Fiscal Situation Update

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Analysis of the Governor's Budget Request for Fiscal Year 2014

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Hope, detached from faith and untempered by the evidence of history, is a dangerous asset, and one that threatens not only those who embrace it, but all those within range of their illusions.
— Roger Scruton, The Uses of Pessimism: And the Danger of False Hope (2010)

Introduction

This Fiscal Update Report prepared by the Center for a New Economy (CNE) presents an independent analysis of the proposals contained in the Governor's budget request for fiscal year 2014. The analysis is based on CNE's evaluation and interpretation of the budget data, rather than the Administration's, and may incorporate estimates made by CNE's staff or by other private sector analysts. Our analysis also includes a review of the fiscal trends for the fiscal year 2013, which ends on June 30, as well as an update of ten budget indicators that we have followed over the last seven years.

Fiscal Year 2013

Revenues – General fund net revenues for the first ten months of fiscal year 2013 (comprising the period from July 1, 2012 to April 30, 2013) amounted to $6.795 billion, approximately $50 million, or 0.7%, less than the $6.845 billion recorded for the same period during the previous fiscal year.

However, Puerto Rico's Treasury secretary reported in January that general fund net revenues are expected to fall $965 million below *budgeted estimates* for fiscal year 2013. Puerto Rico's Treasury has already implemented two, one-time, non-recurrent revenue measures to partially bridge this revenue gap:

(1) A transfer to the general fund of $240 million from a reserve account originally set up to make payments on potential collateral calls made in connection with the value of certain swap agreements to which the Commonwealth is a party; and

(2) A prepayment of $280 million made by companies subject to the withholding tax on payments made by non-resident corporations doing business in Puerto Rico.

According to the official budget documents, these two measures should help reduce the expected revenue shortfall for fiscal year 2013 from $965 million to approximately $445 million by June 30.

Thus, actual general fund net revenues for fiscal year 2013 are currently expected to total $8.305 billion, in contrast with budgeted revenues of $8.750 billion.

Expenditures – On the spending side, general fund expenditures for fiscal year 2013 are budgeted at $9.082 billion. These expenditures, however, *exclude*

(1) Approximately $600 million of principal and interest payments on Commonwealth general obligation bonds that are scheduled to be refinanced by the end of the current fiscal year;

(2) Another $175 million of interest payments on Commonwealth-guaranteed Public Building Authority Bonds that are also scheduled to be refinanced by the end of the current fiscal year; and

(3) Excess spending of $50 million by several agencies of the central government.

Thus, total general fund obligations for fiscal year 2013 are expected to add up to \$9.907 billion (\$9.082 billion + \$600 million + \$175 million + \$50 million).

Deficit Estimate – Accordingly, we currently estimate the Commonwealth's structural deficit for fiscal year 2013 to be approximately \$1.602 billion, which is equal to the difference between revenues of \$8.305 billion less expenditures of \$9.907 billion. The government expects to partially finance this gap with:

(1) A COFINA note/bond offering of \$332 million;

(2) A "scoop and toss" debt refinancing of \$775 million; and

(3) Expense reductions in the amount of \$50 million.

That still leaves a gap of approximately \$445 million to be covered, by:

(1) \$200 million product of a tax amnesty;

(2) \$5 million from tax liens;

(3) \$35 million from closing agreements;

(4) \$12 million from Act 154 audits; and

(5) \$193 million from "other pending initiatives" including the sale of accounts receivable.

We note that the practice of refinancing current-year *debt service* by rolling it over with the issuance of new debt is not unique to Puerto Rico. However, the consensus among analysts appears to be that it is not the most prudent financial practice and it does constitute a significant credit risk for holders of Puerto Rico bonds.

Fiscal Year 2014

Revenues – The Governor announced a general fund budget of \$9.635 billion for fiscal year 2014. This amount would be \$885 million, or 10.1%, higher than this year's general fund budget of \$8.750 billion.

With respect to actual expected general fund revenues of \$8.305 billion for fiscal year 2013, the proposed budget would be \$1.330 billion, or 16%, higher than the current fiscal year's general fund revenues.

The general fund revenue forecast includes a significant increase in the proceeds from the Sales and Use and Tax (SUT), from \$552 million during fiscal year 2013 to \$1.607 billion during fiscal year 2014, a year-over-year increase of \$1.055 billion, or 191.1%. This increase in SUT revenues is expected to be the product of:

(1) New legislation to expand the base of taxable goods and services subject to the SUT; and

(2) Enhanced enforcement measures.

The Governor also announced a reduction of the SUT rate, from 7% to 6.5%. The head of Puerto Rico's Office of Management and Budget (OMB) estimates the effect of reducing the tax rate by 0.5% percentage points to be about \$200 million. Given that there are approximately 1 million households in Puerto Rico, the "tax break" amounts to about \$200 per year, per household, or some 54.7 cents per day, per household.[1] Hardly earth shattering.

We view the proposed rate reduction, essentially, as a politically symbolic gesture that allows the Governor to claim credit for "reducing taxes", but which should have little or no significant impact either on the real economy, given the relatively small magnitude of the reduction, or on general fund revenues, given the significant expansion of the tax base.

In terms of the expected revenue increase, we believe the SUT revenue forecast is on the aggressive side of the spectrum, given:

(1) The historical pattern of SUT revenues;

(2) The relatively limited enforcement capabilities of the Puerto Rico Treasury Department;

(3) The limited experience of service providers in acting as withholding agents for the Treasury; and

(4) The current weak state of the Puerto Rican economy.

We note that at the new 6.5% rate, the forecast implies capturing the SUT on sales and services valued at \$16.2 billion, which are not currently subject to the tax.

However, it is currently not possible for us to objectively estimate the probability of achieving the projected \$1.055 billion revenue increase because:

(1) The economic analysis done by the Treasury Department has not been made public;

(2) We do not know the parameters and specifications used by the Treasury to calibrate its revenue model;

(3) The required legislation has not yet been enacted by the Puerto Rico legislature and, thus, is still subject to amendment by either of the legislative bodies; and

(4) The total tax take will depend to a large extent on compliance by merchants and service providers, many of which are not currently required to collect the SUT, and the Treasury's ability to effectively enforce the new law.

In summary, while we take as good the Administration's SUT revenue estimate for purposes of this report, we do so with great trepidation as we believe it will be subject to significant downward revision during the course of fiscal year 2014.

Expenditures – The proposed budget for fiscal year 2014, as has been the case since fiscal year 2009, provides that certain expenditures traditionally charged to the

[1] This \$200 million estimate is perhaps overly optimistic. We note that according to data from the PR Treasury Department, during FY2012 total SUT revenues from the 5.5% charged by the central government amounted to \$1,141,647,000, approximately \$207.5 million per tax rate percentage point. Thus, a tax rate reduction of 0.5% would amount to "tax relief" of \$103.7 million.

general fund be funded instead with the proceeds from one-time financing sources. For fiscal year 2014 these expenditures are estimated to total $200 million. Therefore, the Administration estimates total general fund expenditures for the next fiscal year to be around $9.835 billion, an amount that is some $753 million, or 8.29%, higher than this year's budgeted general fund expenditures of $9.082 billion.

This $753 million increase in general fund expenditures is due to:

(1) An additional $245 million allocated for retirement system contributions;

(2) Additional GO and PBA debt service of $297 million; and

(3) Other increases in the amount of $211 million, including an additional $103 for the University of Puerto Rico.

We note, however, that the general fund budget for 2013-14 *does not* include $575 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 obligations to be around $10.410 billion.

Deficit Estimate – In sum, we estimate the Commonwealth's structural deficit for fiscal year 2014 to be at least $775 million, which is equal to the difference between revenues of $9.635 billion less expenditures of $10.410 billion. This deficit amount would be $827 million, or 52%, less than the $1.602 billion deficit we estimate for fiscal year 2013.

Use of Non-Recurring Revenues

As shown on Table 1 below, the general fund budget for fiscal year 2013-14 includes at least $775 million in non-recurring revenues, an amount that is $1.298 million, or 62.6%, lower than the $2.073 billion in non-recurring revenues included in the general fund budget for the fiscal year 2012-13.

Table 1
Non-Recurring Revenues (General Fund)

FY 12-13	**Amount**
Transfer from Swap Reserve Account	$241,000,000
Prepayment of Withholding Taxes	$280,000,000
Fiscal Stabilization Fund	$332,000,000
Additional corrective measures	$445,000,000
Debt Service to be Refinanced	$775,000,000
Total non-recurring revenues	**$2,073,000,000**
General fund expenditures FY12-13	$9,997,000,000
% Non-recurring revenues	20.7%
FY 13-14	**Amount**
Deficit Financing	$200,000,000
Debt Service to be Refinanced	$575,000,000
Total non-recurring revenues	**$775,000,000**
General fund expenditures FY13-14	$10,410,000,000
% Non-recurring revenues	7.4%

Source: CNE analysis

The amount of non-recurring revenues as a portion of total general fund expenditures is expected to decrease significantly from 20.7% in fiscal year 2013, or roughly 1 out of every $5 spent from the general fund, to 7.4% during fiscal year 2014, or roughly 1 out of every $14 spent.

The consolidated budget for fiscal year 2014 includes another $192 million in non-recurring revenues left over from the American Recovery and Reinvestment Act (ARRA). Thus, total non-recurring revenues included in next year's consolidated budget amount to $967 million, an amount that is $1.343 billion, or 58.1%, less than the $2.310 billion in non-recurring funds that were included in the current year's consolidated budget.

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:

(1) The phase-out of stimulus spending authorized by the American Recovery and Reinvestment Act; and

(2) The termination of the Fiscal Stabilization Fund, which had been funded with non-recurring revenues from COFINA debt offerings.

