



CENTRO PARA RENOVACIÓN ECONÓMICA,  
CRECIMIENTO Y EXCELENCIA

# PUERTO RICO

ECONOMIC  
➤ FREEDOM  
INDEX



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## ECONOMIC FREEDOM INDEX FOR PUERTO RICO

Centro para Renovación Económica, Crecimiento y Excelencia (Center for Economic Renewal, Excellence and Growth) is a non-partisan, non-profit organization in Puerto Rico that cultivates pro-market solutions to foster self-reliance and growth.

Inteligencia Económica Inc. is a Puerto Rican consulting firm that specializes in the preparation of economic studies and analysis for local and international businesses.

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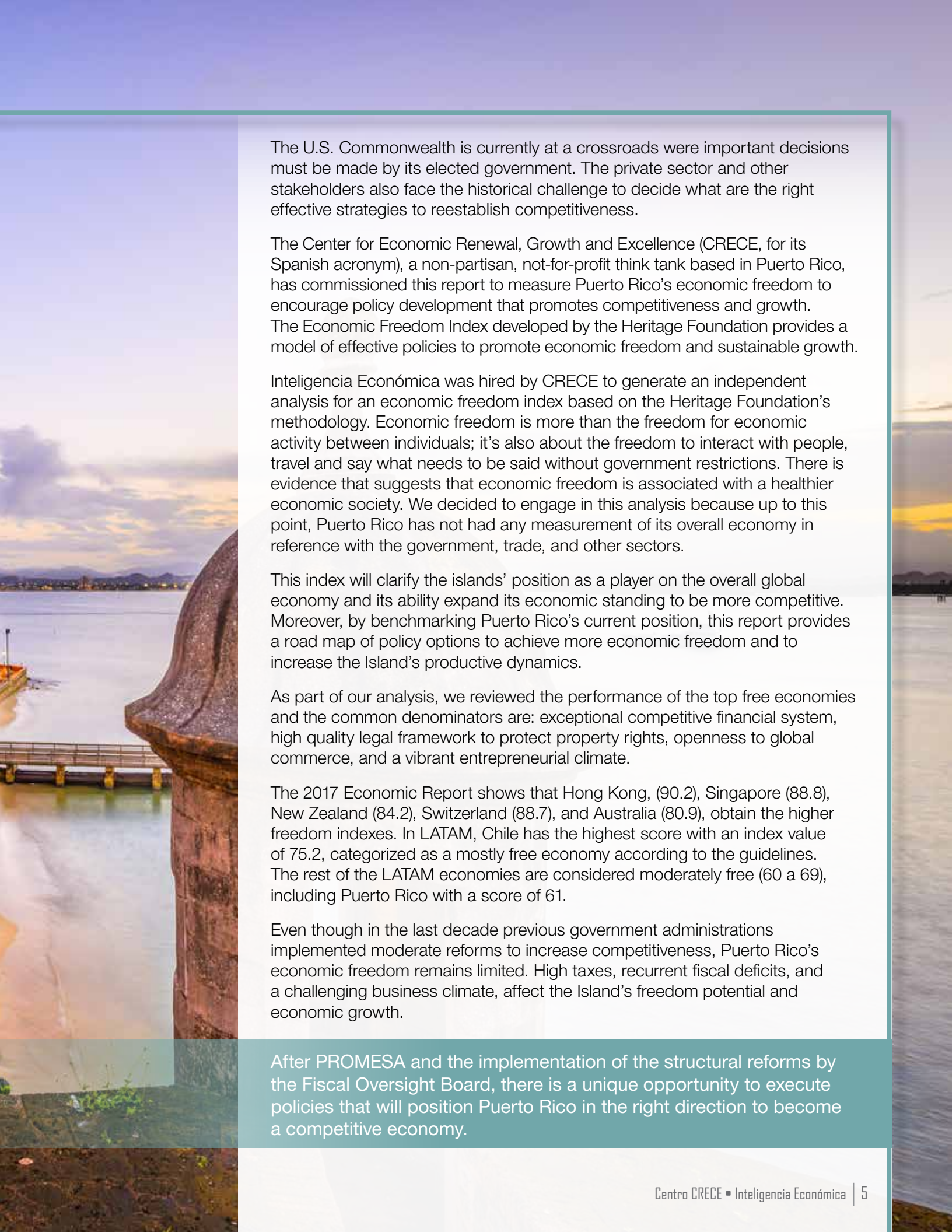
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# INTRODUCTION

**TWELVE YEARS** after Puerto Rico's worst economic crisis began, the private sector struggles to survive in a challenging economic environment. The commonwealth is the only federal jurisdiction that remains in contraction ten years after the mainland financial crisis of 2008. Since then, several government administrations have unsuccessfully implemented policies to reestablish economic growth. There is a consensus among local economists that Puerto Rico's crisis is strongly tied to an obsolete economic model developed during the 1940's, known as "Operation Bootstrap".



The U.S. Commonwealth is currently at a crossroads where important decisions must be made by its elected government. The private sector and other stakeholders also face the historical challenge to decide what are the right effective strategies to reestablish competitiveness.

The Center for Economic Renewal, Growth and Excellence (CRECE, for its Spanish acronym), a non-partisan, not-for-profit think tank based in Puerto Rico, has commissioned this report to measure Puerto Rico's economic freedom to encourage policy development that promotes competitiveness and growth. The Economic Freedom Index developed by the Heritage Foundation provides a model of effective policies to promote economic freedom and sustainable growth.

Inteligencia Económica was hired by CRECE to generate an independent analysis for an economic freedom index based on the Heritage Foundation's methodology. Economic freedom is more than the freedom for economic activity between individuals; it's also about the freedom to interact with people, travel and say what needs to be said without government restrictions. There is evidence that suggests that economic freedom is associated with a healthier economic society. We decided to engage in this analysis because up to this point, Puerto Rico has not had any measurement of its overall economy in reference with the government, trade, and other sectors.

This index will clarify the islands' position as a player on the overall global economy and its ability to expand its economic standing to be more competitive. Moreover, by benchmarking Puerto Rico's current position, this report provides a road map of policy options to achieve more economic freedom and to increase the Island's productive dynamics.

As part of our analysis, we reviewed the performance of the top free economies and the common denominators are: exceptional competitive financial system, high quality legal framework to protect property rights, openness to global commerce, and a vibrant entrepreneurial climate.

