



The Puerto Rican Economy: Historical Perspectives and Current Challenges

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Historical Perspectives

Background

- Puerto Rico in 1940:
 - Traditional agricultural society
 - Per capita income was \$122
 - 70% of the population lived in rural areas
 - Life Expectancy: 46 years
 - Infant Mortality: 109.1 per 1,000 births
 - Birth Rate: 40.1 per 1,000 population
 - Widespread malnutrition

Background

- Capital was scarce, except in the sugar industry.
- Government decides to embark on industrialization program with two goals:
 - Shift labor from low-productivity agriculture to higher-productivity industrial pursuits
 - Jumpstart the accumulation of capital within Puerto Rico

Industrialization

- First Stage: Direct ownership by government of industry. By 1947 the PR government owned five enterprises:
 - Puerto Rico Glass Corporation
 - Puerto Rico Pulp and Paper Corporation
 - Puerto Rican Shoe Leather Company
 - Puerto Rico Clay Products Corporation
 - Puerto Rico Cement Company
- By 1948, all enterprises were sold to the Ferré family.

Industrialization

- Second Stage: Attract U.S. and foreign capital, match it with the local labor surplus and sell the products to the rest of the world.
 - Sub-stage 1 (1947-1965): Focus was on the establishment of relatively labor-intensive, export-oriented light industries, such as clothing and textiles, food processing, and leather and tobacco products.
 - Sub-stage 2 (1965-1980): Promotional efforts were aimed at attracting large, capital-intensive, external-oriented U.S. multinational investments in pharmaceuticals, chemicals and electronics.

Industrialization

- Third Stage (1980-1996): This is the “high-tech, high-finance” phase of Puerto Rico’s development. The vision was that Puerto Rico was to become the banker, the insurer, the marketing design center, trade entrepôt, and high-technology industrial partner. Strategy was:
 - Use Section 936 to attract high-tech firms to PR.
 - Encourage U.S. firms to keep profits in PR
 - Use cheap deposits from 936 firms to finance growth of FIRE sector.

GNP and GNP per capita (current dollars)

	1950	1960	1970	1980	1990	2000
GNP (\$MM)	754.5	1,676.4	4,687.5	11,073.8	21,490.6	41,418.6
GNP per capita	342	716	1,729	3,479	6,118	10,877

Source: PR Planning Board

Avg. Annual Growth Rate of Real GDP per Capita, 1955-1989

	Puerto Rico	South Korea	Taiwan	Mexico	Brazil
1955-1960	8.70%	2.50%	4.80%	4.60%	6.00%
1960-1970	10.1	9.8	9.0	6.4	5.8
1970-1980	8.9	14.1	15.2	12.4	13.8
1980-1989	7.7	13.3	10.1	3.1	4.0

Source: Dietz (2003)

GDP by Sector

Fiscal Years Ended June 30

(in millions at current prices)

	2001	2002	2003	2004	2005
Manufacturing	\$29,037	\$31,243	\$31,532	\$32,991	\$33,132
Services	\$26,615	\$26,913	\$28,919	\$30,567	\$32,285
Government	\$5,992	\$6,303	\$6,948	\$7,377	\$8,336
Transp., Comm. & PU	\$4,698	\$4,948	\$5,178	\$5,333	\$5,474
Agriculture & Fisheries	\$348	\$277	\$333	\$410	\$395
Construction	\$1,802	\$1,648	\$1,772	\$1,893	\$1,881
Statistical Discrepancy	\$717	\$292	\$146	\$378	\$531
Total GDP	\$69,209	\$71,624	\$74,827	\$78,947	\$82,034
Less: Net Payments Abroad	(\$25,162)	(\$26,552)	(\$27,348)	(\$28,556)	(\$28,653)
Total GNP	\$44,047	\$45,071	\$47,479	\$50,391	\$53,380

Educational Attainment Population 25 Years and Older

Year	Average Years of Schooling
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1950	3.7
1960	4.6
1970	6.9
1980	8.7
1990	9.9
2000	11.0

Selected Socioeconomic Indicators 1940-2000

	CBR	CDR	IM	LE	UN	LFP
1940	40.1	18.4	109.1	46	15.0	52.2
1950	40.1	9.9	68.3	60.9	12.9	53.0
1960	33.5	6.7	43.7	69.4	13.1	45.2
1970	25.8	6.6	28.6	72.0	10.3	44.5
1980	22.8	6.4	19.0	73.1	17.0	43.3
1990	18.9	7.4	13.4	74.1	14.3	45.5
2000	15.2	7.2	9.7	76.1	11.0	46.2

