

C
N
E

CENTER
FOR THE
NEW
ECONOMY

CENTRO
PARA LA
NUEVA
ECONOMIA

ANNUAL
ECONOMIC
CONFERENCE

2011



Puerto Rico: Micro Institutions and Macro Performance

Peter Blair Henry

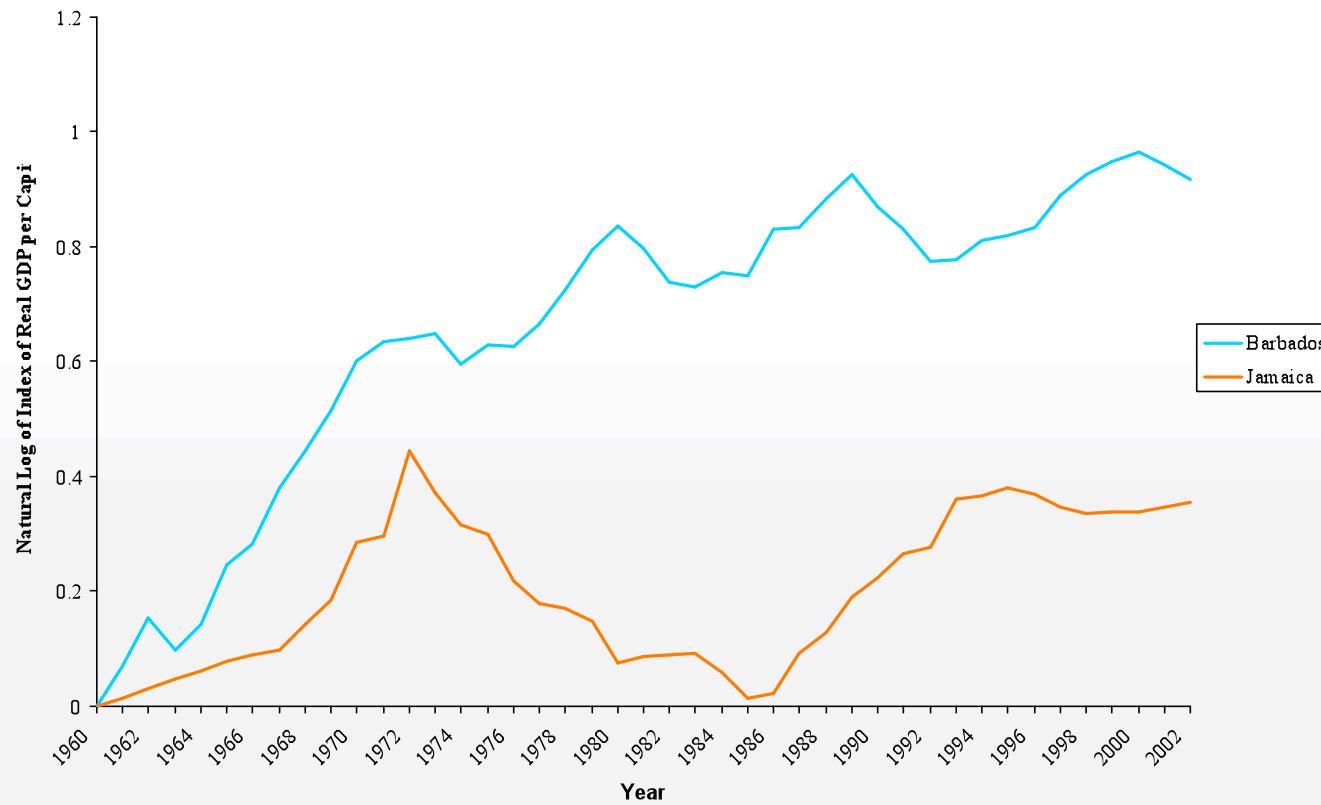
NYU Stern School of Business



Agenda

- A Caribbean Parable
- Macroeconomic Overview of Puerto Rico
- Puerto Rico's Business Environment
- Looking Forward

Figure 1. Standards of Living in Barbados and Jamaica Diverge After Independence.



