

## ***Economics Group***

### **Special Commentary**

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# **Puerto Rico: Failure of the State**

## **Executive Summary**

The Puerto Rican economy has come a long way since it started to industrialize and modernize in the mid-1900s through what was called “Operation Bootstrap” in English, or “Operación Manos a la Obra” in Spanish. The process of industrialization was, by many measures, a success, even though some economic indicators have continued to point to many economic disequilibria that have persisted over time, such as a persistently high rate of unemployment as well as a high rate of inflation compared to the U.S. mainland, even though Puerto Rico uses the U.S. dollar as its currency and monetary policy is conducted by the U.S. Federal Reserve.

Authorities on the island have not been able to integrate the whole of the economy, as a large percentage of economic activity still happens underground in the informal sector. Several authors have written about this and have concluded that too much regulation, at the business permitting levels, labor regulations and the application of the U.S. minimum-wage law have kept the rate of unemployment high. Furthermore, many high-income individuals feel that they should not have to pay taxes or that they pay a disproportionate amount of taxes. This is not uncommon of an economy that has a large underground or informal economy, as governments tend to increase the tax burden on the “legal” or “formal” sectors of the economy because it is almost impossible to broaden the tax base and collect taxes from a larger number of individuals.

***The Puerto Rican underground economy is very large.***

By some estimates, the Puerto Rican underground economy is as large as 30 percent of all economic activity on the island.<sup>1</sup> The inability to eliminate this underground economy has had serious consequences for the economy at all levels and for the island’s government, with its inability to collect taxes due to the limited tax base from “legal” tax payers. At a conference on the island at the end of the 1990s, an economist indicated that only about 10,000 Puerto Ricans say they earn more than \$100,000 per year, according to data from the “Departamento de Hacienda,” the Puerto Rican Treasury Department, out of a population of almost 4 million, according to the U.S. Census Bureau. The comment was probably an exaggeration, but was not that farfetched. The truth is that, by the year 2000, a little more than 14,000 Puerto Ricans claimed to earn more than \$100,000 according to official numbers released by the Puerto Rican Treasury Department. By 2009, the last official number available, that number had risen to 25,257 individuals/filers. This is an important increase in “wealthy” taxpayers and could be showing advances made in tax compliance during the last decade.

However, just by looking at Puerto Rico’s property prices (even after the severe housing downturn), the number of cars sold per year and the price of those cars (which is approximately 10 percent higher for “popular” cars and 30 percent to 40 percent higher for “luxury” cars than in the U.S. mainland), plus the number of luxury cars and yachts on the island’s piers, it is very difficult to believe that even these higher figures of individuals who earn more than \$100,000 are

<sup>1</sup> “The Size of the Shadow Economies of 145 Countries all over the World: First Results over the Period 1999 to 2003,” IZA DP No. 1431, Friedrich Schneider, University of Linz and IZA Bonn, December 2004.



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correct.<sup>2</sup> Thus, while advances have been made, the road to make the Puerto Rican tax system inclusive and reduce the size of the underground economy has not ended.

Facing serious issues on its fiscal accounts and potentially more credit risk downgrades by the major rating agencies, the government of Puerto Rico embarked on a tax reform in 2010 that is still struggling to give the results it pursued. Some of the proposals included a reduction in tax rates, a change in tax scales, a “temporary” tax on multinational corporations, a reduction in tax credits and incentives and added measures to catch tax evaders. According to the government, the tax reform should “save” \$1.2 billion from taxpayers’ pockets during the period of 2010-2016. However, little of those objectives have been met as reflected by labor and consumer market indicators.

In an effort to increase tax collections and refinance some “under the line” debt, the government of Puerto Rico implemented, in 2006, a consumption tax called IVU (Impuesto a la Venta y Uso, or Sales and Use Tax). The current tax rate for this consumption tax is 7 percent, 5.5 percent collected by the island government and 1.5 percent by the island municipalities. This tax has partially substituted an import tax called “arbitrios,” on which the government relied heavily. The government has not eliminated “arbitrios” completely, but now does not rely on the tax as much as it did in the past. The new IVU consumption tax started in November 2006 and part of the collection is a dedicated sales tax to pay for the “non-constitutional” debt incurred by the Puerto Rican government, or debt that was above and beyond what the island’s constitution allowed.

### **Acting on the Consequences, Not the Causes**

The Fortuño administration has tried to reduce the Puerto Rican government’s fiscal deficit by scaling back government expenditures through a reduction in government payrolls over the last several years, as well as some other government austerity measures plus increases in taxes. This “boldness” has prompted some people on the U.S. mainland to consider Fortuño as a potential candidate for the Vice-Presidency of the United States for the Republican Party in the coming elections, as a stalwart of fiscal conservatism.<sup>3</sup>

***The measure to cut approximately 30,000 government employees to reduce the government’s immense budget deficit has worsened the state of the economy considerably.***

The measure to cut approximately 30,000 government employees to reduce the government’s immense budget deficit has worsened the state of the economy considerably, irrespectively if the decision was correct or not. The measure was also reminiscent of the closing of the Puerto Rican government during the previous administration of Governor Acevedo Vilá, which lasted for two weeks in May 2006. During that episode, almost 100,000 public employees were temporarily dismissed without pay, which set off the start of the ongoing recession that has yet to ease its grip over the Caribbean island.

In 2006, the move by the Acevedo Vilá administration was viewed as “grandstanding” against the political opposition of the NPP (New Progressive Party) now in office, while the recent measure to cut 30,000 workers from government payrolls is also viewed as “grandstanding” by the DPP (Democratic Popular Party), the main opposition party.

While both measures were “grandstanding” efforts by the largest political parties on the island, neither Mr. Acevedo Vilá’s party, the DPP, nor Mr. Fortuño’s party, the NPP, have acted on the causes for the current structural budget deficit of the island’s government. Puerto Rico is going through a structural period that requires bold measures that can retool the economy for the new-world economic environment. If one adds the mismanagement of public monies to the current

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<sup>2</sup> While information is hard to come by in Puerto Rico, according to a 2005 report there were 60,911 boats registered in Puerto Rico in 2003. “Developmental and Social Recommendations for the Puerto Rico Ramp System.” Worcester Polytechnic Institute, Brett Dickson, Jamison Divoll, Brian Martiniello and Ashley Zalucky, 2005. Another report, “The Louisiana Department of Wildlife and Fisheries Survey of Louisiana Recreational Boaters,” published in November 2010 puts, the number of registered boats in Puerto Rico at 59,580 by 2008. Thus, it is fair to estimate the number of boats in Puerto Rico today at 60,000.

<sup>3</sup> “Fortuño Favors the GOP, Puerto Rico’s Republican governor would be a fine choice for vice president.” William McGurn, The Wall Street Journal, Dec. 6, 2011.

structural fiscal imbalances, then it creates a “perfect storm,” which is what Puerto Rico is facing today.

This problem is not new. It is not something that started with the Fortuño administration; it is an issue that has persisted for a long time. There is no easy way out for the island and any solution is going to have to be approached as a long-term solution. However, standing in the middle is the fact that the Puerto Rican political system has been built along the lines of its status versus the United States.

### **The Puerto Rican Political Party System: A Matter of Status**

The island’s political party system has been built along the lines of its status vis à vis the United States. Everything pursued by the political parties is either directed toward keeping the current status, becoming the 51<sup>st</sup> state of the union or achieving independence. It is depressing to hear Puerto Ricans from different parties accuse each other of sabotaging the other party’s objectives. As an example, followers of the PDP accuse the NPP of sabotaging the IRS Special Code 936 laws that gave U.S. firms tax benefits, i.e., subsidies, to invest in Puerto Rico by not lobbying in favor of the laws and allowing the U.S. government to eliminate them without a fight. The benefits of the 936 laws ended in 2006, just as the Puerto Rican economy entered the current recession. The PDP and its followers argue that the NPP purposely sabotaged the code to demonstrate to the United States that the island did not need “handouts” from the U.S. government and that rejecting such “handouts” helped the NPP’s statehood case. On the other hand, the PNP and its members blamed the latest PDP administration to have “expelled” U.S. military bases from the main island and from Vieques, a top destination for U.S. military forces’ training exercises.

