



MACROECONOMIC OVERVIEW AND PROPOSALS TO RESTORE ECONOMIC GROWTH

PRESENTED TO: FISCAL OVERSIGHT AND MANAGEMENT BOARD

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Macroeconomic overview

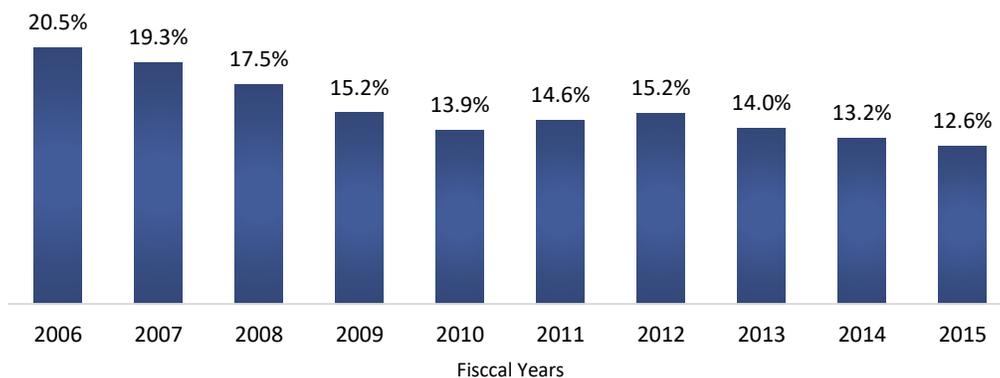
The current economic crisis is directly related to the obsolete institutional framework created during “Operation Bootstrap” in 1948. The Island’s growth strategy based on the program “industrialization by invitation” is no longer effective, in the new global economic reality. There is a consensus among local economists, that the underlying cause of the financial crisis is the collapse of the Island’s production platform.



Since 2006, Puerto Rico faces its worst economic depression in modern times. During the last decade, measured in constant dollars, the GNP experienced a contraction of -19.2%, while total employment fell by **220,000 jobs (20% of total labor force)**. Key productive industries such as manufacturing and construction suffered a significant contraction, affecting the growth capacity of the economy.

Right after the elimination of Section 936, private investment started to decrease¹. For instance, during the phase-out period between 1996 and 2005, investment as a share of GNP decreased from 25% to 22%. Nevertheless, once the federal incentives were totally phased out, in 2005, private investment as a share of GNP collapsed from 20.4% to 12.6% in 2015². Also, global factors, such as the free trade agreements and the rise of other economic world players, as China and India, also affected the Island’s competitiveness.

Investment as a share of GNP



Source: Puerto Rico Planning Board

Since the elimination of the federal tax incentive program, Puerto Rico has failed to create a new economic development strategy. Instead, all the government efforts focused on the fiscal dimension of the problem,

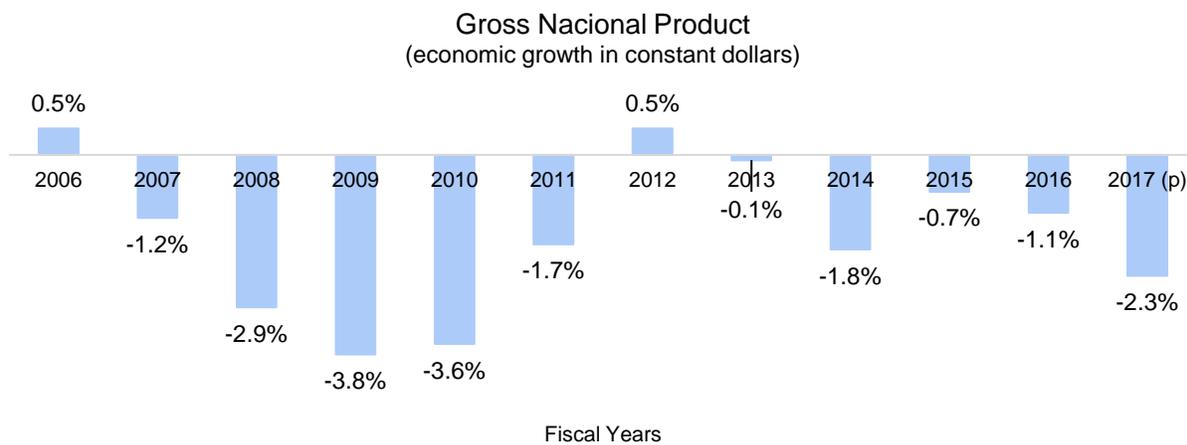
¹ For over eighty years the federal government granted various tax incentives to U.S. corporations operating in Puerto Rico, to spur the industrialization of the Island.

