

PUERTO RICO

ECONOMIC FREEDOM INDEX

REVISED APRIL 2020



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
Graphic Design: Carlos López | Uará Media



PO Box 190913
San Juan, PR 00919-0913

787.356.1206
www.centrocrece.org

Follow us:

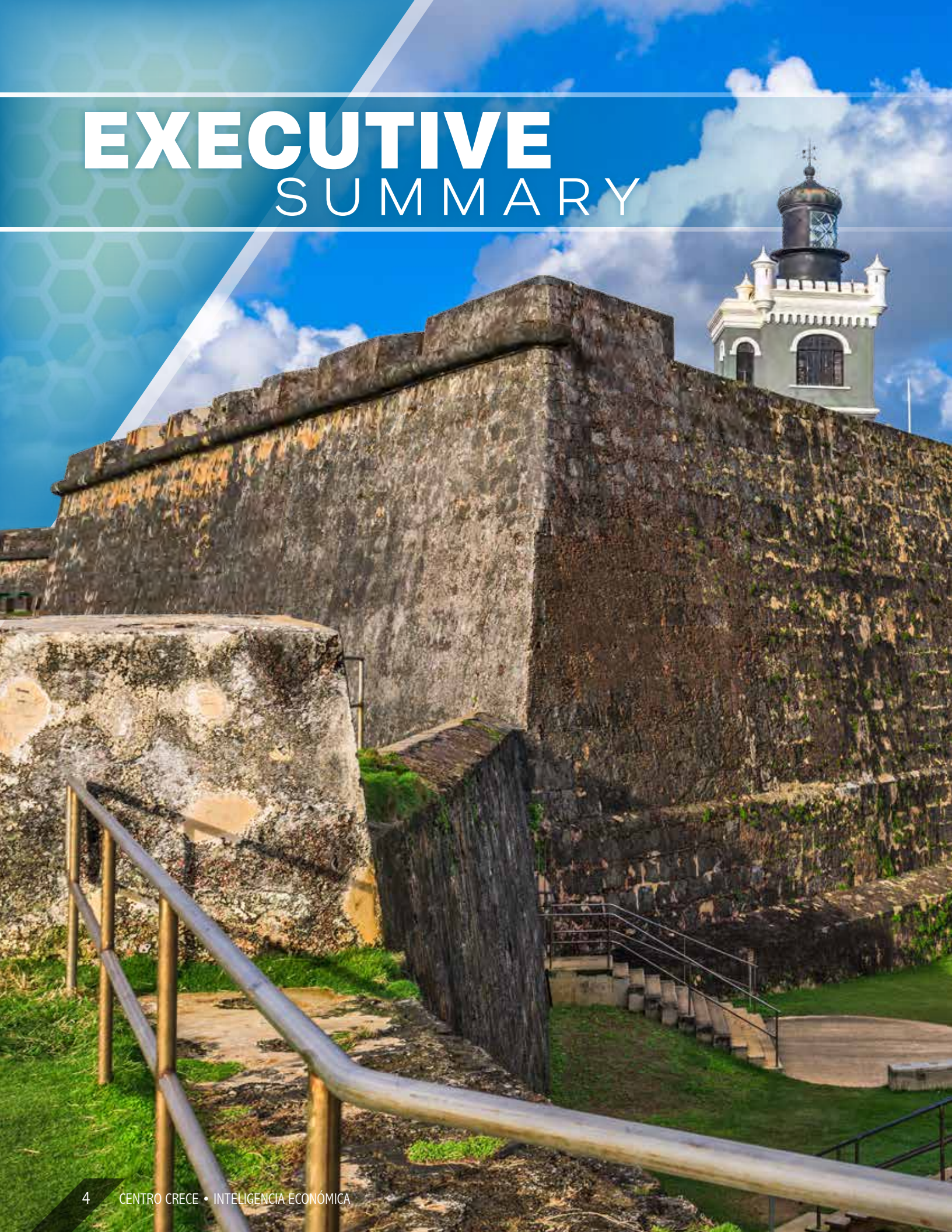
 @centrocrece.org  @centrocrece  @crecepuertorico

All rights reserved.
Printed in Puerto Rico.

CONTENT

EXECUTIVE SUMMARY.....	4
PUERTO RICO'S ECONOMIC CONTEXT	6
PUERTO RICO ECONOMIC FREEDOM INDEX 2019	10
METHODOLOGY	10
I. RULE OF LAW	
Property Rights	11
Judicial Effectiveness	12
Government Integrity	13
II. GOVERNMENT SIZE	
Tax Burden.....	15
Government Spending	16
Fiscal Health	17
III. REGULATORY EFFICIENCY	
Business Freedom	19
Labor Freedom	21
Monetary Freedom	22
IV. OPEN MARKETS	
Trade Freedom	23
Investment Freedom	23
Financial Freedom	23
WORLD & REGIONAL POSITIONING	24
Puerto Rico's Economic Freedom Compared with States.....	25
Recommendations for Improving Puerto Rico's Economic Freedom.....	26
CONCLUSION	30
REFERENCES	32

EXECUTIVE SUMMARY



The Center for Economic Renewal, Growth and Excellence (“CRECE”, for its Spanish acronym) appointed Inteligencia Económica for a second consecutive year with the task of analyzing and creating the Puerto Rico Economic Freedom Index 2019 based on The Heritage Foundation’s methodology. Our firm agreed to revisit the index to better understand the current situation of the economy on the island.

As previously stated, economic freedom is more than the freedom for economic activity between individuals. Economic freedom is essential to protect basic human rights to private property, generating income, mobility and more. The Economic Freedom Index is a vital tool to promote growth and prosperity.

KEY POINTS:

