PUERTO RICO HOUSING INCENTIVES POLICY: ANALYZING GOVERNMENT SPONSORED HOUSING INCENTIVES IN PUERTO RICO FROM 2007 TO 2011

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I. THE STATE OF PUERTO RICO'S REAL ESTATE MARKET

Puerto Rico's economy has been on a steady decline since 2007. The island's real Gross Domestic Product (GDP) growth rate has declined from 0.05% in 2006 to -5.8% in 2010.[1] This negative growth is expected to continue throughout 2011. The more optimistic expect this situation to turn around in 2012.[2] As expected, the financial, real estate, and construction sectors have been severely affected by the island's poor economic

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[1] *The World Fact Book*, CENTRAL INTELLIGENCE AGENCY 2011, https://www.cia.gov/library /publications/the-world-factbook/geos/rq.html (follow "Economy"). (negative estimates for GDP growth though the period -1.2% in 2007, -2.8% in 2008, -3.7% in 2009).

[2] Carlos Marquez & Jose L. Carmona, *Puerto Rico is Now Ready for Growth Finally*, CARIBBEAN BUSINESS, March 10, 2011 (citing GDP President Juan Carlos Battle who expects the economy to report positive economic growth in the 2012 fiscal year).

performance over recent years. Furthermore, the global economy collapsed in 2008, dealing another serious blow to the local economy. At that point, Puerto Rico's public debt was already growing at a higher rate than its economic growth, forcing the government to undertake massive budget cuts in 2009 to prevent the island's bonds from reaching junk bond status.[3] All these factors had major effects on virtually every economic sector. For instance, the economy contracted as a result of a steady increase in the unemployment rate and a reduction in capital investments. Local economists have dubbed this local recession as the "Recesión Criolla".

Before Puerto Rico's recession started, the construction and real estate markets seemed to thrive by posting strong sales numbers. As a result, new construction developments flourished and people rushed to take advantage of extremely accessible and attractive financing offers in order to make a seemingly "safe" and profitable investment. Speculation in the market led to increases in property values and homebuyers were more than happy to spend as much as 50% of their household incomes on housing expenses as they expected to capitalize on their property's appreciation in value.[4] However, after peaking in 2006, this speculative appreciation of property values came to a screeching halt by year's end. As property values rose to unattainable levels, housing market developments that were usually sold before completion started to accumulate in unprecedented amounts. Developers and their financial partners faced a huge problem as the current economic climate and their poor forecasting decisions led them to a dead end.[5]

Due to an increase in the cost of materials, the Federal minimum wage, and a long bureaucratic permit process amongst other factors during the aforementioned time period, developers of new properties chose to focus on mid to high price range properties in order to obtain profit margins that would justify undertaking such projects. The increase in construction and other development costs forced developers to steer away from low income housing projects despite the availability of government subsidies and instead focus on higher priced projects with greater profit margins.[6] Therefore, although the demand for low income housing units existed, low profitability and market risk scared developers from constructing these types of

[3] *See* The Special Act to Declare a Fiscal Emergency and to Establish a Fiscal Stabilization Plan to Salvage the Credit of Puerto Rico, Act. No. 7 of March 9, 2009, P.R. LAWS ANN. tit. 3, §§ 8791-8810 (2009). (Puerto Rico's bonds had been downgraded by credit rating agencies to BBB- and where closely monitoring the islands actions).

[4] *See* Graham A. Castillo, *Situation and Outlook of the Housing Market*, 18th Housing Congress, Estudios Técnicos, Inc., August 18, 2010.

[5] Castillo, *supra* note 4 (it is estimated that there is an existing inventory surplus of 19,841 new housing units of which 97% have been on the market for more than 18 months).

[6] HOUSING AND URBAN DEVELOPMENT COMMISSION POSITIVE REPORT ON P. DE LA C. 1577, Legis. Assemb. 16-1577, 1st Sess., at 3-8 (P.R. June 16, 2009).

properties. The difference between the increase in real estate prices and household income created an oversupply of mid to high-end properties and a lack of supply of lower priced properties.[7] This, along with stricter lending guidelines adopted by banks due to the global financial crisis, led to a drastic reduction in new home sales, constructions, and loans originated by local financial institutions. Unlike the situation in the United States, the island's housing problems were not necessarily due to sub-prime mortgage lending practices as economic hardship, foreclosures, and distressed properties were substantial problems as individual's struggled to fulfill their financial obligations.[8]

The problem in Puerto Rico was not lack of demand but lack of adequate housing supply for the market's needs.[9] Developers and financial institutions ignored key economic variables[10] and saturated the market with mid to high income housing units and developments which offered the highest profit margins. This had the effect of undersupplying the mid to low income housing market, which in turn had limited viable housing options to choose from. The most undersupplied segment consisted of potential buyers with moderate income who did not qualify for public housing benefits, because of their income, but could not afford to buy houses due to high asking prices and limited financing options.[11] Due to the importance of the construction industry's multiplying effect in the economy,[12] since 2007 it has been the acting government's priority to reduce the inventory of properties available for sale in order to encourage new capital investments by developers and provide liquidity to the financial institutions tied to these developments. Consumers were supposed to benefit from the government's efforts to stimulate the real estate market, as they would obtain different types of incentives such as tax exemptions and bonuses which could be used as down payments or to cover closing costs. We now proceed to analyze these strategies established by the acting government in response to the collapse of the real estate market.

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[7] Castillo, *supra* note 4 (of the existing inventory surplus of 19,841 reported as of June 2010, only 5,560 units were priced under $150,000 and 6,136 were priced over $300,000).

[8] *Id.* (delinquency rates on home mortgages have reportedly increased from 2.8% in 2006 to 13.5% in 2010 and personal bankruptcies have spiked 10.2% and commercial bankruptcies climbed to 30.3% as of June 2010).

[9] DEPARTMENT OF HOUSING IN THE HOUSING AND URBAN DEVELOPMENT COMMISSION FINAL REPORT ON R. DE LA C. 238, Legis. Assemb. 16-238, 1st Sess., at 6 (P.R. May 13, 2009).

[10] Such as unemployment rate, median income, population increases/decreases and general economic health of the island.

[11] FINAL REPORT R. DE LA C. 238, *supra* note 9, at 6.

[12] My New Home Program, Act No. 209 of December 29, 2009, P.R. LAWS ANN. tit. 17, § 1034 (2009). (estimated at 165 according to the Statement of Motives).

II. HOUSING INCENTIVES LAUNCHED IN PUERTO RICO SINCE 2007

A. The Newly Built and Existing Housing Acquisition Tax Credit Programs

The first attempt to stimulate the real estate market was launched in 2007 in the form of Act No. 197 of December 14, 2007 ("Act 197") also known as the "Newly Built Housing Acquisition Tax Credit Program and Existing Housing Acquisition Tax Credit Program." Act 197's Statement of Motives acknowledges that the sale of newly built housing units is an important activity that generates financial activity on the island and provides revenue to the state.[13] It states that increased unemployment, cost of living expenses, and the costs of doing business in Puerto Rico have led to an economic slowdown specific to the island which contrasts to the growth experienced by other neighboring economies.[14] As a result of this slowdown, sales of newly built housing units had reportedly dropped by more than 50%.[15] Proposed as a job creating measure that would encourage new investment in the construction industry, Act 197 provided a tax credit that ranged from $10,000 to $25,000 to financial institutions that financed newly built pre-designed housing and existing housing units sold.[16] However, these credits would have to be applied towards the balance of the obligation assumed by the buyer, effectively subsidizing the purchase. The incentives provided under this Act had a cap of $220 million dollars, regardless of the number of qualified candidates.[17]

This legislation offered three different types of incentives depending on the type of property the buyer intended to purchase and the use it would be destined for. Since the main purpose of the legislation was to reduce the inventory of newly built housing units, the highest incentives were offered to buyers of new properties, especially those who intended to use them as primary residences.[18] Such buyers could qualify for a 20% credit off the purchase price with up to a maximum of $25,000 applied towards the purchase price.[19] Buyers of newly built housing units intended for use as

