

Fiscal Situation Update



Fiscal Year 2011-2012 Budget
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**An Analysis of the Governor's Proposed Budget
for Fiscal Year 2012**

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I. Fiscal Year 2010-2011

Budget Deficit

General fund net revenues for the first ten months of fiscal year 2010-11 amounted to \$6.405 billion, some \$124 million, or 1.9%, more than the \$6.281 billion reported for the same period last year. The most recent official revenue estimate for the current fiscal year is \$8.133 billion. The Puerto Rico Treasury Secretary is confident this revenue target will be met due to (1) increased enforcement measures and (2) revenues generated by a new excise tax imposed on sales to the foreign affiliates of certain multinational companies with operations in Puerto Rico.

On the spending side, total general fund expenditures are expected to total \$9.149 billion, which is \$1.021 billion, or 10%, less than total general fund spending of \$10.170 billion reported during the last fiscal year.

Therefore, the budget deficit for fiscal year 2010-11 is estimated to be around \$1.016 billion, which is \$1.484 billion, or 59.4%, less than the \$2.5 billion general fund deficit registered during the prior fiscal year.

Table 1

Budget Deficit FY 10-11

General fund revenues	\$8,133,000,000
General fund expenditures	\$9,149,000,000
Projected budget deficit	\$ (1,016,000,000)

Structural Deficit

The term “structural deficit” is used here as it has been interpreted by the credit rating agencies, which define it as the excess of recurring expenditures over recurring revenues. If we analyze the Commonwealth’s structural balance for fiscal year 2010-11, we find that recurring general fund revenues for the current fiscal year total \$7.892 billion¹, while recurring expenditures are projected to add up to \$9.149 billion. This gap between recurring revenues and recurring expenditures, commonly known as the Commonwealth’s structural deficit, is expected to be around \$1.257 billion this year. This amount would be \$243 million, or 16.2%, less than the structural deficit of \$1.5 billion registered during the previous fiscal year.

In sum, both the budget and structural deficits are expected to decrease during fiscal year 2011. However, both deficits are still in excess of \$1 billion and 2011 marks the Commonwealth’s twelfth year in a row showing a general fund deficit.

¹ The revenue forecast of \$8.133 includes \$241 million that we classify as non-recurring because they are the product of one-time enforcement measures. Thus, we estimate recurring revenues at \$7.892 billion.

II. Fiscal Year 2011-12

The Governor announced an \$8.650 billion general fund budget for fiscal year 2011-12. This amount would be \$517 million, or 6.4%, higher than this year's general fund budget of \$8.133 billion.

However, certain expenditures traditionally charged to the general fund will be charged instead against the Fiscal Stabilization Fund, a special fund set up with the proceeds of COFINA bond offerings, and these are estimated to total \$610 million. Therefore, general fund expenditures for the next fiscal year are estimated to be around \$9.260 billion, some \$111 million, or 1.2%, higher than this year's total general fund expenditures of \$9.149 billion.

We note, in addition, that the general fund budget for 2011-12 does not include \$668 million for the debt service due on General Obligation bonds that should have been included in the general fund budget—an amount that, presumably, will be refinanced at some point during the next fiscal year. Therefore, we estimate the true amount of general fund spending to be around \$9.928 billion.

On the revenue side, the general fund revenue forecast includes a significant increase in the proceeds of the Sales and Use and Tax, from \$555 million in fiscal year 2011 to \$680 million in fiscal year 2012, an increase of \$125 million, or 22.5%. This increase in SUT revenues is to be generated from enhanced enforcement through the implementation of IVU Lotto. In our view, this forecast is inconsistent with both the historical pattern of SUT revenues and the current weak state of the Puerto Rican economy. Therefore, we are adjusting downward the expected increase in SUT revenues by \$63 million, or 50%. Thus, we estimate general fund recurring revenues to be around \$8.587 billion.

FY 10-11	Amount
Fiscal Stabilization Fund	\$1,000,000,000
Tax enforcement measures	\$241,000,000
Total non-recurring revenues	\$1,241,000,000
General fund expenditures FY10-11	\$9,149,000,000
% non-recurring revenues	13.6%
FY 11-12	Amount
Fiscal Stabilization Fund	\$610,000,000
GO Debt Service to be Refinanced	\$668,000,000
50% Adjustment to SUT revenue increase	\$63,000,000
Total non-recurring revenues	\$1,341,000,000
General fund expenditures FY11-12	\$9,928,000,000
% non-recurring revenues	13.5%

As shown on Table 2 above, the general fund budget for fiscal year 2011-12 includes \$1.341 billion in non-recurring revenues, an amount that is \$100 million, or 8.1%, higher than the \$1.241 billion in non-recurring revenues included in the general fund budget for the fiscal year 2010-11.

We also note that the consolidated budget includes another \$509.7 million in non-recurring revenues from the American Recovery and Reinvestment Act (ARRA). Thus, total non-recurring revenues included in next year's consolidated budget amount to \$1.850 billion, an amount that is \$416 million, or 18.4%, less than the \$2.266 billion in non-recurring funds that were included in the current year's consolidated budget.

In sum, the amount of non-recurring revenues as a portion of total general fund revenues is still relatively high at 13.5%, or roughly 1 out of every \$7 spent from the general fund. On the other hand, the proposed consolidated budget reflects a significant reduction in the use of non-recurring funds in comparison with the current budget. This reduction is due mostly to the phase-out of stimulus spending authorized by the American Recovery and Reinvestment Act.

III. Public Pensions

On May 3, 2011, Moody's Investors Service issued a press release announcing it was placing the Commonwealth's of Puerto Rico A3 rating on its watchlist for possible downgrade. Its decision was based on the weak funding of the government's pension plans and the "significant strain that future pension requirements will likely exert on the Commonwealth's financial position."

The government of Puerto Rico currently runs five different retirement systems: (1) the Employees' Retirement System ("ERS"), which covers most employees of the central government, the public corporations, and the municipalities; (2) the Teachers' Retirement System ("TRS"), which covers public school teachers; (3) the Judiciary Retirement System ("JRS"), which covers judges; (4) the University of Puerto Rico Employees' Retirement System; and (5) the Puerto Rico Electric Power Authority Employees' Retirement System.

Each one of these retirement systems is running an actuarial deficit. This means they do not have enough assets to invest today in order to meet its future obligations. However, the Moody's report focuses on the problems of the ERS, the TRS, and the JRS because funding for these three systems depends in large measure on the general fund.

As of June 30, 2010, the ERS had an unfunded actuarial liability of \$17.834 billion; the TRS had an unfunded actuarial liability of \$7.058 billion; and the JRS had an unfunded actuarial liability of \$283 million. Therefore, the aggregate unfunded liability for these three systems amounted to \$25.175 billion, which is equivalent to 39.8% of Puerto Rico's GNP in 2010.

The warning from Moody's is based on two analytical conclusions. First, the sum of (1) the aggregate unfunded actuarial liabilities of the three systems that depend on the general fund (\$25.175 billion) and (2) Puerto Rico's net tax supported public debt (\$42 billion) is approximately \$67 billion, an amount that is seven times the annual general fund budget and greater than the total indebtedness for states such as Texas, Florida, and New York, which are much larger than Puerto Rico. The analysts at Moody's conclude, reasonably in our opinion, that this combined burden will exert significant budgetary pressure for many years to come.

