ONE STEP FORWARD

by Jaime Santiago

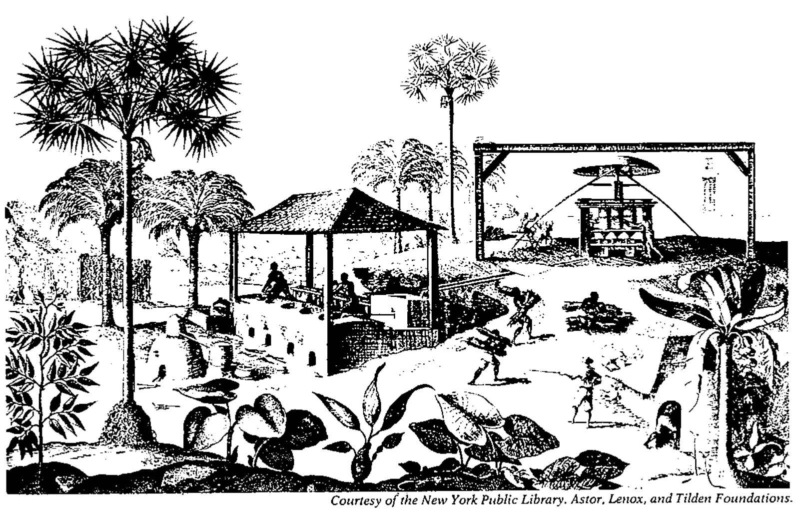
Part colony, part state, part independent nation, Puerto Rico is an anomaly with no true counterpart anywhere in the world. The island's economy is hostage to this circumstance. It is a victim, too, of nature. Puerto Rico has virtually no natural resources. It is self-sufficient only in people, of whom it has long been a net exporter. For other resources it must rely on the outside world, primarily the United States, its chief trading partner for nearly 100 years.

Like Taiwan and South Korea, Puerto Rico faced a postwar challenge. It had to devise an economic strategy that could somehow turn the island's basic vulnerability—or someone else's strength—to its own advantage. Three decades ago, Puerto Rico found such a strategy, or so it seemed.

Puerto Rico was desperately poor. Its strength and resources had been sapped by more than 400 years of colonial rule. During the 1930s, two great hurricanes and one Great Depression had hit the island. The Puerto Rican economy depended largely on sugar, but world sugar prices were at rock bottom. What few "industries" there were had been crippled when the U.S. Congress in 1938 set 25¢ as the minimum hourly wage, then about five times the going rate on the island. Real per capita income in 1940 was less than $125 a year, slightly better than Bulgaria's at the time, slightly worse than Hungary's. Illiteracy and infant mortality were high.

With some justification, Puerto Rico was popularly considered "the poorhouse of the Caribbean." Island politicians smarted at the designation, but they did little to try to change it. Indeed, for more than a century, "politics" on the island had been synonymous with factional squabbling over Puerto Rico's once and future political "status."

The first major local politician to behave differently was Luis Muñoz Marín, leader of the Popular Democratic Party, or *Populares*. For Muñoz Marín, any status that enabled Puerto Rico to address its chronic problems of poverty and high unemployment was acceptable. He was willing to make do with the "status" quo, and he got his chance when the *Populares* took control of the island legislature in 1940.



Courtesy of the New York Public Library. Astor, Lenox, and Tilden Foundations.

The Spaniards began importing slaves into Puerto Rico in the early 1500s; from the 17th century onwards, most of them were employed on great sugar plantations. Slavery was abolished in 1873, but sugar remained the backbone of the island's economy until the 1940s.

Muñoz Marín's chief ally in those early days was World War II. Some 65,000 young islanders, mainly from depressed rural areas, enlisted or were drafted into the U.S. armed services; their families received generous dependents' allowances. At a cost of $30 million, new U.S. military bases were built and old ones were expanded. The island's road system, extended with Washington's help, soon linked mountain villages to the cities. Personal income climbed, and conspicuous consumption acquired a permanent toehold among all of the island's classes.