Source: Dietz (2003)

Other Socioeconomic Effects

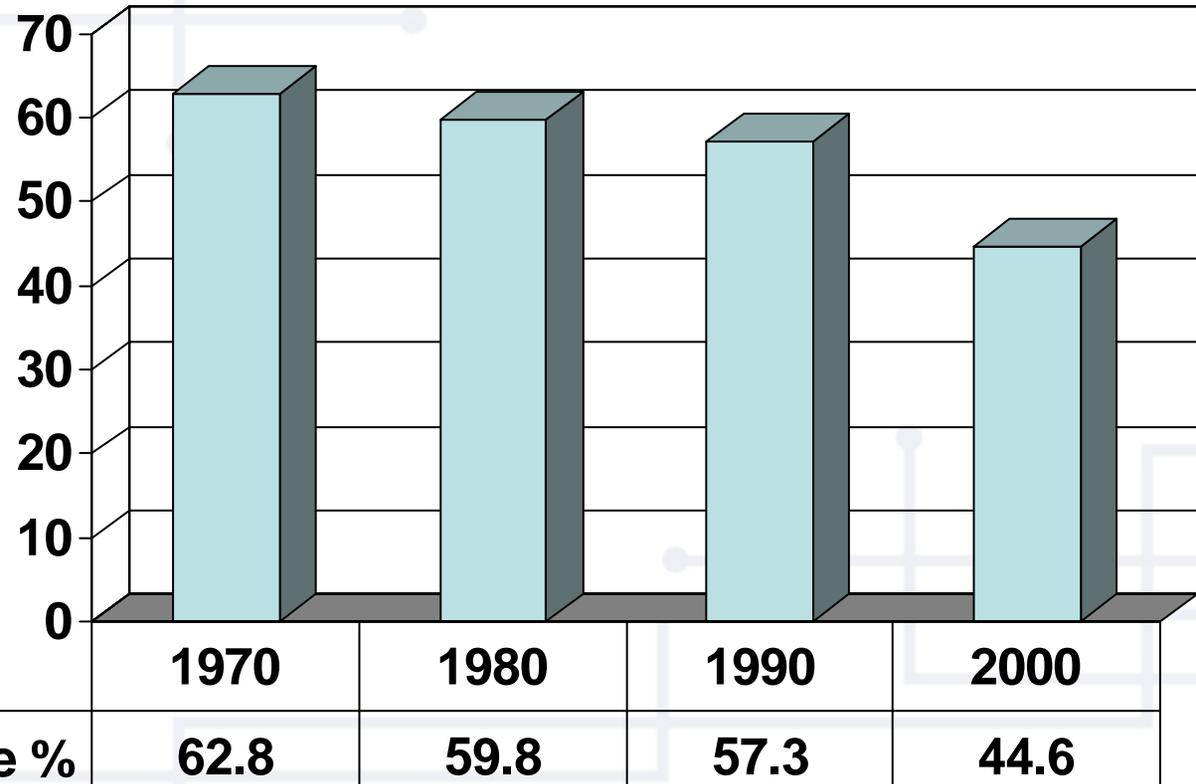
- Economic growth prompted other significant social changes:
 - Urbanization
 - Displacement to the cities
 - Rise of slums and urban problems
 - Social Mobility
 - Erosion of established social rankings
 - Change in Gender Roles
 - Work outside the home available to women
 - New Family Structure
 - Delayed marriage, sexual relations are transformed, reduction in fertility rate
 - Sharp Division of Labor
 - Specialization

Current Challenges

Analysis

- At the beginning of the 21st century students of economic development consider Puerto Rico to be an economic conundrum.
- From some perspectives, Puerto Rico has been quite successful. Living standards exceed those in the rest of Latin America and some quality of life measures are comparable to those in the most highly developed countries.
- At the same time, after fifty years of intense social change and economic growth, close to half of the Puerto Rican population still lives under the U.S. poverty line.

Poverty Rates in Puerto Rico for All Families (Census Data)



■ Poverty Rate %

Distribution of Family Income (2000 Census Data)

Income	% of Families	Cumulative %
Less than 10,000	31.4	31.4
10,000-14,999	14.9	46.3
15,000-24,999	20.1	66.4
25,000-34,999	12.3	78.7
35,000-49,999	10.0	88.7
50,000-74,999	6.4	95.1
75,000-99,999	2.3	97.4
100,000-149,999	1.5	98.9
150,000-199,999	0.4	99.3
200,000 or more	0.7	100.0



Analysis

By most criteria, Puerto Rico has created the conditions for strong sustained growth. It has made extensive investments in physical capital and infrastructure, increased education to OECD levels, and implemented policies to foment technological progress and innovation.

