

CARIBBEAN TRENDS AND THE PROSPECTS FOR PUERTO RICO

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Chapter I

EXECUTIVE SUMMARY:
PUERTO RICO'S POLITICAL AND ECONOMIC FUTURE

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EXECUTIVE SUMMARY:
PUERTO RICO'S POLITICAL AND ECONOMIC FUTURE

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This report examines trends in the Puerto Rican context in which Commonwealth Oil and Refining Company must operate in the years to come. This context includes not only the general political and economic conditions, but most importantly the economic policy orientations of future Puerto Rican governments. These contextual factors are in turn determined by Puerto Rico's political-legal status with respect to the United States, and her present and future relations in the Caribbean.

THE CURRENT SITUATION

THE CARIBBEAN CONTEXT

Puerto Rico is insulated by her historical lack of trade with other Caribbean nations besides the Dominican Republic, the specialness of Commonwealth status, the cultural separation from the British-oriented West Indies, and the near monopoly of the international news services (especially UPI and AP) in providing foreign news to Puerto Rican newspapers. Puerto Rican culture, modified by the long association with the United States and the influx of Americans to Puerto Rico, is quite distinct from the Hispanic cultures in the Caribbean and in Latin America in general. Puerto Ricans speak Spanish -- but they are American citizens. Thus, sharing the Caribbean geographically with other nations does not make Puerto Rico particularly sensitive to political developments

in the region.

The chances for a general radicalization of the Caribbean area, such that the security of Puerto Rico were threatened or Puerto Rican independentistas were strongly supported by neighboring revolutionaries, have been reduced in recent years by Cuba's apparently permanent decision to forego Latin American conflicts. Cuba is well on the way to restoring economic and diplomatic ties throughout the Caribbean and the Western Hemisphere in general, premised on a moratorium on ideological or military confrontations. Even Venezuela, an adamant supporter of OAS sanctions against Cuba during the 1960s, is involved in selling oil to Cuba.

A further reduction in the probability of the rise of leftist revolutionary governments or strong anti-U.S. sentiment will be achieved as soon as a Panama Canal treaty is affirmed. Progress in negotiations over the Canal indicates that a satisfactory treaty is imminent.

The growing influence that oil revenues provide Venezuela constitutes another source of Caribbean stability, since Venezuelan governments are likely to remain moderate and to favor economic and political stability in the Caribbean. Mexico, probably the next oil-rich power in the region in the 1980s and

1990s, is likely to be even more conservative.

DOMESTIC POLITICS

Puerto Rican politics is dominated by two moderate, pragmatic parties, the Popular Democrats (founded by Lu s Mu oz Mar n and recently led by Rafael Hern ndez Col n, Governor from 1973 to 1976) and the New Progressives (led currently by the incumbent Governor Carlos Romero Barcel ), distinguished primarily by the former party's advocacy of commonwealth status and the latter's support for statehood. Both parties emphasize a commitment to populist programs and opposition to "business interests"; yet both have significant support from and influence by the business community. Party positions have been quite responsive to shifts in public opinion, such that neither party is strongly identified with a particular policy approach. Even the differing positions on Puerto Rico's political-legal status are somewhat blurry, since the New Progressives in office seem reluctant to pursue strong policies for the transition to statehood and have generally denied that statehood is an issue in the gubernatorial campaigns.

The lack of party distinctiveness has resulted in the inability of either party to carve out a lasting majority. While this circumstance provides much more democratic give-and-take than in most nations and certainly than in most U.S. states, it has two negative effects on Puerto Rican economic policy-making.

First, alternations of administrations (every four years since 1968) have hindered the formulation of coherent economic policies. Second, an incumbent administration without secure electoral support cannot afford to tackle difficult economic problems requiring unpopular solutions. Faced with unrelenting economic pressures, Puerto Rican administrations are likely to pursue short-run rationality.

THE CURRENT ECONOMIC SITUATION

The Puerto Rican economy, transformed in the post World War II period from a depressed agricultural structure to a diversified industrial system financed by U.S. capital, is currently faced with a severe recession, high indebtedness, and very high unemployment.

Although the U.S. and world recession contributed to Puerto Rico's poor economic performance in the 1970s, there are also chronic underlying causes which will dampen economic growth in Puerto Rico for decades. Puerto Rico's attractiveness to manufacturing, created through th labor-cost advantage and the ingenious promotions policy of Operation Bootstrap, is offset by the permanent disadvantages of necessarily higher shipping costs for goods to be sold on the mainland and higher energy costs resulting from dependence on OPEC oil. The discovery of oil off

Puerto Rico's shores is highly unlikely.