Second, the magnitude of the annual actuarially required contribution ("ARC") necessary to start amortizing the accumulated unfunded liability is enormous. If the government of Puerto Rico began to make the annual ARC for these systems, its ability to comply with other obligations would be *severely* impaired.

Table 3	
General Fund Mandatory Spending +ARC	
FY2011	
Contributions to Municipalities	\$355,000,000
University of Puerto Rico	\$691,000,000
Judicial Branch	\$348,000,000
Rent Payments PBA	\$217,000,000
GO Debt Service	\$201,000,000
Other Debt Service	\$517,000,000
ARC for ERS, TRS, & JRS	\$2,105,000,000
Total Mandatory Spending (MS) + ARC	\$4,434,000,000
Total GF Spending	\$9,149,500,000
MS/GF	48.5%
ARC/GF	23.0%

For fiscal year 2011, the ARC was \$2.105 billion, an amount equivalent to 23% of that year's general fund. Furthermore, as shown on Table 3, if we were to add the ARC and the annual mandatory expenditures for FY2011, the combined amount would total \$4.434 billion, or 48.5% of the general fund budget. Please note that such amount does not include other "discretionary" general fund expenditures on public education, healthcare, and public safety.

In sum, the public pension problem raises extremely complicated financial, political, legal, and moral issues. Puerto Rico currently owes approximately 40% of its GNP to 8% of its population. Wealth transfers of this magnitude do not occur without political consequences. In our view, solving this problem will require retirees, current employees, and taxpayers in general to make and honor significant concessions.

IV. Public Debt

For the first time in more than a decade the growth rate of Puerto Rico's public indebtedness appears to have slowed down to a sustainable pace. As of March 2011, Puerto Rico's total public debt had increased by 2.6% when compared with the previous year, while GNP increased at a rate of 2.7% on a year-over-year basis.

However, as shown on Table 4 below, between 2000 and 2011, Puerto Rico's public debt increased at a compound annual growth rate of 9.2%, while GNP grew at a CAGR of only 4.2% in nominal terms. Thus, during this period Puerto Rico's debt increased at an unsustainable rate of more than twice that of its nominal GNP.

FY	GNP	%Δ	Public Debt	%Δ	PD/GNP
2000	41,418.6	--	\$24,188.8	--	58.4%
2001	44,046.5	6.3%	\$27,159.6	12.3%	61.7%
2002	45,071.3	2.3%	\$30,012.6	10.5%	66.6%
2003	47,479.4	5.3%	\$32,524.5	8.4%	68.5%
2004	50,708.7	6.8%	\$37,433.6	15.1%	73.8%
2005	53,752.4	6.0%	\$40,268.3	7.6%	74.9%
2006	56,732.3	5.5%	\$43,136.3	7.1%	76.0%
2007	59,520.5	4.9%	\$46,183.3	7.1%	77.6%
2008	61,665.2	3.6%	\$53,392.9	15.6%	86.6%
2009	62,677.8	1.6%	\$58,414.9	9.4%	93.2%
2010	63,291.5	1.0%	\$62,206.2	6.5%	98.3%
2011	64,973.0	2.7%	\$63,809.0	2.6%	98.2%
CAGR	4.2%		9.2%		

Debt data for 2011 is as of March 2011

Several bond offerings by COFINA account for most of the increase in public debt since 2009. According to a recent presentation to the legislature by the administration's economic team, COFINA issued \$7.935 billion in new debt during 2009 and 2010. These funds were used for the following purposes:

- \$1 billion to repay a GDB loan that was initially secured with accounts receivable from Hacienda.
- \$1.302 billion to repay interim deficit financing incurred by the prior administration.
- \$635 million for debt service of existing GDB loans which did not have an identifiable source of repayment.
- \$756 million for payments to suppliers owed by the prior administration.

- \$2.5 billion for the 2010 Fiscal Stabilization Fund.
- \$1 billion for the 2011 Fiscal Stabilization Fund.
- \$500 million for the local stimulus plan.
- \$241 million for other undisclosed uses.

V. Budget Indicators

The Center for the New Economy, in fulfillment of its mission to provide rigorous, independent analysis to policymakers, the press, and the public at large, has established a fiscal analysis program to monitor and keep track of important fiscal trends affecting the Puerto Rican economy.

Table 5 below sets forth a series of budget indicators that we plan to update every year around the time when the governor submits the recommended budget to the legislature for its enactment. Among the indicators included in the table we find the following: (1) the trend for the consolidated budget, both in absolute and per capita terms; (2) the trend for federal funds, both in absolute terms and relative to the consolidated budget; (3) the trend for the general fund budget; (4) the trend for payroll expenditures relative to the general fund; (5) the tax revenue trend, both relative to the general fund and to GNP; (6) the trend for recurring and non-recurring revenues; (7) various indebtedness and debt service ratios; and (8) the trend in government employment, both in absolute terms and per 100 inhabitants.

**Table 5
Budget Indicators 2008-2012**

	Fiscal Year					CAGR
	2008	2009	2010	2011	2012	
1. Consolidated Budget (CB)	\$27,568,459,000	\$28,146,886,000	\$29,128,862,000	\$28,142,842,000	\$28,624,086,000	0.94%
CB per capita	\$6,971.32	\$7,094.74	\$7,818.17	\$7,568.66	\$7,713.51	
CB/GNP	44.71%	44.91%	46.02%	43.31%	42.34%	
2. Federal funds*	\$5,560,761,000	\$7,021,403,000	\$6,850,586,000	\$6,165,823,000	\$6,442,792,000	3.75%
Federal funds/CB	20.17%	24.95%	23.52%	21.91%	22.51%	
3. General fund budget (GF)	\$9,242,000,000	\$9,483,792,000	\$7,670,000,000	\$8,133,500,000	\$8,650,000,000	-1.64%
GF/GNP	14.99%	15.13%	12.12%	12.52%	12.79%	
4. GF Payroll	\$5,189,758,000	\$5,501,074,000	\$4,608,861,000	\$4,618,242,000	\$4,707,323,000	-2.41%
Payroll/GF	56.15%	58.01%	60.09%	56.78%	54.42%	
5. Tax revenues GF	\$7,412,200,000	\$6,948,100,000	\$6,894,000,000	\$7,343,500,000	\$8,012,000,000	1.96%
Tax revenues/GF	80.20%	73.26%	89.88%	90.29%	92.62%	
Tax revenues GF/GNP	12.02%	11.09%	10.89%	11.30%	11.85%	
6. GF recurring revenues	\$8,017,000,000	\$7,600,000,000	\$7,670,000,000	\$7,892,000,000	\$8,587,000,000	1.73%
GF recurring expenditures	\$9,343,000,000	\$10,479,000,000	\$9,170,000,000	\$9,149,000,000	\$9,928,000,000	1.53%
GF structural deficit	(\$1,326,000,000)	(\$2,879,000,000)	(\$1,500,000,000)	(\$1,257,000,000)	(\$1,341,000,000)	
Structural deficit/GF	-14.35%	-30.36%	-19.56%	-15.45%	-15.50%	
7. Non-recurring funds (CB)	\$804,000,000	\$1,173,107,000	\$4,379,000,000	\$2,266,171,000	\$1,850,672,000	23.17%
Non-recurring funds/CB	2.92%	4.17%	15.03%	8.05%	6.47%	
8. Debt service GF	\$554,126,000	\$834,189,000	\$662,807,000	\$717,969,000	\$670,922,000	4.90%
Debt service/recurring revenues GF	6.91%	10.98%	8.64%	9.10%	7.81%	
Debt service consolidated budget	\$3,041,344,000	\$3,184,823,000	\$3,645,830,000	\$3,873,339,000	\$4,308,220,000	9.10%
Debt service/CB	11.03%	11.32%	12.52%	13.76%	15.05%	
Debt service per capita	\$769.07	\$802.77	\$978.54	\$1,041.69	\$1,160.96	
Debt service CB/GNP	4.93%	5.08%	5.76%	5.96%	6.37%	
9. Total public debt**	\$53,392,900,000	\$58,415,000,000	\$62,206,200,000	\$63,809,000,000	--	
Public debt per capita	\$13,501.63	\$14,724.16	\$16,696.11	\$17,160.63	--	
Gross National Product (GNP)***	\$61,665,200,000	\$62,677,800,000	\$63,291,500,000	\$64,973,000,000	\$67,610,000,000	2.33%
Total public debt/GNP	86.59%	93.20%	98.29%	98.21%	--	
10. Government employees****	212,879	213,502	201,629	180,095	180,788	-4.00%
Government employees per 100 persons	5.38	5.38	5.41	4.84	4.87	
Population	3,954,553	3,967,288	3,725,789	3,718,337	3,710,901	