The war fattened the Puerto Rican government's bank balance. When domestic U.S. liquor distillers converted to industrial alcohol production in 1942, Puerto Rican rum filled the void. Because excise taxes on Puerto Rican rum sold in the United States were returned to Puerto Rico, the island government quickly built up a $179 million "grubstake," giving Muñoz Marín cash in hand to finance his ambitious schemes.

He began in the early 1940s with land reform—predictably enough, since the *Populares'* electoral base was in rural areas. Many (but not all) sugar plantations of more than 500 acres, the long-unenforced legal limit, were broken up and run on a cooperative basis. The government built rural housing and distributed land to farmers in new farm communities.

Although Muñoz Marín's emphasis was decidedly on agriculture, he also dabbled in manufacturing, believing it might one day become a strong "second sector." In 1943, under the mantle of the new, state-owned Industrial Development Company, he launched an experimental program with a simple premise: If the government took the lead in building and operating small companies—and showed it could be done profitably—private entrepreneurs would soon follow suit. To that end, the state acquired a cement plant and several factories producing shoes, bottles (for rum), and cardboard (for shipping rum).

Operation Bootstrap

Muñoz Marín's agricultural policies had little impact on farm output or income; his industrial policies did no better. Once whiskey production started up again in the United States after the war, the bottom fell out of the Puerto Rican rum (and bottle, and cardboard) industry. It turned out, too, that Puerto Ricans preferred stylish American shoes to the rather basic, homemade product. Only the cement plant turned a profit. Moreover, the 3,000 jobs created by state-owned factories helped only a small fraction of the 80,000 unemployed Puerto Ricans. And local entrepreneurs, lacking venture capital, assiduously kept their hands out of manufacturing.

Muñoz Marín scrapped his "semi-socialist" industrial experiment in 1947. He was now convinced, however, that industrialization, not farming, was the key to Puerto Rico's economic future. Virtually all of the island's arable land was in use, even as the rural population continued to grow. Though important as a source of employment, agriculture was not going to provide many *more* jobs—and, in terms of exports, could hardly compete with the mechanized "agribusiness" of the U.S. mainland.

Muñoz Marín turned instead to something that island economists had been quietly studying since 1944: tax exemption to lure American factories to the island. Under section 931 of the IRS code, private companies operating in Puerto Rico and other U.S. possessions were exempt from federal taxes on profits. In 1947 and 1948, at Muñoz Marín's behest, the island legislature enacted laws granting factories relocating to the island a 10-year "holiday" from local Puerto Rican taxes as well. There

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were other incentives. Wages were lower in Puerto Rico than on the mainland. The island lay within the U.S. "customs union" and used American currency. Cheap Venezuelan oil was only two tanker-days away. In short, Puerto Rico offered all of the advantages of, say, Haiti but none of the potential disadvantages—political instability, currency devaluation, expropriation.

Operation Bootstrap, as the Muñoz Marín program came to be called, worked as planned for 25 years, carefully nurtured by Puerto Rico's new Economic Development Administration (*Fomento*, in Spanish). By 1960, some 500 new factories had set up shop in Puerto Rico; by 1975, there were 1,700 *Fomento*-sponsored plants. Union Carbide, Upjohn, Levi Strauss, RCA, Johnson & Johnson—these and many other companies found that the projections of their financial analysts tallied nicely with the upbeat tenor of *Fomento* ads in *Business Week* and the *New York Times*. Between 1948 and 1974, more than 140,000 new manufacturing jobs were created.

The construction industry boomed, employing 80,000 workers in 1973. Tourism prospered with a hand from the growing

"100 percent tax exemption for all corporations that build a factory in Puerto Rico." This 1976 advertisement was placed in the West German weekly Der Spiegel *by the Puerto Rico Economic Development Administration. Tax exemptions for industry have since been reduced.*

airlines, and from Castro's takeover in Cuba. The island became an urban society where life expectancy reached 72 years and literacy was almost universal. Real annual per capita income climbed from $278 in 1948 to $1,865 in 1974. By the early '70s, GNP was growing at a rapid annual rate of more than 6 percent.

