# CARIBBEAN BUSINESS

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# Better days ahead!

Treasury Secretary Jesús Méndez

Office of Management & Budget Director Juan Carlos Pavía

Government Development Bank President Juan Carlos Batlle

## Tax relief and infrastructure projects to drive economy into positive turf

By John Marino pages 16-19

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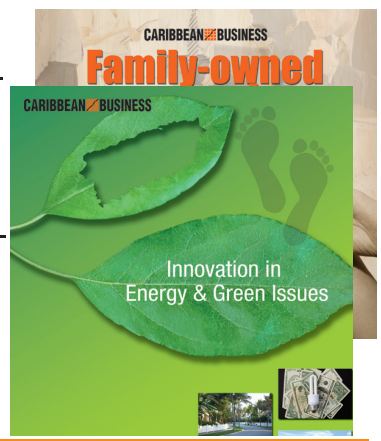

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# On track

## The FY 2012 budget restores sanity to the island's finances and launches a new era of private-sector leadership in development promotion

*From left, Treasury Secretary Jesús Méndez, Government Development Bank President Juan Carlos Batlle and Office of Management & Budget Director Juan Carlos Pavía say that next year's budget proposal shows the administration philosophy of providing tools to the private sector so that it can drive economic growth.*

BY JOHN MARINO
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The proposed $9.26 billion General Fund budget for fiscal year (FY) 2012 that Gov. Luis Fortuño presented this week is very much a sign of the times, more sober than exuberant, but confident about a slowly brightening future.

Free of flashy new spending programs, the budget for FY 2012 is most noteworthy for its reflection of the new fiscal restraint the administration has returned to government and its continuous march toward being balanced, which is slated to take place next year.

Yet, the budget delivers some big shots for economic development, including at least $2.55 billion in direct infrastructure-project funding this year and a historic reduction in tax rates, with businesses getting an average 30% cut. The projects, which are expected to create 38,250 construction jobs and an additional 20,400 indirect jobs, also will improve the island's competitiveness. For example, the $450 million Vía Verde natural-gas pipeline will cut power costs by $1 billion annually, attacking what Fortuño called the No. 1 problem confronting business in Puerto Rico.

The budget also will fund the additional hiring of hundreds of police officers, prison guards and prosecutors, whose ranks have thinned

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over the past several years through attrition, while the cash-strapped central government passed on filling the vacancies, the governor said during an exclusive interview with CARIBBEAN BUSINESS, as the final touches were being put on the budget document.

The budget also makes a provision to increase government payments to the employee-retirement system, to start to reduce the deficit in the program.

During the interview, Treasury Secretary Jesús Méndez, Government Development Bank (GDB) President Juan Carlos Batlle and Office of Management & Budget Director Juan Carlos Pavía sat down with CARIBBEAN BUSINESS to discuss its details.

The budget's primary feature, of course, is that it reflects the impact of the tax reform, which aims to turn the tax code into an engine of economic development by rewarding hard work and success, slashing tax rates across the board and streamlining the code to make it more user-friendly and easier to enforce.

Whether tax cuts—and other administration reforms aimed at improving operating conditions in the areas of energy, permitting and public-private partnerships—are enough to stir the economy into solid, sustainable growth remains to be seen. While the economic slide (-2.9%, 2008; -4.0%, 2009; -3.8%, 2010; projected -0.1%, 2011) appears to have bottomed out and the economy is moving slowly toward positive terrain, a return to sustained, robust growth still isn't in sight.

While the administration wants to spur economic development as much as possible, cash is tight and the administration is being careful to invest its money wisely. It also has to ensure it meets the expectations to maintain its improved credit ratings, a direct response to its ability to cut $2.6 billion in annual spending since taking office. Standard & Poor's just upgraded the island's credit, following Moody's move last year, which gave the island the best-possible treatment under a rating-recalibration effort.

"Things are starting to get better, but if we don't maintain fiscal discipline, we are at risk of falling back into the hole we just climbed out of," Fortuño said in summing up his proposed budget.

"A lot of people will realize that tax reform not only will have an economic impact, but also a psychological impact as well that will build confidence. This is the first time we will have growth in Puerto Rico, modest as it may be, in a very long time," the governor added.

### Recession to end with crawl forward

The budget is based on revised economic Planning Board projections that show the economy will close FY 2011 June 30 with a 0.1% decrease (-0.1%), the fifth-straight year of negative contraction, and will grow during 2012 by a mild 0.7% growth.

Employment figures are finally showing signs of stabilizing, with the services sector increasing 1.6% to 2.8% in recent months, compared to the same period last year.

