FISCAL SITUATION UPDATE

CNE 15
Fiscal Year 2014-2015 Budget
Volume VIII, No.1
June 2014

Final Version

Analysis of the Governor's Budget Request for Fiscal Year 2015

Sergio M. Marxuach
Policy Director
Center for a New Economy
San Juan, PR
June 2014

Ad Majorem Dei Gloriam

Is man a predator of man? Does the fear of this predator slumber within us? An anxiety, formerly concealed by a poorly applied varnish of civilization, about a state of nature that is re-emerging?...Consider that dance of wolves, the ferocious ballet of battered predators sniffing at each other, detecting the scent of death on their neighbors, coveting their remains...The scent of execution and of collective suicide has been circulating in the middle of the pack.

It is as though we have been watching a deadly dance around a fire…And the result has been, for all of us, a suspended apocalypse, in which it is easy to lay out the implacable chain of consequences, but also a situation in which no one knows how to defuse the mechanism…

How should we react if electrical and gas utilities default on payment to their employees? What will happen when an angry mob of ruined savers, mainstream borrowers harassed by those who pressured them to go into debt in the first place, and the desperate and unemployed erupt in protest and--according to a scenario that we in France know too well--shout their rage beneath the windows of the speculators, loan sharks and others with golden parachutes?

—Bernard-Henri Levy, "A Suspended Apocalypse",
The New Republic, October 27, 2008

Introduction

This Fiscal Update Report prepared by the Center for the New Economy ("CNE") presents our independent analysis of the proposals contained in the Governor's budget request for fiscal year 2015. The analysis set forth below is based on CNE's own independent 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 2014, which ends on June 30, as well as an update of ten budget indicators that we have followed over the last eight years. The analysis presented in this Report is based on data available as of June 11, 2014.

Fiscal Year 2014

Revenues – General fund net revenues for the first eleven months of fiscal year 2014 (comprising the period from July 1, 2013 through May 31, 2014) amounted to $8.021 billion, approximately $613 million, or 8.3%, more than the $7.408 billion recorded for the same period during the previous fiscal year. This increase is largely due to the sizeable tax increase legislated last year.

However, general fund net revenues as of May 31, 2014 were $320 million, or 3.8%, *below* the official forecast of $8.341 billion. This revenue shortfall was due to a significant decrease in corporate tax receipts, which were $446 million, or 21.8%, below the forecast for this eleven-month period. The Secretary of the Treasury has announced an official inquiry into the causes of this shortfall, specifically the explanation behind why thousands of corporations filed requests in April to delay their tax payments for three months.

Therefore, if everything else stays the same *and* the revenue target is met for the month of June, actual general fund revenues should total $9.205 billion, some $320 million, or 3.4%, less than the original forecast of $9.525 billion.

Expenditures – On the spending side, total general fund expenditures for fiscal year 2014 were budgeted at $10.345 billion, including debt service of $575 million, which was scheduled to be refinanced during the course of the fiscal year. However, on February 3, 2014, Governor Garcia Padilla proposed legislation "to reduce fiscal year 2014 appropriations by $170 million." [1] This proposed legislation was subsequently enacted and signed into law by the Governor. Therefore, total general fund spending for fiscal year 2014, *ceteris paribus,* should be approximately $10.175 billion.

[1] Commonwealth of Puerto Rico, *Quarterly Report Dated February 18, 2014*, p. 8.

Deficit Estimate – Accordingly, we currently estimate the Commonwealth's structural deficit for fiscal year 2014 to be approximately $970 million, which is equal to the difference between revenues of $9.205 billion less expenditures of $10.175 billion.

According to the Treasury Secretary, the government plans to close this gap by implementing the following measures:

- "Utilization of a surplus of $35 million from a 2009 COFINA bond issue;
- Other measures to increase the collections that Hacienda usually executes at the closing of the year, including advancing payments to be made on or before July 15 by corporations that applied for extensions; and
- Adjustments totaling up to $370 million will be made to undisbursed special allocations; the final number will depend on the need for adjustments. The number includes, adjustments to the repayment of about $250 million to the Government Development Bank ("GDB") from lines of credit payable from legislative allocations; payment of the remaining undisbursed $90 million from the additional uniform contribution to the Central Government Employees Retirement Systems Administration (ASR, by its Spanish acronym) and other items. The Office of Management and Budget (OMB), based on the legal power granted by our Constitution and laws in light of a resource gap, but acknowledging the importance of protecting the solvency of the GDB and ASR, will configure and negotiate the corresponding payment plans to make these contributions in installments in future fiscal years."[2]

In our opinion there is a high degree of uncertainty with respect to the ability of the Puerto Rican government to implement all these measures before the end of the fiscal year in June. Furthermore, the extent of the adverse effect of these measures on the liquidity of the GDB and the Employees Retirement System is unknown at this time. Finally, the government is counting on several non-recurring sources to close the deficit for the current fiscal year, which means that the revenue base for the next fiscal year may need to be revised on the downside by a significant amount.

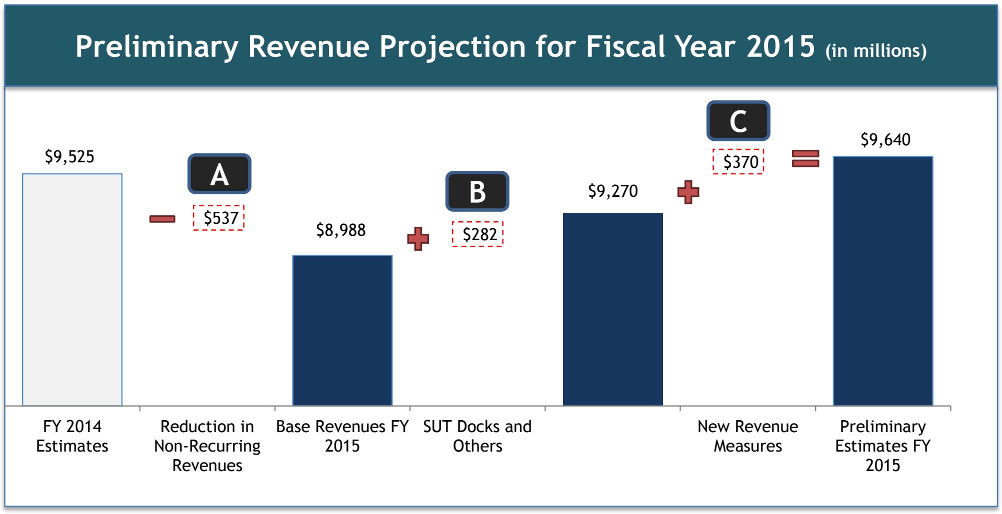
Fiscal Year 2015

Revenues – The Governor announced a general fund budget of $9.640 billion for fiscal year 2015. This amount would be $115 million, or 1.2%, higher than this year's general fund budget of $9.525 billion. However, when compared against

[2] Puerto Rico Treasury Department, "PRELIMINARY MAY 2014 COLLECTIONS UP $141 MILLION COMPARED TO PRIOR YEAR PERIOD; EXCEED ESTIMATE BY $29 MILLION *Press Release*, 10 June 2014.

actual expected revenues of $9.205 for fiscal year 2014, the proposed budget represents an increase of $435 million, or 4.7%.

