Policy Brief

Municipal Fiscal Crises in the United States: Lessons and Policy Recommendations for Puerto Rico

Ad Majorem Dei Gloriam

THE CENTER FOR THE NEW ECONOMY

The Center for the New Economy is a non-partisan, non-profit, research and policy development organization dedicated to creating innovative economic development strategies. The Center works in four main areas: expanding access to financial services; the transition to the digital economy/information society; strategic philanthropy; and entrepreneurship.

This paper can be downloaded, free of charge, from the Center's website at www.grupocne.org.

Sergio M. Marxuach
Director – Policy Development
Center for the New Economy
San Juan, Puerto Rico

April, 28, 2006

Introduction

Puerto Rico is facing a severe fiscal crisis. Central government expenditures consistently exceed income and the Commonwealth has been forced to borrow from the Government Development Bank (GDB) $250 million, $233 million and $550 million to balance each of the last three central government budgets.

For fiscal year 2006 the Commonwealth's current structural imbalance is estimated at $1.222 billion. This amount represents the difference between estimated expenditures of $9.683 billion, plus $384 million related to a portion of debt service for general obligation bonds due during fiscal year 2006 which was paid with funds from a GDB line of credit, for a total of $10.067 billion in expenses, less recurring revenues of $8.845 billion.

Debt and General Fund Revenues – In addition, the Commonwealth has been on a borrowing spree for at least the last 14 fiscal years. As shown in Table 1, during the period between 1992 and 2004, general fund revenues increased at a compound annual growth rate (CAGR) of 6.2% while central government debt increased at a CAGR of 8.0%.

Table 1
GNP, General Fund Revenues and Central Government Debt

Fiscal Year	GNP	% Change GNP	General Fund	% Change GF	Debt Cent. Gov.	% Change Debt
1992	$23,696.4	--	$3,861.1	--	$3,401.9	--
1993	$25,132.9	6.06%	$4,025.3	4.25%	$3,603.4	5.92%
1994	$26,640.9	6.00%	$4,665.3	15.90%	$3,833.5	6.39%
1995	$28,452.3	6.80%	$5,080.1	8.89%	$4,265.9	11.28%
1996	$30,357.0	6.69%	$5,247.6	3.30%	$4,203.4	-1.47%
1997	$32,342.7	6.54%	$5,600.7	6.73%	$4,512.6	7.36%
1998	$35,110.7	8.56%	$5,902.5	5.39%	$4,818.6	6.78%
1999	$38,281.2	9.03%	$6,550.0	10.97%	$5,096.9	5.78%
2000	$41,418.6	8.20%	$6,943.6	6.01%	$5,348.9	4.94%
2001	$44,046.6	6.34%	$6,962.1	0.27%	$5,837.9	9.14%
2002	$45,071.3	2.33%	$7,454.4	7.07%	$6,115.3	4.75%
2003	$47,438.5	5.25%	$7,841.7	5.20%	$6,886.2	12.61%
2004	$50,320.0	6.07%	$7,985.4	1.83%	$8,519.3	23.72%
CAGR	**6.5%**	**--**	**6.2%**	**--**	**8.0%**	**--**

Source: PR Planning Board; GDB

Moreover, between June 30, 2003 and June 30, 2004, central government debt increased from $6.89 billion to $8.52 billion, a year-over-year increase of $1.63 billion or 23.7%. Even more troublesome is the fact that, as shown in Table 2, Puerto Rico's total public debt has increased from $24.18 billion in June 2000 to $40.26 billion in June 2005, an increase of $16.08 billion, or 66.48%. Clearly this level and rate of indebtedness is unsustainable when nominal GNP is growing at an average annual rate of 5.63%.

Table 2
Public Debt of the Commonwealth of Puerto Rico
($ MM)

June 30,	Constitutional Debt	Municipal Debt	Public Corporations	Extra-Const. Debt	Other	Total
2005	$7,307.1	$2,181.3	$19,234.1	$7,980.5	$3,565.3	$40,268.3
2004	$6,878.7	$2,046.0	$18,040.6	$6,977.3	$3,491.0	$37,433.6
2003	$6,222.1	$1,955.1	$15,889.8	$5,640.0	$2,817.5	$32,524.5
2002	$5,853.8	$1,795.8	$15,124.1	$5,192.7	$2,066.2	$30,032.6
2001	$5,573.4	$1,632.2	$13,699.1	$4,310.1	$1,944.9	$27,159.7
2000	$5,348.9	$1,464.4	$13,431.6	$3,576.8	$367.0	$24,188.7
% Change 2000-05	36.61%	48.96%	43.20%	123.12%	871.47%	66.48%
CAGR	6.44%	8.30%	7.45%	17.41%	57.57%	10.73%

Source: GDB; Office of Management and Budget

To top it all off, the Acevedo Vilá administration has announced that the central government will not be able to meet its payroll during the month of May 2006. If this comes to pass, the Puerto Rican government would be officially insolvent because, at that time, it would have been unable to meet its obligations as they came due.[1]

This precarious financial situation has forced Moody's and Standard & Poor's to downgrade the credit of the government of Puerto Rico to Baa2 and BBB respectively, which is borderline investment grade. Puerto Rico currently has the lowest credit rating and the highest level of net tax supported debt per capita in the U.S., a volatile combination, and it is possible that Puerto Rico's credit rating will be downgraded below investment grade in the near future.[2]

[1] It is important to note, however, that the government of Puerto Rico is not currently in danger of defaulting on its debt obligations, which have statutory preference over financial obligations to government employees and suppliers.