² Vélez, G. *The Impact of the repeal of Section 936*. (2009). UPR Graduate Program.

by increasing taxes (\$22 billion) and expanding public debt to unsustainable levels (\$30 billion)³. Debt as a ratio of GNP increased from 70.6% in 2007 to 92.0% in 2016, fiscal years⁴.

These fiscal policies not just have failed, but created a death spiral and extended the crisis. Also, the political resistance to reduce government and public spending, contributed to the current fiscal situation. Moreover, Puerto Rico is the only federal jurisdiction that still holds depression status after the U.S. financial crisis of 2008.

During the last decade, manufacturing and construction, key drivers of private investment, experienced historical challenges that affected their role within the local economy. Also, as the government fiscal problems arose, public investment vanished. In the short term, the Island’s main economic challenge is how private investment could be increase to acceptable levels. We estimate that the economy needs from \$5 to \$8 billion per year in new investment during the next five years to restore economic growth. To achieve this, the Public-Private Partnerships will be highly relevant.



Source: Puerto Rico Planning Board

Structural reforms to restore economic growth

Restoring economic growth, will demand radical changes in the current government structure. Puerto Rico must implement several structural reforms to modernize the Island’s institutional framework, and to create a friendly business environment. It must be the private sector, not the government, the major driving force of economic growth and long term development. The current administration and the private sector, must work together to implement these reforms within a broader agenda of social and economic transformations.

Fiscal reform

Puerto Rico needs to develop a culture of public finance transparency and reliable fiscal planning to restore credibility to the capital markets. As recommended by many external organizations the commonwealth should adopt multiannual budgets aligned to specific macroeconomic goals. Also, local

³ Vélez, G. *Puerto Rico Debt Crisis and Opportunities*. (2015).

⁴ *Economic Report to the Governor: Statistical Appendix 2016*. Planning Board.

government should consider the creation of an independent fiscal council like the U.S. Congressional Budget Office (CBO), to promote sustainable fiscal planning.

1. **Improve the Commonwealth's financial reporting:** The institution stated that recent research shows that more transparent budgets are associated with lower public-sector funding costs, other things equal.
2. **Strengthen performance of public corporations:** The NY FED recommends enhance the fiscal discipline and governance standards of the public corporations. The recommendations include the implementation of selective privatization, setting targets for profitability and payments of dividends to the central government. In addition, public corporations must comply with transparently budgeting for any remaining subsidies from the central government.
3. **Adopt a capital budget and binding balanced-budget:** The central government should adopt state budget practices. This model split the budget into an operating piece that must be balanced, and a capital piece that can be financed with debt. According to the FED, Puerto Rico could better align financing methods with its spending priorities.

Tax Reform

Previous tax reforms have not accomplished the desired goals in terms of economic growth and expansion of the tax base. In the short term, any tax reform should be aligned with a comprehensive economic reactivation strategy to break the current contraction cycle by simultaneously broadening the tax base and reducing rates across a range of taxes, including corporate and individual taxes.

Proposals

1. **Reduction of the corporate tax rate:** Corporate tax collections decreased from \$2 billion in 2007 to \$1.6 billion in 2015. We propose a corporate tax rate of 28%, and a reduction of the marginal tax rate for individuals to 30%.
2. **Reduction of the personal income tax:** Total collections from personal income tax decreased from \$2.9 billion in 2005 to \$2 billion in 2015. Individuals with an income of \$25,000 or lower, represent 60% of total tax payers, but their contributions represent 10% of total collections. Tax payers with income of \$65,000 and higher, represent 14% of total tax payers, but contribute 86% of total fiscal revenues. We recommend a gradual reduction of tax rates across the high and medium income levels as a measure to expand the tax base and incentivize savings and job creation.
3. **Special tax rate to attract Puerto Ricans from the mainland:** Another component of the tax reform proposed is a special tax rate of 10% to attract professional Puerto Ricans that have relocated to the mainland. The strategy is like Act 22, of 2012, which aimed to draw individuals with higher incomes from abroad to relocate to Puerto Rico. The main objective of the program is to expand the tax base by attracting returning native Puerto Rican professionals that relocated to the U.S.