Public Debt

Table 2
Puerto Rico Public Debt and GNP

(US$BN)

FY	Debt	%Δ	GNP	%Δ	PD/GNP
2000	24.19	--	41.42	--	58.40%
2001	27.16	12.28%	44.05	6.34%	61.66%
2002	30.03	10.58%	45.07	2.33%	66.63%
2003	32.53	8.30%	47.48	5.34%	68.50%
2004	37.43	15.09%	50.71	6.80%	73.82%
2005	40.27	7.57%	53.75	6.00%	74.91%
2006	43.14	7.12%	56.73	5.54%	76.03%
2007	46.18	7.06%	59.52	4.91%	77.59%
2008	53.39	15.61%	61.67	3.60%	86.59%
2009	58.41	9.40%	62.60	1.51%	93.32%
2010	62.21	6.49%	64.29	2.71%	96.75%
2011	64.28	3.33%	65.57	1.98%	98.04%
2012	69.95	8.82%	69.46	5.94%	100.70%
CAGR	**9.25%**		**4.40%**		

Source: GDB, PRPB, and CNE Analysis

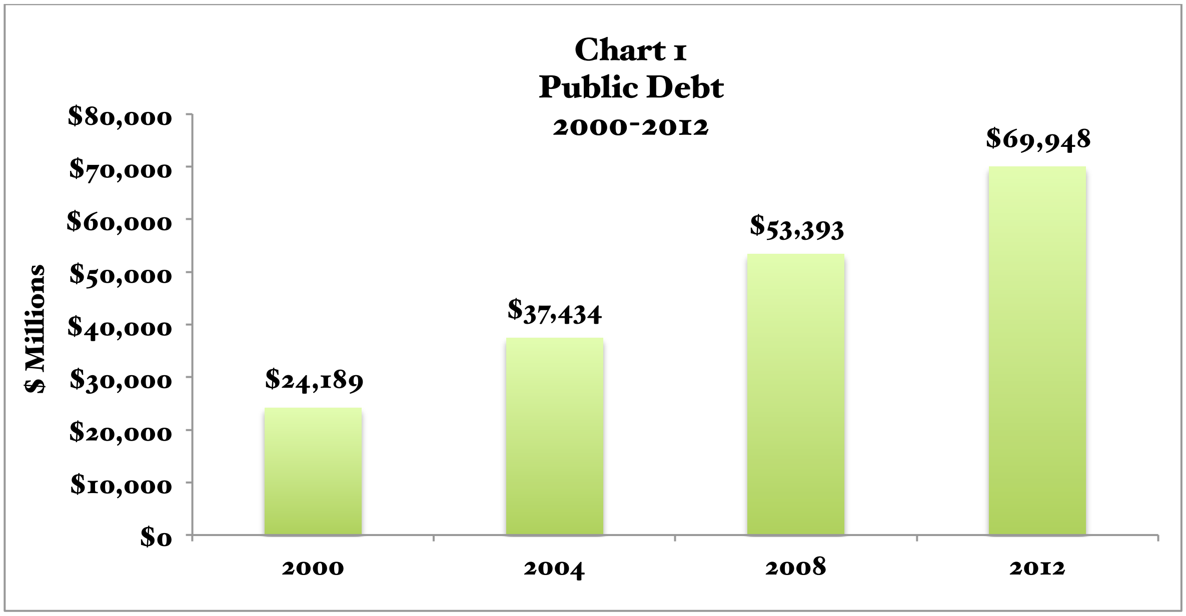
Unsustainable Debt Dynamics – Since fiscal year 2000, Puerto Rico's total public debt has exploded both in absolute terms and relative to the size of the Puerto Rican economy. At the end of fiscal year 2000 total Puerto Rico public debt amounted to approximately $24.2 billion, while as of June 2012 it amounted to $69.9 billion, an aggregate increase of $45.7 billion, or 188.8%. During this period public indebtedness increased at a compound annual growth rate of 9.25%.

Meanwhile, Puerto Rico's Gross National Product (GNP), at current prices, increased from $41.4 billion in 2000 to an estimated $69.5 billion at the end of fiscal year 2012, an aggregate increase of $28.1 billion, or 67.9%.[2] During this period Puerto Rico's GNP increased at a compound annual growth rate of 4.4%.

Given that Puerto Rico's indebtedness has grown at an average annual rate that is 2.1 times faster than the growth rate of its GNP during the last twelve years, it should not be surprising that Puerto Rico's total public debt currently equals its GNP.

[2] In Puerto Rico, GNP, which measures income earned by residents or by locally owned production factors, is a more accurate measure of economic activity than GDP due to distortions induced by the transfer pricing practices of multinational companies operating in the island. For a technical analysis of the GNP/GDP gap in Puerto Rico see "Economic Growth" by Barry P. Bosworth and Susan M. Collins in *The Economy of Puerto Rico: Restoring Growth*, (Brookings Institution Press: Washington, DC, 2006), p. 17-81.

As shown on Chart 1 below, Puerto Rico's public debt almost tripled during the period between 2000 and 2012. Each of the last three administrations added an *average* of $15 billion to Puerto Rico's public debt. It is highly unlikely, however, that the Garcia Padilla administration will be able to repeat that feat. Nonetheless, the consolidated budget for fiscal year 2014 includes $1.522 billion from "loans and bond offerings", which presumably will be used to finance new public works in the amount of $1.441 billion.



Source: GDB and CNE Analysis

In our view, Puerto Rico's levels and rates of indebtedness are not sustainable. Puerto Rico desperately needs to "grow the denominator", that is, to reignite robust economic growth.

However, even if Puerto Rico were to start growing at rates it has not seen in decades, it would take several years to bring down debt ratios to manageable levels. To understand why we need to analyze Puerto Rico's debt dynamics. According to standard macroeconomic theory, government debt growth is driven by two factors:

(1) The difference between real interest rates and GDP growth (r-g), and

(2) The primary budget balance (i.e., before interest payments) as a percentage of GDP.

In any given period the debt stock (D_{t+1}) grows by the existing debt stock (D_t) multiplied by (r-g), less the primary budget balance (p).

The difference between real interest rates and GDP growth (r-g) is the key to sustainable debt dynamics: an (r-g) difference greater than zero (when interest rates are greater than GDP growth) means that the debt stock increases over time. An (r-g) difference of less than zero (when interest rates are lower than GDP growth) causes it to fall.

Between 2007 and 2011, Puerto Rico experienced negative real GNP growth rates, while real interest rates remained relatively high due to low inflation. In addition, Puerto Rico has also been running substantial primary budget deficits during this period.

Therefore, both factors point to a significant increase in the debt stock, which is what has actually happened since 2000. Indeed, Puerto Rico's public debt to GNP ratio has increased from a relatively manageable 58.4% in 2000 to a decidedly risky 100.7% in 2012.

Reversing this trend will require:

(1) Puerto Rico's real GNP growth to consistently exceed the real interest rate on Puerto Rico's debt; and

(2) Running a primary budget surplus on a regular basis for many years into the future.

Budget Indicators

Table 3 below sets forth the series of budget indicators that we update every year around the time the governor submits his budget request to the legislature for enactment. Among the indicators included in the table you will 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 3

Budget Indicators 2010-2014

	Fiscal Year					
	2010	**2011**	**2012**	**2013**	**2014**	**CAGR**
1.Consolidated Budget (CB)	$29,239,711,000	$27,870,265,000	$28,894,165,000	$28,679,696,000	$29,030,885,000	-0.18%
CB per capita	$7,857.59	$7,544.55	$7,879.33	$7,879.15	$8,035.09	
CB/GNP	45.48%	42.51%	41.60%	39.50%	38.31%	
2. Federal funds*	$6,919,556,000	$6,757,457,000	$6,866,701,000	$6,618,858,000	$6,590,450,000	-1.21%
Federal funds/CB	23.66%	24.25%	23.77%	23.08%	22.70%	
3. General Fund budget (GF)	$7,670,000,000	$8,133,500,000	$8,650,000,000	$8,750,000,000	$9,635,000,000	5.87%
GF/GNP	11.93%	12.40%	12.45%	12.05%	12.71%	
4. GF Payroll	$4,608,861,000	$3,633,914,000	$3,595,934,000	$3,632,732,000	$3,691,875,000	-5.40%
Payroll/GF	60.09%	44.68%	41.57%	41.52%	38.32%	
5. Tax revenues GF	$6,894,000,000	$7,376,000,000	$8,036,000,000	$7,548,000,000	$9,069,000,000	7.10%
Tax revenues/GF	89.88%	90.69%	92.90%	86.26%	94.13%	
Tax revenues GF/GNP	10.72%	11.25%	11.57%	10.39%	11.97%	
6. GF recurring revenues	$7,670,000,000	$7,892,000,000	$8,650,000,000	$8,305,000,000	$9,635,000,000	5.87%
GF recurring expenditures	$9,170,000,000	$9,149,000,000	$10,099,000,000	$9,907,000,000	$10,410,000,000	3.22%
GF structural deficit	($1,500,000,000)	($1,257,000,000)	($1,449,000,000)	($1,602,000,000)	($775,000,000)	
Structural deficit/GF	-19.56%	-15.45%	-16.75%	-18.31%	-8.04%	
7. Non-recurring funds (CB)	$4,379,000,000	$2,266,171,000	$1,958,672,000	$2,310,419,000	$967,102,000	-31.45%
Non-recurring funds/CB	14.98%	8.13%	6.78%	8.06%	3.33%	
8. Debt service GF	$662,807,000	$578,402,000	$574,074,000	$527,070,000	$658,164,000	-0.18%
Debt service/recurring revenues GF	8.64%	7.33%	6.64%	6.35%	6.83%	
Debt service consolidated budget	$3,645,830,000	$3,499,162,000	$3,486,254,000	$3,998,682,000	$3,943,952,000	1.98%
Debt service/CB	12.47%	12.56%	12.07%	13.94%	13.59%	
Debt service per capita	$979.74	$947.23	$950.69	$1,098.55	$1,091.60	2.74%
Debt service CB/GNP	5.67%	5.34%	5.02%	5.51%	5.20%	
9. Total public debt**	$62,206,200,000	$64,279,000,000	$69,948,000,000	--	--	
Public debt per capita	$16,716.67	$17,400.48	$19,074.56	--	--	
GNP***	$64,294,600,000	$65,567,000,000	$69,461,600,000	$72,616,000,000	$75,779,000,000	4.19%
Total public debt/GNP	96.75%	98.04%	100.70%	--	--	
10. Government employees****	202,525	180,971	177,769	171,420	169,813	-4.31%
Government employees per 100 persons	5.44	4.90	4.85	4.71	4.70	
Population*****	3,721,208	3,694,093	3,667,084	3,639,948	3,613,012	-0.73%