[2] Debt burden comparisons between Puerto Rico and the fifty-states are distorted by the fact that the functional scope of government in Puerto Rico is considerably larger than that of the average mainland state. Some services that are provided by public corporations in Puerto Rico are provided in the United States by local governments, private firms or the federal government, so that debt associated with these services is not included in state debt calculations. Therefore, debt ratios for Puerto Rico may be

Consequences of a Downgrade – Such a downgrade would have serious and long-lasting consequences. Some institutional investors which currently hold Puerto Rico debt would have to divest because they are allowed to hold only investment grade securities. In addition, many investors would be precluded from buying any new Puerto Rico debt until it is upgraded to investment grade.

Table 3
Long-Term Municipal Issuance – General Obligation
General Use of Proceeds by Moody's Rating Category
Twelve Month Period Ending December 31, 2005
Amounts in $ Million

Sector	Aaa Rating	Aa Rating	A Rating	Baa Rating	Below Baa Rating	Unknown Rating	Total Amount
Education	$51,284.2	$7,389.9	$1,271.0	$28.3	$0.0	$3,698.5	$63,671.9
General Purpose	$43,238.9	$10,670.2	$8,109.8	$321.6	$2.0	$3,529.2	$65,871.7
Utilities	$2,779.3	$359.8	$39.6	$31.3	$0.0	$848.8	$4,058.8
Public Facilities	$2,365.2	$634.3	$34.4	$1.2	$0.0	$475.9	$3,511.0
Transportation	$2,093.6	$2,528.6	$17.4	$0.0	$0.0	$140.7	$4,780.3
Housing	$235.7	$386.4	$223.3	$0.0	$0.0	$232.7	$1,078.1
Other	$1,249.9	$192.4	$59.6	$13.6	$0.0	$151.4	$1,666.9
Totals	**$103,246.8**	**$22,161.6**	**$9,755.1**	**$396.0**	**$2.0**	**$9,077.2**	**$144,638.7**
% of Total LT G.O.	**71.4%**	**15.3%**	**6.7%**	**0.3%**	**0.0%**	**6.3%**	**100.0%**

Source: *Municipal Bond Credit Report February 2006* -- Bond Market Association

As shown in Table 3, more than 93% of the total amount of $144 billion of long-term municipal GO debt issued during calendar year 2005 in the United States was rated A or above by Moody's and only one issue, in the amount of $2 million, was rated below Baa. Thus, if Puerto Rico's credit rating was downgraded below investment grade (below Baa in the case of Moody's), then the Puerto Rican government would effectively lose access to the bond markets.

It would be very difficult for the Puerto Rican government to operate if it cannot borrow from the bond market. For example, the Commonwealth plans to use the proceeds of a proposed $675 million GO bond issue to finance, among other things, capital improvements in several municipalities and to repay past borrowing from the

somewhat inflated. Nonetheless, credit rating agencies consistently compare Puerto Rico's net per capita tax-supported debt burden with the same ratio for the fifty states.

GDB by the central government. If this money is not available, then we can expect infrastructure investment by the central government to decrease, which could negatively impact GNP growth; some municipalities could be forced to impose new taxes to pay for needed infrastructure; and the GDB could take a hit on its balance sheet if the central government cannot honor its obligations on outstanding loans.

Effects on the Government Development Bank – The potential adverse effect of the Commonwealth's fiscal imbalance on the finances of the GDB could be particularly significant. As of December 31, 2005, the outstanding principal amount of Government Development Bank loans made to finance the central government's budget deficit, which are payable from uncollected taxes and legislative appropriations, was $1.02 billion and constituted 16.7% of the outstanding principal amount of GDB's public sector loans and 10% of the bank's consolidated assets.

In addition, as of September 30, 2005, the GDB had:

- $1.3 billion in loans outstanding payable from proceeds of Commonwealth GO bonds;
- $1.2 billion in loans outstanding payable from the proceeds of other bond issues (other than proceeds of Commonwealth general obligation bonds);
- $689 million in loans outstanding payable from the operating revenues of the respective borrower; and
- $272 million in loans outstanding payable from funds expected to be received from the federal government.[3]

The failure to enact the required future appropriations or to issue the new GO debt to pay-off these loans could weaken the bank's balance sheet as some outstanding loans would have to be restructured or re-classified as non-accruing assets.

Furthermore, there is evidence that the Commonwealth's ability to honor its obligations to GDB is already impaired to some extent. For fiscal year 2006, debt service payments of approximately $510.7 million on certain loans payable from uncollected taxes and legislative appropriations were postponed.[4] Also, in fiscal year 2006 the Commonwealth initially planned to finance a portion of the debt service payments on its debt due during such fiscal year. Because of this planned financing, which has not been carried out, the appropriations included in the current fiscal year 2006 budget are "insufficient to cover all debt service payments due during the fiscal year on the Commonwealth's debt."[5] The Commonwealth expects to cover this insufficiency with a line of credit from the GDB in the amount of $384 million. It is expected that this line of credit will eventually be repaid with the proceeds from a bond issuance.