Potential revenues of the program to attract professionals from the U.S.

	Professionals	Net income	Tax rate	Fiscal revenues
2017	30,000	\$90,000	10%	\$270,000,000
2018	45,000	\$90,000	10%	\$405,000,000
2019	55,000	\$100,000	10%	\$550,000,000
2020	70,000	\$100,000	10%	\$700,000,000
2021	60,000	\$100,000	10%	\$600,000,000

Source: *Inteligencia Económica Inc. projections*

Welfare reform

The social impact of the welfare state has been dramatically adverse. Furthermore, welfare programs have seriously affected Puerto Rico's economic potential. For instance, historically the local economy labor market participation rate has been relatively low compared to U.S. standards. During the last decade, as the economy entered in depression, participation rate plummeted from 50% in 2005 to **39% in 2015**.

According to the U.S. Census Bureau, the poverty rate in Puerto Rico is 44.9%, twice the level of Mississippi (24.2%), the poorest U.S. state. It is evident that policies adopted to reduce poverty on the island have failed⁵.

The administration must develop a comprehensive policy to reduce dependency on federal and local welfare programs. Through a "welfare to work" social policy, government and the private sector could work together to transition current welfare recipients to the labor market.

Proposals

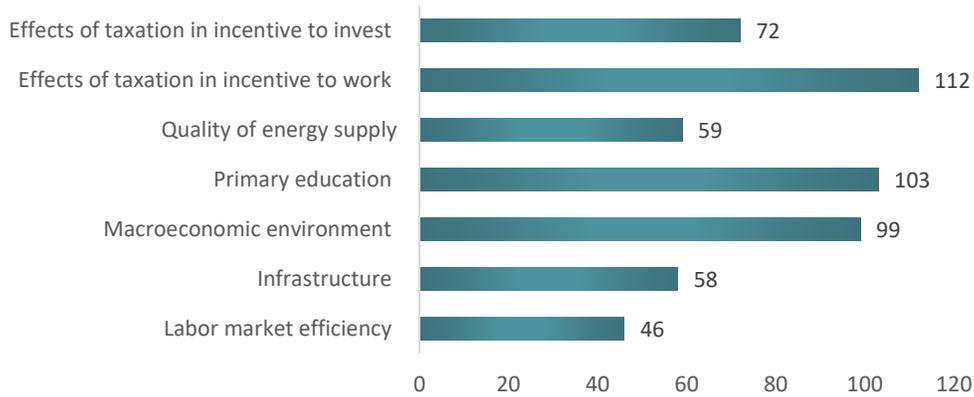
1. Create a ten-year strategic plan to reduce the poverty level to 35% by 2027. Based on current data, that would represent a reduction of 350,000 people (35,000 per year).
2. Create a government task force with representation of the Labor, Agriculture, Economic Development, and the Family Department, tasked with creating a comprehensive program to transition current welfare recipients to the labor market.
3. Once approved, welfare recipients eligible for work must start to look for a job as a condition to keep receiving their benefits. In the case that the recipient could not find a formal job (part time or full time), the recipient must do voluntarily work at a non-profit organization or the government.

⁵ Odishelidze, A. and Laffer, A. *Pay to the order of Puerto Rico: The Cost of Dependence to the American Taxpayer*. (2004). Allegiance Press.

- Welfare recipients would benefit from a five-year phase out period where they will continue to receive social benefits from the government. During the five-year transition period welfare recipients, will not be subject to any form of taxes.

Competitiveness ranking

World Economic Forum
2015



Source: WEF Competitiveness Report, 2015

Labor reform

In recent years, labor market reforms presented by the private sector and business organizations have been constantly rejected by the legislature, and in some cases by the executive branch. Despite empirical evidence concerning the effect of current labor laws on job creation, the political leadership has been reluctant to legislate a comprehensive labor reform.

Proposals

- Probationary periods:** Permit one-year probationary period contracts (which are presently limited to 90 days; with a permissible 90-day extension, at the discretion of the Puerto Rico Secretary of Labor and Human Resources).
- Flexi-time:** Improve the flexibility of daily overtime rules by amending the law to provide that daily overtime (excess of 8 hours) will be determined on the basis of the calendar day, instead of the present rolling 24-hour cycle.
- Compressed work weeks:** By legislation, authorize alternate scheduling arrangements, whereby overtime will only be determined on a weekly basis (excess of 40 hours).
- Wrongful Discharge Reform:** The EPL reform proposal would limit Puerto Rico’s wrongful discharge law (Law No. 80 of May 30, 1976, as amended) to “non-exempt” employees. This term is not defined, but generally, this term is used to refer to employees who are not “executives, administrators or professionals” under the Fair Labor Standards Act. Future clarification will be required.

