Economic development and the political status of Puerto Rico

Dr. José Caraballo-Cueto
University of Puerto Rico at Cayey

June 13th, 2021

Introduction

Thank you all for the invitation to testify before the Natural Resources Committee hearing on H.R. 2070, "Puerto Rico Self-Determination Act of 2021" and H.R. 1522, "Puerto Rico Statehood Admission Act." These projects are commendable efforts; my congratulations to the individuals that wrote them. Below I provide a short analysis on Puerto Rico's political status and economic development. At the end, I provide my recommendations.

Political status and economic prospects for Puerto Rico

According to the world data gathered by Angus Madisson from 1955 to 1980, the economy of Puerto Rico was among the top growing economies in the world. The Gross Domestic Product per capita was 210% higher in 1980 than in 1955. Such growth doubled the world rate (83%) and would have placed the Island among the top 14 countries in the world in terms of income per capita growth.

The economic model at the time was rather simple: attract manufacturing corporations from abroad with federal and local tax incentives. In the words of Baumol and Wolff (1996): "Puerto Rico serves as an example of an extreme form of what Prebisch and his colleagues called 'dependence,' both in terms of import openness and its reliance on foreign direct investment - both almost exclusively from the US mainland. Yet, because of its high investment rate and educational gains, Puerto Rico grew very rapidly, at least from the mid-1940s through the early 1970s." (Baumol and Wolff, p. 883). This was in part due to Section 936 of the federal tax code enacted 45 years ago; arguably the last time that Congress took a strong action to boost Puerto

Rico's economy. After that policy, we have observed many Congressional hearings but few to none positive economic policies.

The problem with such a model was its fragility: after trade liberalization and the removal of Section 936 of the federal tax code the economy of Puerto Rico collapsed (for more details, see Caraballo & Lara, 2018). This finding leads to the crucial questions: Is there a new economic model for Puerto Rico?

Policymakers attempt to implement one by increasing federal funding, providing tax incentives to attract high-income individuals (local Act 22 of 2012 and inclusion in federal designation of opportunity zones), and to promote the export of services (local Act 20 of 2012). However, such a model is insufficient in its ability to grow an economy that has not grown sustainably since 2006. Some observers are betting on the new geopolitics in the Caribbean (e.g. China's Belt & Road influence on Latin America) as a way for pushing Congress to favor Puerto Rico again, but that is just a theoretical scenario.

The bottom line is that, no matter how much federal funds are sent to Puerto Rico, for long-term economic development Puerto Rico needs a fundamental change in its political relationship with the US. Federal funds can provide economic growth only in the short term, but they will not put Puerto Rico in its past growth path. Ilzetzki et al. (2010) found that fiscal stimulus has a low impact on economies with a ratio of external trade to Gross Domestic Product that exceeds 60%. In the case of Puerto Rico, that ratio was 156% in 2020.

Fiscal, monetary, and industrial policies are key to economic development, especially in this new century, but Puerto Rico has barely any control over these. The monetary policy (e.g. exchange rate and interest rate, among others) imposed on Puerto Rico by the Federal Reserve (Fed) is not designed for the particular business cycle of the island and sometimes the decisions taken by the Fed exacerbate the economic conditions of this territory. Puerto Rico has almost no representation in this important institution. The local fiscal policy (taxes and government spending) is now handled by the fiscal control board imposed by Congress, reducing the elected officials' authority from low to no influence on these issues: in fact, the last couple of budgets have been imposed by this board.

Industrial policies, such as preferential taxes to manufacturing industries, have been managed by Congress without major consideration of the economic situation of Puerto Rico. For instance, the current debt crisis was caused by (in addition to the exclusion of Puerto Rico from the federal bankruptcy code in 1984) the economic clash created by the removal of federal tax incentives without any alternative economic strategy: this deindustrialization reduced government revenues, increasing Puerto Rico's dependency on external funding (Caraballo and Lara, 2018). The GILTI (Global Intangible Low-Taxed Income) enacted in 2017 is also harming the remnant of the industrial sector in Puerto Rico and if the global taxation of 15% is extended to the island, it will have a similar or even greater negative effect.

For some unexplained reasons, Congress provides better economic tools to other territories: the U.S. Virgin Islands is exempt from the 1920 Jones Act and the Northern Mariana Islands and Guam have a visa waiver program that boosted their tourism.[1] The Jones Act does not just increase import costs according to most studies,[2] moreover, it excludes Puerto Rico from international logistics. For instance, a vessel departs from, say, Colombia to Puerto Rico, it cannot continue to the largest market in the region (the US): either the vessel returns to Colombia or goes to another small economy. It should be pointed out that in 2015 Puerto Rico paid altogether $3.5 billion in federal taxes; almost five-times more than the combined taxes paid by the U.S. Armed Service members overseas and other U.S. territories (IRS 2015).

Both sovereignty and statehood provide better economic prospects than the current status. Let me start with the case of sovereignty. In the 20th century, some economies (such as Singapore (1963), Ireland (1921), Finland (1917), S. Korea (1945), and Iceland (1944) have benefitted from independence while others did not (e.g. almost all African former colonies (except for S. Africa (1910), many colonies in the Middle East, and many countries in South Asia). However, the initial conditions for Puerto Rico, in terms of infrastructure and level of income, are more favorable than many former colonies of the last century. Sovereignty would let Puerto Rico implement tailor-made fiscal, monetary, and industrial policies (e.g. protection for local

[1] https://www.guamvisitorsbureau.com/news/news-releases/philippine-arrivals-soar-in-march-2016
[2] https://docs.wixstatic.com/ugd/5b4228_4e79040fd1b043a59df921358825334a.pdf

businesses without being subject to the interstate commerce clause). In addition, it would also liberate the island from institutional constraints such as the Jones Act and regulations associated with product quality. Research by Caraballo-Cueto and Gautier (2020) shows that Puerto Rico export potential is limited by about $20 billion (in 2011 PPP dollars, after adjusting for transfer pricing effect) in 2016. This would represent about 17% of the Puerto Rico's GDP. This number does not consider export of services.