---

[3] Government Development Bank for Puerto Rico, *Official Statement*, prepared in connection with the issuance of $885,000,000 of Senior Notes, February 8, 2006, p. 33.
[4] Id. at p. 29.
[5] Id.

In conclusion, it is evident that the GDB already shows signs of strain as a result of the Commonwealth's failure to control expenses and balance its budget.

Organization of the Paper – In the United States, there are two mechanisms to deal with a municipal fiscal crisis: (1) implementation of financial emergency procedures at the state level and (2) municipal bankruptcy filings under Chapter 9 of the federal Bankruptcy Code. This paper will briefly examine the financial emergency procedures implemented in New York City in 1975, Philadelphia in 1990 and Washington DC in 1995, in order to distill some policy lessons from these prior crises. In addition, we will analyze the possibilities of filing for municipal bankruptcy and of establishing a federal receivership for Puerto Rico. We conclude with some policy recommendations for the current administration in the event that Puerto Rico's credit is downgraded below investment grade.

New York City's Fiscal Crisis

The City of New York faced a difficult fiscal crisis and almost defaulted on its debt in 1975. The city had continuously borrowed increasing amounts to cover current account deficits between 1960 and 1974. By 1974, the city's current account deficit amounted to $487 million. Unfortunately, most of these deficits were financed using short-term debt and by fiscal year 1974 the city had outstanding short-term debt per capita of $485, higher than any other large city at the time. In addition, servicing this short-term debt would claim 32% of the city's current expenditures, almost the entire "controllable" portion of the expenditure budget, to pay it off if new lenders could not be found.[6]

The city managed to run these deficits despite a New York state law that required political subdivisions to run balanced budgets. Among other things, the city: used overly optimistic revenue forecasts; relied heavily on the issuance of revenue anticipation notes, including notes backed by revenues that did not materialize; delayed or postponed pension funding payments; used funds raised for capital expenditures to cover operating costs; and overestimated special fund revenues.[7] This fiscal situation became unsustainable by February 1975, when the city had to cancel a sale of tax anticipation notes because the main underwriter backed out of the deal.

By April 1975, the city was running out of cash. In order to meet its current obligations, including its payroll, the city government was forced to take out a three-day loan from banks based in New York City and pension funds.

This situation prompted the state of New York to step in and provide financial help and oversight to city. State officials feared that if the city filed for bankruptcy, the state's own finances could be adversely affected. In addition, state officials feared that

[6] Edward M. Gramlinch, "The New York Fiscal Crisis: What Happened and What is to be Done", *Journal of the American Economic Association*, Vol. 66, No. 2, May 1976, p. 416.
[7] Roger Dunstan, "Overview of New York City's Fiscal Crisis", *CRB Note*, Vol. 3, No. 1, March 1, 1995, California Research Bureau, California State Library, p. 1.

widespread social disorder could ensue if public employees were unwilling to report to work if paychecks were missed. Therefore, in mid-April the state advanced revenue sharing funds to the city and the governor appointed an advisory committee to monitor New York City affairs.

One of the principal recommendations of the advisory committee was the creation of the Municipal Assistance Corporation (MAC), which consisted of private citizens and government officials, to provide liquidity to the city. The MAC was an independent corporation authorized to issue bonds on behalf of the city of New York. In order to repay these bonds, the state passed legislation that converted the city's sales and stock transfer taxes into state taxes. Revenues from the imposition of these taxes passed directly to the MAC without ever passing through the city's books.

The municipal bond market gave the MAC a lukewarm reception. It was authorized to issue up to $3 billion of securities but could only sell $2 billion and only at a high interest rate. The notes issued by the MAC yielded 11% at a time when an index of high-grade municipal bonds yielded 6.89%.[8] In order to reassure the bond markets, the MAC demanded that the city institute a wage freeze, lay off employees, increase subway fares, and begin charging tuition at city universities.

In September 1975 the state created the Emergency Financial Control Board (EFCB) to oversee and supervise the city's budgeting process. The EFCB could control the city's bank accounts, issue orders to city officials, remove them from office, and press charges against city officials. The law that chartered the EFCB required the city to balance its budget within three years, change its accounting procedures and submit a three-year financial plan. The EFCB had the power to review and reject the city's financial plan, operating and capital budgets, contracts negotiated with public employee unions and all city borrowing. In effect, the EFCB put the city on receivership.

Even after taking all these corrective steps, the city was still shut out from the bond markets. The continuing difficulties of the city led the federal government to agree to assist the city in November 1975. Federal legislation extending up to $2.3 billion of short-term loans to the city was enacted. However, the Ford administration was concerned about setting a precedent that other cities or municipalities could use to request federal aid in the future. Therefore, the federal government imposed strict conditions to its assistance package. Among these we find the following:

- The city was forced to increase fees for services and to cut wage increases for city employees;
- The city's pension funds were required to purchase MAC securities, at one point 40% of the assets of the city pension fund were invested in these securities;
- The banks that held securities issued by the city agreed to purchase additional securities, and/or to lengthen the maturity or lower the interest rate on securities that they held;

[8] Id. at p.4.