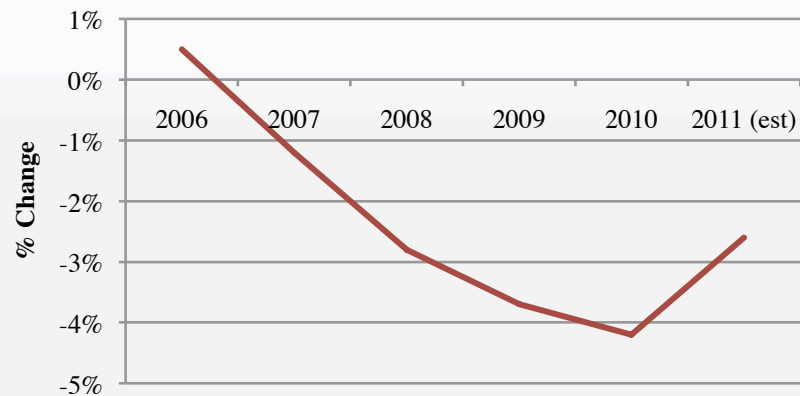
Macroeconomic Performance

- Puerto Rico's economy fell into a recession in 2006 due to domestically-driven factors.
- By 2010, real GDP per capita fell below its 2001 level.
- Real GNP has contracted in parallel and is expected to continue falling in 2011, according to the EIU.

| <i>Average Real GDP Growth 2004-2008</i> | |
|--|-------|
| Puerto Rico | -0.1% |
| Latin America & the Caribbean | 3.4% |
| World | 2.1% |

USDA, 2011

Puerto Rico's Real GNP Growth



EIU, 2011



Macroeconomic Performance, ctd.

- The impetus of Puerto Rico's recession: fiscal woes
 - A close election in 2004 resulted in a two year stalemate over the fiscal budget.
 - In May 2006 government had to shut down for two weeks because it could not meet its payroll obligations.
 - A deal was reached that included the introduction of a sales tax on consumer goods ranging from 5.5 to 7%, further shrinking consumption.
- In 2009, Fortuño's administration inherited a \$3.3 billion deficit and has since worked to lower it by raising fees for students, firing 13,000 public employees, and raising taxes on foreign enterprises.

Puerto Rican Government Development Bank (2011)



The situation is still unstable.