The chart below summarizes the government's revenue forecast for fiscal year 2015:



A Reduction of $537 million = $300 million in corporate tax payments, $100 million increase in reserve for reimbursements, $137 million in non-resident withholdings

B Increase of $282 million = $170 million SUT Docks + $27 million increase in sales of rum subject to federal cover-over and $85 million other adjustments

C Increase of $370 million of new revenue legislative action

Source: Government Development Bank, Fiscal Year 2015 Budget Highlights

As shown in the chart above, the preliminary revenue forecast includes a reduction of the tax base in the amount of $537 million due to the elimination of non-recurring revenues, which is expected to be offset by an increase of $652 million product of new revenue measures. Among these new revenue measures, the most important are:

(1) $170 million from collecting the Sales and Use Tax ("SUT") on at the point of entry [3];

(2) $124 million from the elimination of the refundable Puerto Rico Earned Income Tax Credit; and

(3) $100 million from cutting by 50% a special bonus for low-income elderly taxpayers.

[3] On June 9, 2014, the Treasury Secretary announced that the implementation of this measure would be delayed by one month until August 1, 2014. The impact of this delay on revenue collections is unknown at this time.

We note that the government expects at least $145 million of the $170 million increase in SUT collections to be deposited into the general fund. That would represent an increase in general fund SUT revenues of 23.6%, from $614 million during fiscal year 2014 to $759 million during fiscal year 2015. In terms of the expected revenue increase, we believe the SUT revenue forecast is subject to significant downside risk, given:

(1) The historical pattern of SUT revenues;

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

(3) The limited experience of the Puerto Rico Treasury Department in enforcing what would in effect be a hybrid value added/sales tax system; and

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

In addition, the forecast includes revenue from a controversial gross receipts tax enacted last year, which has generated strong resistance from the business community and the political opposition. At this time, it appears to us that there is significant uncertainty regarding the continuation of this tax. In the event the legislature decides to eliminate it, it would have to come up with a viable, credible alternative to raise the foregone revenues or further reduce government spending.

Expenditures – The governor's budget sets general fund spending at $9.640 billion and relies mostly on "corrective measures or adjustments" in its attempt to achieve structural balance. Indeed, the governor announced during his budget speech that this would be first budget in decades that (1) will be "structurally balanced" and (2) will not rely on borrowed money to finance debt service. Unfortunately, as shown in the table below, both claims are untrue.

USE OF PROCEEDS

General

The Bonds are being issued for the purpose of: (i) repaying certain of the GDB lines of credit extended to the Commonwealth and PBA; (ii) repaying certain bond anticipation notes issued by COFINA (the "COFINA BANs"); (iii) refinancing certain of the Commonwealth's outstanding general obligation bonds (the "Refunded Bonds") as set forth below; (iv) paying, either directly or through reimbursement to the Commonwealth, termination amounts under certain interest rate exchange agreements; (v) providing for a portion of the payment of interest on the Bonds through July 1, 2016; and (vi) paying expenses related to the issuance and sale of the Bonds.

Refunded Bonds

Series of Refunded Bonds	Principal Amount or Amortization Requirement Refunded	Maturity Date (July 1)	Redemption Date
Public Improvement Refunding Bonds, Series 2003 C-5-1	$ 44,905,000	2021	March 17, 2014
Public Improvement Refunding Bonds, Series 2003 C-5-2	188,710,000	2020	April 10, 2014
Public Improvement Refunding Bond, Series 2003 C-6-1	98,695,000	2025	March 17, 2014
Public Improvement Refunding Bond, Series 2003 C-6-2	98,690,000	2025	March 17, 2014
Public Improvement Refunding Bonds, Series 2007A-2	14,915,000	2029	April 10, 2014
Public Improvement Refunding Bonds, Series 2007A-3	14,925,000	2029	March 17, 2014

The Secretary of the Treasury will deposit a portion of the net proceeds of the Bonds required to refund in full the Refunded Bonds to be redeemed after the delivery date of the Bonds and to repay in full the COFINA BANs in an escrow fund with an escrow agent to be selected by the Commonwealth. The net proceeds of the Bonds deposited in the escrow fund will be held uninvested and will be used to pay the principal and any premium of and interest on the Refunded Bonds and the COFINA BANs through their respective redemption dates.

Sources and Uses of Funds

Sources:	
Principal amount of the Bonds	$3,500,000,000
Original Issue Discount	(245,000,000)
Total Sources	$3,255,000,000
Uses:	
Repayment of GDB lines of credit and deposit to Redemption Fund	$1,896,072,196
Repayment of COFINA BANs	342,365,760
Refinancing of the Refunded Bonds*	466,574,005
Termination amounts for certain interest rate exchange agreements†	90,417,100
Payment of interest on the Bonds	422,749,408
Underwriting discount, legal, printing and other financing expenses	36,821,531
Total Uses	$3,255,000,000

* Includes capitalized fees.
† Includes fees related to the termination of the interest rate exchange agreements.

Source: Commonwealth of Puerto Rico, Official Statement, dated March 11, 2014, issued in connection with the offering of $3,500,000,000 General Obligation Bonds of 2014, Series A, p. 24.

Puerto Rico plans to use $422 million from its March 11, 2014 General Obligation bond offering to pay essentially all the interest due on those bonds during fiscal years 2014 and 2015, and a portion of the interest due during fiscal year 2016. The government makes its intentions explicit when it states in the Official Statement that:

> A portion of the proceeds from the issuance of the Bonds will be used to pay interest on the Bonds. As a result, the Commonwealth General Fund budget will include minimal appropriations for the payment of interest on the Bonds during fiscal years 2014 and 2015. Beginning in fiscal year 2016, the Commonwealth will be required to begin paying interest on the Bonds from its General Fund, which amount will be significant. There is no assurance that the Commonwealth will be able to make the

> necessary adjustments in its General Fund budget in order to be able to pay interest on the Bonds when due.[4]

Accordingly, during fiscal year 2015, the government will use $269.8 million of capitalized interest to offset the cost of the debt service due on the new bonds. In our view, the use of capitalized interest means the fiscal year 2015 budget will not be structurally balanced. In this sense we agree with analysts at Nuveen Asset Management when they state that:

> A budget that relies on bond proceeds to partially pay for debt service as it comes due, is by definition, not a structurally balanced budget. Structurally balanced budgets generally feature recurring revenue sufficient to meet recurring expenses. Therefore, by virtue of earmarking $269.8 million of bond proceeds for FY2015 debt service, Puerto Rico has already failed to deliver on its promise of a balanced budget in FY2015. A promise that, paradoxically, Puerto Rican officials were making while marketing the bonds to potential investors. This is very much in keeping with Puerto Rico's decade-long streak of promising to balance its budget but ultimately falling short of that goal.[5]

