative Options Concerning Puerto Rico (JCT, 2006) may result in inconsistencies with well-established US tax legislation that is in force, such as section 933 of the US tax code, that exempts Puerto Rico-sourced income of Puerto Rico residents from US personal income tax. It is important to note that any phase-out of this exemption will result in major changes in Commonwealth-owned tax policy.

With regard to creating a market-friendly business environment to promote competition and innovation in business practices that would enhance the choice and the quality of goods and services (and/or lower prices), the past two Administrations have promoted deregulation in the critical sectors of telecommunications and financial services. For example, the Puerto Rico Telephone Company monopoly of the domestic telephone market ended in 1998 in the wake of the adoption of the 1996 US Telecommunications Act and the resulting new regulatory framework administered by the US Federal Communications Commission (FCC).

Once again it is important to highlight that Puerto Rico's latitude to promote a more business-friendly climate is limited because the proposed reforms must be consistent with the regulatory regimes of the US mainland. Therefore, self-directed improvements in the business environment are similar to those advanced by state governments in the US, such as lowering the local tax burden on businesses, simplifying the local licensing requirements, etc.

A third ingredient that is deemed important for a competitive micro-economic substructure is the privatization of state-owned assets. In addition to the Puerto Rico Telephone Company that was privatized in 1998, with GTE (now Verizon) purchasing a controlling share, the Rossello administration (1993-2001) also privatized several hotels, health care facilities, and a merchant shipping company. On the "waiting list" for privatization are the Workers Compensation Fund (an insurance unit for job-related injuries and illnesses), the Public Buildings Authority, and civil service pensions (EIU, 2006b). The only major public corporation that has eluded privatization, no doubt due to the opposition of the unions, is the state-owned Puerto Rico Electric Power Authority (PREPA), which produces almost all of the Commonwealth's electricity. PREPA has signed cogeneration agreements (and contracts) with two private firms, though it still retains a monopoly on electricity sales to residential, commercial and government customers. Some manufacturing firms are planning to generate their own power from their local activities.

The last component included in the formation of a competitive micro-economic environment is the financial services sector – the institutions responsible for channeling savings into productive household, public, and private sector investments. During the 1990s there were profound regulatory changes in the US financial services sector. Decades-old restrictions on multi-branch and inter-state banking were swept away, and a new banking act, the Bank Modernization Act of 1999, inaugurated "one-stop shopping" for financial services – putting banking, brokerage and insurance services under one roof – to enable banks to compete globally and to reduce the cost of financial services to US residents. These regulatory changes have triggered a rationalization of the Commonwealth's financial services sector thereby improving the development of the local capital market (EIU, 2006b, p. 13-4). Banco Popular De Puerto Rico, the largest bank with branches in the Caribbean and on the US mainland, provides brokerage, insurance and banking services "under one roof". Likewise for Banco Santander and Citibank. Other local banks, such as First Bank, have also begun to offer brokerage services through alliances, such as with UBS. In addition, there is also an ongoing consolidation in the sector as financial services firms rationalize their strategic business plans with the new regulatory regime. In 2006, the island had 13 commercial banks and trust companies. Just a decade earlier, on the eve of the launch of the US financial services liberalization program, Puerto Rico had 17 commercial banks and trust companies (Casiano Communications, 2006).

The Puerto Rico financial system is almost completely integrated into the US system. Puerto Rico has no central bank and no official reserves, and the island's banks are subject to the regulatory oversight of the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the local financial authority, the Puerto Rico Commission of Financial Institutions. The Government Development Bank (GDB) operates as the fiscal agent of the government of Puerto Rico. Mortgages originating in Puerto Rico are sold in the US secondary market with credit insurance provided by the Federal Housing Authority (FHA). Consequently, local institutions can supply credit on terms similar to those on the US mainland.

It is important to note that in the past Section 936 profits deposited into the commercial banking system have been an important source of credit creation for the local banking sector – about 40% of total bank deposits – but these are disappearing in the wake of the elimination of the tax benefits that began in 2006 (EIU, 2006b).

C. Strong Global Linkages.

Among the items included under "strong global linkages", the World Bank's third "requirement" to certify an economy as "battle ready" to meet the challenges of the fiercely competitive world economy is adherence to GATT (now the WTO) regulations that is manifested by low and uniform tariff rates, the absence of non-tariff barriers, a uniform and market-determined exchange rate, and the liberalization of the rules governing capital flows and foreign investment.

