

Understanding Puerto Rico's Economy and its Political Status

Edwin Meléndez, Ph.D.
Director and Professor of Urban Planning

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The Political Status

The status of Puerto Rico is important to the economic system. The three political options are:

1. Commonwealth: the current status.
2. Statehood: Puerto Rico would become a state of the United States.
3. Independence: Puerto Rico would become a sovereign nation.

[See handouts]

Tax Exemption as Economic Development: Operation Bootstrap

In 1947 Puerto Rico's **Industrial Incentive Act** is enacted granting tax exemption to U.S corporations.

Operation Bootstrap consisted of a plan to transform the island of Puerto Rico from an agricultural society to an industrial one. It's main components were:

- Labor-intensive manufacturing
- Tax exemption
- Migration and population control
- Tourism

Tax Exemption as Economic Development: Federal

1921—**Section 262** (re-numbered as **Section 931**):

- Exempted from U.S. taxation all corporations that received at least 80% of their income from U.S. possessions.
- Taxed income on repatriation but liquidated distributions were tax free.

1976— **Section 936**:

- Converted federal tax exemption to a foreign tax credit.

1996 –Congress enacts a 10-year phase-out of Sec. 936 tax credit; the program ended completely on December 31 2005.

Stylized Facts: Puerto Rican Population

	Puerto Rico	United States
1970	2,712,033	1,429,396
1980	3,196,520	2,004,961
1990	3,522,037	2,727,754
2000	3,808,610	3,406,178
2009	3,967,288	4,426,758

Source: U.S. Census Bureau, various publications and years.

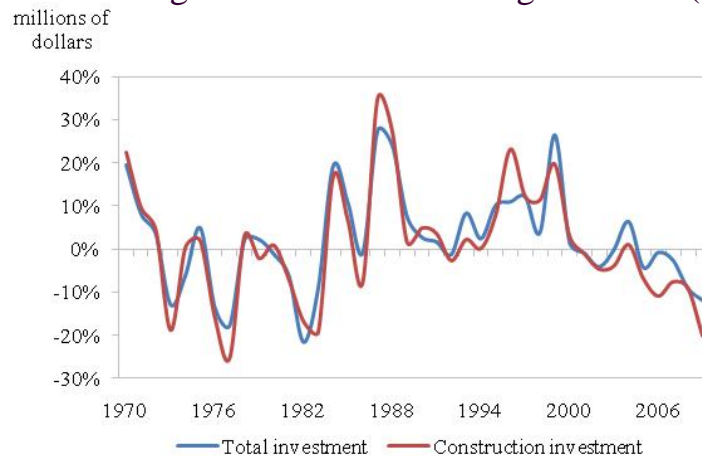
Stylized Facts: Net Migration (16 years and over)

Period	Emigrants	Immigrants	Net Migration	Annual Average
1982-88	-285,787	134,587	-151,200	-21,600
1991-2002	-466,948	166,447	-300,501	-30,500
2005-2007	-171,206	110,006	-61,200	-20,400

Source: Author's estimates based on unpublished data from the Puerto Rico Planning Board and from the American Community Survey, US Census Bureau.

Stylized Facts: Stagnant Investment

Annual real gross fixed investment growth rate(%)



Source: Puerto Rico Planning Board

Stylized Facts: Private Sector Employment Growth



Source: U.S. Department of Labor, Bureau of Labor Statistics.

Note: Shaded areas indicate periods designated national recessions by the National Bureau of Economic Research.

Taken from: Bram, Jason, Francisco E. Martínez, and Charles Steindel. Trends and Developments in the Economy of Puerto Rico. Current Issues in Economics and Finance, March 2008 Volume 14, Number 2. Federal Reserve Bank of New York.

Stylized Facts: Public Sector Employment



Source: Departamento del Trabajo y Recursos Humanos de Puerto Rico, *Encuesta de Establecimientos*

The Perfect Storm

The Puerto Rico economy entered a recession earlier than the U.S., and factors other than the global financial crisis are at play.

At least three major structural factors triggered the current economic crisis in Puerto Rico:

- The decline in manufacturing jobs induced by the elimination of Section 936,
- The crisis in public finances, and
- The impact of the housing crisis on construction and the banking industry.