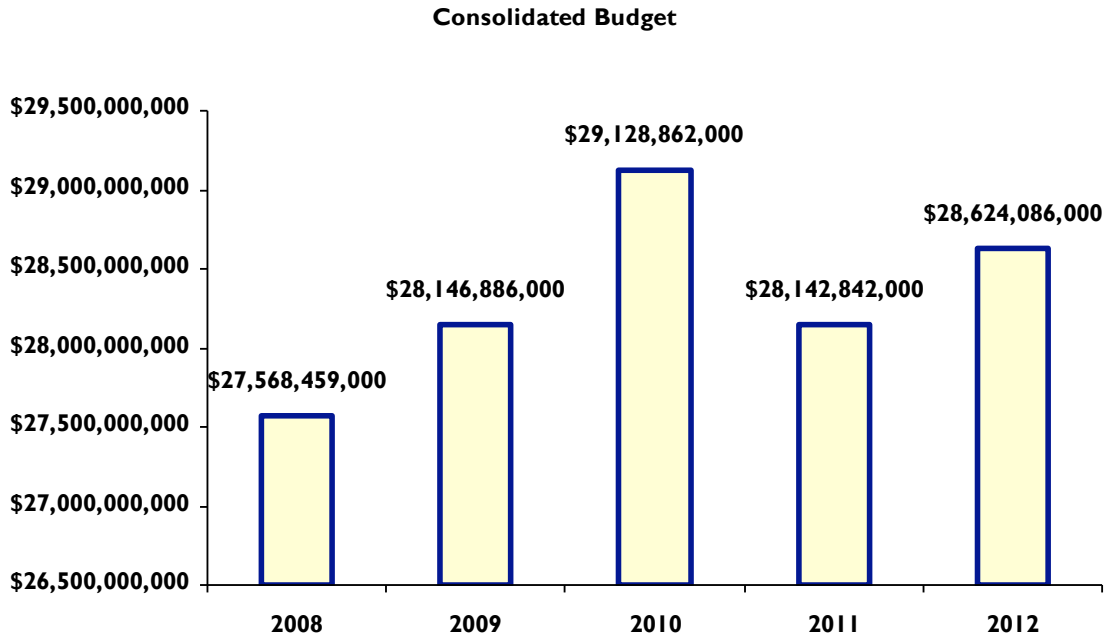
* Includes ARRA funds for 09, 10, 11, & 12

** Data for 2011 is as of March 2011

*** Data for 2011 and 2012 are PRPB estimates

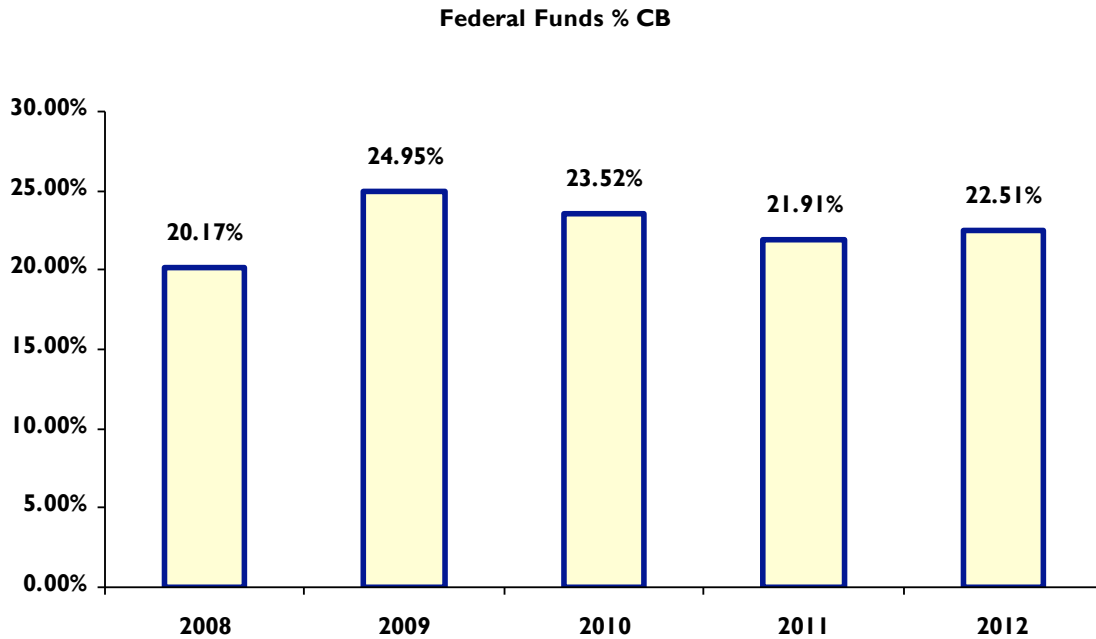
**** Central government and public corporations only