- **Labor productivity:** Any labor reform needs to be aligned with policies to promote productivity as a driver of better salaries in the work place.

Permitting process

The permitting process is an important factor that affects the competitiveness of any economy. According to the World Economic Forum report on competitiveness, in 2015 Puerto Rico ranked 57 out of 144 economies in the category of steps to start a business. To that extent, the reforms to strengthen the island's competitiveness must include a comprehensive reform of the permitting process.

Puerto Rico's permitting process in the last decade transformed from a Planning Board centralized approval process that worked well, to a decentralized inefficient and unaccountable process that gave municipalities and multiple government agencies the power to delay or impede project approvals. To make matters worse, autonomous municipalities run their own permitting process independent from the PR Planning Board with their own set of rules and processes. The process for a permit takes at least 2 to 4 years which is simply too long compared to other states.

Although Act 161-2009 started as an effort to centralize the permitting process, several tiers of regulatory government entities still have jurisdiction on construction permits. The Permits and Endorsements management Office (OGPe) was created to replace a stalemate permitting authority. Still, several related permits have not been integrated to OGPe's virtual permitting process platform. This has resulted in a still seemingly cumbersome process with no clear and definite end.

The Builders Association has prepared and already submitted to the Task Force a comprehensive proposal titled Reform to Current Permitting System, that we endorse.

To summarize the guiding principles of the organization's proposal to reengineer the permitting process.

Proposals

- A comprehensive consolidation of responsibilities be performed to streamline evaluation and decision processes of construction permit applications.
- Agencies with actual or potentially significant environmental quality roles should be merged under a restructured Department of Environmental Quality and Water Resources.
- Permits, once granted and absent of fraud, shall not be revoked or annulled without due process of law.
- Not all proposed actions, projects or activities pose the same degree of risk of harm to public health, safety and welfare, and should not be treated as such.
- Actions, projects, or activities with a potential for significant environmental impact, as determined by local or federal environmental impact analysis legislation, should be subject to centralized, integrated environmental permitting, on a case-by-case basis, with all environmental aspects considered simultaneously.

- Small and medium sized businesses and activities, actions, or projects that do not pose a risk of significant environmental impact as determined by local or federal environmental impact analysis legislation, should not be subject to case-by-case permitting which would impose a disproportionately heavy burden on them, as well as on the permitting authorities. These should be handled through general permits and/or authorizations, or depending on the type of action or activity, simply through registration procedures.
- All permit reform should evaluate every government authorization required and eliminate any kind of duplicity that exists in the current system.

Economic growth strategies

Aligned with the structural reforms, the Fiscal Oversight Board, the local government, and the private sector must develop an economic growth strategy. Based on my research and previous publications, this strategy should include the following components.

1. Puerto Rico as Free Trade Zone⁶

For centuries, our geographical position has been a competitive advantage. Puerto Rico is the southernmost jurisdiction under the U.S. flag, right in the middle of well-traveled and growing multiple air trade lanes between South, North America, Europe, Middle East and Africa. The local government and Congress must work together to transform Puerto Rico into a Foreign Trade Zone of the United States under the Foreign-Trade Zones Act of 1934.



This Zone would permit the free entry of material goods, free immigration, and free trade into the territory. Puerto Rico would then be transformed into the first truly Global Metropolis. The International Insurance Center and the international Financial Entities Act (Act 273), are successful show cases of how Puerto Rico is leveraging on its fiscal autonomy and geographical position, to attract international financial players.

The rules would be few and simple. US Citizens children born in this Zone will continue to be born as US Citizens. However, the rights of the United States Constitution would not cover those non-US Citizens that visit or reside in the territory. Residence in Puerto Rico would not count as time spent in the United States nor acquire any rights or entitlements to the fruits of the US Constitution.

The income generated in Puerto Rico would not be cover by the IRS worldwide income rules. Everyone must clear U.S. immigration and customs in Puerto Rico’s ports before embarking to the mainland.