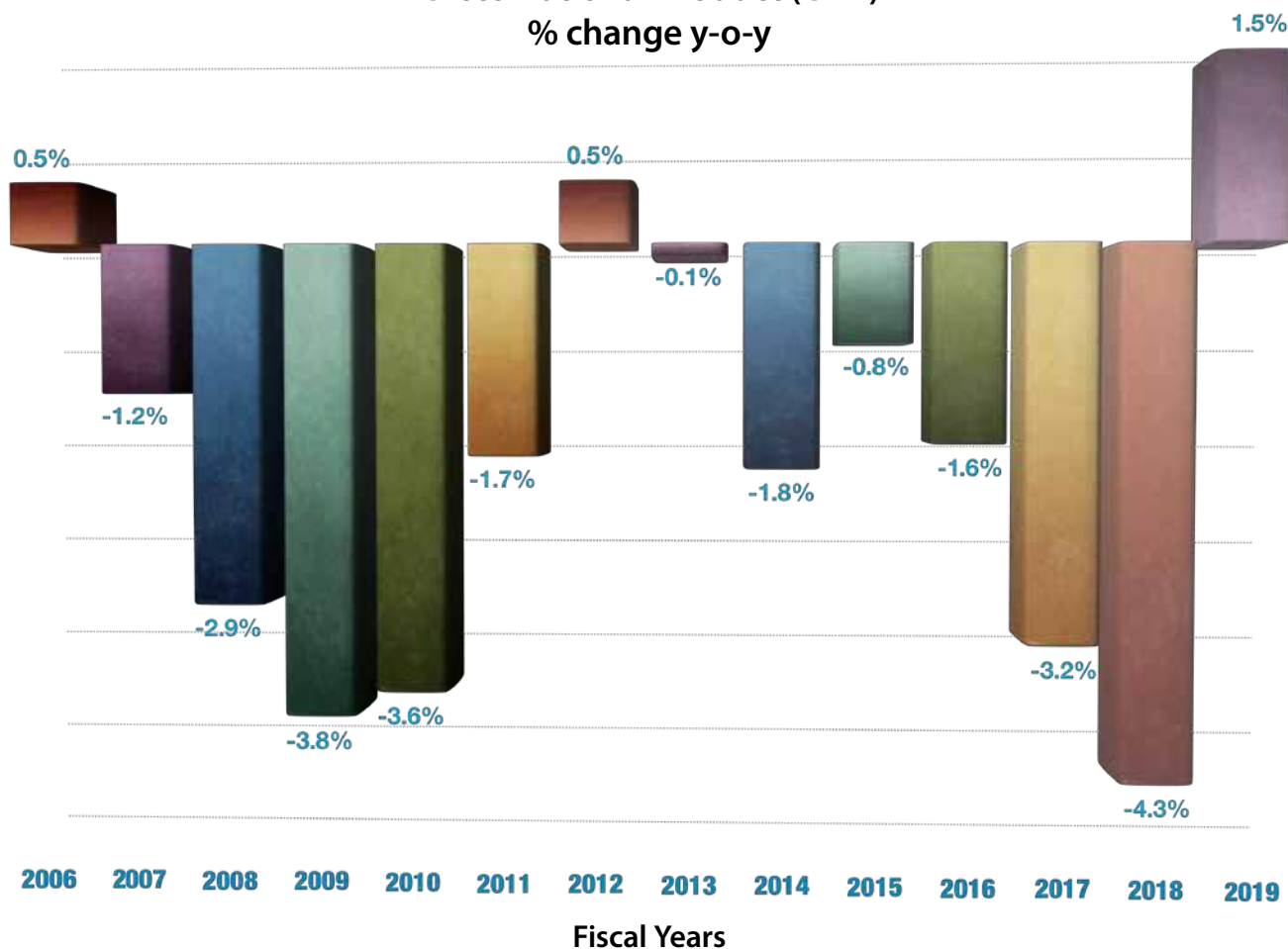
- Because of the \$20 billion in federal funds that were received for disaster relief after hurricanes Irma and María, Puerto Rico’s economy experienced a surge that lasted through all of 2018 and the first half of 2019.
- The Financial Oversight and Management Board’s (FOMB) structural reforms and debt restructuring efforts were affected by Hurricane María.
- Dependency on United States (US) federal aid discouraged the local government from implementing political reforms that could potentially spur growth.
- Important reforms, such as those related to energy, government permits, and tax reform continue to be postponed by the local government.

Variable	2017	2018	2019
Property Rights	70	50	64.1
Government Integrity	-	41.8	48.5
Judicial Effectiveness	-	50	64.3
Tax Burden	-	61	61.1
Government Spending	77	31	24.5
Fiscal Health	-	71.3	65.2
Business Freedom	63	62	51.2
Labor Freedom	79	63	65.0
Monetary Freedom	77	77	76.6
Trade Freedom	80	80	86.6
Investment Freedom	70	70	85.0
Financial Freedom	70	70	80.0
Puerto Rico SCORE	71	61	64.4

PUERTO RICO'S ECONOMIC CONTEXT

Puerto Rico's economy has been in a continuous decline since 2006 when the full effects of free trade agreements entered by the US 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. The economy has not experienced real growth since 2006. In the aftermath of the housing market collapse, the injection of federal monies under the American Recovery and Recovery Act (ARRA) in 2009-2010, coupled with local fiscal and economic policies, resulted in temporary growth in 2012. However, starting in 2013 the economy took a downward turn again. The economic growth reflected in 2019 is the direct result of the arrival of recovery funds in the aftermath of Hurricane María.