- The city raised an additional $200 million in taxes;
- The city would have to balance its budget by 1978;
- The First Deputy Mayor, the Deputy Mayor for Finance and the city budget director all had to resign;
- Federal loans were made at 1.00% above the cost of funds for the federal government; and
- The city was obligated to regain access to the credit markets no later than 1978.[9]

Between 1976 and 1978 the city worked on reducing short-term debt and controlling expenses by reducing city employment by 20% and maintaining wage increases below the rate of inflation. By 1978, however, the city had not been able to regain access to the credit markets. Therefore, additional assistance was requested from the federal government. This assistance was granted on the condition that EFCB be extended until after the year 2000. In addition, the word "emergency" was dropped from the board's name.

By 1979, the city's finances were stable enough to allow it to sell some short-term notes. In 1981, New York City reported its first balanced budget according to generally accepted accounting principles since the beginning of the crisis. In that same year the city issued new long-term bonds which were rated investment grade for the first time since 1974.

Philadelphia's Fiscal Crisis

In the early 1990s the city of Philadelphia experienced a grave fiscal crisis.[10] On June 8, 1990, Standard & Poor's reduced Philadelphia's credit rating two steps, to BBB-, which was, at the time, the lowest rating for a major city in the United States. S&P based its decision on what it perceived to be the lack of "fiscal stability" in the city's new budget. This action was followed by Moody's, which on June 30 lowered the city's rating to Ba, the top category of the speculative or "junk" bond category. Moody's rating action was taken in response to what it considered to be an "unrealistic budget."

In late August the city was preparing to issue $400 million of new tax anticipation notes in order to cover temporary fluctuations in cash flow. However, city officials realized that there was little or no investor interest in purchasing such notes. Thus, the city arranged in mid-September for a bank syndicate, led by the Swiss Bank Corporation (SBC), to issue letters of credit as a guarantee for the repayment of the tax anticipation notes. SBC, however, decided to withdraw its offer only two days after making it. The withdrawal meant that it was impossible for the city to borrow at an interest rate it

---

[9] Id. at p.6.

[10] The following is a summary of that experience based mostly on the account set forth in Timothy Sinclair, *The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness,* (Cornell University Press, 2005).

could afford. Two days later Moody's and Fitch further downgraded Philadelphia's credit. S&P followed with a downgrade to CCC, meaning that Philadelphia's debt "had a currently identifiable vulnerability to default."

At the same time, the city's difficult financial situation was aggravated by the political conflict between the black, urban Democratic mayor of the city and the white, suburban Republican-dominated Commonwealth of Pennsylvania legislature. The intensity of the partisan bickering essentially precluded any state aid to the struggling city.
And then it got worse, as the city of Philadelphia began to run out of cash. The city finance department drafted an emergency plan that set up spending criteria and a hierarchy for paying bills. Nonetheless, some of the city's most critical services, such as those provided by the city's AIDS Activities Coordinating Office, which provided funds to terminally ill AIDS patients, suffered as city funding was cut.

The following year, the city was able to raise some money from employee pension funds. In order to do this, the city had to amend the rules governing the pension fund's investments because those rules prohibited the city pension funds from purchasing junk-rated securities. Needless to say, this action was strongly opposed by the city's labor unions.

On June 5, 1991, the Pennsylvania state legislature enacted the Pennsylvania Intergovernmental Cooperation Act for Cities of the First Class for the purpose of providing financial assistance to the City of Philadelphia. This law created the Pennsylvania Intergovernmental Cooperation Authority (PICA), which was given broad financial and oversight functions with respect to the city. In its oversight capacity, PICA has the authority to exercise advisory and review powers with respect to the city's financial affairs, including the power to review and approve five-year plans prepared at least annually by the city. PICA also has the power to issue bonds and to grant or lend the proceeds thereof to the city. Eventually, through debt issuance and capital program earnings, PICA provided $1.184 billion to directly assist the city.[11]

By November 1991, however, it was evident that Mayor Wilson Goode could not resolve the ongoing imbalance between costs and revenues, without requesting the imposition of massive new taxes. That same month the voters of Philadelphia elected Edward Rendell as their new mayor.

One of Rendell's first acts in office in 1992 was to announce a "draconian" five-year plan that called for $1.1 billion in savings through reduced labor costs, management efficiencies, stricter tax-collection, privatization of some city agencies, and a five-year wage freeze for the city's 25,000 employees. At the time the plan was announced, the New York Times reported that lack of access to the municipal bond market had forced the city to postpone needed building and maintenance projects, to delay payment to

[11] Pennsylvania Intergovernmental Cooperation Authority, *Annual Report for Fiscal Year 2005,* October 27, 2005, p. 2.

thousands of creditors and to pay premium rates on small loans from local lenders and pension funds. Clearly, Philadelphia's finances had reached rock bottom.

The implementation of the five-year plan produced positive results, as the city closed fiscal year 1993 with a small surplus. Both S&P's and Moody's praised Mayor Rendell's ability to control finances and his political acumen in negotiating with the city council and state legislature. The city, however, was not yet out of the woods. In 1994, the mayor announced a new competitive contracting committee which sought to further reduce costs in trash disposal, maintenance, and cleaning costs. Eventually the city's fiscal discipline paid off, as it closed 1994 and 1995 without deficits. By March 1995, both Moody's and S&P's had upgraded Philadelphia's credit rating back to investment grade, "ending five years in the junk-bond doghouse."