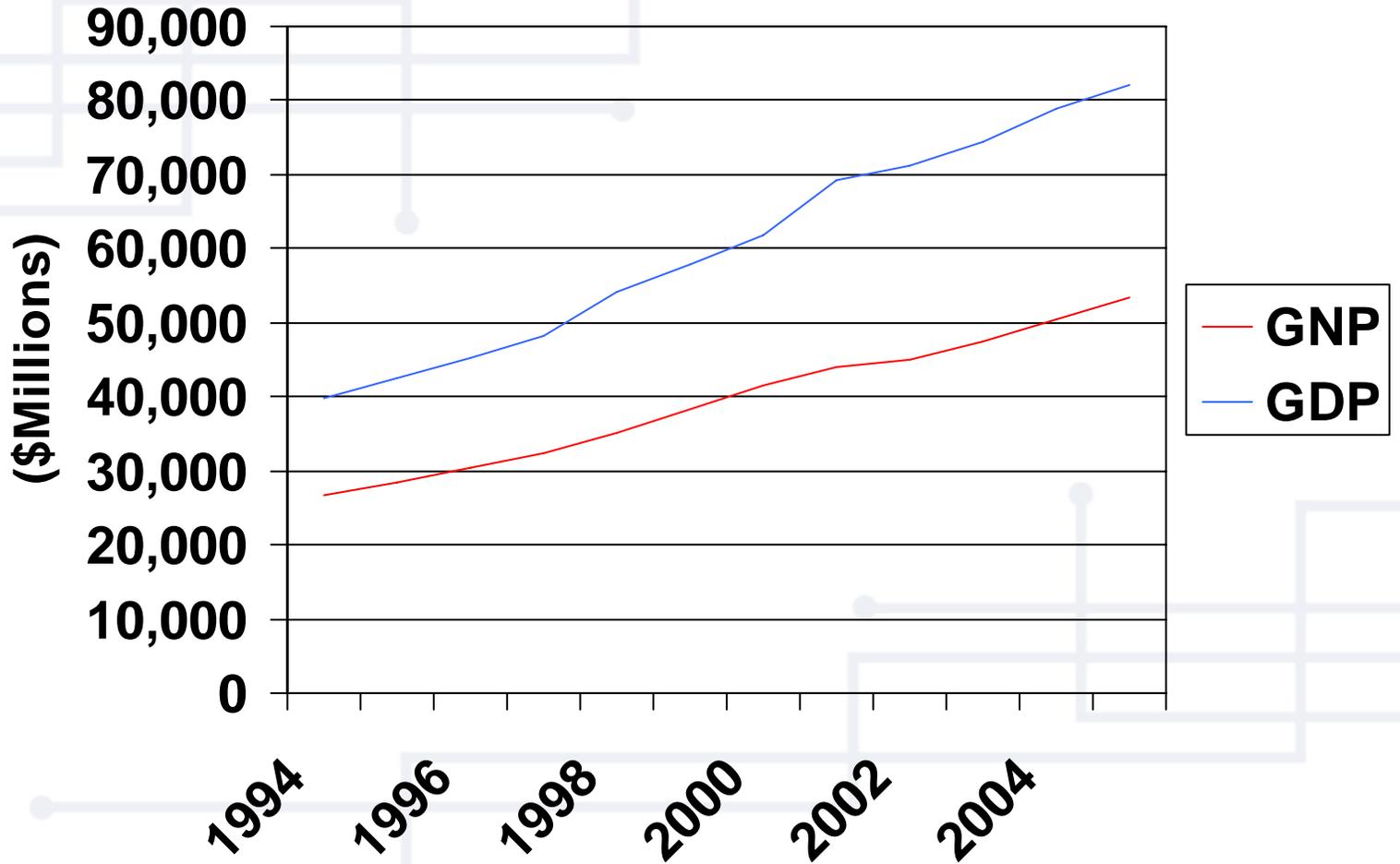
- In addition, Puerto Rico is one of the world's most open economies; has a stable legal and political system, certainly when compared with many other emerging markets, and has a decent institutional framework and respect for the rule of law.
- Therefore, by these standards, Puerto Rico should be growing much more rapidly.