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These cross accusations are probably simplifications of what was otherwise a state-accomplish event, something that was going to happen sooner or later regardless of any effort from either party or from lobbyists. What is true is that both events were handled irresponsibly by both parties, without trying to preempt the potential future effects on the overall wellbeing of the island’s economy.

### **The Reds, the Blues, the Greens and...the Watermelons**

The Puerto Rican political parties are color coded. The Popular Democratic Party (PDP) is red, the New Progressive Party (NPP) is blue and the Puerto Rican Independency Party (PIP) is green. The “red” is the party that wants to keep the current Commonwealth status with the United States, but has also proposed some changes to the current status to “broaden” it, according to the party. The “blue” is the party that wants Puerto Rico to become the 51<sup>st</sup> state of the United States (currently in power) and the “green” party wants complete independence from the United States. However, Puerto Ricans also talk about an interesting “breed,” which they call the “watermelons” because it is green on the outside and red on the inside; in other words, this “breed” favors the independence of the island but, when push comes to shove, these individuals vote for the PDP to keep their cause alive, as they know if statehood ever wins, then the search for independence will be all but dead.

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I have Puerto Rican friends of every color and combination of colors, including “watermelons.” I respect their views and their fights. However, the “reds,” the PDP, are standing in the middle of any long-term solution for the island, and the “greens,” the PIP, continue to take advantage of this fact. The PIP has never governed the island because it barely qualifies as a party, as it has had to reapply for party status after almost every election because the PIP does not get the necessary votes to be considered a party. However, as is many times the case with minorities, they pull a lot of power in the fight between the PDP and the NPP because they can break the tie between the two major parties. Thus, they wield enormous power in the Puerto Rican political arena.

***An objective and impartial analysis of the current situation of the island would indicate that Puerto Rico should have only two alternatives: either it becomes a state of the United States or it becomes independent.***

It is clear that Puerto Rico needs to solve its status problem, but the PDP, or more specifically the Commonwealth, is in the middle. An objective and impartial analysis of the current situation of the island would indicate that Puerto Rico should have only two alternatives: either it becomes a state of the United States or it becomes independent. This is going to be extremely controversial and I may lose some of my “red” friends along the way. However, the current “no-status” of the Commonwealth is unsustainable.<sup>4</sup> As long as this alternative is available, there is no solution to the status of the island. This causes the current environment to persist over time and affect the ability of Puerto Rico to finally move forward and decide whether it wants to become a state of the United States or become independent.

In general, the PDP aligns with the U.S. Democratic Party, while the NPP has both a Democratic Party line and a Republican Party line. Luis Fortuño, the current governor of Puerto Rico, is from the Republican Party line of the NPP. The PIP does not have any allegiance to either U.S. political party, which is consistent with its complete independence view for the future of the island.

Puerto Rico has had several “plebiscites” on the status of the island during the last 45 years. The first was in 1967, and the Commonwealth beat the other alternatives by 60.4 percent to 39.0 percent for statehood and 0.6 percent for independence. The second plebiscite was in 1993, with the Commonwealth alternative winning again. However, this time the result was not as lopsided as in 1967, with the Commonwealth winning 48.6 percent, statehood 46.3 percent and independence 4.4 percent. The third plebiscite was in 1998. With this opportunity, the PDP went for “none of the above” choices, as it wanted changes to the current Commonwealth status to, according to the party, “broaden” the relationship with the United States. In this case, the “none of the above” option got 50.3 percent of the votes, statehood got 46.5 percent of the votes, “free association” got 0.3 percent, independence got 2.5 percent and the Commonwealth got 0.1 percent.

However, all these plebiscites have been non-binding in that it is the U.S. Congress, not Puerto Ricans, who has the ultimate decision on the future status of the island. The next plebiscite is scheduled to occur on Election Day, November 6, but first the Fortuño administration will conduct a “yes or no” vote on Aug. 12, 2012, to ask Puerto Ricans if they agree with the need for change or for the need to have a plebiscite. If the result is “no,” no further action will be needed. If the result is “yes,” then there will be a plebiscite conducted on Election Day on the three status alternatives. We must stay tuned for the results.

### **Analysis of Economic Conditions: Some Caveats Worth Noting**

We will start analyzing Puerto Rico’s economic performance over the last several years. However, before doing this, we need to emphasize that the conclusions drawn from this economic analysis are “data-dependent.” The reason for this is that Puerto Rico still uses its real GDP statistics from 1954. That is, the base for Puerto Rico’s national accounts is 1954. Whatever these data series say mean little today, which is why we use these series, but subject them to caveats. A base year in terms of National Account series means we are comparing today’s economic numbers for Puerto Rico with the Puerto Rico of 1954 and using tools and instruments, but fundamentally comparisons, that were true in 1954 but are no longer true today. Today’s Puerto Rico has no resemblance to what Puerto Rico looked like in 1954. Thus, any similarity to the economic conditions of Puerto Rico between today and 1954 is just a coincidence; if one says Puerto Rico grew 1 or 2 percent in real terms in 2011, it is very difficult to argue in favor or against the number.

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<sup>4</sup> The United Nations has concluded several times during the last several decades that Puerto Rico is a colony and has to decolonize. A lot of research has been written about the status of Puerto Rico. However, a research paper from 1993 by Dorian A. Shaw published in the *Fordham International Law Journal* could help clarify the topic. The paper is called “The Status of Puerto Rico Revisited: Does the Current U.S.-Puerto Rico Relationship Uphold International Law?”

To analyze the economic conditions of the Puerto Rican economy, we will use some of the same data used when analyzing the U.S. economy because we find similar series in Puerto Rico that are collected in the same way in the United States. In some circumstances, these series are collected by the same agency or under the supervision of the same agency. This is the case with the Labor Department's data, both the establishment and the survey data of the labor market, and the U.S. Other data (what is used in estimating the health of the construction industry, i.e., the number of bags of cement produced, consumed and imported on the island, etc.), all of which could give an idea of the state of the Puerto Rican housing market and so forth.

Making sense of what happens in the Puerto Rican economy is very difficult; some would even say it is an art. However, there are people who have become very good at it, and I have sought their advice. Nevertheless, all of the analysis and conclusions that follow is the author's own.

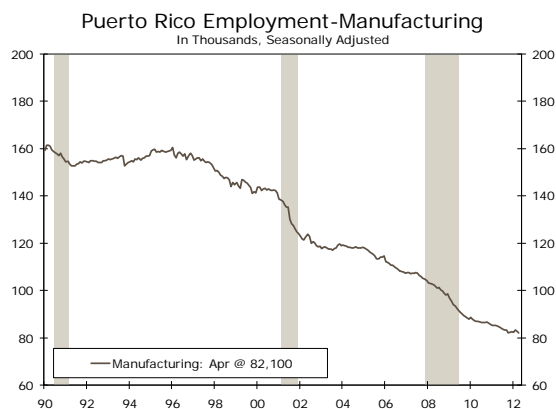
### **Access to the U.S. Market: No Longer a Competitive Advantage**

Many argue that Puerto Rico's problems started when the U.S. government ended the tax benefits for U.S. firms doing business on the island.<sup>5</sup> However, the problems for the island predate that event and run much deeper. It is probably true that the elimination of the 936 IRS Special Code sections was the nail in the coffin for the importance of labor in Puerto Rico's manufacturing sector and the island's relative competitive advantage versus other countries or states in the United States. However, the transition to the new reality perhaps started with the signing of the NAFTA agreement between the United States, Canada and Mexico in 1994 and was worsened by the permanent treatment of the Chinese economy as a Most Favored Nation (MFN) as well as with all the subsequent free-trade agreements the U.S. has signed with other countries of the region. Puerto Rico's coffin has many nails in it and no single issue was the cause of the current state of affairs.

