

The Economy: Concrete Steps in Puerto Rico and Washington

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Puerto Rico has enormous potential for improvement of the economic conditions of its people. Yet for many years economic growth has been slow, and the island has now entered a recession more severe than that on the mainland. The new Governor of Puerto Rico will execute an immediate action program to make sustainable economic growth a reality. Steps to implement the program will commence in Puerto Rico on Day One, and the drive for much-needed changes in Washington will also begin on Day One.

Action in Puerto Rico

The Governor will immediately implement changes in the Puerto Rican government's support for private activity and in the government's own direct involvement in economic affairs in order to improve the economic lives of the people and overcome the lagging performance of the economy. The Governor will:

- ❖ **Clean up the government's budgetary mess.** Immediate actions will yield quick results and will set the government on a path to eliminate the chronic fiscal crisis. Fiscal balance will be obtained by:
 - **Reducing the size of the government bureaucracy without firings and creating a more efficient delivery of services.** Through normal attrition (about 3% of the government work force per year) and allowing for replacement only of workers in vital positions and the maintenance of the teaching work force in the schools, government employment will be reduced by 2% a year. This reduction in the government workforce over four years will yield at least a 25% reduction in the government's deficit and stimulate a 1.4% rise of GDP.¹
 - **Increasing revenues without increasing taxes.** A set of actions by Hacienda will raise revenue without raising tax rates. These actions will include: identifying non-compliant taxpayers; strictly enforcing tax payments; allocating resources to and reorganizing the collection division to accomplish tax collection; and improving the image of Hacienda to that of a service organization. In addition, the minimum level at which people pay income taxes will be raised to a least \$17,000, making the system more progressive and allowing enforcement to focus on higher income taxpayers.

Effective compliance enforcement should reduce the government's deficit by at least 10%.²

- **Promoting economic growth by the private sector.** Immediate steps will provide bottom line incentives to spur Puerto Rican entrepreneurs. Executive actions will dramatically reduce the regulatory and licensing red tape that inhibits business investment. Also, legislation in Washington will encourage more investment by both Puerto Rican firms and firms from off the island. (See below for details.) Economic growth will generate wide benefits to the people of Puerto Rico and will raise government revenue; this will allow a reduction of tax rates on both individuals and businesses and provide funds for infrastructure improvement. As the economy and government revenue grow – and public sector employment does not grow – the people of Puerto Rico will be the winners.
 - **Obtaining well-deserved funds from Washington (see below).** Puerto Rico receives a smaller amount of funds from Washington on a per capita basis than any state. Obtaining Puerto Rico's fair share from the federal government will improve the government's budgetary position, provide direct support to Puerto Rican citizens (especially low-income Puerto Ricans), and deliver a substantial stimulus to the island's economy. Details are presented below in the section on "Actions in Washington."
- ❖ **Take actions that will encourage private sector activity, providing direct benefits to the people of Puerto Rico and yielding a fiscal dividend for the government. Actions will include:**
- **Reforming the government's regulation system.** Starting in June 2009, agencies reviewing permits for new construction and expanding facilities must give a decision or automatically approve a project within 3 months, and within 2 months by December 31, 2009. (Numerous efforts at reform have come up short, so such a "shock" must be mandated.) Each agency involved³ will provide a written plan by March 2009 to the Governor, the Comptroller General, and the Resident Commissioner to show how it will streamline the processing of permits, ensure the protection of the environment, and include and consider community opinion.
 - **Undertaking targeted, direct investment promotion.** The governor will immediately appoint a three person high-level task force that will meet with the CEOs of firms operating in Puerto Rico and firms that should be operating in Puerto Rico to encourage an increase in their Puerto Rican activities and learn what particular actions the government can take (e.g., regulations reform as above and infrastructure improvement as below) to facilitate expanded activity. Both firms based in Puerto Rico and those based off the island will be targeted.

