

Can PROMESA unlock economic growth for Puerto Rico?

October 31, 2016

Introduction

Good governance and financial health are the hallmarks of any successful organization. An incredibly challenging economic environment and poor governance practices have caused governmental organizations around the globe to suffer from common financial distress symptoms such as expenses greater than revenues and excessive future commitments. The Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”) is no exception.

Since the 1970s, Puerto Rico’s economy has been considerably correlated with the United States business cycle but in the late 1990s, their growth paths diverged.

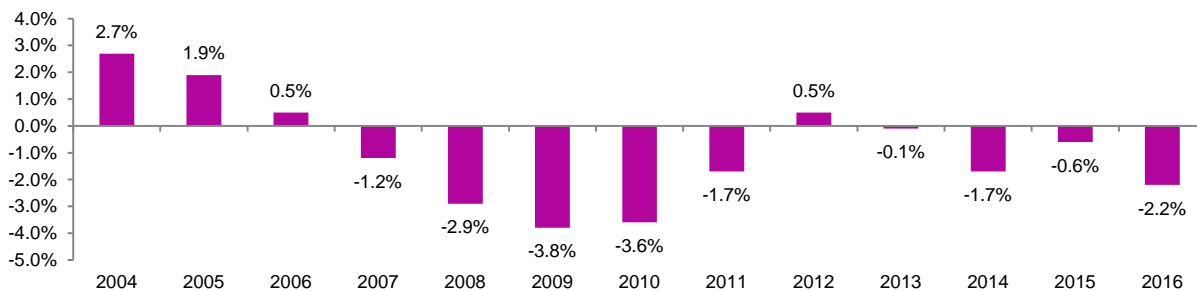
Since 1996, there has been virtually no economic growth in Puerto Rico¹ and Gross National Product (GNP) growth has been negative every

year but one since 2007 (**Figure 1**). This scenario is unlikely to change, absent reforms. The International Monetary Fund (IMF) estimates that Puerto Rico’s economy will continue to experience contractions until 2021.

In 2006, Section 936 of the US Tax Code, which provided certain US tax benefits for corporate income generated in Puerto Rico, was eliminated.

In the same year, both public and private investment in the construction sector started to show declines (**Figure 2**). As private investment fell, so too did the banking sector, combined with the onset of the US 2008 financial crisis which led to limited financing available for economic activity. Unemployment rose significantly as private sector jobs disappeared reaching levels double that of the US average.

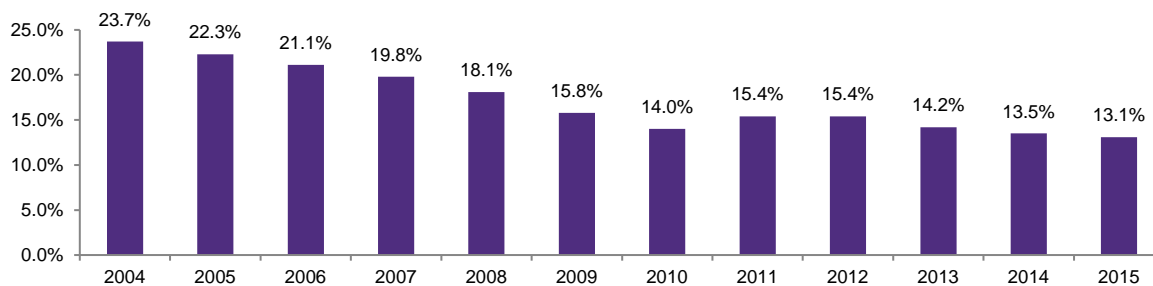
Fig. 1: Real GNP growth



Source: Government Development Bank for Puerto Rico

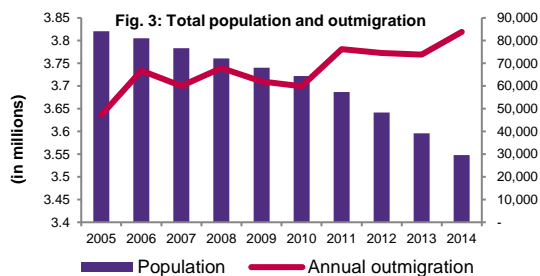
¹ Anne O. Krueger. Puerto Rico’s Growth and Macroeconomic Situation and Prospects

Fig. 2: Investment as a % of GNP



Source: Puerto Rico Planning Board

Outmigration also reached historical levels with the loss of approximately 331,000 people or 9% of the total population in the period between 2006 and 2015. This has led to an aging of the remaining population, a decreased net birth rate and declines in Puerto Rico’s tax base. Recent data also suggest that the rate of outmigration appears to be increasing in recent years (see **Figure 3**).