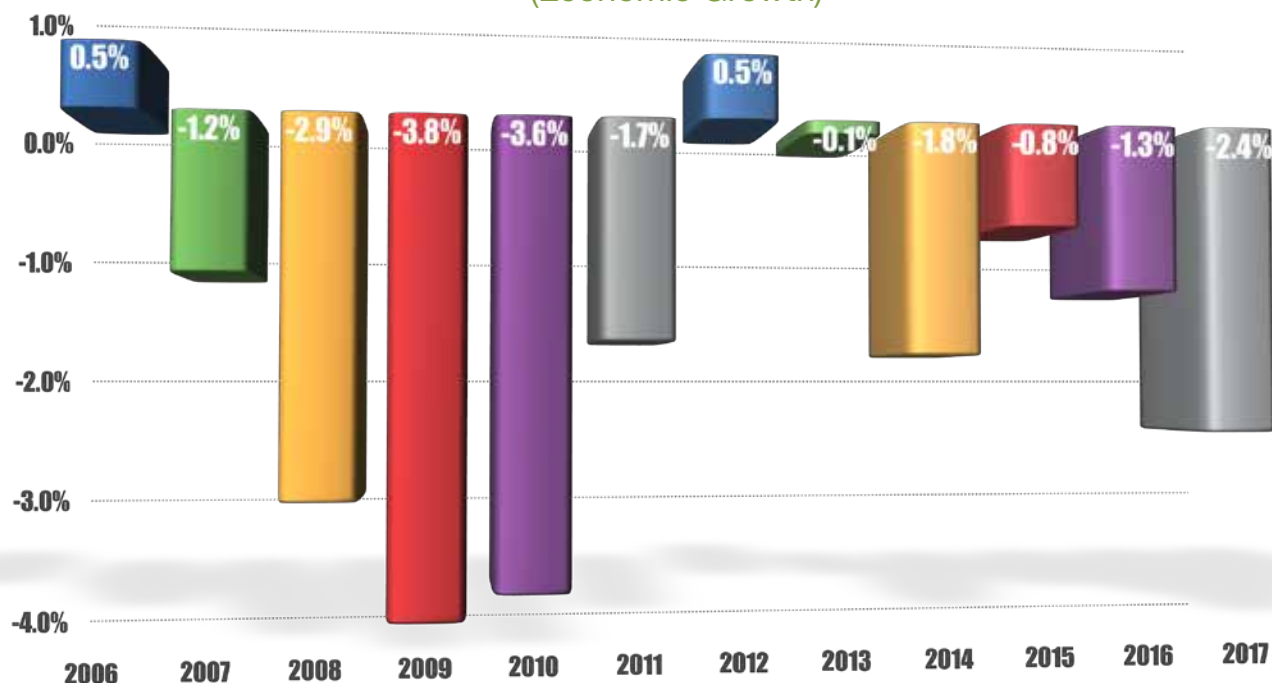
The 2017 Economic Report shows that Hong Kong (90.2), Singapore (88.8), New Zealand (84.2), Switzerland (88.7), and Australia (80.9), obtain the higher freedom indexes. In LATAM, Chile has the highest score with an index value of 75.2, categorized as a mostly free economy according to the guidelines. The rest of the LATAM economies are considered moderately free (60 a 69), including Puerto Rico with a score of 61.

Even though in the last decade previous government administrations implemented moderate reforms to increase competitiveness, Puerto Rico's economic freedom remains limited. High taxes, recurrent fiscal deficits, and a challenging business climate, affect the Island's freedom potential and economic growth.

After PROMESA and the implementation of the structural reforms by the Fiscal Oversight Board, there is a unique opportunity to execute policies that will position Puerto Rico in the right direction to become a competitive economy.

# PUERTO RICO'S ECONOMIC CONTEXT

**Gross National Product  
(Economic Growth)**



*Source: Statistical Appendix 2017. Data refers to fiscal years.*

**THE COMMONWEALTH OF PUERTO RICO** is an unincorporated territory of the United States since 1898 when it was acquired from the Spanish government after the U.S. defeated Spain in the Spanish-American War. Puerto Ricans have American citizenship by birth, but do not have voting power in Congress as do citizens living on the mainland. Nonetheless, Puerto Rico has its own Constitution, similar to those in the fifty states, and is under the jurisdiction of the federal U.S. government. Overall, Puerto Rico is intrinsically linked to the U.S. historically, politically and economically.

The Puerto Rican economy has been in and out of recession since 2006 when the full effects of free trade agreements entered by the U.S. with countries in the region affected the island's competitiveness and, an exemption for manufacturers in the island under Section 936 of the IRS Code expired. In 2009 and 2010, the economy went through its worst period with dips of -3.8%, and -3.6% due to its close ties with the U.S. economy and the financial crisis of 2008. The following years it saw an increase in output, partly due to \$7 billion in transfers of federal funds under the American Recovery and Reinvestment Act (ARRA) of 2009, and the implementation of local fiscal and economic policies. However, starting in 2013, the economy slipped into a recession again. Since 2006, the real GNP has shrunk over 14%.

In February 2014, Puerto Rico's access to capital markets was closed after its credit was downgraded to "junk". In 2015, Puerto Rico's agencies defaulted with investors, followed by a government default in 2016. Due to the island's continuous fiscal problems and its underperforming economy, Congress enacted the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA) and created the Fiscal Oversight and Management Board of Puerto Rico (FOMB).

The Oversight & Management Board is tasked with restructuring Puerto Rico's debt and achieving fiscal balance to regain access to capital markets. Nevertheless, the island declared bankruptcy under Title III of PROMESA in May 2017.

In September 2017, just months after the certification of the first Fiscal Plan by the FOMB and bankruptcy, hurricanes Irma and Maria struck the Island, causing devastation and altering Puerto Rico's macroeconomic reality.

The destruction caused by Maria moved Congress to act and transfer federal funds to alleviate the economic struggles of the island. The income transfers are for government operations, investment in infrastructure and more. It is still unclear how much and when the government will receive these funds, which are estimated at about \$48 billion in total.

Puerto Rico's ongoing fiscal crisis has done a great deal to accelerate the discussion of possible solutions to its economic woes. There is a strong consensus among economists and social scientists that one important issue in Puerto Rico is the size of the private sector.

Currently, the private sector on the island represents 75.4% of total employment, the lowest percent when compared to other states like Mississippi (79.1%), Florida (87.4%), and Louisiana (83.7%). Yet, this sector creates over 92% of all production.

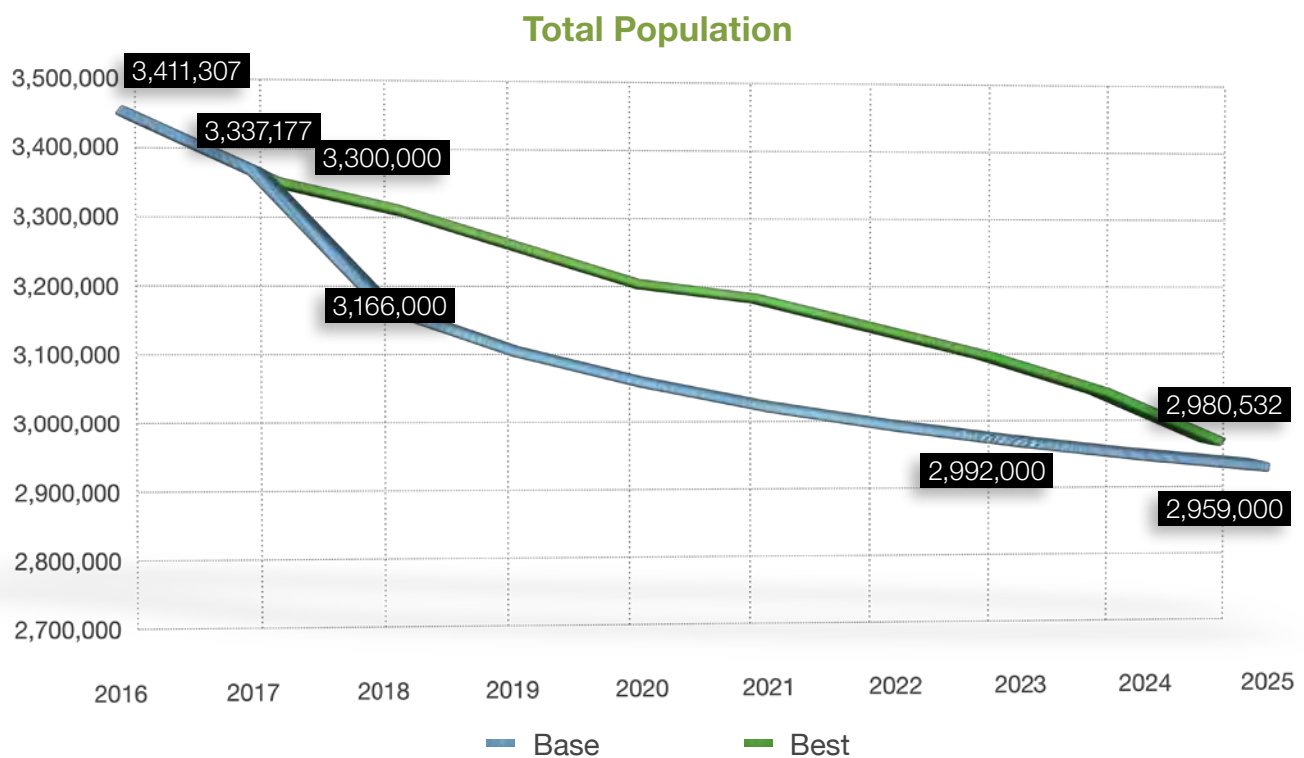
The private sector on the island is heavily dependent on the government for either federal transfers, consumption or investment. New tendencies have changed the culture, but it is still an uphill battle. The government is trying to improve the means of doing business on the island to attract investment. There is, however, no consensus on how to go about creating the conditions necessary for the private sector to thrive in.