Increased reliance on non-recurring revenue

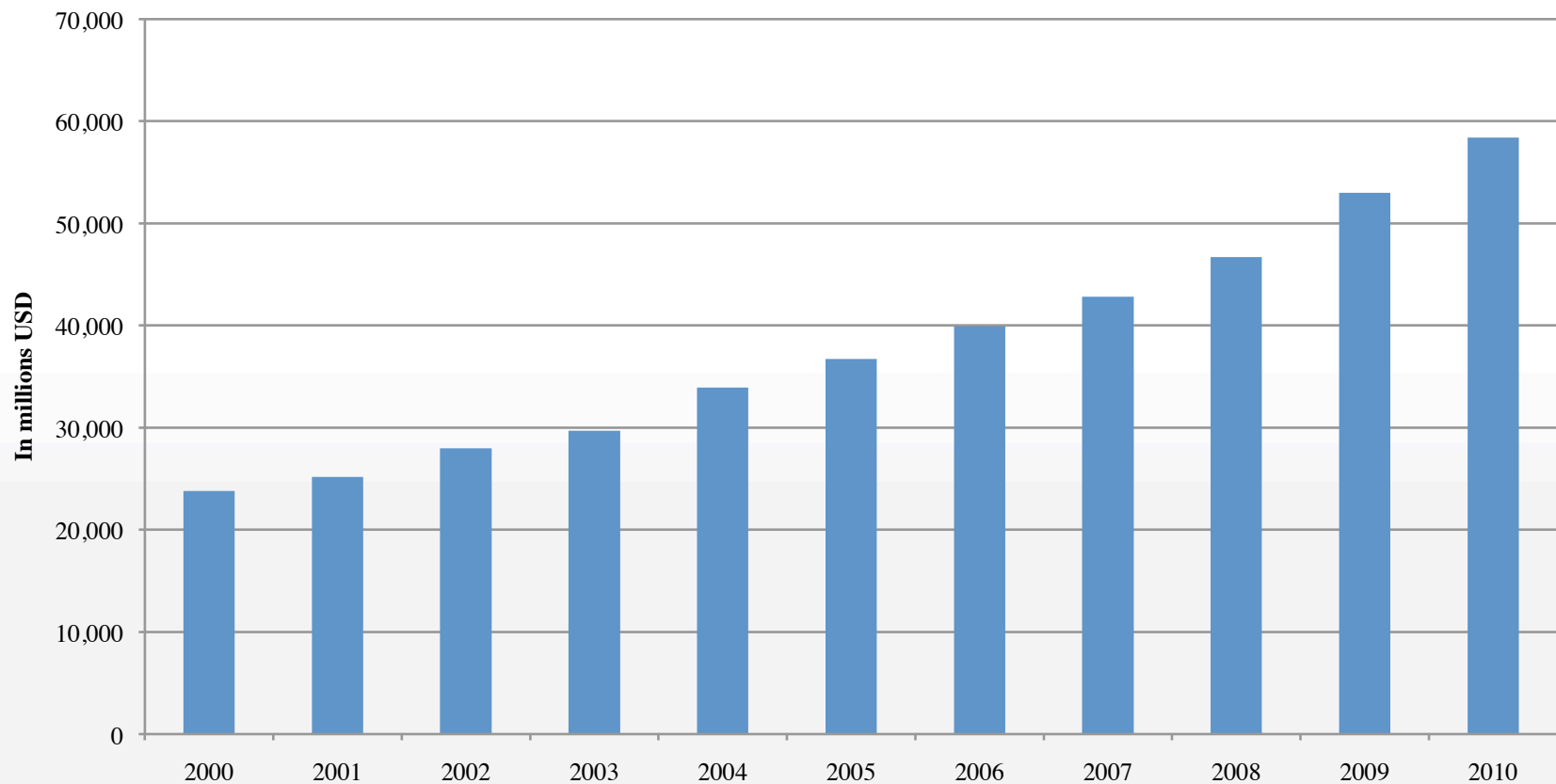
Tax reform

Pension reform

Social Tension: Who will bear the burden?