Source: U.S. Census Bureau

During the years 2006 to 2014, the Puerto Rico Government’s (the “Government”) net position deficit increased by \$33 billion which was primarily funded by a large increase in debt as well as delayed payments to the pension systems, creating a fiscal crisis that contributed to the deterioration of an already fragile economy.

Despite the Government’s attempts to offset the effects of its fiscal crisis, there’s still high degree of uncertainty stemming from almost every sector. Over the years, the Government has taken significant steps to control expenses and reduce its deficit, including a significant reduction in Commonwealth and municipal employment,

freezing of employee salaries, new tax collections, and federal subsidies.

Liquidity issues eventually affected the Commonwealth. The high debt burden situation caused a series of defaults and, consequently, a downgrade of Puerto Rico’s public debt. By the end of fiscal year 2016, the Commonwealth had defaulted on approximately \$1.4 billion of debt service and yields on the Commonwealth’s General Obligation bonds and other credits had virtually doubled, implying that any debt the Commonwealth could incur would not be obtained on reasonable and sustainable economic terms.

With the enactment of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), the Commonwealth expects to restore fiscal stability and regain access to capital markets under the supervision of a seven member Financial Oversight and Management Board (the “Oversight Board”).

This second article of our series on PROMESA provides an overview of the Act’s dispositions with regards to economic growth initiatives and fiscal reforms for the Commonwealth.

Fiscal reforms for economic growth

Congress’ point of view

Since the enactment of PROMESA, various stakeholders from both the public and private sector have expressed concerns regarding the absence of a clear path for Puerto Rico to achieve economic growth.

Section 701 of PROMESA establishes the “sense of Congress” regarding fiscal reforms for Puerto Rico. A “sense of Congress” is generally a statement expressing an opinion of the majority of the House of Representatives and Senate. Within PROMESA, this section provides the basis for review of local tax laws and/or the enactment of new federal tax laws. Section 701 states that “any durable solution for Puerto Rico’s fiscal and economic crisis should include, permanent, pro-growth fiscal reforms that feature, among other elements, a free flow of capital between possessions of the United States and the rest of the United States.”

Through Section 409 or the creation of an eight-member Congressional Task Force on Economic Growth for Puerto Rico (the “Task Force”), the US Congress takes its first step towards determining a viable course of action that could potentially trigger the enactment or amendment of federal laws in order to achieve Congress’s perspective towards new public and fiscal policy.

Congressional Task Force

Section 409 establishes an eight (8) member Congressional Task Force and charges it with the responsibility to issue a report by December 31, 2016 that would examine, among other things, the impediments in current Federal law and programs to economic growth in Puerto Rico, including equitable access to Federal health programs.

Congressional Task Force members

Congressional Task Force members are:

1. Senator Orrin Hatch (R-UT)
2. Senator Robert Menéndez (D-NJ)
3. Senator Marco Rubio (R-FL)
4. Senator Bill Nelson (D-FL)
5. Representative Tom MacArthur (R-NJ)
6. Resident Commissioner Pedro Pierluisi (PR)
7. Representative Sean Duffy (R-WI)
8. Representative Nydia Velázquez (D-NY)

The Task Force would then be in charge of proposing changes to Federal laws and programs that, if executed, would serve to spur sustainable long-term economic growth, job creation², attract investment, and reduce child poverty in Puerto Rico.

On September 15, 2016, the Task Force issued its first status update as required by the law. In this document, the Task Force highlighted its concerns regarding “the relative lack of reliable data pertaining to certain aspects of the economic, financial, and fiscal situation in Puerto Rico.”