The Perfect Storm: Manufacturing and Private Sector Stagnation

	Basic Indicators: Manufacturing Sector		
	Total	936 Firms	None-936
Number of firms	2,318	521	1,797
Direct Employment	16,4121	107,350	56,771
Value Added:			
Wages and Salaries	2,414,000	1,790,857	623,143
Other Value Added	8,236,000	8,116,573	119,427
Total	1,065,000	9,907,431	742,569
Gross Output	21,761,887	17,324,109	4,437,778

Source: Ruiz-Mercado, Angel L. and Edwin Meléndez, The Potential Impact of the Repeal of Section 936 on Puerto Rico's Economy in E. Melendez & A. Ruiz, Ed.s, The Economic Effects of the Political Options for Puerto Rico. San German: Interamerican University Pres, 1998.

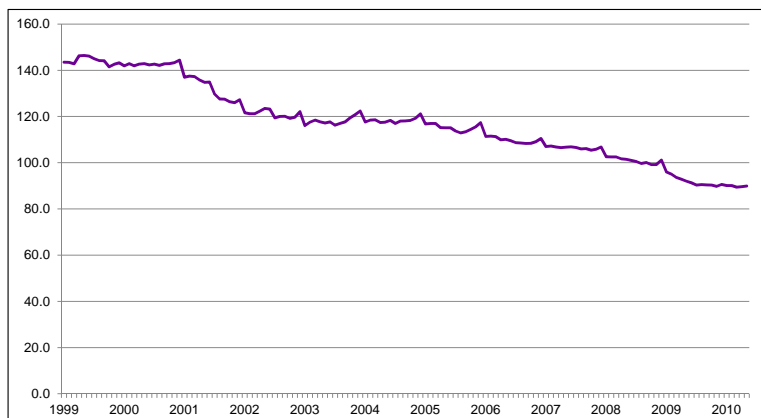
Note: Fiscal Year 1991; output and value added in thousand 1982 dollars.

The Perfect Storm: Private Sector Stagnation

According to Mohinder S. Bhatia, a leading Puerto Rican economist, the elimination of Sec. 936 largely explains job creation in the private sector:

- **1986-96** --jobs increased from 868,000 to 1,166,000, an addition of **29,800** jobs annually. The unemployment rate declined to 10.1% from 17.1%.
- **1996-2006** --jobs increased from 1,166,000 to 1,273,000, an addition of **10,700** jobs per year. Unemployment remained flat.
- **2006-2009** --jobs declined from 1,273,000 to 1,125,000, an annual decline of **16,000**. The unemployment rate increased to 14.3% from 10.5%.

The Perfect Storm: Manufacturing Employment (000)



Source: Departamento del Trabajo y Recursos Humanos de Puerto Rico, *Encuesta de Establecimientos*

The Perfect Storm: The Crisis in Public Finances

The **2006 budget crisis** started when the government ran out of funds near the end of the 2005-2006 fiscal year and had to shut down.

- The shut down lasted for two weeks, left nearly 100,000 public employees without pay and over 1,500 public schools were closed.
- It was the result of a political power struggle between the Commonwealth's main opposing political parties.
- \$25 billion in bond rating dropped to a Baa3 classification and other \$6 billion in bond rating plunged to junk bond.

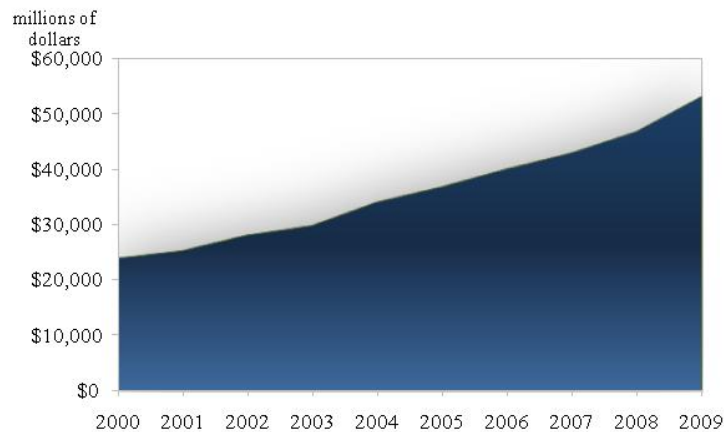
The Perfect Storm: The Crisis in Public Finances

Why was the government unable to borrow in financial markets to sustain operations?