According to PICA's Annual Report for Fiscal Year 2005, the city of Philadelphia ended FY2005 with a surplus of nearly $97 million and projected a balanced budget for the next five fiscal years. However, it took the city of Philadelphia five years, $1.1 billion in cuts, the privatization of municipal agencies, a five-year wage freeze, and the elimination of municipal jobs to get out of the crisis and re-attain its investment grade status.

Washington DC's Fiscal Crisis

During the mid-1990s, Washington DC suffered a similar fiscal crisis. The city commenced to show symptoms of financial distress in 1994 when it reported a general fund deficit of approximately $300 million. The situation did not improve over the next two fiscal years and by the close of fiscal year 1996, the accumulated general fund deficit was $518 million. In that same year, both Moody's and Standard & Poor's downgraded the city's credit rating below investment grade, to Ba and B, respectively, which effectively denied the City access to the municipal bond markets.[12]

In response to the intensification of the crisis, the Congress of the United States enacted H.R. 1345, known as the District of Columbia Financial Responsibility and Management Assistance Act of 1995, pursuant to its broad constitutional powers to administer the District under Article I, section 8, clause 17 of the Constitution of the United States.[13]

In enacting this law, the Congress made the following official findings (among others):

- A combination of accumulated operating deficits, cash shortages, management inefficiencies, and deficit spending in the current fiscal year has created a fiscal emergency in the District of Columbia.

[12] Summary of FY2004 Comprehensive Annual Financial Report for the City of Washington, DC, prepared by the Office of the Chief Financial Officer, January 2005.
[13] This clause states, among other things, that the Congress shall "exercise exclusive Legislation in all Cases whatsoever, over such District as may, by Cession of particular States, and the Acceptance of Congress, become the Seat of the Government of the United States."

- As a result of its current financial problems and management inefficiencies, the District of Columbia government fails to provide its citizens with effective and efficient services in areas such as education, health care, crime prevention, trash collection, drug abuse treatment and prevention, human services delivery, and the supervision and training of government personnel.
- A comprehensive approach to fiscal, management, and structural problems must be undertaken which exempts no part of the District government and which preserves home rule for the citizens of the District of Columbia.
- The current deficit of the District of Columbia must be resolved over a multi-year period, since it cannot be effectively addressed in a single year.
- The ability of the District government to obtain funds from capital markets in the future will be severely diminished without Congressional action to restore its financial stability.
- The efficient operation of the Federal Government may be adversely affected by the current problems of the District of Columbia not only through the services the District government provides directly to the Federal Government but through services provided indirectly such as street and traffic flow maintenance, public safety, and services affecting tourism.

In order to address these problems, Congress created the District of Columbia Financial Responsibility and Management Assistance Authority, commonly referred to as the "Control Board." The Act required the mayor of the city to submit a detailed financial plan and budget to the Control Board, which in turn, was given ample review and oversight powers over the city's finances.

In addition, the Act established the Office of the Chief Financial Officer of the District of Columbia. The CFO became the "czar" of the city's finances, and was given supervisory control of: (1) the Office of the Treasurer of the city, (2) the Controller of the District of Columbia, (3) the Office of the Budget, (4) the Office of Financial Information Services, and (5) the Department of Finance and Revenue. The creation of the office of the CFO centralized responsibility about the city's financial situation in one office. This office, in turn, was granted ample powers to make financial decisions on behalf of the city. The CFO, basically, runs the city's finances, subject only to nominal control by the Mayor.

The Control Board was also authorized to issue bonds or to take out loans on behalf of the city. In order to secure the payment of these obligations, the Authority was authorized to require the Mayor: (1) to pledge or direct taxes or other revenues otherwise payable to the District government, including payments from the Federal Government, to the Authority; and (2) to transfer the proceeds of any tax levied for purposes of securing such bonds, notes, or other obligations to the Authority immediately upon collection.

The tight oversight of the city's finances began to pay off in 1997, as the city closed that fiscal year with a surplus of $186 million and a "clean" audit opinion. By 1998, the city had eliminated 10,000 jobs from its payrolls and thoroughly modernized its financial

information systems. Furthermore, "as a result of the surplus and a strict congressional mandate limiting its use, the District [had] the cash to pay its bills and access to the credit markets, albeit with a speculative rating for its bonds." [14]

In 2000, Moody's and S&P's rewarded the city's fiscal discipline by upgrading its rating to investment grade (Baa3 and BBB, respectively). Even more impressive, the city closed fiscal year 2004 with a $230.5 million local fund surplus and a cumulative general fund balance of $1.2 billion. The city's credit ratings at the end of that fiscal year were A2 and A, according to Moody's and S&P's respectively.