In retrospect, it is apparent that Operation Bootstrap, for all its promise and real achievement, harbored some of the seeds of its own destruction. At its peak, manufacturing was never completely able to offset job losses due to the decline of the island's agriculture. (In 1948, 36 percent of employed Puerto Ricans worked on farms; the proportion dwindled to 6 percent by 1973.) Puerto Rico's economic "miracle" thus depended largely on massive out-migration to the United States. Between 1945 and 1970, about one-third of the island's population left to seek a new life on the mainland, thereby helping to keep unemployment low "back home." Even then, the island's official jobless rate never fell below 10 percent.

Operation Bootstrap was flawed in other respects. Its very success in attracting U.S. factories and creating jobs inevitably narrowed the "wage gap" between Commonwealth and mainland, a problem compounded by the ever-rising U.S. minimum wage.* Puerto Rico became less attractive to labor-intensive industries, such as textiles, more attractive to capital-intensive endeavors, such as pharmaceuticals and petrochemicals. The latter did little to alleviate unemployment. Many industries simply went elsewhere. Puerto Rico's factories, of whatever type, also needed sewage systems, water, electricity. Since most of the companies themselves were tax-exempt, the Puerto Rican people had to foot the bill.†

The built-in weaknesses of the Puerto Rican economy became a serious problem in 1970. Puerto Rico had weathered the first four postwar U.S. recessions—1948, 1954, 1958, 1960—without much trouble. The downturns generally hit the island six to nine months after appearing on the mainland, but the island economy always picked up rapidly.

In 1970, the pattern changed. The island's construction industry, long sustained by heavy demand for factories and second

*The Fair Labor Standards Act of 1938 was amended in 1940 to allow the minimum wage in Puerto Rico to be set somewhat below the mainland level for selected industries. However, further amendments to the act in 1974 and 1977 require Puerto Rico to achieve "parity" with the mainland by January 1, 1981, when the U.S. minimum wage will be $3.35.

†Puerto Rico's progressive personal income tax takes a bigger bite than federal income tax does on the mainland. There are also stiff excise taxes on liquor, cigarettes, and automobiles, and a flat 5 percent sales tax on all nonfood items. But owing to widespread tax evasion at both ends of the income ladder, Puerto Rico's effective tax base is narrow.

homes, suddenly went into a slump. Tourism slackened as wealthy Americans sought new pleasure spots while middle-class Americans, hit by recession, stayed home. And, in a reversal of a 25-year trend, Puerto Rican migrants to the United States began returning to the island.

Faced with a mounting economic crisis, Governor Luis A. Ferré (1969–73) opted for a quick fix, a kind of Keynesian sleight-of-hand. Instead of trying to promote job creation in the private manufacturing sector, Ferré made the government the employer of last resort and sank millions into public-works projects to refuel the economy. To pay for it all, the government borrowed money, much of it from U.S. banks. This cushion of debt, which Governor Rafael Hernández Colón, Ferré's successor, kept inflated, buoyed the Puerto Rican economy for a time.