Increased consumer confidence can be seen in retail sales, which were up 0.92% as of Dec. 31, 2010, and auto sales, which were up 5.8% in February, when compared to the prior-year period.

Driven by strong local incentives, new housing sales are also up 51.8% and existing sales are up 8.1% in Puerto Rico over the past six months, while sales of new homes fell by 19.9% and existing homes by 12.8% across the U.S. during that same timeframe. In all, 13,194 homes were sold, representing $1.8 billion in sales on the island.

In an important sign the construction industry is stirring back to life, cement sales increased 10.3% during the first three months of 2011.

"The growth is being driven by both the private and public sectors. We have a big chunk of government work going on right now, and you have private-capital projects such as the new hotels in Dorado and the new retail centers," said GDB chief Batlle. "That is one of our main challenges right now, transitioning to get the private sector to be the main driver of the economy."

General Fund revenue is expected to get a boost from the improving economic scenario, increased tax compliance and a new tax on the offshore affiliates of multinational manufacturers operating on the island, Méndez said. After increasing an expected 5.8% this year to $8.13 billion, government revenue is expected to jump again by 6.4% to $8.65 billion during FY 2012 that starts July 1.

*Gov. Luis Fortuño says that his administration's policy of attacking fiscal problems, while instituting policies that spark economic growth, should be a model for the U.S. now that the federal government is getting serious about bringing the federal deficit under control.*

The agency expects to recoup an additional $100 million next year in sales-&-use-tax (IVU by its Spanish acronym) revenue, and Méndez pledged a full rollout by the new fiscal year of the IVU-Loto, a twice weekly drawing based on numbers embedded in sales receipts aimed at ensuring clients request them from stores. A hotline to report cases of IVU-related fraud also has been established.

"Everybody knows the unacceptable inefficiency of the IVU collection," Méndez said, pointing to an IVU-capture rate of just 52%. "We are looking to turn that huge inefficiency into a huge opportunity."

### Underneath the numbers

In many ways, this year's budget proposal looks very much like the current budget, further evidence of the administration's fiscal discipline. That not only is a choice, but also a necessity now that federal spending is expected to be curtailed as a bipartisan consensus builds in Washington, D.C. about the need to attack the U.S. government's deficit.

Look under the hood, however, and the budget shows the profound changes wrought by the tax reform, which its architects say brings a fundamental shift in taxation in Puerto Rico by dramatically shifting the tax burden among the various players as it remakes the code with the aim of rewarding hard work and success, and streamlining it to make enforcement easier.

The path to getting to a funding level nearly identical to last year's will be dramatically different in 2012 as a result.

The FY 2012 General Fund budget, which is made up of only commonwealth funds, rises slightly to $9.26 billion from the current $9.133 billion. The increase, however, stems from the expiration of certain funds authorized under the American Recovery & Reinvestment Act and an assignment for a possible 1% increase in the government's contribution to the government-employee-retirement system, Pavía said.

The budget deficit, which was $3.3 billion when Fortuño took office in January 2009, will be reduced to $616 million this year, from $1 billion last year.

In 2009, Puerto Rico was dead last among U.S. jurisdictions when its deficit was measured as a percentage of revenue. The island now is ranked 15th among all U.S. jurisdictions.

Puerto Rico's consolidated budget, which takes into account federal funds and public corporations, will increase $481 million, or 1.7%, to $28.62 billion.

Tax-reform relief will spark the loss of $630 million in government revenue, while the cancellation of a series of temporary taxes imposed under Fiscal Emergency Law 7 will cost Treasury coffers an additional $315 million. While tax relief under the reform equals $1.2 billion annually, the FY 2012 budget only needs

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to provide for the first six months of reform, which kicked in Jan. 1, 2011.

This year's budget also has to deal with a $178 million decline in rum-rebate revenue, the $30 million University of Puerto Rico Scholarship Program and the impact from a $40 million housing-stimulus program.

A new tax on the offshore affiliates of pharmaceuticals and other manufacturers will raise $1.5 billion, while a $100 million increase in IVU revenue is projected along with an additional $177 million through an improving economy and increased tax compliance.

Revenue from individual taxpayers will drop 9.8%, or $231 million, to $2.117 billion because of reduced rates under the tax reform, while local corporations will pay 3.3%, or $51 million, for a projected $1.51 billion. Tax-exempt manufacturers and their affiliates will see their tax burden surge a projected $969 million to $1.5 billion for a 159% increase.