Gross National Product (GNP)
% change y-o-y

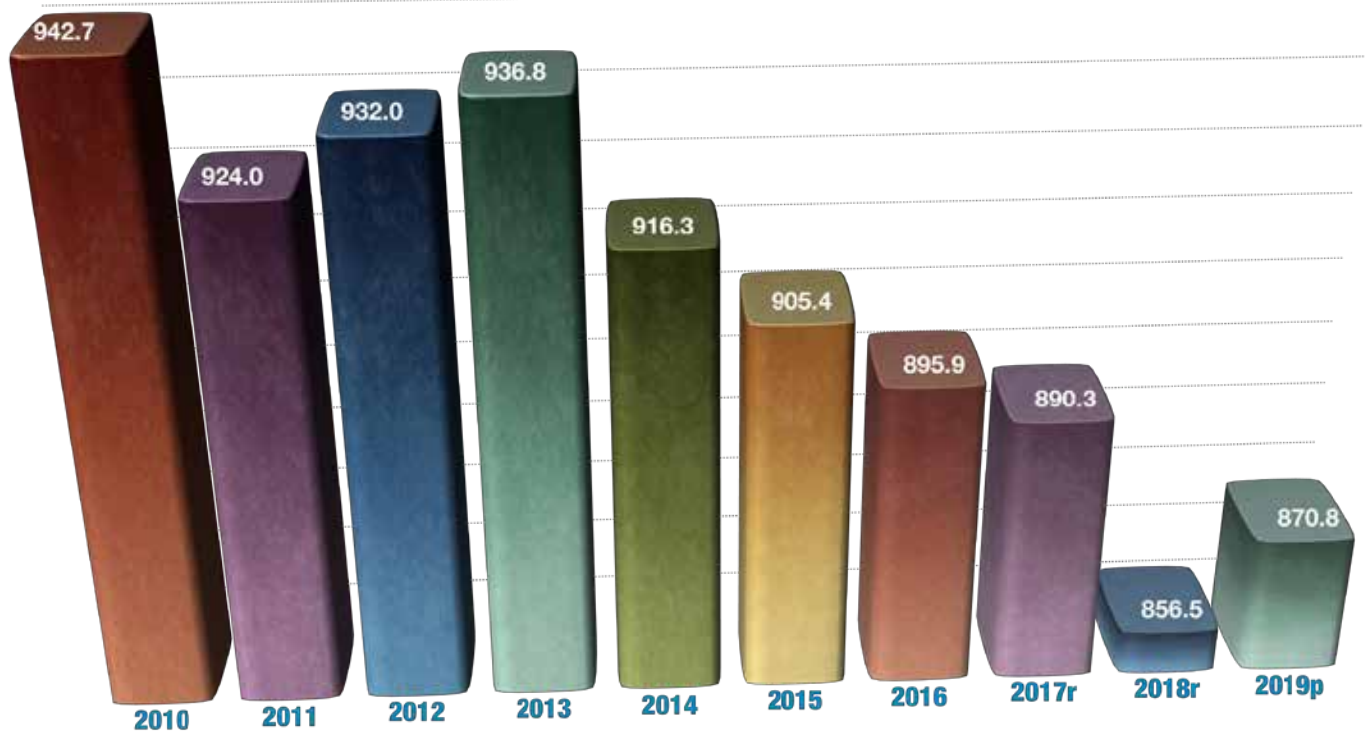


Source: Statistical Appendix 2019

In September 2017 (FY2018), Puerto Rico was hit by two category-5 hurricanes causing almost \$80 billion in damages. To support relief and recovery efforts, Congress approved various aid packages for Puerto Rico. Approximately \$20 billion were disbursed in the first six months of 2018, while the remaining \$10 to \$12 billion are still being expended.

Meanwhile, total non-farm payroll on the island managed to remain constant, alleviating some fears that continued emigration would snowball after Hurricane María, placing even greater pressure on the local government's capacity to bankroll its spending with an ever dwindling population.

Total Non-Farm Payroll (,000)

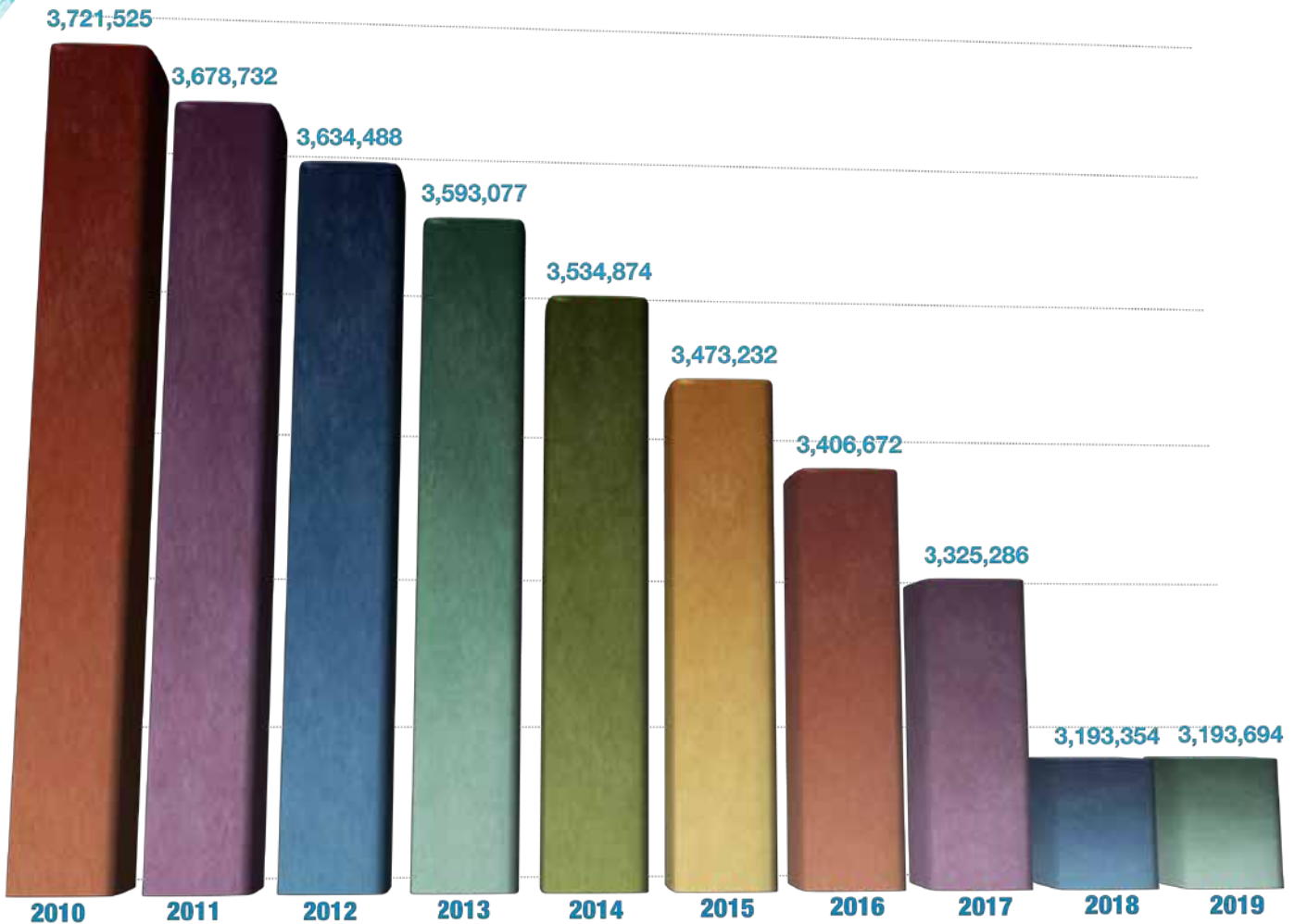


Source: Statistical Appendix 2019

Non-farm payroll increased in 2019 due to the stabilization of labor reductions experienced during FY2018 caused by Hurricane María. Monthly employment statistics have remained stagnant, showing a market capacity with low employment rates. Post María, population loss reached an all-time high for the year, with 130,000 people relocating to the Mainland. In 2019, the island's population loss leveled off.



Population of Puerto Rico



Source: Statistical Appendix 2019

Fiscal Situation in Puerto Rico

The FOMB continues to watch over the state's fiscal plans and is now overseeing municipalities. A recent agreement reached between the FOMB and bondholders could lower annual debt servicing for the government from \$4 billion to just \$1.5 while also lowering the total amount to be paid from \$90 billion to \$40 billion. This deal, however, must be approved by the local legislature, which is presenting considerable opposition to it. The current governor, Honorable Wanda Vázquez, has also expressed her opposition.

In addition, the federal government has expressed concern over the island's ability to effectively distribute and manage the federal funds assigned, and has cited its desire to delegate the disbursement of federal funds to the FOMB, yet no concrete actions have been taken in that direction.