Lessons from Municipal Fiscal Crises in the United States

Although the three crises we have described occurred in diverse locations at different points in time, it is possible to identify several characteristics common to all of them. These common elements allow us to distill the following lessons from these three municipal fiscal crises:

- **Fiscal Discipline is Usually Imposed from Above** – In all three cases studied, local political officials were incapable of reaching agreement, much less implementing, the emergency measures that the situation demanded. In all cases stern fiscal control measures were imposed by a higher-ranking entity: the state government, in the case of New York City and Pennsylvania; and the U.S. Congress, in the case of Washington, DC. This option is not available in the case of the central government of Puerto Rico, as it is the equivalent of a state government. Therefore, fiscal discipline measures will have to be developed and implemented locally. Furthermore, the successful execution of these policies will require the exercise of forceful leadership on the part of our elected officials.
- **Liquidity is Key** – In all three cases, emergency liquidity facilities were set up, in order to allow the cities to function while fiscal sanity was restored. MAC, PICA and the DC Control Board were each authorized to issue notes and bonds and to lend the proceeds from those issues to New York City, Philadelphia and the District, respectively. In the absence of these emergency liquidity facilities, the crises would have been much more disruptive as city services were cut off and as the cities were unable to meet their payrolls.
- **Centralization of Financial Responsibility is Required to Obtain Results** – During normal times, it is common practice to distribute financial policy functions among different government entities (tax, budgeting, bond issuance etc.). One of the common elements we find in the three cases under study is that in times of fiscal crisis, centralization of these functions appears to have helped in the implementation of the difficult measures that were required to get out of the crisis. In New York City, for example, the EFCB had ample oversight and review powers, including the power to fire City officials. Similarly, in the

[14] Claire O'Cléireácain, *Bolstering D.C.'s Fragile Fiscal Recovery*, Brookings Institution Policy Brief No. 36 – 1998, p.2.

case of Pennsylvania, the PICA had veto power over the city's budget and borrowing decisions. Perhaps the most representative of all is the case of Washington, DC where Congress required the establishment of a city CFO to execute the city's fiscal and financial policies.

- **Increasing Tax Revenues is Necessary but Not Sufficient** – In all jurisdictions under study, tax increases were a part of the solution to the fiscal crisis but in every instance they were accompanied by other austerity measures. Specifically, wage freezes, cuts in government services and reductions in government payrolls were implemented during each crisis period.
- **Fiscal Recovery is a Multi-year Process** – It is important to note that the financial recovery process will likely take several years. Indeed, in the cases under study it took between 4 and 6 years for the cities to obtain an investment grade credit rating after being downgraded to junk status. The implications are twofold: (1) it is not necessary to do everything at once and (2) any recovery plan should contain immediate, short-term and medium-term policy recommendations.
- **Don't Count on the Federal Government for a Bailout** – The federal government traditionally has been reluctant to intervene in state/local financial crises. In the case of New York, it intervened only after the governments of France and Germany officially expressed their concerns regarding the potential fallout of a bankruptcy. Once the federal government decided to intervene, it did so with draconian conditions. In the case of Washington DC, Congress has a constitutional mandate to oversee the operations of the seat of the federal government. However, a reading of the law that created the Control Board indicates that federal intervention materialized only after it was evident that failure to intervene would likely have an adverse effect on the operations of the Federal government.

Federal Municipal Bankruptcy Law

The other mechanism to deal with municipal financial crises in the United States consists of filing for bankruptcy. Due to constitutional limitations, municipal bankruptcy relief in the United States is of more recent vintage than bankruptcy programs for businesses and individuals. State governments could not provide debt restructuring relief because the Contracts Clause of the U.S. Constitution (Article I, section 10, clause 1) prohibits states from enacting "any bill of attainder, ex-post facto law or law impairing the obligation of contracts" and Article I, section 8, clause 4 grants Congress the power to establish "uniform laws on the subject of bankruptcies throughout the United States." On the other hand, the Tenth Amendment to the Constitution grants state sovereignty over the governance of subnational units of government. Thus, state municipal bankruptcy laws would violate the contract and bankruptcy clauses, while federal

municipal bankruptcy legislation would violate state sovereignty under the Tenth Amendment.[15]

The first municipal bankruptcy legislation was enacted in 1934 during the Great Depression. This legislation was invalidated on constitutional grounds in 1936.[16] Congress enacted a revised Municipal Bankruptcy Act in 1937, which was subsequently upheld by the Supreme Court.[17] However, in the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts, there have been fewer than 500 municipal bankruptcy petitions filed. In contrast, more than one million individuals and corporations file for bankruptcy every year. Municipal bankruptcy filings, thus, are a relatively rare occurrence.

Current federal bankruptcy law is codified in Title 11 of the United States Code. Chapter 9 of that Title covers municipal bankruptcy filings. However, the "single most important provision for municipal bankruptcy is set forth in section 109(c), which serves as the gatekeeper for filings under Chapter 9."[18] Under section 109(c) only a "municipality" may file for relief under Chapter 9. The term "municipality" is defined in section 101(40) of the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State."[19]

While this definition is broad enough to include cities, counties, townships, school districts and public improvement districts, it is clear that Chapter 9 covers only municipalities; there is no federal provision for state government bankruptcy. States are expressly excluded from federal bankruptcy proceedings because of the belief that such legislation by the U.S. Congress would violate constitutional guarantees of state sovereignty.[20]

In the case of Puerto Rico the threshold question is whether the central government of Puerto Rico qualifies as a "municipality" for purposes of filing under Chapter 9 of the federal Bankruptcy Code. The answer is probably no. First, Puerto Rico is neither a state nor is it a political subdivision, public agency, or instrumentality of a state. Thus, the government of Puerto Rico would seem to fall through a jurisdictional gap, which is not otherwise covered in the federal Bankruptcy Code.