⁶ Proposal being developed with José González, local exporter, and former president of The Puerto Rico Export Council.

Homeland Security and the U.S. Department of Commerce would oversee overseeing the Foreign Trade Zone.

Visitors to Puerto Rico would not need a U.S. Visa to visit and do business in the territory.

The benefits would be a massive increase in tourism as Visas would no longer be required. The utilization of our infrastructure of our airports and ports as Global transportation hubs for passengers and for cargo would also be massive. Puerto Rico would become the healthcare hub for a region that encompass more than 40 nations. It would be the Regional Hub provider of services such as Banking, Finance, Insurance, Accounting, Architecture, Engineering and Educational services. Our added value manufacturing center would be reviving along with the revival of our construction Industry.

Proposals

1. Congress amends Section 808 of Law 108-176 of December 12, 2003, also known as the Stevens Amendment, to include the Puerto Rico name next to Alaska, under 49 U.S.C. section 41703 (e) and reestablish "transit-without-visa" program on the island.
2. Congress legislates that US. Laws must specifically mention Puerto Rico Free Trade Zone in order to apply.
3. Congress legislates that the whole territory will be covered under the Foreign Trade Zone act of 1934.
4. This would be an experiment into the future. If it doesn't develop into the promise economic and social welfare, Congress can cancel it.

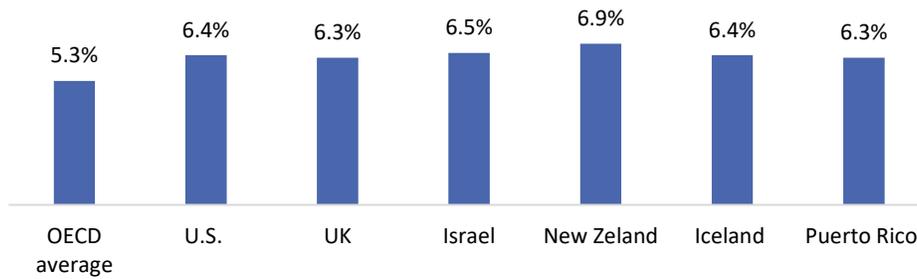
2. Position PR as the lowest tax jurisdiction in the U.S.

Puerto Rico needs to leverage its fiscal autonomy and implement a low tax policy to be positioned as the U.S. jurisdiction with the lowest tax rates. Competitive income and corporate tax rates could be powerful incentives to attract high-income professionals and all type of corporations from the U.S. mainland. Since 2012, the local government has successfully implemented the Act 20/22 program to attract investors and businesses oriented to export activities using the Island as a hub. We should expand this program to other professionals and investors, from all parts of the world.

3. World class education system

In the knowledge-based economy, education plays a major role as the key driver of global competitiveness. There is enough empirical evidence about the strong correlation of investment in education as a share of GDP and economic growth. The most successful economies like Singapore, Hong Kong, Switzerland have higher ratios education investment to GDP. Furthermore, the qualitative aspect of education is also crucial to support economic growth, since human capital has become highly relevant in the new global economy. Puerto Rico needs to transform its education system (K -12) and post-secondary institutions, into a world class model capable of producing the best human capital. **The education system, needs to be a key component of the economic development strategy.**

Total education expenditure as a share of GDP 2015



Source: World Bank, Economic report 2015

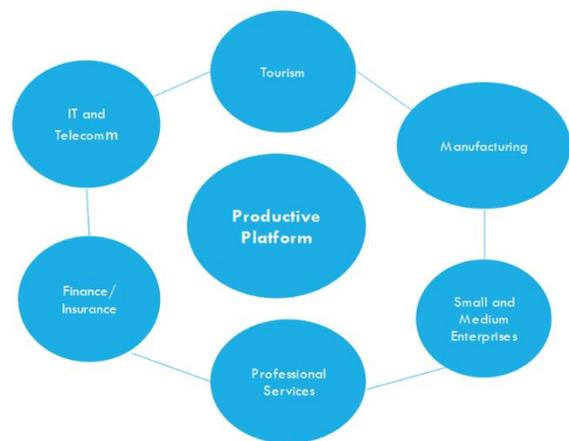
Proposals⁷

1. Create the Educational Alliances and Innovation Board as a fiscally independent and autonomous entity responsible for ensuring the proper administration and operation of all Public LIDER Schools;
2. Delegate administrative, fiscal and operational powers to School Directors;
3. Ensure the administrative, fiscal and operational autonomy of all Public Schools in Puerto Rico;
4. Modify the composition of the School Board, to convert it into the LIDER School Board, with the capacity to transform schools; create mechanisms for the operation of the volunteer registry;
5. Ensure access to books and technology in all classrooms; establish the Teacher Evaluation and Support Program;
6. Establish the national per student budget formula; establish the formula to determine the maximum amount of Public Schools.