Analysis

	2001	2002	2003	2004	2005	CAGR
Gross National Product (\$MM)	\$44,046.6	\$45,071.3	\$47,479.4	\$50,391.3	\$53,380.0	4.92%
Annual Growth %	--	2.3%	5.3%	6.1%	5.9%	
GNP at 2000 prices	\$42,045.9	\$41,902.2	\$42,796.7	\$43,985.6	\$44,884.0	1.65%
Annual Growth %	--	-0.3%	2.1%	2.8%	2.0%	
Gross Domestic Product (\$MM)	\$69,208.4	\$71,623.5	\$74,827.4	\$78,947.2	\$82,032.5	4.34%
Annual Growth %	--	3.5%	4.5%	5.5%	3.9%	
GDP-GNP	\$25,161.8	\$26,552.2	\$27,348.0	\$28,555.9	\$28,652.5	
(GDP-GNP)/GDP	36.4%	37.1%	36.5%	36.2%	34.9%	

Source: PR Planning Board

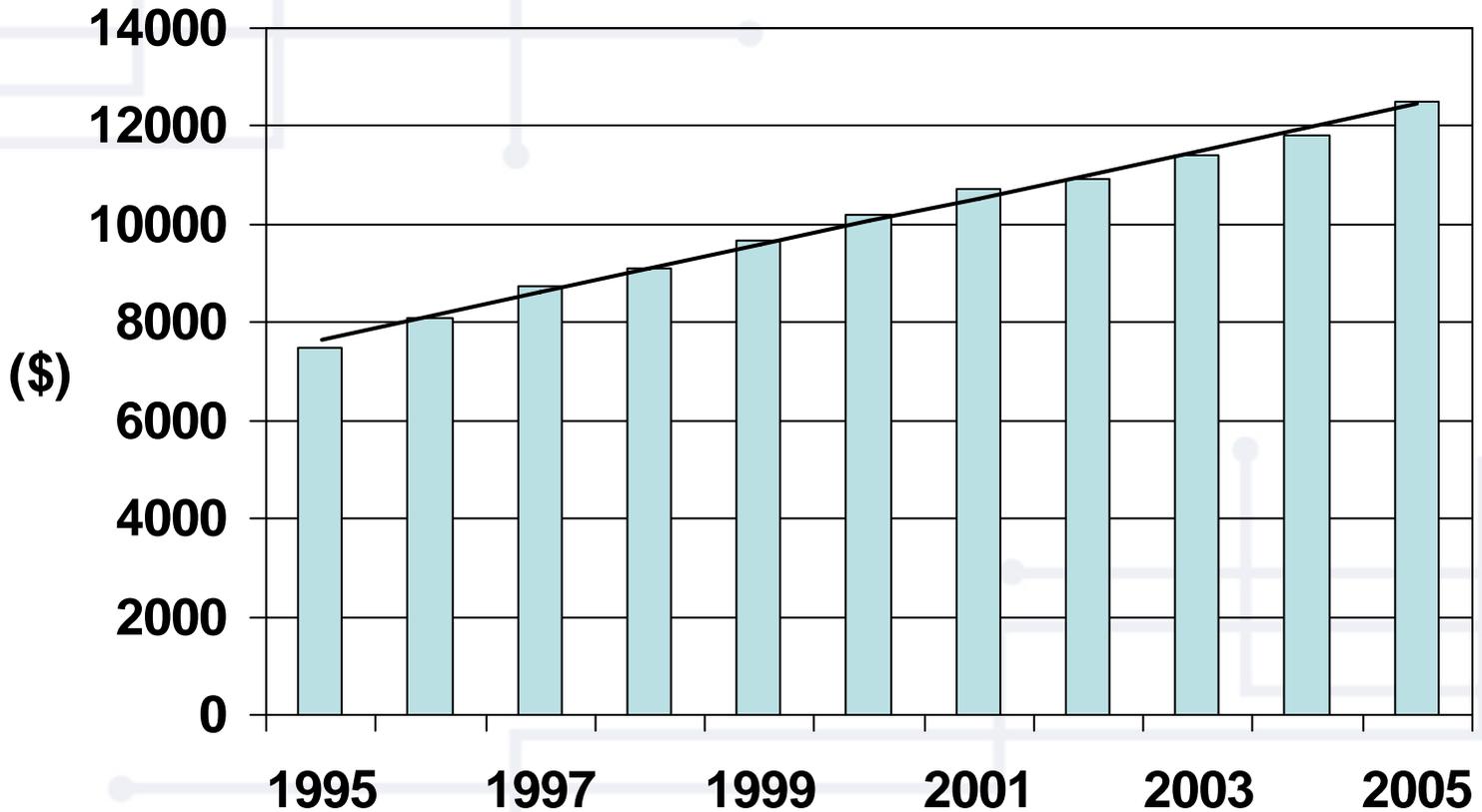
GNP and GDP



Analysis

- During the past five (2001-05) fiscal years Puerto Rico's GNP has grown in real terms at the anemic average annual rate of 1.7%.
- During that same period the unemployment rate averaged 11.3% and the labor force participation rate hovered around 47%.
- In addition, 44% of our families and 58% of our children currently live under the federal poverty line.