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13 The Newly Built Housing Acquisition and Existing Housing Acquisition Tax Credit Programs, Act No. 197 of December 14, 2007, P.R. LAWS ANN. tit. 13, §§ 8044(K)-8044(L), 8514 (2007).
14 *Id.*
15 *Id.* (Act 197 adds section 1040K, section 1040L and sub clause (G) to clause (l) of subsection (b) to the Puerto Rico Internal Revenue Code of 1994).
16 *Id.*
17 *Id.* § 1(h).
18 *Id.* § 1(a)(8). ("Qualified Residence" is defined as a newly built housing unit owned and used by the acquirer as his/her main residence for a term of not less than three years as of its acquisition. Although this three-year limit may not apply under certain circumstances and may not have the effect of invalidating the credit).
19 *Id.* § 1(b)(2).

second homes or investment properties, could in turn qualify for a 10% credit off the purchase price up to a maximum of $15,000.[20] Finally, buyers of existing housing units, regardless of the intended use of the housing unit, could qualify for a 10% credit off the purchase price, up to a maximum of $10,000.[21] This latter group was limited to a maximum of 1,500 existing housing units.[22] These different alternatives were intended to provide benefits to financial institutions with tied up capital who couldn't afford to offer new commercial lending by reducing their risk on new loans. Two other goals of Act 197 were to provide buyers with opportunities to buy a primary residence which in turn would reduce the new housing inventory and, to a lesser degree, to offer buyers of second homes or investment properties and buyers of existing homes in the secondary market benefits and cost saving opportunities. This way all market participants, regardless of the type of housing (existing, pre-built, or new), would benefit from government sponsored incentives previously unavailable for such a wide spectrum of candidates.[23]

Financial institutions that wanted to take advantage of the tax benefits offered by Act No. 197, were required to register the property with the Puerto Rico Department of Treasury ("Hacienda") and the seller had to register with the Department of Consumer Affairs or "DACO" (Spanish acronym), which would keep an inventory of qualifying units and available credits.[24] The original expiration date on the tax credits was June 30, 2008, but it was subject to the availability of funds and a maximum number of existing properties to which the credits would be applied (for existing housing units). However, there were some initial complications and confusion that caused the original deadline to be extended to December 31, 2008.[25] At this point, the market was still desperate for a reduction in its inventory and there were still funds available from the original $220 million designation. However, existing housing unit sales quickly reached the maximum number of units allowed to benefit from the legislation incentives. Act No. 61 of May 12, 2008 ("Act 61") was thus passed to amend Act No. 197

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[20] *Id.* § 1(b)(1).
[21] *Id.* § 2(b)(1).
[22] *Id.* § 2(h).
[23] Qualification was not limited by traditional factors such as income or other social variables. The incentives were available for all home buyers purchasing a qualifying residence in a new construction or a pre-existing residence as long as they followed the guidelines set forth in Act 197 in order to register the project or property for the incentive program.
[24] The Newly Built Housing Acquisition and Existing Housing Acquisition Tax Credit Programs, Act. No. 197 of December 14, 2007, §§ 1(c)(i) & 2(c)(i). P.R. LAWS ANN. tit. 13, §§ 8044(K)-8044(L), 8514 (2007).
[25] Act. No. 61 of May 12, 2008, § 3(a)(8), P.R. LAWS ANN. tit. 13, §§ 8040(G), 8040(K)-8040(L) (2011).

in order to extend the number of existing housing units available for a maximum credit of $10,000 from 1,500 to 3,500 units.[26] Nevertheless, this increase in the maximum number of units would still be subject to the original funding limits of $220 million allotted for the stimulus program. The government hoped these incentives would encourage skeptical investors who were hesitant to purchase properties.

In order to provide homebuyers with credits without sacrificing the operating budget for fiscal year, Act No.197 provided financial institutions the aforementioned credits in three installments, to be collected on consecutive tax years starting on June 30, 2009.[27] The actual total amount of disbursements was higher than the credit amount allotted for the subsidies in order to account for interest and to compensate for opportunity costs and risk incurred by financial institutions.[28]

It is important to note that Act 197 did not identify where the funds to finance the credits would come from. In other words, the tax credits granted would simply be a pure reduction of taxes collected since no corresponding revenue generating source matched the tax credits identified. This revenue reduction would consequently affect the Government's operating budget for the next three fiscal years.

By December 31, 2008, Hacienda had processed a total of 11,518 applications for the credits set forth in Act 197 and Act 61.[29] The total amount of credits granted by the government amounted to $219,923,549, just under the assigned $220 million. Thus, the government would have a decrease in earnings throughout the extension of the tax credits equal to the $219,923,549 awarded plus interest.[30] Hacienda warned that the tax credits would have a negative impact on the central government's income and revenue generating capabilities since taxpayer obligations would be reduced by the same amount of the credits.[31] As such, these credits would substantially reduce Puerto Rico's general operating fund during the years corresponding to the credit installments. Hacienda went on to state that it would not recommend another incentive package aimed at the housing sector without first identifying alternative sources of income to compensate for the loss of revenue resulting from the tax credits.[32]

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[26] *Id.* § 4 (h)

[27] The Newly Built Housing Acquisition and Existing Housing Acquisition Tax Credit Programs, Act. No. 197 of December 14, 2007, §§ 1(d) & 2(d). P.R. LAWS ANN. tit. 13, §§ 8044(K)-8044(L), 8514 (2007).

[28] *See* Exhibit 2.

[29] *See* Exhibit 3 for distribution of credits in units and dollar amounts.

[30] Which will actually be a greater amount considering interest on the three credit installments. *See* Exhibit 2.

[31] FINAL REPORT R. DE LA C. 238 *supra* note 9.

[32] *Id.* at 4.

B. The Puerto Rican Economic Stimulus Plan

In May 2008, shortly after the enactment of Act No. 61, the global economy collapsed. Puerto Rico, already experiencing a difficult time dealing with its internal economic problems, was now being affected by a global recession which severely limited investment opportunities in both the public and private sectors. This situation would further affect the housing market since financial institutions would forcedly establish stricter financing requirements and availability of funding options would be limited. The events taking place did very little to bolster consumer confidence in the housing sector; the housing bubble had burst and the market was inevitably going into a price correction phase. This was terrible news for Puerto Rico's unsold inventory of new housing units and also for sellers of existing housing units. Increased delinquencies on mortgage payments, which resulted in increased foreclosures by lending institutions, resulted in an additional influx of properties into the market. These foreclosed properties would also affect the value of comparable properties, since financial institutions usually auction off or sell these properties for much less than their initial market value in order to get rid of the liability. In hopes of continuing the efforts set forth by the previous housing stimulus, the newly elected New Progressive Party government passed Act No. 9 of March 9, 2009 ("Act 9"), known as the "Puerto Rican Economic Stimulus Plan" in an attempt to boost the struggling Puerto Rican economy which was expected to continue its contraction.[33] This stimulus plan was part of the newly elected government's denominated "Economic and Fiscal Reconstruction Plan" which aimed to control and reduce government spending, raise additional resources for the general fund, promote the creation of Public Private Partnerships, and offset the recessionary impact of fiscal control measures to be implemented[34]

Pursuant to Act 9, $500 million would be disbursed through several programs in order to stimulate the overall economy,[35] of which a total of $54

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[33] The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009, P.R. LAWS ANN. tit. 12, §§ 142-155 (2009). (the Statement of Motives alludes to a budgetary deficit that is equal to 40% of the Government's recurring revenues and to the precarious state of the overall economy It refers to Puerto Rico's economy as being in a recession since 2007, when it experienced a contraction of 1.9%, followed by a 2.5% contraction in 2008, and an expected contraction for 2009 and 2010 of 3.4% and 2.0% respectively, which turned out to be too optimistic. At the time it was expected that the recession would last until 2011. It also points out the necessity to "restore fiscal health, improve its credit ratings and promote economic recovery.").

[34] *Id.* at 5.

