CRECE

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.

Authors: Gustavo Vélez, Chantal Benet
Editor: Teresita Nolla
Graphic Design: Carlos López | Uará Media

CENTRO PARA RENOVACIÓN ECONÓMICA, CRECIMIENTO Y EXCELENCIA

PO Box 190913
San Juan, PR 00919-0913

787.356.1206
www.centrocrece.org

Follow us:
CRECE @centrocrece.org centrocrecepr @centrocrece @crecepuertorico

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EXECUTIVE *SUMMARY*

The Center for Economic Renewal, Growth and Excellence ("CRECE", for its Spanish acronym) and Inteligencia Económica continue their endeavor for a fourth consecutive year in calculating Puerto Rico's *Economic Freedom Index* based on the Heritage Foundation's methodology, which measures the degree of economic freedom in 180 countries.

As previously stated, economic freedom is more than the freedom to engage in voluntary exchange and transactions between individuals. It addresses personal issues that affect an individual's capacity to travel freely, own private property, generate income and more. The Economic Freedom Index is a vital tool to promote growth and prosperity in Puerto Rico.

In 2020, Puerto Rico's economic freedom did not see a dramatic change. Of the eight categories that directly apply to governance on the island, four changed when compared to 2019. Among these, the only category that showed a decrease compared to 2019 was the Government Integrity sub-index. This index is based on the public perception of government transparency and corruption on the island. The events of the summer of 2019, which led to former Governor Ricardo Rossello's resignation, had a significant impact on the public perception of the government, which in turn led to a reduction of 14 points in this category. The erosion of the public's trust in its institutions negatively impacts economic freedom because it weakens our rule of law and contaminates the economic climate with coercion.

Fiscal health and government spending both showed increases in scores due to the transfer of federal funds in the aftermath of Hurricane María, which led to an increase in GNP during the beginning of the 2019 fiscal year. This increase, coupled with decreased government expenditure, led to increases in the government spending and fiscal health sub-indexes. It should be noted that these increases are short-term, as they are not the product of the local government's actions to exercise fiscal responsibility, but merely reflect the impact of temporary federal transfers to Puerto Rico.

Variable	2018	2019	2020
Property Rights	50	64.1	64.6
Government Integrity	41.8	48.5	34
Judicial Effectiveness	50	64.3	64.3
Tax Burden	61	61.1	62.5
Government Spending	31	24.5	49.3
Fiscal Health	71.3	65.2	73.9
Business Freedom	62	51.2	51.2
Labor Freedom	63	65.0	65
Monetary Freedom	77	76.6	75.5
Trade Freedom	80	86.6	79.8
Investment Freedom	70	85.0	85
Financial Freedom	70	80.0	80
Puerto Rico SCORE	**61**	**64.4**	**65.3**

Throughout our past economic research collaborations, CRECE and Inteligencia Económica have reaffirmed the urgent need for a tax reform that eases the burden on corporations and individuals to expand economic freedom and improve Puerto Rico's competitiveness in world rankings. In this year's edition of the *Economic Freedom Index*, we have focused on the tax burden in Puerto Rico to highlight this precise point and demonstrate our competitive disadvantages and differences in tax structures when compared to the 50 states. A better understanding of how taxes in Puerto Rico compare to taxes in the states can help policymakers develop tax policy to improve competitiveness, and, more importantly, attract and retain human capital to select Puerto Rico as their home.

The analysis was performed using the methodology of the Tax Foundation's *State Business Tax Climate Index*. Some of its key findings are:

- Puerto Rico's territorial status, which exempts its citizens from many federal taxes, has led to the local tax regime being fundamentally and structurally different from that of a US state, with the biggest difference being property taxes as a source of state and local tax revenues.
- Puerto Rico has the highest individual income tax rates in the United States.
- Puerto Rico's tax burden as a percentage of personal income is 12.9%, making it the 2nd highest amongst the 50 states and the territory, falling just behind New York, which has a tax burden that is 1.8 percent higher.
- Puerto Rico's sales and excise taxes are the highest among all 50 states and the territory.
- In Puerto Rico, the percentage of personal income paid in sales and excise taxes is 8%, the highest in the country. This shows the regression of the sales and excise taxes as individuals with lower incomes spend a much higher percentage of their earnings in paying for the sales and excise taxes when compared with individuals of higher income levels.
- Despite Puerto Rico being exempt from paying some federal taxes, the island's corporate income tax has a maximum rate of 37.5%, again, the highest in the US. The state with the highest corporate income tax rate is Iowa, with 12%. Puerto Rico's corporate income tax rate is still higher than any of the 50 states, even when adding federal corporate income taxes (currently 21%) over state tax rates.

The findings in this year's Index reinforce the need to advance structural reforms in Puerto Rico that will expand economic freedom and improve our competitiveness both at the global and national levels. Recommendations include:

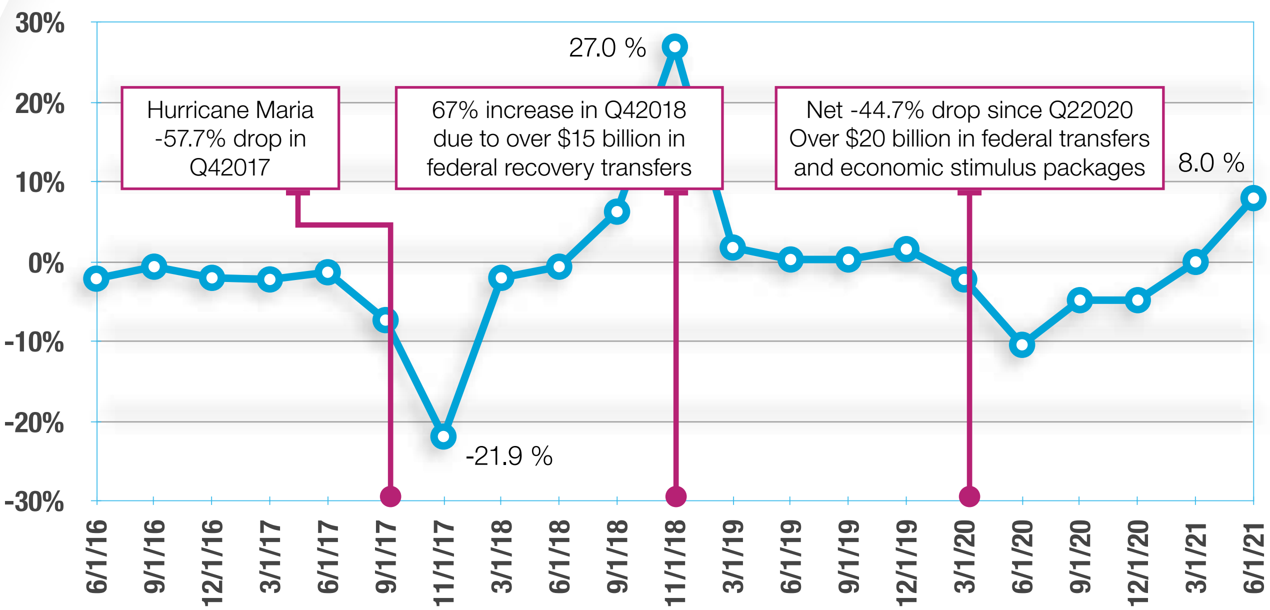
- Securing property rights through comprehensive land administration reform and the protection of minority investors in businesses and corporations.
- Improving judicial effectiveness by improving timely resolution of court cases, increasing automation of the courts, and making it easier for court reports and documents to be accessed by the public at large would also go a long way towards expanding economic freedom.
- Reducing the size and pervasive role of government as well as extending accountability, efficiency, and transparency to restore public trust in government and boost confidence in investing in the island.
- Decreasing the high tax rates, particularly personal and corporate income taxes, which remain a hurdle in the path towards economic freedom.
- Streamlining the permits processes, zoning regulations, and reducing the high cost of utilities to improve the ease of doing business in Puerto Rico.
- Maintaining the progress that has been made in the fiscal health and government spending categories. Lower debt obligations for the future will allow Puerto Rico's government to maintain budget surpluses while whittling away at the massive debt. Tax reform and increasing public trust in government should be two main priorities moving forward, as ways of increasing economic freedom and creating a healthier economic environment.