* Includes ARRA funds

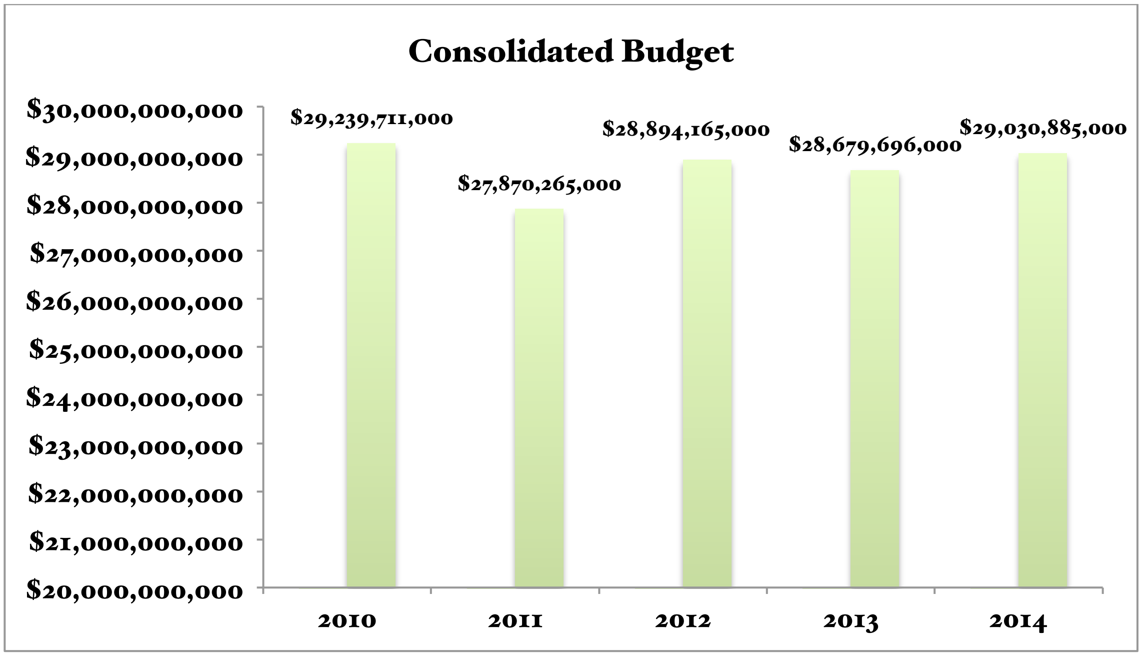
** Data is as of June 30

*** Data for 2013 and 2014 are PRPB estimates

**** Central government and state-owned companies only

***** Data for 2013 and 2014 are CNE estimates

Consolidated Budget



- The Commonwealth's consolidated budget has decreased from $29.239 billion in fiscal year 2010 to a projected $29.030 billion for fiscal year 2014, a decrease of $209 million, or 0.71%. This decrease is equivalent to a compound annual growth rate (CAGR) of negative 0.18% during the period between fiscal years 2010 and 2014, which is significantly lower than the 4.19% CAGR of nominal GNP during the same period.

- Relative to the consolidated budget for the current year the proposed budget for fiscal year 2014 shows a net increase in spending of $351 million, or 1.22%. Thus, this is essentially a relatively austere budget.

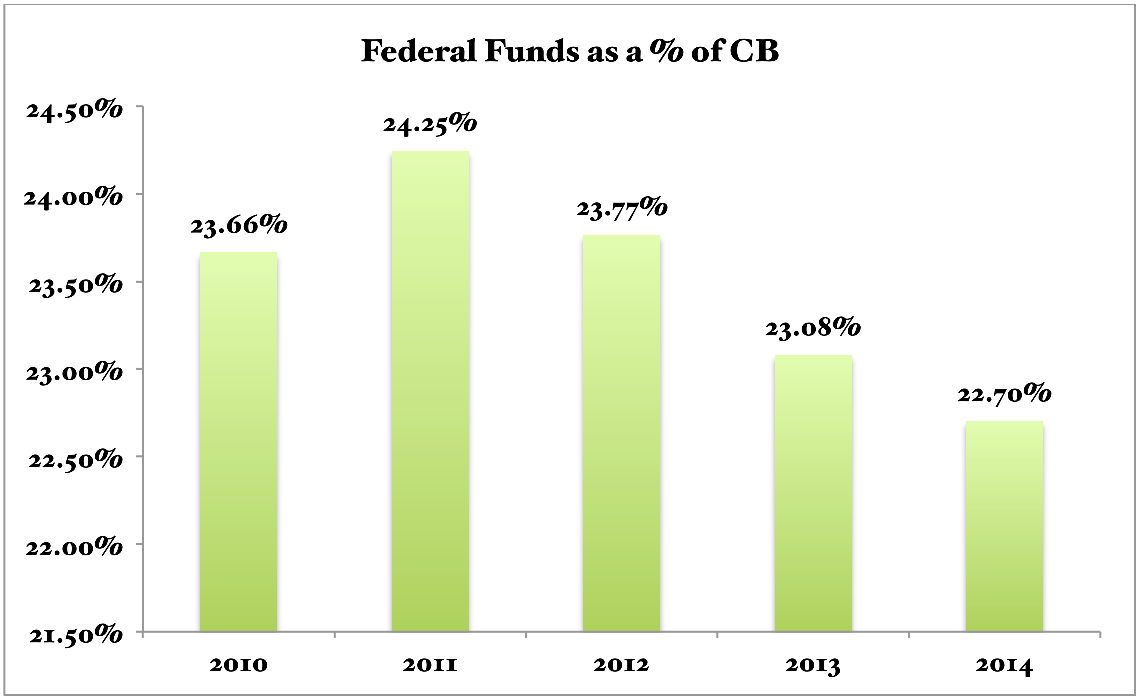
- On a per capita basis, consolidated budget expenditures show a significant increase, rising from $7,857 in 2010 to a projected $8,035 for fiscal year 2014. This increase, however, is driven mostly by a reduction in Puerto Rico's population instead of increasing expenditures.

- Relative to per capita personal disposable income, government expenditure remains fairly high. In 2012, per capita disposable personal income in the island was $16,286; thus, per capita government spending of $7,879 represented 48.37% of per capita disposable personal income. In contrast, federal expenditure per capita in the U.S. is approximately $11,200, which is equivalent to 29.8% of per capita disposable personal income of $37,576.

- Finally, consolidated budget expenditures have declined significantly relative to GNP, from 45.5% in 2010 to a projected 38.3% in 2013.

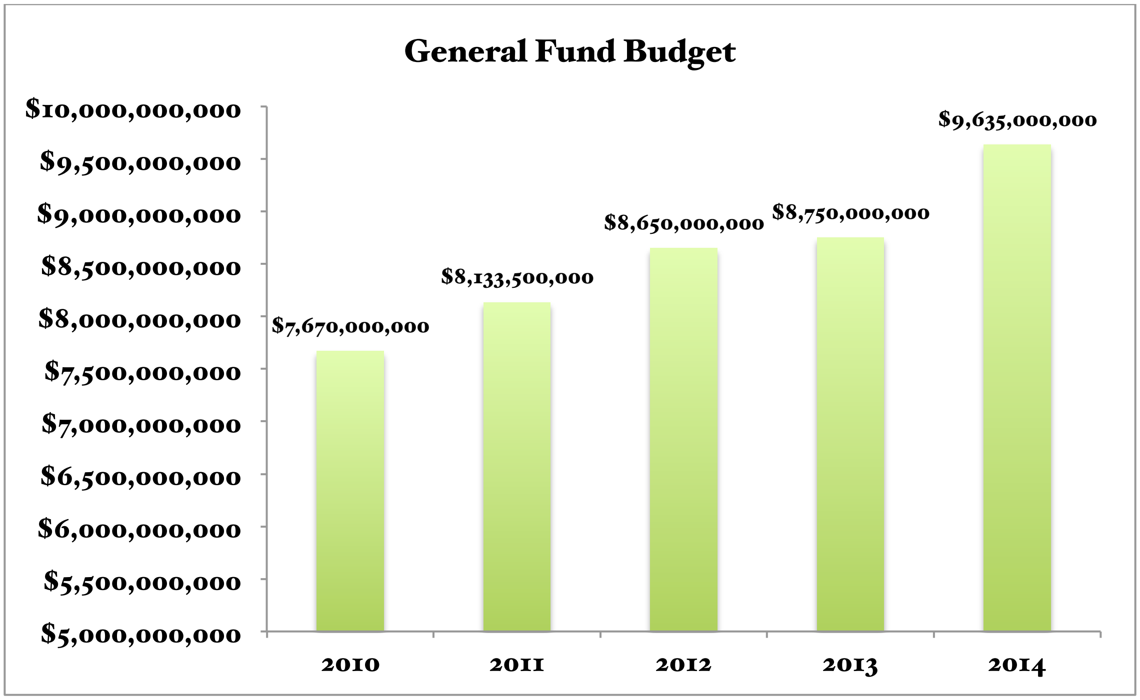
- In our view, the overall trend with respect to the consolidated budget reveals that the Puerto Rican government has achieved significant success in restraining the growth rate of government spending since 2010. Furthermore, perhaps in contrast with popular perception, in real terms government spending has decreased significantly over the last four fiscal years.