Personal Income Per Capita





Structural Problems

- Reliance on foreign capital and the expansion of the section 936 tax program shifted the focus away from developing activities in which Puerto Rico had a comparative advantage toward those with significant tax advantages to U.S. corporations.
- Growth was narrowly focused around a few manufacturing industries with large inputs of intangible capital (patents) that benefited from Puerto Rico as a tax shelter.

Structural Problems

- Furthermore, industrialization in Puerto Rico always relied heavily on large multinational companies headquartered on the mainland, and it did little to promote linkages with local supplying firms.
- As a result, Puerto Rico did not develop a large cadre of dynamic local entrepreneurs like that which emerged in the East Asian economies, nor was there significant transfer of know-how from the multinationals to Puerto Rican firms.

Structural Problems

- In addition, Puerto Rico has witnessed a significant drop in rates of labor force participation during the last thirty years.
- The expansion of the U.S. transfer programs in Puerto Rico during the 1970s was a significant contributing factor to the decline in the participation rate.
- The level of benefits provided by those programs was more attractive in Puerto Rico, with its lower average wage rates, than in the United States and there was a large increase in the proportion of Puerto Ricans receiving benefits from the various means-tested programs in the 1970s and 1980s.

Structural Problems

- Federal transfers to Puerto Rico during FY2004 totaled \$15.47 billion, or roughly 31% of Puerto Rico GNP. The principal components were:
 - Individuals: \$8.67 billion
 - PR government: \$5.32 billion
 - Wages and Salaries: \$1.03 billion