The Economy in 2020

Heading into 2020, two major issues cloud the island territory's future with uncertainty. The series of earthquakes that began in December of 2019 and culminated with a disastrous 6.4 magnitude earthquake on January 7, 2020 froze economic recovery yet again, and the state's response to the disaster has sparked more skepticism on its ability to handle the disbursement and distribution of recovery funds. Significant reconstruction efforts will be necessary to bring normalcy back to the southwest region of the island, which was the most affected by these earthquakes.



Another event adding to the island's economic uncertainty is the lockdown due to the COVID-19 pandemic. Preliminary estimates show an \$8.4 billion blow to the economy with approximately \$5 billion in recovery funds. There is a clear projection for economic contraction in 2020.

CDC/ Alissa Eckert, MS; Dan Higgins, MAM / Public domain

PUERTO RICO ECONOMIC FREEDOM INDEX 2019

“*Economic freedom is the fundamental right of every human to control his or her own labor and property. In an economically free society, individuals are free to work, produce, consume, and invest in any way they please. In economically free societies, governments allow labor, capital, and goods to move freely, and refrain from coercion or constraint of liberty beyond the extent necessary to protect and maintain liberty itself.*”

—The Heritage Foundation

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.

ABOUT THE PUERTO RICO ECONOMIC FREEDOM INDEX 2019

The *Index of Economic Freedom* is an annual collaboration between The Heritage Foundation and *The Wall Street Journal*. The Index is based on 12 quantitative and qualitative factors that are grouped into four broad categories, or pillars of economic freedom:

- I. Rule of Law (property rights, government integrity, judicial effectiveness)
- II. Government Size (government spending, tax burden, fiscal health)
- III. Regulatory Efficiency (business freedom, labor freedom, monetary freedom)
- IV. Open Markets (trade freedom, investment freedom, financial freedom)

All sub-indexes or components are graded on a scale of 0 to 100. A country's overall score is derived by averaging these twelve economic freedoms, with equal weight being given to each.

METHODOLOGY

Our basis for this analysis was The Heritage Foundation's methodology. It should be noted that several sources used for The Heritage Foundation's Index do not include Puerto Rico in their analysis. To fill the gap, we used statistics and studies from Puerto Rico whenever possible.



RULE OF LAW

PROPERTY RIGHTS

According to The Heritage Foundation, “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.”¹ It measures the degree to which a jurisdiction’s laws protect rights to private property and the extent of observance of said laws. It further considers the possibility of the state’s expropriation of private property.

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	51
Risk of expropriation	39.1
Quality of land administration	83

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

2017	2018	2019
70	50	64.1

Puerto Rico’s score for property rights was 64.1. This is comparable to Bahrain (63.5), Brunei (64.0), Qatar (64.5). This sub-index’s score went up due to a **change in methodology** from the World Economic Forum’s (WEF) *Competitiveness Report* to the Credendo Group’s *Country Risk Assessment*.

KEY POINTS:

Private property in Puerto Rico is guaranteed under the US and PR Constitutions. Like the US Constitution, the Puerto Rican Constitution places two requirements on the use of expropriation, or eminent domain: the expropriation must be for public use, and just

1 2019 Index of Economic Freedom. (2020) The Heritage Foundation.

compensation must be paid. However, Puerto Rican laws remain ambiguous on this important subject, allowing for manipulation by government officials to advance private development projects, and limiting the property rights of its citizens. Simply put, “there are no “public use” limitations. Instead, total deference is given to legislative determinations about the public purpose of a taking”². This is rarely seen in any other US jurisdiction. As a result, the sub-index of Risk of Expropriation is low (39.1).

Another challenge with property rights in Puerto Rico is the recording process in the Puerto Rico Property Registry. The Registry ensures the validity of registration and preserves property rights as a benefit, but it has a long filing and deed review process. Overall, property registry, information about property, embargos, another related items, take time to be made public, which slows down the process of the real estate market, thus, affecting homeowners and potential buyers.

RECOMMENDATION:

For Puerto Rico to create a robust real estate market, it must implement landowner registration reform to expedite and validate transactions.

JUDICIAL EFFECTIVENESS

According to The Heritage Foundation, “well-functioning legal frameworks are essential for protecting 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.”³

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:

$$Sub-factor\ Score\ i = 100 \times (Sub-factorMax - Sub-factori) / (Sub-factorMax - Sub-factorMin)$$

The more effective the judicial process, the higher the score.

The World Bank’s *Doing Business* (DB) report was used for calculating this index. The judicial independence component of this sub-index is taken from the WEF. In Puerto Rico’s case, this was replaced with the enforcing contracts score from DB. Usually this index’s methodology requires standardizing scores, but since this score was already graded on a scale of 0-100, it was used as is.

2 Institute for Justice. *Expropriation in Puerto Rico: policy brief and report card*. August 2018.

3 *2019 Index of Economic Freedom*. (2020) The Heritage Foundation.

We believe that this led to a more accurate score for Puerto Rico than The Heritage Foundation's original methodology. The original methodology gave a score of 38. Since the island's score of 61 was much closer to the top score in this category than to the bottom, we believe that using 61 without converting it, is a more accurate reflection of Puerto Rico's reality than the standardized score. As for quality of judicial processes, the same thing occurred. DB's original score for Puerto Rico was an 11 out of 18. The top score in this category was a 16.5. Using the original methodology led to a score of 36.67, which is not indicative of Puerto Rico's performance. The 11.5 out of 18 was standardized to 100 by setting the top score of 16.5 as a 100, dividing, and then using that result as a multiplier which could be used to arrive at a reasonable score.

2017	2018	2019
-	50	64.3

Puerto Rico's score for 2019 is 64.3, an increase when compared to 2018. The increase is due to the change in methodology. It is comparable to countries such as Dominica (63.8), Saint Vincent and the Grenadines (63.8), Saint Lucia (63.8), Iceland (63.8), Portugal (64.3), and France (66.1).

KEY POINTS:

As mentioned above, we decided to change the methodology so it can reflect the reality of the Index. Even so, we believe this score is low, given that Puerto Rico's judicial system is the same as in the US, which has a score of 78.6.

RECOMMENDATION:

Puerto Rico should be included in the WEF's *Competitiveness Report* to expand availability of comparative resources and provide important measurement outlets to develop policy solutions that encourage growth and improve competitiveness.