Because of its political status -- a territory of the United States -- Puerto Rico does not design its own trade policy and must be in compliance with all US trade agreements – global (through the World Trade Organization), regional (such as NAFTA or, more recently, the 2006 DR-CAFTA agreement), and any bilateral trade agreements between the US and another country, for example, Chile. As a result, tariff rates applied to imports into Puerto Rico are the same as those applied to imports into the US mainland from foreign trading partners. Needless to say, Puerto Rico's exports have unrestricted access to the US mainland. In short, Puerto Rico has no independent trade policy.

Nevertheless, Puerto Rico is a very open -- but small -- economy and trade is critical for its economic performance. Its exports are very responsive to the US business cycle. Indirectly, new major trade agreements, such as China's entry into the World Trade Organization in 2001, the phase-out of the Multi-Fiber Agreement in 2005, and the new agreements between the EU and the Caribbean banana- and sugar- producing states, all create exposures for Puerto Rico and the larger Caribbean region. However, given sufficient lead-time to implement the necessary adjustments with appropriate industrial policies, these vulnerabilities can be managed. For example, the initial assessment of the impact on Puerto Rico of the DR-CAFTA agreement was much more pessimistic than a later analysis that reported the likelihood of increased sugar and clothing exports (EIU, 2006a, pp 7, 9).

As a territory of the US, Puerto Rico uses the US dollar as its currency and, as a result, has no independent exchange rate policy. In addition, Puerto Rico enjoys full capital account liberalization, as in the United States. To be sure, past US preferential corporate tax policies (sections 936 and 30A) and the local Industrial Incentives Act, promoted by PRIDCO/FOMENTO and scheduled to expire in 2007, have played a huge role in determining Puerto Rico's comparative advantage as a result of massive "foreign" investment flows over the last 30 years. Recent data indicate that Puerto Rico's "high-tech" sectors, such as pharmaceuticals, will continue to prosper, but the sector's contribution to future employment growth is more uncertain.

D. A Modern Public Policy Agenda

The final category of reforms recommended by the World Bank to "globalize" an economy for the first decades of the 21st century concerns an active government policy that "promotes social and economic investment, especially in the area of education, infrastructure, and health" (World Bank, 1991). In the subsequent report (World Bank, 1997), the Bank expanded the reach of this article to include the promotion and enforcement of property rights, ensuring a reliable legal system, and a reduction in the level of corruption in the country.

With regard to the latter three, since Puerto Rico operates under the US legal code if there are problems in these areas, it would have to be at the enforcement level not at the statutory level. While public sector corruption exists on the US mainland at all levels of government -- federal, state and local -- it is generally acknowledged to be within tolerable limits. Local representatives of US federal agencies in Puerto Rico have been active in tracking computer software piracy, copyright and other property rights violations, and in cases of white-collar corruption in federal funding of local public sector activities, convictions have resulted in jail sentences. Recognizing the constraints that Puerto Rican government officials must work with that emanate from Puerto Rico's political status -- the lack of an independent exchange rate and monetary policy, the elimination of the long-lasting corporate tax benefits derived from sections 936 and 30A legislation, the need to comply with all US safety, health, and environmental codes, US banking and environmental regulations, US maritime laws (specifically the Jones Act), and air travel regulations (that specifically restrict travel between the US mainland and Puerto Rico to US flagged airlines) -- an intelligent and broad-based industrial policy is, according to the B/C study (2006), "one of the few levers the territorial government has to affect economic growth and development on the island" (page 14).

An intelligent industrial policy should be formulated with a view towards encouraging growth in the private sector. Again, according to the B/C study, Puerto Rico has an "undeveloped" private sector, that is, businesses that operate in the formal sector (without large subsidies, special regulatory advantages or extensive oversight by government bureaucracies) employ less than a quarter of working-age Puerto Ricans compared with more than 50% on the mainland. The B/C study highlights the bloated role played by the public sector in employment (and production) that has "softened the competitive (labor market) pressure on the island and discouraged the emergence of a vibrant private sector" (page 503).

To nurture the formation of private sector growth in Puerto Rico requires -- given all of the above-mentioned (implied) costs imposed on private sector firms -- a lighter local regulatory burden for establishing businesses, along with faster and less expensive access to finance (Davis and Rivera-Batiz, 2006).