- **Making all of Puerto Rico an Enterprise Zone by obtaining appropriate support in Washington for legislation filed by Luis Fortuño as Resident Commissioner.** As part of a nation-wide program to encourage business activity in low-income, high unemployment regions, all of Puerto Rico will become an “Enterprise Zone.” (See “Actions in Washington” below for elaboration.) This status will greatly enhance the ability of the task force (noted above) to generate enduring investment in the island.
- **Advancing R&D activity.** Because research and development is the foundation for long-run economic success of Puerto Rico in the global economy, several actions will be taken to promote R&D on the island. High priority will be given to reducing the corporate income tax on earnings from intangible property such as patents to between 2% and 5%, with the condition that some of the R&D be conducted in Puerto Rico. Actions having their impacts over the longer-run will include funding basic research, promoting university-industry partnerships, and improving Puerto Rico’s public education system (see below). Further, the direct targeting of investment will focus on R&D related activity. (See above regarding the creation of a task force that will meet with firms’ CEOs.)
- **Improving the infrastructure of Puerto Rico to a level of global competitiveness.** A strategic plan will be developed for infrastructure upgrades – specifying priorities and sources of funding – that will greatly improve the environment in which businesses operate. Ports, roads, public transportation, water, power, and IT infrastructure must all be improved and better managed to ensure that Puerto Rico can attract investment and create good jobs. To reduce costs and improve services, private sector solutions must be evaluated and pursued wherever possible. For greatest impact on economic growth, infrastructure is the most effective investment for federal funds (see below).
- **Promoting tourism more extensively and in new ways.** In cooperation with the existing tourism organizations, the government will initiate an expansion of tourism promotion activities, both on the mainland and in Europe, taking full advantage of the island’s competitive advantage as a U.S. territory. Beyond traditional tourism, special emphasis will be given to ecotourism. Numerous sites offer opportunities for expanded ecotourism – not only El Yunque, but also, for example, the numerous state forests (e.g., Boqueron, Maricao, Guaniquilla), the caves, reefs, and small islands (Mona, in particular). For entrepreneurs to take full advantage of Puerto Rico’s tourism potential, however, government must ensure the quality of the island’s natural environment, the foundation for tourism’s success. In addition, the Puerto Rican government needs to invest in the infrastructure for tourism – both the particular tourism infrastructure, such as the visitors’

center at El Yunque, and the overall infrastructure on the island (see above).

❖ **Fix the public school system at little if any cost, providing a better education for Puerto Rican children and allowing parents to keep their children in good public schools and avoid the cost of private schools, by:**

- **Breaking up the current single school district into several districts.** Large school districts tend to be bureaucratic, inefficient economically, difficult to change, and weak in terms of student outcomes. Decentralization of the system will strengthen the schools in numerous ways, including enhancing parent participation and connection to communities. It must be done, however, without creating inequalities among the new, smaller districts.
- **Creating choice within the public school system, including choice of bilingual English-Spanish programs.** Choice within the public schools can both improve the quality of the schools and allow for special options that would enhance the opportunities for Puerto Ricans and strengthen the economy. One of these options would be the creation of schools offering bilingual English-Spanish programs.
- **Developing a system of assessment.** Strengthening the public schools demands a thorough system of assessment. Both education authorities and parents need to have better knowledge about how well (or how poorly) the schools are doing. Assessment needs to be based on multiple instruments, including but not limited to testing.
- **Preparing a plan to provide more resources to the schools when the fiscal situation improves.** While important steps toward improvement of the schools can be taken without more funding, more funding will ultimately be needed to raise salaries of teachers and administrators and provide for new, technology-based programs. While the fiscal situation of the government will limit immediate infusions of funds to the schools, a plan for increased funding needs immediate attention.
- **Working with all stake-holders to bring about these changes.** Effective reform of the schools has previously foundered in part because it has been undertaken from above. All stake-holders – parents, community leaders, teachers and their unions, as well as education authorities – will be included in these developing these new reforms.