GOVERNMENT INTEGRITY

Corruption is a barrier to economic freedom because it tarnishes healthy commercial relations with coercion and uncertainty. Corruption can exist in business and in government institutions, and can take the form of bribery, extortion, nepotism, cronyism, and patronage, among others. Corruption erodes the public trust in its institutions and increases 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	Score
Public trust in politicians	-
Irregular payments and bribes	46.5
Transparency of government policymaking	-
Absence of corruption	-
Perceptions of corruption	-
Governmental and civil service transparency	51.5

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

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

A higher score indicates that citizens perceive their government to have integrity. A lower score points to distrust for the government's institutions. The higher the level of corruption, the lower the level of economic freedom.

2017	2018	2019
-	41.8	48.5

Puerto Rico's score for 2019 was 48.5, an increase when compared to 2018. This is comparable to countries such as Lithuania (47.8), India (47.8), China (49.1), and Saudi Arabia (49.8). For this index, there was also a change in methodology.

KEY POINTS:

This sub-index's methodology changed from the WEF's *Competitiveness Report* to the TRACE *Bribery Risk Matrix*. If alternate sources were to be applied, such as the *World Values Survey* used by the Puerto Rico Statistic Institute, Puerto Rico's score would be much lower, as surveys indicate that most people on the island believe corruption and bribery to be commonplace⁴. It should be noted that this does not consider the events that occurred in the summer of 2019, when the Governor of Puerto Rico abruptly resigned following mass protests over alleged corruption. Perception of corruption hurts the economy because it erodes public trust in institutions, diminishes credibility in the markets to access capital, and deters private investment.

4 "In terms of corruption in Puerto Rico, using a scale from 1 to 10, where 10 represents that there is a lot of corruption in Puerto Rico, the average response was 9.4 and a median of 10, confirming a high level of perceived corruption in Puerto Rico. This includes 78.4% who selected 10 in the answer " p.23. World Values Survey (WVS) conducted by the Statistical Institute of Puerto Rico. *World Values Survey for Puerto Rico: 2018*

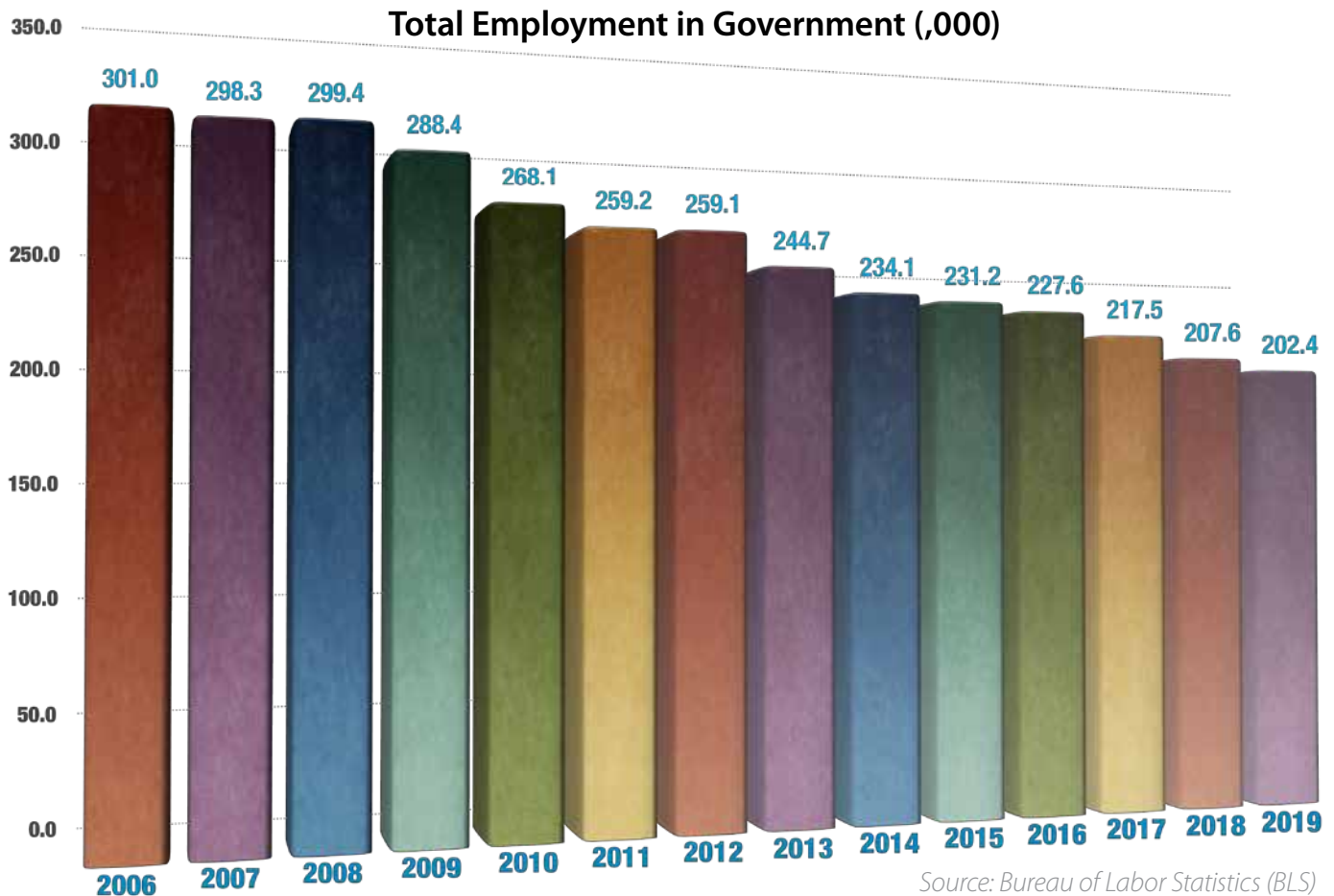


GOVERNMENT SIZE

While many economists see free markets as the ideal mechanism for resource allocation in a society, the reality is that some 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 government⁵.

Puerto Rico's government size has been an ongoing topic in the local and federal spheres. The government controls – or is the largest provider – of services like public transportation, and utilities that include electric power and water. Since the beginning of the recession in 2006, most governors have taken to task of reducing payroll.

As of 2006, total employment in government has been reduced by nearly 100,00 employees. Over 100 government agencies have been consolidated and reduced in numbers.



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

TAX BURDEN

For purposes of The Heritage Foundation's *Economic Freedom Index*, tax burden is defined as a composite measure that takes into account personal and corporate marginal tax rates as well as 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 (only two are available for Puerto Rico):

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

Each of these numerical variables is weighted equally as one-third of the component score. This equal weighting allows a country to achieve a score as high as 67 based on two of the factors even if it receives a score of 0 on the third.

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

$$\text{Tax Burden}_{ij} = 100 - a (\text{Factor}_{ij})^2$$

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, while also taxes corporations at a low level to encourage investment, merits this score.