Federal Funds



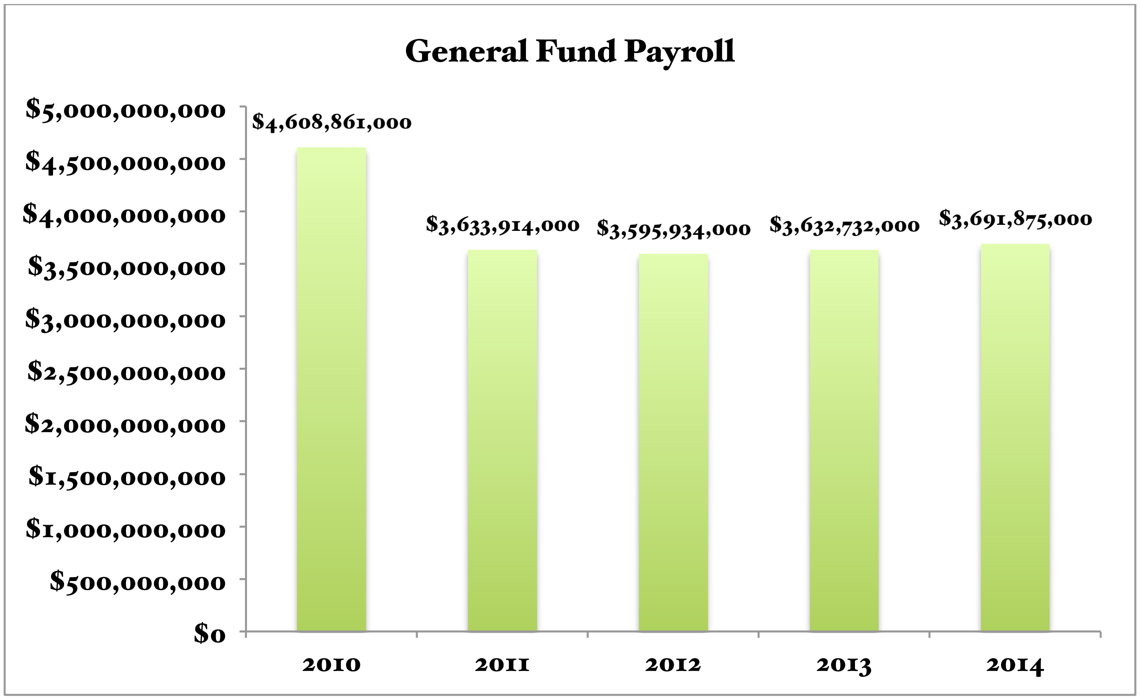
- Grants from the U.S. federal government to the various government agencies of the Commonwealth, including some remainder ARRA funds, are expected to total \$6.590 billion during fiscal year 2014, a decrease of \$329 million, or 4.8%, relative to the \$6.919 billion received during fiscal year 2010.
- Federal funds are expected to account for 22.7% of all consolidated budget expenditures during fiscal year 2014, a proportion that is slightly lower than the 23.08% registered in 2013. This means that approximately 1 out of every 5 dollars spent by the Commonwealth's central government during the next fiscal year will come from Washington.
- Since 2010, federal grants to the government have decreased at a CAGR of 1.21%, while the rate of growth of the overall consolidated budget during the period under study was negative 0.18%. This decrease in the growth rate is due mostly to the phase-out of ARRA funds and deficit reduction measures implemented at the federal level.
- In our opinion, the high relative weight of federal funds in the consolidated budget is a negative factor 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.

General Fund



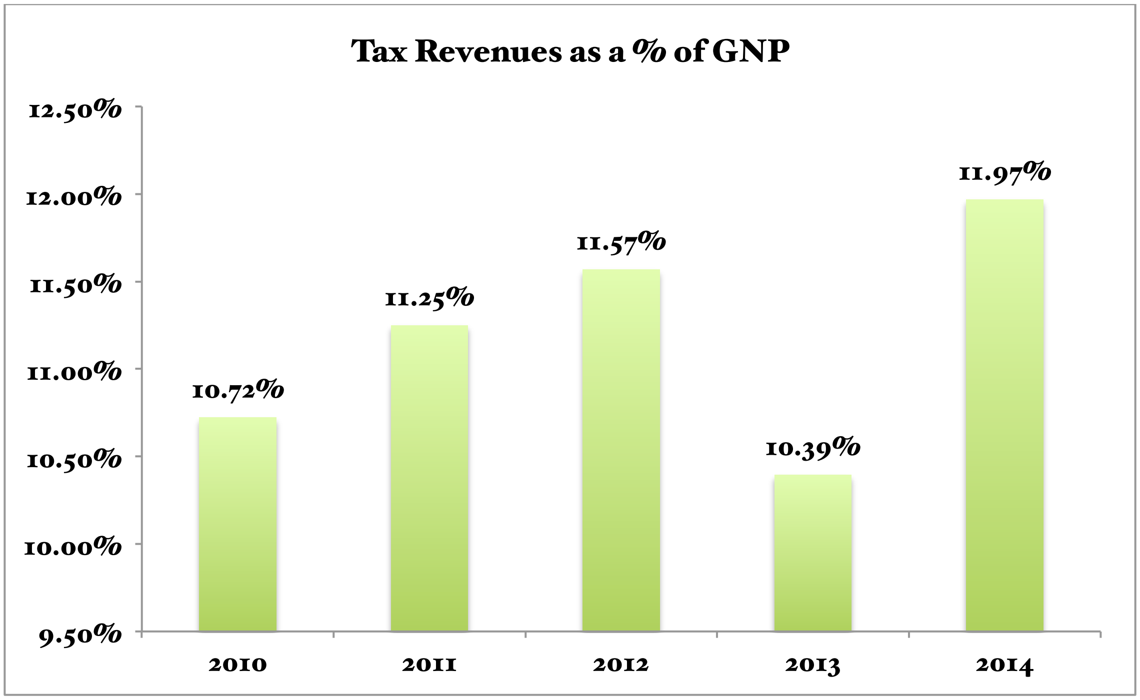
- The Commonwealth's general fund budget has increased from $7.670 billion in fiscal year 2010 to a projected $9.635 billion for fiscal year 2014, an increase of $1.965 million, or 25.6%. This increase is equivalent to a CAGR of 5.87% for the period between fiscal years 2010 and 2014.
- However, the magnitude of this increase could be somewhat deceptive because between 2010 and 2013, as we have already noted, some expenditures traditionally charged to the general fund were charged instead against the Fiscal Stabilization Fund, a special fund set up with the proceeds of COFINA bond offerings. Indeed, during fiscal year 2013 the general fund is slated to receive $332 million from this special fund.
- Total general fund spending for the next fiscal year is estimated to be around $10.410 billion, an amount that is $413 million, or 4.1%, more than total general fund expenditures of $9.997 billion during fiscal year 2013.
- Overall, the general fund budget shows an increasing trend since 2010. We warn, however, that this trend can be deceiving since the use of ARRA funds, the Stabilization Fund, and significant debt refinancing during the past four fiscal years means that the 2010 base may be artificially low.

General Fund Payroll



- The amount of the general fund allocated to payroll has decreased from \$4.608 billion for fiscal year 2010 to a projected \$3.691 billion during fiscal year 2014, a decrease of \$917 million, or 19.9%. This decrease is equivalent to a CAGR of negative 5.4%.
- In essence, the general fund payroll in nominal terms has remained flat since fiscal year 2011 staying at around \$3.6 billion per year. This means general fund payroll expenditures have declined significantly in real terms.
- In relative terms, the portion of the general fund allocated to payroll has decreased significantly from 60% in 2010 to a projected 38.3% in 2014.
- General fund payroll expenditures have declined significantly since 2010, and have stayed flat since 2011. In our view, this means that there are relatively little savings that remain to be squeezed from the payroll component of the general fund.