Other existing social programs cited by the B/C study that discourage private sector employment growth on the island include the generous federal government transfer payments that undermine work incentives, and US-mandated minimum wage laws that discourage hiring of low-skilled workers which reduces opportunities for new workers to acquire workplace experience and skills that could be used throughout their working lives. Reforms -- both planned and implemented -- of the island's anti-poverty programs such as the proposed (local) earned income tax credit and better compliance with the existing "work for welfare" directive are steps in the right direction for providing positive incentives to increase the participation rate in the formal economy.

A more controversial recommendation to reduce the disincentives for employment growth in Puerto Rico is to petition Washington for a reduction of the island's minimum wage to a level that would be more aligned with Puerto Rico's lower income level. The most recent increase in the US minimum wage rate in 1998 was blamed, **in part**, for the loss of 8,000 jobs in the manufacturing sector -- in conjunction with the impending phase-out of the section 936 and section 30A tax benefits -- as manufacturers relocated capacity to Asia, that, as was mentioned above, was also influenced by China's expected entry into the World Trade Organization in early 2001 and the planned expiration, in 2005, of the Multi-Fiber Agreement signed in 1995 (EIU, 2006b; p.13).

While attempts to reduce the minimum wage rate are likely to meet fierce resistance by local vested interests, its legality is certain to be challenged in the US courts because of the precedent it would present for other US possessions (and even states), particularly at a time when the newly constituted House and Senate, both now controlled by the Democrats, have already voted to increase the US minimum wage as one of their first acts of official "business" in 2007.

Turning to the education system that, in part, is responsible for equipping the labor force -- especially the future labor force -- with the enhanced skills needed to compete in the global economy, the long-term trend is impressive. From 1940-2000, the average number of years of schooling for Puerto Rican workers increased from 2.7 to 11 years (Collins, Bosworth and Soto-Class, 2006. p.7). However, despite the fact that free education is available through high school, only 60% of the adult population 25 and older in 2000 had completed high school or more as compared with 80.4% on the US mainland, although 18% of the island population had college or professional degrees in 2000, roughly in line with rate in the US mainland (Census, 2003;Burtless and Sotomayor, 2006). Particularly at educational risk are almost half the youth aged 18-24 residing in the poorest 30% of Puerto Rican households. Despite increased spending on primary and secondary education, Puerto Rico continues to spend only 50% of the US average per pupil. In 2002-03, only 39% of students enrolled in higher education were male, suggesting that many young males are migrating to the US mainland or are being absorbed in the lower paying and lower skilled jobs on the island, most likely in the large informal sector. Finally, again to highlight the over-sized role played by the Puerto Rico's public sector, in 2000 almost 40% of all employed workers with a college degree (or more) were working for the government (Ladd and Rivera-Ratiz, 2006).

The share of manufacturing in Puerto Rico's GDP in 2005 doubled to 40% from its 1960 share, no doubt due to the generous federal and local tax benefits enjoyed by the manufacturing sector for the three decades that ended in 2006. However, since 1992, employment in the manufacturing sector has declined from 179,000 to 132,000 jobs in November 2006 (Planning Board of Puerto Rico, 2006). In 2005 manufacturing accounted for approximately 11% of total employment on the island (or about 138,000 jobs), a percentage that is likely to decline further over the coming years with the elimination of the above mentioned tax benefits and the relocation of some labor intensive manufacturing activities to Asia, in response to the global competitive pressures created by China's entry into the World Trade Organization.

If the Commonwealth is to retain its high-tech manufacturing in pharmaceuticals, electronics, and scientific and precision instruments without the attractive tax regime of recent years the government will have to play a very active role to encourage productive public and private investment in infrastructure -- lowering the cost of transport, communications, and electricity -- that would indirectly compensate the private sector, through lower input costs, for the loss of their tax benefits thereby preserving their competitive position in the global economy. The loss of 8,000 manufacturing jobs in recent years has been attributed to these relatively high utility and infrastructure costs. In addition, active public policies by the pertinent government agencies (such as FOMENTO, and the Departments of Education and Labor) are urgently needed in order to upgrade the island's human resources -- enhancing skills and improving the quality of the education system -- to ensure that the quantity of labor supplied, and more importantly, its quality, is better aligned with the future demand for labor.