Consolidated Budget



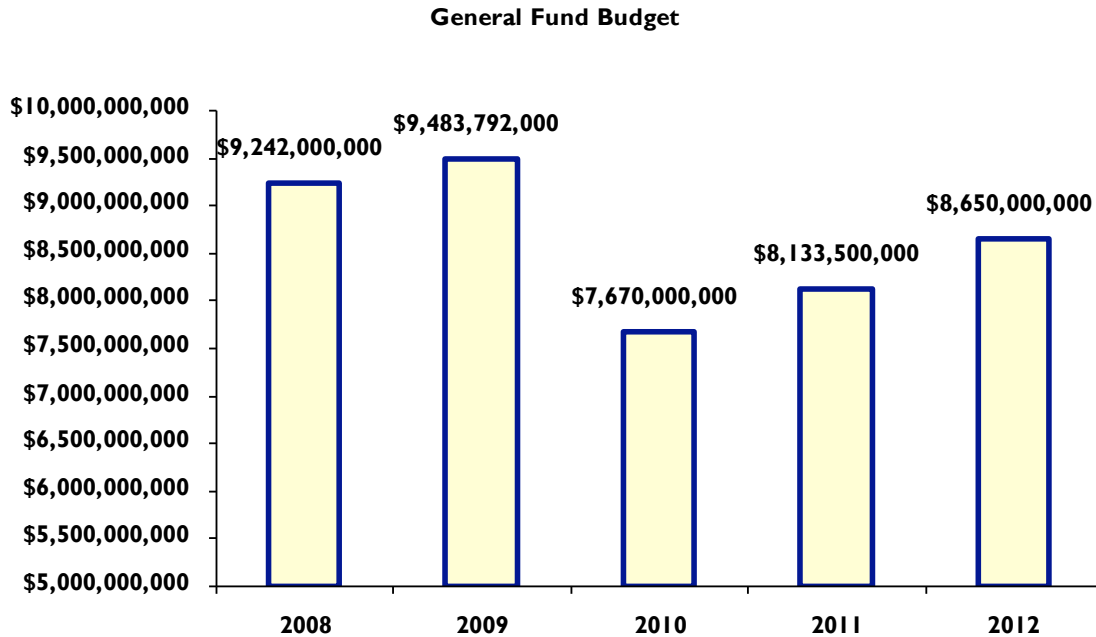
- The Commonwealth's consolidated budget has increased from \$27.568 billion in fiscal year 2008 to a projected \$28.624 billion for fiscal year 2012, an increase of \$1.056 billion, or 3.8%. This increase is equivalent to a compound annual growth rate (CAGR) of 0.94% during the period between fiscal years 2008 and 2012, which is significantly lower than the 2.33% CAGR of nominal GNP during the same period.
- Relative to the consolidated budget for the current year the proposed budget for fiscal year 2012 shows a net increase in spending of \$482 million, or 1.71%. Thus, this is essentially a conservative budget.
- On a per capita basis, consolidated budget expenditures show a significant increase, increasing from \$6,971 in 2008 to a projected \$7,713 for fiscal year 2012. This increase, however, is driven mostly by a reduction in Puerto Rico's population. Relative to per capita personal disposable income, government expenditure remains fairly high. In 2010, per capita disposable personal income in the island was \$14,485; thus, per capita government spending of \$7,818 represented 53.9% of per capita disposable personal income. In contrast, federal expenditure per capita in the U.S. is approximately \$11,654, which is equivalent to 31% of per capita disposable personal income of \$37,573.
- Finally, consolidated budget expenditures have declined significantly relative to GNP, from 44.7% in 2008 to a projected 42.3% in 2012.
- In our view, the overall trend with respect to the consolidated budget reveals that the Puerto Rican government has achieved significant success in restraining the growth rate of government spending since 2008.

Federal Funds



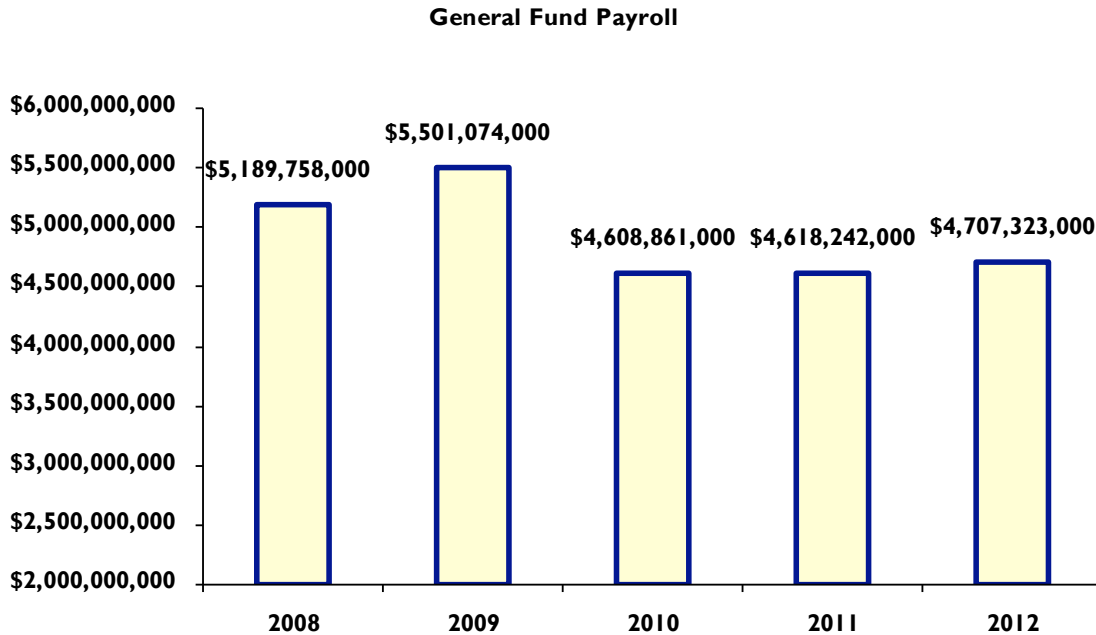
- Grants from the U.S. federal government to the various government agencies of the Commonwealth, including ARRA funds, are expected to total \$6.442 billion during fiscal year 2012, an increase of \$277 million, or 4.5%, relative to the \$6.165 billion received during fiscal year 2011.
- Federal funds are expected to account for 22.5% of all consolidated budget expenditures during fiscal year 2012, an amount that is slightly higher than the 21.9% registered in 2011. This means that roughly 1 out of every 5 dollars spent by the Commonwealth's central government during the next fiscal year will come from Washington.
- Furthermore, federal grants to the government have increased at a CAGR of 3.75%, significantly higher than the rate of growth of the overall consolidated budget, which in the period under study was only 0.94%.
- In our opinion, this increase in the relative weight of federal transfers is negative because the amount of federal funds received by the island depends solely on the fiscal and political dynamic in Washington DC, where Puerto Rico has limited representation. In simple terms, our dependence on federal funds has increased significantly over the last five years.

General Fund



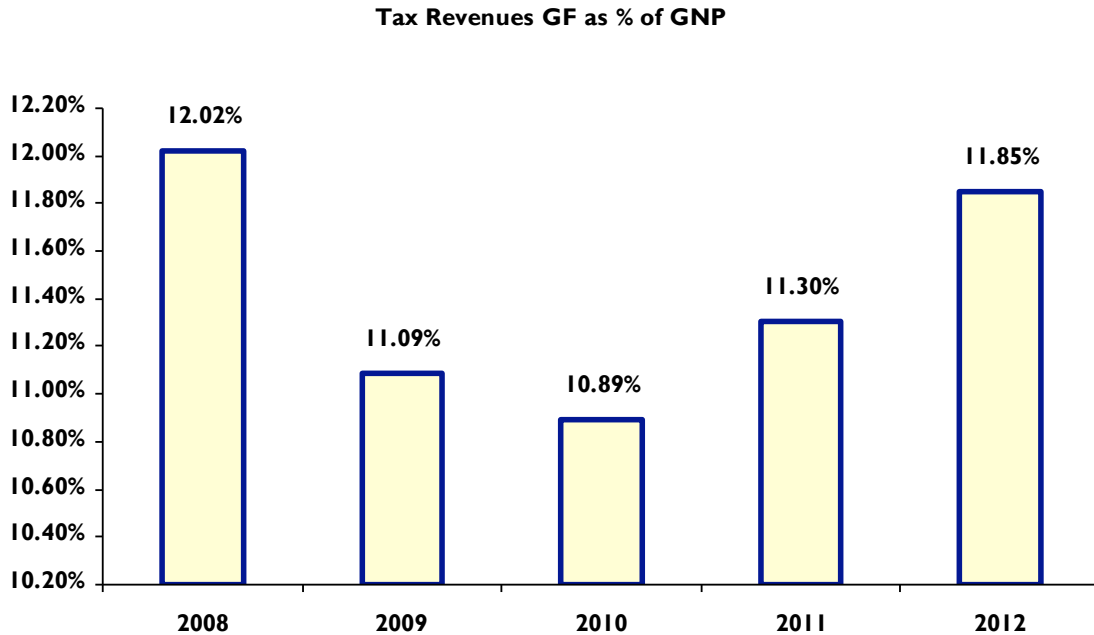
- The Commonwealth's general fund budget has decreased from \$9.242 billion in fiscal year 2008 to a projected \$8.650 billion for fiscal year 2012, a decrease of \$592 million, or 6.4%. This reduction is equivalent to a CAGR of negative 1.6% for the period between fiscal years 2008 and 2012.
- However, the magnitude of this decrease is deceptive because, as we noted above, some expenditures traditionally charged to the general fund will be charged instead against the Fiscal Stabilization Fund, a special fund set up with the proceeds of COFINA bond offerings. During fiscal year 2011 the general fund is slated to receive \$610 million from this special fund.
- Actual general fund spending for the next fiscal year is estimated to be around \$9.260 billion, an amount that is essentially the same as the fiscal year 2008 general fund budget of \$9.242 billion.
- However, the general fund budget for 2011-12 does not include \$668 million for the debt service on General Obligation bonds that should have been included in the general fund budget—an amount that, presumably, will be refinanced at some point during the next fiscal year. Therefore, we estimate true general fund spending to be around \$9.928 billion.
- Overall, the trend with respect to the general fund budget is difficult to discern. On one hand, the government appears to have successfully controlled the growth rate, perhaps even reduced it, for certain segments of general fund spending. On the other hand, however, the use of ARRA funds, the Stabilization Fund, and debt refinancing casts some doubt on the true extent of any reduction in general fund spending.