Puerto Rico's traditional advantage of low labor costs has diminished. Wage levels have been rising because of internal political pressures as well as U.S. Congressional efforts to extend the full federal minimum wage level to Puerto Rico. Currently, wages per se are moderately higher than those of developing countries competing against Puerto Rico in labor-intensive manufacturing such as apparel and footwear. The Puerto Rican government, unlike the governments of independent nations with national currencies, cannot increase the competitiveness of its exports by devaluing its currency. By the late 1960s, industrial growth in Puerto Rico consisted primarily of expansions by capital intensive, heavy and technical industries attracted mainly by the tax exemption incentives rather than by inherent advantages of operating in Puerto Rico.

The troubled tourist industry, with facilities expanded in the 1960s to handle U.S. tourists diverted from Cuba, will face increasing competition from Cuba, the Dominican Republic, and even Haiti.

The positive aspects of the Puerto Rican economic outlook include its past growth record and its remaining tax advantages. From 1960 to 1970, the real GNP of Puerto Rico grew at nearly 7%

annually with fairly low net population growth. The Commonwealth Economic Development Administration, which coordinated this development, is still an active and persuasive promoter of U.S. investment in Puerto Rico. Because of the promotions policy, Puerto Rico is an attractive location for certain enterprises that do not require heavy energy inputs or high shipping costs. If there is another wave of expansion of U.S. high technology and research industries (electronics, scientific instruments, pharmaceuticals, etc.), Puerto Rico may acquire a Boston-like R&D nucleus.

Two other factors, the imminent Romero Barceló promotions policy and the two-way flow of migration, present equivocal prospects for the Puerto Rican economy. The promotions policy soon to be unveiled by the Commonwealth government will probably offer new, complicated formulas of exemptions and other investment incentives, to replace the long-standing legislation automatically exempting new enterprises from all Commonwealth taxation. The Economic Development Administration claims that the new promotions package will be highly flexible and even more attractive to investors than is the current law. On the other hand, the 100% tax exemption has the strong advantage of being a straightforward, familiar, venerable rule. Any firm that invests under the present arrangement can be assured that the

Puerto Rican government will not renege on the exemption. Potential new investors will not lose sight of the fact that the introduction of new regulations opens the possibility of even further modifications. The crucial question, therefore, is whether a promotions package intended to be more attractive will indeed be regarded as such by potential investors, who must take into account not only the manifest benefits of the provisions as they are presented when the investment is made, but also the possibility that future modifications could reduce these benefits.

Open migration has long served Puerto Rico as a safety valve when population growth and the sluggish expansion of labor-intensive industries worsened the employment outlook on the island. Out-migration has saved Puerto Rico from many of the acute problems of population expansion and extremely high unemployment. Yet the other side of the freedom to migrate -- the return of Puerto Ricans to the island -- will have deleterious effects on the ability of Puerto Rican governments to make headway with the unemployment problem. When general economics conditions and employment prospects in Puerto Rico improve relative to mainland conditions, return migration increases, eroding the improvement

in Puerto Rico's employment situation. This equilibrium has maintained the unemployment rate at between 12% and 24%, depending on the state of the Puerto Rican economy and the economy of the United States as a whole. It also means that even short-lived economic booms in Puerto Rico cannot eliminate the welfare drain on the Puerto Rican government.

PUERTO RICO'S POLITICAL-LEGAL STATUS

In the long run (10 to 20 years) it is likely that there will be a strong attempt to resolve Puerto Rico's ambiguous political status. Commonwealth status as it currently stands is not only ambiguous in a practical sense, in placing Puerto Rico between sovereignty and statehood, it is also legally ambiguous. Although Luís Muñoz Marín, the founder of Commonwealth status, successfully promoted the idea in Puerto Rico that the Commonwealth represents a "compact" between the U.S. and Puerto Rico, the U.S. Congress has never acknowledged that the Commonwealth Constitution has the character of a "treaty" any more than the constitution of any state in the Union. To the U.S., Puerto Rico is a "Commonwealth" (as are several U.S. states such as Pennsylvania and Virginia); to Puerto Ricans it is a "Free Associated State" ("Estado Libre Asociado"). In 1964 the U.S. Supreme Court ruled that Puerto Rico "Belongs to

but is not a part of" the United States. Puerto Rico's international legal status is also subject to differing interpretations; one interpretation is that Puerto Rico is simply a colony of the United States.

The nature of the search for new status is as important as the eventual resolution, if any, of the status question. Any change in Puerto Rico's status could come only after a drawn-out, largely-public process of deliberation and negotiation, giving concerned parties (including individual Puerto Ricans) ample time to react. Consequently, the search for a new status has built-in constraints, since even the discussion of options involving the elimination of economic incentives or federal aid could trigger a serious deterioration of the investment climate, stepped-up migration, or other negative economic reactions reinforcing the attractiveness of the status quo. Another aspect of this dynamic is that the impetus for status change is fed by dissatisfaction with economic conditions. (Note that the current dissatisfaction emerged with the economic downturn of the 1970s). Yet the worse the domestic problems, the more dependent Puerto Rico must be on federal sources of welfare, and the more precarious and sensitive the Puerto Rican investment climate becomes in the face of perceived threats to the incentive system. Moreover, Puerto

Rican leaders may be reluctant to initiate debate on the status issue simply because of the danger that a debate would publicize Puerto Rico's drain on federal funds. (This drain is not yet well known, because of its recency and because of the glaring lack of a centralized federal entity in charge of Puerto Rican affairs.)