[35] The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009 § 2. P.R. LAWS ANN. tit. 12, §§ 142-155 (2009). (such funds would be under the administration of the Government Development Bank for Puerto Rico ("GDB"), which would utilize the funds of the Puerto Rico Economic Stimulus Fund created by virtue of § 6 of Act No. 91 of May 13, 2006, as amended).

million would be allotted to measures directed towards the real estate market.[36] Of the $54 million assigned to help address the real estate market situation, $30 million would be assigned to establish a program to assist families struggling with their mortgages payments[37] and $24 million would be assigned towards homebuyer incentives. While acknowledging the government's attempt to implement a comprehensive plan to stimulate the real estate market (and the overall economy), for the purposes of this work we will focus on the "Homebuyer Stimulus Aid" set forth in § 5 of Act 9 which established a $25,000 or $10,000 credit towards the down payment of newly built or existing housing unit purchases, respectively. This bonus towards the down payment of a homebuyer's purchase would be provided by placing a second mortgage over the house for the appropriate amount in the name of the Puerto Rico Housing Financing Authority ("PRHFA").[38] This second mortgage would not be payable for 10 years, after which the homebuyer would have to start paying back the principal along with a fixed interest rate.[39] This interest rate could never be greater than the prevailing interest rate on the market plus one fourth percent (1/4 %) upon closing of the sale.[40]

The $30 million assigned to assist families pay their mortgages through the "Protecting Your Home Program", was aimed at decreasing mortgage loan delinquencies and foreclosures. This program had strict requirements and benefited lower income households which had recently gone through financial troubles and could not pay their mortgages. The program offered qualified participants up to eighteen months-worth of

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[36] The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009 § 12. P.R. LAWS ANN. tit. 12, §§ 142-155 (2009). (another $500,000 were assigned to the Regulations and Permits Administration in order to cover expenses related to the implementation of an interim procedure in order to create a more efficient permit and endorsement application procedure. One of the main purposes of the Interagency Permits and Endorsements Committee created by Executive Order OE-2009-6, is to expedite the bureaucratic nature of obtaining necessary permits and endorsements, in hopes of stimulating investing including Real Estate Developments, however, due to its administrative nature and applicability to other industries it was not included in the amount assigned towards the Real Estate Market in this work).

[37] The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009 § 4. P.R. LAWS ANN. tit. 12, §§ 142-155 (2009). (which allowed the Puerto Rico Housing Authority to provide a surety equal to 25% of the principal of a mortgage for eligible homes. Although this program would provide distressed homeowners with alternatives in order to avoid foreclosure on their homes and help reduce risk and increase liquidity in financial institutions, for the purpose of this work we will focus on incentives geared towards the purchase of new and existing housing units).

[38] *Id.* § 5.

[39] *Id.* § 5.

[40] Act. No. 28 of June 8, 2009, P.R. LAWS ANN. tit. 12 § 145, *amending* Act. No. 9, § 5 (in order to establish the applicable interest rate for the second mortgage originated from the "Homebuyer Stimulus Aid").

subsidies, up to a maximum amount of $20,000, in order to complement the mortgage payment.[41] These subsidies helped families who were at risk of losing their homes and also helped financial institutions by avoiding unnecessary foreclosures. In order to benefit from these payment guarantees, financial institutions were required to waive any late fees and other administrative charges incurred up to that point. This was intended to reduce the influx of distressed properties and corresponding depreciation of property values associated with this situation.

C. My New Home Program Act

Just 9 months after the approval of the Puerto Rican Economic Stimulus Plan, Act No. 209 of December 29, 2009, also known as the "My New Home Program Act" ("Act 209") was enacted. The purpose of this Act was to grant subsidies to lower income families for the purchase of their own property. Previous incentives were aimed at reducing the newly built housing inventory. However, most of these properties were simply not accessible to most market participants, whose options were very limited. As such, this program would favor individuals with low to moderate income levels, disabilities, the elderly, and public servants whose duties are essential to society.[42] Qualifying housing units could not exceed the maximum limits set by Federal Housing Authority ("FHA") loans. However, the PRHFA could raise previously preset price limits in order to reasonably cover purchasers' needs and market demand.[43] The incentives provided by Act 209 would provide qualifying participants a voucher for 5% of the sale price or appraised value of the property for a minimum of $5,000 and a maximum of $10,000.[44] This subsidy would have to be matched by the project's developer or the financial institution that financed the project.[45] In this way, the government hoped to reduce the amount of subsidies financed with public funds while allowing the private sector to contribute in order to provide homebuyers with a considerable incentive. Participating developers would benefit from this program by hopefully boosting stagnant sales and by not having to reduce property prices. To qualify for the "My New Home Program", the homebuyer would have to use the voucher for closing related

[41] *Id.* (as defined, a qualified participant would have to be at least 3 months late on their mortgage payments, have suffered a 20% loss of income or more, have a maximum family income of $48,000 and have an outstanding debt on their mortgage worth less than $200,000),
[42] My New Home Program, Act No. 209 of December 29, 2009, P.R. LAWS ANN. tit. 17, § 1034 (2009).
[43] *Id.* § 1, *amending* Act No. 124 of December 10, 1993 (this price limit could be ignored if the Permits for Use have been valid for a period in excess of 18 months, as provided therein).
[44] *Id.* § 1.
[45] *Id.* § 1.

costs,[46] use the unit as his or her main residence, be a first time beneficiary of the program, have an annual income below $125,000, and be purchasing a home with a price below $300,000.[47] This program allowed for participants to benefit from other programs or incentives in addition to those offered by Act. 209.[48]

In order to sell a property without any penalties, program participants would need to keep the property for a minimum 10 year term. If the purchased property were to be sold within the 10 year term, the benefits obtained by the program participant would have to be returned in proportion to the remainder of the term.[49]

The funds allocated for Act 209 would be administered by PRHFA according to the rules and regulations adopted by the authority as provided by the Act.[50] Act. No. 122 of August 6, 2010, known as the "My New Home Financing Program", would set forth the source of funding for this new subsidy. As per Act 122, PRHFA would be assigned a recurrent source of funding obtained from the transfer of unclaimed liquid funds being held by financial and insurance institutions along with future assignments as approved by the legislature.[51] PRHFA could also dispose additional funds to this program by means of internal cost saving measures or budget redistribution as it deemed pertinent.[52]

D. The Puerto Rico Real Property Market Stimulus Act

Upon the expiration of Act 9, property inventories were still at unacceptable high levels. This forced the Government to pass its most expansive attempt yet to stimulate the real estate market in the form of Act No. 132 of September 2, 2010 ("Act 132"), also known as the "Real Property Market Stimulus Act." Once again, the government's purpose was to promote the sale of new and existing housing units through the adoption of a new

[46] As defined in the Puerto Rico Housing Financing Authority's Procedural Guidelines for the My New Home Program, § 4(V) (including lawyer's fees, realtor commissions, loan origination fees, cancelation fees and other related costs).
[47] *Id.* § 5.
[48] My New Home Program, Act No. 209 of December 29, 2009 §4. P.R. LAWS ANN. tit. 17, § 1034 (2009).
[49] *Id*, § 1.
[50] *Id*, § 1.
[51] My New Home Program Financing Plan, Act No. 122 of August 6, 2010, P.R. LAWS ANN. tit. 7, §2105 (2010). (This law would propose an amendment to Act No. 36 of June 28, 1989, Art. 6 (a)(2), in order to reduce the ten year holding period that financial and insurance institutions would have to wait in order to revert unclaimed liquid assets to the state to three years).
[52] *Id.* § 4.

incentive package.[53] This package consisted of real property tax exemptions, capital gains tax exemptions, income tax exemptions from the leasing of residential properties, and exemptions from transaction fees and duties. Act 132 was passed in response to projections which had newly built housing unit sales dropping by as much as 30% in comparison to the previous year.[54] This time, qualification requirements were loosened even more in order to allow for maximum participation in the program. Prospective buyers of high priced homes could now potentially qualify. Since the main purpose was to sell new housing units, restrictive requirements such as those based on the intended use of the property were eliminated. Like previous programs, pre-designed houses and existing housing units would also be included in the program. However, in contrast to the previous packages, the rental market and the non-residential real estate market were included in the package to create a more comprehensive effect on the overall market and the economy. This would provide alternatives for developers and sellers that are unable to sell properties and for consumers that are not able to purchase a property right now.