Tax Revenue Trend



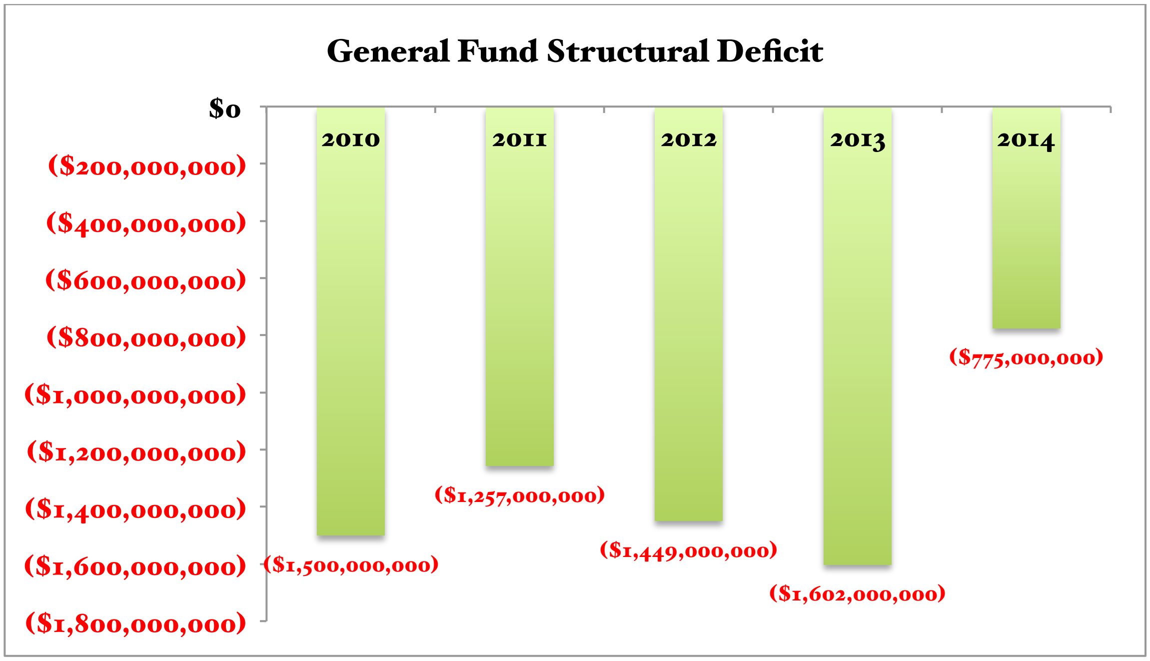
- General fund tax revenues, the principal component of the general fund, are expected to increase from $6.894 billion in fiscal year 2010 to a projected $9.069 billion during fiscal year 2014, an increase of $2.175 billion, or 31.5%. This increase is equivalent to a CAGR of 7.1%.

- In our view, the estimated year-over-year increase in sales tax revenues allocated to the general fund, from $552 million in 2013 to $1.607 billion in 2014, some $1.055 billion, or 191%, is on the aggressive end of the spectrum, and will probably be revised downward during fiscal year 2014.

- General fund tax revenues have increased relative to GNP, increasing from 10.7% in 2010 to a projected 11.9% during fiscal year 2014. To put this data in perspective, total federal tax receipts in the U.S. currently amount to approximately 16% of GDP.

- In our view, the biggest risk to budgetary stability in the short-term comes from the revenue side. However, it is currently not possible for us to estimate with any accuracy the probability of actually realizing the SUT revenue target of $1.607 billion because (1) we do not know the parameters and specifications used by the Treasury to calibrate its revenue model; (2) the proposed legislation has not yet been enacted by the Puerto Rico legislature and, thus, is still subject to amendment by either of the legislative bodies; and (3) the total tax take will depend to a large extent on compliance by merchants, many of which are not currently required to collect the tax, and the Treasury's ability to enforce the new law.

Structural Deficit

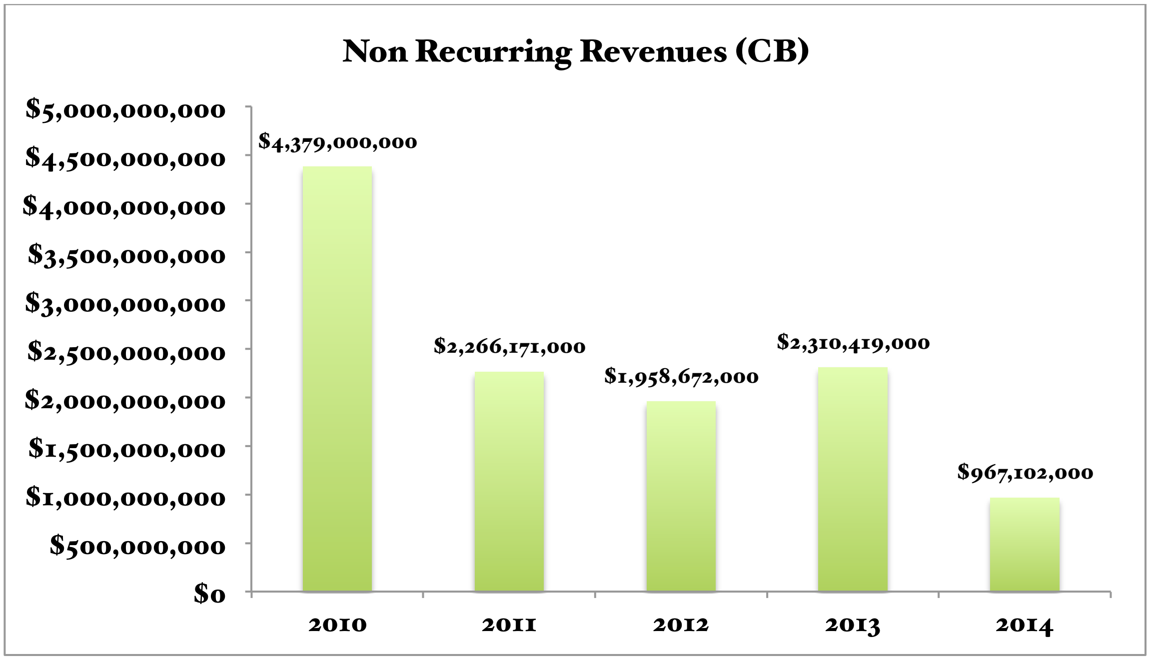


- The credit rating agencies define the structural deficit as the excess of recurring expenditures over recurring revenues. According to our analysis, the Commonwealth's structural deficit has decreased significantly, from $1.5 billion in 2010 to a projected $775 million for fiscal year 2014, a decrease of $725 million, or 48.3%. For fiscal year 2014, the projected structural deficit of $775 billion equals the difference between recurring revenues of $9.635 billion and recurring expenditures of $10.410 billion.

- Relative to the current fiscal year, the general fund structural deficit is expected to decrease from $1.602 billion to $775 million in fiscal year 2014, a decrease of $827 million, or 51.6%.

- Finally, as a percentage of total general fund expenditures, the structural deficit is also expected to decrease significantly, from 19.6% in 2010 to a projected 8% in 2014. In our view, the trend with respect to the structural deficit is positive because it shows a conspicuous reduction over the last five years, both in absolute and relative terms.

Use of Non-Recurring Funds



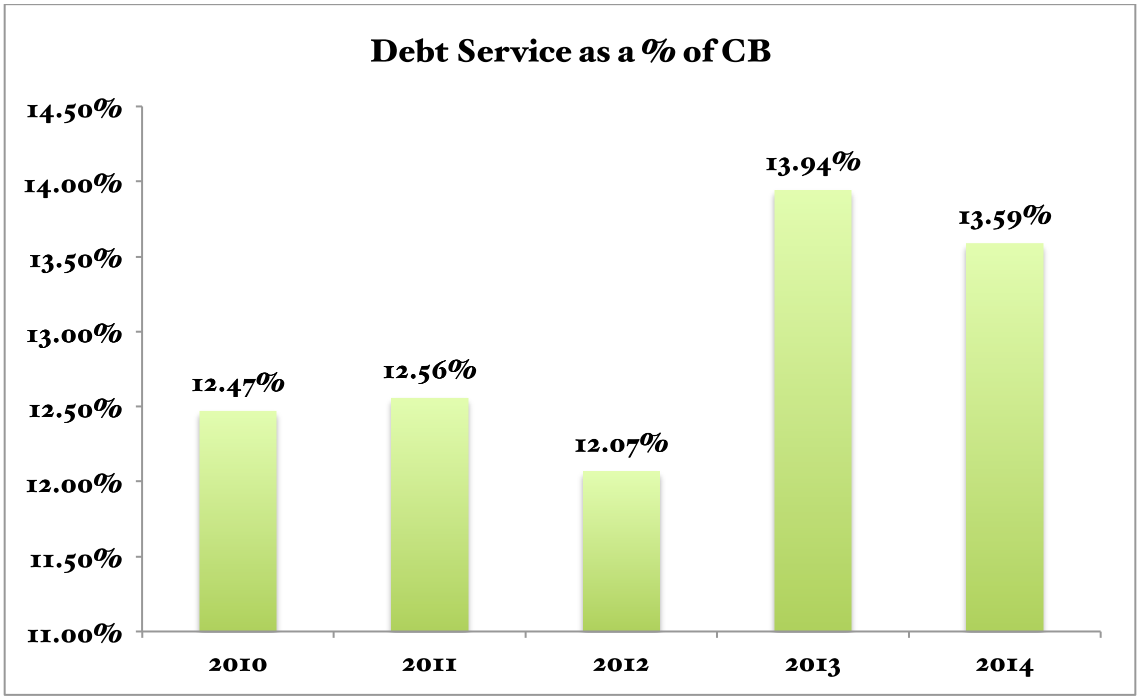
- To cover its yearly deficits the Commonwealth government has turned to using non-recurring revenues. Total non-recurring revenues included in the *consolidated budget* have decreased significantly from $4.379 billion in fiscal year 2010 to an expected $967 million for 2014, a decrease of $3.412 billion, or 77.9%.

- The *general fund* budget for fiscal year 2013-14 includes $775 million in non-recurring revenues, an amount that is $1.298 billion, or 62.6%, lower than the $2.073 billion in non-recurring revenues included in the general fund budget for the fiscal year 2012-13.

- Therefore, the proposed general fund budget reflects a significant decrease in the use of non-recurring funds in comparison with the current budget. In addition, the amount of non-recurring revenues as a portion of total general fund revenues has also decreased significantly from 20.7% in 2013 to a projected 7.4% in 2014.