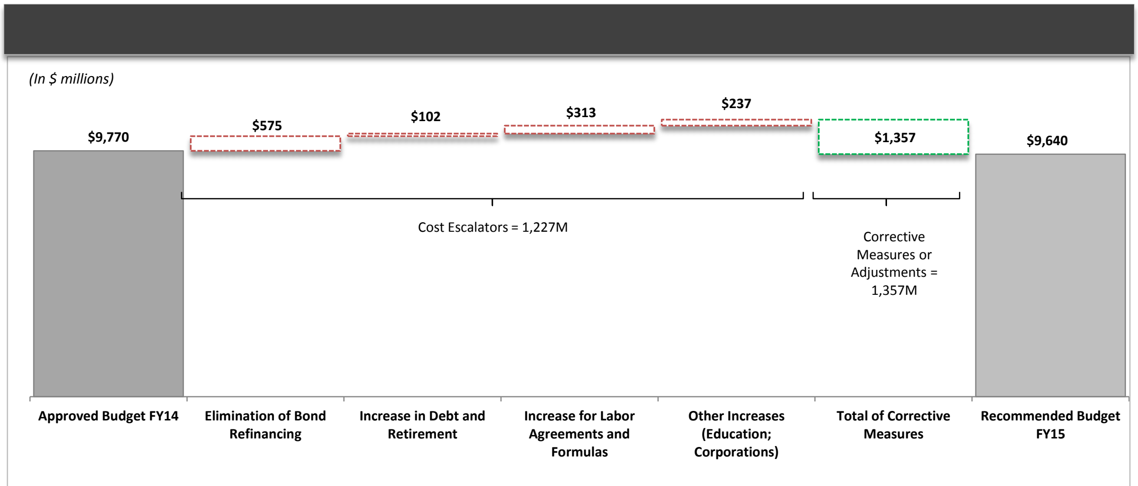
To be fair in our analysis, we should mention that the current administration has essentially doubled the amount of funds dedicated to GO debt service, from $654 million to $1.273 billion, and undertaken other efforts to achieve structural balance. Nonetheless, it is not quite true, as we have demonstrated above, that the fiscal year 2015 budget will be structurally balanced, at least as currently configured.

---

[4] Commonwealth of Puerto Rico, Official Statement, dated March 11, 2014, issued in connection with the offering of $3,500,000,000 General Obligation Bonds of 2014, Series A, p. 11.

[5] Shawn P. O'Leary and Molly Shellhorn, *Market Commentary, Puerto Rico's $3.5 billion GO Deal: Cure or Symptom*, Nuveen Asset Management, March 2014, p. 1 and 2.

CONFIGURATION OF PROPOSED BUDGET FOR FY 2015



Main components:	Elimination of Bond Refinancing	Increase in Debt and Retirement	Increase for Labor Agreements and Formulas	Other Increases (Education; Corporations)	
	• Amount refinanced in FY14	• Increase in retirement employer contribution • Higher TRANs interest • Increase in GDB debt amortization	• Increase in retirement employer contribution • Higher TRANs interest • Increase in GDB debt amortization	• "Gross up" of Dep. Ed. budget due to non-recurring origins • Operating deficit at subsidized public corporation • Pre-legislated appropriations • Others	• All numbers are OMB estimates and are provided for purposes of qualitative understanding only. • We exercise qualitative judgment as to what constitutes a cost escalator or corrective measure, and how such are quantified. • Estimates are iterative and limited by underlying reporting systems

Source: Government Development Bank, Fiscal Year 2015 Budget Highlights

In its effort to achieve that elusive structural balance the administration has presented to the legislature an exceedingly complicated budget package, consisting of some 40 different bills. As shown in the chart above, the proposed "corrective measures or adjustments" total $1.357 billion, equivalent to approximately 1.9% of Puerto Rico's GNP, in order to offset $1.227 billion of "automatic cost escalators."

The $1.357 billion in cuts and other "corrective measures" include:

(1) $542 million in cuts to the fiscal year 2014 budget, including $296 million from re-organizing public-school staff and closing 92 public schools;

(2) $364 million from "neutralizing" planned funding and salary increases, including $132 million from freezing automatic spending increases related to the funding of the University of Puerto Rico, transfers from the central government to the municipalities, and the funding of the Judiciary Branch, as well as $120 million from suspending scheduled increases in employee benefits and compensation[6];

[6] On June 9, 2014, several union leaders announced that they had reached an agreement with the Garcia Padilla administration to ameliorate the impact of some of these measures on the compensation of certain government workers. The effect of this agreement on the deficit reduction plan is unknown at this time.

(3) $184 million in savings from "efficiencies generated from establishing a lower spending base"; and

(4) $267 million in "savings" from transferring funds from other government entities that do not depend on the general fund, such as certain state-owned corporations, to cover certain central government expenses currently paid for with money from the general fund.

We believe, however, that there exists a significant amount of downside risk with regard to the implementation of these cuts. First, we expect the political opposition, especially from schoolteachers and labor unions, to be intense and the legislature to be receptive to their demands.

Second, the Puerto Rico Office of Management and Budget ("PROMB") has also admitted that some of the proposed budget cuts "require a high degree of managerial coordination, entail complex implementation processes, and are subject to a high degree of estimation risk". According to PROMB, of the $1.357 billion in budget cuts, (1) $309 million have a high implementation risk; (2) $79 million have a medium implementation risk; and (3) $969 million have a low implementation risk.

Finally, some of the proposed "savings" are questionable. For example, the $267 million in "savings" generated by transferring funds from entities that do not rely on the general fund are not really savings, they are just general fund expenditures financed by non-general fund governmental entities such as the State Workers Compensation Insurance Fund. Furthermore, what, exactly, are "efficiencies generated from having a lower spending base"? Sounds a little like fuzzy "consultant speak" to us.

Given all of the above, we assume that, at a minimum, the $309 million projected cuts that PROMB has identified as having a "high implementation risk" will not be realized. We also reiterate that the Governor's budget does not include the $269.8 million in capitalized interest that will be used to offset the cost of the debt service due on the GOs issued in March. Therefore, we estimate that real general fund spending totals approximately $10.218 billion ($9.640 billion base expenditures + $309 million of unrealized budget savings + $269.8 million of capitalized interest).

Deficit Estimate – In sum, we estimate the Commonwealth's structural deficit for fiscal year 2015 to be *at least* $578 million, which is equal to the difference between revenues of $9.640 billion less expenditures of $10.218 billion. This deficit amount would be $392 million, or 40%, less than the $970 million deficit we estimate for fiscal year 2014.

Use of Non-Recurring Revenues

As shown on Table 1 below, the general fund budget for fiscal year 2014-15 includes at least $578 million in non-recurring revenues, an amount that is $967 million, or 63%, less than the $1.545 billion in non-recurring revenues included in the general fund budget for the fiscal year 2013-14.

Table 1
Non-Recurring Revenues (General Fund)

FY 13-14	**Amount**
Deficit Financing	$970,000,000
Debt Service to be Refinanced	$575,000,000
Total non-recurring revenues	**$1,545,000,000**
General fund expenditures FY13-14	$10,175,000,000
% Non-recurring revenues	15%
FY 14-15	**Amount**
Capitalized Interest	$269,800,000
Deficit Financing	$309,000,000
Total non-recurring revenues	**$578,800,000**
General fund expenditures FY14-15	$10,218,000,000
% Non-recurring revenues	5.7%

Source: CNE analysis

The amount of non-recurring revenues as a portion of total *general fund* expenditures is expected to decrease significantly from 15% in fiscal year 2014, or roughly 1 out of every $6 spent from the general fund, to 5.7% during fiscal year 2015, or roughly 1 out of every $17 spent.

The *consolidated budget* for fiscal year 2015 also includes another $189.6 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 $768 million, an amount that is $1.002 billion, or 56%, less than the $1.770 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.