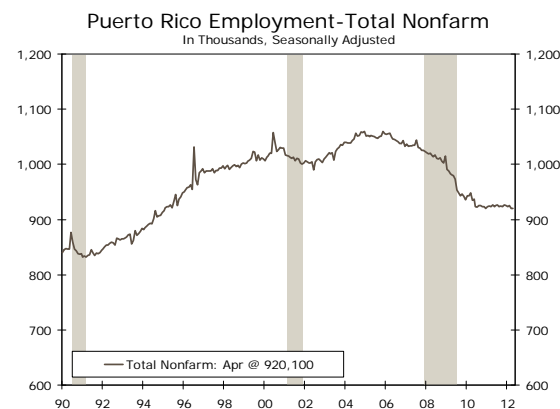
For many decades, Puerto Rican products enjoyed unparalleled access to the U.S. market, compared to other Latin American countries. However, this changed when access was given to other countries of the world, as Puerto Rico no longer had this benefit for itself. With these free-trade agreements, any country in the region could produce and export goods to the United States and, thus, Puerto Rico had to compete not only with the other 50 U.S. states but also with other countries that now had equal access into the U.S. market; what is more important is that this access led to much lower wages than in Puerto Rico. When the U.S. government eliminated the IRS 936 Special Code, the last advantage for Puerto Rico disappeared.

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**Figure 1**



**Figure 2**



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

<sup>5</sup> The U.S. government eliminated the IRS 936 Special Codes in 1996 but allowed for a phaseout period of 10 years. Thus, 2006 was the last year when the subsidies were available for U.S. firms.

Those who are politically motivated have tried to argue that it was the elimination of the IRS 936 Special Code sections that wrecked havoc on the Puerto Rican manufacturing sector. This has served their purpose perfectly, i.e., blame your responsibility on somebody else. However, it is clear from Figure 1 that manufacturing employment in the island started to decline just after the signing of the NAFTA trade agreement between the United States, Canada and Mexico, and it was not due to the elimination of these IRS Special Code laws. Of course, this is difficult to prove, but it is clear that the elimination of these laws did not worsen the situation. In fact, the last benefits from the IRS 936 code laws ended in 2006, and there was no reaction from the manufacturing sector's job perspective to this event, just "business as usual," i.e., a continuous loss of manufacturing jobs in the island, which was what had been happening since the mid-1990s, unabated. Furthermore, effects of the 2001 recession on manufacturing employment are clear by looking at Figure 1 compared to the "no-extra-effects" of the ending of the IRS 936 codes in 2006.

The elimination of the IRS 936 codes, as well as the free trade agreements did change the structure of the manufacturing sector in the island. Many industries left the island for better pastures, with the exception of the pharmaceutical and some electronic goods manufacturing firms.

From Figure 2, we can see that total nonfarm employment in the island continued to increase unabated, even as manufacturing jobs were disappearing at a fast pace. It is true that after 1995 we can observe a flattening of employment growth on the island, as manufacturing employment started to decline, but employment remained positive during the period and until the 2001 recession. However, when the recovery took hold again, job growth resumed, as had been the case in previous recoveries from recession.

### **Free the Puerto Rican Economy**

According to many analysts, the Puerto Rican economy suffers from overregulation, and even though government officials and followers of the current administration and past administrations have tried to negate this fact, this overregulation remains at the forefront of the inability of the island to recreate itself. For many years, the island's economy has relied on subsidies and regulation to try to manage economic growth. The current administration has tried to fix this dependency, but it is something entrenched in the political system and it is difficult to get rid of this dependency in only one term in office. The economic model created by the Commonwealth has outlived its usefulness, and what Puerto Rico is experiencing is the failure of state intervention in the economy.

For many decades, the Puerto Rican economy was a testing ground for interventionist policies, from subsidies to transform the economy from an agricultural economy into an industrialized economy to state ownership of public utility companies and telephone companies that supported the state-owned economic development model. The Puerto Rican government, no matter what party was in power, used this ownership of public utilities and state-owned corporations to extend subsidies to different industries. While there were known and established subsidies, some of the subsidies were not written in the law, but were given as a "matter of fact." In the past, some of the hotels that have gone bankrupt over the years on the island had been delinquent in their public utility bill payments and phone bills for years before the bankruptcy, but state-owned public utilities never enforced the collection of their bills from those hotel chains.

This meant that public utilities would have to recoup the costs of these subsidies either by not investing or by charging a higher rate to other businesses or individuals or a combination of both strategies. For many decades, they did not do either. This is one of the reasons why public utilities are in such dismal conditions today. While they have recently ended some of these subsidies and have started to rationalize their pricing structures, it has not come without a severe depressing effect on the economy. Public utility costs to businesses and households have increased 15 percent–50 percent during the past several years at a time when the recession limited the ability of small businesses to pass through those cost increases into the final price of their products. Granted, some of these increases in public utility prices have been a consequence of

***Government intervention and state ownership of firms has had its cost—monetary as well as in terms of efficiency.***

higher oil prices, but some have been just a process of rationalization of public utility prices and an elimination of subsidies to businesses and households.

According to a Government Accountability Office (GAO) report on Puerto Rico, by 1989, the Puerto Rican government operated 52 public corporations. These corporations included “a maritime shipping company, the island’s telephone system and a sugar company.”<sup>6</sup> Today, the Puerto Rican government no longer owns the telephone company, but it still owns the electricity, water and sewage, and other, in some cases, very inefficient companies. In fact, the ownership of these companies has given the political parties in power the ability of implementing income transfer policies that have threatened the existence of these public utilities and is breaking government finances, year in and year out.

While the current administration has moved forward in trying to address some of the issues limiting the ability of the Puerto Rican economy to grow, much of what has been done has been cosmetic. The transformation that is needed has to go to the core, not only of the Puerto Rican economy but also at the core of its political system.

A labor reform is, perhaps, one of the most important pending reforms, but it is, at the same time, one of the most difficult to pass, as the Puerto Rican labor movement will oppose any change to the current status quo. The Puerto Rican labor movement remains a powerful force preventing change in the economy, as it feeds from the government’s ownership of so many corporations and remains a formidable force in the Puerto Rican political system.

A second pending reform has to do with the privatization of public corporations, so they are no longer an instrument of political manipulation, government favors and government employment. This reform is also a very difficult endeavor in the current political environment. The first step to reforming this sector is to broaden the tax base, so that the government can privatize these firms without suffering a decrease in revenue. A rationalization of prices charged, which has started in the public utilities sector, has been very difficult to implement in the island’s public university system, as it has been opposed by student unions in mass protests that have become violent in the past.