Finally, a lack of information and data for Puerto Rico in the global landscape has been a historical hurdle to overcome when doing business on the island. Participation in surveys such as the *Economic Freedom Index* and the World Bank's *Doing Business Report* are invaluable ways in which to attract new investment.

PUERTO RICO'S ECONOMY IN 2020

After more than 14 years of economic depression, the COVID-19 pandemic has produced a sustained economic downturn in Puerto Rico that rivals any in our history. Since 2006, the only years with economic growth have been 2012 and 2019. Economic growth in 2019 was driven by billions of federal funds assigned to Puerto Rico in the aftermath of Hurricane Maria.

Year over Year Change in Economic Activity Index



Source: Economic Development Bank

The economic downturn seen during the COVID-19 pandemic has not been as severe a shock as was experienced in the aftermath of Hurricane Maria, but it has been more prolonged. The Economic Activity Index is still 2.2% below where it was in February of 2020. Employment is still down by 33,500 jobs, with employment in the tourism industry being slow to recover. Construction and manufacturing have been amongst the sectors of the economy least affected by the pandemic and have in fact surpassed pre-pandemic levels.

Ongoing negotiations between the Fiscal Oversight and Management Board of Puerto Rico (FOMB) and bondholders have led to a new agreement that could reduce the central government's debt by up to 62%. This presents the island with a unique opportunity to create a new economic structure fueled by economic competitiveness and freedom reforms. This analysis highlights the areas in which Puerto Rico lags in creating and maintaining an economic ecosystem which allows private enterprise to flourish.

I RULE OF LAW

Property Rights

The property rights component assesses the extent to which a country's legal framework allows individuals to acquire, hold, and utilize private property, 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.

The score for this component is derived by averaging scores for the following five sub-factors, all of which are weighted equally:

Sub-Factor	Score
Physical Property Rights	83
Intellectual Property Rights	-
Strength of Investor Protection	39
Risk of Expropriation	83
Quality of Land Administration	53

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

Sub-factor Score i = 100 x (Sub-factorMax–Sub-factori)/(Sub-factorMax–Sub-factorMin)

The more effective the legal protection of property, the higher a country's score will be. Similarly, the greater the chances of government expropriation of property, the lower a country's score.

2018	2019	2020
50	64.1	**64.6**

The only change in this section compared to 2019 happened in the quality of land administration category. A slight change in the methodology of the *World Bank's Doing Business Report* led to a 2-point increase here. This increase was not due to any improvement in local governance.

Country	Property Rights Score
Hungary	64.8
Saudi Arabia	64.6
Puerto Rico	**64.6**
Bulgaria	64.2
Kenya	63.2

Puerto Rico's score in this category was the 61st best out of 181 countries and equaled Saudi Arabia's.

Within the Americas region, Puerto Rico ranks in the 7th position. Even though the island scored high in physical property rights and risk of expropriation, the scores for land administration and investor protection brought down the overall score.

The score for investor protection suffered due to regulations concerning minority investors in corporations. In the *Doing Business Report*, Puerto Rico scored a 1 out of 6 in the extent of shareholder rights index and a 1 out of 7 in the extent of ownership and control index.

Legal reforms aimed at protecting minority investors in businesses as well as at ownership of corporations would go a long way towards increasing the island's score in this category.

Quality of land administration on the island has also been a hot button issue, particularly in the aftermath of Hurricane Maria, when many FEMA insurance claims were not able to be processed due to lack of documentation and informal housing throughout the island.

Facilitating minority rights within corporations and comprehensive land reform are the two main ways of increasing the score in this category.

Judicial Effectiveness

Efficient legal frameworks protect the rights of all citizens against unlawful acts by others, including governments and powerful private parties. Judicial effectiveness requires efficient and fair judicial systems to ensure that laws are fully respected and appropriate legal actions are taken against violations.

Sub-Factor	Score
Judicial Independence	66.7
Enforcing Contracts	61.8

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

Sub-factor Score i = 100 x (Sub-factorMax–Sub-factori)/(Sub-factorMax–Sub-factorMin)

The more effective the judicial process, the higher a country's score.

Using the Heritage Foundation's original methodology led to a score that we believed was not indicative of Puerto Rico's performance in this category. The enforcing contracts subsection of the *World Bank's Doing Business Report* was used as one of the sub-factors, alongside a converted version of Puerto Rico's score in the quality of judicial processes subcategory of the same report.

In the quality of judicial processes category, we arrived at a score of 66.7 after dividing Puerto Rico's score, an 11, by the highest score in the same category, a 16.5 (China). This led to a score more appropriate for the island's robust legal system, which has all the checks and balances of the American legal system.

Country	Judicial Effectiveness Score
Portugal	65.6
Ireland	64.4
Puerto Rico	**64.3**
India	64.1
Iceland	63.2

Puerto Rico had the 30th highest score in this category. The island's score in this category was most similar on a global scale to Ireland. Both are liberal democracies with a strong respect for the rule of law.

Within the Americas, Puerto Rico ranked 3rd, behind only the United States and Canada. Puerto Rico lags the United States in judicial effectiveness because: 1) time standards are respected in only about 50% of cases in the island's courts; 2) there is a low level of court automation; and, 3) there is no court dedicated solely to commercial cases.

A lack of timely resolution to court cases can have a large impact on the ease of doing business in Puerto Rico. Making it easier for court reports and documents to be accessed by the public at large would also go a long way towards expanding economic freedom.

Government Integrity

Corruption erodes economic freedom by introducing coercion into economic relations. Bribery, extortion, nepotism, cronyism, patronage, embezzlement, and graft corrupt government institutions and decision making. The lack of government integrity caused by these practices reduces public trust and economic vitality by increasing the costs of economic activity.

The score for this component is derived by averaging scores for the following six sub-factors, all of which are weighted equally:

Sub-Factor	2019 Score	2020 Score
Public Trust in Politicians	-	-
Irregular Payments and Bribes	46.5	28
Transparency of Government Policymaking	-	-
Absence of Corruption	-	-
Perceptions of Corruption	-	-
Governmental and Civil Service Transparency	51.5	48

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

Sub-factor Score i = 100 x (Sub-factorMax–Sub-factori)/(Sub-factorMax–Sub-factorMin)

The higher a country's score, the more its citizens believe in the integrity of their government. The lower the score, the higher the perception of corruption.

