Tracing Pathways to Success and Failure

By Richard W. Rahn

HONG KONG, CUBA AND PUERTO RICO TEACH VALUABLE ECONOMIC LESSONS

Why is Hong Kong rich, Cuba very poor, and Puerto Rico struggling? Back in 1955, the islands of Puerto Rico, Cuba and Hong Kong had roughly the same real per capita income. They each took very different economic paths. Now, some 60 years later, Hong Kong is even richer than the United States on a per capita income basis. Cuba is an economic disaster, having gone from the richest Caribbean nation to the poorest, next to Haiti. And Puerto Rico finds itself flirting with bankruptcy, with a per capita income much higher than Cuba's but only roughly half that of Hong Kong. Incomes have increased approximately 22-fold in Hong Kong, 11-fold in Puerto Rico, and only fourfold at best in Cuba, in a little over a half-century.

Cuba became a communist nation, with the Soviet Union-Russia as its economic big brother, from which it received considerable subsidies. Puerto Rico has had the United States as its big brother — it is a largely self-governing territory of the U.S. — from which it has received considerable economic assistance. Hong Kong was a largely self-governing territory of the United Kingdom until 1997, when it became again a largely self-governing territory under China. Neither Britain nor China has provided subsidies to Hong Kong.

Cuba is relatively rich in natural resources, and Puerto Rico has some, but Hong Kong has almost none. The improbable success of Hong Kong and the improbable failure of Cuba is a direct result of the economic policies each followed. Hong Kong is perhaps the best example of what can be achieved under the rule of law, with limited government and free markets. Cuba is a poster child of how rule by man rather than law, coupled with government ownership of the means of production and the destruction of the price system, results in no freedom and a great deal of poverty. The Cubans like to brag about their health care system, while ignoring the fact that, when faced with a really serious illness, high-level Cuban officials have been known to go to Spain or other places for medical care. Life expectancy is a good proxy for overall health care; and it is true that among poor countries Cuba ranks high, but Puerto Rico has a slightly higher life expectancy and has made greater gains than Cuba over the last half-century, and Hong Kong has one of the highest life expectancies in the world (84).

Puerto Rico, while largely a free-market economy, has been plagued by corruption, destructive unionism and crony capitalism. The result has been a rapid increase in debt, which the government says it can no longer service, and economic stagnation. Many of Puerto Rico's most productive and educated citizens have moved to the U.S. mainland (note: Puerto Ricans are U.S. citizens).

The Puerto Rican fiscal problem has now reached crisis proportions. The government is currently selling assets from pension funds (which may be illegal) to pay money dedicated to one group of creditors to other creditors, as well as to pay for other government services. The U.S. Congress is now considering creating an oversight board with sufficient powers to deal with the debt and the underlying fiscal problems. The Puerto Rican government does not now have the legal authority to declare bankruptcy; and even if did, it would not solve the underlying problem of excessive spending. Bankruptcy would also be breaking a covenant with the existing bondholders — and would probably result in Puerto Rico no longer having access to the credit markets.

The intent is for the oversight board to work with the various parties to create a restructuring agreement, fair to all parties and which would not endanger the ability of Puerto Rico to re-enter the credit markets once the necessary reforms are put in place. The economic reforms need to be bold, such as radically reducing the size of government and the powers of the unions, deregulation, and fundamental tax reform resulting in a low top rate. Some critics who think in only static terms will claim that tax rates cannot be reduced given Puerto Rico's debts. The fact is that Puerto Rico will never be able to service its current or future debt if the economy does not revive and grow rapidly.

Other countries have shown that tax rate and regulatory reductions spur growth and actually generate more tax revenue over the long run. Hong Kong not only gets by but prospers with a maximum individual tax rate of 15 percent, a maximum corporate rate of 16 percent, and a government that only spends 18 percent of gross domestic product. If Puerto Rico had similar tax rates, hundreds of thousands of skilled Puerto Ricans would pour back into the island and create many new businesses and jobs. Many very rich Americans would also take up residence in Puerto Rico to take advantage of the lower tax rate, and all of their spending would also create many more jobs.

Hong Kong has demonstrated what works, and Cuba as demonstrated what fails. Puerto Rico's current ailments can be quickly cured by a good dose of greater economic freedom.

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