There were three different types of beneficiaries eligible for Act 132 benefits. The first type of beneficiary were purchasers of "newly built properties" as defined by the Act,[55] would receive the most benefits, since reducing this type of inventory was the stimulus package priority. Under this scenario, total net long-term capital gain obtained from the sale of a new residential unit purchased under Act 132 would be exempted from state income tax obligations.[56] Buyers of new property under Act 132 would not have to pay income tax on capital gains upon the sale of the property in the future.[57] Buyers of new properties under Act 132 would also be exempt from the payment of real property taxes for five years[58] and exempt from paying the "Special Real Property State Tax"[59] approved in 2009 as a measure to

[53] The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010, P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2010).
[54] *Id.* (only a total of approximately 5,000 newly built housing units were sold in 2009 and only 1,726 units were sold for the first semester of 2010, for an estimated total amount of around 3,500 units sold for the year for an expected 30% decline in sales).
[55] *Id.* §1(a)(1-2) ("newly built residential property which is suitable for family living and has not been occupied." It also includes predesigned housing units acquired from approved developers).
[56] *Id.* § 3(b)(1).
[57] *Id.* § 3(c)(2). (such benefits would only be available to first time purchasers of the property, not to any other subsequent transfers).
[58] *Id.* § 5. (pursuant to Act No. 83 of August 30, 1991 and/or Act No. 71 of Jul 2, 2010. Commencing on Jan 2, 2011).
[59] *Id.* § 6.

increase the government's revenue stream.[60] Furthermore, all parties involved in a new property sale were exempted from incurring in any internal revenue stamp or voucher expense as required by law for the execution, filing, and recording of public documents.[61]

The second group of beneficiaries was composed of those who acquired a "qualified property." This included any existing residential or non-residential property whose sale price did not exceed $3 million.[62] The seller of a "qualified property" during the validity of Act 132 was fully exempted from state income taxes concerning the long term capital gains associated with the sale.[63] As was the case with new properties, those who bought a "qualified property" before the expiration date of the Act, would also obtain a tax benefit upon the future sale of their property. However, instead of the 100% exemption granted to sellers of "newly built properties", the seller of a "qualified property" would obtain a 50% exemption on the net long-term capital gains generated from the future sale of their property.[64] Acknowledging the devaluation of properties during recent years which forced sellers to sell their homes for less than the value of their mortgage loans, Act No. 132 included provisions to reduce losses on sales of "qualified property." As such, a taxpayer who is a natural person was allowed to deduct a $5,000 capital loss against his or her personal income, thus increasing the current capital loss limit allowed against regular income.[65] The carry-over of such losses was allowed to be carried over to a maximum of 15 years, as opposed to the 5 years previously allowed.[66] Sellers of a "qualified property" also received a 50% exemption from charges related to internal revenue stamps and other vouchers required by law for the execution, filing, and recording of public documents.[67] Sellers were also fully exempted for the same purposes regarding the cancelation of any mortgage burdening the property.[68] Also, the buyer of a "qualified property" would be exempted from 50% of the costs of internal revenue stamps and vouchers as required by law for execution, filling and registration purposes with respect to the purchase and mortgage of the property.[69]

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[60] The Special Act to Declare a Fiscal Emergency and to Establish a Fiscal Stabilization Plan to Salvage the Credit of Puerto Rico, Act. No. 7 of March 9, 2009, P.R. LAWS ANN. tit. 3, §§ 8791-8810 (2009).
[61] The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010, § 7. P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2010).
[62] *Id.* §1(c)(1)(2).
[63] *Id.* § 3(a)(1).
[64] *Id.* § 3(b)(2).
[65] *Id.* § 4 (a).
[66] *Id.* § 4(b).
[67] *Id.* § 7.
[68] *Id.*
[69] *Id.*

The final group of eligible beneficiaries was composed of "eligible lessors" of any residential property.[70] Under Act 132, any income earned from the rental or leasing of any residential property would be fully exempted from all applicable state income taxes[71] for a period of 10 taxable years commencing on January 1, 2011.[72] This alternative hoped to provide new options for home sellers and developers who were not able to sell their units and to provide a more accessible rental market for those looking to purchase homes but who were not able to do so due to strict lending conditions and inaccessible inventory alternatives. In theory, this program would also provide the lessor with additional income to meet his obligations and invest or consume in other economic areas. Financial institutions or individual sellers tied to these developments would hopefully benefit from increased account receivables collections, less bankruptcies, and less foreclosures.

III. EFFECT OF INCENTIVES IN THE HOUSING MARKET

Governments can intervene in the housing markets in five major ways: (1) by defining and enforcing property rights; (2) by taxation; (3) by the granting of subsidies; (4) through housing regulations; and (5) by direct public provisions.[73] Governments implement these measures in order to balance the different interests that affect a variety of important issues inextricably tied to housing. The majority of the provisions included in the real estate incentives discussed herein concern subsides implemented by altering applicable tax provisions, altering property rights, and plain cash incentives. An exemption from a regulation, which has an identifiable benefit to society similar to its cost, is treated as a subsidy.[74] Reductions, which do not yield corresponding benefits, are treated as pure cost reductions.[75] Although market interventions by governments may seek different purposes, it is useful to apply a cost/benefit analysis in order to gauge the economic effects of implementing such measures. The purpose of a cost/benefit analysis is to determine if the investment in such an incentives program was effective and worth implementing.

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[70] *Id.* §1(b) (whereby "eligible lessor" is defined as any individual, succession, corporation, partnership or trust that leases new or existing housing units).
[71] *Id.* § 2(a).
[72] *Id.* § 2(b).
[73] Deniz Baharoglu, Lawrence M. Hannah & Stephen Malpezzi, *Getting Housing Incentives Right in Turkey* 14 (University of Wisconsin-Madison working papers 97-03, May 30, 1997), *available* at the University of Wisconsin Center for Urban Land Economic Research.
[74] Getting the Incentives Right, URBAN NOTES Vol. 1, No. 1 (April 1989) Published by the Urban Development Division of PPR, at 2.
[75] *Id.*

The various stimulus packages promoted by the Puerto Rican Government directly affected four groups: (1) property buyers and sellers; (2) developers; (3) the government; and (4) the local economy.[76] The ideal scenario is one where all four groups benefit from the stimulus packages. However, because of the nature of the incentives and the variability of the factors that affect the housing market, most often some groups will benefit while others bear the measures' cost burden. We will now explore the effects of the incentives implemented by the Puerto Rican government, as well as other foreign governments, in order to gauge the effectiveness of these strategies in improving the real estate market situation.

A. Effects of Incentives in Home Prices During their Validity

Governments establish incentive packages with certain expectations and to fulfill specific purposes. However, studies show that on many occasions the results of such incentives prove to be counterproductive towards the achievement of said purposes or have other related unexpected effects, which offset the benefits provided. In theory, consumer subsidies increase a purchaser's buying power, artificially increasing demand and in turn raising prices. With most goods, manufacturers would respond by increasing supply, which would bring costs back down. Nevertheless, some goods, such as housing, face constraints to new supply due to various factors like construction time and pre-construction requisites.[77] Moreover, increasing supply would not make sense in Puerto Rico's case, considering the current overstock of housing. In practice, housing subsidies have the unwanted lateral side effect of increasing property prices.[78] Subsidies simply end up getting capitalized into housing prices, which by definition would increase prices, therefore potentially affecting affordability and limiting access to the market.[79]

The International Monetary Fund ("IMF") has found that first home buyer grants, variable rates mortgages, and capital gains tax concessions all serve to destabilize housing markets.[80] Furthermore, according to the IMF: "[s]ubsidies to first time home buyers are shown to both amplify house

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[76] See Exhibit 7, in order to view factors considered in a cost/benefit analysis for housing market participants.

[77] Jack Hough, *Why the US Doesn't Need Any More Home–Buyer Perks*, SMART MONEY, A WSJ ONLINE MAGAZINE (October 30, 2009), http://www.smartmoney.com/invest/markets/why-us-does-not-need-more-home-buyer-perks/.

[78] Miguel-Angel López García, *Precios de la vivienda e incentivos fiscales a la vivienda en propiedad en España*, 12 REVISTA DE ECONOMÍA APLICADA 39 (1996).

[79] *Why Housing Incentives Must Go*, MACROBUSINESS (February 27, 2011), http://www.macrobusines.com.au/2011/02/why-housing-incentives-must-go/.

[80] David Uren, *Incentives Hurting Housing Market*, THE AUSTRALIAN, April 11, 2011, *available at* 2011 WLNR 6938715.

prices, swings in the upturn and lead to deeper subsequent busts."[81] Similarly, "tax deductibility of capital gains tends to both amplify the boom and exacerbate the bust."[82] Some, like former Australian Treasury chief Ken Henry, believe that first time home buyer grants only result in prices being bid higher and that buyers leverage the government grants in order to spend more.[83] All of these incentives were implemented in Puerto Rico but none of the previously described potentially negative long run effects were considered. The implementation of housing incentives in Puerto Rico has been solely based on short run statistics with no mention of future implications or unintended consequences.