2018	2019	2020
41	48.5	**34**

Using the Heritage Foundation's own methodology led to an increase in the score for 2020, compared to 2019. Since both scores used in this calculation decreased when compared to last year, an adjustment was made to accurately portray this. Most of the scores used in this section come from the World Economic Forum's *World Competitiveness Report*, which does not include Puerto Rico. This explains why only the scores for "Irregular payments and bribes" and "Governmental and civil service transparency" were included.

Country	Government Integrity Score
Guyana	34.1
Burkina Faso	34.1
Puerto Rico	**34**
Egypt	34
Vietnam	33.8

Puerto Rico's score in this section was the same as Egypt, and similar to Burkina Faso's and Guyana's, and ranked 111th out of 181. In the Americas region, Puerto Rico ranked 21st out of 33.

While we agree that Puerto Rico's score should reflect the negative impact of recent events in government integrity, we believe the score is too low and the comparisons with other nations given the score do not accurately reflect Puerto Rico's positioning. The resulting score is tied to the methodology used by the Heritage Foundation and the *TRACE International Bribery Risk Matrix*. The lack of economic data available for Puerto Rico and its absence in global economic studies contributes to the score.

Corruption and lack of transparency have been substantial issues affecting governance in Puerto Rico for a long time. Measures anchored in accountability, efficiency, and transparency to restore public trust in government would improve this score and boost confidence in investing in the island. Reducing the size and pervasive role of government would also help in addressing this issue.

II GOVERNMENT SIZE

While many economists see free markets as the ideal mechanism for resource allocation in a society, the reality is that much resource allocation takes place outside the market and is both effected and affected by government. The size of the public sector is related to how a society's reliance on markets and private institutions has evolved, which in turn can be driven by differences across economic philosophies concerning the role of government[1].

One subject that has been of interest to our firm and CRECE this year has been the high rate of taxes on the island. To contextualize this, we applied the Tax Foundation's *State Business Tax Climate Index to Puerto Rico*. The findings are presented at the end of this subsection.

Tax Burden

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). The component score is derived from three quantitative sub-factors:

Sub-Factor	Score
The Top Marginal Tax Rate on Individual Income	33
The Top Marginal Tax Rate on Corporate Income	37.5

Each of these numerical variables is weighted equally as one-half of the component score.

Tax burden scores are calculated with a quadratic cost function to reflect the diminishing revenue returns from very high rates of taxation. The data for each sub-factor are converted to a 100-point scale using the following equation:

$$Tax\ Burdenij = 100 - a\ (Factorij)^2$$

The score in this category is derived from information from Puerto Rico's Treasury Department. Using the Heritage Foundation's methodology, we arrived at a score that places Puerto Rico's performance in this category as above average. Puerto Rico's tax regime, which taxes personal income at a lower level than European nations, and taxes corporations at a lower level relative to Europe, particularly through incentives to US based companies, to encourage investment, merits this score.

2018	2019	2020
61.1	61.1	**62.5**

1 Di Matteo, L. Measuring government in the 21st century: An international overview of the size and efficiency of public spending. Fraser Institute. 2013.

Compared to last year's ranking, a decrease in the top marginal tax rate on corporate income from 39% in 2018 to 37.5% in 2019 led to an increase in this score.

Country	Tax Burden Score
Republic of Congo	63.3
Australia	63
Puerto Rico	**62.5**
Zimbabwe	61
Spain	60.9

Puerto Rico ranks 165th out of 181 in this category. Puerto Rico's score in this category is most like Israel, and just under Spain. Puerto Rico's score in the Americas region is 32nd out of 33, ahead of only Cuba.

This sub-index is based on the top marginal rates for both individuals and corporations. Puerto Rico's government offers a series of subsidies for corporations and individuals, such as pharmaceuticals and foreign investors under Acts 20 and 22 (now incorporated into Act 60). Other nations in the Americas region rely mostly on low corporate tax rates to incentivize investment. Puerto Rico relies largely on tax policies set at a federal level, which are not reflected in this score.

Puerto Rico's high marginal tax rates relative to other jurisdictions in the United States will be explored more in depth in an annex to this report. Puerto Rico's low median household income relative to the United States as a whole, $20,474 in Puerto Rico versus $65,712 for the US, leads to a smaller percentage of taxpayers falling under higher tax brackets on the island.

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. While there is no optimal level of government spending, the ideal level will vary from country to country, depending on factors that range from culture to geography to level of economic development.

At some point, however, government spending becomes an unavoidable burden as growth in the size and scope of the public sector leads inevitably to misallocation of resources and loss of economic efficiency. Volumes of research have shown that excessive government spending that causes chronic budget deficits and the accumulation of public debt is one of the most serious drags on economic dynamism.

The Index methodology treats zero government spending as the benchmark.

For this category, GNP was used instead of GDP due to Puerto Rico's unique political status. Because it is a territory of the United States, there tends to be large amounts of capital outflow on the island due to transfers back to the mainland from corporations operating in Puerto Rico. This leads to inflated GDP numbers that do not reflect the fact that these large profits that are transferred away from the island cannot be captured by taxation and are not included in the government's ledger. This leads to GNP being an accurate account of Puerto Rico's economic activity. While this leads to a much lower score in this category, it is a more precise one.

2018	2019	2020
31	24.5	**49.3**

Puerto Rico's score in this category more than doubled in 2020. It increased by 24.8 points and is now at 49.3. This increase was due to the local government spending less in the 2018-2019 fiscal year relative to the previous one. As a result, Puerto Rico is ranked 151st out of 181 in the world. This ranking, however, is not a reflection of poor performance in this category. Top performers in this category are mostly developing economies with low economic outputs that do not rely on government spending to provide essential services to their citizens.

Puerto Rico's score is comparable to the United Kingdom and other European countries, and reflects the local government's approach to spending, which utilizes government budgets to provide services to citizens in lieu of allowing them to be provided by private entities.

Within the Americas region, Puerto Rico is 31st out of 33, ahead of only Dominica and Cuba.

Country	Government Spending Score
United Kingdom	49.5
Bosnia and Herzegovina	49.3
Puerto Rico	**49.3**
Poland	48.8
Spain	48.3

The increase in Puerto Rico's Government Spending score was not due to structural reforms that would lower the role that government plays in the local economy, which is large compared to other jurisdictions in the region. Instead, it reflects the effect that Hurricane Maria had on both spending and GNP.

Government spending in the 2017-2018 fiscal year increased as more federal funds were made available, and this spending was necessary to return the island's damaged infrastructure back to functioning levels. Telecommunications and the electric grid needed almost complete reconstruction. Simply put, spending for the 2018-2019 fiscal year decreased by 8.7% while the effect of a 4% increase in spending during the 2017-2018 fiscal year impacted GNP.