2017	2018	2019
-	61.1	61.1

Puerto Rico's score for 2019 was 61.1, remaining the same as 2018, and compares to countries like Portugal (59.9), Germany (60.8), Israel (61.9). The island's tax rates are positioned between those in European countries, which are heavily taxed, and those of countries seeking to promote investment through lower taxes like Singapore.

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.”⁶ 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.

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 of its territorial status, there are large amounts of capital outflow due to transfer payments to the mainland executed by corporations operating in Puerto Rico. This leads to inflated GDP numbers that do not reflect these transfers. Thus, the GNP is a more 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. If we used GDP numbers, the score would be 66.

2017	2018	2019
77	31	24.5

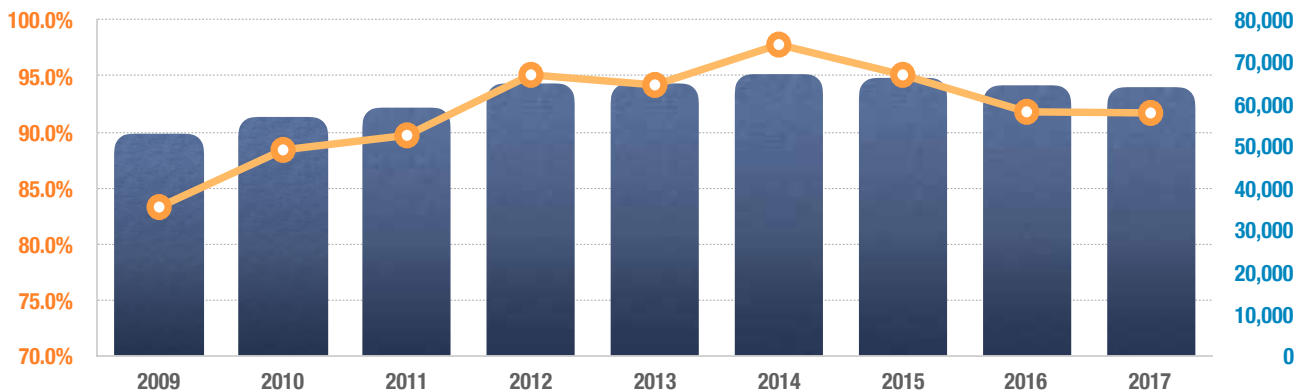
Puerto Rico’s score for 2019 was 24.5, a decrease from 2018 at 31, which is comparable to countries like Greece (23.3), Austria (24.5), and Norway (25.3). The index decreased almost 50 points because of an increase in government spending in 2017 and 2018. In 2017, two category five hurricanes ravaged Puerto Rico, leading to immediate government action in transfers to individuals, spending in recovery efforts, and reconstruction.

FISCAL HEALTH

A lack of controls and sound management demonstrated by the government contribute to widening deficits and increased debt burden, which wears down a country’s fiscal health. Poor fiscal health causes economic uncertainty.

In 2014, Puerto Rico’s debt increased to a 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. The process is under the oversight of the FOMB and a bankruptcy judge.

Gross Public Debt Of Puerto Rico



	2009	2010	2011	2012	2013	2014	2015	2016	2017
Debt (Millions)	52,980	56,823	58,942	64,760	64,957	67,273	66,183	64,254	64,180
As % of GNP	83.3%	88.4%	89.7%	95.1%	94.2%	97.8%	95.1%	91.8%	91.7%

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 2018.

Sub-Factor	Score
Average deficits as a percentage of GDP for the most recent three years (80% of score)	78.75
Debt as a percentage of GDP (20% of score)	11.03

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

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

A high score points to better fiscal health.

2017	2018	2019
-	71.3	65.2

Puerto Rico's score for 2019 is 65.2, a decrease from 2018 at 71.3. This is comparable to countries like France (64.9), and Bahamas (65.7). As mentioned above, in 2018 and 2019 the government had to negotiate with bondholders because of the need to spend in recovery efforts after the hurricanes.

KEY POINTS:

The score in this sub-index decreased due to increased spending in 2018 from the injection of federal disaster relief recovery funds. The sub-index has two components: the deficit as a percentage of GNP, and government debt as a percentage of GNP; and it is weighed heavily towards the deficit. The increase in spending in 2018, coupled with a lack of growth in government tax income, led to this score.



REGULATORY EFFICIENCY

BUSINESS FREEDOM

The Heritage Foundation’s *Economic Freedom Index* measures business freedom as “the extent to which the regulatory and infrastructure environments constrain the efficient operation of businesses.” (Index of Economic Freedom, 2019) The score is based on 13 sub-factors, all of which are weighted equally, using data from the World Bank’s DB 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 calculated. 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:

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

The higher the index, the more business freedom.

2017	2018	2019
63	62	51.2

Puerto Rico’s score for 2019 is 51.2, a decrease from 2017 and 2018. It is comparable to countries like Bangladesh (50.9), Nigeria (51.2), and Burkina Faso (51.6). While Puerto Rico did improve its score in sub-factors compared to last year, the international average improved as well.

KEY POINTS:

It should be noted that the data utilized in this sub-index came directly from the World Bank. Actual figures for categories such as procedures necessary to start a business, or time spent to start a business are much higher. According to the World Bank, there are 6 procedures to obtain a permit, yet local studies have shown that there is an average of 23 steps to obtain a permit.



LOC 2011633462, Carol M. Highsmith Collection

World Bank HQ Building, Washington D.C.

To remain consistent with the other countries that are featured in the *Index of Economic Freedom*, these numbers were taken at face value and not revised or modified in any way. Puerto Rico's numbers remained virtually identical to last year's, but the international averages improved. The trend is significant as it underlines the need for Puerto Rico to continue making strides towards improving its business climate if it wants to be competitive and relevant, not just in the Caribbean, but in the world.

RECOMMENDATION:

The government has taken the right steps to shorten the time and cost to start a business, but further improvements are urgently needed to provide ease of doing business for entrepreneurs seeking to start or expand their businesses. This is particularly important to incentivize start-ups and innovation as the cost and time of getting permits pose a considerable obstacle to entrepreneurs with limited access to capital. Additional efficiency tools that produce shorter periods, and smarter requests, can improve Puerto Rico's business freedom.

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.”⁷

All information for this sub-index was derived from the World Bank’s DB. 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	65.05	

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:

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

The higher the score, more labor freedom exists.

2017	2018	2019
79	63	65.0

Puerto Rico’s index for 2019 was 65.0, an increase when compared to 2018. Puerto Rico’s ranking is similar to countries like Kosovo (64.9), Chile (65.0), and Israel (65.1).

Puerto Rico's score for the category of dismissal of redundant employees improved because of the labor reform passed in 2017, which removed restrictions placed on businesses when dismissing redundant employees.