Task Force responsibilities and duties

The Task Force would issue a report by December 31, 2016, with information on:

1. Impediments to economic growth or equitable access to Federal healthcare programs.
2. The economic effects of a Puerto Rico’s Department of Health Regulation 346, which requires natural product and dietary supplement companies to pay application and registration fees.
3. Recommendations to spur long-term economic growth, job creation and attract investments.

In addition, the Task Force established an email portal for stakeholders to submit their input and proposals regarding economic growth initiatives for Puerto Rico. As of September 15, 2016, the Task Force had received over 335 submissions from individuals and organizations representing a wide variety of interests. The Task Force’s update report states that all submissions will be considered part of the public record and intends to publish them prior to or along with the final report.

² The areas and terms “job creation” and “attract investment” were included in the Congressional Task Force’s first status update issued

on September 15, 2016 but were not part of the original scope of the Task Force as described in S.2328 or PROMESA.

The Task Force also reported that it will continue to obtain support from various congressional offices as well as consult with Puerto Rico offices and agencies and the private sector to obtain input and recommendations.

Once the report is issued by December 31, 2016, the Task Force would be terminated.

Proposals for economic growth

On September 2, 2016, a group of Puerto Rico's main private associations and trade organizations, collectively known as the Puerto Rico Private Sector Coalition, submitted a series of recommendations to further promote economic growth on the island. The recommendations were presented in accordance to PROMESA's requirements, and the Task Force's main objective, in regards to the identification of impediments to local economic growth in current Federal law and programs.

In addition to these proposals, the Private Sector Coalition understands that, in order to secure the flow of information on the progress of such economic growth initiatives mandated by Congress, the tenure of the Task Force should be extended past its December 2016 conclusion date.

Table 1 describes some of the proposals and their potential impact on Puerto Rico's economy presented by the Private Sector Coalition as well as other interest groups and individuals.

Private Sector Coalition members

The Private Sector Coalition is composed of the following private associations and trade organizations:

- Puerto Rico Farmers Association
- Puerto Rico Lessors Association
- Puerto Rico Bankers Association
- Puerto Rico Retail Commerce Association
- Puerto Rico Insurance Companies Association
- Home Builders Association
- AGC, Puerto Rico Chapter
- Puerto Rico Car Dealers Association
- Puerto Rico Hospital Associations
- Puerto Rico Manufacturers Association
- Puerto Rico Southwestern Industrial Association
- Puerto Rico Shippers Association
- Puerto Rico Products Association
- Puerto Rico Restaurants Association
- Puerto Rico Chamber of Commerce
- Puerto Rico Chamber of Food Marketing, Industry and Distribution
- Puerto Rico College of Architects and Landscape Architects
- Puerto Rico Society of CPAs
- Puerto Rico Engineers and Surveyors Association
- Automobile Import United Group
- Puerto Rico Internet Society
- Latin American Business Council
- Puerto Rico Hotel & Tourism Association
- Puerto Rico Pharmaceutical Industry Association
- Medicaid and Medicare Advantage Products Association of Puerto Rico
- Puerto Rico Society for Human Resource Management
- Puerto Rico College of Optometrists
- Puerto Rico Real Estate Brokers and Dealers Alliance
- PR 3000

