

# Economic Development Initiatives for Puerto Rico

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**Date : August 31, 2016**

## Background

Puerto Rico's economic development strategy has not evolved with the times. It has been based on 1950's strategies based on the Government's role as one the major economic agents. The Government's participation in the AEE, AAA, PRIDCO, the Public Buildings Authority and the Ports Authority made sense when Puerto Rico lacked access to global capital markets due to the underdeveloped state of its economy.

However, the global trend over the past 20 years has been that of privatization beginning with the UK, followed by Brazil, Chile, Mexico, Japan, and the Eastern European region. Privatization leads to greater competition, better services and lower costs. The telecommunications industry is one of the best examples of the benefits of privatization.

Another major obstacle to development facing Puerto Rico is its dependency on government transfer payments, both from the federal government and the Commonwealth. For example, according to Table 14 of the Statistical Appendix the 2015 Economic Report of the Governor, payments from the federal government and the Commonwealth have increased from 25% to 34% of Personal Income between FY 2006 and FY 2015 (from \$13 billion to \$22 billion). This demonstrates that the economic model is not self-sustaining because despite the massive growth in funding, the economy has declined in real terms during this timeframe. Unless major structural reforms are implemented, this trend of increasing dependency on government transfer payments is likely to continue to grow.

Furthermore, these transfer payments have mostly promoted consumption which over the years has created a massive "welfare mentality" throughout our society that has stifled individual initiative and ambition. An economic study of Puerto Rico commissioned by the Brookings Institution in 2006 estimated that the bundle of benefits received by a "single unemployed mother would qualify for TANF, nutrition assistance, section 8 housing and public medical insurance would amount to \$1,276 in cash and services" ("Labor Supply and Public Transfers" p. 117, Gary Burtless and Orlando Sotomayor published in *The Economy of Puerto Rico*, Susan M. Collins, Barry P. Bosworth and Miguel A. Soto Class, The Brookings Institution, 2006). This estimate was based on federal and state programs and rules in place in 2003. Assuming a 2% growth in the value of these benefits due to inflation, the comparable figure in current dollars would amount to approximately \$1,650 per month.

This means that the private sector must compete with this minimum income level in order to attract workers at the lower levels of employee skill sets. This minimum income floor (reservation price) becomes the base salary required to entice many workers to enter the labor force thereby increasing labor costs across the board which, in turn, erodes our global competitiveness.

Moreover, our manufacturing sector grew largely due to federal tax incentives (Section 936, among others). These tax incentives offset many of the competitive disadvantages faced by Puerto Rico, namely, high energy costs, high transportation costs, slow government permitting, and burdensome government regulation, among others. As soon as the phase-out of Section 936 commenced in 1996, our manufacturing sector began a steady decline. Employment in the manufacturing sector has declined from 135,000 in 2006 to 82,000 in 2015. (Note- This trend was exacerbated by our high energy costs which, in our view, the single greatest obstacle to economic growth because it serves to reduce the competitiveness of all sectors of the economy).

## **Recommendations**

In order to develop a sustainable economic growth model for Puerto Rico, key initiatives should be implemented in the following areas:

- A. Government Restructuring
- B. Private Sector Initiatives
- C. Capital Formation
- D. Federal Government Initiatives
- E. Research and Development

## **Government Restructuring**

In general terms, the Government should divest itself of all Public Corporations (Power, Water, Workmen's Compensation Fund, Automobile Accidents Compensation Authority, Public Building Authority, Ports Authority, PR Industrial Development Corp. (real estate assets only), among others. Funds obtained should be utilized to pay bond holders and capitalize the Public Pension System.

## **Municipios**

The 72 municipalities need to be consolidated into 8 regional entities along the lines of the Senatorial districts. The Senatorial districts will allow for the achievement of critical scale for the more efficient provision of services and regional investments. The total cost to operate the municipalities is around \$400M. Consolidations should allow for significant budgetary savings as the 72 political bodies are folded into 8.

## **University of Puerto Rico**

It does not make economic sense for the UPR to have 10 campuses. First of all, Puerto Rico is a relatively small island, thus travel distances are not that great and the operational costs are simply too high. The Carolina, Utuado, Aguadilla and Humacao campuses could be closed and excluding the Medical School, the remaining 5 campuses (San Juan, Bayamon, Ponce, Cayey, Arecibo and Mayaguez would cover the cardinal points of Puerto Rico.