However, independence also has its costs to Puerto Rico. Firstly, if residents do not save more, without access to broker deposits and other instruments, interest rates would be very high, limiting households and businesses investments. Secondly, currency devaluation would be good for exporters but hurtful for consumers. Thirdly, reconstruction after disasters would be similar to other countries in Latin America, where there is a net negative effect. Most federal funds received in Puerto Rico are contractual rights such as Social Security, Medicare, and veteran benefits. In 2020, $14 billion out of $25 billion were this type of transfer. Part of the difference ($11 billion) could be substituted with remittances from abroad (Dominican Republic receives more than $3 billion in remittances). However, without the remaining federal transfers, local government must be very efficient. Otherwise, essential services would be worse than now. All in all, if economic actors take full advantage of the benefits of sovereignty, the disadvantages can be outweighed.

In the case of statehood, fiscal, industrial, and monetary policies would not depend on the sympathy of Congress and the Fed but on the negotiation that takes place when representatives from Puerto Rico have voting power. In the case of Puerto Rico, there are no current studies but in the past Jenkins and Islam (1998) found that sectors unrelated to Section 936 (both households and residents) won with statehood while local government lost funds. In 2013, if Puerto Rico were a state, small and medium size enterprises (SMEs) as well as its middle and upper classes would have paid an additional $2.9 billion in federal taxes but low-income individuals would have received an additional $3 billion in federal funds. Just by receiving parity in Supplemental Security Income and nutritional assistance, the poverty rate would decrease by 14 percentage points (Caraballo-Cueto 2019). In addition, by being fully annexed, Puerto Rico would take advantage of its comparative edge over other states in terms of wages and would receive more investments from the US. In the case of Hawaii, its gross state product did not decline after annexation in 1959 (Schmitt 1977), though structural changes were felt by the population (Bell 2019).

Statehood also carries disadvantages. Firstly, federal taxation would impact the middle class and SMEs of the Island. Secondly, if local taxes are decreased to compensate SMEs, more painful austerity would be needed to balance the budget. Thirdly, statehood also changes the tax status of Puerto Rico and many multinational manufacturers that are now in Puerto Rico operating as a Controlled Foreign Corporation would move to a third country, shrinking the industrial base even further. However, these disadvantages of statehood are probably not worse than the disadvantages of the colony.

Both a “PRexit” or statehood will carry painful structural adjustments in the short term, but in the long term will probably be better for economic growth. There are no recent empirical studies but my colleagues and I will soon use a mathematical model to construct diverse scenarios to better inform this discussion.

Recommendations

1. Streamline the H.R. 2070 by reducing steps and establishing specific dates. I strongly oppose the recommendations of the US Department of Justice to include the territorial status and to avoid specific mandates to the federal government.

2. In the case of H.R. 1522, it should **specify** that if statehood is not supported **by either a** majority of Puerto Ricans or by the federal government, the **U.S.** government will end the **territorial status on a specific date**.

3. Change the PROMESA act so that the fiscal control board disappears once the debt restructuring ends. This would return fiscal policy to duly elected officials.
4. Exclude Puerto Rico from the global tax of 15%, the GILTI taxation, and from any other measure that entails a greater intervention from the federal government in the Puerto Rico economy.
5. Exclude Puerto Rico from the 1920 Jones Act.

REFERENCES

1. Baumol, W. J., & Wolff, E. N. (1996). Catching up in the postwar period: Puerto Rico as the fifth "Tiger"? *World Development*, *24*(5), 869-885.
2. Bell, R. (2019). *Last among equals: Hawaiian statehood and American politics*. University of Hawaii Press.
3. Caraballo-Cueto, J., & Lara, J. (2018). Deindustrialization and unsustainable debt in middle-income countries: The case of Puerto Rico. Journal of Globalization and Development, 8(2).
4. Caraballo-Cueto, J. (2019). The impact of disparities in SNAP and SSI on Puerto Rico's poverty and economic growth. Retrieved from: https://www.researchgate.net/publication/340610699_The_impact_of_disparities_in_SNAP_and_SSI_on_Puerto_Rico's_poverty_and_economic_growth
5. Caraballo-Cueto, J. & Gautier, L. (2020). Are Satellite Economies Losing Trade? Manuscript under revision.
6. IRS (2015). Internal Revenue Service Data Book. Retrieved from: https://www.irs.gov/pub/irs-soi/15databk.pdf
7. Ilzetzki, E., Mendoza, E. G., & Végh, C. A. (2010). How big (small?) are fiscal multipliers? (No. w16479). National Bureau of Economic Research
8. Jenkins, G. P., & Islam, N. (1998). *Economic Consequences of Statehood for Puerto Rico: A General Equilibrium Analysis* (No. 1998-06). JDI Executive Programs.

9. Schmitt, R.C. (1977). Historical Statistics of Hawaii. Retrieved from: https://files.hawaii.gov/dbedt/economic/data_reports/Historical-Statistics-of-Hawaii.pdf