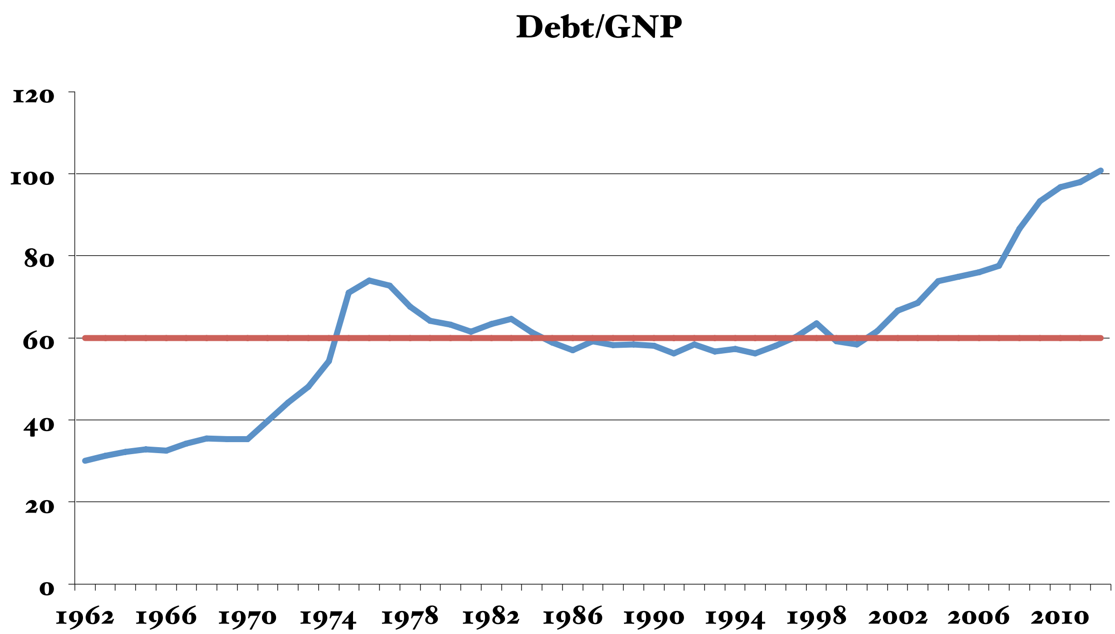
- Overall, this indicator shows a positive trend, as the reliance on non-recurring revenues appears to have decreased meaningfully, both in absolute and relative terms, in the case of both the consolidated budget and the general fund.

Debt Service



- The amount of the general fund allocated to debt service has not changed significantly during the last four fiscal years, decreasing very slightly from $662 million for fiscal year 2010 to a projected $658 million during fiscal year 2014, a decrease of $4 million, or less than 1%. This decrease is equivalent to a CAGR of negative 0.18%. In relative terms, however, the amount allocated to general fund debt service has decreased significantly from 8.64% of general fund recurring revenues in 2010 to a projected 6.8% of recurring revenues in 2014.
- This trend, however, is misleading due to the practice of excluding certain debt service obligations that are expected to be refinanced later in the fiscal year.
- With respect to consolidated budget, the amount allocated for debt service has increased from $3.645 billion in 2010 to a projected $3.943 billion in 2014, an increase of $298 million, or 8.2%. This increase is equivalent to a CAGR of 1.98%.
- In relative terms, the portion of the consolidated budget allocated to debt service has increased moderately, from 12.5% of the total consolidated budget in 2010 to a projected 13.6% in 2013. This means that almost $1 out of every $7 spent by the government of Puerto Rico is allocated for debt service.
- Relative to GNP, consolidated budget debt service has declined slightly, decreasing from 5.6% of GNP in 2010 to 5.2% in 2014.

Public Debt



- The Commonwealth's total public indebtedness increased from $62.206 billion in 2010 to $69.948 billion in 2012, an increase of $7.742 billion, or 12.4%.

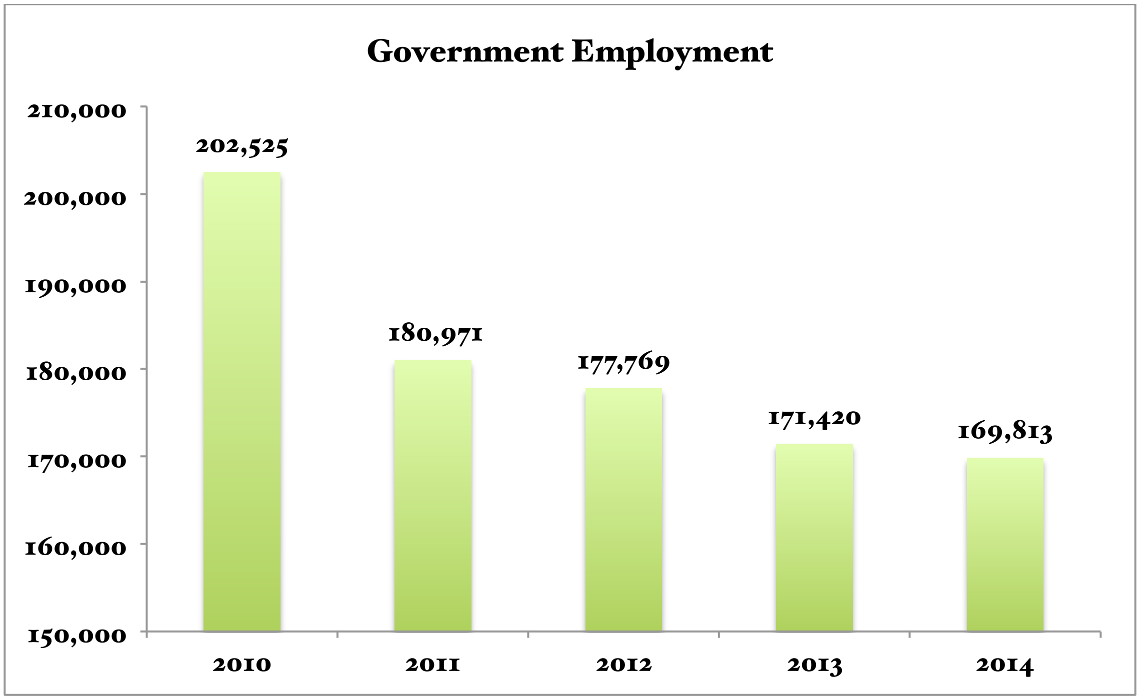
- During that same period, Puerto Rico's GNP, at current prices, increased from $64.294 billion to $69.461 billion, an increase of $5.167 billion, or 8.0%.

- Relative to GNP, Puerto Rico's total public debt increased from 96.8% of GNP in 2010 to 100.7% in 2013. The red line in the graph above shows the 59.96% historical average Debt/GNP ratio for Puerto Rico during the 50-year period between 1962 and 2012.

- On a per capita basis, total public debt per capita in 2012 amounted to $19,074 which is equal to 117.1% of the island's per capita disposable personal income of $16,286.

- 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 income and currently hovers around 100% of the island's GNP.

Government Employment



- According to statistics published by the Office of Management and Budget as part of the Governor's budget request, the number of people employed by the Commonwealth (central government and state-owned enterprises only) has decreased significantly from 202,525 in 2010 to a projected 169,813 in 2014, a reduction of 32,712 workers, or 16.2%. This decrease is equivalent to a CAGR of negative 4.31%.
- In relative terms, the number of central government employees per 100 inhabitants has also shown a reduction, from 5.44 government workers per 100 people in 2010 to a projected 4.7 government workers per 100 people in 2014.
- Contrary to popular belief, if we compare Puerto Rico's rate of state government employees (including public school teachers) per 100 inhabitants with the United States, we find that Puerto Rico has a slightly lower ratio of government workers to population. According to the U.S. Census Bureau, in 2011 there were 16,358,439 full time equivalent state and local government employees in the United States out of a total population of 311,587,816. This amounts to 5.25 state and local workers per 100 people.

Short and Medium-Term Risks

While Puerto Rico appears to have stabilized its fiscal situation, as demonstrated by the trends reflected in several of the budget indicators we have reviewed previously, it is also true that the Commonwealth still faces a challenging fiscal and economic environment and there are several risks that need to be monitored in the short and medium-term.

Proposed Tax Changes Increase the Complexity of the System – The proposed budget requires making substantial changes to the Puerto Rico tax system. The proposed changes will significantly increase the complexity of Puerto Rico's already Byzantine tax system. In our view, the additional layers of complexity will make both compliance with and enforcement of tax obligations more difficult.

First, the proposed changes to the SUT include taxing certain business-to-business services that are currently exempt. The government expects to generate approximately $883 million from these changes to the existing SUT system, an amount equal to 84% of the expected revenue increase of $1.055 billion. The proposed changes, if enacted, would in effect create a sort of hybrid between a traditional sales tax and a gross receipts tax on a large portion of business-to-business sales.[3] It is not clear to us at the moment how these complicated changes would be implemented, whether merchants would be able to comply with them, and whether the Puerto Rico Treasury has the resources necessary to effectively enforce them.

Second, there has been significant debate about the effects to the real economy of implementing the proposed changes to the SUT. All taxes induce distortions in the real economy. Some of those distortions are due to the efforts of economic agents to avoid, evade, or reduce the impact to the tax. These costs may include passing along the tax to the end consumer, thus increasing inflation; developing complicated tax strategies to legally avoid the tax; and outright fraud. In addition, all taxes generate a deadweight loss, which is defined as a loss of consumer surplus that is not matched by a corresponding producer, or in this case, seller surplus. In the absence of redistributive transfers, the inefficiency caused by any tax can be calculated by measuring the resulting deadweight loss.[4]

In the case of the business-to-business tax proposal, the estimates of the economic distortions and inefficiencies resulting from the corresponding deadweight loss range from the minimal and marginal to the calamitous and catastrophic. In most cases the arguments for these calculations are based on nothing more than a long string of non-sequiturs, uncorroborated assumptions, and unsubstantiated premises. The fact is the economic effect of the new tax will depend on the demand and supply elasticity of the services provided by each business sector affected by the new tax. It is, therefore, very difficult to make general statements about these effects with significant accuracy.