PROSPECTS FOR STATEHOOD

Statehood is the only economically and politically viable alternative to Commonwealth status. Yet, though statehood has the advantage of the incumbency of the pro-statehood New Progressive Party, the economic and political liabilities of statehood make it at best only a long-range possibility, probably at least 20 years into the future. In practice, the adoption of statehood would require the approval of the U.S. Congress and well over a majority of the Puerto Rican electorate. Both are unlikely to opt for statehood in the foreseeable future.

Statehood would hold the promise of greater security of investment and equal formal eligibility with other states for federal aid, which conceivably could eventually reduce the income gap between Puerto Rico and mainland U.S. To those who regard commonwealth as a form of colonial status, statehood and the accompanying

full political rights may represent greater dignity for Puerto Rico. Yet statehood, and even the transition to statehood, would cause severe short- and medium-term problems threatening the political survival of any incumbent Commonwealth government.

The economic drawbacks of statehood result from the dependence of the Puerto Rican economy on the special provisions of Commonwealth status that would have to be abandoned under statehood. First, the profitability of many firms in Puerto Rico depends on the continued exemption from federal taxes. (Only contributions to Social Security are currently required). Many companies have established facilities in Puerto Rico only because of this exemption, and could shut down if the exemptions were phased out. Second, the direct deposit of customs revenues and excise taxes collected on Puerto Rican rum and tobacco into the Commonwealth treasury is an important source of government funds that would disappear under statehood. Third, Puerto Rico as a commonwealth is still exempt from certain federal labor laws, such as the minimum wage law, though political pressures within Puerto Rico have been forcing up wage levels regardless of Puerto Rico's status. On balance, the additional federal funds for which Puerto Rico would be eligible as a state could not offset the costs to Puerto Rico arising from the new obligation to pay federal taxes and the loss

of businesses because of the elimination of federal tax exemption.

The growth in popularity of the pro-statehood New Progressive Party is therefore somewhat surprising. However, its success is probably more easily explained in terms of the economic failures of the competing Popular Democratic Party -- further emphasizing the importance of economic constraints in Puerto Rican politics. The growth in the New Progressives' electoral support indicates that the Puerto Rican electorate is not so committed in principle to Commonwealth status that New Progressive politicians could not mobilize majority support for statehood. The question is whether the New Progressives could survive once statehood became a truly important, imminent issue. Thus far, opposition to statehood has been manifested quietly in referenda; since the commonwealth option has been favored by more than 60% of the population, pro-commonwealth support has never been fully mobilized. If the statehood issue were seriously raised, pro-commonwealth sentiment would emerge much more vehemently, emphasizing the danger that statehood poses to Puerto Rican national and cultural identity. Independientistas, who reject even the partial incorporation of Puerto Rico into the United States, would oppose complete absorption even more vigorously, and probably much more violently. The terrorism that reached its peak around 1971 can be traced to the

promotion of the statehood cause by the incumbent Governor Ferré between 1968 and 1972. The shift to statehood would be detrimental to the standing of the incumbent party, since the phasing out of federal income tax exemptions would deter investment and thus damage the administration's own record as manager of the economy.

From the U.S. side, objections to statehood would arise from Puerto Rico's economic weakness and the problem of terrorism. Puerto Rico, as a state with half the per capita income of Mississippi, deteriorating investment attractiveness, and a continuing fiscal crisis, would not receive an enthusiastic hearing in the U.S. Congress, even if it is acknowledged that Puerto Rico as a commonwealth is also currently an economic burden. Puerto Rico without special investment attractions would be an even greater welfare burden for the United States. The fact that the U.S. government could then collect federal taxes from Puerto Rican individuals and firms would be of little consolation, since the low per capita income implies low personal income tax revenues, and corporate tax revenues would diminish with the disinvestment and declining profitability of many firms operating in Puerto Rico.

The deliberations over statehood would also trigger independentista terrorism on the mainland, which could be a greater

political liability to U.S. politicians inasmuch as turmoil over the status of Puerto Rico is not regarded by most Americans as an issue that must be confronted. Therefore, although Gerald Ford publically advocated Puerto Rican statehood and Jimmy Carter promised to support statehood should Puerto Rico "formally and legally" request it, the likely reaction of the U.S. Congress to an outbreak of terrorism following a pro-statehood plebiscite would be to bury the statehood issue as quietly as possible.

PROSPECTS FOR INDEPENDENCE

Both short and long term trends deny any significant probability of Puerto Rican independence. Domestic Puerto Rican economics and politics minimize the internal demand for independence; U.S. opposition is likely to be very great; and external support for Puerto Rican independence is very unlikely to rise above its current modest level.