## ➤ POPULATION

The population in Puerto Rico continues to drop. According to the US Census Bureau, in 2017 total population was 3,337,177, almost half a million less than a decade before. Following those US Census metrics, both hurricanes struck the island and population estimates are much lower than those reported in 2017.

The exodus of Puerto Ricans changed the demographic characteristics of the island. The new demographic profile of the Puerto Rican who remains on the island is that of a person of greater age, with less purchasing power, and dependent on the government - either for pension payments, retirement, or federal transfers. This changes the patterns of consumption and business activities.



Source: Statistical Institute of PR; Fiscal Oversight Board. Data refers to fiscal years.

While net migration is a large driver of population change in the short term, this factor is volatile: in the long run, net migration is projected to return to more balanced trends.

Population is set to decrease to 2.98 million in FY2025 under a best-case scenario, while in a base-case scenario population is set to reach less than 3 million in FY2023. Population decrease brings with it negative effects including serious labor shortages, brain drain, disproportionate aging, gender inequality, crime, and more.

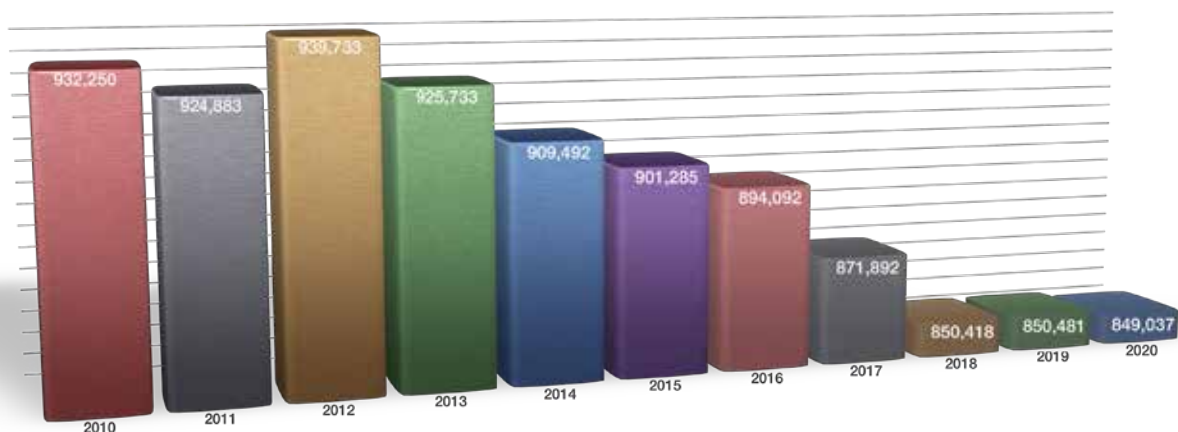
Many of these problems are reflected in the ongoing economic challenges of the island.

**Population control is a priority because no economy can expand while losing a high percentage of its population each year.**

## ➤ EMPLOYMENT AND INCOME

Employment has decreased significantly as a result of the ongoing recession. Migration has also contributed to employment reduction; many people have left the island in search of a better living wage or a better quality of life. Following the 2017 hurricane, which prompted many to migrate to the mainland, employment fell over 25,000 jobs in a month, and has not picked up since then. Projections situate nonfarm employment below the 850,000 when the number reached over 1.2 million in 2000.

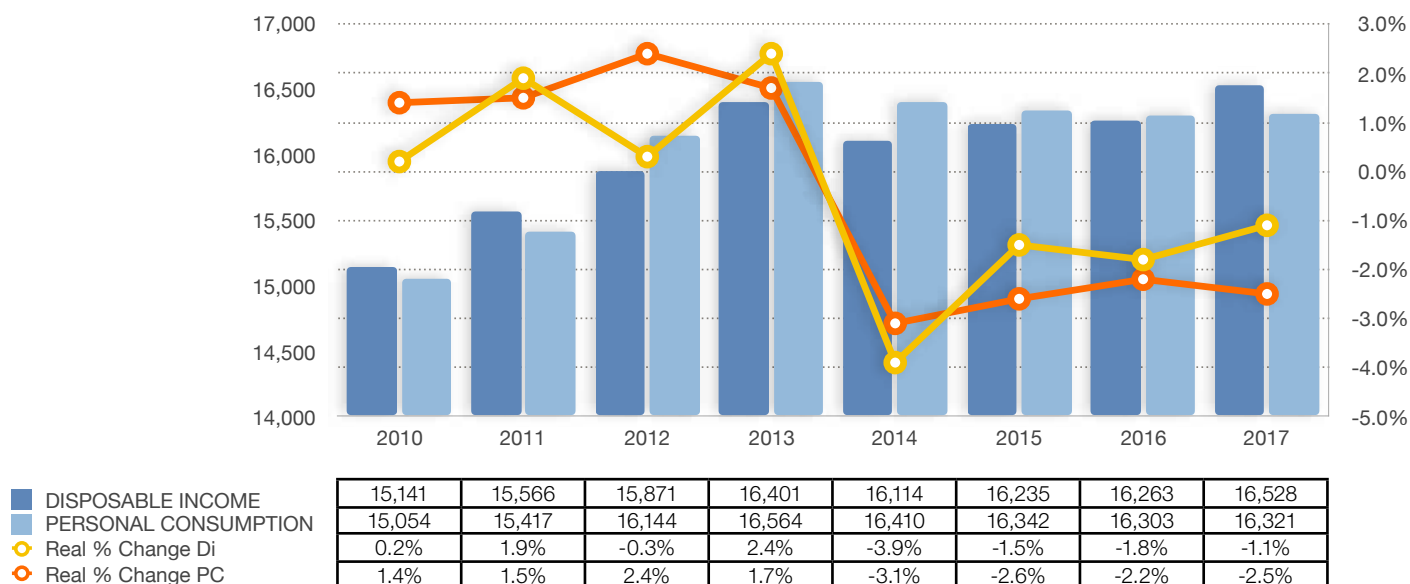
### Total Nonfarm Payroll



Source: Department of Labor, Projections by Inteligencia Económica. Data refers to fiscal years.