4. Promotion of the emerging industries

Despite the fact, that the economy still in contraction, some industries are showing a modest recovery process and creating its own competitive advantages. I refer to these sectors as the emerging industries, that will support the economic recovery. Tourism, information technologies, professional services are among the potential drivers of the post-depression economy. The government must leverage on these sectors to accelerate the reactivation process.

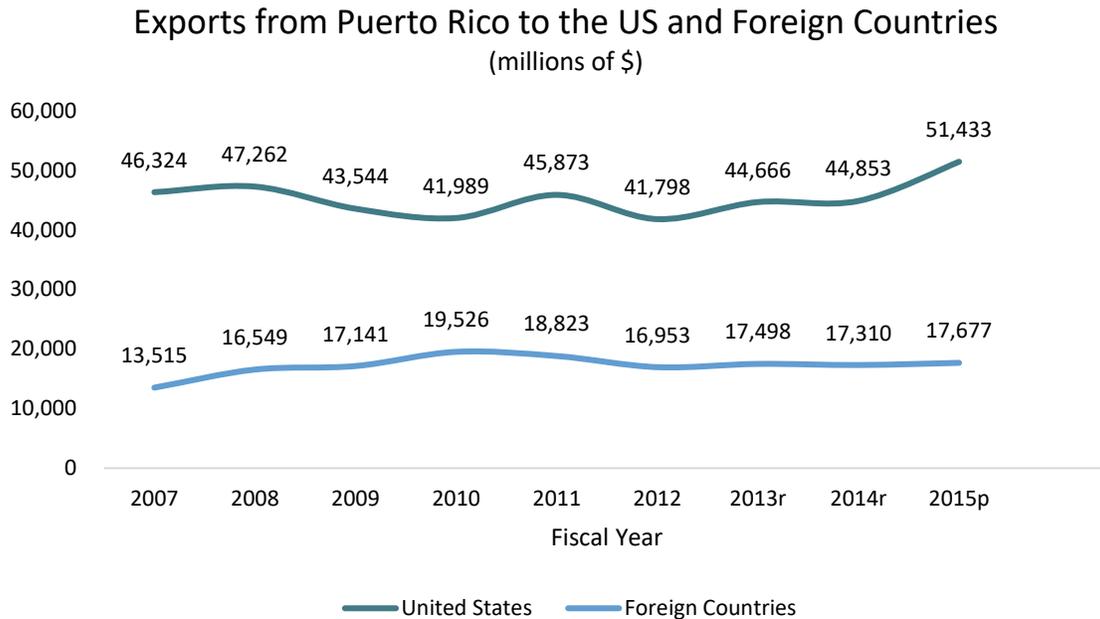
Puerto Rico's post-fiscal crisis Economic Platform



⁷ Education reform presented by former President of the Senate, Hon. Eduardo Bhatia, Senate Bill 1456, August 2015.

5. International trade

The private sector needs to develop an export capability and pursue full participation on the free trade agreements such as CAFTA-DR. Government and the business community must develop a trade policy to integrate local companies in the global marketplace. The internationalization of the local economy and the expansion of the export activity will be essential to the economic recovery process. The U.S. market, the Caribbean region, and LATAM, are natural export markets for the local enterprises.



Source: Puerto Rico Trade and Commerce

6. A new Industrial policy

Manufacturing still the backbone of the local economy contributing to 45% of the GDP. Nevertheless, the multination industrial operations are under intense global competition. Puerto Rico needs to develop a new industrial policy to modernize its promotional strategy to attract new global companies and diversify the industrial base. Recently, PRIDCO started to develop an aerospace cluster, where Puerto Rico is creating a competitive advantage. However, to compete globally, the promotional strategy should not depend exclusively on tax incentives. The government economic team and the private sector must work together to identify industrial segments, were the Island could compete globally⁸.

⁸ The Governor of Puerto Rico recently signed into law, "Puerto Rico Enterprise" a public-private collaboration to promote internationally the government incentives programs.