The impact of the incentives varies depending on the chosen strategies. New and existing properties are in most cases perfect substitutes.[84] Incentives that are applied towards the purchase of both new and existing properties maintain their respective prices unaltered in relation to each other.[85] However, if the two types of properties were to be treated differently by incentivizing one more than the other, relative prices between them would have to be modified.[86] This different treatment would lead to a new valuation process that would result in a decreased price for the properties not receiving the equal incentives (usually the existing properties).[87] Some studies show that "savings incentives" have a positive effect on pricing in the long run and, in the short run, results in the increase of prices being capitalized by all the existing properties.[88] This would entail that all properties would equally increase in value by the amount of the incentive. These same proponents argue that "investing incentives" have a negative long-term effect on property prices and also have an adverse effect on existing home prices upon their implementation.[89] Therefore, investing incentives would also have the effect of increasing demand, while controlling price increases because of the corresponding depreciation of existing properties. In other words, the increase in new property prices due to the capitalization of incentives would be counter-balanced by the decrease in prices of existing properties, thus effectively controlling the overall increase in prices. As described herein, Puerto Rico's focus has been primarily on new housing units' sales and, to a lesser degree, existing housing units sales, thus qualifying as an investment incentive.

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81 International Monetary Fund, *Housing Finance and Stability-Back to Basics*?, GLOBAL FINANCIAL STABILITY REPORT, April 2011.
82 Uren, *supra* note 80.
83 *Id.*
84 *Id.* at 2.
85 *Id.* (referred to as "Savings Incentives").
86 *Id.* (referred to as "Investing Incentives).
87 *Id.* at 3.
88 *Id.*
89 *Id.*

Incentives granted are usually justified as a way to provide buyers with more access to the market; nonetheless, in many ways these incentives do the complete opposite. A secondary purpose of these incentives, considering the dramatic decline in home values, may be to prevent a free-fall of home prices by injecting confidence into the market. Goldman Sachs estimated that government support boosted house prices by 5% (or kept them from falling that much more) in the United States in 2009 by means of the Federal housing stimulus program.[90] Therefore, once a program like this expires, it is possible that homes would drop in value by that same 5% in addition to any further drop in value related to other factors in the market. Economists believe that temporary incentives mostly convinced people who were already considering buying a property to do so sooner rather than later, before the incentive programs expire. This means that upon the expiration of the incentives, a sudden drop in the number of buyers and housing prices could suddenly take place.[91] It is estimated that of the American Recovery and Reinvestment Act ("ARRA") beneficiaries, only 15% would not have purchased their home if they were not offered the $8,000 incentive.[92] Therefore, in order to determine if these incentives were worth the investment, we must examine the market's behavior upon their expiration.

B. Effect on Property Values after Incentive Expiration

Puerto Rico is not the only country facing a real estate crisis, although the underlying reasons for each country's situation may differ. However, many other countries have turned to incentives as an option to reverse their situations. Countries that have implemented similar stimulus packages have found out that the expiration of these packages have brought adverse unintended consequences. For instance, the month after the expiration of the $8,000 Federal incentive program,[93] the Mortgage Bankers Association reported a 27% decline in mortgage applications.[94] Existing home sales dropped by 10% in February of 2011 to their lowest point in 9 years, 40% of which are estimated to have been distressed property sales. Since the expiration of the homebuyer incentive program new housing sales have decreased 22% and existing home sales have decreased 6% in the United

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[90] Jack Hough, *Shopping for a House? Consider Waiting Nine Months*, SMART MONEY, A WSJ ONLINE MAGAZINE (January 29, 2010), http://www.smartmoney.com/invest/markets/shopping-for-a-house-consider-waiting-6-months/.

[91] *Id.*

[92] Hough, *supra* note 77.

[93] American Recovery and Reinvestment Act of 2009, 26 U.S.C. §§ 36(b) (2012). (which was extended from its original expiration date to April, 2010).

[94] Ana González Ribeiro, *New Home Buyer Incentives Replace Government Tax Credit*, MINT.COM (May 20, 2010), http://www.mint.com/blog/goals/home-buyer-credit-05202010/.

States,[95] while $26 billion in state sponsored subsidies has been incurred by the government.[96] In the United States, homebuyers have lost almost twice what they received as government cash incentives to property price decline. Since the expiration date of the federally sponsored program, median home values fell from $185,000 to $170,000. Thus, program beneficiaries obtained $8,000 but on average lost $15,000.[97] In places like Australia, it is argued that first time-home buyer incentives proved to be a boon for home sellers instead of homebuyers as was originally intended.[98] In Spain, after the end of a tax incentive proposed to stimulate property sales, sales dropped significantly, again suggesting a negative backlash directly attributable to the expiration of incentives.[99] The goals of these programs were similar to those of the programs established in Puerto Rico: incentivizing home purchases within an established time period so as to hopefully create a sense of urgency and boost the economy through property sales while decreasing inventories. Although Puerto Rico's incentives programs have yet to expire and have been extended for the fourth time throughout 2012,[100] property values have decreased from a median price of $250,000 in 2009 to $215,000 in 2011, suggesting that once the programs have concluded prices could experience a free-fall and possibly at a faster rate as demand decreases.

C. Private Sector Incentives

Due to the desperation created by stagnant sales, developers have had to create and implement an unprecedented number of creative strategies in order to sell properties. Accordingly, developers and financial institutions have teamed up in order to provide further incentives in addition to those offered by the government. These incentives are intended to provide additional benefits that could be considered cost reductions for buyers but do not affect the selling price of the homes. Developers and their creditors try to avoid reducing selling prices since this would affect consumer confidence and would certainly enrage recent homebuyers in those same projects (not

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[95] Jack Hough, *How the $8,000 Tax Credit Cost Home Buyers $15,000*, SMART MONEY, A WSJ ONLINE MAGAZINE (May 10, 2011), http://www.smartmoney.com/spend/real-estate/how-the-8000-tax-credit-cost-home-buyers-15000-1304981110838/?zone=intromessage.
[96] *Id.*
[97] *Id.*
[98] *The Impact of First-Home Buyer Stimulus*, TOMORROW: A HOME LOANS BLOG (June 9, 2011), http://www.tomorrowfinance.com.au/blog/the-impact-of-first-home-buyer-stimulus/.
[99] *El fin de deducción por comprar casa comienza a mostrar su cara negativa en el Mercado,* EL MUNDO, November 5, 2011 9:06am, http://www.elmundo.es/elmundo/2011/05/11/ suvivienda/1305097617.html?a=4b5c0d087d59965c7588b6734aca0685&t=1310248396. (citing data from the Spanish Instituto Nacional de Estadísticas (INE)).
[100] Joanisabel González, *Otro salvavida a vivienda*, EL NUEVO DÍA (June 9, 2012), http://www.elnuevodia.com/otrosalvavidasalavivienda-1275181.html.

to mention reduce profit margins and capacity to meet obligations). Also, by preventing a further drop in home values, buyers would be less hesitant to wait to purchase a home for fears of declining values. Buyers perceive they are getting more value for their purchase and are enjoying costs savings. Some examples of such increasingly creative incentives granted by developers are: free upgrades, vouchers for home appliances, customizations, and attractive project specific financing options.[101] Some argue that the use of rebates actually makes the real estate market look healthier than it actually might be by preventing price reductions.[102] However, savvy homebuyers are increasingly looking at pure price reductions as the only acceptable incentive because other incentives cannot guarantee that home prices would not decline in the near future resulting in their loan becoming "under water."[103] Also, some buyers would rather use these savings to purchase what they really need without being limited by incentive options and restrictions.[104] Developers continue to re-evaluate alternatives in order to adapt to this new economic reality. More and more projects are being redesigned in order to reduce the price and size of developments in an attempt to serve the demands of the market and not add to the un-sellable high-priced inventory surplus.

D. Why Stimulate the Housing Market through Incentives?

Despite the negative effects of incentivizing home purchases, why have so many countries turned to incentive based policies in order to help mitigate the effects of the real estate market crisis?

First, governments have faced harsh pressures to act in order to stabilize their respective economies due to the financial crisis. By incentivizing the real estate market, governments hope to stimulate the economy along with a series of other measures so as to stop the "bleeding". In Puerto Rico, the real estate and construction industries have a considerable multiplying effect on the economy, helping to stimulate related industries. Buyers of existing houses spend in repairs, new appliances, legal fees, and sales commissions amongst other expenditures. Buyers of new homes have an even greater impact, since these units had to be built and therefore would contribute to the economy with construction jobs, materials purchased, permit and impact assessment fees, and other regulatory and

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[101] *See* Exhibit 8 for a more expansive list of incentives.