On the other hand, personal income and consumption had been increasing at a slow rate until 2014, when both real income and consumption began to decrease significantly in consecutive years for the first time.

### Personal Disposable Income and Consumption Per cápita % Change in Real Terms



Source: Statistical Appendix 2017

# THE FOMB AND STRUCTURAL REFORMS FOR PUERTO RICO

ON JULY OF 2016, President Barack Obama signed into law PROMESA, imposing a Fiscal Oversight and Management Board (FOMB) over the Commonwealth of Puerto Rico as a mechanism to reestablish fiscal responsibility and restructure a public debt of \$70 billion. After a decade of failed economic policies and fiscal mismanagement, Congress exercised its constitutional powers over the territorial government by authorizing the creation of a financial oversight entity with extraordinary powers.

Since then, the FOMB, composed by seven members, has been implementing fiscal control initiatives and enforcing a debt restructuring process leveraging on the legal framework provided by PROMESA.

Title III and VI of PROMESA provide the mechanism to conduct negotiations between the different commonwealth debt issuers and creditors. Also, Title II of PROMESA mandates that a Fiscal Plan must be prepared by the territorial government as a comprehensive program of fiscal and economic policies and strategies to achieve balanced budget.

Nevertheless, the most important component of the Fiscal Plan certified by the FOMB in October of 2018, is the program of structural reforms that the territorial government must implement as a requirement to achieve economic growth. Though PROMESA does not require the development of an economic plan, the FOMB and the territorial government decided to include specific reforms aimed to boost economic growth in the certified Fiscal Plan.

Some of these reforms, once implemented, could increase the level of economic freedom in Puerto Rico, according to the analysis presented in this report. The tax, fiscal, welfare, and labor reforms, are key areas that the FOMB and the territorial government have agreed to implement as part of the Fiscal Plan adopted. The next five years will be crucial to the local economy, and the successful implementation of adequate structural reforms will determine not only the Island's short-term recovery prospects, but its long-term economic sustainability.

## ➤ TAX REFORM

To manage the structural deficits over the last decade, different taxes and tax hikes have been implemented with an aggregate impact of \$15 billion. On November 2018, the administration passed a limited tax reduction that will lower the annual tax burden \$300 million over the next five years. This represents an average of \$0.16 for every \$1.00 generated in the formal economy. This does not include municipal taxes which yield an additional \$1 billion annually.

The tax package includes the reduction of corporate tax rates from 39% to 37% and a 5% tax credit for individuals. Nevertheless, tax rates remain at the current level. It also proposes the elimination of the 4% business to business sales tax for all corporations with revenues below \$200,000 and includes the reduction of the sales tax on processed foods from 11.5% to 7%.

## ➤ FISCAL REFORM

The Fiscal Plan's main objective is to reduce spending levels and achieve a balanced budget by fiscal year 2023. Fiscal measures being implemented are expected to generate \$12.4 billion through savings and extra-revenue.

The inventory tax is still under debate at the legislative level since it was not included in the tax reform package. While mayors do not want to eliminate the tax, the FOMB recognizes the burdens this tax imposes on businesses, as illustrated after hurricane Maria struck the island, when businesses lacked sufficient inventory in stock due to the tax.



## ➤ LABOR REFORM:

On January 26, 2017, the Governor of Puerto Rico, Hon. Ricardo Rosselló, signed into law the Labor Transformation and Flexibility Act ("LTFA"). The amendments provide flexibility to Puerto Rico's labor market as one of the structural reforms to promote economic growth.

### **Employment contracts.**

Establishes an automatic probationary period (a contract is no longer required) of 9 months for non-exempt employees, and 12 months for those classified as executives, administrators and professionals under the Fair Labor Standards Act; allows new temporary employment contracts to be verbal, and no longer requires that the purpose for the temporary contract be of a temporary nature; reduces from 3 to 1 year the statute of limitations for contractual or statutory compensation claims arising after the enactment of the LTFA;

### **Overtime.**

For employees hired after the enactment of the LTFA, sets a uniform overtime rate of 1.5 times the regular rate of pay for daily and weekly overtime, and for work performed on the 7th consecutive day of work. For all employees, eliminates technical overtime by redefining the regular workday on the basis of 8 hours on a natural day rather than rolling 24-hour periods, allows a compressed work week of work days of up to 10 hours without incurring in daily overtime; allows employees to make-up lost hours of work within a week without incurring in daily overtime if the work day does not exceed 12 hours and the work week does not exceed 40 hours;

### **Vacation and sick leave.**

For employees hired after the enactment of the LTFA, increases from 115 to 130 the monthly minimum hours of work required to accrue vacation and sick leave; reduces vacation accrual from 1.25 to 0.5 days per month during the first year of employment, progressively increasing it with tenure up to 1.25 days per month after fifteen (15) years of employment; creates lower accrual rates for employers with 12 employees or less; excludes tips and service charges from the computation of the rate at which leave is paid. Sick leave accrual remains at 1 day per month, regardless of number of employees.

### **Year-end bonus.**

For employees hired after its enactment, the LTFA increases from 700 to 1,350 the minimum number of hours required to qualify for the bonus and reduces the bonus to a uniform 2% of salaries, retaining the current maximum of \$600 for employers with more than 20 employees and \$300 for the smaller employers; new employees will receive only 50% of the bonus during their first year. The LTFA changes the payment date and allow more flexibility to credit prior bonuses against the statutory bonus.

**Termination.**

For employees hired after the enactment of the LFTA, reduces the discharge indemnity and caps it at 9 months of salary. For all employees, it eliminates the presumption that all unjustified terminations are discriminatory and reduces the statute of limitations to file a wrongful termination claim from 3 to one 1 years. It exempts severance pays from taxation up to the amount of the wrongful termination indemnity; in discrimination and retaliation cases, caps compensatory (non-economic) damages based on number of employees. Allows employers to preferentially recall laid off employees on the basis better performance or disciplinary history, in addition to the seniority and productivity criteria allowed until now.

**Closing law.**

The LTFA repealed the Puerto Rico Law to Regulate the Operation of Commercial Establishments (also known as “the Closing Law”), under which certain establishments had to remained closed during certain holidays and from 5:00 to 11:00 a.m. on Sundays and pay a special rate for Sunday work. However, all those commercial establishments that were required by the Closing Law to remain closed during Good Friday and Easter Sunday must remain closed on those days.

## ➤ EASE OF DOING BUSINESS REFORM

Promoting the ease of doing business is a key component of Puerto Rico's new path to economic recovery. Some of the reforms that need to be implemented include improving construction permitting, streamlining the process for business permitting, and registrations by creating a simpler and digitized one-stop-shop system for business processes. Also, Puerto Rico must improve the ease of registering property, and paying taxes.



## OTHER POLICY RECOMMENDATIONS

### ➤ GOVERNMENT INTEGRITY

- Paying public servants well
- Creating transparency and openness in government spending
- Cutting red tape
- Replacing regressive and distorting subsidies with targeted cash transfers
- Optimizing use technology in government processes

### ➤ JUDICIAL INTEGRITY

- Strengthening internal oversight within the judiciary
- Modernizing of the court management systems
- Facilitating disclosure of information and public monitoring trials
- Creating a nonpartisan system to select judges and prosecutors

### ➤ TRADE FREEDOM – REPEAL OF THE CABOTAGE LAWS

Hurricane Maria revealed how dependent Puerto Rico is to imports of final goods and raw materials. Since 1917, the Jones Act imposed that all maritime transportation from the U.S. mainland must be conducted by U.S. vessels. This statute is highly restrictive and costly to local importers - who depend on three shipping vessels to transport \$24,589 million in goods from the U.S. mainland (2017), representing 53.2% of total imports.

