To Reclaim Prosperity, Puerto Rico Should Adapt Ireland's Model for Modernization And Focus on Attracting Investors from Around the World

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Puerto Rico's current and long-standing program for economic growth has clearly failed, and the Commonwealth government and the people it serves need a new approach. For nearly two generations, the Island's economic policy has focused on preserving U.S. corporate tax preferences for American firms that locate operations in the Commonwealth. The record shows that this singular focus has produced economic decline. Instead, Puerto Rico should adopt a version of Ireland's economic approach, which used targeted public investments, tax preferences, and the country's low-cost access to markets in the European Union (E.U.), in order attract large scale foreign direct investments (FDI). In the process, Ireland transformed itself over one generation from the poorest country in the E.U. to one of its most prosperous members.

Puerto Rico's Urgent Need for a New Economic Approach

Over the last decade, Puerto Rico has been one of the world's poorest-performing economies. From 2004 to 2012, the Commonwealth's GDP declined in seven out of nine years, contracting by a total of 13 percent and an average annual rate of 0.725 percent.[i] Over the same years, the GDP's of Puerto Rico's 13 Caribbean neighbors expanded at an average annual rate of 2.0 percent. Furthermore, unemployment in Puerto Rico is more than double that of the United States, including a jobless rate of over 39 percent for Puerto Ricans ages 16 to 24.[ii] Moreover, this high unemployment rate has persisted despite the Commonwealth's very low labor participation rate (LPR): The World Bank reports that Puerto Rico's LPR was 42.4 percent in 2012, fully 20 percentage points lower than the United States; and according to the International Labour Organization (ILO), Puerto Rico ranks 79th out of 81 countries in labor participation.[iii] And Puerto Rico's low LPR has persisted despite the Island's net emigration: The Census Bureau reports a net loss due to migration of 83,825 Puerto Ricans from mid-2010 to mid-2012, and there are reports that the numbers of Puerto Ricans leaving have risen since then.[iv] Even as researchers say that only 20 percent of those emigrants had college or graduate degrees,[v] Census data show that the number of doctors and teachers emigrating quadrupled in 2011, producing a genuine "brain drain."

The Island's contracting GDP and the falling government revenues that have accompanied it also have driven up its budget deficits. The Commonwealth's gross public debt increased from \$33.9 billion in 2004, when it equaled 65.5 percent of the Island's GNP, to \$65.8 billion in 2012 or 95.7 percent of its GNP.[vi] This combination of high debt and poor economic performance has led Moody's and Standard & Poors to rate the Commonwealth's bonds as "junk;" and before Argentina's default in July of this year, Moody's ranked Puerto Rico as the second most-likely candidate for a sovereign debt default, following only Argentina.

This troubling record of falling output and rising public debt has depressed incomes and investment. From 2004 to 2013, the real *per-capita* income of Puerto Ricans declined by nearly $1,000, or 5.9 percent, despite a 5.4 percent drop in the Commonwealth's population.[vii] Over the same period, gross business investment in Puerto Rico averaged just 12.2 percent of GDP, compared to an average of 25.7 percent of GDP for the 13 other Caribbean nations. Moreover, for the last four years, annual gross fixed investment in Puerto Rico has fallen below 10 percent of GDP.[viii] Foreign investors in particular have been fleeing Puerto Rico's economy. The Government Development Bank reports that net financial flows in and out of the Commonwealth have been negative since 2004.[ix] And while Puerto Rico managed to maintain positive FDI flows until 2012, supported by the U.S. tax incentives for American companies, the phase-out of those incentives on top of the Commonwealth's continuing economic decline have turned FDI flows to Puerto Rico negative.[x] These net outflows of FDI reinforce the adverse effects of the long-standing net outflows of financial investments, and both forms of capital flight increase the drags on growth, investment, and incomes.

The Role of FDI in Growth and Modernization

For developing economies in particular, economic policies focused on attracting FDI are sound. When multinational companies site their operations in developing countries, they transfer advanced technologies, business methods and new forms of economic demand there. These transfers boost growth, productivity and incomes directly through the multinational's production and employment, as numerous studies of FDI around the world have shown.[xi] Equally important, FDI can promote substantial long-term gains in growth, productivity and incomes through its spillovers to the domestic economy: Native businesses learn how to deploy advanced technologies and business methods; local managers and workers trained to use the new technologies and methods take those skills to other, native businesses; and the multinational's demand for business goods and services to supports its operations stimulates the creation of new native businesses and the expansion and modernization of existing businesses.[xii]

This success of this strategy depends on more than simply cutting taxes for foreign investors, especially since most developing nations already offer low corporate taxes. Multinational companies locate their FDI in places that can provide the broad range of factors that modern enterprises need to operate efficiently – from skilled labor and efficient infrastructure (including energy and telecommunications networks as well as roads, bridges, ports and airports), to liberal regulation, the reliable rule of law, strict enforcement of contacts and property rights, and a government that keeps its word.[xiii] Among those countries that can meet those standards, multinationals invest especially in places with large markets such as China or good proximity to such large markets.