Rising Debt

Gross Public Debt



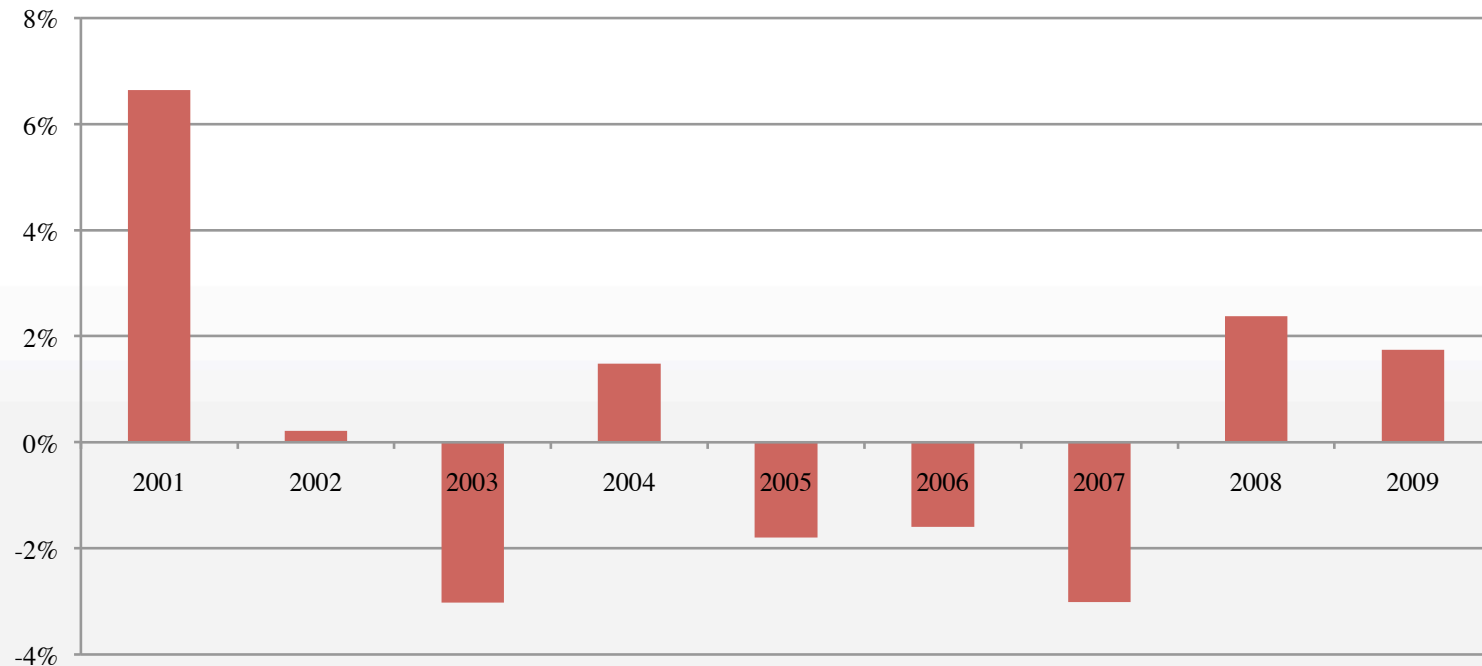


Some of Puerto Rico's problems are cyclical, but there are important structural issues.

Microeconomic institutions play a major role (e.g., labor regulations, the permitting process, and tax administration).

Labor Productivity

Puerto Rico's Change Labor Productivity (%)



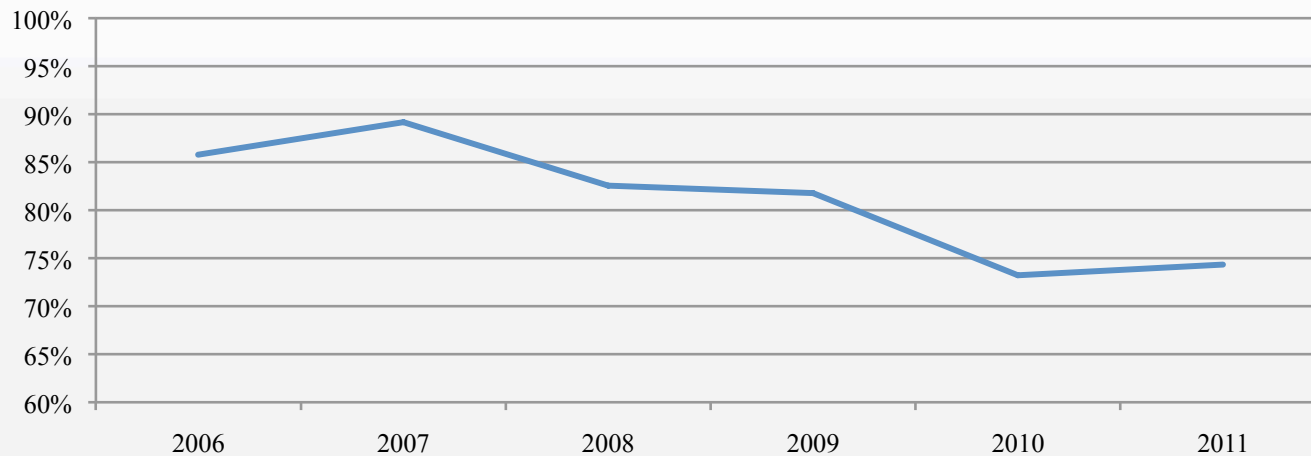
Puerto Rican Government Development Bank (2011)



Doing Business in Puerto Rico

- The World Bank surveys 183 economies' business environments across 9 indicators.
- In 2011, Puerto Rico ranks 47/183 (74th percentile).
- Since 2007, its percentile ranking has slipped.