CONCLUSIONS: ENHANCING GROWTH IN PUERTO RICO

Because of its deep historical ties to the US, it is unlikely that Puerto Rico's institutional constraints -- the absence of independent monetary, trade, exchange rate, environmental, and foreign policies, its need to comply with most US regulatory codes that embrace safety, health, telecoms, banking, and financial services, transport, accounting, and legal issues, and the territory's right to enjoy the whole spectrum of "social safety-net" programs such as social security, Medicare, Medicaid, uninhibited migration to and from the US mainland (and, of course, the exemption from paying income taxes) -- will be significantly modified during the rest of this decade.

Consequently, in charting a policy agenda for the next decade the Commonwealth government should focus its resources on forging well-designed and market-friendly industrial and fiscal (tax and expenditure) policies -- the only policy levers available -- given the above mentioned institutional constraints. Before addressing these measures it is important to include at this time the political dynamics on the island that add to the difficulty of adopting clear, internally consistent policies that will enhance the island's growth prospects over the next decade. According to the Economist Intelligence Unit (2006b, p.6), most policy differences -- that, of course, spill over to create budgetary tensions -- between the two major political parties, the Popular Democratic Party and the Progressive Party, can be traced to the "existential" debate over Puerto Rico's ultimate political status, which today is a choice between maintaining the "status quo", i.e. remaining a territory, versus full statehood in the US. In 2007, both, the island's elected representative in Washington, Luis Fortuño, and the majority in the Commonwealth legislature, advocate statehood for Puerto Rico (the position of the Progressive Party), while the Commonwealth Governor, Aníbal Acevedo-Vilá, of the Popular Democratic Party, favors the political status quo. In fact the indecision regarding the island's future political status has reached a stage where not only is it impossible for the population -- through occasionally scheduled plebiscites -- to provide their elected officials (and the US Congress, which has the ultimate authority on the issue) with clarity regarding their preference on the question, but, according to the recent report of the US Government Accounting Office (GAO, 2006), Puerto Ricans "are unable to agree on the process to be used to consider the status proposal."

Furthermore, the important new B/C study, in reviewing the reasons for the lackluster performance of the economy since 1980 relative to that of the mainland (along with their recommendations to trigger higher rates of economic growth), alerted readers early on that their description and analysis of Puerto Rico's predicament was based on the need for better policies -- that included those directly under the control of the Commonwealth government on the one hand, and, on the other, those "manufactured in the USA"-- and not on alternative political options, i.e., better, or even, different institutions that could be adopted if (and when) a decision on Puerto Rico's ultimate political status is agreed, once and for all.

This paper has argued from the beginning that the institutions and policies that "migrated" to Puerto Rico from the US mainland, while well-intentioned at inception, have created many harmful "facts on the ground" and "home grown" policies that act as impediments to faster economic growth, lower poverty rates, and higher material well-being in Puerto Rico, especially in light of the powerful forces of increased globalization and accelerated technological change that have been observed over the last quarter century.

Puerto Rico's dilemma resembles the parable associated with the 14th century rector of the University of Paris, Jean Buridan: unable to decide whether to walk to the water on its right or to the food on its left, Buridan's donkey died of thirst and hunger. Similarly, Puerto Rico's vested interests on both sides of the political divide are benefiting from the political "limbo" caused by the unwillingness and/or inability to settle, once and for all, the "final status" issue. As a result, the continuing political indecisiveness has created a bloated, inefficient, and mismanaged public sector, an "under-developed" private sector, an inefficient tax regime, and formidable distortions in the island's labor market derived from a poor mix of incentives to affect changes in both the demand for, and the supply of, labor. Consequently, while the economy will not "starve to death", the continuing indecisiveness over the status issue does considerably restrain Puerto Rico's growth prospects in today's global economy.

It is unlikely that the above issues can be addressed properly -- within the context of today's global economy -- before Puerto Ricans decide, definitively, to seek statehood in the US or to remain a territory (or, to request some modification in their Commonwealth status that will provide some local control over immigration, tax policy and other local public-policy concerns. This, however, would require at the least Congressional action, and could even raise Constitutional issues). It is also important to keep in mind that any vote on Puerto Rico's "final status" can have little legitimacy for the resident population -- or perhaps, more importantly, for the US Congress -- unless the result is a convincing one in favor of one position or the other. History is littered with examples of elected governments attempting to implement "existential" changes with weak and fleeting mandates.

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