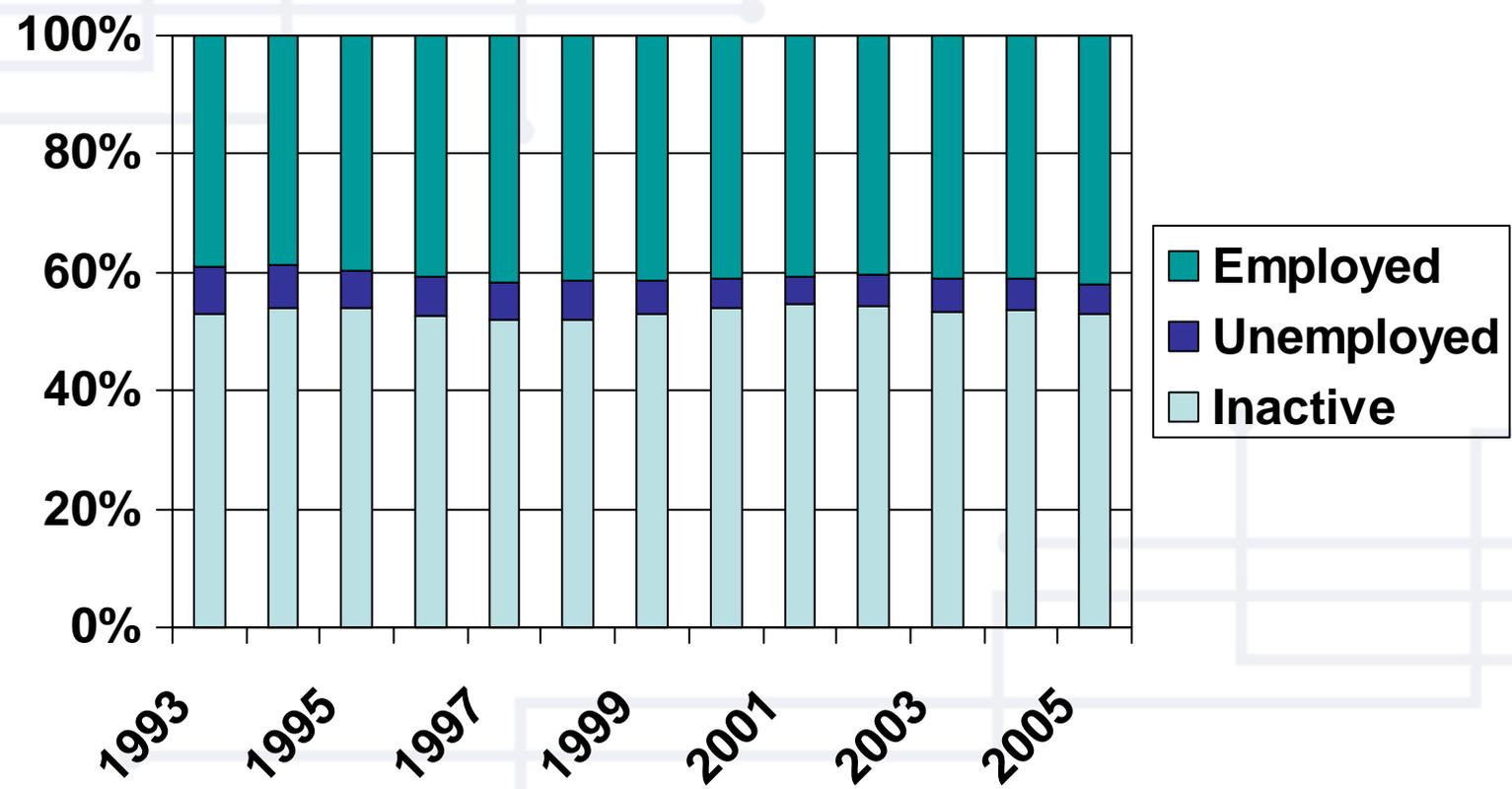
Structural Problems

- The introduction of the U.S. minimum wage in Puerto Rico in the 1970s also played a role in reducing job opportunities for the least educated portion of the population.
- Because prevailing wages are only half those of the mainland, however, the U.S. minimum on the island constitutes a far larger barrier to the employment of low-skilled workers than in the states. The current U.S. minimum of \$5.15 is equivalent to a \$10 minimum wage on the mainland.

