Special Comment

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Puerto Rico Moves to Address Economic and Fiscal Crisis

Seven bills signed into law since January

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Summary Opinion

In an effort to swiftly deal with the economic and fiscal crisis Puerto Rico is facing, the governor has signed seven bills into law since January, 2009. They contain a mixture of items, but all aim to bring the commonwealth closer to structural balance by 2012. The bills do the following, among other things:

- Raise some revenues permanently (including cigarette taxes and taxes on alcoholic beverages);
- Raise some taxes temporarily (including personal income taxes, corporate income taxes, and real estate taxes);
- Lay out a plan for a dramatic reduction in payroll spending, including layoffs and reduction in working days; and
- Expand the borrowing program under COFINA (the sales tax revenue bonding program).

These measures, together with federal fiscal stimulus monies and an opportune restructuring of the Puerto Rico Infrastructure Financing Authority's escrow account, support plans to reestablish fiscal solvency for the commonwealth.

While we recognize the challenges the commonwealth is facing, and consider it a significant achievement that the administration and legislature have worked together to quickly produce a plan for recovery, we will be focused not only on the passage and implementation of these measures, but, more importantly, the results they produce.

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New Laws Aimed at Reestablishing Fiscal Balance

Governor Luis Fortuno, who ran on a platform of expenditure reduction, won the election with 52.8% of the popular vote. This support translated into the passage of seven pieces of legislation in the first three months of the newly elected governor's term, evidencing a change in Puerto Rico's willingness to make structural changes in its operations meant to lead to an improvement in financial position. The newly adopted laws establish a state of fiscal emergency in Puerto Rico. Most significantly, one of the new laws permits the reduction of workforce to save the island a total of $2 billion annually. The new laws also provide for some permanent and other temporary revenue enhancements estimated to be worth approximately $800-$900 million per year to the commonwealth as soon as they are fully implemented. Through two different measures, the government has agreed to dedicate an additional 1 ¾ cents of the existing sales and use tax to support bond issues that will repay some debt, help to ease the deficit, and fund local fiscal stimulus (one cent of the existing sales and use tax is already leveraged in this manner).

Employment Reductions Planned

Expenditure reductions were initiated by the governor in his first executive order whereby he ordered a 10% reduction in government expenses, a hiring freeze and the reduction of 30% of trust (non civil service) personnel. Now that these new laws have been passed, the government intends, first, to offer voluntary retirement to government workers. Once public workers have had an opportunity to volunteer for separation, the government will calculate how much they anticipate saving from this action. Afterwards, the government intends to reduce the workforce further through layoffs until they have achieved $2 billion in annual savings. They hope to complete this process by January 1, 2010.

New Taxes to Raise Revenues

The bills contain a multitude of revenue raising measures, some permanent and some temporary. Tax revenue collections are down (see Figure 1), and these measures attempt to increase revenues to the commonwealth. The permanent revenue increases include an alternate base tax to be imposed on certain items of exempt income, repeal of the credit against sales and use tax for purchases of products manufactured in Puerto Rico for export, an increase of the cigarette tax by $1.00 per pack, addition of motorcycles to that class of vehicles on which an excise tax is charged, replacement of the exemption certificate for resellers with a credit for taxes paid, and an increase in excise taxes on alcoholic beverages.

Figure 1

Puerto Rico Revenue Collections ($000s)

Fiscal Year to Date	July 2007-Jan 2008	July 2008-Jan 2009	% Change
Tax Revenues	4,037,943	3,786,733	-6.2%
Personal Income Taxes	1,520,461	1,492,681	-1.8%
Corporate Income Taxes	846,330	744,830	-12.0%
Sales and Use Tax	486,524	454,229	-6.6%
Non-Tax Revenues	304,680	242,702	-20.3%
Traditional Lottery	25,426	14,214	-44.1%
Electronic Lottery	68,132	41,911	-38.5%
General Fund Revenues, Total	4,555,552	4,281,753	-6.0%

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The temporary measures include a modification to the alternative minimum tax on corporations to limit deductions for expenses incurred outside Puerto Rico for taxable years beginning after December 31, 2008 and before January 1, 2012; also for tax years beginning after December 31, 2008 and before January 1, 2012, a 5% surcharge on corporations and individuals whose adjusted gross income exceeds $100,000 or $150,000 for married persons filing joint returns, a special income tax of 5% on Insurance Credit Unions whose net income exceeds $250,000, a special income tax of 5% on Savings and Loan Credit Unions whose net income exceeds $250,000, a special income tax of 5% on every international banking entity on its net income for the taxable year (but only to the extent such income has not been subject to income tax as "excess income" under the International Banking Center Regulatory Act); for fiscal years 2009-10, 2010-11, 2011-12 and 2012-13, a special tax on all residential real estate in an amount equal to the property tax; and a three-year (2009, 2010 and 2011) moratorium on certain tax credits related to all but those under the Tourism, Film Industry and Economic Incentives Acts.