[102] Jessica Saunders, *Home Buyer Incentives Another Sign Housing Boom is Over*, THE SAN FRANCISCO BUSINESS TIMES (September 10, 2006), http://www.bizjournals.com/eastbay/stories/2006/09/11/story2.html?page=all.

[103] Common term used to describe a loan, usually a home mortgage loan, with a higher balance than the value of the home.

[104] Such as brand or store specific vouchers, limited upgrade options, or financing offers tied to a specific institution.

administrative fees. Both types of purchases generate a post-closing economic chain where real estate brokers, notaries, engineers, architects, appraisers, moving companies, hardware stores, electronic stores, and other sectors of the economy benefit.[105] All of these incidental transactions generate revenue for the State through collections of sales taxes and other applicable taxes. Homeowners also pay property taxes and other special taxes which are based on estimated home values. These taxes generate considerable income for both the State and Municipal Governments. It is therefore clear that a decrease in home values would mean a corresponding decrease in taxes collected. By maintaining or increasing property values, assuming that these values are constantly revised, the State can prevent a further reduction of revenue collections. In the best-case scenario, the increase in the amount of taxes collected as a result of the stimulus effect of the incentives on the economy would be greater than the amount of subsidies granted by the State.

Some incentives are also aimed at promoting new developments. A drop in the development of new projects also decreases revenues for the State due to reduced building permits, hookup fees, impact assessment fees, titling taxes and inscription fees. Sales taxes collected would also decline due to lower sales of building materials, household appliances, and other related goods. According to the Nelson A. Rockefeller Institute of Government Tax, the amount of state taxes collected in the United States in 2010 was 17% below the amount collected in 2008.[106] Although, this drop in tax collections may not be solely attributable to real estate, construction and other related industries, it is certainly a significant part of the equation.

In order to free some tied up capital from financial institutions and investors, the new housing unit inventory must be reduced. This inventory ties up investors' and financial institutions' opportunities to undertake new projects and pursue new opportunities. Existing properties also affect financial institutions which provide and service mortgage loans. Therefore, property sales are crucial in order to increase liquidity for local banks so that they may lend to consumers and make commercial investments. Through incentives, it is hoped that inventories will be reduced and the capacity to make new investments will increase.

Furthermore, a struggling global economy and an extended local recession have hit the job market in Puerto Rico particularly hard. Naturally, considering the state of the real estate market, construction jobs have disappeared at an alarming rate. It is estimated that 60,000 construction

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105 The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010. P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2010).

106 John E Petersen, *The Housing Markets Effect on Government Finance*, GOVERNING (November, 2010), http://www.governing.com/columns/public-finance/effects-housing-market-government-finance.html.

related jobs have been lost since 2004.[107] In the United States, approximately 2 million construction jobs had been lost as of mid-2010.[108] It is estimated that every on-site construction job generates roughly two other off-site jobs.[109] This could represent a total loss of approximately 180,000 construction related jobs in Puerto Rico and around 6 million in the United States. In order to turn the economy around it is crucial that job opportunities are created and a healthy construction sector would certainly help to that effect.

E. Other Factors to Consider

To fully comprehend the extension of government sponsored incentives we must briefly discuss other types of subsidies. As described, Puerto Rico's housing inventory surplus consists, in its vast majority, of medium to high-priced units. Throughout our history, several programs have been established, using both state and federal funds, to promote the development of low-income housing units and provide low-income families with proper housing alternatives. Most recently, in an attempt to reduce low-income housing development costs, a bill has been proposed by the state senate to impose a three-year moratorium regarding the payment of impact assessment fees, which can amount to 25% of the costs of developing low-income projects.[110] This would hopefully motivate developers to provide more low income housing to meet market demand without forcing the government to fund such projects exclusively with public funds. However, as discussed, subsidies do not necessarily cancel out taxes and other regulatory costs.[111] Thus, it would be questionable to assume that they would translate into lower prices for buyers or motivate developers to undertake low-income projects.

In order to qualify for subsidies to produce low-income housing units, developers are imposed pricing controls by the government in order to guarantee the affordability of the units for buyers. These controls restrict developers' profits which are supposed to be mitigated by the granted subsidies. However, studies have shown that in most cases the costs of regulatory and pricing restrictions outweigh the subsidies and regulatory exemptions provided to developers. Administrative processes and regulatory

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[107] The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010. P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2010). (as of the approval date of the Act).

[108] Petersen, *supra* note 106.

[109] *Id.*

[110] S. 16-1447, 5th Sess. (P.R. October 25, 2011).

[111] Stephen Malpezzi & Stephen K. Mayo, *Getting Housing Incentives Right: a Case Study of the Effects of Regulation, Taxes, and Subsidies on Housing Supply in Malaysia*, LAND ECONOMICS, Vol. 73 No. 3, (Aug. 1997), *available at* http://info.worldbank.org/etools/docs/library/156603/housing/pdf/Hannah_handout.pdf

requirements add risk to any development project and delays caused by regulatory procedures tie up capital and increase risk.[112] These delays add further uncertainty and cost to developments which depend on the prompt completion of such procedures in order to fulfill expected projections. This is a well-documented subject matter that is critical when analyzing the profitability and/or viability of any new real estate development.[113] Puerto Rico is significantly affected by this problem. Some argue that the current permit approval process is the riskiest factor in investing in Puerto Rico.[114] The IMF ranks Puerto Rico as the 151 out of 183 economies with respect to dealing with construction permits as of 2011.[115] This ranking does not motivate investors to do business in Puerto Rico and adds uncertainty to investors who do. The average time to undertake construction projects in Puerto Rico is estimated to be 5 to 7 years from initiation to completion.[116] However, these projections should be altered in order to include the additional time it takes to sell a finished property in the current economy, thus adding further costs to the bottom line. The burdensome approval process increases risk and the "hurdle rate", that developers require before proceeding with projects.[117] Some of these requirements have legitimate public interests which justify their existence such as security, acceptable living standards, and urban planning necessities. These priorities need to be balanced out in order to develop an expedite, cost effective process that guarantees proper land use. It is therefore imperative that this issue be addressed properly to improve efficiency, reduce costs, promote investments and also prevent an unchecked growth in inventory.

IV. CONCLUSION

The real estate market in Puerto Rico has been going through an unprecedented negative slump since 2007. Pressured to act, incumbent political leaders were forced to create various incentive based packages in order to confront this crisis. The urgency and magnitude of the problem, along with outside pressures from various lobbyist groups, have caused decision makers to enact legislation focusing on short run strategies without fully examining the collateral and long term effects of their decisions. The collapse of the global economy did little to improve the situation and to this

[112] Getting the Incentives Right, *supra* note 74.
[113] *Id.*
[114] HOUSING AND URBAN DEVELOPMENT COMMISSION POSITIVE REPORT ON P. DE LA C. 1577, *supra* note 6, at 1.
[115] *Ease of Doing Business in Puerto Rico*, THE DOING BUSINESS PROJECT BY THE INTERNATIONAL MONETARY FUND, (2011), http://www.doingbusiness.org/data/exploreeconomies/puerto-rico#dealing-with-licenses.
[116] Alexander Lopez, *Home Sour Home*, CARIBBEAN BUSINESS, June 2, 2010 at 17.
[117] Malpezzi & Mayo, *supra* note 111.

day we are still struggling to come up with solutions to a problem that, in spite of all efforts, has become worse. Sales of new and existing homes have decreased, property values have plummeted, and new properties are being foreclosed adding a further influx of properties to the already alarmingly overstocked housing inventory. Due to increased weakness in capital gains outlook, investors are deserting the market.[118] Moreover, considering the most recent extension of the current stimulus package until December 31, 2012,[119] Puerto Rico has had an almost ongoing subsidy of the market for three years and is yet to face the aftermath of a definite change in policy. Although the diminishing property sales numbers cannot be completely attributable to an inadequate incentives policy, the results on the market after the incentives expire and the effect these incentives have on those who chose to take advantage of them can.