In addition, section 101(52) of the Bankruptcy Code defines the word "State" to include "the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title." The effect of this provision, when construed in light of the definition of "municipality" set forth in section 101(40), is to preclude

---

[15] John L. Mikesell, *Subnational Government Bankruptcy, Default, and Fiscal Crisis in the United States,* Working Paper 02-21, December 2002, International Studies Program, Andrew Young School of Policy Studies, Georgia State University, p. 2.
[16] Ashton v. Cameron County Water Improvement Dist. No. 1, 298 U.S. 513 (1936).
[17] United States v. Belkins, 304 U.S. 27 (1938).
[18] Michael W. McConnell and Randal C. Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy", *The University of Chicago Law Review*, Vol. 60 (1993), p. 455.
[19] 11 USC § 101(40)
[20] Mikesell, *supra*, n.15 at 4.

federal bankruptcy filings even by the political subdivisions, public agencies or instrumentalities of the government of Puerto Rico.

If the intent of the drafters of Chapter 9 was to allow filings by political subdivisions of states but not by the state governments themselves, and if filings by political subdivisions of the government of Puerto Rico already are not permitted under the Code, then it follows, by analogy, that filings by the central government of Puerto Rico are also not allowed because the central government of Puerto Rico is equivalent to the central government of a state, and thus, deserving of the same kind of deference.

In any event, due to political considerations, it is highly unlikely that the current PPD administration would ever make such a filing in federal court, even if it were expressly permitted under the Bankruptcy Code.

Congressional Receivership

Similarly, some analysts have raised the possibility that Puerto Rico could be put under some sort of federal receivership if the central government is deemed to be insolvent. In theory, Congress could, under the broad powers granted to it under the Territorial Clause of the United States Constitution, legislate to impose federal control over the island's finances, similar to what it did in the case of Washington DC.[21]

In our view, however, it is highly unlikely that Congress would exercise these powers. First, the traditional federal response to municipal fiscal crises has been to let local authorities figure it out on their own. The initial federal response to the New York crisis was to let the city work out its financial emergency with the help of the state government. Only when it became clear that NYC's bankruptcy could have international ramifications did the federal government intervene.

Second, Congress has elected to intervene in these cases only when the situation was near *in extremis*, even in the case of Washington DC, where the Constitution grants Congress express powers to supervise the district. In the case of Puerto Rico, this means that Congress would probably not intervene unless there is a high probability that Puerto Rico is in danger of defaulting on its debt and such a default would affect the capitalization of U.S. financial institutions. While Puerto Rico's current financial situation is unpromising, the government is not even close to defaulting on its debt, at least for the time being.

Finally, any Congressional action would inevitably re-open the century-old status debate, and Congress would probably want to avoid getting stuck in that quagmire if it is at all possible. For all these reasons, we believe that Congressional action is unlikely and solutions to the current crisis in Puerto Rico will have to be developed and implemented locally.

---

[21] Article IV, section 3, clause 2 of the U.S. Constitution states that "the Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States…"

Policy Recommendations to the Government of Puerto Rico

We believe that Puerto Rico should have a contingency plan in the event that its credit is downgraded below investment grade. The following recommendations form the basis for such a plan and are based on the following premises:

- Given the current political situation in Puerto Rico and the emergency nature of the measures that need to be implemented, executive action should be maximized and time-consuming legislation should be minimized.
- Tax reform is enacted that raises at least $600 million in net additional revenues for the central government.
- Access to the U.S. municipal bond markets is closed.

1. Prepare a Three Year Financial Plan

This plan should be prepared by the Office of Management and Budget, the Department of the Treasury and the Government Development Bank. It should establish clear and measurable financial, revenue and expenditure objectives to be achieved during the next three years. This plan would be submitted to a newly-created Financial Control Board for its review and approval. Once approved by the Board the plan will be delivered to the governor, who will declare it to be the public policy of the Commonwealth of Puerto Rico.

2. Cut Expenditures Over Three Years

Puerto Rico's structural imbalance is estimated at $1.222 billion for fiscal year 2006. Assuming that tax reform legislation produces net revenues of $600 million for the general fund, expenditures would have to be cut by about $600 million. There are many ways to achieve these cuts. Table 4 sets forth one of the various plausible scenarios, based on the following premises:

- Savings are measured against a baseline of actual expenditures incurred in FY2006;
- No lay-offs of government workers;
- Government workers agree to a three-year wage freeze;
- Government health care plan expenditures increase at a compound annual growth rate equal to, or less than, 4.7% between FY07 and FY09; and
- General fund debt service is estimated at $625 million for fiscal years 08 and 09.

With the following exercise we hope to demonstrate that achieving significant expenditure cuts in the government's budget, without firing any government workers, is difficult but not impossible.