With respect to the use of ARRA funds we believe it is important to highlight that in the Commonwealth's Quarterly Report dated February 18, 2014, it included the following disclosure that has not been given much notice locally:

> As part of the American Recovery and Reinvestment Act of 2009 ("ARRA"), in 2009 the United States Congress adopted the Making Work Pay Credit ("MWPC") to provide refundable tax credits of up to $400 (or $800 if joint filers) to working individuals for taxable years 2009 and 2010. In order to provide the tax credit to residents of Puerto Rico, the United States Treasury paid the Puerto Rico Treasury Department approximately $1.2 billion. The Commonwealth was to return the balance of ARRA funds not spent as of December 31, 2013. As of December 31, 2013, the balance owed to the United States Treasury was $349 million, including $300 million that was not spent on MWPC and $49 million in overpayments made to certain taxpayers. The Commonwealth has reached an agreement with the United States Treasury to return the fund balance of $300 million in monthly installments of $25 million beginning on February 3, 2014 until the balance has been repaid. Thereafter, the Commonwealth will make two additional monthly payments of $25 million and $24 million, respectively, to cover the MWPC related overpayments. These funds, which are currently on deposit with GDB, constitute a portion of GDB's current funding sources. The withdrawal of these funds as provided or at a faster rate may have a negative effect on GDB's liquidity position.[7]

In our opinion, the fact that the Commonwealth had to return $349 million of stimulus funds *granted* by the federal government speaks volumes about the dismal state of the management of its finances.

[7] Commonwealth of Puerto Rico, *Quarterly Report Dated February 18, 2014*, p. 17.

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%	57.85	7.63%	74.56%
2007	46.18	7.06%	60.64	4.82%	76.16%
2008	53.39	15.61%	62.70	3.40%	85.15%
2009	58.42	9.41%	63.62	1.46%	91.82%
2010	62.21	6.49%	64.29	1.06%	96.75%
2011	64.28	3.33%	65.72	2.22%	97.81%
2012	69.95	8.82%	68.70	4.53%	101.82%
2013	70.04	0.14%	70.74	2.97%	99.01%
2014*	72.80	3.93%	72.82	2.94%	99.97%
CAGR	8.19%		4.11%		

Source: GDB, PRPB, and CNE Analysis
**Debt data for FY2014 is as of March 2014*

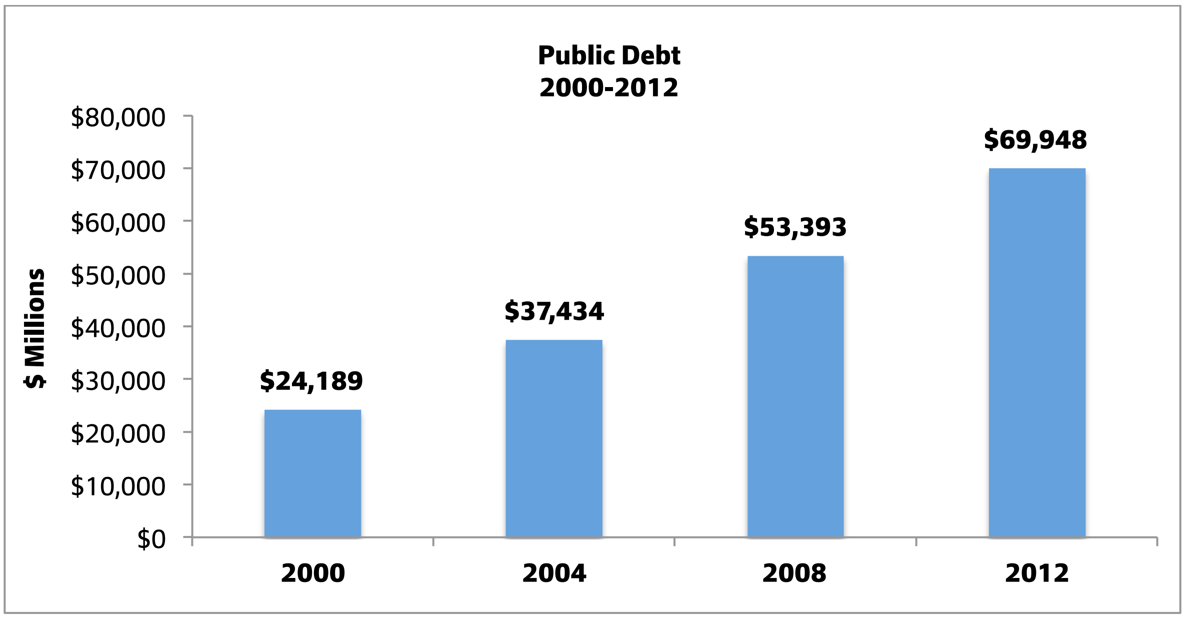
Unsustainable Debt Dynamics – Since fiscal year 2000, Puerto Rico's total public debt has exploded both in absolute terms and relative to the size of the Puerto Rican economy. At the end of fiscal year 2000 total Puerto Rico public debt amounted to approximately $24.2 billion, while as of March 2014 it amounted to $72.8 billion, an aggregate increase of $48.6 billion, or 200.8%. During this period public indebtedness increased at a compound annual growth rate of 8.2%.

Meanwhile, Puerto Rico's Gross National Product (GNP), at current prices, increased from $41.4 billion in 2000 to an expected $72.8 billion at the end of fiscal year 2014, an aggregate increase of $31.4 billion, or 75.8%.[8] During this period Puerto Rico's nominal GNP increased at a compound annual growth rate of 4.1%.

[8] 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.

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

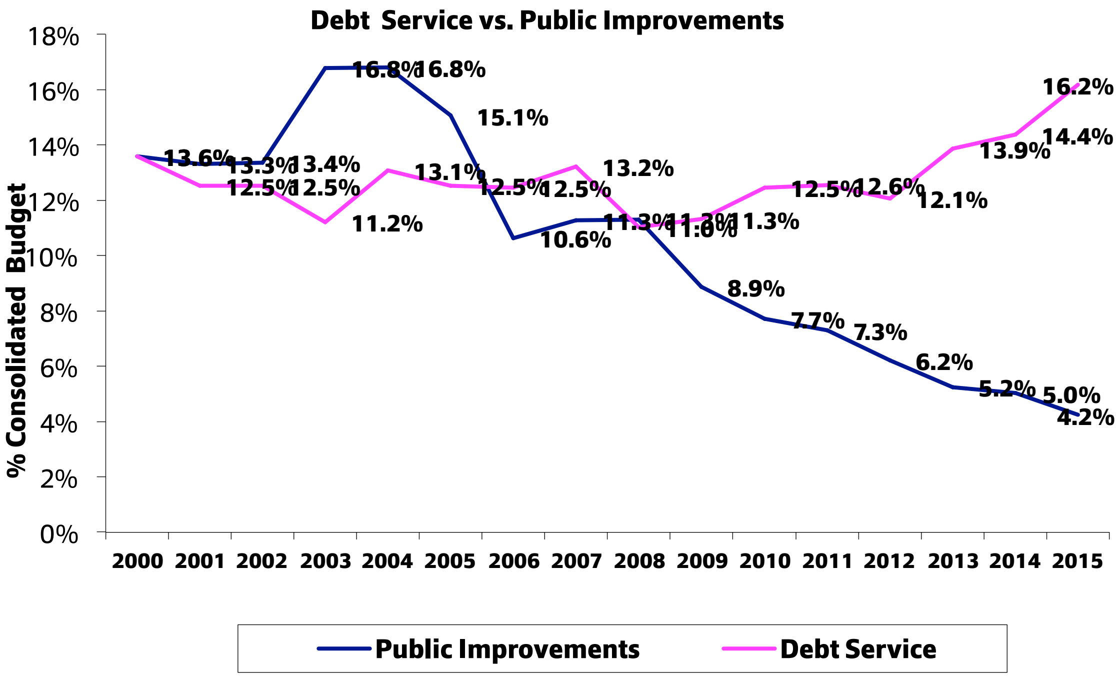
As shown on the chart below, Puerto Rico's public debt almost tripled during the period between 2000 and 2012. Each of the last three administrations added an *average* of $15 billion to Puerto Rico's public debt. It is highly unlikely, however, that the Garcia Padilla administration will be able to repeat that feat. Nonetheless, the consolidated budget for fiscal year 2015 includes $1.072 billion from "loans and bond offerings", which presumably will be used to finance public works in the amount of $1.190 billion.