In this regard, the best model for Puerto Rico is Ireland. Widely seen in the 1970s and 1980s as the "poor man" of Europe, Ireland adopted an extensive package of economic reforms in the late-1980s designed to attract FDI. Ireland's success in both drawing FDI and translating those investments into full employment and rising incomes also depended on its proximity to the huge E.U. market. In effect, Ireland created a new comparative advantage for itself, as the only low-wage, English-speaking platform for multinationals from the United States and other places to produce and sell goods and services into the large E.U. markets, and on a level playing field with European companies.

A New Economic Program for Puerto Rico

Puerto Rico actually could replicate Ireland's advantage by offering itself as a low-wage, English and Spanish-speaking platform for multinationals *outside the United States* to produce and sell goods and services into the enormous American market, and on a level playing field with American companies. In particular, foreign companies operating in Puerto Rico can trade into U.S. markets without concern for the tariffs, quotas, customs and other regulations applied to companies selling into the American market from almost anywhere else. Ireland targeted U.S. companies for its E.U.-based advantage, in part because both are English speaking. As a bilingual society, Puerto Rico can target multinationals from the Spanish-speaking countries of Latin America, as well as from European and Asian countries where English is a widely-used second language. This approach would give Puerto Rico a unique advantage in attracting FDI from everywhere *except* the United States, an approach which Commonwealth governments have ignored by focusing on U.S. tax preferences for U.S.-based companies.

There is no doubt that Ireland's strategy succeeded. Ireland joined the E.U. and undertook its first round of extensive reforms in 1987. From that time to 2006, more than 1,000 multinational companies established new facilities in Ireland, including Microsoft, Dell, Motorola, Citicorp, IBM and Bristol-Meyers Squibb; and many hundreds of new Irish companies were created to support and supply their operations. Over the same period, Ireland's real GDP grew at an average annual rate of 6.9 percent, the highest in the E.U., and its unemployment rate fell from 17 percent to 4 percent. In addition, the government's debt as a share of GDP declined from 112 percent to 33 percent.[xiv] Further, Ireland's long-term trend of losing population to migration, especially educated young people, reversed; and from the 1990s on, the country reversed its brain drain and gained significant population from migration, including the return of many former Irish emigrants. Finally, even with rising population, the *per-capita* GDP of the Irish people increased from 60 percent of the E.U. average in 1987 to 136 percent of that average in 2003.[xv]

This singular success depended on more than Ireland's membership in the E.U. and favorable tax treatment for foreign investors. The Irish government also pursued specific economic reforms designed to create the business conditions valued by multinationals when locating new FDI. To begin, the Government put together and carried out a new National Development Plan for improvements in the Island's telecommunications, roads and transport services such as light rail. The reforms also included the creation of a new public-private agency to attract FDI by helping foreign companies find the best locations and workers to meet their needs. As needed, the agency also can reduce certain taxes and regulation for individual companies facing particular challenges. Ireland's government also established 10 "enterprise zones" for foreign-based companies and created new educational institutions in each zone to provide the advanced training needed by the firms in that zone. The program also included the creation of the new Science Foundation Ireland to promote education for highly-skilled careers, and those who pursue that education also receive special tax deductions.

To attract foreign financial institutions to Ireland, the Government also created the International Financial Services Centre in Dublin, and the financial firms housed there produced more than 14,000 new, highly-paid positions in accounting and in legal and financial management services. Ireland's new economic program also includes a new public-private agency that encourages native businesses to expand their investments in their Irish operations, as well as another public-private agency ("Enterprise Ireland") to provide financial, technical, and social support for start-up businesses. Tax incentives also play a part in Ireland's program for economic modernization and growth: The corporate rate first was lowered to 10 percent for those companies that trade internationally – including multinationals that established operations in Ireland – and then the corporate rate was reduced to 12.5 percent for all companies in Ireland. (Ireland has been cutting corporate taxes since the mid-1950s, but with little effect until the FDI-based program was put in place.) Finally, the Government financed these various initiatives new through difficult entitlement and tax reforms that also sharply reduced Ireland's budget deficits.