The Puerto Rican economy is tightly integrated into the U.S. economy on the basis of the absence of trade barriers. Exports to the U.S. mainland are equivalent to about half of Puerto Rico's gross domestic product. Puerto Rico's precarious attractiveness to manufacturing for both internal consumption and shipment to the mainland would be crushed by U.S. tariff barriers.

Moreover, the U.S. Department of Defense is the largest employer and consumer on the island.

The economic difficulties of Puerto Rico during the 1970's, high unemployment, and the lower per capita income level of the Puerto Rican population have made Puerto Rico a heavy recipient of federal transfers, amounting to a rapidly growing net sum of 2 billion dollars annually at this time. Half of Puerto Rico's families receive some form of federal welfare. If independence means abandoning this crucial source of income and services, the economic prospect of independence is very bleak and the reality of independence would be politically disastrous. While there are some opportunities for economic integration with the Caribbean community and particularly with the Dominican Republic, which could be negotiated by an independent Puerto Rico, the potential benefits would be dwarfed by the loss of U.S. interchange and aid.

The political climate in Puerto Rico reinforces there economic obstacles to independence. Contrary to the impression created by independentista terrorists that independence is a burning issue in Puerto Rico, the bulk of the Puerto Rican population has consistently opposed the independence option. Both in plebiscites and in electoral support for pro-independence candidates, only a tiny fraction of Puerto Ricans have indicated that they favor

independence. Even if the long-run attractiveness of independence is projected by examining the attitudes of the generations that will be the source of Puerto Rican leadership twenty years from now, there is little evidence of support for independence except for the traditional cluster of pro-independence intellectuals centered at the University of Puerto Rico at Río Piedras. Historically, the pro-independence stance of Puerto Rican university youth has been consistently replaced with identifications with the positions of either of the major parties, usually (as in the U.S.) with the individual adopting the party identification of his or her parents. There is no evidence that this pattern is changing.

U.S. opposition to Puerto Rican independence would be based on economic, political and even military grounds. Although Puerto Rican independence could relieve the huge welfare burden and probably eliminate Puerto Rican terrorism once and for all in the U.S., the perceived costs to the United States are enormous. With respect to security concerns, the U.S. has large military installations in Puerto Rico, and Cuban support for Puerto Rican independence has had the ironic effect of portraying independence as a major loss to U.S. prestige and geopolitical power.

In economic terms, U.S. private investment in Puerto Rico

exceeds \$12 billion. The U.S. corporations in Puerto Rico would certainly vigorously oppose any "concessions" by the U.S. government. Moreover, any projected savings in reducing federal aid flows to Puerto Rico would be severely reduced by the migration of Puerto Ricans to the mainland during the period prior to independence.

Finally, even if economic and military considerations did not stand in the way of U.S. acceptance of Puerto Rican independence, the issue would create an unprecedented legal and political morass. The constitutionality of Puerto Rico's current status and that of independence, the status of Puerto Ricans' American citizenship, and even the legal requisites for establishing independence (is this the prerogative of the Puerto Rican people or the U.S. Congress?) would be open to vigorous and divisive debate. These problems are obviously not insoluble -- Britain, France, and other colonial powers devised means for devolving independence to possessions even more closely incorporated into the mother country than Puerto Rico is integrated into the U.S. -- but these are problems traditionally skirted by politicians. Moreover, the political costs of U.S. politicians supporting Puerto Rican independence would be very great. -- Puerto Rico is a more integral part of the United States than is the Panama Canal Zone. Opposition

to losing U.S. territory would far exceed sentiment for jettisoning an economic liability.

There are two conceivable external influences bearing on Puerto Rican independence: the long-standing support from Cuba, either encouraged or checked by Soviet policy; and potential support on the part of groups from other Caribbean areas of from future radical Caribbean governments.

Cuban support for Puerto Rican independence, which dates from Castro's break with the United States, has been the only significant external support for Puerto Rican independence to date. Without Cuban initiatives, the consideration of Puerto Rico's status by the United Nations Decolonization Committee (which the U.S. regards as lacking jurisdiction) and the conferences of the Non-Aligned Countries Movement would not have materialized.

For the Cuban regime, support for Puerto Rican independence certainly is consistent with the regime's ideology, and is probably satisfying as a modest source of discomfort and concern for the United States. Nevertheless, it is very unlikely that the Cubans would be willing to jeopardize their interests in improved trade relations with the U.S. by pushing Cuban support of independentistas to the point of confrontation or crisis. First, more active support for Puerto Rican independentistas, involving Cuban

soldiers or matériel, would be inconsistent with the 1968 decision of Cuban leaders to abandon active support for revolution in Latin America and turn their attention to the more promising opportunities for revolution elsewhere. Second, although the Cuban leadership is committed to a Marxist-Leninist strategy, it is also nationalist, and therefore would welcome the opportunity to reduce Cuban economic dependence on Soviet aid, as would the Soviet Union, which is preoccupied with its own development needs. The United States represents the best source of trading opportunities and technology for the Cuban economy. Consequently, as long as Cuban-U.S. relations (such as tourism) are controlled adequately by Cuban authorities to safeguard the loyalty of Cuban citizens to the existing political structure, the Cuban government has very strong incentives to improve relations with the United States.

