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Puerto Rico’s Moment of Truth

By Andrew Schrank and Michael PioreJuly 4, 2016

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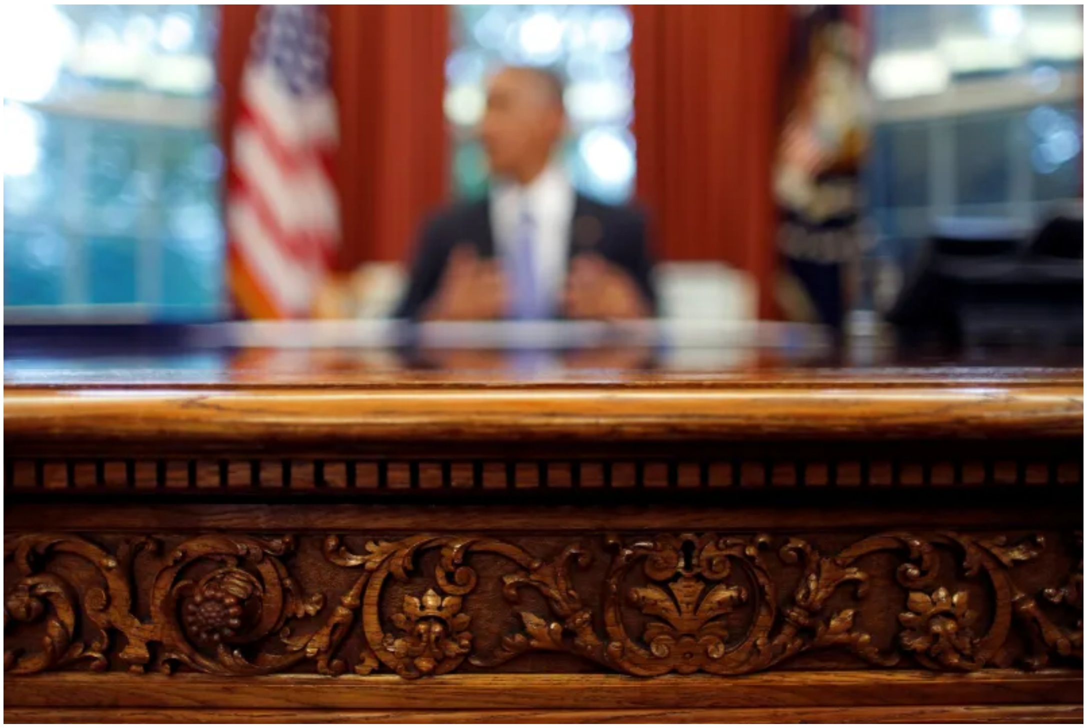
On June 30, the U.S. Congress approved the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which is designed to address Puerto Rico’s debt crisis by imposing a stay on litigation brought by creditors demanding repayment and empowering a board to oversee the island’s taxation, regulatory, and spending policies. But debt is not the root cause of Puerto Rico’s problems, and the board—to be appointed by U.S. President Barack Obama—could actually make matters worse by gutting regulations, undercutting spending, and encouraging the flight of the skilled workers who hold the key to the island’s future. What Puerto Rico really needs is not a PROMESA but a growth strategy.

Over the course of the past decade, Puerto Rico has fallen into a state of near-permanent recession marked by rising unemployment, falling personal income, and an exodus of skilled and unskilled labor. The results include a declining tax base that can fund neither the provision of essential services nor the payment of public debt. The island has thus found itself trapped in a vicious circle of divestment, departure, and decline.

This represents a profound reversal of fortune for an economy that until recently represented a model for the developing world. In the 1950s and 1960s, Puerto Rico was transformed from a poor, ill-educated backwater into one of the wealthiest and most prosperous territories in Latin America—with an abundance of engineering talent and a per-capita income that dwarfed those of its regional neighbors. By most of the standard metrics, in fact, the Commonwealth was a superstar. It was on a par with—and in some senses ahead of—the so-called Asian tigers.



U.S. President Barack Obama's desk is seen as he signs into law S. 337: FOIA Improvement Act of 2016 and S. 2328: Puerto Rico Oversight, Management and Economic Stability Act at the Oval Office of the White House in Washington, U.S., June 30, 2016.

Carlos Barria / Reuters

That turnaround was, in large part, the product of Operation Bootstrap, a Washington-backed development strategy that lured labor-intensive industry to the island with the promise of tax breaks, low-cost labor, and duty-free access to the mainland market. In the early days of Operation Bootstrap, the strategy targeted firms that provided primarily unskilled jobs at rock-bottom wages. Eventually, though, they contributed to a broader process of social and economic change that would fundamentally transform the island. Over time, the Puerto Rican workforce gained training, education, and experience; wages rose with skill levels; and more sophisticated and capital-intensive industries arrived, promising to deepen the development process.

Before the gains could be fully consolidated, however, Washington would undermine their foundations in two principal ways: first, by opening the U.S. market to trade with lower cost competitors in Central America and Asia—many of whom had imitated Operation Bootstrap in the late twentieth century, and second, by making changes to the federal tax code, which limited Puerto Rico's ability to leverage its wage advantages to attract businesses going forward and thereby opened the door to crisis.

But the crisis is no less the product of paralysis on the island itself. After all, Puerto Rico has a range of assets beyond low wages and tax breaks, including a reliable justice system, unfettered access to mainland labor and product markets, a skilled and increasingly bilingual labor force, a modern telecommunications network, and eligibility for a range of U.S. subsidies, set-asides, and procurement programs that are unavailable to foreign countries. But the Commonwealth has, for the most part, been unable to forge a new development strategy to take advantage of these opportunities. Unless it manages to do so in the near future, debt restructuring —whether undertaken by an oversight board or not—will prove short-lived, and the crisis will reemerge down the road.

Fortunately, some are pushing for a more systematic approach. Although PROMESA itself calls for a narrowly defined and delimited Congressional Task Force on Economic Growth, the Center for a New Economy, a nonpartisan Puerto Rican think tank, has initiated a series of dialogues on the island with an eye toward creating a growth commission with a broader mandate and vision.

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At the first of these dialogues last month, it was immediately clear that the success of Operation Bootstrap presupposed not only low wages and generous tax breaks but an elaborate array of institutions, including overseas offices that matched investors to incentives, brought interested companies to Puerto Rico to visit potential production sites, tailored tax and subsidy arrangements to the needs of particular firms, and—once a facility had been opened on the island—worked with investors and managers to identify and overcome obstacles to their success.

Such institutions exist, but over the last two decades, they have been starved of resources. The Commonwealth government has been forced to close offices on the mainland and curtail its recruitment activities. It lacks the resources to attract new firms and does little to support the old, and it is no longer able to benchmark its policies against those of competitors on the mainland and abroad who—in a final profound irony—cut their teeth learning the lessons of Operation Bootstrap.

The case for development planning is much debated, and skeptics tend to prefer laissez faire alternatives. But Puerto Rico stands as both a monument to planning's potential and a product of free-market failure. When policymakers took an active part in development planning, their economy prospered. When they forgot the lessons they had imparted to others, their economy collapsed.

Institutions capable of formulating and implementing a new development strategy will be an indispensable element of long-term economic recovery. They should be revitalized now and protected from any austerity measures to come.