***Puerto Rico needs to reform its labor market, deregulate the economy and privatize state-owned enterprises.***

A third reform will be to deregulate the Puerto Rican economy, especially in the business permitting side that hinders competition. According to Steven J. Davis and Luis Rivera-Batiz “based on interviews with experts and participants in the permitting process, and supplemented by other sources, (there is) evidence that the permitting process is excessively slow and costly, fraught with uncertainty, subject to capricious outcomes, susceptible to corruption, and prone to manipulation by business rivals and special interest groups.”<sup>7</sup>

Without these reforms, the Puerto Rican economy will be unable to grow. The Puerto Rican economy does not currently have the ability to devalue its currency to gain competitive advantage and export its way out of this recession, or, perhaps, depression. For that to happen, Puerto Rico would need to get its independence from the United States and adopt a different currency than the U.S. dollar, something that is currently highly unlikely. Puerto Rican exports to the mainland United States are 70 percent of total exports, down from 88 percent at the end of the previous century. Thus, if Puerto Rico remains as a Commonwealth of the United States, it will have to gain competitiveness versus the United States by either recording a lower inflation rate than in the mainland United States, a process that could take decades, if it can actually be accomplished at all, or increase the productivity of its workers. One of the few ways this can be achieved is through a comprehensive labor reform.

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<sup>6</sup> Puerto Rico, “Update of Selected Information Contained in a 1981 GAO Report,” Fact Sheet for the Chairman, Committee on Energy and Natural Resources, U.S. Senate, United States General Accounting Office, August 1989. GAO/HRD-89-104FS.

<sup>7</sup> For a very good analysis on the permitting process in Puerto Rico and on employment growth please see the paper “The Climate for Business Development and Employment Growth in Puerto Rico,” by Steven J. Davis and Luis Rivera-Batiz, Sept. 2, 2005.

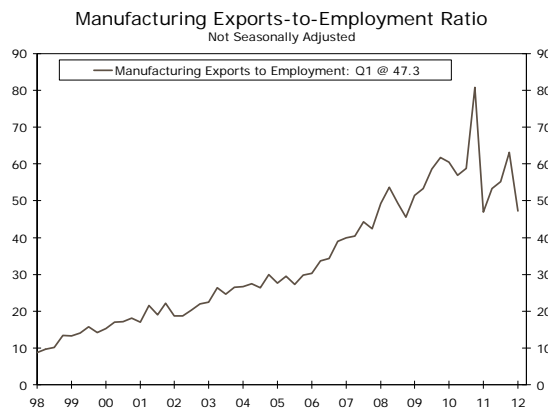
### A Digression: Capital- versus Labor-Intensive Industries

Since the implementation of Operation Bootstrap during the 1950s, many analysts and almost all of the research on the effectiveness of the Puerto Rican industrialization process have dealt with the issue created by the subsidies given to U.S. corporations. The overwhelming conclusion of this research has been that those subsidies have favored industrial processes that are highly capital intensive. That is, instead of being a force for labor creation, they have become a force for labor destruction as they have used more capital, i.e., machinery and equipment, than Puerto Rican workers.

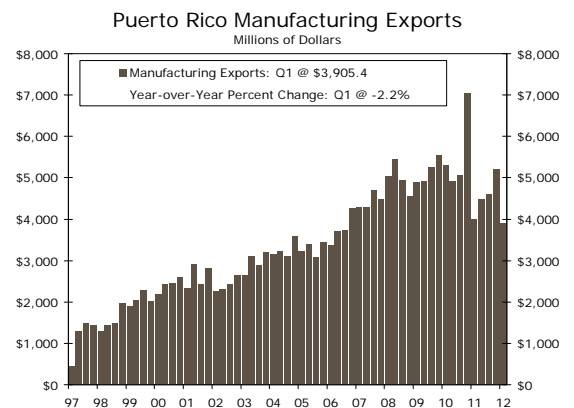
**Industrial subsidies reduced the degree of capital intensity of the sector, not the other way around.**

However, what the elimination of the subsidies has shown is that without those subsidies, the industrial processes that have remained in Puerto Rico have actually become even more capital intensive. Today, manufacturing employment has dropped by 50 percent, but our argument is that it was not the elimination of the IRS 936 codes that produced this but the leveling of the playing field in terms of access to the U.S. market. This points to other reasons, rather than the subsidies, as the causes for Puerto Rico to attract or keep highly capital-intensive production processes. In economic theory, the argument is that Puerto Rican wages are probably too high compared to the productivity of workers, and thus it is more profitable for firms to invest in machinery and equipment rather than hiring more workers, or that labor costs, i.e., wages plus benefits, are too high compared to other alternative countries. According to a GAO report on Puerto Rico called "Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit," "the economic census on capital expenditures on manufacturing plant and equipment...show that this investment increased dramatically between 1997 and 2002 after having dropped from 1992 to 1997."<sup>8</sup>

**Figure 3**



**Figure 4**



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

While manufacturing employment has collapsed by 50 percent since 1995, manufacturing exports have skyrocketed. Figure 3 shows a plotting of manufacturing exports-to-manufacturing employment ratio. This ratio has exploded since the early part of this century, indicating that productivity in the manufacturing sector, which is mostly composed of the pharmaceutical industry, has surged, meaning that there has been an intensive process of substituting capital for labor in that industry.

Thus, the whole discussion regarding the effects of the IRS 936 subsidies over the capital-intensive nature of the Puerto Rican manufacturing sector is a highly relative issue, and today, that industry is much more capital intensive than when the subsidies were in place. This means that there is something else that is making manufacturing firms to produce in the island using capital-intensive technology. Normally, this something else is high wages or labor costs.

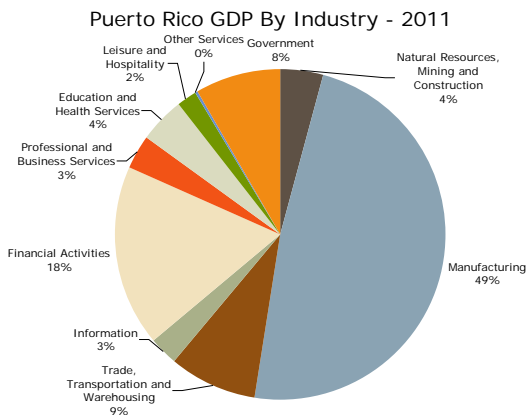
<sup>8</sup> "Puerto Rico, Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit," Page 96; United States Government Accountability Office (GAO); Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate, May 2006.



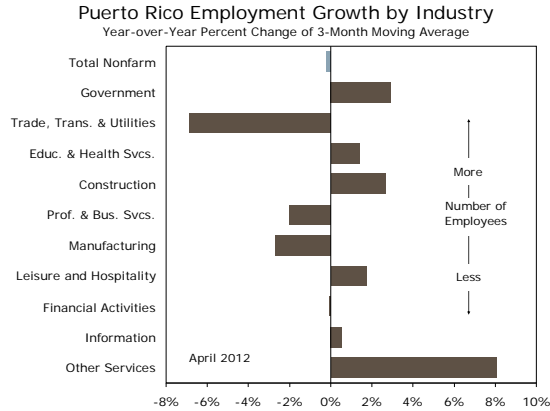
**All Eggs in the Same Basket**

One of the biggest risks of the Puerto Rican economy is its reliance in only a few sectors for economic growth. According to Puerto Rican national accounts—please remember how flawed these accounts are—the Puerto Rican manufacturing sector represented 49 percent of total nominal GDP in 2011. Of this 49 percent manufacturing GDP, 60 percent represents the pharmaceutical industry, and if we include the chemical industry as a whole, which includes the pharmaceutical industry, the share of manufacturing GDP increases to 70 percent.

**Figure 5**



**Figure 6**



Source: Puerto Rico Planning Board, U.S. Department of Labor and Wells Fargo Securities, LLC

Puerto Rico’s manufacturing sector is extremely dependent on the chemical industry and any problem this industry faces is a problem for the entire Puerto Rican economy. One of the biggest challenges for the future of the Puerto Rican economy will be to diversify its manufacturing base so as to not be so reliant on the chemical industry. This is, of course, easier said than done. The Puerto Rican manufacturing sector was a bit more diversified before the elimination of the IRS 936 subsidies, but this worsened with the end of the subsidies as almost every other manufacturing sector, which had come into the island drawn by the subsidies, left the island.