The repeal of the Jones Act could be an important enabler of trade freedom.

Moreover, the scope of reforms is limited by the island's political relationship with the US and the unwillingness of the population to tolerate further austerity after many years of recession.

The Economic Freedom Index intends to give an accurate estimate of the economic freedom of Puerto Rico based on specific factors. It is a useful tool to determine economic policies geared to help individuals achieve their goals and to promote free enterprise. Therefore, it is a vital tool to promote growth and prosperity.

## PUERTO RICO ECONOMIC FREEDOM INDEX SUMMARY

**IN THIS STUDY,** we apply the methodology of the *Economic Freedom Index* developed by The Heritage Foundation to determine Puerto Rico's own Economic Freedom Index.

The index focuses on four key aspects of the economic environment, where government usually exercises policy control (rule of law, government size, regulatory efficiency, and market openness).

The index measures 12 specific components, each of which is graded on a scale from 0 to 100. The analysis presents a short overview of Puerto Rico's economic performance, as well as the methodology and procedures executed to obtain each score component for the economic index.

### Puerto Rico Economic Freedom Index Summary Table

DESCRIPTION	SCORE
Property Rights	50
Judicial Effectiveness	50
Government Integrity	41.8
Tax Burden	61
Government Spending	31
Fiscal Health	71.3
Business Freedom	62
Labor Freedom	63
Monetary Freedom	77
Trade Freedom	80
Investment Freedom	70
Financial Freedom	70

*The final scores for each component are detailed below.*

# ECONOMIC FREEDOM INDEX

In this section, we analyze each economic freedom component as well as its methodology. Components are graded on a scale from 0 to 100.

Each section will present the final score for each component as well as a brief explanation of the result.

## METHODOLOGY

**OUR BASIS** for this analysis was CRECE's 2016 Puerto Rico Economic Freedom Index report and the Heritage Foundation's methodology.

CRECE's report for the 2016 EFI included all major categories and most sub-categories. This edition broadens the sub-categories. In addition, an analysis with improved precision in some categories was achieved.

To have access to the sub-indexes, we investigated online sources that include the World Bank, the World Economic Forum and the Puerto Rico Statistics Institute.

A direct comparison of this report and the 2016 edition is not recommended, as this one expands on other sub-indexes that were not included in the previous report. However, we do encourage a review of the previous report as a stepping stone to understand Puerto Rico's unique circumstances.



## I. RULE OF LAW

**RULE OF LAW** is a principle under which all individuals, institutions, and entities are accountable to the laws of the land. Each jurisdiction differs in laws, legislation processes, and government organization. However, the index determines key factors that allow for its analysis: property rights, judicial effectiveness, and government integrity.

Property Rights	50
Judicial Effectiveness	50
Government Integrity	41.8

### ➤ PROPERTY RIGHTS

“The property rights component assesses the extent to which a country’s legal framework allows individuals to accumulate private property freely, secured by clear laws that the government enforces effectively. Relying on a mix of survey data and independent assessments, it provides a quantifiable measure of the degree to which a country’s laws protect private property rights and the extent to which those laws are respected. It also assesses the likelihood that private property will be expropriated by the state.” (Heritage, 2018)

To develop a score for this component we averaged the scores for the following sub-factors, all of which are weighted equally. To develop the index, we only found 2 out of 5 sub-factors: strength of investor protection and risk of expropriation. The three missing sub-factors are: physical property rights, intellectual property rights and quality of land administration. We consider that the two sub-factors found are suitable to construct a reliable score for the island.

The scores for the two sub-factors are:

Sub-factor	Score
Strength of investor protection	70
Risk of expropriation	43

Each of these sub-factors is derived from numerical data sets that are normalized for comparative purposes using the following equation:

$$\text{Sub-factor Score } i = 100 \times (\text{Sub-factorMax} - \text{Sub-factor } i) / (\text{Sub-factorMax} - \text{Sub-factorMin})$$

Thus, the final score for the property rights factor in Puerto Rico is 50, similar to countries such as the Dominican Republic, Barbados, and Greece, among others. The score places Puerto Rico in the lower end of the list, however, it is our understanding in the overall data, that Puerto Rico does have efficient property rights and should be compared, or at least situated in the same range as the United States (79.3). The lack of data influences the result of this component and is considered skewed.

## OVERVIEW ON PROPERTY RIGHTS IN PUERTO RICO:

Puerto Rico's Constitution states "No person shall be deprived of their freedom or property without due process of law, the right to education is recognized as the fundamental right of a human being to life, freedom and the enjoyment of property". Therefore, despite the property rights score, the island's laws prevent the risk of expropriation and protects an individual's property rights.

The challenge with property rights on the island is the recording process at the Puerto Rico Property Registry. The Registry, which ensures the validity of registration and preserves property rights as a benefit, has a long filing and deed review process.

The FOMB has stated that a reform of the Property Registry is one of its priorities to improve the ease of doing business in Puerto Rico. More specifically, they have stated their goal is to: "Improve ease of registering a property. Streamline and digitalize the property registry system to reduce delays from the Property Registry Agency. Also, improve geographic coverage and transparency of information on the registry system."<sup>1</sup>

## > GOVERNMENT INTEGRITY

"Corruption erodes economic freedom by introducing insecurity and coercion into economic relations. The systemic corruption of government institutions and decision-making by such practices as bribery, extortion, nepotism, cronyism, patronage, embezzlement, and graft are the greatest concern. The lack of government integrity caused by such practices reduces economic vitality by increasing costs and shifting resources into unproductive lobbying activities" (Heritage, 2018).

In the case of Government Integrity, The Heritage Foundation defines this component based on 6 sub-factors. Only 4 sub-factors were found, which are:

Sub-factor	Score
Freedom from corruption	63
Public trust in Politicians	31.9
Irregular Payments and Bribes	47
Transparency of government policymaking	40

Each of these sub-factors is derived from numerical data sets that are normalized for comparative purposes using the following equation:

$$\text{Sub-factor Score } i = 100 \times (\text{Sub-factorMax} - \text{Sub-factor } i) / (\text{Sub-factorMax} - \text{Sub-factorMin})$$

The score for Government Integrity is **41.8**, similar to Armenia, Belarus, Cyprus, and Croatia, among others. This score is relatively low. Therefore, we can presume that corruption is present in Puerto Rico. The higher the level of corruption, the lower the level of economic freedom.

<sup>1</sup> Restoring Growth and Prosperity. New Fiscal Plan for Puerto Rico. Draft October 21, 2018. Published October 23, 2018. Pg. 55

## ➤ JUDICIAL EFFECTIVENESS

“Well-functioning legal frameworks are essential for protecting the rights of all citizens against unlawful acts by others, including by governments and powerful private parties. Judicial effectiveness requires efficient and fair judicial systems to ensure that laws are fully respected, with appropriate legal actions taken against violations.” (Heritage, 2018)

The Heritage Foundation defines this component based on 3 sub-factors. Of the 3 sub-factors, the following 2 were found:

Sub-factor	Score
Judicial Independence	45
Enforcing Contracts	54.4

In this case, the enforcing contracts sub-factor from the *World Bank's Doing Business Report* was used instead of quality of the judicial process, which is the specific sub-factor used by the Heritage Foundation in its methodology<sup>2</sup>. Each of these sub-factors is derived from numerical data sets that are normalized for comparative purposes using the following equation:

$$\text{Sub-factor Score } i = 100 \times (\text{Sub-factorMax} - \text{Sub-factor } i) / (\text{Sub-factorMax} - \text{Sub-factorMin})$$

Thus, the score for the Judicial Effectiveness component is **50**, similar to countries like: Egypt, Guinea Bissau, and Cabo Verde, among others. This score locates Puerto Rico in the lower end of the list as compared to the United States with a score of 76.9, despite sharing the same Constitutional foundations.