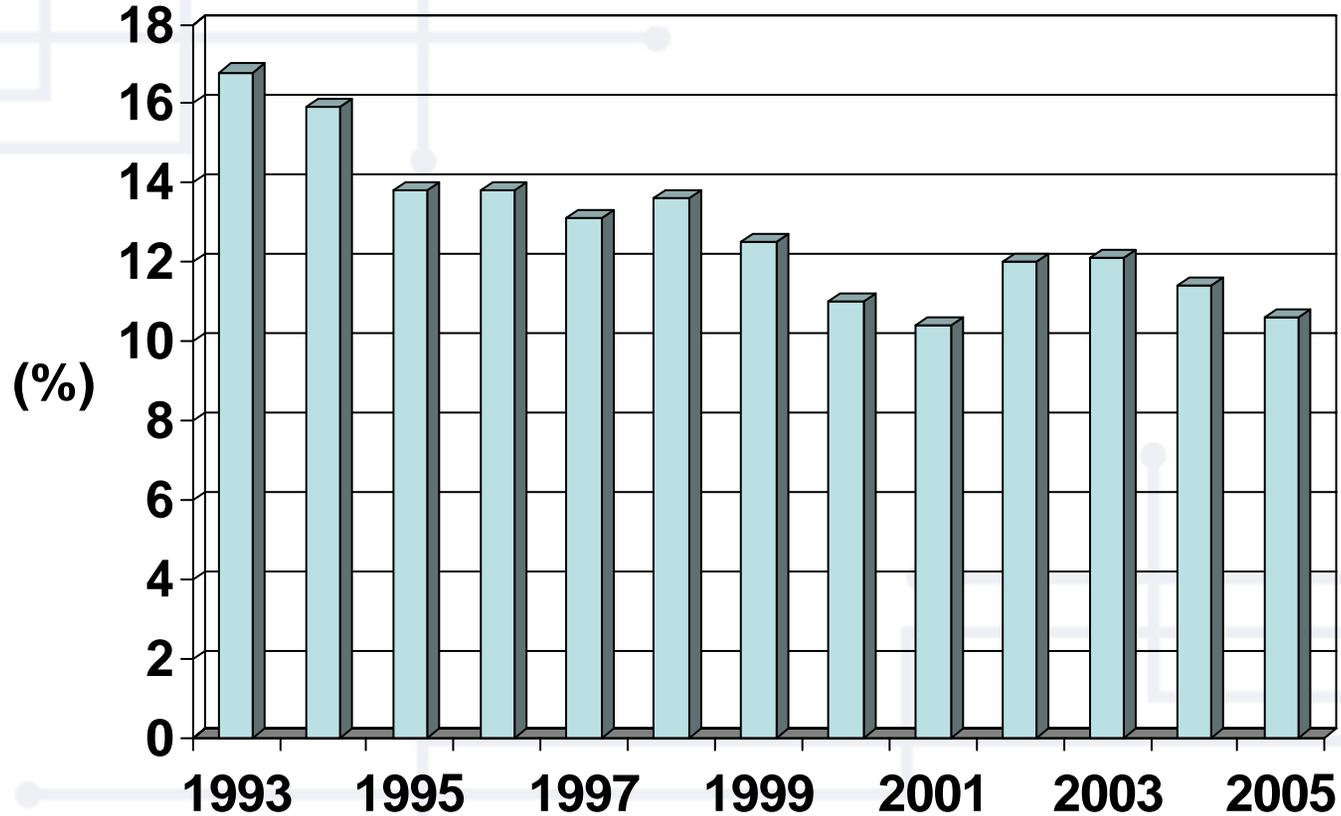
Non-Farm Employment by Sector

Dec/2006	(000s)	% of Total
Total	1,041.1	100.00%
Government	295.5	28.38%
Private	745.6	71.62%
Construction	66.7	6.41%
Commerce	164.9	15.84%
Transport and PU	18.6	1.79%
Mass Media	22.7	2.18%
FIRE	50.8	4.88%
Services	305.9	29.38%
Manufacturing	106.0	10.18%
Durable Goods	45.5	4.37%
Non-Durable Goods	60.5	5.81%
Pharma and Chemicals	29.5	2.83%

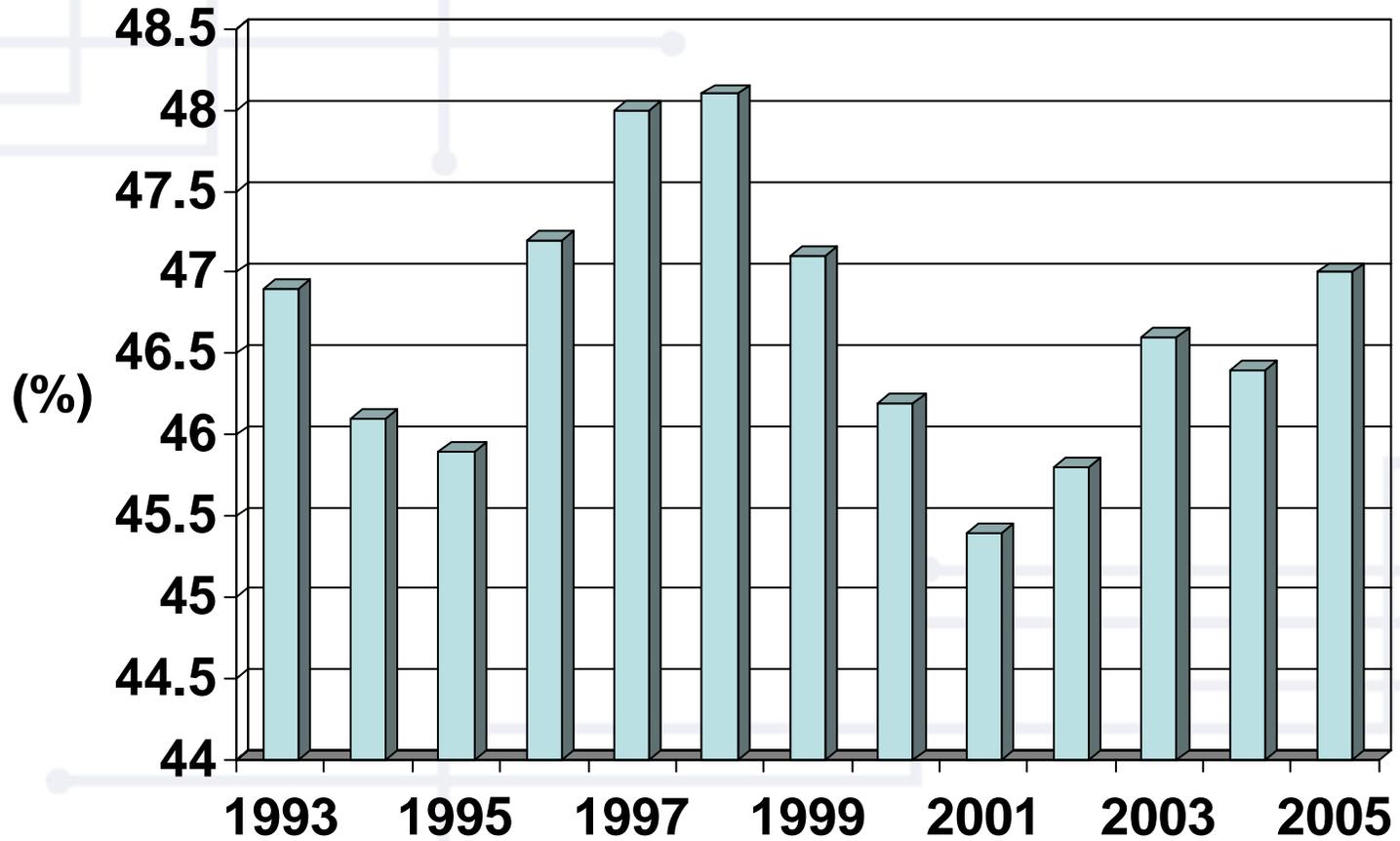
Employment Status Persons Age 16 and Older