Table 4
Proposed Three Year General Fund Budget
By Expense Type

($ Thousands)	2006 Actual	2007 Proposed	2008 Proposed	2009 Proposed	Cumulative Savings
Operating Expenses					
Payroll and Related Costs	$5,166,294	$5,166,294	$5,166,294	$5,166,294	$0
Payments for Public Services	$505,171	$454,654	$409,189	$368,270	$136,901
Purchased Services	$320,291	$288,262	$259,436	$233,492	$86,799
Transportation Expenses	$84,985	$76,487	$68,838	$61,954	$23,031
Professional Services	$138,976	$125,078	$112,571	$101,314	$37,662
Other Operating Expenses	$727,865	$655,079	$589,571	$530,614	$197,251
Equipment Purchases	$38,776	$34,898	$31,409	$28,268	$10,508
Materials and Supplies	$169,116	$152,204	$136,984	$123,286	$45,830
Advertising Expenses	$4,235	$3,812	$3,430	$3,087	$1,148
Sub-total OE	$7,155,709	$6,956,768	$6,777,720	$6,616,578	$539,131
Capital Improvements	$17,000	$0	$0	$0	$17,000
Debt Service*	$623,917	$609,767	$625,000	$625,000	($1,083)
Sub-total	$640,917	$609,767	$625,000	$625,000	$15,917
Subsidies, Incentives and Grants					
Grants to NGOs	$75,990	$68,391	$61,552	$55,397	$20,593
Incentives and Subsidies	$1,810,790	$1,798,790	$1,786,790	$1,774,790	$36,000
Sub-total	$1,886,780	$1,867,181	$1,848,342	$1,830,187	$56,593
Total General Fund Budget	**$9,683,406**	**$9,433,716**	**$9,251,062**	**$9,071,764**	**$611,642**

*Estimated for FY08 and FY09

Source: OMB and CNE analysis

In the alternative, we ran the numbers for a scenario in which agency heads were required to implement across-the-board cuts of 3.5% in FY07 and 3.0% in FY08 in every government agency. Under this scenario, total general fund outlays are reduced from $9.68 billion in FY06 to $9.06 in FY08. For this second scenario to work each agency

head has to be held personally responsible (i.e. summarily fired) if he fails to meet the expected target.

The advantage of this second approach, relative to the one set forth in Table 4, is that it provides agency heads, who should know what their priorities are, with greater flexibility in determining which areas to cut. However, under either scenario close monitoring of expenses will be required in order to successfully achieve the desired budget goals.

3. Establish a Financial Control Board through Executive Order

The governor should establish a Financial Control Board (FCB) with power to review and revise the annual budget prepared by the Office of Management and Budget prior to submitting it to the legislature. This Board should consist of private citizens with experience in financial matters and/or public administration issues and would serve at the pleasure of the governor. In addition, the FCB should be given broad financial and oversight functions with respect to the Commonwealth. In its oversight capacity, the FCB should have the authority to exercise advisory and review powers with respect to the Commonwealth's financial affairs, including the power to review and approve three-year plans to be prepared at least annually by the Commonwealth.

4. Create a GDB Subsidiary to Provide Emergency Liquidity

In order to provide short-term liquidity to the government, the GDB should form a new subsidiary to be jointly capitalized by local financial institutions, both domestic and foreign, and the GDB. This new affiliate could then provide financing similar to the TRANs, as well as other short-term funding and revolving credit facilities. These obligations will be payable from sources identified at the time of each financing. In the alternative, a syndicated credit facility, similar to what was done in 1976, could be negotiated and executed with local banks to provide short-term liquidity to the government.

5. Implement Medium-Term Fiscal Control Measures

- **Zero-Based Budgeting** – Zero-based budgeting would end the current practice of baseline budgeting. Under baseline budgeting procedures, government programs can exist on autopilot, since budgets are written assuming an expected annual growth rate in all government programs. Zero-based budgeting would assume that every government program starts the fiscal year with zero taxpayer money and every program would have to justify its budget request from the bottom up.
- **"Sunset" Rules** – The legislature should establish a "sunset" commission to structure the process of terminating ineffective government programs. Sunsetting is the process of automatically terminating government agencies and programs after a period of time unless they are specifically reauthorized. A sunset commission could review Commonwealth government programs on a

rotating basis and recommend major overhauls, privatization or elimination of programs that have outlived their usefulness.

- **Limit General Fund Outlays to Growth in Nominal GNP** – Growth in general fund expenditures should be limited to the growth rate of nominal GNP. For example, if the Planning Board forecasts nominal growth for fiscal year 2010 to be 5.9%, then the growth in government expenditures for that fiscal year should be capped at that level too.
- **Supermajority Approval for Borrowing from the GDB** – During recent years it has become common practice for the Secretary of the Treasury to finance the central government's deficits by borrowing from the GDB. This is the Puerto Rican equivalent of printing money. With a supermajority approval requirement, any such borrowing would have to be approved by a two-thirds vote in both the House and the Senate for passage. This requirement will likely help reduce reliance on this type of lending.
- **Pay As You Go Procedures** – The Governor should propose, and the legislature should enact, legislation requiring that any bill increasing expenditures must include an offsetting decrease in other expenditures or an increase in taxes and that any bill decreasing taxes must include an offsetting decrease in expenditures or an increase in other taxes.

Conclusion

Puerto Rico is on the brink of a fiscal crisis. If the island's credit rating is downgraded below investment grade, stern measures would have to be implemented in order to restore fiscal sanity. Fortunately, we can use the prior experience of other jurisdictions as a guide to lead us down this path. However, the best laid plan will be useless unless (1) there exists the political leadership to implement it and (2) the private sector, especially the financial institutions, supports it wholeheartedly.

It is our hope that Puerto Rico never faces a situation where it becomes imperative to implement the recommendations set forth in this paper. But, if that time ever comes, we hope this paper will help illuminate the available options and provoke the clear thinking necessary to allow the "better angels of our nature" to carry the day.