General Fund Payroll



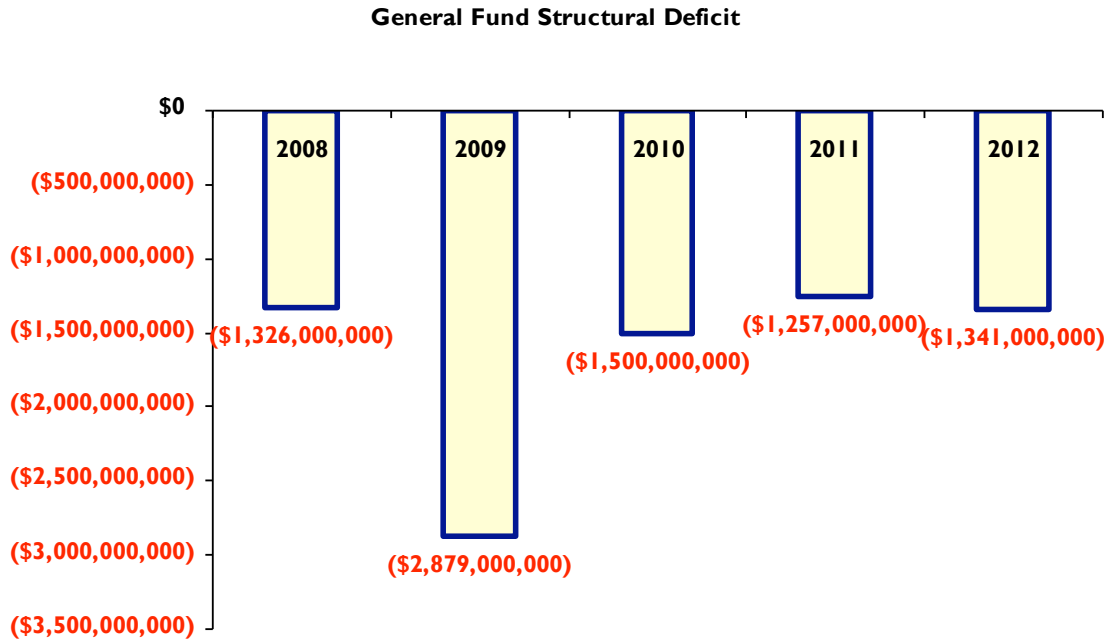
- The amount of the general fund allocated to payroll has decreased from \$5.189 billion for fiscal year 2008 to a projected \$4.707 billion during fiscal year 2012, a decrease of \$482 million, or 9.3%. This decrease is equivalent to a CAGR of negative 2.4%.
- While the general fund payroll has been decreasing during the last few years, it is important to note that relative to fiscal year 2011 the proposed budget includes a small net increase in these expenditures, from \$4.618 billion to \$4.707 billion, an increase of \$89 million, or 1.9%.
- In relative terms, the portion of the general fund allocated to payroll has decreased slightly from 56.1% in 2008 to a projected 54.4% in 2012.
- Therefore, the trend with respect to payroll is uncertain, or mixed at this time. The medium term trend reflects a decrease in general fund payroll expenditures but the short-term, year-over-year trend, reflects a slight increase in these expenditures. Given that 2012 is an election year, our best estimate at this time is that the recent upward trend will probably prevail, at least during the near term.

Tax Revenue Trend



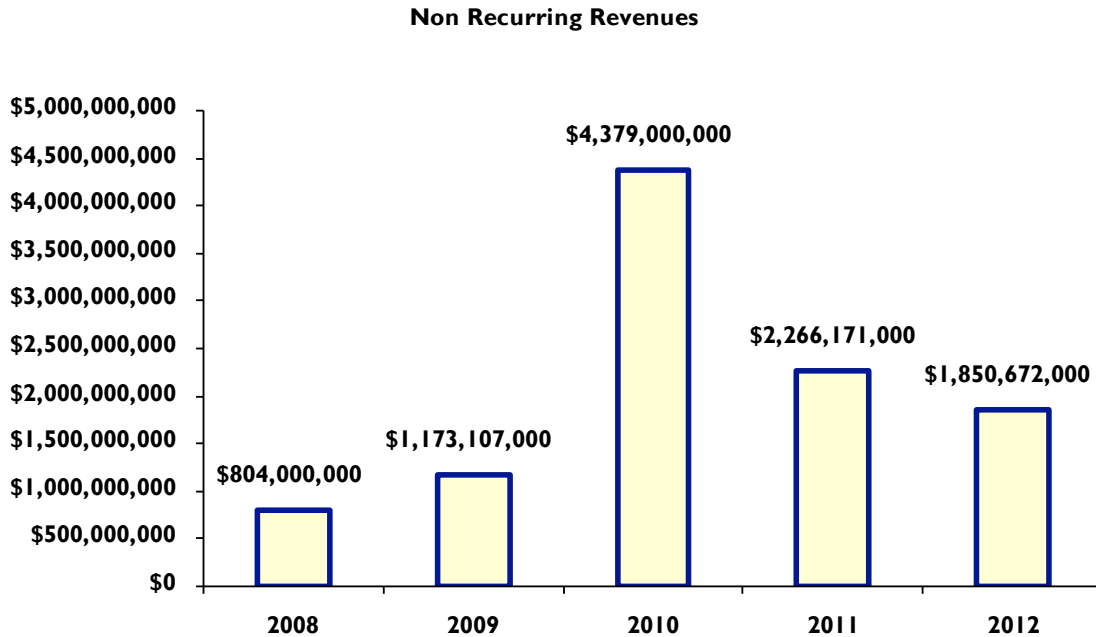
- General fund tax revenues, the principal component of the general fund, are expected to increase from \$7.412 billion in fiscal year 2008 to a projected \$8.012 billion during fiscal year 2012, an increase of \$600 million, or 8.1%. This increase is equivalent to a CAGR of 1.9%.
- In our view, the estimated year-over-year increase in general fund tax revenue, from \$7.343 billion in 2011 to \$8.012 billion in 2012, some \$669 million, or 9.1%, is on the aggressive end of the spectrum.
- General fund tax revenues have stayed essentially flat relative to GNP, declining slightly from 12% in 2008 to a projected 11.8% during fiscal year 2012. To put this data in perspective, total federal tax receipts in the U.S. currently amount to approximately 15% of GDP.
- The biggest risk to budgetary stability in the short term comes from the revenue side. This risk is the product of the interaction among three different factors: (1) the five year recession (depression?), which has had a material adverse effect on government revenues; (2) the usually lax administration of the tax laws in Puerto Rico; and (3) the recent massive overhaul of the Puerto Rico tax code.
- It is very difficult to accurately forecast tax revenues at this time because taxpayers, both individual and corporate, are still adjusting to the new rules. The government, however, is betting on significant revenue increases to be generated by increased enforcement of the Sales and Use Tax, through the IVU Lotto, and the special excise tax on foreign affiliates of certain multinational companies with operations in Puerto Rico. It remains to be seen whether these expected increases will be realized.