Debt and Taxes

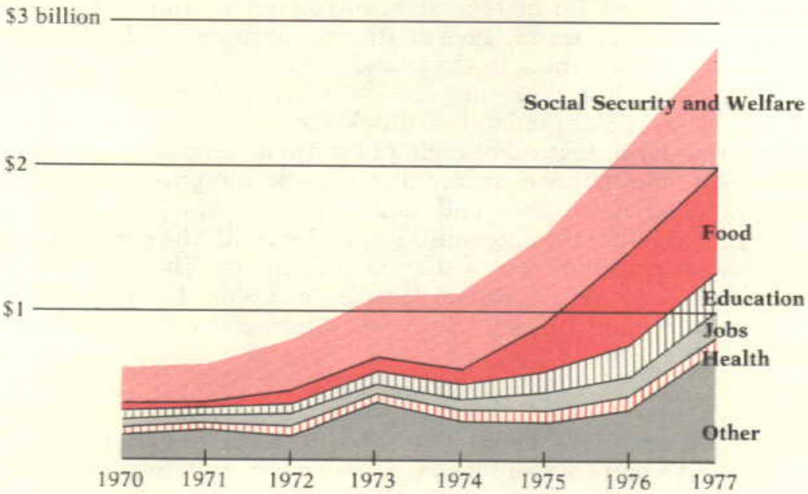
Then came the deep 1974–75 U.S. recession. It gave the mainland a bad cold and Puerto Rico pneumonia. Brought on in part by the quadrupling of OPEC oil prices in 1973, it bared the island's underlying structural problems. In 1975, growth in Puerto Rico's real GNP fell to 2.5 percent. The jobless rate soared to 20 percent, with employment in the vital construction industry cut by half. Inflation stood at 15 percent, far above the mainland rate. *Fomento* officials found it increasingly difficult to show U.S. factory owners the advantages of moving to an island that was 99 percent dependent on imported oil. External investment fell by $400 million from the 1972 peak. The U.S. bond markets were virtually closed to the Puerto Rican government, which was already $6.5 billion in debt.

In December 1975, a Puerto Rican government study overseen by Yale economist James Tobin called for "drastic adjustments" in the island's economic practices.* The bottom line: austerity. To his credit, Governor Hernández Colón acted on the recommendations. He decreed sweeping tax increases, a cut in real government expenditures, and a wage freeze for government workers (one in five of all employed Puerto Ricans). It was a painful program, and as such it virtually guaranteed that La Fortaleza, the 16th-century governor's palace, would not be Hernández Colón's residence after the 1976 elections.

As his advisors struggled to devise a new, long-term economic strategy, Hernández Colón grabbed a life line from Wash-

***Informe al Gobernador del Comité para el Estudio de las Finanzas de Puerto Rico*, Río Piedras: Editorial Universitaria, 1976.

FEDERAL OUTLAYS FOR PUERTO RICO, 1970–77



Source: U.S. Department of Commerce, *Economic Study of Puerto Rico,* 1979.

Puerto Rico relies heavily on aid from Washington. In 1978, 1.5 million Puerto Ricans, nearly half the island's population, supplemented their grocery budgets with USDA Food Stamps valued at $831 million—10 percent of all Food Stamps issued during that year.

PUERTO RICO: COMPARATIVE STATISTICS

	Gross Domestic Product (per capita)	Life Expectancy at Birth (in years)		Infant Mortality (per 1,000)		Literacy (percent of population)	
	1976	1950s	1970s	1950s	1970s	1950s	1970s
United States	$7,780	69.3	71.6	29.2	18.5	96.8	99.0
Martinique	3,340	60.1	69.8	46.7	34.0	73.9	87.8
Puerto Rico	**2,310**	**68.0**	**73.5**	**67.5**	**24.2**	**73.3**	**89.2**
Trinidad & Tobago	2,190	61.8	67.4	80.3	23.5	77.4	92.0
Jamaica	1,150	61.1	69.9	81.2	32.2	77.0	91.3
Mexico	1,095	55.6	64.8	89.8	71.1	36.8	73.2
India	142	38.2	54.9	182.5	135.0	19.3	33.4

Source: *World Bank Atlas,* 1978; *International Development Review,* Vol. 21, #1, 1979.

ington in the form of federal transfer payments, primarily Food Stamps, which had just been introduced to the island.* The volume of transfer payments to Puerto Rico had been growing slowly since 1969, but between 1974 and 1976, federal outlays to the island doubled. In 1975, Puerto Rico received $600 million in Food Stamp *cupones* alone. About 60 percent of the population was eligible for the program. Today, federal transfer payments account for 16 percent of personal income in Puerto Rico, compared to 9 percent on the U.S. mainland.