Furthermore, the level of subsidies offered in the tuition of the University of Puerto Rico is too high. Its total budget is around \$1 billion yet it only generates around \$200M from tuition revenues resulting in subsidies of around 80% compared to 50% for state supported colleges in

the US. All households with income in excess of \$50,000 should be required to pay a more reasonable share of these costs. It could be based on increasing percentage based on household incomes.

Part of the funds received could be set aside for a research and development fund that the university could utilize to fund promising new technologies in the areas where PR has a competitive advantage, such as, life sciences, manufacturing processes, software development, biotechnology, pharma, solar energy, among others.

### **Electric Power Authority**

The Electric Power Authority should be sold to a private sector. However, its charter should be changed so that it only engages in power distribution as a monopoly. The power generation sector should be opened up to competition. This will attract the capital required to upgrade our aging and nearly obsolete power infrastructure.

The Board should ensure that the EPA grants the permits for the Aguirre Offshore plant. This is the single most important short term initiative in terms of impacting the Puerto Rico economy since the shift to natural gas will result in immediate reduction in energy costs in Puerto Rico. To illustrate the point, today energy costs represent the highest cost of retail outlets and restaurants in Puerto Rico, even higher than payroll costs!

By separating power generation from distribution, the power distribution monopolist will want to maximize power transmission, contrary to its present motivations which are to stifle any new industry entrants. This is the main reason why renewable power has not been able to grow in Puerto Rico.

All funds obtained should be utilized to pay bond holders.

### **Water Authority**

Although it appears to be working, the Water Authority it should be privatized in order to ensure the optimum operation and deployment of its capital. The funds obtained should be utilized to pay bondholders.

### **Highway Authority**

All of the existing toll roads and all future construction should be converted into toll concessions. The funds obtained should be utilized to pay bondholders.

### **Police Department**

The Police are badly in need of modern technology. All of the Police stations and regional offices should be connected in a broadband digital network with access to public law enforcement databases in Puerto Rico, the rest of the 50 states, the justice department, Homeland Security, etc. All police officers should be equipped with radios and digital data devices.

### **Public Sector Employment**

Puerto Rico should benchmark itself against a Group of comparable countries and metrics should be developed regarding government employees per population. Public sector employment needs to be reduced to comparable levels in order to improve the competitiveness of the Economy. However, said process should be phased in over a 10 year period in order to avoid a shock to the economy and provide for a transition period for private capital to commence flowing once more into Puerto Rico.

### **Private Sector Initiatives**

The Privatization of government services and/or corporations will provide opportunities for the private sector. This process should provide local businesses the opportunity to participate and/or enter into joint ventures with non-Puerto Rico firms. It is essential that Puerto Rican companies be made part of this process. Significant weight (and in some cases it should be mandatory) should be given to local Company participation in privatization ventures.

### **Capital Formation**

One of the impediments to obtaining access to Bank financing is that most local companies have historically been severely undercapitalized. In fact, one of the reasons why major Commercial Banks failed in Puerto was that they took venture capital type risks while pricing their exposure at commercial banking rates.

Law 185 was enacted with 2 (two) objectives (a) provide tax incentives to attract US and global capital to Puerto Rico and (b) channel local savings into investment vehicles that would lend and/or invest funds in higher risk local ventures that the commercial banking sector is not equipped to handle given the current state of affairs of the PR economy and their regulatory framework.

However, Law 185 did not go far enough because investments in these Funds are only deductible (up to 15% of the taxable income per year). Law 185 should be modified to allow local investors to obtain a tax credit against the tax liability (as opposed to the current tax deductibility of the investment). Although it will have an impact on tax revenues, the impact will be limited to the extent that an investor may only obtain a credit up to 15% of his/her net income subject to taxes. Furthermore, this mechanism should attract local capital that is currently invested in investments, such as, Government bonds, and stocks of public companies (US and Global) that do not contribute to the economic growth of Puerto Rico.

### **Act 20/22**

The US Treasury should support these initiatives since they constitute very powerful initiatives that seek to attract capital and, more importantly, entrepreneurs to Puerto Rico.

## **Federal Government Initiatives**

### **Special Economic Zone**

Puerto Rico should be named a special economic zone given its dire economic condition. All branches of the federal government should set aside 5% of their purchasing budget for Puerto Rico goods and services over a 10 year period. This is not a bail out, but it will ensure that Puerto Rican companies commence to export goods and services. Only firms that meet the strict purchasing specifications of the federal government will qualify. This means that for the first 3-5 years, there will remain unused funds due to lack of eligible companies.