Unemployment Rate



LFP Rate



Structural Problems

- Puerto Rico has developed an unusual industrial structure. As measured by the distribution of employment, it has a very small private sector; and within the private sector, the service-producing industries are underdeveloped.
- The missing jobs in Puerto Rico are largely in industries that would employ the least educated workers. At the same time, Puerto Rico has not generated growth in medium-sized enterprises, based locally, to offset the declining role of the large mainland firms.
- In a variety of ways, such as occupational licensing and control of location decisions, the government has restricted competition and the entry of new enterprises.

Structural Problems

- In several respects the size and performance of the Puerto Rican government have become an impediment to growth.
- During fiscal year 2005, the government sector accounted for roughly 30% of total non-farm employment in Puerto Rico and government expenditures amounted to 48% of GNP.
- This relatively large government sector has not delivered the quality services Puerto Ricans have come to expect.

Structural Problems

- Economic activity in Puerto Rico is dominated by the government through a complicated system of special privileges, which include, among others, licensing restrictions, multiple permitting processes, and several tax incentives.
- Furthermore, the Byzantine structure of our government, with its manifold executive departments, has generated a complete lack of accountability, oversight and transparency in government operations.
- The result is extensive rent-seeking behavior by those with links to the government that sometimes borders on the illegal, as is evidenced by the recent allegations of wrongdoing in several government agencies.

Structural Problems

- Puerto Rico is also facing a severe fiscal crisis. Central government expenditures consistently exceed income and the Commonwealth has been forced to borrow to balance the last three central government budgets.
- For the current fiscal year the Commonwealth's current structural imbalance is estimated at \$1.110 billion. This amount represents the difference between expenditures of \$9.488 billion, plus \$522 million related to a portion of debt service for certain bonds due during fiscal year 2007 which was paid with funds from a line of credit, for a total of \$10.010 billion, less recurring revenues of \$8.900 billion.

Structural Problems

- Puerto Rico has been on a borrowing binge for at least the last 14 fiscal years. It currently has the lowest credit rating and the highest per capita level of tax supported debt in the U.S.
- During the period between 1992 and 2004, general fund revenues increased at a compound annual growth rate (CAGR) of 6.2% while central government debt increased at a CAGR of 8.0%.
- Moreover, between June 30, 2003 and June 30, 2004, central government debt increased from \$6.89 billion to \$8.52 billion, a year-over-year increase of \$1.63 billion or 23.7%.

Structural Problems

- Even more troublesome is the fact that Puerto Rico's total public debt has increased from \$26.18 billion in December 2000 to \$45.88 billion in December 2006, an increase of \$19.7 billion, or 75.25%.
- Clearly this level and rate of indebtedness is unsustainable when nominal GNP is growing at a rate of 4.9%.

Other Challenges

- Education: High school drop out rate is estimated to be between 21 and 40%.
- Teenage Births: Rate of teenage mothers (live births per 1000 women aged 15 to 19) was 67 in 2001 compared to 16 for the OECD countries.
- Crime: Second highest homicide rate in the U.S.:
 - 19 homicides per 100,000 inhabitants in 2006

Looking Forward

- Given this state of affairs, it is evident that Puerto Rico is at a crossroads in its economic development path and decisions that we make, or fail to make, today will affect and impact the future rate of growth of our economy.
- A vigorous and growing economy will allow us to tackle a whole host of problems that currently afflict Puerto Rican society. To the extent that we have a healthy economy, it will be easier to get to the root of other pressing social problems such as drug addiction, environmental pollution, domestic violence, chronic disease, mental illness, rising inequality, violent crime, and poverty.