Big changes to the budget are contained to significant increases for health (16%), education (6%) and public safety (5%), Pavía said. Debt service makes up $663 million of the proposed budget, and a $183.6 million payment to the Puerto Rico Aqueduct & Sewer Authority (Prasa) will allow this public corporation to avoid a pledge to debtholders to increase water-and-sewer service hikes.

Pavía said an across-the-board payroll reduction, sparked by the firings in 2009 and 2010 of thousands of government employees, is largely responsible for any reductions seen in agency budgets.

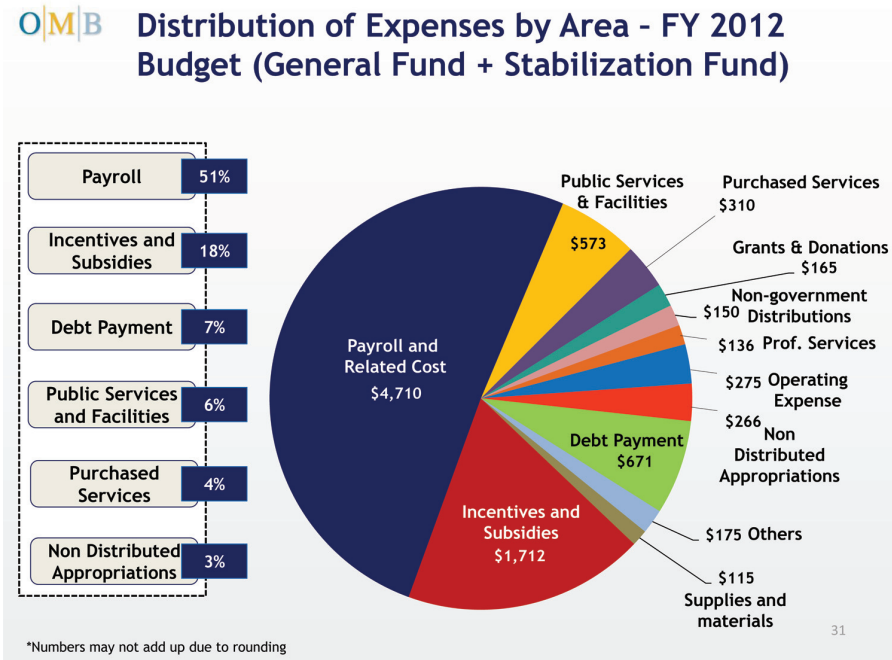
The consolidated-budget payroll, which includes public corporations and jobs paid for with federal funds, will account for $8.03 billion in FY 2012, versus the $8.71 billion in 2009.

"We can't spend more than we have. That's fundamental," Pavía said. "The model that the government does everything doesn't function anymore."

### AN ECONOMIC GAME-CHANGER

The budget doesn't give big boosts to economic-development agencies, nor does it envision new incentives to spur investment.

Moreover, the tax reform is only made possible through the imposition of a temporary six-year excise tax on the offshore affiliates of island manufacturers, which critics say undermined the credibility of the Puerto Rico government in the international investment community and could harm the island economy's most productive sector, manufacturing, which still accounts for more than 40% of gross domestic product (GDP). The tax is expected to raise an average $1 billion annually.




Core incentives for manufacturers and tourism projects, as well as newly sweetened incentives for renewable-energy developers and film ventures, are being retained. Beyond that, the administration is focusing on making basic changes to improve competitiveness that will impact various sectors of the economy, rather than crafting incentives to specific industries.

Tax reform is a "game-changer," Pavía said, that will "fundamentally" change the investment climate for all businesses operating on the island. The average 30% tax cut for businesses takes full effect this year, while an average 50% cut for individual taxpayers will be phased in over the next six years.

That is better, he argued, than an incentive for one industry that might or might not work.

Fortuño also believes the tax reform will be the spark that brings the island economy back to definitive growth, and will do so by restoring consumer and investor confidence, and putting more money back in the private sector, where he said it belongs.

The largest and most sweeping tax reform implemented in recent memory, it delivers three times the tax relief given to taxpayers in the 1994 reform. Designed to reward hard work and investment, its big winners are salaried workers and local businesses, which officials say have borne more than their fair share of the island's tax burden over the past several decades. Such "unprecedented relief" has been promised to both individual and corporate taxpayers since the enactment of the IVU in November 2006.

The tax reform will deliver about $1.2 billion in annual relief for individual taxpayers over the next six years—an average $1,500 per taxpayer. It will also provide an average annual $260 million in corporate tax relief over that time period.