Source: GDB and CNE Analysis

Furthermore, if we compare the share of the consolidated budget set aside for debt service with the share dedicated for public improvements, as shown on the chart below, it is evident that most of that indebtedness incurred since 2006 has been dedicated to finance deficits and other current expenses instead of public improvements. Indeed, 16% of the consolidated budget for fiscal year 2015 is dedicated to debt service while only a meager 4.2% is assigned for public improvements or investment.

Collins in *The Economy of Puerto Rico: Restoring Growth*, (Brookings Institution Press: Washington, DC, 2006), p. 17-81.



Source: PROMB and CNE Analysis

We at CNE have been warning for years that, in our view, Puerto Rico's levels and rates of indebtedness were not sustainable. In February of this year the three principal rating agencies agreed by downgrading the Commonwealth's debt, as well as debt issued by several of its agencies and instrumentalities, to speculative or non-investment grade.

To understand the reasons underlying the downgrade we need to analyze Puerto Rico's debt dynamics. According to Drelichman and Voth, who use the IMF framework to analyze debt sustainability, "the basic idea is that debts will be serviceable as long as the growth rate of debt does not exceed the growth rate of output. This requires a primary surplus—keeping expenditure (net of the cost of debt service) below revenue. Thus, revenue growth combined with cheap borrowing can lead to a favorable outcome even if debts continue to increase."[9]

In mathematical terms, they express the relationship as follows:

$$\Delta d_t = pd_t + \frac{(r_t - g_t)}{(1+g_t)} d_{t-1}$$

[9] Mauricio Drelichman and Hans-Joachim Voth, *Lending to the Borrower from Hell: Debt, Taxes, and Default in the Age of Philip II*, (Princeton University Press: Princeton, 2014), p. 120.

where Δd is the change in the debt as a percentage of GDP, r is the (nominal) rate of interest, g is the growth rate of GDP, and pd is the primary deficit as a percentage of GDP. In essence, "the increase in the debt to income ratio equals the current period primary deficit plus the interest on previous period debt, adjusted by the growth rate of the economy."[10]

The problem is that the growth rate of Puerto Rico's debt between 2000 and 2014 has been twice the growth rate of its output. 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, both in absolute terms and as a percentage of GNP, 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 categorically unsustainable 99.9% in 2014. Furthermore, relative to GNP, consolidated budget debt service has increased significantly, from 5.3% of GNP in 2011 to 6.1% in 2015.

Reversing this trend will require:

(1) Not merely "balancing" the budget, but actually running a primary budget surplus—that is, keeping expenditures (net of the cost of debt service) below revenues—on a regular basis for many years into the future; and

(2) Puerto Rico's GNP to grow at a nominal rate that consistently exceeds the interest rate on Puerto Rico's debt.

The probabilities of Puerto Rico actually achieving these two objectives in the near future are decidedly low, not to say asymptotically approaching zero. Puerto Rican policymakers, however, have been extremely reluctant to even mention the possibility of restructuring its debt, including that of some state-owned enterprises, which as we explain later on, are essentially insolvent.

This official unwillingness is consistent with the findings of a recently published paper by the Committee on International Economic Policy and Reform, when it states that: "There is evidence that policymakers are often reluctant to restructure their debts and suboptimally postpone unavoidable defaults." The problem is that:

> Delayed defaults can lead to the destruction of value because a prolonged predefault crisis may reduce a country's capacity and willingness to pay. Its capacity to pay is reduced because procrastination prolongs the climate of uncertainty, high interest

[10] Id.

> rates and restrictive fiscal policies that are ineffective in avoiding default but amplify output contractions. Delayed defaults reduce its willingness to pay because electors that have suffered long periods of economic austerity are less likely to support a creditor-friendly debt restructuring.[11]

Although Puerto Rico is not a "sovereign" borrower in the classical sense, it does appears to us that it exhibits some of the pre-default dynamics described by the Committee on International Economic Policy and Reform, namely, elevated levels of uncertainty, high interest rates, restrictive fiscal policies that have intensified the contraction of the economy, and an electorate that has suffered from a long period of austerity policies and that may be reaching the limits of its endurance.

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.

[11] Committee on International Economic Policy and Reform, *Revisiting Sovereign Bankruptcy*, (Brookings Institution: Washington, DC, October 2013), p. 10.

Table 3

Budget Indicators 2011-2015

	Fiscal Year					
	2011	2012	2013	2014	2015	CAGR
1.Consolidated Budget (CB)	$27,870,265,000	$28,895,380,000	$28,556,838,000	$28,729,701,000	$28,126,906,000	0.23%
CB per capita	$7,559.92	$7,913.19	$7,899.35	$8,025.42	$7,934.39	
CB/GNP	42.41%	42.06%	40.37%	39.45%	37.66%	
2. Federal funds*	$6,757,457,000	$6,967,925,000	$6,290,435,000	$6,350,109,000	$6,020,410,000	-2.85%
Federal funds/CB	24.25%	24.11%	22.03%	22.10%	21.40%	
3. General Fund budget (GF)	$8,133,500,000	$8,650,000,000	$8,750,000,000	$9,525,000,000	$9,640,000,000	4.34%
GF/GNP	12.38%	12.59%	12.37%	13.08%	12.91%	
4. GF Payroll	$3,633,914,000	$3,595,934,000	$3,659,663,000	$3,701,916,000	$3,451,781,000	-1.28%
Payroll/GF	44.68%	41.57%	41.82%	38.87%	35.81%	
5. Tax revenues GF	$7,376,000,000	$8,036,000,000	$7,695,000,000	$8,970,000,000	$9,094,000,000	5.37%
Tax revenues/GF	90.69%	92.90%	87.94%	94.17%	94.34%	
Tax revenues GF/GNP	11.22%	11.70%	10.88%	12.32%	12.18%	
6. GF recurring revenues	$7,892,000,000	$8,650,000,000	$8,305,000,000	$9,205,000,000	$9,640,000,000	5.13%
GF recurring expenditures	$9,149,000,000	$10,099,000,000	$9,907,000,000	$10,175,000,000	$10,218,800,000	2.80%
GF structural deficit	($1,257,000,000)	($1,449,000,000)	($1,602,000,000)	($970,000,000)	($578,800,000)	
Structural deficit/GF	-15.45%	-16.75%	-18.31%	-10.18%	-6.00%	
7. Non-recurring funds (CB)	$2,266,171,000	$1,958,672,000	$2,310,419,000	$1,770,619,000	$768,361,000	-23.69%
Non-recurring funds/CB	8.13%	6.78%	8.09%	6.16%	2.73%	
8. Debt service GF	$578,402,000	$574,074,000	$514,070,000	$654,664,000	$1,273,725,000	21.82%
Debt service/recurring revenues GF	7.33%	6.64%	6.19%	7.11%	13.21%	
Debt service consolidated budget	$3,499,162,000	$3,486,254,000	$3,961,075,000	$4,127,917,000	$4,552,087,000	6.80%
Debt service/CB	12.56%	12.07%	13.87%	14.37%	16.18%	
Debt service per capita	$949.16	$954.73	$1,095.71	$1,153.10	$1,284.11	7.85%
Debt service CB/GNP	5.32%	5.07%	5.60%	5.67%	6.10%	
9. Total public debt**	$64,279,000,000	$69,948,000,000	$70,043,000,000	$72,796,000,000	--	
Public debt per capita	$17,435.94	$19,155.73	$19,375.20	$20,334.99	--	
GNP***	$65,720,700,000	$68,697,600,000	$70,740,300,000	$72,821,000,000	$74,684,000,000	3.25%
Total public debt/GNP	97.81%	101.82%	99.01%	99.97%	--	
10. Government employees****	180,971	177,769	175,334	164,195	164,559	-2.35%
Government employees per 100 persons	4.91	4.87	4.85	4.59	4.64	
Population*****	3,686,580	3,651,545	3,615,086	3,579,839	3,544,935	-0.97%