The island's legal framework provides criminal penalties for political corruption, and implementation is generally effective. However, many influential government officials have private business conflicts of interest.

<sup>2</sup> The Heritage Foundation uses quality of the judicial process instead of enforcing contracts. Due to the lack of data for PR, we decided to use enforcing contracts as a substitute of the mentioned sub-factor. Enforcing contracts is defined as “the time and cost to resolve a commercial dispute and the quality of the judicial process”.

## II. LIMITED GOVERNMENT

**LIMITED GOVERNMENT** is one whose governing or controlling body power exists only within pre-defined limits that are established by delegated sources of authority. Jurisdictions with limited government usually have fewer laws regulating what individuals and businesses can do.

Tax Burden	61
Government Spending	31
Fiscal Health	71.3

### > TAX BURDEN (FISCAL FREEDOM)

“Tax burden is a composite measure that reflects marginal tax rates on both personal and corporate income and the overall level of taxation (including direct and indirect taxes imposed by all levels of government) as a percentage of gross domestic product (GDP).” (Heritage, 2018)

The component score is derived from 3 quantitative sub-factors, of which we only have two of them, with the total tax burden as a percentage of GDP being the missing sub-factor.

Sub-factor	Score
The top marginal tax rate on individual income	33
The top marginal tax rate on corporate income	39

The data for each sub-factor are converted to a 100-point scale using the following equation:

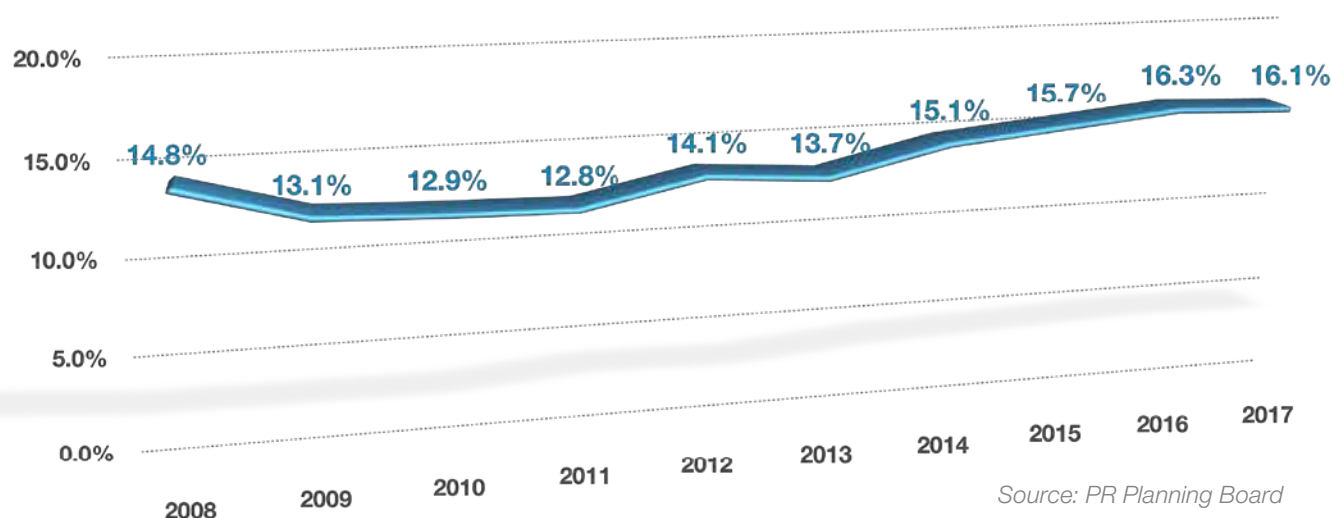
$$Tax\ Burden_{ij} = 100 - \alpha(Factor_{ij})^2$$

Thus, the Tax Burden (Fiscal Freedom) score for Puerto Rico is **61.1**, comparable with Israel, Germany, and Greece, among others. The higher the score, the greater the fiscal freedom. This is not an attractive fiscal freedom score. Puerto Rico could be at a disadvantageous position compared to other jurisdictions in the same region such as Jamaica (80.0), Dominican Republic (84.6), Panama (85.0) and Colombia (80.3).

### OVERVIEW OF TAXES IN PUERTO RICO

The tax burden for Puerto Ricans in 2017 was 16.1% on personal income. Over the last decade, the government has collected over \$15 billion in taxes between new taxes and increases on existing taxes. Simply put, for every \$1 a person generates, \$0.16 goes to the government. This includes all taxes except municipal taxes.

## Tax Burden on Personal income



## ➤ GOVERNMENT SPENDING

“The government spending component captures the burden imposed by government expenditures, which includes consumption by the state and all transfer payments related to various entitlement programs” (Heritage, 2018).

For this component, we used the average total government spending at all levels as a percentage of GNP for the most recent three years. The equation for computing a jurisdiction’s government spending score is:

$$GE_i = 100 - \alpha(Expenditures_i)^2$$

Puerto Rico obtains an average government expenditure level (including transfer payments) of 48% for the last three years with respect to the Gross National Product<sup>3</sup>. Thus, the result for this component is **31**, similar to Croatia, Hungary, and Timor-Leste, among others. This is a quite low score. Governments which can provide few, if any, public goods are likely to receive low scores.

On the other hand, using the Gross Domestic Product<sup>4</sup>, the island has an average government expenditure (including transfer payments) of 32% for the last three years (2015, 2016, 2017).

Therefore, it has a score of **68**, like Ireland, Fiji, Angola, Jordan, Rumania, and Tonga, among others. This is a moderately high score. Underdeveloped countries, particularly those with little government capacity, may receive artificially high scores. The correct measure for the island is the GNP, due to the amount of production that leaves the island, which averages \$30 billion a year.

3 GNP measures the levels of production of all citizens or corporations from a country working or producing in any country.

4 GDP refers to and measures the domestic levels of production in a country. It represents the monetary value of all goods and services produced within a jurisdiction’s geographic borders over a specified period.

## ➤ FISCAL HEALTH

“Widening deficits and a growing debt burden, both of which are caused by poor government budget management, lead to the erosion of a country’s overall fiscal health. Deteriorating fiscal health, in turn, is associated with macroeconomic instability and economic uncertainty.” (Heritage, 2018)

The score for Fiscal Health is based on 2 sub-factors which are weighted as follows:

Sub-factor	Score
Average deficit as a percentage of GNP for the most recent three years	5.7
Debt as a percentage of GNP	101.4

The equation used for computing this score is:

$$\text{Sub-factor Score}_i = 100 - \alpha(\text{Subfactor}_i)^2$$

Thus, the score for the Fiscal Health is **71**, comparable with countries such as: Greece, Cameroon, Mauritania and Uruguay. Once again, using the GDP, Puerto Rico obtained a result of **87** comparative to Russia, Ethiopia, Guinea-Bissau, and Honduras, among others. Both results represent a moderate and high score, respectively. Higher scores for this component mean that countries manage their budget adequately.