Puerto Rico's Doing Business Percentile Ranking



World Bank, 2011



Doing Business in Puerto Rico

| Topic Rankings | DB 2010 Rank | DB 2011 Rank | Change in Rank |
|--|--------------|--------------|----------------|
| <i>Starting a Business</i> | 15 | 16 | -1 |
| <i>Dealing with Construction Permits</i> | 150 | 150 | No change |
| <i>Registering Property</i> | 127 | 127 | No change |
| <i>Getting Credit</i> | 30 | 32 | -2 |
| <i>Protecting Investors</i> | 16 | 16 | No change |
| <i>Paying Taxes</i> | 104 | 108 | -4 |
| <i>Trading Across Borders</i> | 106 | 107 | -1 |
| <i>Enforcing Contracts</i> | 100 | 99 | +1 |
| <i>Closing a Business</i> | 30 | 25 | +5 |

Note: There is considerable heterogeneity in the rankings, for instance, the island's peer group in rankings is Luxembourg, Hungary, Armenia, Spain, and Qatar; all with very different business environments.



Key Doing Business Indicators

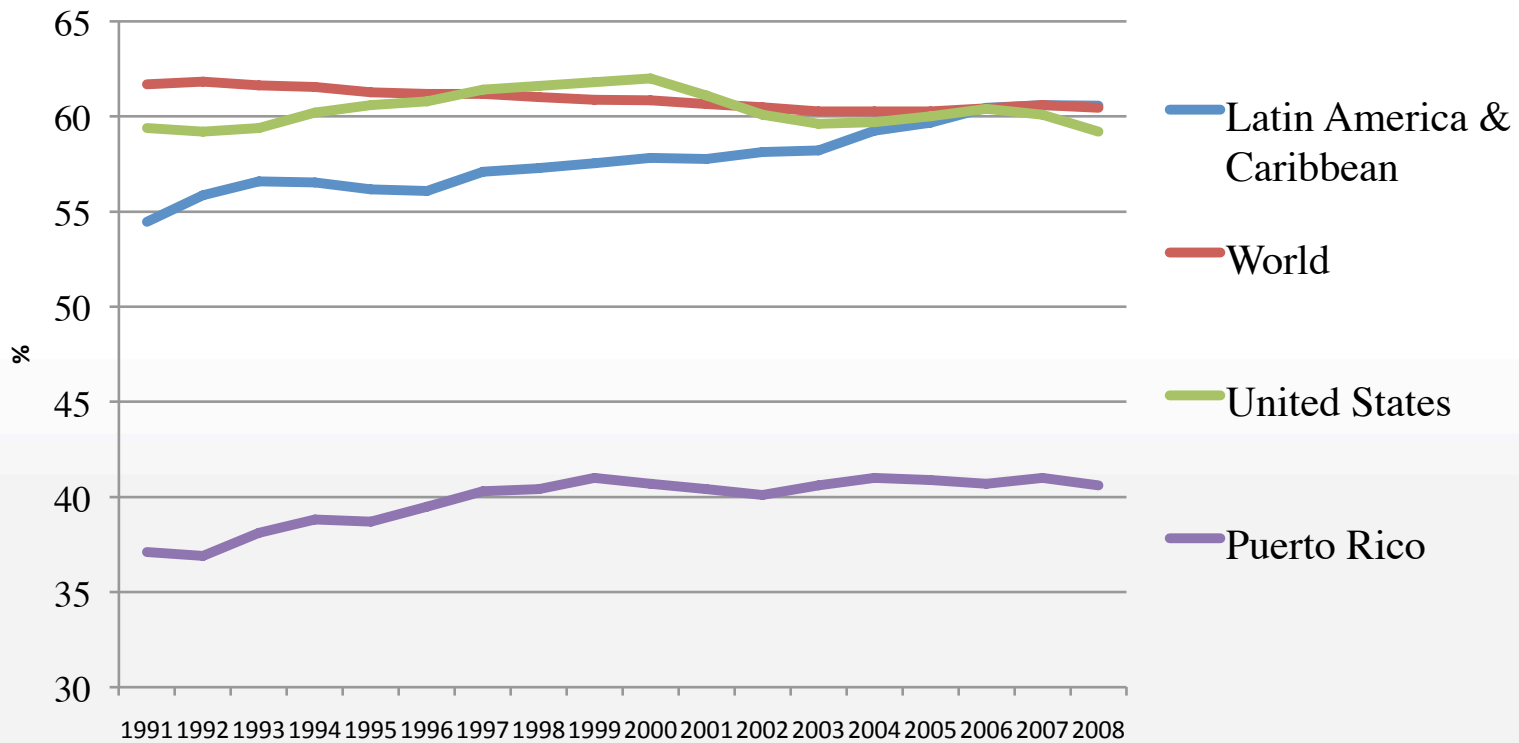
The 1st most cited impediment to doing business in Puerto Rico is an inefficient government bureaucracy.