- A mounting deficit for poorly conceived and executed projects, such as:
 - The Urban Train (added \$100 million), and
 - The 1990s Health Care Reform (added \$500 million).
- Uncollected back taxes exceeded \$3.5 billion in 2009.
- Current estimates of the 2010-11 operational budget deficit range from \$2 to \$3.2 billion.

The Perfect Storm: The Growth of Public Debt

Total gross public debt (\$M)



Source: PR Planning Board

The Perfect Storm: The Crisis in Public Finances

Legislation enacted in 2006 created a 7% sales tax.

- The Puerto Rico Sales Tax Financing Corporation (by its Spanish acronym, COFINA) was created to secure repayment for \$6.8 billion in debt.
- 5.5% for the benefit of the Commonwealth and a separate 1.5% for the benefit of municipalities of Puerto Rico.
- Each fiscal year the first receipts of the Commonwealth's Sales Tax are applied to the payment of the Sales Tax Revenue Bonds.

The Perfect Storm: The Crisis in Public Finances

What is the aftermath of the sales tax?

- Around \$1,000 million collected in F2010.
- The estimated collection rate is only 52% according to Certified Public Accounts Association.
- The PR House of Representatives estimated income from the sales tax at \$328 million for every percentage point. Actual revenues are closer to \$200 million for every percentage point.

The Perfect Storm: The Crisis in Public Finances

Law 7 of 2010 authorizes the government to bypass both collective bargaining and existing labor laws when firing public employees.

- A layoff program specifically excluded 99,600 public workers (security, health and education).
- 53,900 workers qualify for layoffs.
- \$1 billion was set aside to pay for severance packages.
- To date, some 30,000 public workers have been laid off.
- Provides for “Public-Private Alliances” to outsource public services to private entities.

The Perfect Storm: Construction Sector under Pressure

Annual fixed investment in construction (\$M)



Source: PR Planning Board

The Perfect Storm: Collapse of the Banking Industry in 2010

Losses on 7 Bank Failures Total \$7.3 Billion.

Three of the failed banks in Puerto Rico had total assets of \$20.4 billion, representing one quarter of the Island's total banking assets:

- Eurobank, \$2.3 billion
- R-G Premier Bank, \$5.9 billion, and
- Westernbank, \$12 billion.

Regulators point to:

- Collapsing property values,
- Poor lending decisions, and
- A depressionary economy.

The Political Status Revisited: Report by The President's Task Force on Puerto Rico's Status*

Proposes a system involving two plebiscites:

- First, Puerto Ricans will vote on the question of whether to be part of the United States or independent, and
- Second, to choose between the available status options, as limited by the outcome of the first vote.

Puerto Ricans should be able to express their will about status options and have that will acted upon by the end of 2012 or soon thereafter.

* Released March 2011

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Economic Recommendations:

- Building capacity to use Federal programs in Puerto Rico;
- Increasing coordination between Federal agencies and a "one-stop shop" interagency technical assistance to increase grants to the Island.

Building competitive industries that could potentially drive long-term growth and job creation:

- Renewable Energy and Energy Efficiency;
- Tourism and gateway to the Caribbean and Latin America;
- Puerto Rico as a health services and research hub for the Caribbean.

* Released March 2011

Conclusions: Puerto Rico, Puerto Pobre

In 1960, well before the current economic crisis, Pablo Neruda, a renowned Latin American poet, wrote a dictum for the island when he wrote **Puerto Rico, Puerto Pobre** as a title to a poem.

Prospects for the immediate future of the economy are grim:

- There is no clear industry in the private sector to replace manufacturing (the knowledge sector?).
- The prospects for a more active public sector through fiscal or tax policies are very low.
- Global diversification has eluded numerous attempts to improve linkages and the island faces increased competition from Brazil, Mexico and other Latin American countries.

Conclusions: Questions of Interest

- What are the economic prospects under the Commonwealth status?
- If the Commonwealth has run its course, can statehood or independence spark economic growth?