Welfare Island?

What Hernández Colón regarded as a temporary cushion his successor, Carlos Romero Barceló, made the bedrock of economic policy. Romero Barceló is an ardent champion of statehood for Puerto Rico; the sure-fire way to achieve it, he believes, is by gradually eliminating industrial tax exemption and increasing Puerto Rico's dependence on federal welfare funds. Essentially, he wants to bring Puerto Rican policies into line with those on the mainland, not create further distinctions. (Upon assuming office in 1977, Romero Barceló promptly made tax exemption partial, thereby eroding its attractiveness for U.S. business.) He is selling his program with the slogan "Statehood is for the poor"; by joining the Union, he believes, Puerto Rico can keep the welfare faucet open.

Tempting though they are, federal transfer payments come with a high social cost: a compelling disincentive to work. Real unemployment in Puerto Rico now probably hovers around 40 percent (as opposed to the official 18 percent) if one counts the underemployed and the *ociosos voluntarios*, the voluntarily idle. The proportion of persons 16 years of age or older in the labor force (working or looking for work) has dropped from 53 percent in 1950 to 43 percent in 1979.

Idleness has simply become too comfortable. Because 400,000 island families receive Food Stamps, and many of them are entitled to welfare or unemployment compensation as well, it often doesn't pay for a "breadwinner" to work. So great is the island's current dependence on federal funds that Puerto Rico in the future could well become a kind of welfare sump, a South Bronx in the Antilles. Already, Food Stamp *cupones* have become almost a second (illegal) currency.

Puerto Rico's economy is, without question, in deep trouble.

*Owing to its peculiar Commonwealth status, Puerto Rico can participate in only 644 out of 1,046 federal domestic assistance programs. The island is excluded from Revenue Sharing and its participation in Medicaid and Aid to Families with Dependent Children is limited.

In 1980, real economic growth (according to official estimates) will fall from 5.4 percent to somewhere between 1.7 and 3.9 percent. In my own view, real growth will be closer to zero. The island remains almost entirely dependent on outside capital; there seems to be no alternative, given Puerto Rico's *negative* personal savings rate, a consequence of unchecked consumerism. The island's balance of trade is consistently unfavorable—to the tune of $1.6 billion in 1977 alone. According to one recent estimate, 192,000 Puerto Rican youths between the ages of 16 and 24 are neither at work nor in school. The economic situation in Puerto Rico is explosive, and there is no consensus on what to do about it.

There has been some fresh thinking, however.

One idea was put forward recently by former governor Hernández Colón, the *Populares'* candidate for governor in 1980. Last summer, Hernández Colón proposed what has come to be called *La Nueva Tesis*, "the new thesis." In it, he calls for Washington to transfer broad new powers to San Juan within the framework of a much-revised Commonwealth formula—"culminated Commonwealth" as it has come to be called. Briefly, he would like Puerto Rico to be able to set its own (lower) minimum wage, relax environmental controls, erect tariff barriers to protect local manufacturers, and make its own labor relations laws. There is a belated emphasis, too, on reviving agriculture, the island's sickest sector. (Puerto Rico imports about half of its food.) The ultimate goal is to return to the strong productive roots of Operation Bootstrap, but with an emphasis on self-sufficiency, not on reckless growth.

Neither independence nor statehood strikes me as a workable option at this time.

Puerto Rico's overriding economic problem lies in the *character* of its relationship with the United States, not the fact that a relationship exists. The island needs strong economic ties with the mainland. But, like any developing nation, it also needs insulation. Puerto Rico can hardly "make it" while saddled with the acquired regulatory baggage—and consumer habits—of a fully developed, highly industrialized country. Unfortunately, this issue is not high on the agenda in Washington, where Puerto Rico has roughly the importance of the human appendix: that is, no importance at all until the pain becomes unbearable.