* Includes ARRA funds

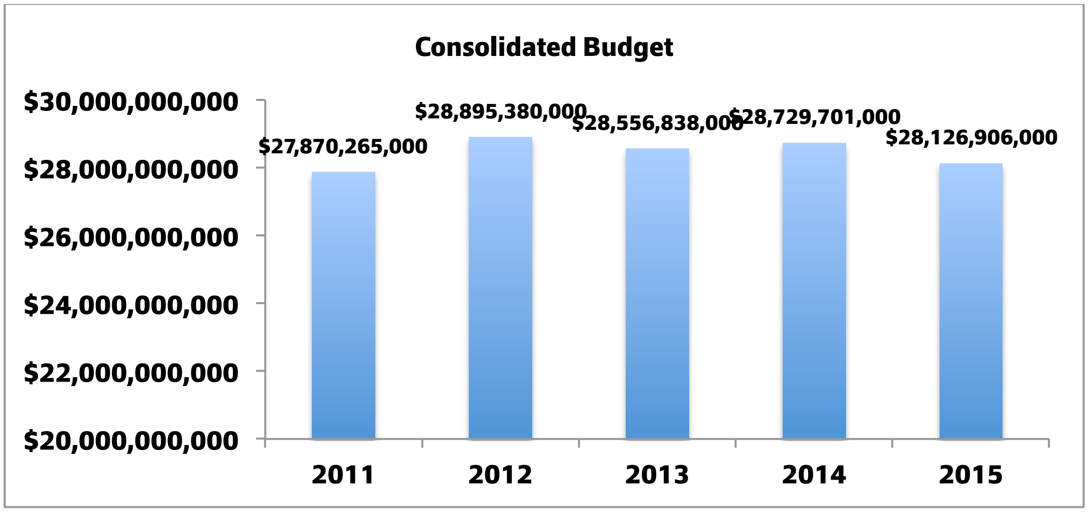
** Data is as of June 30, except for FY 2014 which is as of March 2014

*** Data for 2014 and 2015 are the official PRPB estimates

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

***** Data for 2014 and 2015 are CNE estimates

Consolidated Budget



- The Commonwealth's consolidated budget has increased from $27.870 billion in fiscal year 2011 to a projected $28.126 billion for fiscal year 2015, an increase of $256 million, or 0.9%. This increase is equivalent to a compound annual growth rate (CAGR) of 0.23% during the period between fiscal years 2011 and 2015, which is significantly lower than the 3.25% CAGR of nominal GNP during the same period.

- Relative to the consolidated budget for the current year the proposed budget for fiscal year 2015 shows a net decrease in spending of $602 million, or 2.1%. Thus, this is essentially another austere budget.

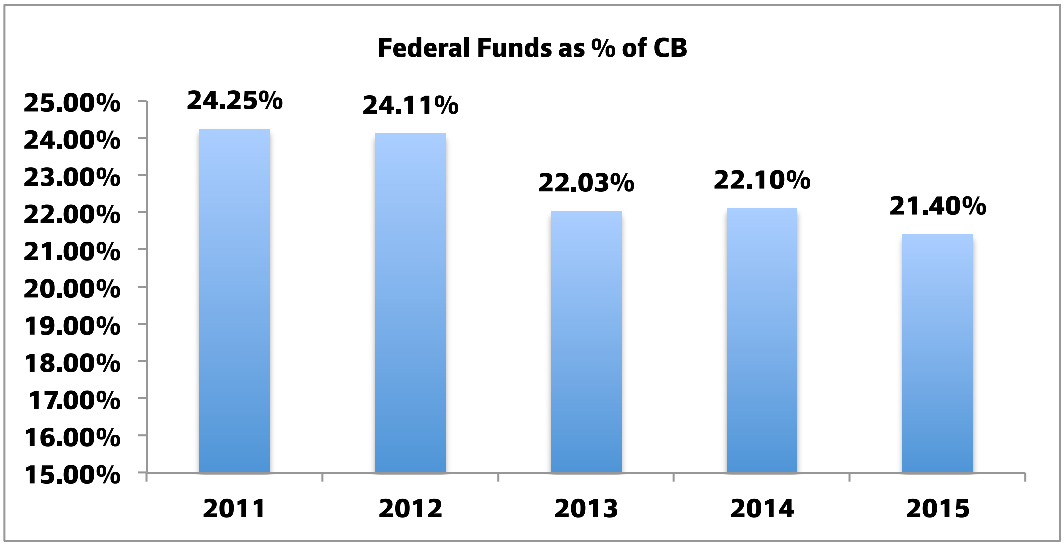
- On a per capita basis, consolidated budget expenditures show a modest increase, from $7,559 in 2011 to a projected $7,934 for fiscal year 2015. This increase, however, is driven mostly by a reduction in Puerto Rico's population instead of increasing expenditures.

- Relative to per capita personal disposable income, government expenditure remains fairly high. In 2013, per capita disposable personal income in the island was $16,776; thus, per capita government spending of $7,899 represented 47% of per capita disposable personal income. In contrast, federal expenditure per capita in the U.S. is approximately $12,031, which is equivalent to 30.2% of per capita disposable personal income of $39,782.

- Finally, consolidated budget expenditures have declined significantly relative to GNP, from 42.4% in 2011 to a projected 37.6% in 2015.