Structural Deficit



- The structural deficit is defined as the excess of recurring expenditures over recurring revenues. According to our analysis, the Commonwealth’s structural deficit has stayed essentially flat, increasing very slightly from \$1.326 billion in 2008 to a projected \$1.341 billion for fiscal year 2012, an increase of \$15 million, or 1.1%. The projected structural deficit of \$1.341 billion is the difference between recurring revenues of \$8.587 billion and recurring expenditures of \$9.928 billion.
- The government estimates the structural deficit for fiscal year 2012 will be around \$610 million. The \$731 million difference between our estimate and the government’s is due to (1) the government’s failure to include in their calculations some \$668 million for the servicing the debt on certain General Obligation bonds and (2) our downward adjustment of SUT receipts by \$63 million.
- Relative to the current fiscal year, the general fund structural deficit increases from \$1.257 billion to \$1.341 billion in fiscal year 2011, an increase of \$84 million, or 6.7%.
- Finally, as a percentage of total general fund expenditures, the structural deficit also increases slightly, from 14.3% in 2008 to a projected 15.5% in 2012. In our view, the trend with respect to the structural deficit is negative because it has stayed essentially flat over the last five years, both in absolute and relative terms.

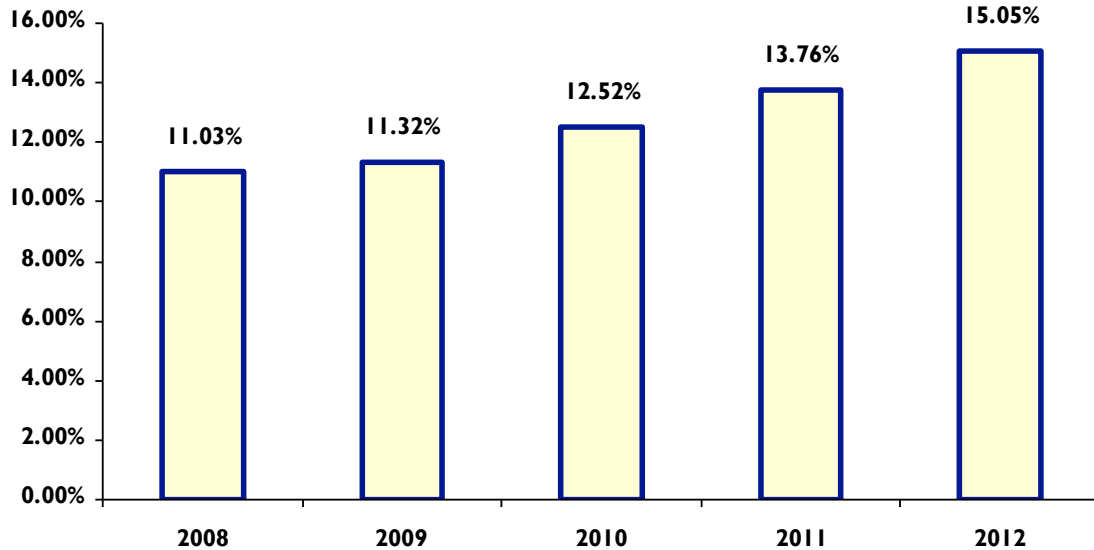
Use of Non Recurring Funds



- To cover its yearly deficits the Commonwealth government has turned to using non-recurring revenues. Total non-recurring revenues included in the *consolidated budget* have increased from \$804 million in fiscal year 2008 to \$1.850 billion for 2012, an increase of \$1.046 billion, or 130%.
- The *general fund* budget for fiscal year 2011-12 includes \$1.341 billion in non-recurring revenues, an amount that is \$100 million, or 8.1%, higher than the \$1.241 billion in non-recurring revenues included in the general fund budget for the fiscal year 2010-11.
- Therefore, the proposed general fund budget reflects an increase in the use of non-recurring funds in comparison with the current budget. Furthermore, in our opinion, the amount of non-recurring revenues as a portion of total general fund revenues remains relatively high at 13.5%, or roughly \$1 out of every \$7 spent from the general fund.
- Overall, this indicator also shows a mixed or uncertain trend at this time. The medium term trend has shown an increase in the use of non-recurring funds in the Commonwealth's consolidated budget, its use growing at a compound annual rate of 23.1%. However, the shorter-term trend appears to be downward, especially in contrast with the recent peak in 2010. But this downward trend could be solely result of the phasing out of the ARRA funds and the decreasing available balance from the Stabilization Fund, and not due to a significant improvement in the Commonwealth's structural balance.