The U.S. has indicated, though in a somewhat ambivalent fashion, that Cuban support for Puerto Rican independence is indeed an obstacle to U.S.-Cuban economic accords. From a different angle, Cuban support for Puerto Rican independence may be seen as a Cuban bargaining chip, which could be cashed in for more tangible concessions from the United States. As such, Cuba's verbal and diplomatic support for Puerto Rican independence

is likely to diminish as part of a U.S.-Cuban agreement. There is already some indication that Cuban leaders have written off the possibility of actually separating Puerto Rico from the U.S. After the Socialist Party's dismal performance in the 1976 Puerto Rican election, Cuban funds for the party's publications dried up.

The prospects for direct Soviet support for Puerto Rican independence are even more limited. Besides U.N. voting, the Soviets' opposition to the "colonial status" of Puerto Rico has been limited to a few articles appearing in the Soviet Union and in Soviet-financed international journals. The USSR will certainly not commit material resources to this end. Moreover, Puerto Rico could not, like Cuba, trade her dependence on the U.S. for dependence on the Soviet Union. Cuba suffices as an adequate -- and itself very expensive -- agent for Soviet foreign policy in the Caribbean and Latin America. The Soviet Union would be financially incapable and utterly unwilling to take on the multi-billion-dollar responsibility of underwriting the Puerto Rican economy. While the Soviet Union may have some incentive to step up its support for Puerto Rican independence in order to offset its diplomatic defeats in other world areas (e.g., the defiance of the Eurocommunists and the decline of Soviet influence in the Middle East) and to counter the U.S. attack on the Soviet

human rights violations, the direct Soviet "offensive" would certainly be no more than verbal, and hence would hardly become the focus of attention of the Puerto Rican people.

All the Caribbean trends reviewed in the Introduction of this report tend to reduce the likelihood of a change in Puerto Rico's status. It is possible that a leftist government in the Dominican Republic, along the lines of Juan Bosch's old Dominican Revolutionary Party or his new Party of Democratic Liberation, could support the independence of neighboring Puerto Rico. Bosch and his followers have been radicalized by President Balaguer's repression and by the U.S. support of Balaguer. Occasionally anti-Balaguer guerrillas and pro-independence Puerto Rican Socialists have collaborated. However, Balaguer's control in the Dominican Republic is extremely strong. Aided by a basically expanding economy (with some fluctuations reflecting changes in world sugar prices), Balaguer has combined the support of the military, the business community, and the peasantry, along with adept harrassment of his political opposition.

Haiti, because of its proximity to Puerto Rico also conceivably relevant, is not a significant factor in the independence issue. The extreme inward orientation of Haitian politics, preoccupied with the narrow power struggle among old guard and mildly

modernist Duvalierist factions against the backdrop of a politically unaware population, will continue. Leftist activity in Haiti is almost entirely precluded by the minimal political awareness of the bulk of the Haitian people.

PROSPECTS OF MODIFICATION OF COMMONWEALTH STATUS

Finally, there is the intermediate option of alterations in the nature of the Commonwealth status, ranging from the possibility of suffrage in presidential elections to the authority to enter into commercial treaties with other nations. Although a proposal for greater Puerto Rican autonomy through a "New Compact" drawn up in 1975 by a high-ranking advisory committee headed by Muñoz Marín was ignored by President Ford, the conjunction of a Popular Democratic governor and a Democratic president might be conducive to serious consideration of alterations in commonwealth status, designed to reduce some of the legal ambiguities and political limitations of the current arrangement. Obstacles to the consideration of a new compact include the fact that Congress has not acknowledged the the U.S.-Puerto Rican relationship is governed by compact, the lobbying strength of the pro-statehood forces, and the Congressional reluctance to grant to Puerto Rico greater power than that held by full-fledged states. The acceptability of such a compact to Puerto Ricans, should it be accepted first

by the federal government, is also questionable, since pro-statehood advocates would probably see it as a step away from integration, independentistas would regard it as a mechanism for perpetuating the U.S.-Puerto Rican connection, and even pro-commonwealth advocates would not be completely satisfied with provisions acceptable to Congress.

FUTURE ECONOMIC POLICIES & THEIR CONSEQUENCES

POLITICAL CONSTRAINTS ON GOVERNMENTAL POLICY

It is clear from the past actions of Puerto Rican administration that maintaining the employment level is the most important political imperative and constraint, regardless of which major party is in power. Because higher minimum wages could threaten jobs, the administrations of both pro-statehood governors, Ferré and Romero Barceló, chose not to push the equalization of Puerto Rican and mainland minimum wage levels, even though eventual equalization is a statehood prerequisite. Precisely the same situation holds for the New Progressives' reluctance to tamper with the federal tax exemptions, also not permitted under statehood but necessary for employment maintenance. Despite an absence of statist orientation by either major party, several unprofitable enterprises were nationalized to avert employee layoffs. Finally, employment in government has increased tremendously since 1969, in spite of the fact that this expansion has necessitated dangerously high

levels of public borrowing.