**The Puerto Rican Economy According to the Government**

According to the Puerto Rican government, the Puerto Rican economy dropped by 1.5 percent during fiscal 2011 compared to the previous year when it had dropped by 3.4 percent. Puerto Rican analysts normally use Gross National Product rather than Gross Domestic Product to explain the growth of the island economy.<sup>9</sup> For the U.S. economy, the difference between GNP and GDP used to be negligible, but for Puerto Rico, the difference between nominal GNP and nominal GDP is very large, and increasing. Just to give an idea, during fiscal 2011, Puerto Rican nominal GNP was \$64.106 billion, while nominal GDP was \$98.757 billion. Nominal GNP grew by only 1.7 percent during fiscal 2011 after growing by only 0.7 percent in fiscal 2010.

***The Puerto Rican economy dropped by 1.5 percent during fiscal 2011 compared to the previous year when it had dropped by 3.4 percent.***

<sup>9</sup> Gross Domestic Product (GDP) is the value of all goods and services produced in an economy during a year while Gross National Product (GNP) is Gross Domestic Product plus what nationals earn from overseas investments less income earned by foreign nationals in that country. Since the amount of money foreigners earn in Puerto Rico is larger than what Puerto Ricans earn in the rest of the world then GDP is much larger than GNP.

Figure 7

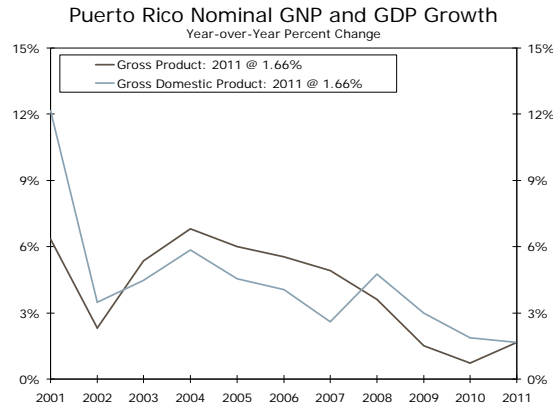
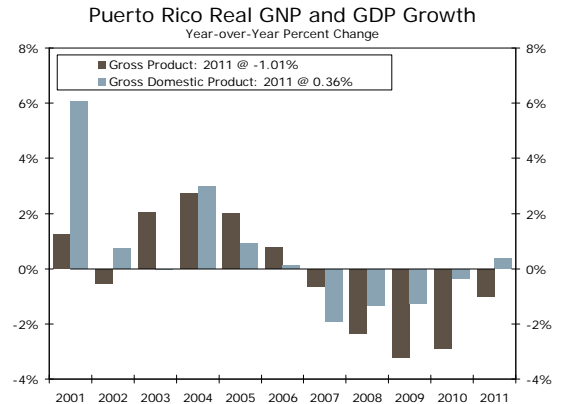


Figure 8



Source: Puerto Rico Planning Board and Wells Fargo Securities, LLC

The drop in real GNP of 1.5 percent in fiscal 2011 was the fifth consecutive drop in GNP, which would put the Puerto Rican economy close to a depression rather than a recession. The recession started before the U.S. recession, and many argue that the reason for the recession was because of the elimination of the IRS 936 subsidies during that year. However, it is clear from looking at the data that the effects of such an event are not discernible as other events were.

As we said at the beginning of this report, in 2006, the then Acevedo Vilá administration (PDP) and the opposition-controlled legislature (PNP) brought the Puerto Rican economy to its knees by shutting down the Puerto Rican government for two weeks and temporarily laying off 100,000 government employees without pay. This is what brought down the Puerto Rican economy, not the elimination of the IRS 936 codes. The Puerto Rican economy has still not recovered from that shock. Of course, the end of the IRS 936 subsidies did not help, but the political system was the culprit of the demise of the Puerto Rican economy.

### Recent Economic Developments

The Puerto Rican economy is struggling to grow in an environment that remains basically unchanged from several years ago even as the Fortuño administration has tried to come up with solutions to some of the more daunting problems faced by the island economy. Even as these efforts have failed to bring changes to the way the Puerto Rican economy works, the Fortuño administration or administration officials have tried to override the truth by talking about how the economy is better today than several years ago. However, the best they can claim is that the economy seems to not be falling off a cliff any more, but then again, the government seems to have a lot to do on this outcome.

Puerto Rican employment is still falling, even as the Puerto Rican government steps up its hiring as the gubernatorial elections approach. We will probably see this same environment continuing over the next several quarters, because, irrespectively if the economy or government finances are in trouble, this is a political year. And, political years bring lots of money into the economy. However, as we said before, even with the help of the Puerto Rican government the employment situation is still weak. Employment has dropped by 0.1 percent during the first four months of this year compared to the year-earlier period. This is the lowest drop in employment during the first four months of the year since 2006 when employment grew by 0.2 percent.

However, if we look at the composition of this employment growth, we see the hand of the government is everywhere. Private employment has dropped by almost 9,000 positions during the first four months of the year, or 1.3 percent versus the year-earlier period, which represents acceleration in job losses after dropping by only 0.2 percent during the first four months of last year. Employment was down by 0.7 percent in 2011 and by 1.7 percent in 2010.

***Puerto Rican employment is still falling, even as the Puerto Rican government steps up its hiring as the gubernatorial elections approach.***

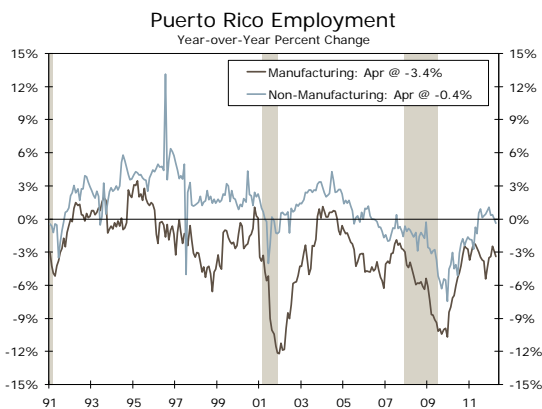
Employment has improved in two sectors—construction and government employment. And, because the Puerto Rican government is involved in almost everything related to construction in the island, the only reason why construction employment is growing is because the Puerto Rican government is subcontracting for construction projects. Of course, Keynesian economic theory would be OK with this intervention in the economy, but the fact that it is coming so close to the political cycle makes the “sudden” realization, by an administration that does not believe in government involvement in the economy, of the benefits of Keynesianism, very suspicious, to say the least.

Construction employment has increased by 7.4 percent during the first four months of this year, year over year, or by 2,300 positions after falling by 2.1 percent during all of 2011. Meanwhile, government employment has increased by 3.1 percent during the period, or by 8,000 positions during the first four months of the year.

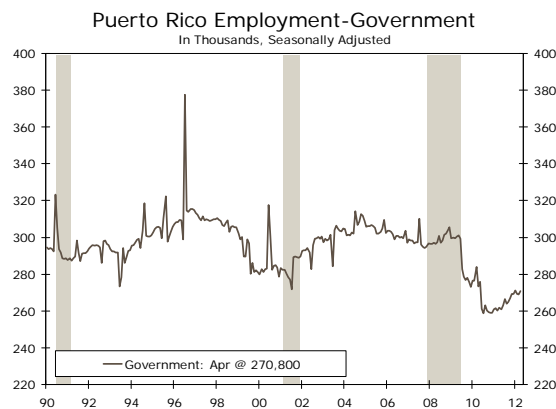
On the other hand, private-sector employment continues to suffer with the exception of a few sectors. Manufacturing employment continues its downward path, dropping by 2.8 percent during the first four months of the year, or by about 2,400 positions, while the trade, transportation and utilities sector’s employment has plunged during the period, falling by 11,400 positions, or by 6.5 percent during the first four months of the year compared to a year ago. The most affected sector within this last employment group has been retail trade. Retail trade employment is down by almost 10,000 positions during the first four months of the year, or by 7.6 percent. This is, so far, the worst employment performance of the retail sector since the recession started in 2006. Granted, this performance by the retail sector could be related to the warmer-than-normal weather conditions in the United States as Puerto Rico is a prime destination for U.S. tourists during the winter season.