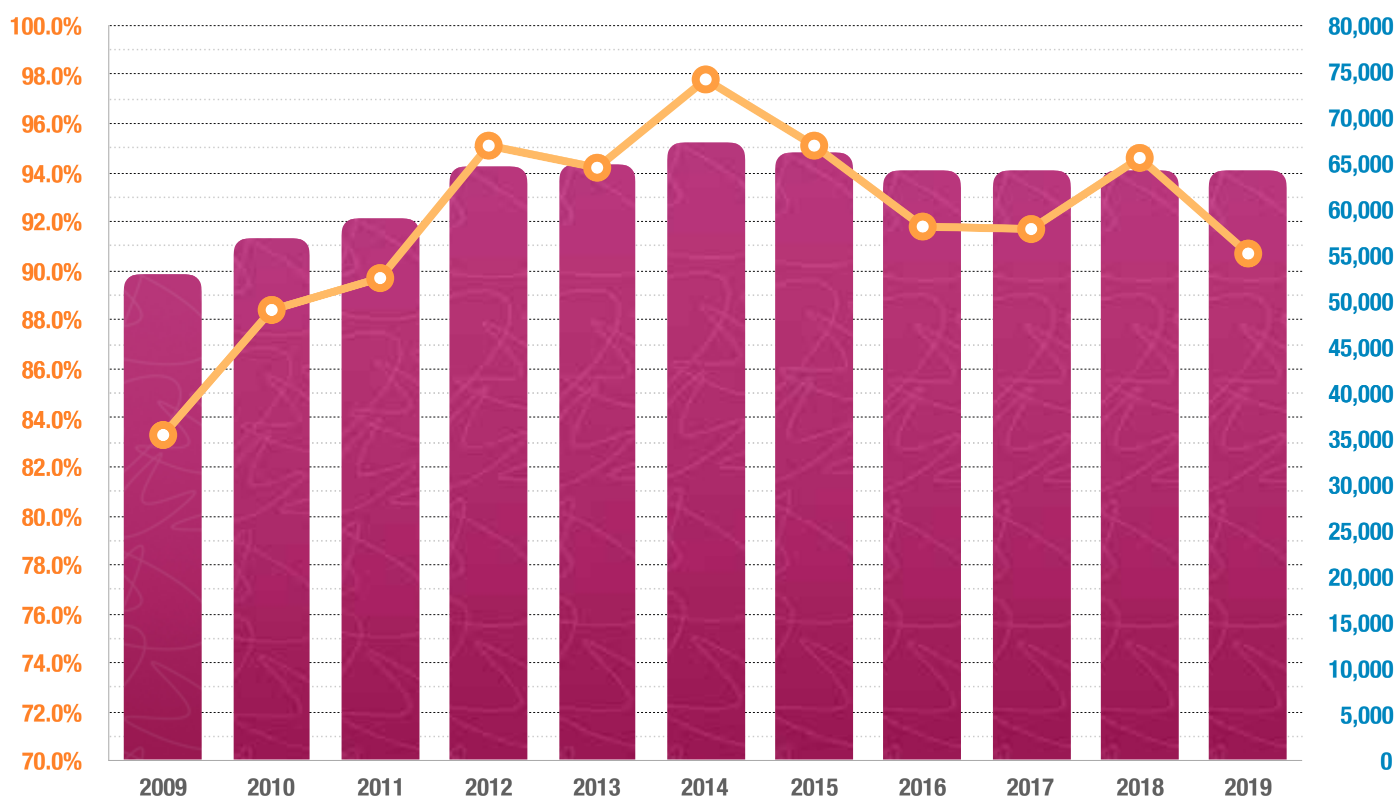
As the entity responsible for overseeing the state government's finances since 2017, the FOMB wants to establish balanced budgets, as these are necessary for the island to restart debt payments. This should lead to a reduction of government spending in the coming years, which should increase our score in this category.

Fiscal Health

Widening deficits and a growing debt burden, both of which are caused by poor government budget management, worsen a country's overall fiscal health. Deteriorating fiscal health, in turn, is associated with macroeconomic instability and economic uncertainty.

In 2014, Puerto Rico's debt reached its peak of 97.8% of its GNP, or 65.7 of its GDP. The government – and several of its agencies - filed for bankruptcy under PROMESA to repay its debt with bondholders. This is still under the supervision of the FOMB and a bankruptcy judge.

Gross Public Debt Of Puerto Rico



Debt (Millions)	52,980	56,823	58,942	64,760	64,957	67,272	66,182	64,254	64,180	64,180	64,180
As % of GNP	83.3%	88.4%	89.7%	95.1%	94.2%	97.8%	95.1%	91.8%	91.7%	94.6%	90.7%

Source: Planning Board: Statistical Appendix 2018

The information used for this section was obtained from the *Statistical Appendix of the Economic Report for the Governor of Puerto Rico* in 2020.

Sub-Factor		Score
Average Deficits as a Percentage of GDP for the Most Recent Three Years (80% of score)		89.65
Debt as a Percentage of GDP (20% of score)		17.78

The equation used to compute a country's fiscal health score is:

$$\textit{Sub-factor Scorei} = 100 - \alpha\,(\textit{Sub-factori})^2$$

The higher the score, the better fiscal health is.

2018	2019	2020
71.3	65.2	**75.3**

The increase in this year's score is a direct result of the freezing of the island's debt after the implementation of the FOMB, and of not adjusting for inflation. When shown in 1954 dollars, which is how GNP is presented by the Puerto Rico Planning Board, we can see that the only year with economic growth in the past 5 years was 2019 and this growth was tied to the influx of federal recovery funds in the aftermath of Hurricane Maria.

The deficit portion of this sub-index has also been directly affected by the FOMB. Since Puerto Rico has not made debt payments in recent years, it has been able to reduce its customarily large budget deficit.

Country	Fiscal Health Score
Bhutan	74.8
Portugal	74.4
Puerto Rico	**73.9**
Mali	73.6
São Tomé and Príncipe	73

Puerto Rico ranks 118th out of 181 in the world in this category. The island's poor performance in this category stems from its debt to GNP ratio, which has been above 90% for the past 10 years. In the Americas region, Puerto Rico ranks 18th out of 33, ahead of the United States.

Lacking monetary policy to be able to confront its debt, the island must instead rely on fiscal measures, such as reducing government spending and carefully navigating international capital markets once it is able to do so again.

III REGULATORY **EFFICIENCY**

Business Freedom

The business freedom component measures the extent to which the regulatory and infrastructure environments constrain the efficient operation of businesses. The score is based on 13 sub-factors, all of which are weighted equally, using data from the *World Bank's Doing Business Report:*

Sub-Factor	Puerto Rico	International Average	Score
Starting a Business—Procedures (Number)	6	6.66	55.48
Starting a Business—Time (Days)	5.5	19.61	71.30
Starting a Business—Cost (% of Income Per Capita)	1.2	19.77	823.95
Starting a Business—Minimum Capital (% Of Income Per Capita)	0	5.42	
Obtaining a License—Procedures (Number)	22	14.86	33.76
Obtaining a License—Time (Days)	165	153.64	46.56
Obtaining a License—Cost (% of Income Per Capita)	6.7	5.01	37.38
Closing a Business—Time (Years)	2.5	2.46	49.18
Closing a Business—Cost (% Of Estate)	11	15.96	72.53
Closing a Business—Recovery Rate (Cents on the Dollar)	67.7	42.27	31.22
Getting Electricity—Procedures (Number)	5	4.88	48.82
Getting Electricity—Time (Days)	32	82.53	51.58
Getting Electricity—Cost (% of Income Per Capita)	318.3	1044.18	65.61
		Final Score	**51.22**

Each of these sub-factors is converted to a scale of 0 to 100, after which the average of the converted values is computed. The result represents the country's business freedom score in comparison to the business freedom scores of other countries. Each sub-factor is converted to a scale of 0 to 100 using the following equation:

Sub-factor Scorei = 50 x (Sub-factoraverage/Sub-factori)

The higher the index, the fewer obstacles are placed to potential entrepreneurs when starting their businesses.