Thus, sustaining the already deteriorated employment level is a practically uncompromisable goal for any Puerto Rican government that wishes to remain politically competitive. The precipitous decline of Hernández Colón's Popular Democratic Party in the 1976 election followed the most severe increase in unemployment. While the defeat obviously cannot be attributed solely to unemployment, this problem is regarded as one of the major causes of the incumbent party's defeat. It would be unreasonable to expect the adoption of economic policies entailing greater immediate unemployment, even if such policies were directed at long-term solutions to the basic economic problems.

Wage policy is another particularly sensitive issue because of the awareness of U.S. mainland wage levels. Puerto Rican policy-makers are well aware of the tradeoff between higher wages and investment attractiveness, yet they also recognize that Hernández Colón's attempts to restrain wage increases cost him many votes in the 1976 election. Labor-intensive manufacturing is locating elsewhere in Latin America or Asia, thereby closing off an avenue for ameliorating Puerto Rico's unemployment.

Government spending on social programs is becoming increasingly

difficult for the Puerto Rican government to limit, both because of the political popularity of such programs and because matching Commonwealth expenditures are necessary to take advantage of some of the federal aid opportunities. Federal funds currently provide one third of Commonwealth government income.

Although the Commonwealth government considers the very high reliance on federal grants-in-aid as a temporary condition -- and one which they argue would be foolish to pass up during this period -- the key problem is that federal aid per se weakens the Puerto Rican economy in several ways. First, because of the low personal savings rate in Puerto Rico, transfer payments to individuals lead to higher consumption but little increase in capital accumulation. Second, wages must keep ahead of welfare levels, thus adding to the pressures to reduce Puerto Rico's labor cost advantage. Third, the availability of welfare on the island has been an important factor in the return migration of Puerto Ricans from the mainland, thereby exacerbating the problem of unemployment. Fourth, the welfare cushion gives workers greater incentive to undertake prolonged searches for other jobs, resulting in an erosion of Puerto Rico's traditionally low employee turnover rate as well as adding to the unemployment problem. Finally -- and this is a crucial factor in the future pressures on the Puerto Rican

government -- the matching provisions of federal grants-in-aid have committed Commonwealth funds to the maintenance of already initiated, ambitious social sector programs. Such programs are obviously directly beneficial to the health, education, and well-being of the Puerto Rican people. However, to support these programs, and to operate and expand state enterprises (operated in part to prevent further unemployment), the Puerto Rican government has borrowed heavily, thus greatly increasing the likelihood of future fiscal crises.

The untying of federal aid would unquestionably relieve the Puerto Rican government's bind. Yet it cannot be expected that the U.S. government, already putting billions of dollars annually into Puerto Rican programs, would agree to reduce the Puerto Rican share of the costs, or to stimulate even greater demands for federal expenditures by removing the constraint of the availability of the matching funds.

ECONOMIC POLICY SCENARIOS

There are three possible scenarios for Puerto Rican economic policy in the next ten years. The first would be the adoption of a program, such as that recommended by the Tobin Committee Report, entailing major austerity measures (such as wage cutbacks and higher taxes). The second would be a continuation of current policies,

involving a maintenance of the investment incentives now being reviewed, but with no significant attempts to resolve the structural problems, or to avert future fiscal crises, through austerity measures. The third would be a reduction in investment incentives such as the 100% tax exemption (perhaps on the grounds that such exemptions are unfair to the Puerto Rican people) along with a continued reluctance to adopt austerity measures requiring some economic sacrifice on the part of the public.

A tough economic austerity program could be adopted if a determined Puerto Rican administration felt politically confident enough to risk the implementation of unpopular wage restraints, or if the U.S. Congress or Treasury Department were to impose austerity measures in order to reduce the flow of federal aid. Our analysis of the political constraints of future Puerto Rican governments indicates that the initiative is unlikely to come from the Puerto Rican side. The lesson of Hernández Colón's fall was not lost on Romero Barceló -- the latter cut taxes. Since awareness of the problem in the U.S. is minimal, and U.S. actions could antagonize the Commonwealth government as well as kindle dissatisfaction with Commonwealth status, imminent unilateral U.S. action is also unlikely. The most the U.S. government is likely to do is to place a ceiling on federal funds available to Puerto Rico,

without attempting to alter the Puerto Rican government's basic policies. A possible solution would be for a Puerto Rican administration to engineer a hardline policy by the federal government. However, this sort of constructive collusion would require the concurrence of the federal authorities to play the villain, and would presume that the Puerto Rican party in opposition would not reveal the plot to the public. This therefore remains an unlikely outcome.