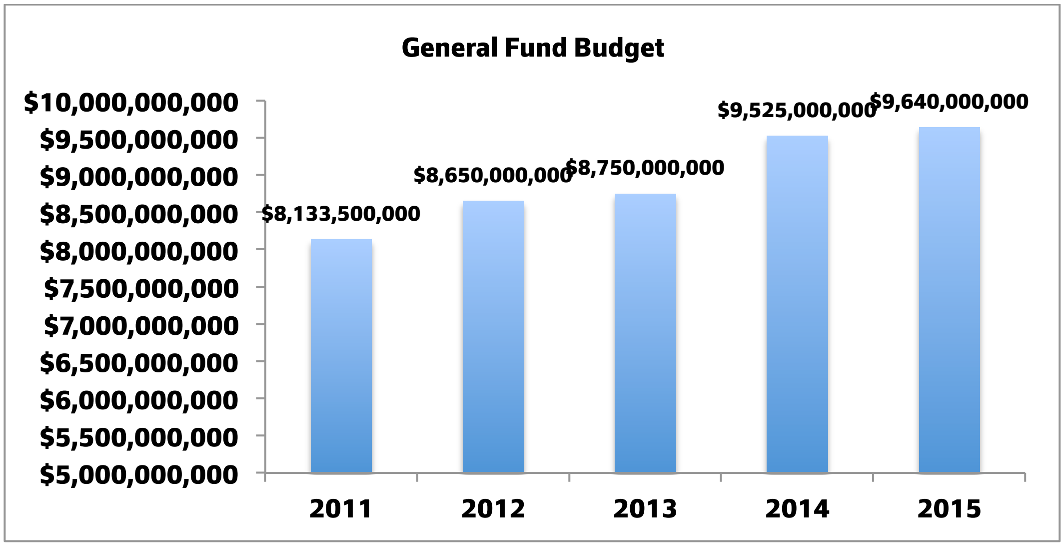
- The Puerto Rican government has achieved significant success in restraining the growth rate of government spending since 2011. Furthermore, perhaps in contrast with popular perception, in real terms government spending has decreased significantly over the last four fiscal years.

Federal Funds



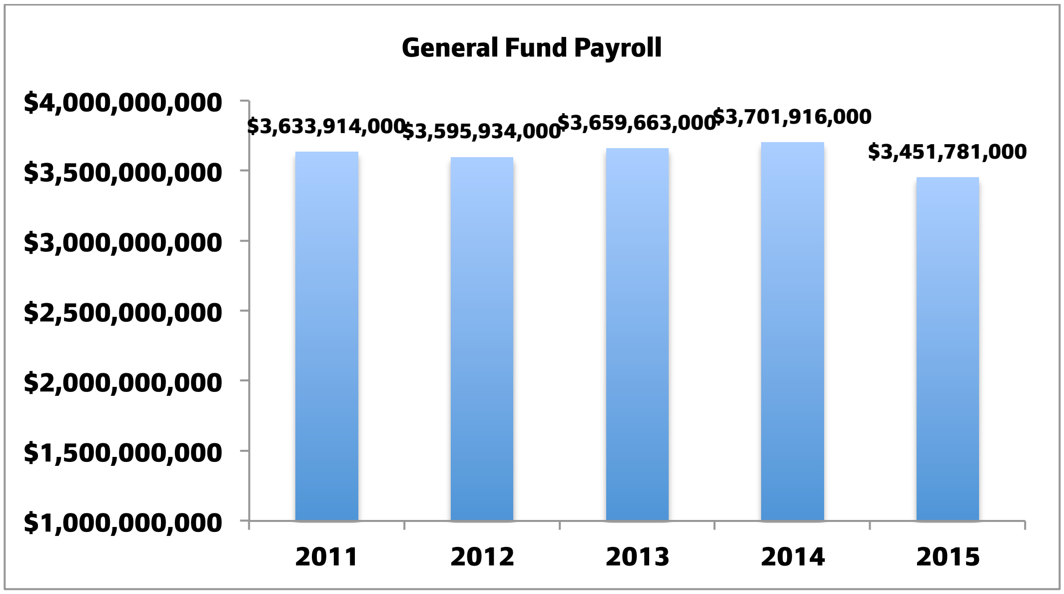
- Grants from the U.S. federal government to the various government agencies of the Commonwealth, including some remainder ARRA funds, are expected to total $6.020 billion during fiscal year 2015, a decrease of $737 million, or 10.9%, relative to the $6.757 billion received during fiscal year 2011.
- Federal funds are expected to account for 21.4% of all consolidated budget expenditures during fiscal year 2014, a proportion that is slightly lower than the 22.1% registered in 2014. 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 2011, federal grants to the government have decreased at a CAGR of 2.85%, while the rate of growth of the overall consolidated budget during the period under study was 0.23%. This decrease in the growth rate is due mostly to the phase-out of ARRA funds and certain 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



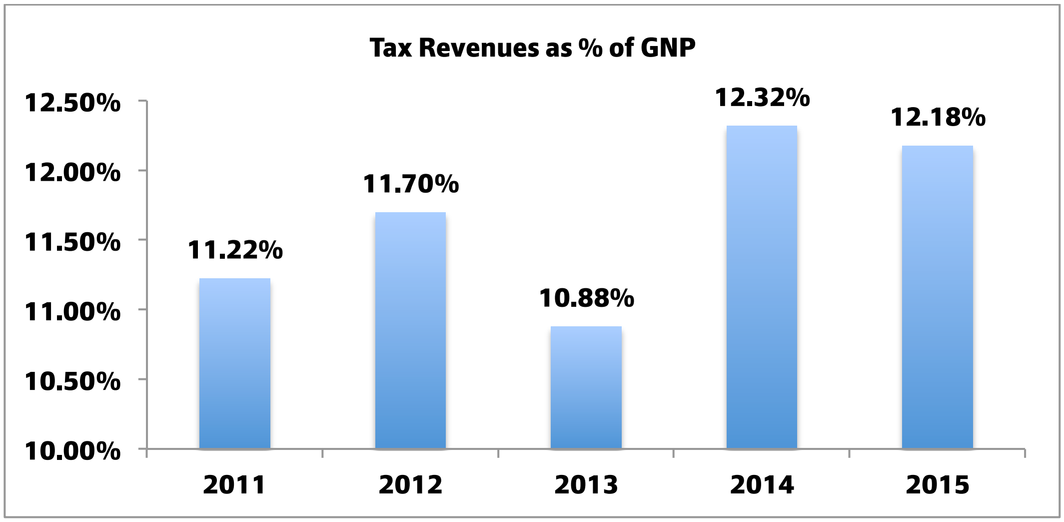
- The Commonwealth's general fund budget has increased from $8.133 billion in fiscal year 2011 to a projected $9.640 billion for fiscal year 2015, an increase of $1.507 billion, or 18.5%. This increase is equivalent to a CAGR of 4.34% for the period between fiscal years 2011 and 2015.
- However, the magnitude of this increase could be somewhat deceptive because between 2010 and 2013 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. For example, during fiscal year 2013 the general fund received $332 million from this special fund.
- Total general fund spending for the next fiscal year is estimated to be around $10.218 billion, an amount that is $43 million, or 0.42%, more than total general fund expenditures of $10.175 billion during fiscal year 2014.
- Overall, the general fund budget shows an increasing trend since 2011. 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 2011 base may be artificially low.