This excuse seems inconsistent with the fact that one of the few private employment sectors to have improved during the first four months of the year has been the leisure and hospitality sector, for which employment levels improved by 2.0 percent, or by 1,400 new jobs. Meanwhile, education and health services employment numbers have improved by 1.5 percent, or by 1,700 new jobs. However, professional and business services employment dropped by 1.9 percent, or by 2,000 jobs during the first four months of the year compared to the year-earlier period.

**Figure 9**



**Figure 10**



**Source: U.S. Department of Labor and Wells Fargo Securities, LLC**

Thus, as we said before, if it were not for the Puerto Rican government preparing for the gubernatorial election, the fate of employment in Puerto Rico would have been much worse than what it is looking today. Granted, there is bound to be some seasonal effects that these data are not able to capture, but the trends look very clear from the latest information available.

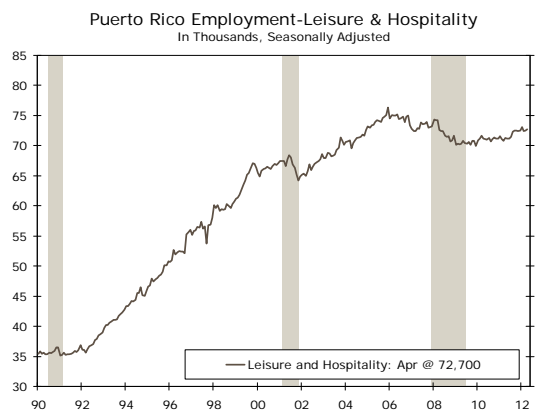
***One of the private sectors that continues to improve is island tourism.***

### The Tourism Sector Is Leading the Way

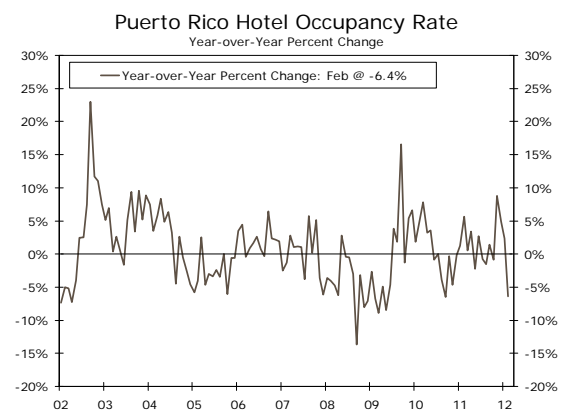
One of the private sectors that continues to improve is island tourism. Consistent with the information on employment mentioned earlier, the tourism industry has been leading the way. According to the Puerto Rico Tourism Company, hotel registrations were up by 3.2 percent during the first two months of the year compared to the year-earlier period. Lamentably, this data point lags considerably, but the trend during the last two months of 2011 and the first months of 2012 gives an indication that the sector has continued to recover, even though February's numbers were weaker than the previous three months. The good news regarding the tourism sector is that it is a private sector and it has important comparative advantages for this Caribbean island. U.S. tourism into Puerto Rico is an important complement to local tourism during the U.S. winter season, and while this winter season in the United States was extremely mild, the tourism sector was not affected as much as one would think.

Hotel registrations from residents were up by 4.4 percent during the first two months of this year compared to the same period of 2011. Furthermore, total hotel registrations by residents during the last quarter of 2011 were up by 16.9 percent compared to the year-earlier period. At the same time, total hotel registrations from nonresidents were up by 2.9 percent year over year during the first two months of the year, while they were up by 4.7 percent during the fourth quarter of 2011 compared to the year-earlier period.

**Figure 11**



**Figure 12**



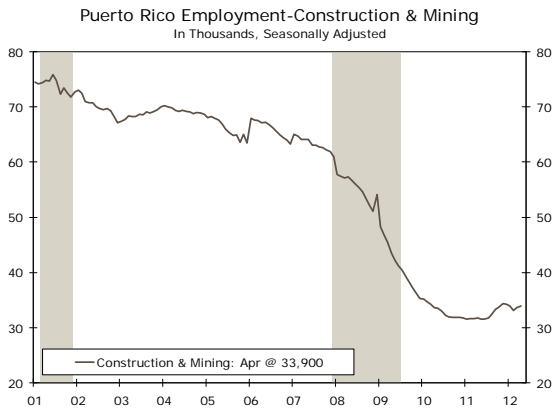
**Source:** U.S. Dept. of Labor, Government Development Bank for Puerto Rico Wells Fargo Securities, LLC

However, the Puerto Rican tourism sector should be doing much better than it actually is doing only because, together with the U.S. Virgin Islands, American citizens do not need to take their passport when they fly to these Caribbean islands. Thus, the U.S. Virgin Islands and Puerto Rico have benefited considerably from the aftermath of Sept. 11, 2001, as American citizens now need to get a passport for traveling to Mexico's beach destinations. While there was a strong recovery of the sector in the aftermath of the 2001 recession, the sector has not grown as much since 2006 as it should have considering the passport requirements for other Caribbean destinations for American citizens.

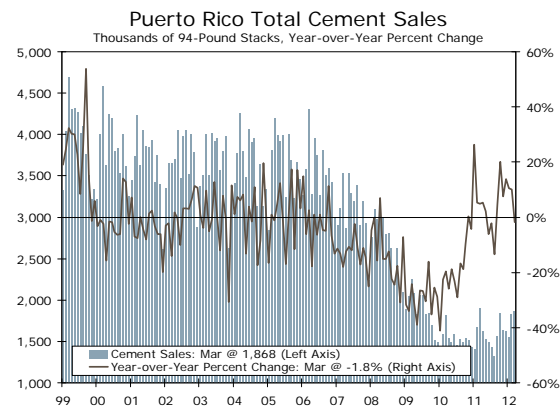
### Housing Activity Still Depressed

While it is difficult to know what is happening with the Puerto Rican housing market because housing market data lag more than a year, there is a dataset used by those that have a command in the analysis of the Puerto Rican economy that could shed some light on the status of the housing market. For example, building permit information is only available through April 2011.

**Figure 13**



**Figure 14**



**Source: U.S. Department of Labor, Puerto Rico Planning Board and Wells Fargo Securities, LLC**

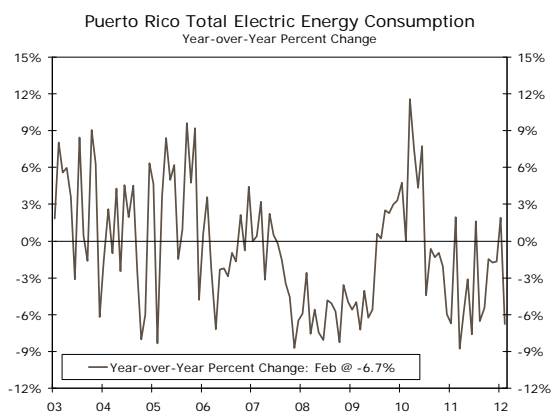
However, by reviewing cement sales data we have a good idea of where the housing market is and where it is heading, and the picture is not good. While cement sales were up 5.7 percent during the first quarter of this year compared to the same quarter a year-earlier, we have already argued that the biggest reason for this behavior is that the Puerto Rican government is subcontracting for public projects. However, if we look at the first three months of this year compared to the first three months of 2005 (the Puerto Rican recession started in 2006), then cement sales on the island are down 52 percent. Recall, Puerto Rican houses have to be constructed from cement due to the strict construction codes implemented in the effort to improve preparedness for hurricanes. Thus, knowing what is happening to cement sales gives a pretty good picture of the conditions of the Puerto Rican housing market.