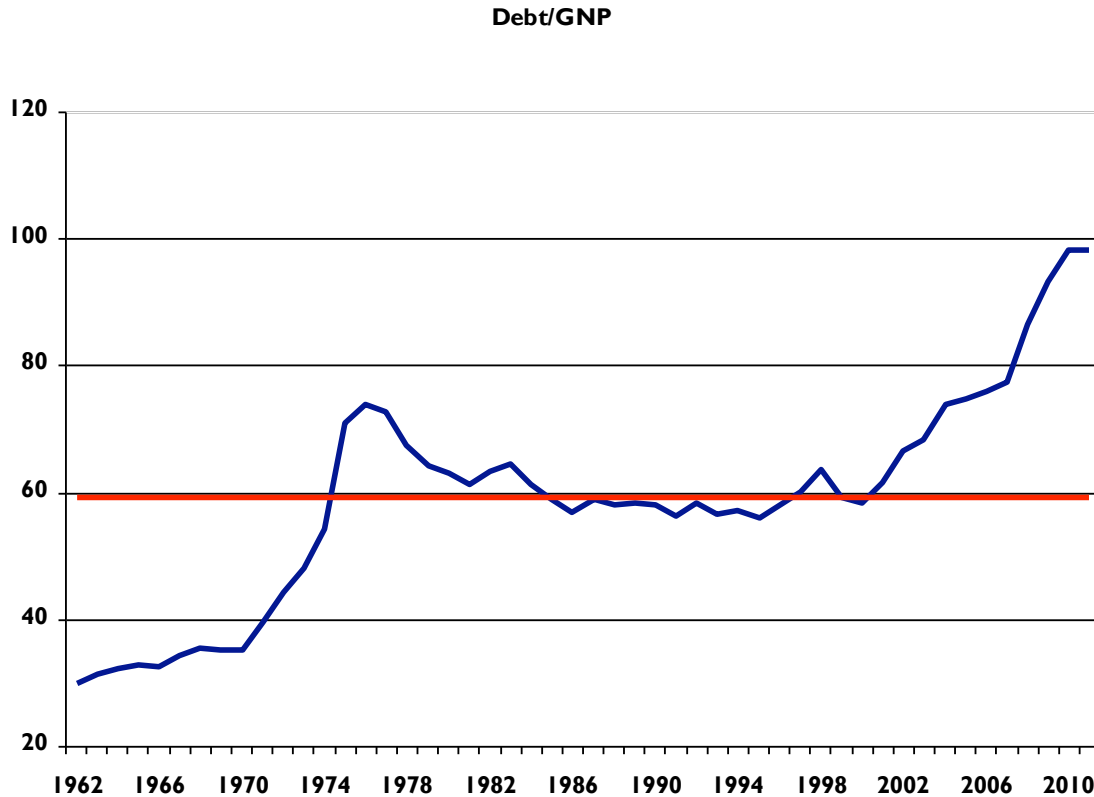
Debt Service

Debt Service as % of Consolidated Budget



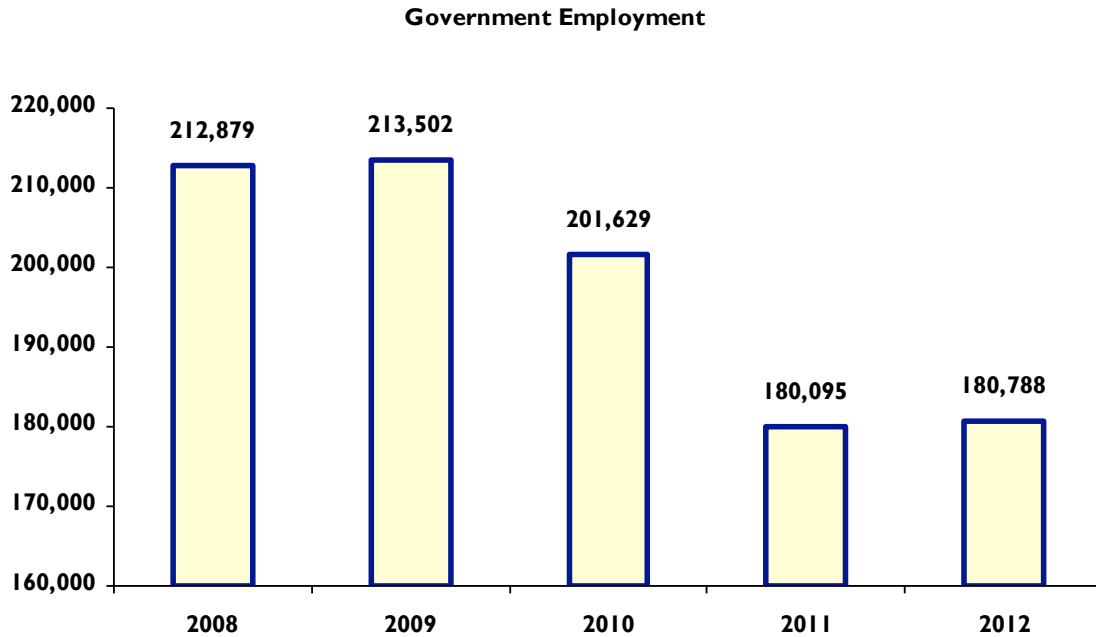
- The amount of the general fund allocated to debt service has increased from \$554 million for fiscal year 2008 to a projected \$670 million during fiscal year 2012, an increase of \$116 million, or 20.9%. This increase is equivalent to a CAGR of 4.9%.
- In relative terms, the amount allocated to general fund debt service has increased significantly from 6.90% of general fund recurring revenues in 2008 to a projected 7.8% of recurring revenues in 2012. This trend is a cause for concern because general fund recurring revenues have increased at an average rate of 1.7% over the last five fiscal years, yet debt service from the general fund has grown at 4.9% per year.
- The picture is similar with respect to consolidated budget. The amount of the consolidated budget allocated to debt service has increased from \$3.041 billion in 2008 to a projected \$4.308 billion in 2012, an increase of \$1.267 billion, or 41.7%. This increase is equivalent to a CAGR of 9.1%.
- In relative terms, the portion of the consolidated budget allocated to debt service has increased significantly, from 11% of the total consolidated budget in 2008 to a projected 15% in 2011. This means that almost \$1 out of every \$6 spent by the government of Puerto Rico is allocated for debt service.
- Relative to GNP, consolidated budget debt service has increased significantly, from 4.9% of GNP in 2008 to a projected 6.4% in 2012. In general terms, the debt service indicators show a negative trend because both the absolute and relative amounts dedicated to debt service have increased significantly since 2008.

Public Debt



- The Commonwealth's total public indebtedness increased from \$53.392 billion in 2008 to \$63.809 billion in 2011, an increase of \$10.417 billion, or 19.5%. During that same period, Puerto Rico's GNP, at current prices, increased from \$61.665 billion to \$64.973 billion, an increase of \$3.308 billion, or 5.3%.
- Relative to GNP, Puerto Rico's total public debt increased from 86.5% of GNP in 2008 to 98.2% in 2011. The red line in the graph above shows the 59.2% historical average Debt/GNP ratio for Puerto Rico during the 50-year period between 1962 and 2011.
- On a per capita basis, total public debt per capita in 2010 amounted to \$16,694 which is 115.3% of the island's per capita personal disposable income of \$14,484.
- On the positive side, the indebtedness rate of growth appears to have slowed down substantially during the first 9 months of fiscal year 2011. During that period, total indebtedness grew at 2.6%, just slightly below the 2.7% increase in nominal GNP.
- In our view, the overall trend with respect to total public indebtedness is negative, as it is still growing at a much higher rate relative to the growth in Puerto Rico's GNP and it is not clear that the slowdown experienced during 2011 will be permanent.

Government Employment



- According to data published by the Office of Management and Budget, the number of people employed by the Commonwealth (central government and public corporations only) has decreased significantly from 212,879 in 2008 to a projected 180,788 in 2012, a reduction of 32,091 workers, or 15.1%. This decrease is equivalent to a CAGR of negative 4.00%.
- In relative terms, the number of central government employees per 100 inhabitants has also shown a decrease from 5.38 government workers per 100 people to a projected 4.87 government workers per 100 people in 2012.
- Contrary to popular belief, if we compare Puerto Rico's rate of state and local employees per 100 inhabitants with the United States the difference is not significant. According to the U.S. Census Bureau, in 2010 there were 16,807,109 state and local government employees in the United States out of a total population of 308,745,538. This amounts to 5.44 state and local workers per 100 people.

VI. What to look out for in the short term

There are several fiscal risks that need to be monitored in the short term. First on the list is Moody's warning of a possible downgrade of Puerto Rico's GO credit ratings. Recent action taken by Moody's suggests this is not an empty threat. For example, on May 17, 2011, the *Wall Street Journal* reported that Moody's was cutting Hawaii's GO bond rating down one notch due to concerns about its public finances and the weakness of its economy. As shown on Table 6 below, Puerto Rico underperforms Hawaii in each of the four indicators that Moody's recently announced it will use to measure the relative combined burden of unfunded pension liabilities and long-term tax supported debt.