Due to limitations in The Heritage Foundation's methodology for this section, 3 out of the 7 components could not be used. As a result, Puerto Rico scores a 65 in this sub-index even though its labor regulations are similar to Singapore, which received a score of 91. Therefore, we proposed that Puerto Rico should receive a score of 80.

PUERTO RICO'S 2017 LABOR REFORM

The 2017 labor reform adopted in Puerto Rico was expected to have a large impact on the economy. Unfortunately, its implementation coincided with Hurricanes Irma and María. Therefore, its effect on the economy is difficult to separate from post-hurricane recovery efforts. One way of measuring its effectiveness is comparing the island's labor freedom score from 2018 against this year's score. Puerto Rico's labor freedom score improved from 63 to 65, which can be attributed to the labor reform.

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

● MONETARY FREEDOM

According to The Heritage Foundation, "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."⁸

Monetary Freedom	
Afghanistan	76.7
Niger	76.7
United States (Puerto Rico)	76.6
Brunei Darussalam	76.5
Macau	76.5

The US score for this index decreased from 77 in 2018 to 76.6 in 2019.

8 2019 Index of Economic Freedom. (2020) The Heritage Foundation.

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.”

Trade Freedom	
Oman	87.0
Canada	86.8
United States (Puerto Rico)	86.6
Peru	86.4
Bulgaria	86.0

The US index for 2019 is 86.6, an increase from 80 in 2018. The increase reflects from the adoption of trade agreements with North America and others. However, the protectionist policies adopted by the Trump Administration that include increased tariffs on imports will negatively impact 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 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.”⁹

In practice, 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.

Investment Freedom	
Switzerland	85
Iceland	85
United States (Puerto Rico)	85
Spain	85
Finland	85

The US index for 2019 is 85, an increase from 70 in previous years.

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.”¹⁰

Financial Freedom	
Liechtenstein	80
Singapore	80
United States (Puerto Rico)	80
Finland	80
Sweden	80

The US index for 2019 is 80, an increase from 70 in previous years.

9 2019 Index of Economic Freedom. (2020) The Heritage Foundation.

10 2019 Index of Economic Freedom. (2020) The Heritage Foundation.

WORLD & REGIONAL POSITIONING

Having calculated Puerto Rico's score for each sub-index, including comparisons with other jurisdictions for each sub-index, we provide Puerto Rico's overall score and its position vis a vis other jurisdictions in the world and in the Caribbean Basin and Latin America.

Puerto Rico: 69 out of 180

In the world	
Barbados	64.7
Mexico	64.7
Turkey	64.6
Puerto Rico	64.4
Serbia	63.9
France	63.8
Philippines	63.8

Puerto Rico in the region: 13 out of 33

The Americas	
United States	76.8
Costa Rica	65.3
Barbados	64.7
Mexico	64.7
Puerto Rico	64.4
Dominica	63.6
Bahamas	62.9
Guatemala	62.6



Puerto Rico's Economic Freedom Compared with States

The World Bank's DB is a useful tool to compare Puerto Rico's economic freedom with the fifty states. A study out of Arizona State University, *Doing Business North America* (DBNA), calculated the World Bank's index at a subnational level, using cities in North America instead of countries. Puerto Rico's DB score for 2019 was 70.1, which places the island in the 59th ranking. By contrast, the US score is 84, placing it 6th in the world, which points to a gaping lag for Puerto Rico, despite its condition as a US unincorporated territory. To better understand Puerto Rico's positioning as compared to the States, we are using the DBNA as we believe that it provides a reasonable means of comparison and provides relevant context. We were unable to identify a head to head analysis of Puerto Rico versus the States with respect to economic freedom or ease of doing business.

In the DBNA, the city with the highest score was Oklahoma City, which received a score of 85.2, and would position it as the 5th ranked economy in the world in terms of ease of doing business. The DNBA report includes 115 cities in North America (US, Canada, and Mexico). Out of the 66 US cities included in the report, Puerto Rico would come in at 57. The island's score of 70.1 would be slightly higher than the city of Rochester, NY's score of 69.41 and slightly lower than Bridgeport, CT's 70.7.

Puerto Rico is better positioned than New York City, Philadelphia, Washington DC, Pittsburgh, and most of the large cities in California. This shows that the level of regulation for doing business on the island is comparable to a large coastal city in the US. We should underscore that the analysis conducted for purposes of this report compares US cities with Puerto Rico. Thus, Puerto Rico's capacity to have the resources of a state, albeit a bankrupt one, positions it as an economy with over \$100 billion in GDP and a population of over 3 million, in comparison with the cities included in the DBNA.

The analysis accentuates the importance of economic freedom for the island. We are not just competing with other countries, but also with other States, most of them offering more appealing economic regulations for establishing a business than Puerto Rico.

Top 3	
Oklahoma City, Oklahoma, United States	85.22
Arlington, Virginia, United States	84.41
Sioux Falls, South Dakota, United States	84.24

Puerto Rico's Ranking	
Orlando, Florida, United States	77.82
Bridgeport, Connecticut, United States	70.71
Providence, Rhode Island, United States	73.41
Calgary, Alberta, Canada	70.12
PUERTO RICO	70.1
Rochester, New York, United States	69.41
Pittsburg, Pennsylvania, United States	68.55
Los Angeles, California, United States	64.31

Bottom 3	
Guadalajara, Jalisco, Mexico	42.18
Zacatecas, Zacatecas, Mexico	41.62
Puebla, Puebla, Mexico	41.31

Recommendations for Improving Puerto Rico's Economic Freedom



The advancement of public policies and strategies to increase Puerto Rico's level of economic freedom is essential to ensure long-term, sustained economic growth. Recent natural events that have adversely affected Puerto Rico's economy have caused the state government to be dependent on non-recurring federal assistance.

While we understand that Puerto Rico is undergoing a recovery period after the effects of Hurricane María, the recent earthquakes, and the COVID-19 outbreak, the recovery process is an opportunity for both the private sector and the government to advance policy changes to improve the ease of doing business on the island.

More federal aid represents an automatic increase in public spending and government interference in the economy. Our first recommendation is that the local government consider these federal funds as short-term incentives that can allow it to implement much needed structural reforms to expand economic freedom.



TAX REFORM

The first of these initiatives is to promote a tax reform that lowers tax rates on both corporations and individuals. The objective should be to reduce tax rates to at least the same level of the federal tax rate adopted under the Trump Administration's tax reform of 2017. Local tax reform should also eliminate the inventory tax, which poses a great obstacle for businesses and hurts consumers. The end goal is to have an efficient and modern tax system that promotes work, production, and investment.