For all of Ireland's economic achievements, its modernization policies have not protected the Irish economy from setbacks and mistakes. The economy went into recession in 2001-2002 when the worldwide slowdown dampened investments in information technologies and software, industries which account for much of Ireland's new FDI. In the same period, the 9/11 attacks reduced worldwide tourism, an important source of foreign currency for Ireland, and outbreaks of foot-and-mouth disease hit Irish agricultural exports. But the Irish economy also recovered quickly; and by 2003 and 2004, Ireland boasted the strongest growth in the E.U.

To be sure, Ireland's FDI-based program also could not protect the Irish economy when the 2008-2009 financial crisis struck the United States and spread to Europe, including Ireland. Ireland's economic problems in this period, however, were derived from serious and extensive mismanagement in its financial sector, not from the country's FDI-based approach to modernization and growth. For example, the government failed to take steps or even take note as the low interest rates maintained by the European Central Bank (ECB) combined with country's strong growth and produced a construction boom and, in time, a housing bubble. Even so, the economic damage would have been modest, but for the excessive and reckless borrowing and lending practices of Ireland's largely-unregulated commercial banks. As a result, the end of Ireland's housing bubble crippled the country's six large banks, and the economy fell into a deep recession. To revive Ireland's bankrupt banking sector, the Dublin government had to solicit and accept bailouts totaling €85 billion from the E.U. and the International Monetary Fund (IMF), plus another €65 billion from the ECB and the Irish Central Bank. The strength of Ireland's real economy, derived in significant part from its FDI-based approach to modernization and growth, enabled the Irish economy to recover by 2011 and repay most of the bailouts ahead of schedule.

Puerto Rico's Challenge

For Puerto Rico to adapt Ireland's model to the Commonwealth and use its legal integration with the United States and proximity to the American market to attract FDI from Latin America, Europe and Asia, its Government will have to undertake major reforms in spending and tax policy. Most of these reforms would involve large and well-targeted increases in public investments in education and infrastructure while reducing its budget deficits. This is the same approach which historically has helped produce sustained growth and prosperity in many advanced economies, from the United States and Scandinavia to East Asia.

Puerto Rico will also have to pursue other policy reforms. A study by the Federal Reserve Bank of New York cites high regulatory costs, high energy prices, and weaknesses in the banking sector – along with the Island's underdeveloped, costly transportation networks -- as impediments to Puerto Rico's competitiveness.[xvi] Similarly, the Global Competitiveness Index of the World Economic Forum gives Puerto Rico low scores for government regulation, the costs to businesses of violence and crime, the transparency of government policy making, and favoritism in government decisions, even as it commended the Commonwealth for its intellectual property protections and the availability of scientists and engineers.[xvii] And the World Bank found that Puerto Rico ranks low among Caribbean nations in the difficulties businesses face in getting construction permits and reliable electricity service, and in trading across borders. [xviii] The World Bank also ranks Puerto Rico 14th in the Caribbean and Central America in the enforcement of contacts, a critical issue for foreign investors. [xix] The prospect of a possible debt default by the Commonwealth government and changes in bankruptcy laws to ward off technical defaults by public utilities must be reversed, to restore the confidence of foreign investors. In this context, Puerto Rico can ill-afford widely-publicized controversies that cast doubt on the Commonwealth government's commitment to keeps its word, such as current efforts by its Treasurer to negate its legal agreement to provide tax credits for tax overpayments to one of the Island's major financial institutions, the Doral Financial Corporation.

Conclusion

Puerto Rico's last decade of economic stagnation and decline, combined with its brain drain and substandard levels of investment and labor participation, provide strong evidence that the Commonwealth needs new economic approaches. Its long reliance on U.S. tax breaks for American corporations operating there to spur growth and modernization has failed. With the phase-out of those tax incentives, Puerto Rico has an opportunity to consider a new program, and Ireland's highly successful FDI-based approach offers a very promising alternative. Like Ireland and its relationship to the E.U., Puerto Rico can offer a low-cost platform for foreign multinationals to engage in the U.S. market. The key to this new approach lies in the deliberate and sometimes politically difficult promotion of the economic and political conditions that attract large volumes of foreign direct investment.