	<u>Personal Income</u>	<u>GDP</u>	<u>Per Capita</u>	<u>% of Revenue</u>
Hawaii	27.7%	16.2%	\$7,987	210.3%
Puerto Rico	108.4%	94.4%	\$16,157	436.8%

Source: Moody's

Therefore, negative ratings action by Moody's is highly likely in the near future. In our view, a two-notch downgrade is quite probable and a three notch downgrade seems to be well within the realm of the possible.

Second, the recent massive overhaul of the Puerto Rico Internal Revenue Code means that it will take a while for general fund revenues to settle. We can expect both individual and corporate taxpayers to adjust their behavior to the new code, a process that will take some time and may adversely affect revenue estimates. In the near future, we should be on the lookout for (1) changes in SUT collections, which are expected to increase 22.5% as a result of the implementation of the IVU Lotto and (2) the performance of the new excise tax on foreign multinationals with operations in Puerto Rico.

In fact, the performance of the new excise tax is the key to whole tax reform legislated by the administration. To the extent those revenues come in line with, or exceed, expectations we can expect the general fund deficit to stabilize and perhaps decline over the next few years. However, to the extent those revenues come below expectations we can expect the general fund deficit to worsen significantly in the near future.

Third, the phase-out of ARRA funds and the depletion of the Fiscal Stabilization Fund means the administration loses several degrees of freedom to deal with fiscal matters. While it is true that general fund payroll expenditures have been brought under control, it is also true that a significant amount of spending that was traditionally charged to the general fund has been financed with funds from these two sources. If general fund revenues remain stagnant or come significantly below expectations, then, in the absence

of ARRA funds and the Fiscal Stabilization Fund, we can expect budgetary pressures to increase significantly in the near future.

Fourth, Puerto Rico needs to undertake substantial reform of its public pensions. Puerto Rico's retirement systems are in a dire situation due to years of inadequate planning; the lack of discipline on the part of the policy makers in charge; the failure to make actuarially required contributions on a consistent basis; the enactment of new benefits and cost of living increases without properly analyzing or understanding the long term consequences; and the failure to provide adequate funding for health care benefits for retirees. The bottom line is a \$25 billion problem that keeps on growing.

Addressing that problem raises issues of extraordinary financial, political, legal, and moral complexity. Tackling Puerto Rico's pension problem along these four vectors will require tolerance, capacity for frank dialogue, commitment to good faith bargaining, and the willingness to make and honor concessions among retirees, current employees, and taxpayers in general.

It appears to us that any fair solution to this problem will require each one of those groups to make painful tradeoffs. Perhaps retirees could be asked to accept cutbacks on recently enacted benefits; current employees could be asked to increase their contributions; and taxpayers in general could be asked to pay a special tax to be applied towards reducing the total unfunded liability. In this context, Richard Lamm, former Democratic governor of Colorado, has stated that "we have to do what unions call givebacks, that is the only way to sanity. Any other alternative, therein lie dragons." We agree.

Fifth, there are several challenges at the federal level. First, the U.S. debt ceiling needs to be raised and the Republican majority in the House of Representatives is demanding major budget cuts in exchange for its support. In addition, the budget for fiscal year 2012 is currently under review in both the House and the Senate. So far Republican budget proposals have focused on non-defense discretionary spending, which amounts to about 12% of total federal outlays. This category consists mostly of domestic spending on things like education, public safety, land conservation, etc. Any cuts on federal funds assigned to Puerto Rico's central government agencies could have a material adverse effect on Puerto Rico's already tight general fund budget.

Furthermore, while Social Security and Medicare appear to be off the table for now, Medicaid reform remains firmly in the sight of Republican leaders. Any reduction in Medicaid funding for Puerto Rico would put enormous pressure on the government healthcare insurance plan to cutback benefits or to increase deductibles and co-payments, because it is highly unlikely the general fund would be able to absorb any additional costs.

Finally, the proposed budget contains a significant increase in the general fund subsidy for the Puerto Rico Aqueduct and Sewer Authority (PRASA), doubling the amount from \$84.1 million in 2011 to \$183 million in 2012, an increase of \$98.9 million, or 117.5%.

This amount is bound to increase substantially in the coming years, as PRASA is obligated to comply with a massive capital expenditure program essentially imposed by the EPA and its management has been reluctant to cut costs significantly or to increase rates to end users. Any future increases in general fund subsidies for PRASA, or any other public corporation, would significantly increase the pressure on the already constrained general fund budget.

VII. Conclusion

The fiscal situation of the Commonwealth of Puerto Rico remains unstable and while some indicators reflect progress, others remain stagnant, negative, or show significant uncertainty.

- The overall trend with respect to the consolidated budget reveals that the Puerto Rican government has achieved significant success in restraining the growth rate of government spending since 2008.
- Federal funds, however, continue to account for more than one-fifth of all government spending in Puerto Rico.
- The trend with respect to the general fund budget is difficult to discern. On one hand, the government appears to have successfully controlled the growth rate, perhaps even reduced it, for certain segments of general fund spending. On the other hand, however, the use of ARRA funds, the Stabilization Fund, and debt refinancing casts some doubt on the true extent of any reduction in general fund spending.
- The trend with respect to general fund payroll is uncertain, or mixed at this time. The medium term trend reflects a decrease in general fund payroll expenditures but the short-term, year-over-year trend, reflects a slight increase in these expenditures.
- It is very difficult to accurately forecast tax revenues at this time because taxpayers, both individual and corporate, are still adjusting to the new rules. The government, however, is betting on significant revenue increases to be generated by increased enforcement of the Sales and Use Tax, through the IVU Lotto, and the special excise tax on foreign affiliates of certain multinational companies with operations in Puerto Rico. In our view, the year-over-year estimate made by the government is on the aggressive side.
- The trend with respect to the structural deficit continues to be negative because it has stayed essentially flat over the last five fiscal years, both in absolute and relative terms.
- The use of non-recurring funds shows a mixed or uncertain trend at this time. The medium term trend has shown an increase in the use of non-recurring funds in the Commonwealth's consolidated budget, its use growing at a compound annual rate of 23.1%. However, the shorter-term trend appears to be downward, especially in contrast with the peak in 2010.

- In general terms, the debt service indicators show a negative trend because both the absolute and relative amounts dedicated to debt service have increased significantly since 2008. Furthermore, during the past five fiscal years, the amount of the consolidated budget dedicated to debt service has increase at an unsustainable 9.1% per year.
- The overall trend with respect to total public indebtedness is still negative, as it is growing at a much higher rate relative to the growth in Puerto Rico's GNP and it is not clear that the slowdown experienced during 2011 will be permanent. In addition, total indebtedness is at a fifty-year high.
- Government employment has decreased significantly from 212,879 in 2008 to a projected 180,788 in 2012, a reduction of 32,091 workers, or 15.1%. This decrease is equivalent to a CAGR of negative 4.00%.

In addition, several short-term risks could further blur the short-term fiscal picture. A GO rating downgrade by Moody's; the implementation of the new, massively amended, tax code; the phase-out of ARRA funds and the depletion of the Fiscal Stabilization Fund; the complexity of pension reform; budget cuts at the federal level; and the need to increase subsidies for public corporations, all have the potential to generate significant budgetary pressures in the short-term.

In sum, despite some recent progress, Puerto Rico's fiscal situation is still very unstable and the short-term fiscal scenario remains subject to a substantial amount of uncertainty.