❖ **Halt degradation of the natural environment and undertake environmental repair by:**

- **Reducing the social conflicts that pit economic development against environmental concerns.** On the one hand, the government regulatory system will be reformed as described above. On the other hand, improved procedures will be developed for thorough and rapid community and expert input on environmental impact studies. To mediate the conflicts that arise, an ombudsman system will be introduced.
 - **Using market mechanisms to reduce strains on natural resources, to provide incentives for private actors to behave in an environmentally friendly manner, and to raise funds for public investment to preserve and repair the environment.** Examples of specific steps include: development impact fees and higher charges to finance water quality infrastructure; performance bonds to ensure compliance with permit conditions; and environmental taxes on agricultural chemicals to promote organic agriculture.
 - **Elevating eco-tourism** (see above).
- ❖ **Develop a disaster preparedness plan to save lives and protect the economy in the event of a Katrina-level disaster and to handle more effectively the “typical” hurricane devastation. The plan will focus on:**
- **Ensuring reliable communications for first-responders.** Investments will be made to provide police, firefighters, civil defense and other professionals with proper equipment and a reliable communications system.
 - **Establishing environmental shoreline protections.** As part of the general upgrading of the island’s infrastructure (see above), steps will be taken to protect the coastline, mitigating the impact of hurricanes and minimize the storm surge on low-lying areas.
 - **Protecting critical infrastructure.** To avoid the devastation to Puerto Rico’s power system incurred, for example, during Hurricane Georges in 1998, several actions will be implemented. Power generator sites and the distribution system need adequate protection, and sufficient alternative power sources need to be available. PREPA has been upgrading the infrastructure, but more needs to be done. Greater dispersion of power generation across the island to more hurricane-safe locations will help limit vulnerability.
 - **Ensuring availability of safe, sanitary and accessible temporary housing.** An effective plan will ensure that people have safe housing, and the lives of students and their families are not disrupted. (After Hurricane Hugo, many schools served as temporary housing so long as to keep

students from learning.) Actions will parallel those taken by states such as Florida, which has been preparing special needs facilities to shelter and protect the frail, elderly and sick.

Actions in Washington

The Governor will use his well-established and extensive experience and contacts in Washington to accomplish both a general change in the federal government's treatment of Puerto Rico and a set of specific improvements in the relation between Puerto Rico and the federal government. These changes will include:

- ❖ **Establishing the principle of equal treatment for Puerto Rico and the states with regard to economic support programs and federal expenditures.** Puerto Rico is currently included in some federal programs – for example, in the realm of education – but excluded from many federal programs that are applied to the states – for example, in the realm of infrastructure development and programs taken up below. The inclusion of Puerto Rico in all federally funded infrastructure improvement programs is especially important (as noted above). Also of great importance is equal treatment of Puerto Rico in all federal procurement. Puerto Rico's full inclusion in all such programs would greatly enhance the island's economic development. The specific programs are important in themselves, but it is also important to establish the principle of equal treatment.
- ❖ **Creating a national Enterprise Zone program by obtaining passage of The National Enterprise Zone Act of 2007 (H.R. 1340), filed by Luis Fortuño as Resident Commissioner.** This Legislation calls for the establishment of Enterprise Zones (EZs) throughout the country. EZs would be regions – such as Appalachia, Harlem, Detroit, and all of Puerto Rico – where the poverty level and unemployment rates are twice the national average. In these zones, firms would be offered a greatly reduced corporate tax rate (12%) on their earnings – including earnings from intangible assets (e.g., patents) – as an incentive to expand their activity or initiate new activity, creating jobs and raising incomes. Under the legislation, all of Puerto Rico would qualify as an EZ. The EZ designation will be especially attractive to R&D-oriented businesses that that derive a significant portion of their profits from intangible assets. These sorts of businesses have been well established in Puerto Rico through the provisions of earlier economic development programs, and thus they are likely to respond especially favorably to the incentives of the Enterprise Zones. (At present, firms based on the mainland can reduce federal taxes on their Puerto Rican

operations by organizing CFC's and deferring the repatriation of their earnings to the parent firm. The EZ designation with the 12% tax rate would make Puerto Rico an attractive investment site, even preferable, for instance, to Ireland.)