***Employment in construction and cement sales give a good picture of the dismal conditions of the island's housing market.***

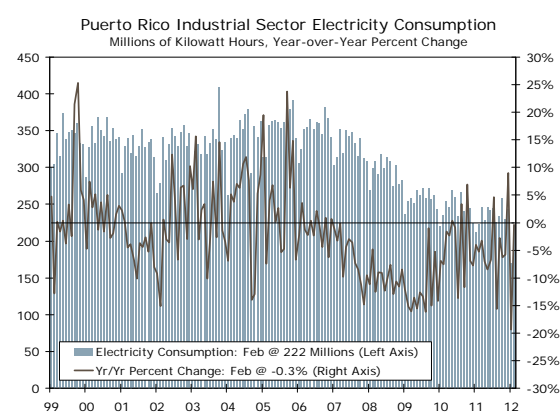
**Electricity Consumption: A Mirror of the State of the Economy**

Normally, one of the best indicators of the state of an economy has to do with the consumption of electricity. And, as is the case with the cement sales indicator, the picture of the economy through the lenses of electricity consumption is also weak. Electricity consumption on the island was down by 2.4 percent during the first two months of this year compared to the same period in 2011. Electricity consumption on the island dropped four consecutive years between 2006 and 2009. In 2010, there was a small recovery of 2.4 percent, but the recovery evaporated in 2011 when electricity consumption dropped by 2.5 percent.

**Figure 15**



**Figure 16**



**Source: Gov. Development Bank of Puerto Rico, Puerto Rico Planning Board and Wells Fargo Securities, LLC**

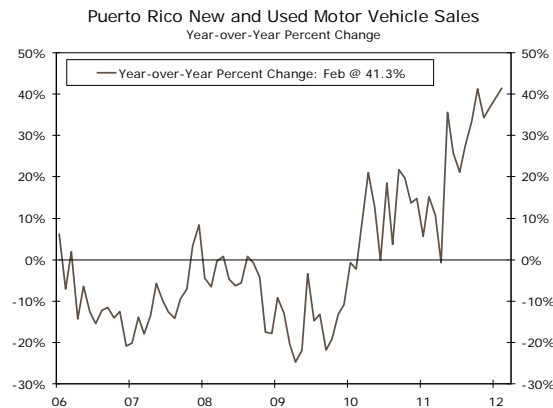
***On a cumulative basis, electricity consumption by the island industrial sector has dropped 39 percent since the start of the recession in 2006.***

The biggest culprit in terms of the drop in electricity consumption has been the industrial sector. Consumption of electricity by the industrial sector has dropped from 2006 to 2011 and 2012 is not looking much better. On a cumulative basis, electricity consumption by the industrial sector has dropped 39 percent since the start of the recession in 2006. This drop in electricity consumption by the industrial sector has meant that the sector has shrunk considerably in importance in terms of electricity consumption on the island. By the early part of this century, the industrial sector represented almost 22 percent of total electricity consumed in the island. However, electricity consumption by the industrial sector today is close to 14 percent.

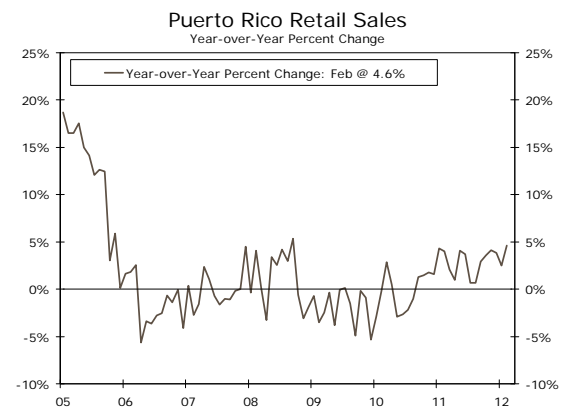
### **The Puerto Rican Consumer Is Showing Some Life, but...**

Puerto Rican nominal retail sales have remained positive lately but, when adjusted for changes in prices, the growth is still weak. Nominal retail sales have increased 3.1 percent during the first two months of 2012, whereas they were up by 4.6 percent during the first two months of 2011, year over year. Furthermore, retail sales were up 3.0 percent during 2011 after dropping 0.2 percent during 2010. If we take the effects of inflation during the first two months of 2012 out of the growth in nominal retail sales, then the growth in real retail sales was only 0.7 percent, whereas real retail sales increased 1.3 percent during 2011.

**Figure 17**



**Figure 18**



Source: Puerto Rico Planning Board and Wells Fargo Securities, LLC

***As has been the case in the United States, one of the most dynamic sectors in terms of retail sales in Puerto Rico has been automobile sales.***

As has been the case in the United States, one of the most dynamic sectors in terms of retail sales in Puerto Rico has been automobile sales. After increasing 10.7 percent in 2010, 24.5 percent during 2011, automobile sales have started this year with a bang and are the driving force in terms of retail sales. Automobile sales during the first two months of 2012 have increased a whopping 40.3 percent compared to the first two months of 2011. The weakness in the overall retail sector is evident by looking at the strength of automobile sales. Automobiles are a large component of total retail sales: they have represented about 8.5 percent of total retail sales during the past seven years. It is probably a mystery why with such a bad economy car sales have taken off during the last two years. There are probably several potential reasons for this behavior: first is the size of the underground or informal economy. Income numbers are probably understating actual income growth in the island; second, an effort by automobile producers to sell more cars by giving very low, even zero, interest rates, just as it is the case in mainland U.S.; and third, very high gasoline prices are pushing individuals to substitute away from gas guzzling vehicles to more efficient ones.

Another sector that is growing above the rate of inflation, at least during the first two months of 2012, is sales of construction materials, which has increased 3.8 percent compared to the same period a year earlier. However, the caveat mentioned above regarding the Puerto Rican construction sector remains in place; that is, the government is the one making the effort. Surprisingly, furniture sales were up 2.0 percent after experiencing a good year in 2011 when sales grew 6.0 percent. This 2.0 percent in nominal sales means a drop in real sales this year for



the furniture business but it comes on the back of a relatively good 2011. Meanwhile, sales in cafeterias and restaurants increased 2.8 percent, which is still below the level of inflation and after dropping 0.7 percent during 2011.

## **Government Finances**

The Puerto Rican government's finances look better, as the Fortuño administration has taken measures to fix the dismal behavior of fiscal accounts during the past several years. However, the recent increase in government employment and the surge in the Puerto Rican government's construction projects could mean trouble if the economy does not improve in the next several quarters.

In 2006, the Puerto Rican government made some changes to its tax system when it introduced a sales tax called the "sales and use tax." The idea was to try to increase government revenues and change the structure of the island tax system so it relied more on taxes on consumption rather than taxes on imports. However, the government did not eliminate every tax on imports—for example, import taxes are still being paid on alcoholic beverages and motor vehicles. Before the change in 2006, this excise tax or import tax represented a little more than 20 percent of total general funds gross revenues. With the change, excise taxes went down to about 10 percent of total tax revenues.