The new tax package also will incentivize charitable giving, simplify the tax code and contain new tools for fighting tax evasion, which dovetail with larger administration efforts to improve efficiency in government, work in greater partnership with the private sector to move the island economy forward and improve quality of life locally.

The governor told CARIBBEAN BUSINESS he isn't worried that the new excise tax will drive pharmaceuticals and other high-tech manufacturers off the island. After meeting personally with most CEOs in the companies, he said he expects to see expansions in the industry.

"We continue to be the best deal in town, and when I say town, I mean the world," the governor said. "We have been working with those 58 affected companies to provide them the certainty they need to continue operating here for 15 years and beyond."

The governor also believes the cost of power is the "No. 1 issue we have before us" and said the Vía Verde project is a direct response to that reality.

"The Vía Verde project will be the most important contribution that has been made in decades to the manufacturing segment," the governor said. "It will benefit tourism, commerce and, certainly, manufacturing."

Puerto Rico Electric Power Authority (Prepa) Executive Director Miguel Cordero reiterated this week that the natural-gas pipeline project, which would allow Prepa to convert several oil-fired plants to natural gas, would allow him to lower the industrial power rate to 12¢ from 21¢ per kilowatt-hour.

The governor also pointed to the permitting reform as another example the administration is attacking problems that have an impact on businesses, and said there would be announcements soon on the public-private partnerships front, with deals to privatize island highways and the international airport among those on the table.

While growth rates of 3% to 5% a year aren't yet in reach, the governor said the reforms were laying the groundwork for a return to growth.

"After five years of recession and 10 years of a truly below-average performance, our economy finally has reached a point where we are about to enter positive terrain. After avoiding bankruptcy, this administration has moved aggressively to restore our lost competitiveness," the governor said.

### BUILDING BLOCKS FOR A BETTER ECONOMY

The budget also delivers on infrastructure investment, which economists and business leaders say is the

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best short-term driver of the economy, with rich job-creation opportunities. Government-infrastructure spending will hit $2.55 billion, well-above the $1.7 billion spent during the current fiscal year.

The biggest project is the $756 million "Schools for the 21st Century," which will take place over the next two years. Some $135 million in bids already have been awarded, and work has begun on 27 schools. The plan envisions eventually renovating 100 schools, at least one in every island town, and building five new modern school buildings.

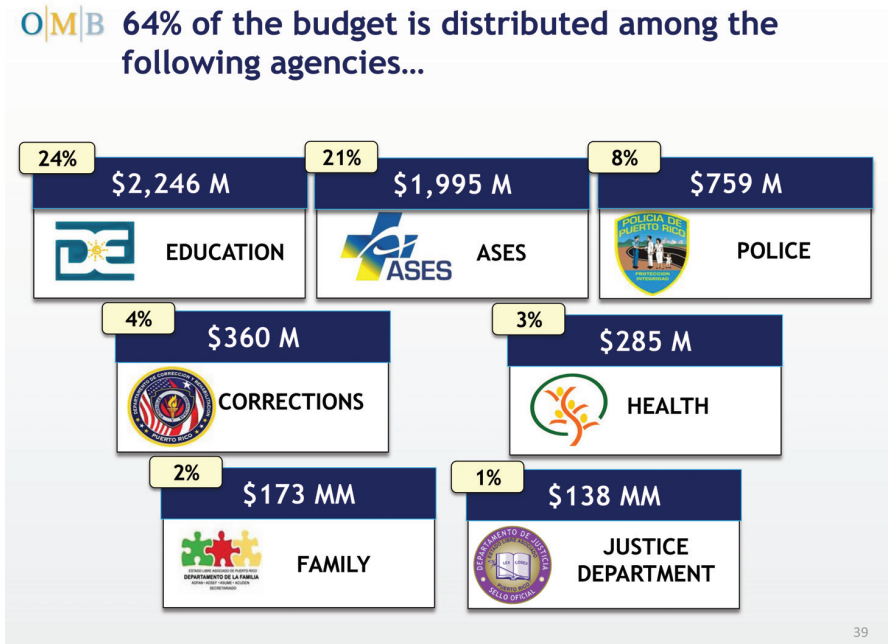
The program is being financed through a low-cost federal-government bond program, which brings borrowing costs down to about 2%, officials said.

The capital-improvement programs of public corporations such as Prepa, Prasa and the Public Buildings Authority will combine for a $1.55 billion investment, including the $450 million Vía Verde natural-gas pipeline, which will begin construction immediately after receiving its federal permits, the governor said. Prepa says the pipeline can be built within a year. The project, which will be built simultaneously in four separate sections, is expected to create 5,000 construction jobs.