In addition, the Puerto Rico legislature has begun tinkering with the Governor's proposal. So far, most of the proposals debated in the legislature can be described as logically incoherent in the best case, and as bordering on economic illiteracy in the worst. We fear that the end product of the legislative process may be an incoherent

[3] Robert Cline, Andrew Phillips, and Tom Neubig, Ernst & Young, *Adverse Effects From Existing and Proposed Sales Taxation of Business Investment and Services*, April 4, 2013, p. 3.
[4] Louis Kaplow, *The Theory of Taxation and Public Economics*, (Princeton University Press: Princeton, 2008), p. 39.

jumble of new taxes and exemptions that will significantly increase the complexity of the system, complicate both compliance and enforcement efforts, and fail to generate the expected revenues. In that event, a further GO downgrade would be almost inevitable.

On the positive side, the proposed tax changes will temporarily limit the applicability of certain tax credits. The government of Puerto Rico currently grants dozens of tax credits, deductions, and exemptions that probably cost billions of dollars in foregone revenues but generate little or no real economic activity. These tax expenditures, mostly corporate welfare, constitute a massive transfer of wealth (economic rents) from all taxpayers to a relatively small group of well-organized and politically influential corporations and individuals. CNE has advocated in the past in favor of quantifying and publishing on an annual basis the cost and benefits, if any, associated with each one of these tax expenditures.

Furthermore, we agree with Michael Spence, recipient of the Nobel Prize in Economics, when he states that if a business needs a tax incentive or subsidy to make it viable over the long-term, "then the original investment should be viewed as a mistake and the activity allowed to go away".[5]

In Puerto Rico, subsidies and tax incentives have been used to compensate for other structural deficiencies that limit economic growth. For example, recently enacted "pro-jobs" legislation includes a tax credit for new businesses that will allow beneficiaries, in essence, to reduce their electric energy bill. This credit, while probably helpful to the owner of the newly created business, does nothing to fix the underlying problem, which is that electricity in Puerto Rico is just simply too expensive. Furthermore, the energy credit, while perhaps well intentioned, creates a dis-incentive for change, as it lessens consumer pressure on the government to effectively address and fix the underlying structural problem.

In sum, the elimination of all these unproductive tax expenditures would simplify the tax system (facilitating both compliance and enforcement), reduce the economic distortions associated with rent-seeking behavior, and generate a substantial increase in tax revenues.

Federal Funds – As we have seen, the consolidated budget for fiscal year 2014 includes some $6.590 billion in federal funds, an amount equal to 22.7% of consolidated expenditures for that fiscal year. Therefore, the implementation of the Budget Control Act of 2011, which mandates significant across-the-board cuts over the next ten years in both defense and non-defense discretionary expenditures commencing in January 2013, could have a material adverse effect on the Commonwealth's public finances.

According to the Congressional Budget Office, discretionary non-defense expenditures would have to be cut approximately 8% during 2014 to comply with the requirements of the law.[6] While the law expressly exempts food stamps, Social Security, TANF, Medicaid, unemployment insurance and other social welfare programs from the mandatory cuts, Puerto Rico could still face significant reductions in federal allocations for education, housing, and highways, among other

[5] Michael Spence, *The Next Convergence: The Future of Economic Growth in a Multispeed World*, (Picador: New York, 2011), p. 77.
[6] Congressional Budget Office, *Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act*, 12 September 2011, p. 8.

important government programs. For example, the 2014 budget for the Puerto Rico Education Department includes $1.192 billion in federal funds. An 8% reduction would equal some $95.4 million, which presumably would have to be squeezed out of an already tight general fund or borrowed from the GDB.[7]

Deficit Financing Capability is Limited – According to Standard & Poor's, since 2009 Puerto Rico's tax-supported debt has increased by $10.3 billion, or 43.7%. Furthermore, "the majority of this increase ($9.2 billion) is attributable to debt issued by the Puerto Rico Sales Tax Financing Corporation (COFINA), whose corporate purpose was to fund the identified accumulated deficits through fiscal 2012. Under its current legal framework, COFINA no longer has authority to issue additional debt. We anticipate that future budget-balancing measures will rely on a combination of restructuring of existing GO and appropriation debt, and one-time revenue measures."[8]

In our view, the expiration of COFINA's authority to issue additional debt together with the phase-out of federal stimulus spending under the American Recovery and Reconstruction Act will severely limit the flexibility of the Commonwealth's financial managers to fund any unexpected expenditures or cover unforeseen contingencies in the short term.

At least some analysts believe that Puerto Rico's market access is already significantly constrained. For example, while the Commonwealth was able to "sell $333 million of junior lien Puerto Rico Sales Tax Financing Corporation bond anticipation notes (BANs) at the end of April…the transaction was privately placed, matures in a short 16 months (perpetuating the trend of refinancing risk), and came in at a relatively high price. The short-term note yields 1.95%, a full 172bps over the AAA general market benchmark at issue and about 86bps over similarly rated issuers at the time."[9] Therefore, it appears that market access, at reasonable yields, for Puerto Rico issuers is significantly limited.

GDB's Balance Sheet – The GDB is another important source of liquidity and market access for the Commonwealth. Loans to the Commonwealth of Puerto Rico and its agencies and instrumentalities amounted to approximately $5.7 billion or 36% of the Bank's total assets as of June 30, 2012. These loans are expected to be collected from appropriations from, proceeds from bond issuances of, or revenues generated by the Commonwealth of Puerto Rico and/or its agencies and instrumentalities.

According to the GDB's external auditors, Deloitte & Touche LLP, "the collectability of these loans may be affected by budgetary constraints, the fiscal situation and the credit ratings of the Commonwealth of Puerto Rico and its agencies and instrumentalities, and their ability to generate sufficient funds from taxes, charges and/or bond issuances. Continuance of and/or significant negative changes in these factors may affect the ability of the Commonwealth and agencies and instrumentalities to repay their outstanding loan balances with the Bank and,

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[7] In addition, Republicans have tried to enact legislation in the House to significantly cut Medicaid funding to Puerto Rico. See the report by the Center on Budget and Policy Priorities, *House Bill Would Cut Medicaid Funding for Puerto Rico by About $5.5 Billion Through 2019,* 25 April 2012.
[8] Standard & Poor's, *Summary Credit Profile – Puerto Rico Public Finance Corp; Puerto Rico Appropriation Bonds; Puerto Rico General Obligation Bonds,* 6 June 2012, p. 3.
[9] UBS Wealth Management Research, "Credit back in the spotlight", *Municipal Market Guide*, 22 May 2103, p. 11.

accordingly, may have an adverse impact on the Bank's financial condition, liquidity, funding sources, and results of operations."[10]

Furthermore, the GDB's president has publicly warned that the bank's equity capital could be wiped-out in the event that one or more of the state-owned entities to which it lends defaults on its obligations to the bank. In that case, the GDB would be rendered insolvent, becoming, in essence, a zombie bank. Particularly worrisome is the case of the Puerto Rico Highway and Transportation Authority (PRHTA), which owes GDB $2.2 billion. Failure by the PRHTA to honor its obligations to GDB may have a material adverse effect on GDB's financial condition, capital, and liquidity.

Even if insolvency can be avoided, a downgrade of GDB's ratings below investment grade could have a knock-on effect on all other Commonwealth credits. In that case, we can expect only COFINA and, perhaps, the Commonwealth's General Obligation bonds to remain as non-speculative investments.

While we hope that scenario can still be avoided, we recommend that the current administration undertake the analysis and formulation of a re-capitalization plan for the GDB. In general terms, the plan could consist of issuing GDB preferred shares to financial institutions in Puerto Rico. Such shares would not entail board representation or any voting rights, but would pay a preferred dividend of *5%* to *6%* of face (par) value. GDB would have the option to call all preferred shares, at par, after five years.

In our view, this type of recapitalization could generate a significant amount of emergency capital for the GDB, while providing local financial institutions with the opportunity to make a significant contribution to solving Puerto Rico's current economic problems.

Pension Reform – The Puerto Rico legislature enacted a comprehensive reform of public pensions in early April. The government expects the enacted reforms to substantially lower the Employees Retirement System's (ERS) cash deficit, from about $900 million per year to about $200 million per year. Yet several risks remain with regard to public pensions in Puerto Rico.

First, the proposed reforms hit current workers the hardest and may have an adverse effect on the retention and morale of government workers.

Second, while the proposed reforms significantly reduce the system's cash flow deficit, which should be credit positive from the point of view of bondholders, they did not address the ERS's funding ratio, which may be a credit negative from the point of view of the rating agencies.

Finally, the government still needs to undertake the reform of the Teachers Retirement System, which had an actuarial deficit in excess of $9 billion as of June 30, 2011.

Insolvent State-Owned Companies – Puerto Rico owns several large corporations, among them the Puerto Rico Aqueduct and Sewer Authority (PRASA), the Puerto Rico Electric Power Authority (PREPA), the Puerto Rico Highways and

[10] Deloitte & Touche LLP, *Independent Auditors Report*, included in the GDB's Basic Financial Statements and Required Supplementary Information as of and for the Year Ended June 30, 2012.

Transportation Authority (PRHTA), and the Puerto Rico Ports Authority. These government-owned companies have been the main driver of public infrastructure investment in Puerto Rico over the last sixty or seventy years.

In theory, these "public corporations" are supposed to be financially self-sufficient and administratively independent from the regular departments and agencies of the Commonwealth's executive branch bureaucracy. In practice, however, instead of reducing red tape, public corporations have added dozens of new bureaucratic layers to government and instead of limiting political intervention in government, public corporations have become important sources of political patronage as they provide ample employment opportunities for loyal party members and generous contracts for politically-connected suppliers.