2017	2018	2019
62	51.2	**51.2**

The *2020 Doing Business* figures for Puerto Rico did not show any change in these categories. For this reason, the island's score remained the same.

Puerto Rico is ranked 153rd out of 181 in this category. Within the Americas region, Puerto Rico ranks 28th out of 33.

Country	Business Freedom Score
Vanuatu	51.8
Congo, Democratic Republic of the Congo	51.2
Puerto Rico	**51**
Senegal	50.4
Dominican Republic	50.3

Puerto Rico scores highest in the categories having to do with the capital costs of starting a business but fares poorly in time to close a business and time to obtain licenses necessary for a business to operate.

This sub-index does not represent an accurate assessment of the reality of doing business on the island. The outdated regulations regarding zoning and permits, as well as high costs of utilities, and high tax burden imposed on businesses, firmly place the island amongst the least-business friendly jurisdictions within the United States, as well as in the Americas. CRECE and Inteligencia Económica have explored this topic in depth through the Puerto Rico Competitiveness Toolkit, which offers solutions to improve our ease of doing business and foster a more competitive environment.

A more accurate methodology for this section would encompass a greater number of procedures, a longer time frame necessary for completing these, and would also consider electricity costs that are on average, almost 50% higher than in the continental United States.

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.

All information for this sub-index was derived from the *World Bank's Doing Business Report*. The international average used in this sub-index improved in 6 out of the 7 categories while Puerto Rico remained the same in all but one.

Seven quantitative sub-factors are equally weighted, with each sub-factor counted as one-seventh of the labor freedom component:

Sub-Factor	Puerto Rico Score	International Average
Mandatory Severance Pays (Weeks of Salary)	0	11.8
Legally Mandated Notice Period	0	5.5
Ratio of Minimum Wage to the Average Value Added Per Worker	0.5	0.4
Labor Force Participation Rate	41.2	62.2
Rigidity of Hours	0	19.7
Difficulty of Firing Redundant Employees	20	27.7
Hindrance to Hiring Additional Workers	22.1	33.3
Final Score	**51.22**	49.18

In constructing the labor freedom score, each of the seven sub-factors is converted to a scale of 0 to 100 based on the following equation:

Sub-factor Scorei = 50 x (Sub-factoraverage/Sub-factori)

The higher the score, the more labor freedom exists.

2018	2019	2020
63	65	**65.0**

The data used for this sub-index stems from the *Doing Business Employing Workers Index*. However, this index was not included in the 202 edition of the *Doing Business Report*. Thus, the international average remained the same. And since no significant labor reform took place in Puerto Rico during the period covered by this report, the score should remain as it was in 2019.

Country	Labor Freedom Score
Azerbaijan	66.2
Qatar	65.9
Puerto Rico	**65**
Chile	64.7
Hungary	64.6

Puerto Rico ranks 60th out of 181 in this category. Within the Americas region, Puerto Rico ranks 11th.

The same caveat that applied in 2019 applies now. Puerto Rico's above average performance in the severance pay and notice period sub-factors of this sub-index merit a higher score in this category.

Even though Puerto Rico has similar labor regulations as Singapore -- the highest score in this category -- following the Heritage Foundation's methodology led to a score of 65.

We propose that the island be given a score of **80**, which we arrived at by assigning a score of 100 out of 100 to the two sub-factors that Puerto Rico excelled at in this category. This would be in line with the United States, which has a score of 87. Puerto Rico's labor regulations are less employer friendly than the average US state, which justifies this score for the island.

The rest of the sub-indexes used were taken straight from the United States' score. As an unincorporated territory of the United States, Puerto Rico does not have its own monetary or trade policy, and its financial markets are regulated by US laws.

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.

Country	Monetary Freedom Score
Côte d'Ivoire	75.7
Lebanon	75.6
United States	**75.5**
Eswatini	75.2
Kenya	75

The United States ranks 113th out of 181 in this category. This low score is due mostly to large subsidies in the federal budget that make up 65% of the total. Inflation has not been an issue in the past but concerns of inflation post-pandemic could lead to this score potentially falling in the future.

IV OPEN MARKETS

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.

Country	Trade Freedom Score
Bosnia and Herzegovina	80
Korea, South	80
United States	**79.8**
Papua New Guinea	79.8
Vietnam	79.6

The United States ranked 74th in the world in this category. There was a decrease in the score for 2020. US tariffs and restrictions imposed on imports both contributed to the decrease in this score.

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 in 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.

In practice, however, most countries have a variety of restrictions on investment. Some have different rules for foreign and domestic investment. Some restrict access to foreign exchange. Some impose restrictions on payments, transfers, and capital transactions. In some, certain industries are closed to foreign investment.

The United States had the 3rd highest score in this category.

Country	Investment Freedom Score
Latvia	85
Malta	85
United States	**85**
Uruguay	85
Hong Kong	80

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.

In this category, the United States had a score of 80. Three countries had the highest score of 90, while 12 other countries tied at 80. This would give the United States a tied ranking of 4th worldwide.

Country	Financial Freedom Score
Australia	90
Switzerland	90
Hong Kong	90
United States	**80**
Luxembourg	80

Within the Americas region, the United States ranked 2nd behind Canada.

WORLD & REGIONAL *POSITIONING*

Following an evaluation of Puerto Rico's scores per each sub-index and its comparables, we submit Puerto Rico's overall score and positioning in the global landscape, and in the region, as follows:

WORLDWIDE: Puerto Rico 69 out of 181

Country	World Ranking
Mexico	67
Costa Rica	68
Puerto Rico	**69**
Bahamas	70
Philippines	71
Turkey	72
Luxembourg	80

AMERICAS: Puerto Rico 13 out of 33

Country	World Ranking
Saint Vincent and the Grenadines	59
Mexico	67
Costa Rica	68
Puerto Rico	**69**
Bahamas	70
Guatemala	74
Paraguay	81

Puerto Rico's ranking both worldwide and in the America's remained unchanged. Issues regarding lack of participation in the surveys used and applying the Heritage Foundation's methodology remain present. This index allows us to examine key issues regarding the island's economy, including availability of information, transparency of government services, and lack of private sector growth on the island.

High tax rates on the island, particularly personal and corporate income taxes, remain a hurdle in the path towards economic freedom.

Other recommendations include maintaining the progress that has been made in the fiscal health and government spending categories. Lower debt obligations for the future will allow Puerto Rico's government to maintain budget surpluses while whittling away at the massive debt. Tax reform and increasing public trust in government should be two main priorities moving forward, as ways of increasing economic freedom and creating a healthier economic environment.

The post-COVID landscape will be a unique opportunity to relaunch recovery efforts for an island whose economy has remained stagnant and reliant on federal transfers in the 21st century. A lack of information has been a historical hurdle to overcome when doing business on the island. Participation in surveys such as the Economic Freedom Index and the *World Bank's Doing Business Report* are invaluable ways in which to attract new investment.

