

How Puerto Rico Kicked Its Deficit to the Curb

by P.J. Dinner

Background:

Puerto Rico is an island situated between the Caribbean Sea and the North Atlantic Ocean, east of the Dominican Republic. It is a self-governing commonwealth in association with the United States. The chief of state is the President of the U.S.; the head of government is an elected governor (Luis Fortu o since 1-2-09). There are two legislative chambers: the House of Representatives, 51 seats, and the Senate, 27 seats.

Puerto Rico's success in beating back a \$2-billion deficit and clearing the path to solvency was the story that Jose R. Pérez-Riera related at the Chamber of the Americas (COTA) Executive Forum luncheon on March 23rd, according to Gil Cisneros, COTA president/CEO. Pérez-Riera is secretary of Puerto Rico's Department of Economic Development and Commerce (DEDC).

Puerto Rico's economy has historically moved in sync with the U.S. economy, lagging behind the U.S. but satisfactory nevertheless. In 2007 that changed. "That's when we saw a divergence between these two economies that created the greatest schism we had ever seen," said Pérez-Riera, who oversees 10 government agencies and public corporations with over 1,300 employees and an FY2011 consolidated budget of US\$377 million. "Puerto Rico's economy in 2007-2008 contracted at a negative rate of 2.5 percent whereas the U.S. economy grew at a rate of 2.4 percent."

Major adjustments were in order.

When Luis Fortu o was elected governor Nov. 2008, it was with the largest margin that any governor has ever received, according to Pérez -Riera. Even before he was sworn in, Fortu o and his team started to draw up a plan in response to the people's mandate: Reverse the downward trend of the last eight years and put us on the path to economic growth. The resultant plan – the Strategic Model for a New Economy – is "the most comprehensive economic development model that Puerto Rico has seen in decades and perhaps ever."

The broad and very specific plan called for restoring economic growth with a short-term federal stimulus and long-term growth measures designed to integrate Puerto Rico into the global arena and accelerate a knowledge-based and innovation-driven economy.

"Puerto Rico's economy has made a series of transitions over the decades, from agrarian society to industrialized economy to specializing in pharmaceutical manufacturing, medical devices and electronics," said Pérez-Riera. The services sector, which includes tourism, is an important piece of the economy which generates a GDP of \$96 billion.

"The biggest component of our GDP is manufacturing followed by the financial, insurance and real estate sectors. It's a fairly diversified economy and we're trying to diversify it

more, particularly into areas that have great potential for growth such as tourism," said Pérez-Riera. Because manufacturing has fueled Puerto Rico's growth over the years, the tourism sector has not gotten the attention it deserves, he said.

"But we don't need to concentrate exclusively on those areas that we do very well at; we should do well at all of them and focus on all of them. That's the way you grow the GDP and that's the approach our administration has taken."

The Strategic Model

At the time the new administration took office, Puerto Rico had a junk bond credit rating, making it difficult to borrow and fund growth. So improving this rating was high among the goals of the Strategic Model, as was tax reform.

"About a month ago the legislature approved the largest tax reform in the history of the island," said Pérez-Riera:

- \$1.2 billion a year in tax relief for individuals with a reduction in the tax rate of 25 percent on average. There will be further reductions over the next six years.
- A reduction of the maximum corporate tax rate from 41 percent to 30 percent. Tax brackets have been streamlined from five to three: 20, 25 and 30 percent.

"The brackets are much broader than previously so it takes higher earnings before that maximum 30 percent is reached. Ultimately the effective tax rate on the corporate level will be about 26 percent; however, by the year 2014 those three tax brackets will be reduced to two: 20 and 25 percent."

In addition to reforming various government systems, the strategic model also called for targeted incentives and strategic initiatives aimed at promoting business expansion from within and attracting new business from abroad.

Pérez-Riera is confident that this multi-pronged approach is working to shore up the economy. "It's clear that the economy has turned around," he said, producing figures that showed gains in every sector, including private sector employment, tourism, housing and exports. "After two very difficult years we find ourselves in a very good position."

But what about that \$2-billion budget deficit?

Budget Cuts

Working under a mandate to reduce the budget deficit by \$2 billion within a two-year period, the administration made decisions that required sacrifices across the board. The government payroll had to be reduced by 12,000 employees. To achieve this, workers were

offered incentives to transition to the private sector. And for private sector businesses that hired a transitioning public employee, the government paid half the salary of that hire for one year.

"Making such huge cuts was not something any of us wanted to do," said Pérez-Riera. "But if you want to achieve your goals you have to do the things that have to be done instead of trying to cover up the problem as Puerto Rico did for eight years."

Other surgical attacks on the budget included a 20-percent reduction of expenditures in the executive branch. "Salaries were cut, and the governor himself took a cut," said Pérez -Riera. Also, the number of political appointments was cut by 30 percent.

He acknowledges "the deficit-cutting process has been very difficult for the people of Puerto Rico. But the things that we've done have been done in a fair fashion, in a compassionate way, and we're now on the other side of that equation." A modest upswing landed the economy in neutral territory in 2010, and "for 2011 the expectation is that we'll see growth for the first time since 2006."

Said Gil Cisneros: "Secretary Pérez-Riera did not suggest that the States use the island's achievements as a template for solving their own budgetary crises, but many in the audience thought it would be a step in the right direction."