Puerto Rico Pursues a Pro-Growth Agenda to Tackle Fiscal and Economic Woes

By Douglas Holtz-Eakin

Since 2006, Puerto Rico has suffered one of the worst recessions of its history while simultaneously facing severe fiscal distress. Reforms made by Gov. Luis G. Fortuño, elected in 2008, have controlled the largest proportional deficit among the states. Puerto Rico's pro-growth reform agenda has since been touted as a model for addressing fiscal and economic problems at the state and federal level.

Introduction

Puerto Rico entered what would become a prolonged recession in March 2006, nearly two years before the downturn in the rest of the United States. By the time Fortuño became governor in January 2009, the gross national product was projected to decline 3.4 percent that year and another 2 percent in 2010.[1] In addition to the nation's economic malaise, the territory government was suffering severe budgetary distress.

The onset of the global economic and financial crisis worsened the economic outlook and further jeopardized the territory's fiscal outlook. The island's economy was already in recession, and the territory government had a long record of deficit spending. From 2006 to 2009, Puerto Rico's budgeted operating expenses exceeded the actual revenue collected by more than 50 percent, a gap bigger than any state in the country. The budgetary authority failed to accurately embed the recession in its forecasts and, as a result, consistently overestimated economic growth and tax receipts. The immense structural deficit that developed was disguised with stopgap measures instead of the requisite fundamental reforms.

Following Fortuño's gubernatorial election on a platform of change, the Puerto Rican government began serious economic reforms to address its weak economy and budgetary crisis. These reforms included reducing the government payroll; enacting a flatter, simplified personal income tax code; reducing corporate tax rates to increase competitiveness; cracking down on tax evasion; reforming the unemployment insurance system to incentivize a timely return to employment; taking comprehensive steps to cut waste and streamline government services; and enacting measures to diversify sources of energy. These measures have been controversial at times, but also generally have been supported by economists, who frequently cite the need for comprehensive reform to remedy budgetary problems at the federal level.

Limited Government and Pro-Growth Policies in Puerto Rico

When Fortuño took office, the territory's fiscal situation was precarious. It was running a $3.3 billion budget deficit representing 44 percent of revenues. As a matter of reality, the territory government had very limited options to close the budget gap—reduce outlays, increase revenues or borrow the budgetary deficit. Realistically, the third option was restricted because of previous and imminent downgrades in the Puerto Rican government's credit rating, which stood just one step above junk. Moreover, access to credit markets was limited during the global financial crisis.

Beginning immediately upon taking office, Fortuño acted to stabilize the fiscal emergency and enact pro-growth reforms to bolster the economy. The history of poor forecasts by the Planning Board (the agency tasked with economic planning) had yielded little relationship between budget projections and fiscal and economic reality. The Fortuño administration implemented an aggressive plan in the form of four legislative measures, enforced by the Puerto Rico Fiscal Stabilization and Reconstruction Board, to close the deficit, stabilize the island's finances and boost economic development. First, Puerto Rico, which previously employed a far greater percentage of its population than most states, managed to reduce its payroll costs by 17 percent and transition to 401k plans for all government workers, one of the first states or territories to do so.

Having reduced spending, the government stabilized its finances by improving oversight of the tax system and increasing revenue—without adding economic hardship to businesses or individuals.

To accomplish this, Fortuño pushed for comprehensive, pro-growth tax reform. This reform was one of the most fundamental tenets of Fortuño's overall plan to bring the deficit under control and restart the economy. The previous tax system, which closely mirrored that of the United States federal government, has been replaced by a new code with a top tax rate of 30 percent on household incomes of more than $250,000. This rate is lower than the U.S. federal income tax, nearly every western European country and many Latin American countries. In addition to reducing rates, the code has been simplified through the elimination or scale back of tax expenditures. Tax reform at the individual level achieved two objectives: It reduced the amount of economic activity undertaken for purely tax-based motives, broadened the tax base by eliminating unneeded exemptions and deductions, and used the broader tax base to reduce tax rates and improve incentives. These income tax cuts will provide an estimated average $1.2 billion in tax relief annually by the time of full implementation.

Perhaps more importantly for the overall economy, Puerto Rico also reduced corporate tax rates to increase economic competitiveness, attract jobs and increase revenue. The existing tax rate of 41 percent was among the highest corporate tax rates in the hemisphere. Effective Jan. 1, 2011, the top rate dropped from 41 percent to 30 percent. The previous seven-tier corporate income brackets were simplified into three lower rates of 20, 25 and 30 percent. By 2014, the top bracket will be lowered further to 25 percent.