The main problem in Puerto Rico, as explained, consists of an oversupply of mid to high-end properties and an undersupply of low-end properties desired by the market. Developers and financial institutions looking to profit on what had been a lucrative industry gave in to speculation and failed to take into account the reality of the market's needs.[120] As a result, what had once been profitable job-generating enterprises became a huge burden for the economy as bankruptcies, delinquencies, layoffs, and reduced associated government tax collections added to the already distressed state of affairs in Puerto Rico. The capital tied up to these developments prevents the promotion of new investment opportunities as financial institutions struggle to stay afloat amidst the crisis.

Every single one of the legislations examined emphasized the importance of providing homebuyers with an opportunity to have access to the real estate market through incentives. The logic behind the implementation of such programs was that homebuyers could not afford to buy or were not inclined to buy without incentives. Buyers could benefit in two ways: by buying a desired property at a lower price or by having access to a higher priced property which they could not previously afford. The Housing Department argued that these types of incentives were positive for

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[118] Uren, *supra* note 80.

[119] Act No. 115 of July 11, 2011, *amending* The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010, P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2011). (extending Act 132 benefits until October 31, 2011); *see also Extienden beneficios gubernamentales al comprar primera casa*, PRIMERA HORA (June 8, 2012), http://www.primerahora.com/extiendenbeneficiosgubernamentalesalcomprarprimeracasa-657870.html.

[120] Alexander Lopez, *supra* note 116, at 18 (quoting Banco Popular Executive Vice President Silvio López: "the Census Bureau reported in 2006 that 85.3% of households earn less than $50,000 and 62.7% earn less than $25,000. On 2006, of the 13,500 new properties sold of which 57% were units under $200,000. Currently, 60% of new properties are priced over $300,000.").

homebuyers by reducing purchase prices and making homes more affordable. However, as previously explained, these incentives have the opposite effect, inflating housing prices by the value of the incentives, thus preventing them from reaching their true market value. This would have the effect of keeping property prices at unattainable levels for those who were supposed to benefit from the incentives. Promoting home ownership through subsidies has induced many buyers to borrow more than they can afford in order to buy a house, using the incentives to leverage their purchases for bigger and more expensive properties. This may add to future loan delinquencies and possible foreclosures. At a time when properties are still declining in value and are expected to continue a downward trend, buyers are paying premium prices for homes which will more than likely be worth less in the very near future, erasing any possible benefit obtained through the subsidies. Incentives gave buyers a false sense of value and were therefore adversely affected by the stimulus program. Consequently, buyers would have benefited more by the natural correction of prices without government intervention. The homebuyer would have potentially bought the same home at a lower price and at less cost to the government if no incentives had been implemented. Because of this, the incentive programs implemented have failed to accomplish the goals set out with respect to benefiting homebuyers.

The investment incentives granted, as previously mentioned, have a negative long-term effect on prices and help create price speculation. Thus, it is difficult to comprehend how one of the causes of the problem could be viewed as a viable solution to the real estate crisis. Moreover, when treating new and existing properties differently, the difference in the subsidy means that while new properties are capitalizing the value of the higher incentive, existing properties are losing value for the same amount. This would not only depreciate existing home values for homeowners but also decrease property tax collections in proportion to the lost value of these properties which, in turn, greatly outnumber new housing units. Therefore, the government has spent taxpayer dollars in order to subsidize a limited group and has collected fewer taxes as a result. Furthermore, with new and existing properties being perfect substitutes in most cases, it would be difficult to assume that new properties will sell at a higher rate when comparable, cheaper alternatives (existing properties) are available as a result of the incentives policy. If the bargaining possibilities that exist in the existing property market are taken into account, which are certainly limited when dealing with new developments, price differences could be even greater between these two alternatives effectively harming the new properties market.

Another reason given to justify incentive programs is that they inject confidence into the market. However, buyers seem reluctant to enter the market as they are confused by mixed signals. If the market were healthy, would it need to be stimulated by incentives? On one hand, there are attractive interest rates, lower prices and incentives, while on the other hand there are prohibitive lending practices, increased foreclosures, and high unemployment rates.[121] In the United States, it is estimated that as much as a third of homeowners owe more than their homes are worth,[122] something which will not appease potential buyers looking to buy now. Celia Chen, a housing market analyst at Moody's Analytics, states that "many are reluctant to purchase a home even if they have the means because of the uncertainties in the economy."[123]

It would be difficult to estimate what would have happened to the real estate market and the local economy without the incentives created. It is very likely that without government intervention home sales would have been lower and the resulting effect on the post transaction chain would have affected other sectors of the economy. This would have amplified the struggles of the local economy, but it would also have cost the taxpayers a considerably lower amount of public funds in the form of subsidy assignments and tax exemptions. Financial institutions and developers have benefited from the government intervention by reducing their inventory, albeit not at expected rates, and increasing their liquidity. These two groups have hailed the results of the incentives and argued that although the market is still struggling, it would be much worse off without the incentives. Recently, sales have slightly increased but not at a considerable rate considering the horrible comparable numbers of years past and the influx of new properties into the market. These sales numbers could also have been adversely affected by conditioning buyers to expect subsidies when making their purchases. As the incentives expire, this may cause buyers to wait until the next set of incentives to buy. Additionally, it could be argued that the incentives program has drained the market of potential homebuyers, since the pool of first time homebuyers was not increased by the stimulus package. This would bring about terrible consequences for future sales, especially as incentives expire.

Home ownership incentives may also distort investment decisions in the economy towards housing and away from more productive business investments.[124] As reported by the GDB, construction only contributes 1.7% to the GDP of Puerto Rico (although other sectors are also affected by this

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[121] Unemployment rate has reached 16.2% according to the most recent statistics reported by the GDB. *Puerto Rico Economic Indicators*, GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO (June 22, 2011), http://www.bgfpr.com/economy/documents/PREI062211.pdf

[122] Michelle Conlin, *Home Sellers Pull Out All the Stops to Attract Wary Buyers*, USA TODAY (March 27, 2011), http://www.usatoday.com/money/economy/housing/2011-03-27-spring-home-buying.htm.

[123] *Id.*

[124] Why Housing Incentives Must Go, *supra* note 79.

industry), so in order to stimulate the economy, public funds may have been put to better use through other incentives or investments. The high subsidies accruing to the few current beneficiaries drain scarce public resources and commit future earnings at a time when the government is struggling to find new sources of income. It is also worth noting that due to the nature of incentives, the rest of the taxpaying population is bearing the costs of these incentives and/or receiving less public services than before for their tax dollars. In effect, a privileged group enjoys special treatment while other property owners' tax obligations are doubled through special legislation in order to increase revenues to finance the aforementioned special treatment. Furthermore, a considerable amount of future revenue generating potential has been compromised in order to finance the subsidies granted.[125] Through these incentives, the government has foregone most of its related revenue generating alternatives for years to come, relying on sales tax and other incidental revenues to make up for this loss of income.

In order to reduce inventories, developers will need to ultimately reduce prices drastically and develop radical new strategies to attract buyers.[126] It has come to a point where cutting losses may be a better strategy than holding on and expecting things to change. Nonetheless, it will take a joint long term effort from the private and public sectors in order to stabilize the market. The government should focus its efforts towards preventing further foreclosures which affect lending institutions and have a negative impact on the market as property values plummet and inventory levels rise.[127] The demand for the "Protecting Your Home Program" was such that its funds almost expired before they were available with the government being forced to inform the public that it would not be accepting further applications just three days after it starting accepting them. This reflects the critical fiscal situation that many households are going through and the huge demand for these types of programs. Such programs also help financial institutions by increasing their revenues and preventing further delinquencies.

The government should also focus its efforts on job creation since, regardless of the magnitude of the incentives, if people do not have have a steady income they won't be able to buy a home or qualify for any loan. Considering the limited space and resources of Puerto Rico, due to its geographical size, the government can no longer rely on the construction

[125] Such as the opportunity cost of the ten year interest and principal exemption for the second mortgages granted by The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009, P.R. LAWS ANN. tit. 12, §§ 142-155 (2009).
[126] Such as no reserve auctions, new property rentals, the promotion of properties to foreign markets as vacation homes, the promotion of fractional ownerships amongst others.
[127] López, *supra* note 116, at 17 (reports show that a foreclosed property on average reduces the value of nearby homes by 27%).

industry to help move the economy. Instead, it should shift its focus to other more sustainable industries in order to move forward. Puerto Rico has to set its economic development priorities in areas that maximize its current capabilities and expertise. Although new development projects create jobs, they do little to transition Puerto Rico's economy towards a more competitive, less labor-intensive economy. With a decreasing and aging population, the government should study the overall need for housing in Puerto Rico. It should also analyze the overall effects of the incentives once they have expired in order to reassess strategies and establish a forward looking policy that will increase the competitiveness of Puerto Rico and its construction and real estate markets.