Prasa, meanwhile, will invest $35 million to improve drinking-water distribution and sewer service in Vieques, Camuy, Coamo, Humacao, Cabo Rojo, Aguadilla and Jayuya this year. Officials are moving ahead with plans for a new reservoir and several renewable-energy projects aimed at controlling its power costs.

The government also will raise $300 million in new money on Wall Street for the first time since raising $250 million in 2008. This will finance several transportation projects, including the $115 million expansion of PR-66, which promises to connect the San Juan-metropolitan area to the east coast of Puerto Rico, and a $64 million Bus Rapid Transit/Dynamic Toll Road project that will run from the final Urban Train station in Bayamón to Toa Baja. The project consists of building a special lane along PR-22 for express buses and cars willing to pay a special toll to ride in and use the quicker lane, and will help boost Urban Train ridership.

The $35 million project to create a new gateway between Old San Juan, Miramar and Condado, and to complete work on Dos Hermanos Bridge, also is slated to get underway. The so-called Intersection 5 is a key project that ties in with San Juan Mayor Jorge Santini's plan to build a $400 million light-rail train system from the Sagrado Corazón Urban Train station in Santurce to Old San Juan. The train is the focal point of a project to redevelop the entire Isleta de San Juan (Puerta de Tierra).




### A SIGN OF ADMINISTRATION PRIORITIES

The administration's fiscal discipline, and a slowly brightening economic outlook, will enable increases in priority-spending areas such as public safety, education and health, the governor said.

The Education Department budget will increase $135 million to $2.246 billion, according to the governor's proposal. This will allow the agency to improve services to special-education students, with $129 million to be spent over the next two years to hire 1,294 special-education facilitators.

Another $43 million will be assigned to provide transportation for the special-education program, and $10 million for the start of a new "Alternative Educational Alliance" directed at that population.

The budget sets aside $23 million to improve school safety, $15 million for increased testing, including participating for the first time in the Program for International Students Assessment, which will allow island student performance to be compared with students across the world.

University of Puerto Rico's budget, which is based on an established formula, will increase $13 million to $704 million in commonwealth funds.

The Health Insurance Administration (ASES by its Spanish acronym) will get a boost in commonwealth funds to $1.995 billion, which will allow for 106,000 new beneficiaries to enter the Mi Salud program, which also has extended service hours and decreased referral requirements.

The Health Department will receive a commonwealth-funding boost of $40 million for a total $285 million. This will allow for a $39 million payment to the Medical Services Administration (ASEM by its Spanish acronym) for payment of services provided through the Río Piedras Medical Center (Centro Médico), which will allow ASEM to become up-to-date with the debts it owes other government agencies.

The budget also fully funds the Catastrophic Illness Fund with $8 million for FY 2012 and makes a special $3 million assignment to ASEM for a Mayagüez Trauma Center.

The Police Department budget increases $29 million to $759 million, with $13 million going to train and hire 536 new police recruits and another $13 million going for new equipment and patrol cars, $17 million for overtime pay and $1 million for drug counseling and psychological testing.

The Corrections Department, meanwhile, will receive a $6.9 million budget increase to $360 million, which will allow for the hiring of 200 additional prison guards and 49 food-service positions, and continued funding of a $17 million rehabilitation & vocational training program.

The Justice Department, which gets a $10 million increase in commonwealth funding to $138 million, will hire 35 new prosecutors and expand the operation of island Drug Courts, which deal with cases related to drugs and usually make referrals for treatment.

The government also will spend some $24 million on technology this year, which will fund the pr.gov Internet platform through which the government provides an increasing amount of services, and a myriad host of other priorities, from new computer systems to software licenses.

The budget will be published immediately online at presupuestopr.gov, and for the first time in a decade, a complete English version will be published as well.

The FY 2012 budget's most telling feature is that it illustrates the administration's dual approach to the fiscal and economic crisis it inherited, of getting the government's fiscal house in order, while at the same time, taking steps to spark economic development.

The governor said his administration has been preparing for an expected cutback in federal funding, as both Republicans and Democrats get serious about cutting the federal government's deficit spending. The message about the discriminatory treatment of the island regarding health and other federal-funding measures is already being delivered to members of Congress and the Obama administration.

How those cuts in federal spending are made are extremely important, the governor added.

"It is obvious the U.S. economy has been underperforming, and the budget situation on the national level needs to be addressed," the governor said. "Washington, D.C. should look at Puerto Rico. We have addressed our fiscal situation, and we have instituted pro-growth policies." ■