Financial self-sufficiency has also turned out to be a chimera as many public corporations rely on the central government to help them cover their operational deficits and in some cases the central government has been obligated to assume their debt servicing obligations in order to avoid a default. In addition, most public corporations suffer from a severe lack of accountability, oversight and transparency at all levels.

The financial situation of PRASA, PREPA, PRHTA, and the Ports Authority is particularly worrisome. Each of these entities needs to be restructured. Such restructuring would entail: (1) increasing rates, tolls, or user fees; (2) gradually eliminating all subsidies from the general fund and/or the GDB; (3) reducing operating costs, including payroll—if necessary; (4) restructuring the terms and conditions of debt issued by each of these entities; and (5) reforming the corporate governance structure of each of these companies.

Weak Economic Environment – The Puerto Rico Planning Board (PRPB) released its economic forecast in late April. According to the PRPB, economic growth (change in real GNP) in Puerto Rico was an anemic 0.1% during fiscal year 2012. The preliminary forecast base scenario calls for a contraction of 0.4% during fiscal year 2013 (which ends on June 30) and for pusillanimous growth of 0.2% during fiscal year 2014. If the forecast for fiscal year 2013 were to be realized, it would mean that the Puerto Rican economy would have contracted during 7 of the first 13 years of this century (2002, 2007 – 2011, and 2013). It should be evident that a slowdown of this magnitude and duration cannot be attributed solely to cyclical fluctuations in the business cycle.

The immediate problem from a policy perspective is that Puerto Rico needs to grow its economy at the same time it stabilizes its public finances. This effort requires maintaining a delicate and difficult balance between stimulating the economy in the short-term and obtaining the ever-elusive structural fiscal balance over the medium to long-term.

In our view, this effort, while difficult, is not an impossible undertaking. In the short-term the government could and should use some of the new tax revenues included in the proposed budget to increase investment in public goods (not consumption). This effort would allow Puerto Rico to buy some time to implement the structural reforms that are needed to maintain it as an economically viable entity.

Over the medium term it is inevitable to undertake a thorough structural reform of the Puerto Rican economy. This reform entails rebalancing our economy away from consumption and towards production. To increase production it is necessary, in turn, to increase both public and private investment in Puerto Rico. To finance growth-supporting long-term investments, domestic private consumption has to shrink. This requires making savings more attractive relative to consumption. This can be done through (1) new taxes on consumption; (2) better incentives for saving; or (3) a combination of both.

On the other hand, the composition of government expenditures, investments, and revenues must be addressed. Government consumption of goods and services needs to be reduced and government investment, especially in education, infrastructure, and technology needs to increase.

We understand that these policy decisions are controversial and difficult to implement. Yet, our policymakers need to understand that while the short-term costs of structural reform may be high, Puerto Rico's long-term economic growth and prosperity depend on shifting the structural characteristics of the island's economy.

Institutional Exhaustion – Puerto Rico's modern economic and political institutions came into being during the immediate post-WWII era. It is perhaps quite difficult for people living in 2012 to imagine the state of the world at the end of Second World War. Europe was shattered, full of ruins from the coast of Normandy all the way to the outskirts of Moscow; Britain was exhausted after six years of war; Germany was literally split in four parts; France was still traumatized by the shame of Nazi occupation and the guilt of those who collaborated with it; Japan had just witnessed the nuclear obliteration of two of its most important commercial and industrial cities; China was in the midst of a civil war; and India was still part of the British Empire. There was little trade, almost no international investment, transnational capital flows had slowed down to a trickle, and migration consisted of refugees displaced by the war, returning POWs, and people escaping from the Soviet army in Eastern Europe. It is safe to say that globalization was then at a low point.

Yet, this was the global context that shaped the thinking of a group of relatively young technocrats who set out to modernize Puerto Rico in the 1940s. Back then, Puerto Rico was a small agricultural economy with a large labor surplus, little or no local capital and an undeveloped local market. The basic idea was to exploit Puerto Rico's advantages in a de-globalized world, namely, the ability to use the dollar as its currency, its cheap labor, its privileged duty-free access to the U.S. market, and its political stability to attract U.S. capital, match it with the excess pool of local labor, and export the resulting products to the United States, and, to a lesser extent, the rest of the world.

By most accounts this model, with some later re-tooling, was relatively successful in jumpstarting the Puerto Rican economy and economic growth rates jumped between 1948 and 1974. However, during the mid-1970s economic growth stopped in part because it was not based on the institutions or structures necessary to sustain it over the long-term. Furthermore, when economic growth collapsed in 1974, the Puerto Rican government, instead of rethinking this model and restructuring the productive basis of the economy, simply put it on life support: obtaining a new federal tax exemption for U.S. firms operating in Puerto Rico (Section 936), increasing government employment, seeking ever-larger increases in federal transfers (food stamps, among others), and issuing public debt in ever larger amounts.

During the first decade of the 21st century it has become evident that Puerto Rico's economic model has collapsed. Section 936 has been phased-out by the federal government; government employment has increased to its upper limits; federal transfers are contingent on the economic and political dynamic in Washington DC—and thus cannot be the basis of future growth—and public indebtedness is currently at historic highs and unlikely to be a significant source of financing for long-term investment in the island.

The fundamental problem is that the world has changed in significant ways since 1945 and Puerto Rico has failed to adapt to this new environment. Today the European Union is an economic giant (admittedly with serious financial problems); Japan and Germany are two of the world's leading exporters and technological innovators; China and India are important players in the world economy, becoming manufacturing powerhouses while adding close to two billion workers to the world's labor supply; and, on this side of the globe, Brazil, Mexico, Chile, and to a lesser extent Argentina, have overcome decades of economic mismanagement to emerge as significant regional economic powers.

Furthermore, those advantages that were specific or particular to Puerto Rico in 1945 have either disappeared, in the case of cheap labor, or ceased to be unique to Puerto Rico, in the case of the dollar, privileged access to U.S. market, and political stability. At the same time, we are at another high point in the globalization cycle and international trade, investment, and financial flows, as well as migratory movements, have exploded. The pressing challenge is to think about how Puerto Rico can insert itself in these global flows. Yet, policymakers in Puerto Rico remain either oblivious to, or willfully ignorant of, this new reality.

Demographic Pressures – Puerto Rico lost 2% of its population between 2000 and 2010, joining Michigan as the only other U.S. jurisdiction to experience such a loss between the decennial censuses. Demographers point to two separate yet mutually reinforcing trends to explain this reduction. First, the Puerto Rican fertility rate has declined to about 1.7 children per woman of child bearing age, a rate that is lower than the 2.1 replacement rate demographers have estimated is required to maintain a stable population.[11] Second, migration, mostly to the U. S., increased significantly during the last decade.

These demographic trends mean that there will be less people working in the future, and therefore, there will be less people contributing to pay off the debts incurred by the Commonwealth with bondholders and pensioners. The unavoidable conclusion is that if the population is decreasing while public debts and obligations continue to increase, then the burden of those obligations will weigh more every day on each taxpayer. It would not be surprising if this situation ends up generating a serious taxpayer backlash over the medium term.

Conclusion

Puerto Rico still faces a challenging fiscal and economic situation over the short to medium-term. On the fiscal front, structural balance remains elusive. The unavoidable fact is that running the Puerto Rico government, and providing the public services the Puerto Rican people have come to expect, costs in excess of $10 billion per year, while annual recurrent general fund revenues do quite not reach $8.5 billion.

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[11] Consequently, Puerto Rico's population is not only decreasing but also aging rapidly with the median age increasing from 28.5 years in 1990 to 36.9 years in 2010.

Furthermore, the recent plunge in general fund revenues, generated mostly by the significant decline in economic activity during the last quarter of 2012, has forced the incoming administration to implement a significant tax increase in the middle of yet another recessionary episode.

In this environment of high debt and low growth, Commonwealth financial managers will be hard-pressed to balance intense competing pressures on the general fund to (1) make up any lost federal funding, (2) subsidize financially struggling public corporations, (3) keep the public pension systems afloat, (4) honor all of the Commonwealth's financial obligations, and (5) finance all the health, education, and public safety services that the Puerto Rican people expect from their government.
Given the Commonwealth's limited financial flexibility and the reduction in the degrees of freedom to manage contingencies, it should not be surprising then that UBS Wealth Management Research "believes the probability that one or more rating agencies will revise the GO rating downward before the end of the year has increased.[12]

On the economic side, Puerto Rico may have reached the limits of sustainable economic growth within its current institutional framework. Adverse demographic changes, the relative shortage of both public and private investment, increased dependency on federal transfers, excessive consumption, ubiquitous rent-seeking behavior, and high levels of public and private indebtedness have combined to limit the growth potential of the Puerto Rican economy. Real growth rates in the 0 to 1% range are not sufficient to significantly increase employment, sustain income growth, and create wealth over the long-term.

In addition, international trends and events, such as the end of the Cold War; the concurrent decline of Puerto Rico's value as a geostrategic asset to the United States; the accession of Mexico to NAFTA and thus to a common market with Canada and the United States; the creation of other trading blocs in the hemisphere, such as CAFTA-DR; the execution of bilateral trade agreements between the U.S. and other nations in Central and South America; the opening up and increasing importance of China and India; the intensification of climate change and other environmental risks; changes in U.S. policies due to significant fiscal constraints; and the amplification of trade, financial, and people flows characteristic of peaks in the globalization cycle, all indicate that Puerto Rico needs to radically rethink its economic and political institutions in order to successfully compete in this changed environment.

In sum, it has become imperative to undertake a thorough structural reform of the Puerto Rican political economy.

[12] UBS Wealth Management Research, "Credit back in the spotlight", *Municipal Market Guide*, 22 May 2103, p. 15.