Table 1: Proposals for Puerto Rico’s economic growth

Organization/Sponsor(s)	Proposal(s)	Investment/Impact
Private Sector Coalition	Health	<ul style="list-style-type: none"> • If parity is not achieved, special allocation for Puerto Rico set to expire by the end of 2017, will be reduced by nearly 75%, reverting to annual level of approximately \$400 million • Savings of approximately \$200 million (2016 estimate) in HIT Tax obligations.
	Jones Act and Maritime Transportation Reform	<ul style="list-style-type: none"> • Promotion of the free market and a more competitive environment for Puerto Rico • Inclusion of Puerto Rico would reestablish “transit-without-visa” program for Puerto Rico related to air cargo.
	Energy	<ul style="list-style-type: none"> • Transition to a highly-efficient electric energy system that would make it possible to produce and distribute electricity at low costs • Increased participation of all sector in planning for the lowest possible base energy cost.
	<ul style="list-style-type: none"> • Implement a 50% reduction in the social security tax for workers, employers and the self-employed for a period of six (6) years. 	<ul style="list-style-type: none"> • \$640 million annually in additional take-home pay for Puerto Rican workers, equivalent to a 2.3% pay rise, and an immediate reduction of \$647 million in annual operating costs for businesses.
US Department of Health and Human Services	<ul style="list-style-type: none"> • 85% exemption on dividends (or repatriation payments) from eligible Puerto Rico companies, as defined • Reduction in half of the full US statutory tax for active Puerto Rico source income on the remaining 15%. 	<ul style="list-style-type: none"> • Stimulus for the return of funds held abroad due to attractive tax environment • Stimulus for investment in Puerto Rico in order to generate Puerto Rico source income.
	Medicaid	<ul style="list-style-type: none"> • Increased funding to strengthen Medicaid program and improved access to health care treatments • Modernization of Medicaid programs • Over \$100 million in funding to support health centers and providers related to Zika virus.
	Medicare	<ul style="list-style-type: none"> • Payments to low income patients and uncompensated care are expected to increase by 12.6% or \$8.4 million in FY17 • Legislation passed by Congress will increase hospital payment rates in the Commonwealth by approximately 5% and payment amounts by \$350,000 • 10% increase in Medicare physician fee scheduled payments • Increased payments to Medicare Advantage plans operating in Puerto Rico to account for possible underestimation of expenses from the normal rate setting mechanisms • Adjustment in Star Ratings will account for the impact of the absence of Low Income Subsidy in Puerto Rico.
	Extend the Earned Income Tax Credit to Puerto Rico.	\$400 million a year in tax refunds to eligible Puerto Rico households
	Extend the Child Tax Credit to Puerto Rico.	Potentially benefit an additional 300,000 families in Puerto Rico in reducing poverty and easing the financial burden of supporting children through a reduction of tax liability and/or a refundable credit.

Expansion of HUBZones in Puerto Rico

To further promote economic growth, PROMESA amends, through section 412, the definition of a “qualified census tract” as established in the Small Business Administration (“SBA”) Act. This amendment, in summary, would provide more flexibility for the Administrator of the SBA to expand the HUBZone program in Puerto Rico.

What are HUBZones?

The Historically Underutilized Business Zones (HUBZone) program was enacted into law as part of the Small Business Reauthorization Act of 1997. Through a certification and designation process, the HUBZone program encourages economic development and job creation in historically underutilized business zones. The HUBZone program requires that 3% of all Federal government’s contracting dollars be assigned specifically for HUBZone-certified businesses. Companies and small businesses that are within a designated HUBZone and manage to pass the certification process will receive preferential treatment in Federal government contracting over regular businesses.

Qualified census tracts and metropolitan statistical areas

A “qualified census tract”, as defined in the Internal Revenue Code (IRC), is a census tract designated by the Secretary of Housing and Urban Development for which, for the most recent year for which census data are available, meets the following:

1. 50% or more of the households have an income which is less than 60% of the area median gross income
2. There is a poverty rate of at least 25%

In the United States, in order to facilitate the statistical collecting, tabulating and publishing process of population data, regions consisting of a

city and its suburbs, plus any surrounding communities that are closely linked to the city because of social and economic factors, are designated into metropolitan and micropolitan statistical areas³. These metropolitan and micropolitan areas could be eligible for designation as a qualified census tract.

However, there is a limit to the portion of any metropolitan statistical area that may be designated as a qualified census tract. The Small Business Act limits this designation by stating that a qualified census tract must not have more than 20% of the population of such metropolitan statistical area.

Section 412 of PROMESA eliminates the 20% restriction from the qualified census tract definition (for Puerto Rico only) until the first of the following events occur:

- a) 10 years after the date that the SBA Administrator implements the amendments, or
- b) the date on which the Oversight Board ceases to exist

With the amendment, more areas could now qualify for the HUBZone designation providing local small businesses the opportunity to benefit from federal contracting opportunities.