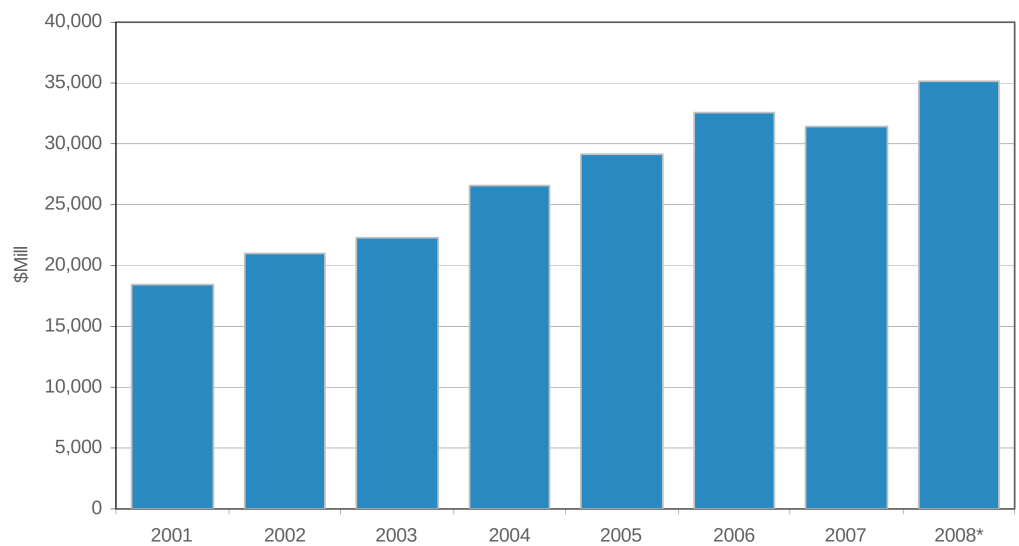
Additional Deficit Financing Anticipated

Puerto Rico is already highly leveraged (see Figure 2) and expects to issue considerably more debt to recapitalize the Government Development Bank, fund a local stimulus package, and pay for operations. The commonwealth intends to use these funds to bridge operations while it restructures the size and cost of its government and increases its recurring revenues. We will monitor the implementation of corrective actions to ensure that our rating appropriately reflects improvement in the commonwealth's financial position over the next few years.

The commonwealth plans to issue additional bonds backed by a dedicated portion of the existing sales and use tax. Initially, the government expected to leverage one additional percent of this tax to repay $1 billion that the Government Development Bank transferred to the commonwealth late last year, fund a local stimulus package and to help pay operations of the commonwealth. In subsequent legislation, the government authorized dedication of an additional ¾ of 1% of the sales and use tax (bringing the total to $2.75) for these same purposes. This increased leverage of its highest-rated credit is an important part of the commonwealth's fiscal plan for the next few years. When plans are finalized, we will assess the extent to which the new bonding program helps the commonwealth move toward its goal of structural balance, the effect of the increased leverage on the existing credit, and the effect that the lost revenue has on the General Fund.

Figure 2

Puerto Rico Net Tax-Supported Debt



** Estimate*

The recently passed legislation allows for additional deficit financing as well. The Commonwealth and the Public Buildings Authority, respectively, are authorized to issue refinancing bonds to restructure any payment of principal and/or interest that becomes due in a taxable year, even though such restructuring will not result in debt service savings. Also, Puerto Rico is now authorized to issue up to $20 million in five-year savings notes, the proceeds of which are expected to be deposited into a "Special Fund for Economic Assistance and Alternatives for Public Employees." In addition, the government is considering leveraging the new incremental cigarette tax.

Federal and Local Stimulus Bills Will Provide Some Relief

Puerto Rico estimates it will receive approximately $5 billion in federal stimulus aid. Of this, approximately $187 million in Medicaid aid is available to be used to close the budget deficit, and a small portion (approximately $100 million) of education aid may also be used for gap-closing purposes. In addition, the commonwealth created the Puerto Rico Economic Stimulus Plan Act in an attempt to promote economic growth on the island. The local stimulus program is worth approximately $500 million, as estimated by the commonwealth, and will be funded with proceeds from sales tax revenue bonds. It contains mortgage relief, a stimulus for home purchases, loans for small and medium businesses, and workforce retraining.

Restructuring of PRIFA

The commonwealth identified an opportunity to take advantage of some market fluctuations through selling the securities it was holding in a corpus account for the Puerto Rico Infrastructure Financing Authority. After selling the securities, the commonwealth is able to reestablish an escrow that will protect the PRIFA corpus account until 2040, repay bonds that were backed by interest on the securities, and still have money left over to put toward the operating deficit and loans from GDB.

Conclusion

In an attempt to revive the sagging economy and restore fiscal health, Puerto Rico has taken swift action to pass a number of laws that could have a dramatic effect on the island's economy and finances. In addition, the federal stimulus package also offers the opportunity to inject a substantial amount of new investment into the weak island's economy. As the laws go into effect and the stimulus proceeds are spent, we will be focused on the results they produce. In particular, we will be assessing the commonwealth's liquidity situation; the maintenance of spending restraint; revenue performance; and the movement toward structural balance. In the meantime, until tangible results of these actions affect financial results and economic activity, our rating for the commonwealth's general obligations remains Baa3 with a stable outlook.

Moody's Related Research

Outlook:

- Outlook Remains Negative for U.S. States: Federal Fiscal Stimulus May Moderate Recession's Effects on U.S. States; Impact from Recession Will Not be Equal, February 2009 (114526)

Special Comment:

- U.S. Federal Stimulus Likely to Relieve Short-term Credit Pressures Facing a Number of Municipal Issuers, February 2009 (114765)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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