In 2010, the Fortuño administration, in an attempt to solve the government's insolvency problem, created what has been called a temporary tax on foreign corporations.<sup>10</sup> It is a new 4 percent excise tax that started in February 2011, which has increased tax revenues considerably. With this tax, the excise tax as a percentage of total government gross revenues has gone to about 30 percent from about 10 percent. The tax is a temporary tax, a tax that will slowly be phased out and will, presumably, disappear after six years. It started at 4 percent, goes to 3.75 percent, then to 2.75 percent, then to 2.5 percent, then to 2.25 percent and last to 1.00 after which it will disappear.

So far, this tax has been a lifeline and a life saver for the Puerto Rican government and has allowed the Fortuño administration to keep the ball rolling. However, the long-term consequences of the tax are unknown even though the tax is scheduled to be phased out. Normally, corporations do not like these taxes and it took these corporations by surprise. The most important issue and the biggest complaint is that this was an ad hoc tax imposed only on foreign corporations and used to pay for a lowering of taxes on domestic firms and individuals. Furthermore, foreign corporations are normally U.S. corporations, and are those corporations that decided to stay after the subsidies given by the 936 laws were eliminated. Thus, this creates a serious issue for these corporations as to whether their decision to stay was the correct one. Of course, foreign corporations call this a discriminatory tax in that it is only levied on foreign corporations rather than on all corporations, but their biggest complaint is that it was imposed suddenly and without any opportunity to discuss its implementation with the affected firms.

***The tax on foreign corporations has been a life saver for the Puerto Rican government.***

The biggest issue today is that there is the potential for mistrust between the private foreign sector and the Puerto Rican government due to this new tax. There is also a sense that this tax is too good to be true for the Puerto Rican government and that it may never go away. Thus, the long-term implications of this tax, even if it is actually phased out, are highly uncertain and this could affect the future of foreign capital investment on the island, diminishing economic growth prospects.

According to the Puerto Rican government, the budget proposal for fiscal year 2013 is \$9.08 billion, which includes a \$933 million funding gap compared to \$1.4 billion funding gap for fiscal 2012, which ends on June 30, 2012.<sup>11</sup> Furthermore, according to the President of the Government Development Bank, Carlos Batlle, the government of Puerto Rico will restructure approximately "\$600 million of principal and interest payments due in fiscal 2013." With these

<sup>10</sup> U.S. corporations are considered "foreign corporations."

<sup>11</sup> "Puerto Rico Plans to Stop Deficit Borrowing," Bloomberg Brief, Municipal Market. Friday, May 11, 2012. Michelle Kaske.

and other measures, Mr. Battle said, the Puerto Rican government will “end its practice of borrowing to balance spending in fiscal 2014.”

**Conclusions**

The Puerto Rican economy today is at a difficult junction. The development model used to industrialize the island, which was extremely successful in the beginning has mutated into a system that has the state, the Puerto Rican government, as the lifeline for almost everything that goes on in the economy. This increased intervention in the economy is strangling the Puerto Rican economy and jeopardizing future growth.

For the majority of the U.S. states and for the United States as a whole, government employment is the second-largest employer, second only to the trade, transportation and the utilities sector. However, in Puerto Rico, the government sector is the largest employer followed by the trade, transportation and the utilities sector. One of the reasons for this is that the Puerto Rican government still owns a large number of corporations, the biggest of which is the island’s electricity company, water and sewer company, which is, for example, in charge of government buildings, roads construction and upkeep, the ports authority, the Government Development Bank, the University of Puerto Rico and the Economic Development Bank.

There is no discussion that government employment is oversized, representing, today, approximately 25 percent of total employment (29 percent of total non-farm employment) on the island. This compares with government employment of 16.5 percent of total non-farm employment for the United States as a whole. While this is a serious issue, especially if the government is in fiscal trouble, it is not that uncommon for small and poor economies. Even in the United States, these levels of government employment are common in small and relatively poor economies in lightly populated states. Figures 19 and 20 give some examples of comparisons between Puerto Rico and lightly populated states (19) and Puerto Rico and MSAs that have low income per capita (20) compared to the United States as a whole. Thus, while Puerto Rican government employment is oversized, it is not as oversized as many tend to argue and it is definitely not an exception. Rather, it is typical for poor cities across the United States where the private sector is limited.

***In Puerto Rico, the government sector is the largest employer followed by the trade, transportation and utilities sector.***

**Figure 19**

State Government Payrolls*	
	Percent
U.S. Average	16.52
West Virginia	20.21
Montana	20.27
Hawaii	21.35
Oklahoma	21.44
Mississippi	22.64
New Mexico	24.17
Wyoming	25.60
Alaska	25.74
Puerto Rico	29.43

\*Government payrolls as a percent on total nonfarm employment.  
 Source: U.S. Department of Labor and Wells Fargo Securities, LLC.

**Figure 20**

Texas MSA Government Payrolls*	
	Percent
U.S. Average	16.52
El Paso, TX	23.00
Brownsville, TX	23.94
Laredo, TX	24.09
McAllen, TX	24.46
Puerto Rico	29.43

\*Government payrolls as a percent on total nonfarm employment.  
 Source: U.S. Department of Labor and Wells Fargo Securities, LLC.

Thus, the biggest problem the Puerto Rican economy has is not its oversized government employment level. Rather, it is how the economy creates more private jobs that could help the government eliminate its debt deficit financing and broaden the taxing base, as the Puerto Rican population becomes wealthier. That is, Puerto Rico has, today, the same problem it had when it started to industrialize through Operation Bootstrap in the mid-1900s. It needs to attract investment that will generate employment on the island.



Many of the institutional settings in the Puerto Rican economy discourage investments in the island compared to other countries in the region that have free access to U.S. market. This is the reason why we say that the elimination of the 936 laws in addition to the closing of the government for two weeks in 2006 probably helped push the Puerto Rican economy off the cliff but Puerto Rico had been walking close to that cliff for a long time. The problem was that the island was privileged in terms of its unique access to the U.S. market and by hefty subsidies provided to U.S. companies producing on the island. However, once those subsidies ended then the only advantage Puerto Rico had was its access to the U.S. market. But that access became a common currency with the implementation of the NAFTA agreement and with other free trade agreements signed with many of the South American, Central American and Caribbean countries. Thus, Puerto Rico's benefits disappeared fast and furiously.

***The biggest problem Puerto Rico has is to find a government that is willing to put its priorities in order and invest in the future of the island's education system. And this is a big if!***

Some say that Puerto Rico has no other advantage to offer U.S. or foreign companies. We disagree. The U.S. government is one of the largest employers of Puerto Rican university graduates because they are bilingual and they can attract good engineers at a much lower cost than what a U.S. educated engineer costs. It is true that the Puerto Rican education system, but especially its public K-12 grade school system, is in crisis and it will take a lot of time and money to fix it. Though, the potential is there. However, the most important step, and the first biggest problem to solve is to find a government that is willing to put its priorities in order and invest in the future of the island. And this is a big if!

Until then, the future of the Puerto Rican economy does not look too promising. It is true that the government of Puerto Rico has to pay its debts first and then pay everything else and this makes a potential default highly unlikely. However, how many years can an economy that does not grow, or even worse, that continues to shrink, continue to keep these levels of expenditures without collapsing? If the economy continues on this path then it will be difficult to keep the payments going, especially once the temporary tax on "foreign corporations" is completely phased off.

We agree that Puerto Rico is not Greece. Puerto Rico has a fiscal union with the United States and this lessens the effects of any crisis. However, today, what used to be the U.S. fiscal largesse with Puerto Rico is fading fast and this will not change anytime soon. Puerto Rico has to recreate itself within the United States, perhaps as a state, or get its independence from the United States. Lamentably for my "populares" friends the Commonwealth has outlived its useful life. It is time for change.<sup>12</sup>

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<sup>12</sup> "Populares" is the common name for those that follow the Popular Democratic Party, which created the Commonwealth and continues to support it.

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