### III. REGULATORY EFFICIENCY

Business Freedom	62
Labor Freedom	63
Monetary Freedom	77

#### ➤ BUSINESS FREEDOM

“The business freedom component measures the extent to which the regulatory and infrastructure environments constrain the efficient operation of businesses. The quantitative score is derived from an array of factors that affect the ease of starting, operating, and closing a business.” (Heritage, 2018)

This score is based on 13 sub-factors, all of which are weighted equally, using data from the *World Bank's Doing Business Report*. Of the 13 sub-factors, only 9 were found for Puerto Rico. Those are:

Business Freedom	Puerto Rico	International Average	Score
Starting a Business (# of procedures)	6	7.14	59.5
Starting a Business (# of days)	6	21.09	87.8
Cost of starting a business (% of income per capita)	0.8	24.48	91.8
Starting a Business minimum capital (% of income per capita)	0	17.42	-
Obtaining a construction permit (# of procedures)	22	14.58	33
Obtaining a construction permit (# of days)	165	166.02	50.3
Cost of obtaining a construction permit (% of income per capita)	6.3	4.36	35
Close a business time (years)	2.5	2.55	51
Cost of closing a business (% of estate)	11	15.84	72
Recovery rate for closing a business (cents on the dollar)	70.5	37.03	26.3
Getting Electricity (# of procedures)	5	5.12	51
Getting Electricity (# of days)	32	94	88
Getting Electricity - cost (% of income per capita)	228.3	1,103.90	97

Each sub-factor is converted to a scale of 0 to 100 using the following equation:

$$\text{Sub-factor Score}_i = 50 \times (\text{Sub-factor average} / \text{Sub-factor}_i)$$

The score is **62**, similar to Belize, Hungary, and the Philippines, among others. Some sub-factors were altered in the methodology because of their incompatibility with the others:

- Starting a Business (# of days)
- Cost of starting a business (% of income per capita),
- Getting Electricity (# of days)
- Getting Electricity – cost (% of income per capita)

Using the right formula for the above-mentioned sub-factors leads to a final score that exceeded 100 on the scale. This is due to the large gap between the international average score and the scores for Puerto Rico. Thus, the ratio between them will be relatively high. Therefore, multiplying that ratio by 50 will lead to a very high score above 100.

Because of this, we decided to multiply the ratio of the specific sub-factors by a number lower than 50. This change led to a score closer to the desired scale and therefore, after averaging all of them, got to a final component score. The final score is moderately high, which means that Puerto Rico has a moderate level of business freedom.

If the FOMB and the government manage to legislate part of the proposed fiscal plan aimed to deregulate part of the bureaucratic process for businesses, this index could increase and situate the island in a competitive advantage with others in the region such as Panama (74.4), and Colombia (78.6), even though the island scores better than the Dominican Republic (53.2), and Cuba (20.0). Puerto Rico should aim to position itself along the same ranking as the U.S. at 82.7.

## ➤ LABOR FREEDOM

“The labor freedom component is a quantitative measure that considers various aspects of the legal and regulatory framework of a country’s labor market, including regulations concerning minimum wages, laws inhibiting layoffs, severance requirements, and measurable regulatory restraints on hiring and hours worked, plus the labor force participation rate as an indicative measure of employment opportunities in the labor market.” (Heritage, 2018)

The score is based on 7 sub-factors, all of which are weighted equally, using data from the *World Bank’s Doing Business Report*.



Business Freedom	Puerto Rico	International Average	Score
Ratio of Minimum wage to average value added per worker	0.52	0.36	35.3
Legally Mandated period for redundancy dismissal (weeks of salary)	0	5.3	-
Mandatory severance pays for redundancy dismissal (weeks of salary)	0	12.18	-
Difficulty of hiring index	22	29.88	67.9
Rigidity of hours index	0	23.75	-
Difficulty of redundancy dismissal	20	29.1	72.75
Labor Force Participation Rate	40.3	62	77

Each of these factors is converted to a scale of 0 to 100 based on the following equation:

$$\text{Sub-factor Score}_i = 50 \times (\text{Sub-factor average} / \text{Sub-factor}_i)$$

Thus, the component score is **63**, like countries such as The Netherlands, Malta, Burundi, and Barbados, among others. The final score is moderately high, which means that Puerto Rico has moderate labor freedom. Within the Caribbean region, Puerto Rico ranks higher than Cuba (20.0) and the Dominican Republic (54.3), but lower than Jamaica (74.5), Colombia (75.2).

## ➤ MONETARY FREEDOM

“Monetary freedom combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market.” (Heritage, 2018)

The monetary freedom score component is based on two sub-factors:

- The weighted average inflation rate for the most recent three years
- Price controls

The two equations used to convert inflation rates into the final monetary freedom score are:

$$\text{Weighted Avg. Inflation}_i = \theta_1 \text{Inflation} + \theta_2 \text{Inflation} - 1 + \theta_3 \text{Inflation} - 2$$

$$\text{Monetary Freedom}_i = 100 - \alpha \text{Weighted Avg. Inflation}_i - \text{PC penalty}_i$$

In this case, we suggest applying to Puerto Rico the same score as the U.S., which is **78.6**. Historically, given the fact that the island is a territory of the U.S., monetary issues are linked to the situation in the mainland.

Puerto Rico does not have a central bank that allows it to establish monetary policies to modify the interest rate or control inflation on the island. This area is overseen by the Federal Reserve Bank, limiting the island's role in this specific component. This score is mostly high, which means that Puerto Rico enjoys a high level of monetary freedom compared to others in the region such as the Dominican Republic (77.1), and Colombia (73.9).

## IV. OPEN MARKETS

Trade Freedom	80
Investment Freedom	70
Financial Freedom	70

### ➤ TRADE FREEDOM

“Trade freedom is a composite measure of the extent of tariff and nontariff barriers that affect imports and exports of goods and services.” (Heritage, 2018)

Trade freedom score is based on two inputs:

- The trade-weighted average tariff rate
- Nontariff barriers (NTBs)

$$Trade\ Freedom_i = \frac{100 (Tariff_{max} - Tariff_i)}{Tariff_{max} - Tariff_{min}} - NTB_i$$

Once again, given the close relationship with the mainland, Puerto Rico is considered part of its customs territory and subject to free trade agreements. We suggest using the same U.S. score but, in this case, adding a penalty.

The incorporation of a penalty is due to the sales and use tax (currently at a rate of 11.5%) as well as the Jones Act, which regulates maritime commerce in the U.S. and requires all goods shipped between U.S. ports to be transported only on U.S. vessels. Those ships are more expensive to build and operate than ships flying foreign flags.

The U.S. has a score of 87. Therefore, we believe that Puerto Rico should have a score of **80**. This score is relatively high, which means that Puerto Rico has a high level of trade freedom. Similar countries with high scores include Costa Rica (84.7), Dominican Republic (72.4), Panama (77.8), and Colombia (81.6).