- ❖ **Including Puerto Rico in the Earned Income Tax Credit provision of the federal tax code, as provided in legislation filed by Luis Fortuño as Resident Commissioner.** The Earned Income Tax Credit (EITC) provision of the federal tax code was established to reduce poverty, offset the burden of payroll taxes for low income workers, and increase the incentive for people to enter the paid labor force. Puerto Ricans have generally been excluded from taking advantage of the EITC, and this exclusion has been rationalized by the fact that Puerto Ricans generally do not pay federal income taxes. However, Puerto Ricans do pay federal payroll taxes; the poverty rate is very high in Puerto Rico; and the rate of participation in the paid labor force is very low. Moreover, many people on the mainland who do not pay income taxes do receive the EITC. So there is every reason to change the EITC so as to include Puerto Ricans fully in the program.

The unfair treatment of Puerto Ricans with regard to the EITC and the Child Tax Credit (the CTC; see next point) has its greatest impact on low-income Puerto Ricans who bear a heavy burden from the regressive federal payroll taxes. The situation must be altered by creating a level playing field for Puerto Ricans along with other U.S. citizens. On the current unlevel playing field, a family in Puerto Rico earning \$25,000 before taxes would end up with \$3,600 less after federal taxes than would the identical family in the states. Puerto Ricans' exclusion from the EITC and CTC causes the difference.

In addition to providing fair treatment for and helping the Puerto Ricans directly affected, this legislation regarding the EITC along with the inclusion of Puerto Ricans in the Child Tax Credit would, when fully implemented, yield an annual infusion of \$1 billion to the Puerto Rican economy. These additional funds would generate an overall increase of income on the island by as much as 3%.

- ❖ **Including Puerto Rico in the Child Tax Credit provision of the federal tax code.** As with the EITC, Puerto Ricans are generally excluded from taking advantage of the Child Tax Credit (CTC) of the federal tax code, with, again, the rationale that they generally do not pay federal income taxes. Here the rationale is even more unreasonable than with the EITC because Puerto Ricans with three or more children are allowed to claim the CTC by filing a federal tax return (even without paying any tax). Clearly, all Puerto Ricans with children, like all mainland residents with children, should be included under the CTC provision. Legislation has been filed to bring about this change.
- ❖ **Remedying the unequal treatment and reduce the higher taxation of manufacturers in Puerto Rico under the domestic activities deduction.**

Including Puerto Rico under Section 199 of the Internal Revenue Code would put manufacturers on a level playing field with the rest of the U.S. Without such legislation, Puerto Rican manufacturers now pay 1% more and will face 3% higher federal tax rates in 2010.

¹ The deficit reduction is based on 2007 figures: a deficit of \$2.46 billion and a payroll of \$8.2 billion. The reduction over four years would reduce the payroll by \$637 million, or 26% of the deficit. Estimates suggest that the lower use of skilled workers in government would, by making those people available to the private sector, yield the increase in GDP; the 1.4% increase over 2006 GDP would amount to an increase of about \$1.2 billion.

² The reduction is based on 2006 figures and the assumptions that personal income taxes on self-employed persons are underpaid by 25% and corporate income taxes are underpaid by 15% due to non-compliance. Full compliance in 2006 then would have brought in \$517 million in additional in taxes (\$232 million personal and \$285 million corporate) or 24% of the 2006 budget deficit, which was \$2.166 billion; and the “at least 10%” assumes some continuing non-compliance.

³ Primarily, the Regulations & Permits Administration, the Department of Natural & Environmental Resources, the Planning Board, and the Environmental Quality Board.