About the Author

Robert Shapiro is the chairman of Sonecon, an economic advisory firm in Washington D.C., and chairs the Globalization Initiative at NDN. Dr. Shapiro has advised, among others, President Bill Clinton, Vice President Al Gore, British Prime Minister Tony Blair and British Foreign Secretary David Miliband, U.S. Treasury Secretaries Robert Rubin and Timothy Geithner, as well as other senior officials of the Obama administration, the International Monetary Fund, and senior executives in many Fortune 500 companies. Dr. Shapiro also is a Senior Fellow at the McDonough School of Business at Georgetown University and advises the Doral Financial Corporation. He served as Under Secretary of Commerce for Economic Affairs in the Clinton administration, Vice President and co-founder of the Progressive Policy Institute, and as a fellow of Harvard University, the National Bureau of Economic Research and the Brookings Institution. He holds a Ph.D. from Harvard University, a M.Sc. from the London School of Economics, and an A.B. from the University of Chicago.

[i] World Bank, data, http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG.

[ii] Federal Reserve Bank of New York (NYFRB), "Report on the Competitiveness of Puerto Rico's Economy," June 29, 2012, http://www.newyorkfed.org/regional/puertorico/report.pdf .

[iii] International Labour Organization. www.ilo.org. Only Algeria and the West Bank and Gaza have lower labor participation rates than Puerto Rico.

[iv] Institute of Statistics, 2013. "Profile of the Migrant," http://www.estadisticas.gobierno.pr/iepr/Inicio.aspx.

[v] Birson, Kurt, "Puerto Rican Migration in the 21st Century: Is There a Brain Drain?" in *The State of Puerto Ricans 2013*, Eds., Edwin Meléndez and Carlos Vargas Ramos. Hunter College Center for Puerto Rican Studies, 2013.

[vi] Government Development Bank for Puerto Rico, Report to the Governor, 2013, Statistical Appendix, http://www.gdb-pur.com/economy/documents/AE2013_T29.pdf; and http://www.gdb-pur.com/economy/documents/AE2013_T2.pdf .

[vii] These calculations are based on GNP in 1954 dollars, reported by the Government Development Bank for Puerto Rico (http://www.gdb-pur.com/economy/documents/AE2013_T3.pdf), adjusted for U.S. inflation from 1954 to 2013 as calculated by the Bureau of Labor Statistics (http://www.bls.gov/data/inflation_calculator.htm), and population estimates by the Census Bureau (http://www.census.gov/popest/data/intercensal/puerto_rico/pr2010.html).

[viii] World Bank, World Development Indicators. http://data.worldbank.org/indicator/NE.GDI.TOTL.ZS.

[ix] Government Development Bank for Puerto Rico, Report to the Governor, 2013, Statistical Appendix, http://www.gdb-pur.com/economy/documents/AE2013_T18.pdf

[x] *Ibid*.

[xi] See, for example, Blomström, Magnus, Globerman, S., & Kokko, A. (2000). "The Determinants of Host Country Spillovers from Foreign Direct Investment," CEPR Discussion Papers No. 2350; Carkovic, Maria & Levine, Ross (2002). "Does Foreign Direct Investment Accelerate Economic Growth?" University of Minnesota Department of Finance Working Paper. June 2002. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=314924; Lall, Sanjaya (2000). "FDI and Development: Policy and Research Issues in the Emerging Context." Queen Elizabeth House Working Paper Series, Working Paper Number 43. Oxford University. June 2000; and Wai-MunHar, Kai-Lin Teo & Kar-Mun Yee (2008). "FDI and Economic Growth Relationship: An Empirical Study on Malaysia." *International Business Research*, Vol. 1, No. 2, pp. 11-18, April 2008.

[xii] Shapiro, Robert and Aparna Mathur, "How India Can Attract More Foreign Direct Investment, Create Jobs, and Increase GDP: The Benefits of Respecting the Intellectual Property Rights of Foreign Pharmaceutical Producers." Sonecon, 2014. http://www.sonecon.com/docs/studies/FDI_IP_and_the_Pharmaceutical_Sector_in_India-Shapiro-Mathur-Final-January2014.pdf

[xiii] See, for example, Carkovic and Ross, *op. cit*; Wang, Miao (2001). "Manufacturing FDI and Economic Growth: Evidence from Asian Economies." http://dx.doi.org/10.2139/ssrn.440440; and Shapiro and Mathur (2014), *op. cit.*

[xiv] European Commission. Eurostat. http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00115.

[xv] *Ibid.*, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00114

[xvi] NYFRB, *op. cit*. For example, the retail rate for electricity charged by the Puerto Rico Electric Power Authority averaged 27-cents per-kilowatt hours in 2011-2012, compared to 10-cents per-kilowatt hour in the United States.

[xvii] World Economic Forum, *The Global Competitiveness Report 2013-2014*, http://www.weforum.org/reports/global-competitiveness-report-2013-2014.

[xviii] World Bank, *Doing Business, 2014*, International Finance Corporation, http://www.doingbusiness.org/rankings.

[xix] *Ibid.*