SPOTLIGHT ON PUERTO RICO'S TAX CLIMATE:

COMPARISON WITH THE 50 STATES

Our firm was contracted by CRECE to calculate where Puerto Rico's tax regime ranks in the *State Business Tax Climate Index*. By better understanding how taxes in Puerto Rico compare to taxes in the states, we can develop comprehensive tax policy to improve the island's economic competitiveness. As stated by the Tax Foundation, most firms do not have to worry about outsourcing to other countries, but rather to other states with more competitive and business friendly tax climates. Puerto Rico in this case, is no exception.

One important disclaimer that must be made is the fact that Puerto Rico's territorial status, which exempts its citizens from many federal taxes, has led to the local tax regime being fundamentally and structurally different from that of a US state. An outline of these differences will be shown in this document to contextualize Puerto Rico's inclusion in this index.

According to the Tax Foundation, a competitive tax climate is one that most effectively attracts capital and labor. Puerto Rico's tax structure is characterized mostly by exemptions from federal taxes which have led to higher base rates at a state level. Puerto Rico has some of the highest base tax rates in the United States, and the myriad of exemptions that exist only serve to make it even more complicated and worsen the burden placed on corporations looking to operate in the island.

The *State Business Tax Climate Index* measures the tax environment of the 50 states. It is divided into 5 distinct types of taxes: individual income tax, sales tax, corporate tax, property tax, and unemployment insurance tax.

Puerto Rico ranks last (51) in corporate and individual income tax as well as in the sales tax. The island has the highest top marginal rates in these categories out of all the states. Despite ranking highly in property and unemployment insurance tax, the island ranks last overall in the index.

Both the *State Business Tax Climate Index* as well as this *Economic Freedom Index* emphasize the importance of limited government and efficient tax systems, as well as the role that both play in economic growth.

Methodology

The methodology used in this index does not assign an absolute score for each state, rather, it establishes an average in each category and establishes rankings relative to other states' performance. Each category can be divided into two sub-indexes. The first is directly related to the rates charged for each tax category. The second is a measure of the tax base, which considers deductions and exemptions to tax laws. Tax rates account for 80 percent of the total score for each category, while the tax base accounts for 20 percent.

In addition to this weighing within each category, for the final score, categories with more variability amongst the states are weighed more highly.

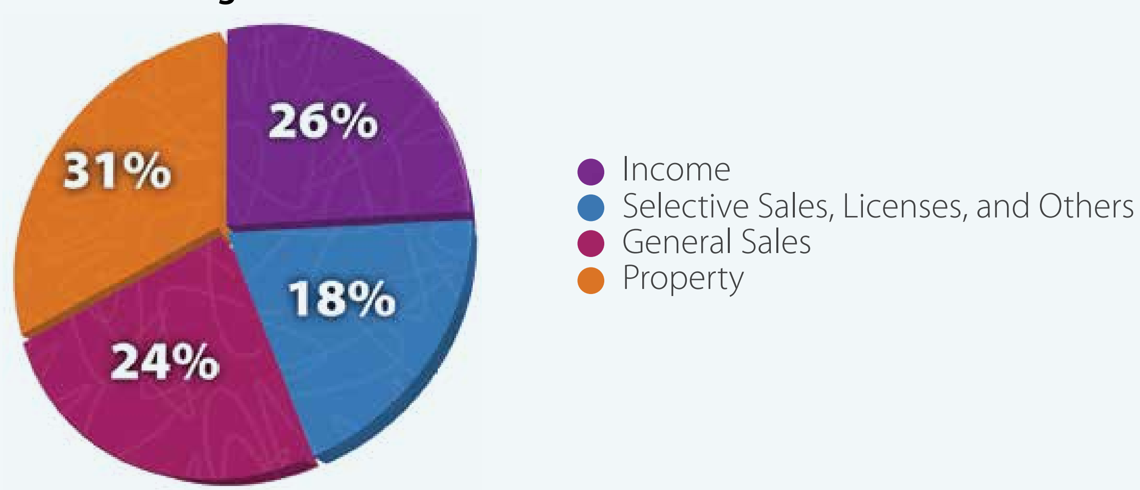
30.5% — Individual Income Tax
24.4% — Sales Tax
20.8% — Corporate Tax
14.8% — Property Tax
9.4% — Unemployment Insurance Tax

What this means is that the individual income tax, despite making up 20% of the scores used, accounts for 30.5% of the final ranking.

Structural Tax Differences:
Puerto Rico and other US Jurisdictions

The lack of federal taxation in Puerto Rico has led to a different tax structure on the island compared to other US jurisdictions. According to the National Association of State Retirement Administrators, the following chart shows a breakdown of state and local tax revenue in the United States by source for 1992-2010.

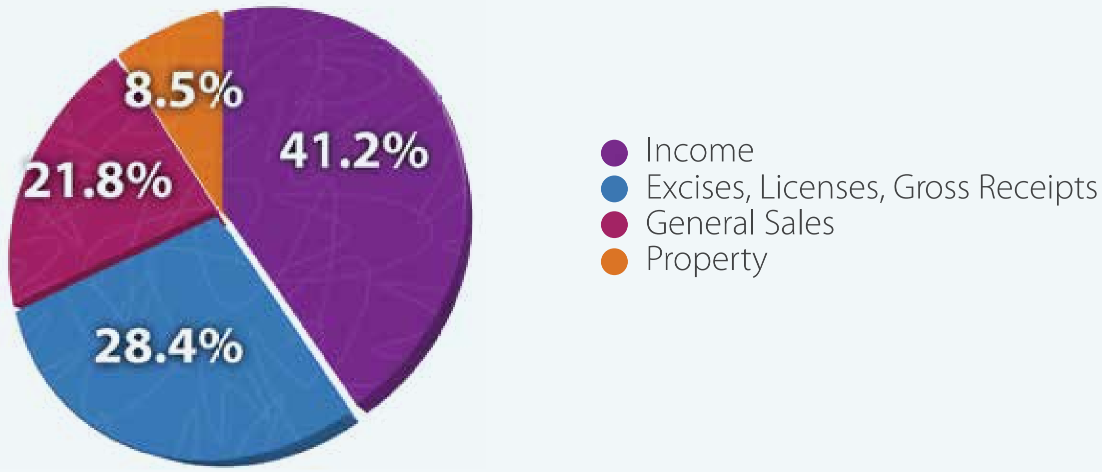
Average Source of State and Local Tax Revenue 1992-2010



Source: NASRA, US Census Bureau

Property taxes in Puerto Rico are managed at a local, municipal level, and alongside municipal patents (a gross receipts tax collected at a local level), make up most of the operating budgets for municipalities on the island. The following breakdown for state revenue shows several key differences with NASRA's study.

State and Municipal Tax Revenue FY2019



Source: Hacienda, OGP

Contrary to the prevailing pattern in the 50 US states, property tax revenue is not collected at a state level in Puerto Rico. Instead, it is collected by each municipality, the equivalent to city or county level government in Puerto Rico. As such, property taxes make up only 8.5% of all tax revenue on the island. Historically low land prices on the island led to property taxes not being a main source of revenue for the central government.