Puerto Rico should strive to position itself as the jurisdiction with the lowest tax rates in the United States and the Western Hemisphere, placing the island as the primary destination for investment and attracting professionals from the mainland as well as from Latin America.



FISCAL REFORM

In terms of real government spending, our recommendation is that the objectives of PROMESA are met, including the fiscal plan established by the FOMB to reduce the government's operational costs. In the short term, any increase in public spending should be focused strictly on investment to mitigate the effects of natural disasters and the pandemic. Increased spending should be temporary.

We recommend creating measurements that can help limit public spending to a reasonable proportion of Puerto Rico's GNP, and that it also be sustainable without increasing tax rates on corporations and individuals.

In the medium and long term, central government and municipal spending is unsustainable, given that the economy cannot withstand the contraction associated with natural disasters and the current pandemic. At the municipal level, the fiscal crisis creates an excellent opportunity to achieve prudent and efficient spending without sacrificing the quality of services provided to citizens. In terms of debt, the government should accelerate public debt restructuring efforts and try to regain access to capital markets. Access to these markets will be essential to finance the reconstruction of the island and attract private capital to jumpstart growth.

The government and the FOMB should work together to bring Puerto Rico out of chapter 3 (bankruptcy) of PROMESA.



PUBLIC TRANSPARENCY

REDUCTION OF CORRUPTION

In terms of the institutional framework and the transparency of public governance, we recommend strengthening the government's own oversight mechanisms, such as the Office of Government Ethics and the Office of the Comptroller. We recommend that the selection and confirmation of both bodies' executive directors be determined by consensus of the major political parties and that it count with the support of three quarters of both legislative bodies. This could help increase the independence of both these offices.

TRANSPARENCY AND ACCOUNTABILITY

US citizens have the right to access information regarding the use and distribution of federal funds. The federal government has required the Puerto Rico government

to provide access to information on the use of disaster recovery funds to promote transparency. These efforts should be extended to all the government's purchases of goods and services, including information on the bidding process and requirements as well as the qualified and winning companies for online public access.



PRIVATE PROPERTY RIGHTS AND PROTECTION

The judicial framework that includes both local and federal laws provides an adequate protection to private property. Nevertheless, the area of greatest weakness and where we urge the local government to act is in modernizing and strengthening the Puerto Rico Property Registry. We recommend that the FOMB proposal to overhaul the Puerto Rico Property Registry be implemented, including the digitalization of the system to shorten the time to register a property, the elimination of needless procedures, and improvement of geographic coverage.



BUSINESS ENVIRONMENT

IMPROVING THE PERMIT SYSTEM

Within the recovery effort, the government should urgently improve the permit process for businesses and construction projects. To achieve this, the government should use all technological tools available and the private sector's own technical know-how, particularly from the College of Engineers, the College of Certified Public Accountants, and other planning experts.

These private sector groups should act as facilitators of the permit process, ensuring the enforcement of existing regulations and acting as intermediaries between businesses and the government during the permit issuing process. The speed and efficiency of permit approval will be a key factor in the island's economic recovery efforts, and its economic dynamism in the medium and short term.

INFRASTRUCTURE

Conversely, investment in the modernization and maintenance of power and water infrastructure is vital to improve the island's scores in this category. The modernization of Puerto Rico's infrastructure should translate into lower costs, which should create a more competitive business environment. The private sector should play an active role in this renovation process, particularly with respect to the development, operations, and maintenance of infrastructure. Puerto Rico already has in place effective mechanisms and a legal framework that encourage and enable cost-effective public-private partnerships. These public-private partnerships can accelerate the transformation of the electric and water systems to make them more reliable.

CONCLUSION

Puerto Rico's index for 2019 was 64.4, an increase when compared to 2018 at 61.

Variable	2017	2018	2019
Property Rights	70	50	64.1
Government Integrity	-	41.8	48.5
Judicial Effectiveness	-	50	64.3
Tax Burden	-	61	61.1
Government Spending	77	31	24.5
Fiscal Health	-	71.3	65.2
Business Freedom	63	62	51.2
Labor Freedom	79	63	65.0
Monetary Freedom	77	77	76.6
Trade Freedom	80	80	86.6
Investment Freedom	70	70	85.0
Financial Freedom	70	70	80.0
Puerto Rico SCORE	71	61	64.4

For 2019, Puerto Rico's economic freedom score (64.4) went up by 3.4 points when compared with last year's study (61). Trade, Investment, and Financial Freedom all saw significant rises, but these sub-indexes are calculated using the numbers for the US. They are not affected by state policies.

In terms of sub-indexes directly calculated for Puerto Rico, the biggest increases were seen in Judicial Effectiveness, which went up 14.3 points, and Property Rights, which went up 14.1 points. We should point out that these increases are not the result of definitive actions taken by the state government to improve economic freedom, but were the result of limitations imposed on the data analysis in the study because of Puerto Rico's exclusion from the WEF's 2018 edition of its *Competitiveness Report*. The use of alternate sources, while still included in The Heritage Foundation's original methodology, led to increased scores due to differing ranking and scoring systems.

Government Spending, Fiscal Health, and Business Freedom all saw decreases in their scores. Government Spending and Fiscal Health mostly saw decreases due to the arrival of federal funds in Puerto Rico in the aftermath of Hurricane María, which led to increases in spending without a corresponding increase in government income. This led to a decrease of 6.5 points and 6.1 points, respectively. The decrease in Business Freedom was due mostly to the rest of the world improving their score in this year's edition. While there were decreases in 4 of the 13 subcategories, it was mostly the increase in the international average for these scores that led to the overall category's decrease.

The main takeaway from this year's edition is the importance of having both government and private sector data in Puerto Rico available to outside investors. The non-inclusion of Puerto Rico in the WEF's yearly survey should serve to highlight the importance of opening our island's economic statistics to the international community.

REFERENCES

- 2019 Index of Economic Freedom*. (2020). Retrieved from The Heritage Foundation.
- Bribery Risk Index*. (2019). Retrieved from TRACE.
- Country Risk Assessment 2019*. (2020). Retrieved from CREDENDO.
- Di Matteo, L. (2013). *Measuring government in the 21st century: An international overview of the size and efficiency of public spending*. Retrieved from Fraser Institute.
- Doing Business North America*. (2019). Retrieved from Arizona State University.
- Doing Business Report*. (2020). Retrieved from World Bank Group.
- (2018). *Puerto Rico Governor's Statistical Appendix*. Government of Puerto Rico Planning Board.
- Walsh, C., McNamara, R., & Fallon, B. (2018, August). *Expropriation in Puerto Rico*. Retrieved from Institute for Justice.
- World Values Survey for Puerto Rico: 2018*. (2019). Retrieved from Statistical Institute of Puerto Rico.