V. EXHIBITS

Exhibit 1: Timeline of Real Estate Market Stimulus Plans Sponsored by Puerto Rico's Central Government

Act No.	Popular Name	Date
Act. No. 197	Newly Built and Existing Housing Acquisition Tax Credit	December 14, 2007.
Act No. 61	Newly Built and Existing Housing Acquisition Tax Credit Deadline Extension	May 12, 2008
Act. No. 9	Puerto Rican Economic Stimulus Plan	March 9, 2009.
Act. No. 209	My New Home Program	December 29, 2009
Act. No. 122	Funds for My New Home Program	August 6, 2010
Act. No. 132	The Puerto Rican Real Property Market Stimulus Act	September 2, 2010
Act No. 115	Extension of Benefits of the Puerto Rican Real Property Market Stimulus Act	July 11, 2011

Exhibit 2: *Actual Credits Granted by the Government Including Interest under Act No. 197*[128]

Example 1: Maximum credit allowed of 15,000 for new housing units

1st. Payment	$5,200	34.37% of total credit

[128] As provided by Act. No. 197, §§ 1(9)(ii)(b)1-2, 2(b)(1)

2nd. Payment	$5,500	36.67% of total credit
3d. Payment	$5,800	38.37% of total credit
Total	$16,500	109.41% of total credit or 10% interest.

Example 2: Maximum credit allowed of 25,000 for new housing units used as primary residence.

1st. Payment	$8,800	35.2% of total credit
2nd. Payment	$9,200	36.8% of total credit
3d. Payment	$9,600	38.4% of total credit
Total	$27,600	110.4% of total credit.

Example 3: Maximum Credit Allowed for Existing housing units.

1st. Payment	$3,500	35% of total credit
2nd. Payment	$3,600	36% of total credit
3d. Payment	$3,800	38% of total credit
Total	$10,900	109% of total credit or 9% interest.

Exhibit 3: Number of Credit Applications Successfully Processed by the Treasury Department under Act. No. 197[129]

Type of Credit	Credits Processed	Dollar Amount of Credits
Existing Housing Unit Credits	3,416	$32,905,512
New Housing Unit Credits	7,919	$183,329,088
Pre-designed Housing Unit Credits	183	$3,688,940
Total	11,518	$219,923,540

Exhibit 4: Second Mortgage Participation under Act No. 9[130]

Units Sold by Month

Month	2009	2010	2011
Jan		118	135
Feb		162	225
Mar		246	233
Apr	1	127	265
May	2	154	
Jun	20	144	
Jul	41	224	
Aug	53	133	
Sep	48	132	
Oct	84	194	
Nov	205	183	
Dec	205	236	
Total	659	2053	858
Total Units Sold: 3570			

Value of Units Sold by Months (‘000)

Month	2009	2010	2011
Jan		$18,543	$20,219

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129 Housing and Urban Development Commission, H.R. Res. 238 16th Leg. (1st. Sess. 2009), May 13, 2009 (Final Report by Pedro I. Cintrón Rodríguez Housing and Urban Commission President).
130 *According to data provided by the PR Financial Institutions Commission (as of Aril 30, 2011)

Feb		$25,199	$30,893
Mar		$36,913	$36,491
Apr	$150	$18,596	$35,240
May	$738	$23,434	
Jun	$4,148	$20,947	
Jul	$7,142	$32,890	
Aug	$7,455	$19,162	
Sep	$10,648	$20,569	
Oct	$19,163	$28,191	
Nov	$30,469	$28,177	
Dec	$31,991	$36,338	
Total	$111,904	$308,959	$122,843
Total Dollar Value of Units Sold: $543,706			

Exhibit 5: Down Payment and Closing Cost Bonus Participation (under Act No. 209)[131]

New and Existing Housing Units Sold by Month

Month	2010	2011
Jan	513	759
Feb	887	794
Mar	938	1067
Apr	652	1089
May	594	
Jun	842	
Jul	510	
Aug	754	
Sep	721	
Oct	883	
Nov	807	
Dec	912	
Total	9013	3709
Total units: 12722		

131 *Id.*

Value of Incentives Granted (in '000)

Month	2010	2011
Jan	$2,761	$4,602
Feb	$4,743	$4,965
Mar	$5,191	$7,033
Apr	$3,643	$7,222
May	$3,367	
Jun	$4,491	
Jul	$2,513	
Aug	$3,726	
Sep	$4,368	
Oct	$5,514	
Nov	$4,955	
Dec	$5,467	
TOTAL	$50,739	$23,822
Total 2010 and 2011: $74,561		

Exhibit 6: Real Property Market Stimulus Participation (Act No. 132)[132]

New Housing Units Sold			Existing Housing Units Sold		
Month	**2010**	**2011**	**Month**	**2010**	**2011**
Jan		249	Jan		745
Feb		260	Feb		844
Mar		299	Mar		901
Apr		370	Apr		1182
May			May		
Jun			Jun		
Jul			Jul		
Aug			Aug		
Sep	211		Sep	559	
Oct	337		Oct	1131	
Nov	262		Nov	791	
Dec	298		Dec	815	
Total	1108	1178	Total	3296	3672
Total Units: 2286			**Total Units: 6968**		

[132] *Id.*

New Units Sold in Dollars ('000)			Existing Units Sold in Dollars ('000)		
Month	**2010**	**2011**	**Month**	**2010**	**2011**
Jan		$57.2	Jan	$119.0	$109.3
Feb		$50.3	Feb	$110.3	$122.6
Mar		$62.0	Mar	$103.4	$132.9
Apr		$73.2	Apr	$118.9	$173.3
May			May		
Jun			Jun		
Jul			Jul		
Aug			Aug		
Sep	$40.5		Sep	$202.4	
Oct	$73.6		Oct	$169.5	
Nov	$61.7		Nov	$120.0	
Dec	$73.8		Dec	$126.6	
TOTAL	$249.6	$242.7	TOTAL	$618.5	$538.1
Total $: $492.3			**Total $: $1,156.6**		

Total Units Combined: 9,254 **Total $ Combined ('000): $1,648.9**

Exhibit 7: Cost Benefit Analysis[133]

The Economy

(Market Value of Unit) – (Resource Cost to the Economy)= (Net Economic Cost /Benefit)

If the economic cost/benefit is positive the unit is efficient.

The Developer

[(Land Subsidy) + (Infrastructure subsidy) + (Construction Subsidy) + (Sales Price)]

— [(Resource Cost of the Economy) + (Cost of Land Use and Building Reg.) + (Land Acquisition) + (Other Taxes)]

= Net Financial Cost/Benefit to the Developer

If the developer's cost/benefit is positive a supply response will be observed.

[133] Stephen Malpezzi & Stephen K. Mayo, *Getting Housing Incentives Right: a Case Study of the Effects of Regulation, Taxes, and Subsidies on Housing Supply in Malaysia*, 73 LAND ECONOMICS 3 (Aug. 1997), at 372 – 391.

House Purchasers

[(Market Value of Unit) + (Recurrent Infrastructure Subsidies) + (End Use Financial Subsidies)]
— [Sales price) + (Registration Taxes) – (Property Taxes) – Extra Cost of Program Participations)]
= Net Financial Cost/Benefit to the Developer

If the purchaser's cost/benefit is positive analysis there will be demand for the unit.

The Government

[(Taxes) + (User Fees & Admin Charges)]
— [(Subsidies Paid Out) + Opportunity Costs of Implicit Subsidies)]
= Net Financial Cost/Benefit

If the Government's cost/benefit is positive there will be a positive effect on the treasury.

Exhibit 8: Examples of Private Sector Incentives for Homebuyers[134]

- Rolled back pricing
- No payment for six months
- 100% financing
- Payment of closing costs and other buying costs
- Free pools
- Home Owners Association fees paid for a determined amount of time
- Free landscaping
- Free upgrades and customization options
- Interest rate buy down
- Vouchers for as much as $50,000 for appliances and other equipment
- Payment of property taxes
- Free Vacation packages
- Free Cars
- Low introductory interest rates for a determined amount of time

[134] In Puerto Rico and the United States.