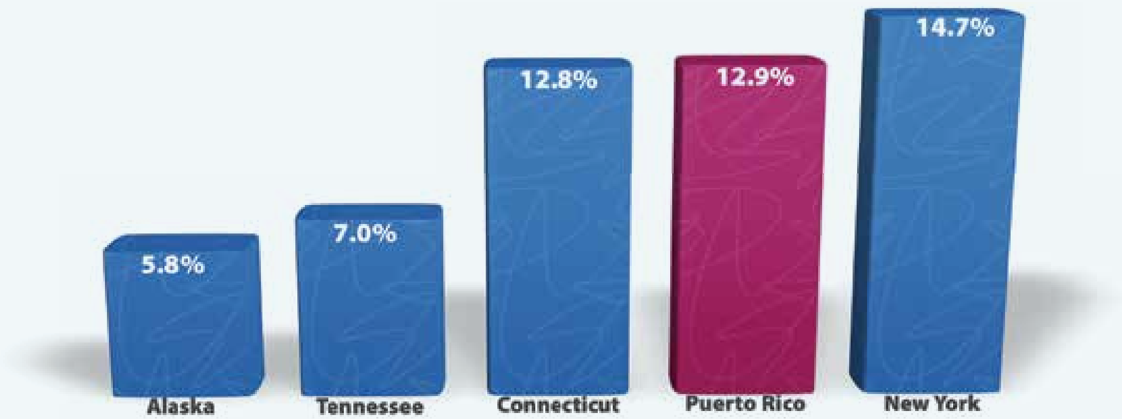
Income taxes make up a much larger percentage of total tax revenue on the island, both corporate and personal. This is due to local residents not being liable for federal income taxes, which leads the local government to increase the rate at which income is taxed.

While maintaining income tax rates at levels comparable to the rest of the US would give the island a very large competitive advantage when it comes to attracting labor, some other mechanism for funding essential government services would then be required. The creation of a state level property tax could certainly lead to capturing a higher level of GDP than what is currently managed, in part due to rampant income tax evasion due to the island's extensive underground economy, but it would require a complete reworking of local government financing on the island.

Thus, the disparity that will be shown between comparatively high levels of income taxes and low levels of property taxes must be taken into context. Improving the island's tax climate cannot be reduced to lowering income taxes without taking into account the political structures that are currently supported by the existing tax regime.

Tax *Burden*

A state's overall tax burden is calculated by comparing revenue from different types of taxes to personal income. For this exercise, information from the 2019 fiscal year in Puerto Rico will be used.



Source: Puerto Rico Treasury Department, Tax Foundation

This graph shows the 2 states with the lowest tax burden relative to personal income and the two highest. Puerto Rico is second highest, with more than double the burden of the 50th ranked state, Alaska. The only state with a tax burden higher than Puerto Rico's is New York, which has a tax burden 1.8 percentage points higher than the islands.

Source: Puerto Rico Treasury Department, Governor's Statistical Appendix

Like most states, Puerto Rico derives most of its tax revenue through sales and excise taxes. Unlike these states however, Puerto Rico has the highest individual income tax rates in the United States.

Sales and Excise Taxes are a regressive tax. Higher income individuals pay less as a percentage of their income than lower income individuals. High income individuals pay a lower percentage of their income in the form of consumption, instead having higher rates of saving and investment. Lower income individuals are forced to use high percentages of their income in the form of consumption, which is then taxed by sales and excise taxes.

Percentage of Personal Income Paid in Sales and Excise Taxes	
Puerto Rico	**8%**
Hawaii	6.7%
Nevada	6.1%
Washington	5.7%

According to state tax information from Wallethub[2] Puerto Rico is the jurisdiction with the highest percentage of personal income captured by sales and excise taxes. This is due both to Puerto Rico having the highest state sales tax as well as high levels of excise taxes on the island levied on new car sales, alcohol, and gasoline. This higher effective rate of taxation on lower income individuals worsens inequality and contributes to a non-business friendly tax climate.

Corporate *Income Tax*

The first measure used in this index is the base corporate income tax rate. The highest possible rate for each state is compared, alongside the number of distinct brackets, the width of these brackets, and the amount at which this highest rate kicks in.

Puerto Rico's corporate income tax has a maximum rate of 37.5%, which kicks in at incomes over $275,000, and there are 6 total brackets. States which score the highest in this category do not levy an income tax on corporations. The state with the highest rate is Iowa, with 12%. Only Iowa and New Jersey have corporate income tax rates greater than 10%.

	Puerto Rico	Iowa	North Carolina
Corporate Income Tax Rate	37.5%	12%	2.50%
Multiple Brackets?	Yes	Yes	No
Top Bracket	$275,000	$250,000	$0
Number of Brackets	6	4	1
Ranking	51	46	4

The preceding table shows an example of a low-ranking state, Iowa, and a high-ranking state, North Carolina. North Carolina's corporate income tax system is a single bracket that applies to all levels of income and is only 2.5%. Iowa's on the other hand, has one of the highest tax rates, and like Puerto Rico, has numerous brackets that kick in at a high level of income.

Aside from this high rate, Puerto Rico ranks 3rd out of 51 in the amount of brackets when compared to other jurisdictions. There are only four states where the highest rate kicks in at a higher amount than Puerto Rico: Maine, at $3.5 million, New Jersey, at $1 million, New Mexico, at $500,000, and Oregon, at $1 million.

2 McCann, Adam. "Tax Burden by State". Wallethub. https://wallethub.com/edu/states-with-highest-lowest-tax-burden/20494

Given the fact that corporations are not liable for federal income taxes, this high rate represents a missed opportunity to maintain rates that are simpler and lower than in other jurisdictions. Even when taking into account the federal income tax rate of 21%, Puerto Rico's is still the highest in the United States.

Other components measured in this section include the existence of a gross receipts tax, an alternative minimum tax, and deductions for net operating losses.

Most municipalities in Puerto Rico utilize a gross receipts tax, known as a municipal patent, as their main source of funding. While the overall rate levied on corporations is limited by law to less than 1.5%, the existence of this tax worsens Puerto Rico's tax climate, as does the existence of an alternative minimum tax.

Puerto Rico's high rate and number of brackets, as well as large tax exemptions and credits, merit its ranking at the bottom in 51st for this category.

Individual *Income Tax*

The next section of this index is the individual income tax section. While businesses do not pay these taxes, they affect capital mobility. States that do not levy taxes on personal income rate have a competitive advantage when it comes to attracting workers, and consequently, firms.

The 2021 edition of the *State Business Tax Climate Index* also cites various studies which show the effect of high personal income taxes on entrepreneurship and self-employment. Taxes by their very nature increase costs associated with the good or service that is taxes. High levels of income tax can serve to discourage labor participation.

	Puerto Rico	California	Pennsylvania
Top Marginal Tax Rate	33%	13.30%	3.07%
Top Bracket	$61,500	$1,000,000	$0
Number of Brackets	5	10	1
Ranking	51	49	19

Puerto Rico has the highest rate of personal income tax, which is 33%, and kicks in at incomes over $61,500. Although the island's personal income tax system has relatively few brackets that kick in at low levels of income relative to those of other states, it is by far the highest; more than 20 percentage points higher than the second highest which is seen in California.

Aside from not levying an income tax at all, the Tax Foundation's methodology favors single bracket income taxes at low rates. Pennsylvania is one such example.