Reporting requirements

To implement and therefore measure the effects of the amendment, the SBA Administrator was assigned with the following responsibilities:

- issue and adopt regulations to implement the amendment not later than 90 days from the enactment of PROMESA
- develop and implement criteria and guidance to request and verify information from entities applying to be designated or recertified as “qualified HUBZone small business concerns⁴”

³ <http://www.census.gov/population/metro/about/>

⁴ A qualified HUBZone small business concern are HUBZones small business concerns that have been qualified as such following a

certification process by the SBA Administrator, which requires, among other things, that at least 35% of the employees of the business reside in a HUBZone.

within 270 days (9 months) after the enactment of PROMESA

- not later than one (1) year after the guidance and criteria is established, the Comptroller General of the United States shall issue a report directed to Congress that includes:
 - an assessment of the criteria and guidance issued by the SBA Administrator;
 - an assessment of the implementation of the criteria and guidance issued by the SBA Administrator;
 - an assessment as to whether these measures have successfully ensured that only qualified HUBZone small business concerns are participating in the program;
 - an assessment as to whether the reforms made by the criteria and guidance implemented have resulted in job creation in Puerto Rico; and
 - recommendations on how to improve controls in the HUBZone program.

Additionally, Section 408 states that the US Government Accountability Office (GAO) shall submit to Congress a report on the application and utilization of contracting activities of the US Administration, including contracting activities related to HUBZones in Puerto Rico. The report shall also identify “any provisions of Federal law that may create an obstacle to the efficient implementation of such contracting activities.”

Overtime pay and minimum wage in Puerto Rico

On June 2015, three former IMF economists published a report⁵ on Puerto Rico’s economy that argued that the federal minimum wage was high relative to the local wage level and presented more of a binding constraint on employment than on the mainland. A few months later, on September 2015, the Working Group for the Fiscal and Economic Recovery of Puerto Rico proposed exempting workers aged 25 and younger from future increases in the federal minimum

wage for a 10-year period. Section 403 of PROMESA responds directly to these proposals.

By amending the Fair Labor Standards Act of 1938, PROMESA allows the Governor, subject to approval, to set a minimum wage less than the federal minimum wage of \$7.25 per hour for workers who are under the age of 25. However, the minimum wage cannot be lower than \$4.25 and will be set for a maximum of four (4) years. If the Board terminates before the set period, the new minimum wage shall not continue in effect.

The new wage will only apply to employees who are initially employed after the date of the enactment of such Act. In addition, employers on the territory may not take any action to displace current employees, including partial displacements such as reduction in hours, wages, or employment benefits, for the purpose of hiring new employees.

Section 404 also establishes special rules regarding Puerto Rico exempt employee compensation. On December 1, 2016, the US Department of Labor’s new overtime rule is scheduled to take effect. The rule would raise the salary threshold that must be met before an employee may be considered exempt from the statute’s minimum wage and overtime requirements by increasing it from \$23,660 a year to \$47,476. Employees who earn less than the new threshold amount would be eligible for overtime pay. Section 404 excludes Puerto Rico from the application of said rule until the Comptroller General of the United States (the “Comptroller General”) completes an assessment and the US Secretary of Labor determines that the rule would not affect negatively the Commonwealth’s economy.

A subsequent report shall be issued by the US Comptroller General which shall include an assessment of the impact of applying the special rules taking into consideration regional, metropolitan, and non-metropolitan salary and

⁵ Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, *Puerto Rico: A Way Forward*, June 29, 2015.

cost-of-living differences. This report shall be issued not later than two years from PROMESA's date of enactment.

Closing remarks

Puerto Rico's financial difficulties are the result of a contracting economy following years of rapidly escalating debt to fund budget deficits. Restoring economic growth is imperative, and a collaborative approach is in the best interest of all constituents.

A monumental task lies ahead, and the establishment of an independent Oversight Board may provide the opportunity to embrace long-term planning as a guiding principle and lead Puerto Rico in the direction of sustainable economic growth and fiscal stability.

We invite you to continue to explore with us the many aspects of this piece of legislation in our future articles.

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