The continuation of current policies for at least the next ten years is politically the most plausible scenario. The tax exemptions, both federal and Commonwealth, are likely to be maintained simply because there is no safe alternative for maintaining capital inflow without a dynamic economy. The current administration's review of the promotions policy will probably reach the conclusion that tax exemptions are indispensable for the economy.

The third alternative -- reductions in the availability of exemptions from Commonwealth taxes -- had been regarded by some observers as unlikely simply because of its obvious effects of discouraging investment at a time when Puerto Rico's other advantages have disappeared. Even discussion of this possibility has contributed to the decline in recent investment interest. Yet the Romero Barceló government seems to be seriously considering this

option; the position of the Economic Development Administration (see appendix) is that "recipients of tax exemption must contribute in some form and manner to the support and improvement of the well-being of our people," and "Inefficient industries seeking abnormal benefits and contributing little to the Puerto Rican economy can't be tolerated." It is unclear whether the modified promotions policy is intended to, or will result in, an effective reduction of exemptions. Thus the possibility of reductions in the tax exemptions cannot be ruled out, and certainly the advisability of such exemptions will remain a topic of public debate, with a dampening effect on the investment climate.

Since on balance the last two scenarios combined are much more likely than the first, the most plausible outlook for the next decade is that Puerto Rico will continue to slide into a chronic but not crushing economic malaise. It is ironic that access to U.S. welfare funds reduces the likelihood that the Puerto Rican economic problem will come to a head sufficiently to trigger decisive action. Given the close political balance between the New Progressives and the Popular Democrats, and the fact that neither can politically afford to antagonize the public by taking decisive austerity measures, the path of least resistance is to pursue federal transfers.

Beyond the next five or ten years, the maintenance of Commonwealth tax exemptions, a large bureaucracy, and extensive social welfare programs is not fiscally sustainable. Low personal incomes and Commonwealth tax exemptions restrict the inflow of government revenues while social programs and public employment require increasing Commonwealth outflows, especially since population growth, so far largely ignored by Puerto Rican governments, will keep up the demand for expanding jobs, education, and health facilities. Rescue by the federal government cannot be taken for granted, since it is not required to provide the Commonwealth with grants-in-aid at the same levels required by states.

Therefore, despite the political costs, Puerto Rican governments will periodically have to give in to the fiscal emergencies by cutting back on social programs and by increasing taxes. The elimination of tax exemptions would not rescue the government from a fiscal crisis, since elimination of tax exemptions for firms already operating in Puerto Rico would irrevocably damage the government's credibility and the revenues gained by eliminating exemptions for new investors would come in too late to rescue the government from a revenue shortage.

However, to minimize the political costs, Puerto Rican governments will reduce expenditures and increase taxes as little as possible.

Therefore, even if the Puerto Rican government can scrape through future financial crises, it will remain on the edge of revenue shortages continually. All "surplus" revenues from prosperous years would be absorbed by government employment or social service programs, by tax reductions, or by the servicing of the public debt.

Because a profitable Commonwealth Oil and Refining Company could supply large amounts of cash to the Puerto Rican government, and because Corco does not wield electoral power, it would be vulnerable to a host of measures (such as levies on oil imports or low prices fixed for Corco products sold to state enterprises) to absorb Corco profits into the Commonwealth treasury. Corco's operations in Puerto Rico are obviously unique. Hence, the Puerto Rican government can drain off Corco profits through legislation pertaining only to these operations, without poisoning the investment atmosphere for any other firm. Thus, the major danger for Corco, once profitable, is that a future Commonwealth government will be unable to resist political pressures to bolster its revenues by nibbling away at the Corco profits, regardless of commitments made in good faith by the current administration. The fiscal deficit of the Puerto Rican government will be a key indicator to monitor as a warning signal of the vulnerability of Corco's profits.

In the long run, the Puerto Rican government's capacity to maintain the expansion of the island's industrial infrastructure (roads, port facilities, electrical power, etc.) to keep pace with reasonably optimistic private-sector industrial expansion is in doubt. The Commonwealth government's heavy reliance on borrowing, and the political pressures to maintain a precarious indebtedness, will put a ceiling on Puerto Rico's capacity to borrow. Because Puerto Rico's fiscal weakness will be known to lenders who have been sensitized by the New York City experience, the availability of loans is likely to be a real constraint, preventing the Puerto Rican government from sustaining the capital investment that is necessary to develop the infrastructure for continuing industrial growth.