The advantage that Puerto Rico has is that income earned on the island is in most cases, not subject to federal income taxes. While it is important to view local rates in this context, this represents a lost opportunity to both attract and maintain human capital on the island. High levels of migration away from the island have been seen towards Texas and Florida, two states that do not levy taxes on personal income.

Features of the Puerto Rico taxation system which reflect positively according to the index are the lack of income recapture, the lack of a marriage penalty, and recognition of limited liability companies (LLCs) for tax purposes. The lack of indexing for inflation and the existence of an alternative minimum both counts negatively for this index.

Puerto Rico's extraordinarily high marginal tax rate, the existence of an alternative minimum, and the lack of indexing for inflation all justify placing Puerto Rico at the bottom of the rankings for this category.

Sales *Taxes*

The next system explored by this index is the local sales tax system. Aspects of it that count towards a jurisdiction's ranking are the rate, the existence of local rate, remote seller protections, and any exemptions.

State	State Sales Tax Rate
Puerto Rico	10.5%
California	7.25%
Indiana	7%
Mississippi	7%
Rhode Island	7%
Tennessee	7%

Puerto Rico has the highest state rate, 10.5%, and the highest combined state and local rate, 11.5%, of any jurisdiction within the United States. One aspect that the island does score positively in is the lack of exemptions.

State	Combined state and local average sales tax Rate
Puerto Rico	11.5%
Tennessee	9.55%
Arkansas	9.53%
Louisiana	9.52%
Washington	9.23%
Alabama	9.22%

While many states allow local governments to levy additional sales taxes, even when looking at the combined state and average local sales tax rates, Puerto Rico's is by far the highest.

One aspect of this ranking where Puerto Rico scores positively is the lack of exceptions for groceries, alcohol, and gasoline. While this might seem counter-intuitive, the existence of tax exemptions is viewed negatively by the Tax Foundation. They argue that tax exemptions unnecessarily complicate tax systems, and favor low, flat rates instead.

	Puerto Rico	Hawaii	Colorado
Sales Tax Revenue as % of Personal Income	3.40%	4.76%	0.98%
Ranking	51	30	36

This table shows that sales tax revenue in Puerto Rico represented 3.4% of total personal income in 2019. This is the 3rd highest amount in the US, lower only than Hawaii and Nevada. What these two states have in common is a large reliance on tourism. This shows however how large a portion of income is captured through consumption taxes. This high sales tax rate makes for a less attractive business environment in Puerto Rico.

Puerto Rico is positioned at the bottom, at 51st in this category. The US territory has the highest state sales tax rate in the nation. It also derives a large percentage of its tax revenue through a series of excise taxes on foreign-based companies, alcohol, and car sales.

Property *Tax*

The property tax section of this index is based on various measures of how states collect these taxes. Property taxes are usually levied at a local level in states, and Puerto Rico is no exception. What makes Puerto Rico an exception is the lack of a state-level property tax. The two main measures that are applied to Puerto Rico are property tax collections per capita, and the effective property tax rate.

Property tax per capita is calculated by using total property taxes paid and dividing this amount by population. Property taxes on the island are set at a municipal level. The Municipal Revenues Collection Center (CRIM, in Spanish) is responsible for the collection and distribution of property taxes to municipalities.

According to the CRIM, there was a total of $1.079 billion paid in property taxes in the 2019 fiscal year. Dividing this by the population estimate for the island in 2019, which is 3.194 million, gives us a total property tax per capita of $338.

This total would rank Puerto Rico 1st in this category. The lowest property tax collections per capita amongst the 50 states belongs to Alabama, which was $582 in 2020. The states that rank poorest in this category are New Hampshire, New Jersey, and Connecticut, which had collections of $3,310, $3,277, and $3,020, respectively.

The other main measure for property taxes is the effective property tax rate. This is obtained by dividing total personal income by total property tax collections. This total for Puerto Rico is 1.6%, which is the second lowest effective rate amongst all states, just behind Alabama's 1.4%.

	Puerto Rico	Alabama	New Hampshire
Property Tax per Capita	$349	$582	$3,310
Effective tax rate	1.6%	1.44%	5.66%
Capital Stock Tax Rate	0	0.18%	0
Ranking	2	19	47

There are many factors that could be contributing to this large disparity. The first one is the role that property taxes play in local municipal finances in Puerto Rico. Many municipalities fund large parts of their budget through gross receipt taxes (patents). They are also entitled to a sales tax of 1% on nearly all goods and services that are sold. These different sources of funding allow for low property tax rates.

Aside from these low rates however, the presence of estate, inheritance, gift, inventory, business property taxes on the island all count as negatives for this section. The lack of a capital stock tax counts as the sole positive variable for Puerto Rico.

Puerto Rico should be at the top or very near the top of the rankings for this section. Puerto Rico's high-income tax rates as well as lack of local-level funding for public schools have led to low property tax rates. The lack of a capital stock tax also contributes to our recommended ranking of 2nd in this category.

Unemployment *Insurance Taxes*

The last category in this index is unemployment insurance taxes. The main measures used in this index are the lowest and highest rates that are levied for unemployment insurance, the taxable wage base, and seasonal cycles, or schedules.

Puerto Rico scores highly in terms of its rates. With a minimum of 1% and a maximum of 5.4%, the island ranks amongst the top jurisdictions in this category.

	Puerto Rico	Massachusetts	Oklahoma
Minimum Rate	1%	0.94%	0.10%
Maximum Rate	5.40%	14.37%	5.50%
Taxable Base	$7,000	$15,000	$18,700
Ranking	5	50	1

Other favorable aspects of unemployment insurance taxes in Puerto Rico are the lack of different schedules and a minimum of benefit add-ons and surtaxes.

The combination of low rates and a favorable tax base merit ranking Puerto Rico 5th in this category.

Conclusions

Puerto Rico has the highest or close to highest marginal rates for both corporate and individual income tax, while also having the highest state sales tax. Property taxes, however, are some of the lowest paid in the entire nation. Puerto Rico's unique status as a non-incorporated United States territory has led to a tax code and a financial structuring and relationship between the local and state government that is reflective of this.

Given the fact that individual income tax, sales tax, and corporate income tax make up 75.8% of the total score Puerto Rico's high scores in the other 2 categories do not make up for the extraordinarily high rates levied in the 3 major ones. Our firm would recommend ranking Puerto Rico last in this index.

A disproportionate tax burden falls on income taxes rather than on property taxes as in the 50 states. Lowering these marginal rates would be in accordance with the Tax Foundation's stated goals of simpler, lower taxes. However, this would lead to a large decrease in public spending if not accompanied by property tax reform that could shoulder some of the burden of funding essential services.

Overall, Puerto Rico's unique territorial status leads to difficulties establishing direct comparisons between its tax code and those of the 50 states. However, there is still value to be found in applying these standards to Puerto Rico. The island government's large dependence on income tax as a primary source of income, as well as having the highest sales tax in the United States, are both deterrents to new investment and new businesses.

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CENTRO PARA RENOVACIÓN ECONÓMICA, CRECIMIENTO Y EXCELENCIA

PO Box 190913
San Juan, PR 00919-0913
www.centrocrece.org

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CRECE @centrocrece.org centrocrecepr @centrocrece @crecepuertorico

inteligencia Economica
B5 Calle Tabonuco Suite 216 PMB 109 Guaynabo PR, 00968-3029
787.404.3496 • gvelez@economiapr.com