### ➤ INVESTMENT FREEDOM

“In an economically free country, there would be no constraints on the flow of investment capital. Individuals and firms would be allowed to move their resources into and out of specific activities, both internally and across the country’s borders, without restriction. Such an ideal country would receive a score of 100 on the investment freedom component of the Index.” (Heritage, 2018)

The Investment Freedom score is based on a variety of regulatory restrictions that typically are imposed on investment. As with Monetary Freedom and Trade Freedom, foreign investment is subject mostly to U.S. laws and regulations. Foreign investment is subject to Puerto Rico’s high taxation rate. Nevertheless, the island countered all these taxes by offering a wide variety of subsidies and incentives such as: Foreign Trade Zones Incentives, Tourism Development Act, Agricultural Incentives Act, Economic Incentives for the Development of Puerto Rico Act, Green Energy Incentives Act, International Insurer and Reinsurer Act (2011), Export Services Act, Cruise Industry Incentives Act, Act 22 and the International Financial Entities Act.

Although the island presents multiple financial insecurities, all these incentives are aimed at facilitating foreign investment. Given the limited reach of the local government in this area, we recommend using the same score as for the U.S., **85**, like Cabo Verde, Costa Rica, and Japan, among others. This score is relatively high, which means that Puerto Rico has a relatively high level of investment freedom.

## ➤ FINANCIAL FREEDOM

“Financial freedom is an indicator of banking efficiency as well as a measure of independence from government control and interference in the financial sector. State ownership of banks and other financial institutions such as insurers and capital markets reduce competition and generally lowers the level of access to credit.” (Heritage, 2018)

Puerto Rico is subject to the United States federal regulatory framework regarding the banking and financial industry. The index score is based on five broad areas:

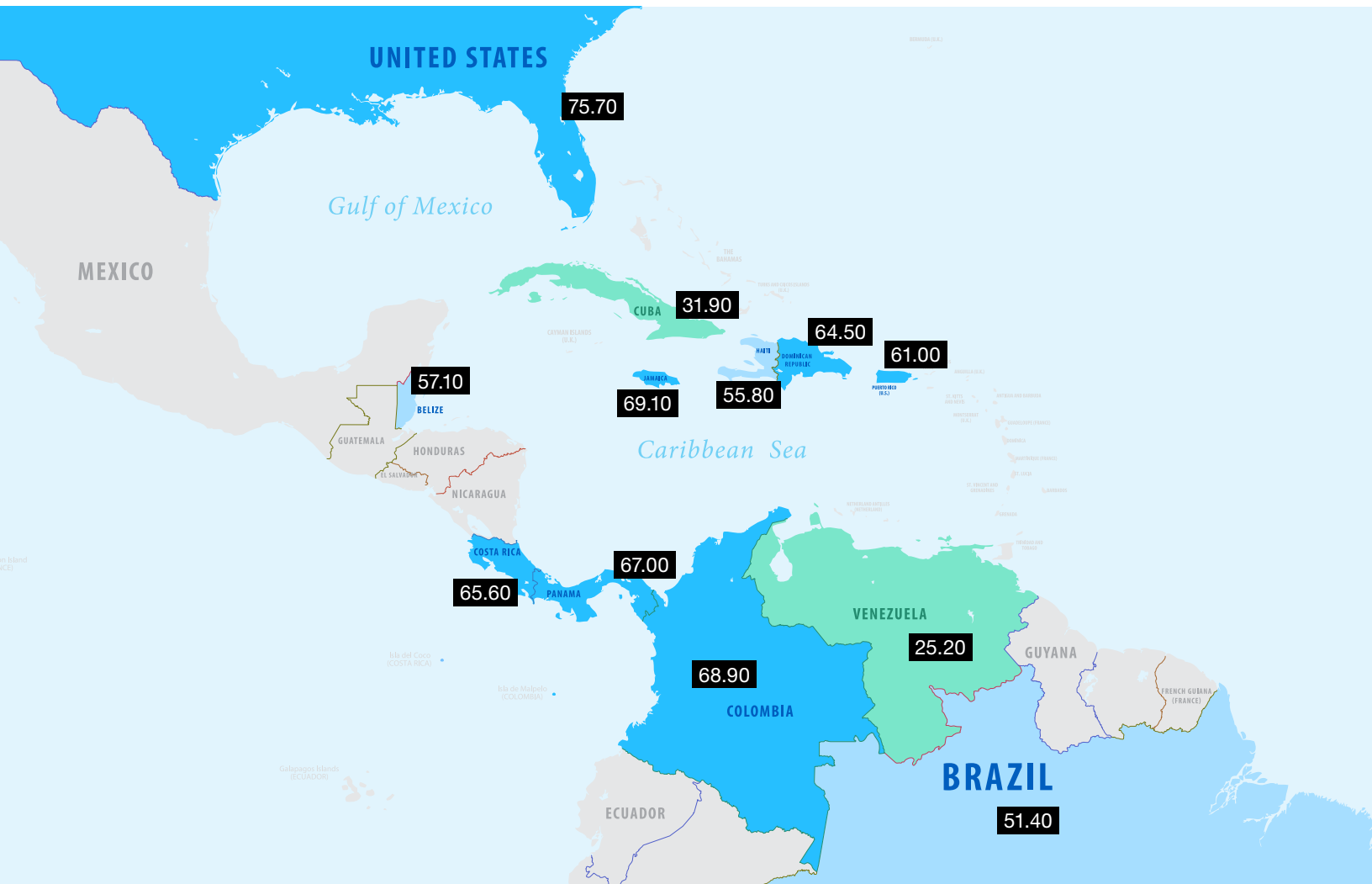
- Extent of government regulation of financial services.
- Degree of state intervention in banks and other financial firms through direct or indirect ownership.
- Extent of financial and capital market development.
- Government influence on the allocation of credit.
- Openness to foreign competition.

Due to the limited reach of the state government in this area, Puerto Rico would attain a similar score to the US. Therefore, the final score would be **80**, which is similar to countries such as: Bahrain, Canada, and the Czech Republic, among others. This score is fairly high, which means that Puerto Rico has substantial financial freedom.



# CONCLUSION

The final average score for the 12 components reaches a level of **61<sup>5</sup>**, positioning Puerto Rico's economic freedom at a level similar to Croatia, Bosnia and Herzegovina, Dominican Republic, and Samoa, among others. When compared to the region, Puerto Rico's competitiveness remains under average.



Scores between 60 to 69 correspond to moderately free countries. The data search and the analysis that was carried out for each component validates Puerto Rico's level of economic freedom within this range. The lack of data for specific sub-factors will not greatly alter the results, but we are aware that each sub-factor plays an important role for each component.

5 Using GNP instead of GDP for the case of Government Spending and Fiscal Health

The world economy is mostly moderately free, locating itself at a 61.1 world average level. As previously stated, the small size of the private sector, government deficit, deficit in pensions, the collapse of the mortgage market, low labor participation, emigration and population reduction, high energy costs, among others, are barriers that limit the growth of free enterprise and economic freedom in Puerto Rico.

## COMPARATIVE ANALYSIS FROM PREVIOUS REPORT

AS MENTIONED ABOVE, the methodology used in the previous index and this one is not to be compared directly, due to variations from one year to the next one. Still, the following table shows the difference of indexes between reports.

### Comparative of 2016 vs. 2017 Index Reports

Variable	2016	2017
Property Rights	70	50
Judicial Effectiveness	-	50
Government Integrity	-	41.8
Tax Burden	-	61
Government Spending	77	31
Fiscal Health	-	71.3
Business Freedom	63	62
Labor Freedom	79	63
Monetary Freedom	77	77
Trade Freedom	80	80
Investment Freedom	70	70
Financial Freedom	70	70

The average for the EFI in 2016 was 71 in 2016, while, under the new methodology, the EFI was 61.

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