This constraint contributes to the plausibility of another long-range scenario, which is possible though not probable: an abandonment of the developmentalist strategy altogether. This is not necessarily connected with the quest for statehood, since the promotions policy, including tax exemptions, is not inconsistent with statehood; a state can regulate the applicability of its own taxes and benefits. Rather, the continual strain of juggling tax exemptions and onerous loans, the frustrations of inadequate infrastructure and insufficient attractiveness, and

the disillusionment with industrialization that entails high unemployment could trigger a long-range reaction against the idea of sacrificing fiscal security and political safety simply to play the promotions game at a disadvantage. The abandonment of the promotion strategy initiated as Operation Bootstrap would be a simplifying strategy -- the complexities and dynamism of industrial promotion would be traded for the certainty that remaining enterprises would at least contribute fully to the maintenance of the fiscal system. This scenario may mean acceptance of a more-or-less permanent situation of Puerto Rico as an industrial backwater, not unlike the stagnation of the northern New England states.

In addition to the general unfavorable economic outlook for Puerto Rico, there are some specific potential hazards--of varying likelihood--for corporations operating in Puerto Rico. In ascending order of likelihood and importance, they are expropriation, labor unrest, and the abolition of federal tax exemptions.

As Puerto Rican administrations have already demonstrated, the employment priority can trigger the takeover of unprofitable enterprises. Corco, with 2,700 employees, would not be allowed to shut down. However, because the independence scenario is so

implausible, the prospect of nationalist governmental efforts to expropriate profitable enterprises can be dismissed, not only because "nationalism" is unlikely to materialize, but also because of the limitations to such actions imposed by the American legal framework. Both New Progressive and Popular Democratic administrations have proven themselves to be, at most, reluctant economic actors.

With respect to oil refineries, there is no evidence that Puerto Rican policy-makers or the public regard petroleum processing as the sort of "natural resource exploitation" that has triggered nationalist sentiment for expropriation or confiscation in many Latin American countries. Oil refining, though essential for Puerto Rico, does not pose the problem of poor performance that motivated the Commonwealth government's takeover of the telephone utility.

Puerto Rican labor unions have been relatively weak. High unemployment and the low share of the labor component in manufacturing costs have limited the bargaining power of unions, and in fact several have lost major strike confrontations recently. With both major political parties campaigning as the champion of the workingman, labor has failed to emerge as an independent political force.

If there is any potential hazard that labor unions pose to normal business operations in Puerto Rico, it is the fact that the pro-Castro Socialist Party (PSP) controls a sizable portion of the union apparatus, despite the party's negligible electoral following. However, the threat is minimized by the fear of unemployment and the fact that Puerto Rican workers apparently separate their political affiliations and their union affiliations. It is very unlikely that the PSP could mobilize strikes on any grounds other than wage negotiations, for which the management side has more bargaining power than in comparable situations on the U.S. mainland.

Finally, there is a low but significant probability that the federal tax exemption for Puerto Rican enterprises could be abolished, in reaction to corporate accounting manipulations designed to reduce the tax liability of mainland operations by transferring profits to Puerto Rican subsidiaries. The abolition of federal corporate tax exemptions would be a major economic blow to Puerto Rico whether it results from this kind of "punishment" or from the transition to statehood (It should be mentioned that the entrance conditions for some territories joining the U.S. as states provide some precedent for gradual rather than immediate elimination of federal tax exemption).

The abolition of federal tax exemption by the federal government is unlikely for three reasons. First, it would create an even more hopeless welfare problem for Puerto Rico, which could not be blamed for the transgressions of the corporations involved. Second, there is the possibility that the general practice of tax avoidance through transfers to subsidiaries could be blocked through tax and accountancy regulations without altering the rules specifically relating to Puerto Rico. Third, it would provoke a very strong reaction from U.S. business interests involved in Puerto Rico and from the Puerto Rican government -- unless the Commonwealth administration at the time is truly committed to a rapid transition to statehood.

CONCLUSIONS

The overall character of the next two decades of Puerto Rican politics will be moderate and stable. No disruptions from the Caribbean context are likely. Many contentious issues that divide and inflame political groups in independent nations -- the selection of big-power sponsors and the ideological contention over the nature of the basic political framework -- simply do not arise in an "associated state". The status issue will be a recurrent pre-occupation for Puerto Rico, with only a modest chance of resolution.

through statehood or modification in commonwealth status. Despite the intractability of the status problem, it will not be ignored, and consequently sporadic outbreaks of pro-independence terrorism will mar an otherwise stable political atmosphere.

The real problem of Puerto Rico's future is the economy, which has strong tendencies to revert to an industrial backwater. The combination of federal aid, deficit Commonwealth spending and tax exemption policies necessary to prop up deteriorating investment attractiveness and politically imperative social welfare programs is simply not sustainable. Depending on the political strength of future Puerto Rican governments and how resolute they are in attacking the fundamental problem of Puerto Rico's inherent cost disadvantages, the short- and long-range prospects range from unpromising to dismal.

A large corporation operating in Puerto Rico is unlikely to face the hazards of expropriation, labor unrest, the abolition of federal tax exemptions, or Commonwealth government actions that would destroy the general investment climate. However, Corco's unique position will make it separately vulnerable to the actions of fiscally strapped Puerto Rican governments in the future.