### **Manufacturing**

A tax incentive needs to be enacted to improve the competitiveness of the manufacturing sector. However, incentives should seek to promote the development of research and development because technology will keep companies in Puerto Rico because history has shown us that “manufacturing only” enterprises can easily move their operations anywhere in the globe based on changing economic variables, such as , inflation, energy costs, exchange rates and tax policy. However, Silicon Valley and Route 128 have shown us that despite very high operating costs, these areas continue to flourish due to their technological prowess.

### **Capital Investment**

The Federal Government should provide tax incentives to attract un-repatriated profits of US Companies held in foreign jurisdictions to the territories (including PR). These profits could be taxed at a nominal rate, say 5%, if invested in the following activities in Puerto Rico:

- a. Manufacturing
- b. Research and Development
- c. Infrastructure investment
- d. Agricultures
- e. Equity investments in local companies

### **Federal Transfer Programs**

The Federal transfer payment mechanism needs to be revamped. A more holistic approach should be taken to these programs. At the present time, each Agency implements its initiatives and budgets in order to achieve its narrow goals. Unfortunately, the majority of funds are geared to support consumption as opposed to investment. For example, in 2105, the Federal Government allocated \$16,314MM in transfer payment to residents of PR and an additional \$3,396MM (total of \$19,710MM) was allocated to the Commonwealth and the Municipalities. Of said amount, only \$255.5MM (1.30% of total federal funds) was allocated for infrastructure development purposes.

<b>Basic Infrastructure</b>	
<b>(millions)</b>	
<b>Highway</b>	\$ 124.80
<b>AAA</b>	\$ 89.10
<b>AEE</b>	\$ 0.96
<b>Ports Authority</b>	\$ 40.65
	<b>\$ 255.51</b>

**Economic Report of the Governor FY 2015-Table 22**

As a result, despite the massive flow of federal funds to PR over the past 40 years, they have failed to transform the Puerto Rico economy into one supporting sustainable growth.

We propose that the mix of funding change over the next 10 years whereby initially 10% of the total federal transfer payments allocated to PR be set aside for capital investments purposes and/or research and development activities. The largest percent should be allocated to the Commonwealth yet a minimum amount should be allocated to the municipalities in order to support their regional economic development strategies. Funds should be allocated on a competitive bidding basis similar to the process utilized for Urban Development Grants. Within a 10 year period, at least 40% of federal transfer payments should utilized to these activities.

During this transition phase, a massive social program needs to be implemented to change the the “welfare culture” that has evolved in Puerto Rico. This is truly the biggest challenge and obstacle to PR economic development since it represents the largest untapped human resource potential of the economy and it drains resources that could be channeled into productive activities. It is one of the reasons behind the low labor participation rate in the PR economy.

Key areas that need to be addressed to transform our Society are the following:

- a. School drop out rates
- b. Teenage pregnancy
- c. Drug abuse
- d. Alcohol abuse
- e. Dysfunctional families
- f. 2<sup>nd</sup> and 3<sup>rd</sup> Generation welfare families

People need to understand that the current welfare system must and will change. However, this type of social change does not occur overnight. First of all, we need to develop a common vision for the future. A vision that will entail sacrifices but one that will reward future generations.

This change cannot be implemented overnight but rather over a 10 year period so that everyone can be ready. The key population targets should be the 8-25 year age group since this group represents the future of Puerto Rico and will be most amenable to social change.

### **Research and Development**

Throughout history, the countries with the highest standards of living have been those with the greatest technological prowess. For this reason, Puerto Rico needs to increase its investment

levels in research and development in order to evolve into an upper income economy. It should target those sectors where it has a competitive advantage, namely, life sciences (biotech, pharma and medical devices), advanced manufacturing processes, software development and the nascent aeronautical industry, among others.

A task force should be set up within the National Science Foundation, and a \$500MM R&D program should be developed in conjunction with local academia, the government and the private sector. A 10 year R&D program should be developed and implemented. All local Universities, the private sector and global companies and universities should be able to participate in the program subject to the requirement that any participant must be willing to match whatever funding may be the NSF. All of these efforts should be coordinated through the Puerto Rico Science and Technology Trust.