Several economic studies show that low corporate tax rates create a better business environment for existing companies and startup entities. One study by the Organization for Economic Cooperation and Development found that a 10 percentage point reduction in tax rates results in a 7 percent increase in investment. The same study also estimated that such a reduction increases productivity growth an additional 0.5 percentage points over its trend. These two effects combine to have a powerful impact on productivity, which over long periods is the basic building block of higher standards of living.[2]

Third, the administration embedded a housing initiative within its comprehensive pro-growth strategy. This initiative cut property and capital gains taxes for buyers, sellers and investors and created a new rental initiative, exempting residential rental income from income taxes for 10 years. In 2011, both new home sales and existing home sales increased, a striking contrast to the largely depressed housing market in the rest of the country.

Fourth, to diversify sources of energy, the island's public utility, Puerto Rico Electric Power Authority (PREPA), is expanding its liquefied natural gas terminal capacity while expanding its natural gas distribution pipelines. With around two-thirds of its energy coming from oil, the government recognized the value of diversifying away from increasingly volatile oil prices, which left the bulk of the island's energy needs at the mercy of global economic conditions.

The combination of dramatically cutting the size of the government workforce, moving employees to a defined contribution pension plan, turning over toll roads and airport to private operators and taking steps to diversify its sources of energy sends a message from Puerto Rico to would-be investors and businesses that the island has permanently changed to be more business-friendly. The reforms were undertaken not only to reduce the massive budgetary deficit, but also to promote economic growth simultaneously.

Result of Reforms: Puerto Rico's Fiscal and Economic Rebound

In the recession, Puerto Rico's economic output fell by more than 10 percent from peak to trough in 2010, a decline that more than offset previous growth that decade. The Puerto Rican economy, however, has largely stabilized and showed positive growth in the final months of 2011.

In December 2011, Puerto Rico's Economic Activity Index registered its first positive year-over-year growth since March 2006, at 0.5 percent.[3] After five years of negative GNP growth, the economy is expected to grow in 2012, albeit at a modest 0.7 percent rate. The unemployment rate, which reached a peak of 16.6 percent in May 2010, fell to 15.1 percent by the beginning of 2012.[4] This marks a more than 9 percent decrease in the number of unemployed Puerto Ricans since May 2010.

A total of 14,716 new corporations were created in 2011, reflecting a 14 percent increase compared to 2010. The reduced rates in the corporate tax code were just one piece of a comprehensive plan to make Puerto Rico a more business friendly environment.

While the Puerto Rican economy remains far from its potential, it is showing broad indications of an upturn.

The fiscal situation also has stabilized. The budget deficit of $3.3 billion when Fortuño took office has been reduced from 44 percent of revenues to 7 percent. The deficit has shrunk from $3.3 billion to $610 million, and the island is on track to close the budget gap next fiscal year. Originally ranked last among the states for having the highest proportional deficit, Puerto Rico is now ranked number 15.

Despite reductions in tax rates, general fund net revenues actually increased in 2011 due to the positive effects of tax reform. General fund net revenues increased by 12 percent, from $6.9 billion in 2010 to $7.7 billion in 2011, one sign that the fundamental tax reforms initiated and passed by Fortuño elicited the desired results.

Both Moody's and Standard and Poor's ratings agencies released improved credit ratings for Puerto Rico, noting their positive outlook for Puerto Rico's credit and economic performance. Moody's raised Puerto Rico's credit rating from Baa3 to Baa1, up two notches, while Standard and Poor's upgraded Puerto Rico from BBB- to BBB, the first credit rating upgrade by S&P in the U.S. since 2009.

The Puerto Rican economy remains below full potential. Nevertheless, the reforms the government passed have put the territory government on a more fiscally sustainable path moving forward and made Puerto Rico more economically competitive. While unemployment is still far too high, the governor's economic and fiscal plans have laid the groundwork for economic growth. Its reforms have essentially averted near disaster and the credit upgrades are a good indication of its improved standing and positive economic and fiscal outlook moving forward.

Notes

[1] Puerto Rico Planning Board, "Press Release: The Board Revises Economic Figures for Fiscal Year 2008 and Updates Forecasts for Fiscal Years 2009 and 2010" (2009), at: *http://www.gdb-pur.com/communications/PressReleases/2009-02-10-ComunicadoJP-ing.pdf*.

[2] Jens Arnold and Cyrille Schwellnus, "Do corporate taxes reduce productivity and investment at the firm level? Cross-country evidence from the Amadeus dataset" (2008), OECD Economics Department Working Paper No. 641, September 30, 2008, at: *http://www.cepii.fr/anglaisgraph/workpap/summaries/2008/wp08-19.htm*.

[3] Government Development Bank for Puerto Rico, "Economic Activity Index for the month of December 2011," (2012),at:*http://www.gdb-pur.com/documents/2011-12-GDB-EAI-FINAL-GS.pdf*.

About the Author

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