The 2nd highest is restrictive labor regulations.

Global Competitiveness Report, World Economic Forum (2010-11)

Employment

Employment as % of 15+ Population



World Bank WDI Indicators (2011)

Minimum Wage Law

Under the U.S. Federal Fair Labors Standards Act, Puerto Rican businesses must comply with minimum wage standards, lowering private sector's incentive to launch labor-intensive enterprises to help absorb Puerto Rico's excess labor supply.

| | Minimum Wage | GNP/per capita |
|------------------------|--------------|-----------------|
| Puerto Rico* | \$7.25/hr | \$15,846 (2009) |
| United States Federal* | \$7.25/hr | \$46,360 (2009) |

*There are some exceptions.

Data for GNP (also known as GNI, sourced from World Bank and the Puerto Rican Government Development Bank.



Key Doing Business Indicators

| Dealing with Construction Permits | Puerto Rico | Latin America and the Caribbean |
|-----------------------------------|-----------------------------|---------------------------------|
| <i>Procedures (#)</i> | 22 | 16.6 |
| <i>Time (days)</i> | 209 | 219.9 |
| <i>Cost</i> | 500.4% of income per capita | 191.1% of income per capita |

- Puerto Rico ranks lowest on this measure- 150/183 countries : Reportedly more than 34 public agencies that take part in the permitting process for construction .

| Paying Taxes | Puerto Rico | Latin America and the Caribbean |
|--|-------------|---------------------------------|
| <i>Payments (number per year)</i> | 16 | 33.2 |
| <i>Time (hours per year)</i> | 218 | 384.7 |
| <i>Profit Tax (%)</i> | 26.3 | 20.9 |
| <i>Labor Tax and Contributions (%)</i> | 14.4 | 14.7 |
| <i>Other taxes (%)</i> | 27.0 | 12.4 |
| <i>Total tax rate (% of profit)</i> | 67.7 | 48.0 |

- Tax rates have been identified as a key barrier to Puerto Rico's private sector development in the past.
- Distortionary effect of the Section 936 tax program
- 2011 Developments
 - Cut taxes for resident businesses and households (largest cuts in Puerto Rico's history), reducing tax burden on households by 50 percent and resident businesses by 30 percent.
 - New 4% excise tax on non-resident businesses (i.e. business with headquarters abroad) in 2011 (the tax drops progressively, hitting 1 percent in 2016, its final year of implementation).



ANNUAL
ECONOMIC
CONFERENCE
2011

Concluding Thoughts

There are many viable growth strategies. Puerto Rico needs to figure out what is right given its particular circumstances.

But no growth strategy will work without a willingness to make tough decisions to create an enabling environment.

Thank you.