General Fund Payroll



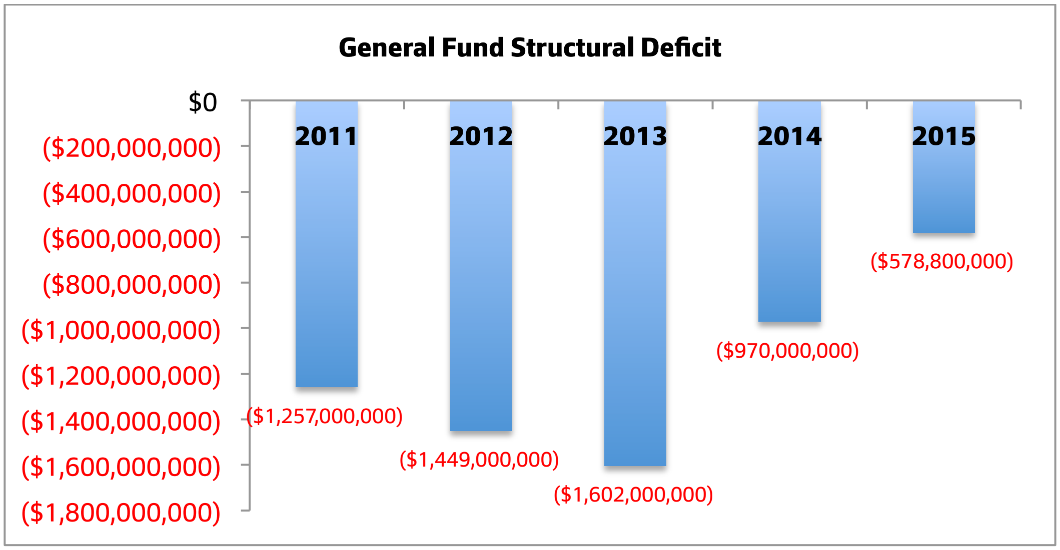
- Contrary to popular belief, the amount of the general fund allocated to payroll has decreased from $3.633 billion for fiscal year 2011 to a projected $3.451 billion during fiscal year 2015, a decrease of $182 million, or 5.0%. This decrease is equivalent to a CAGR of negative 1.28%.
- In essence, the general fund payroll in nominal terms has remained flat since fiscal year 2011 staying at around $3.5 billion per year. This means general fund payroll expenditures have declined significantly in real terms since 2011.
- In relative terms, the portion of the general fund allocated to payroll has decreased significantly from 45% in 2011 to a projected 35.8% in 2015.
- 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, without adversely affecting government services.

Tax Revenue Trend



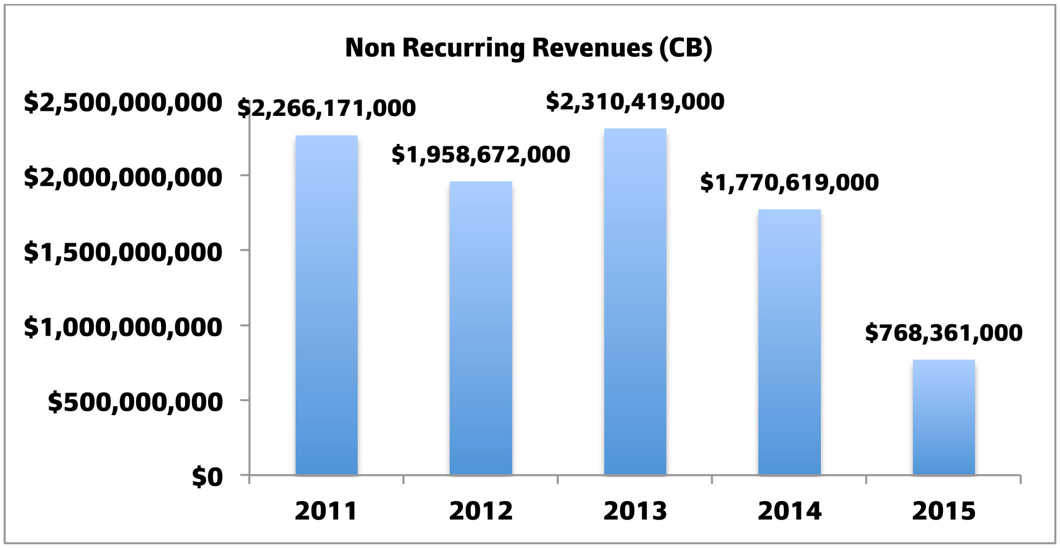
- General fund tax revenues, the principal component of the general fund, are expected to increase from $7.376 billion in fiscal year 2011 to a projected $9.094 billion during fiscal year 2015, an increase of $1.718 billion, or 23.3%. This increase is equivalent to a CAGR of 5.4%.
- In our view, the estimated year-over-year increase in sales tax revenues allocated to the general fund, from $614 million in 2014 to $759 million in 2015, some $145 million, or 23.6%, is subject to significant downside risk, and will probably be revised downward during fiscal year 2015.
- General fund tax revenues have increased relative to GNP, increasing from 11.2% in 2010 to a projected 12.2 % during fiscal year 2015. To put this data in perspective, total federal tax receipts in the U.S. currently amount to approximately 16% of GDP.
- In sum, tax revenues in Puerto Rico remain low in Puerto Rico relative to GNP. This is due in fact to (1) a plethora of tax loopholes that have been legislated through the years; (2) lackadaisical enforcement; and (3) several consecutive years of anemic economic growth (in nominal terms).

Structural Deficit



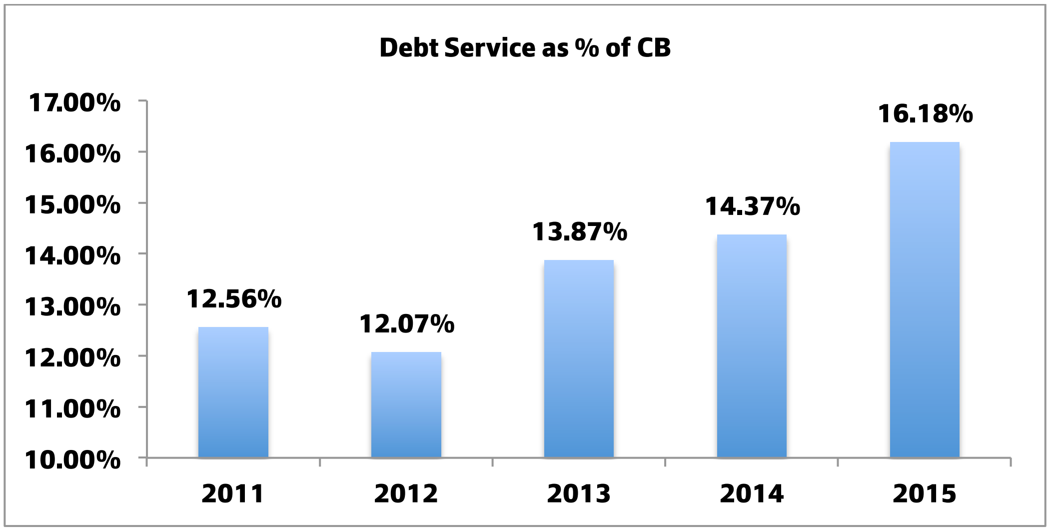
- The credit rating agencies define the structural deficit as the excess of recurring expenditures over recurring revenues. According to our analysis, the Commonwealth's structural deficit has decreased significantly, from $1.25 billion in 2011 to a projected $578 million for fiscal year 2015, a decrease of $679 million, or 54%. For fiscal year 2015, the projected structural deficit of $578 million equals the difference between expected revenues of $9.640 billion and recurring expenditures of $10.218 billion.
- Relative to the current fiscal year, the general fund structural deficit is expected to decrease from $970 million to $578 million in fiscal year 2015, a decrease of $392 million, or 40%.
- Finally, as a percentage of total general fund expenditures, the structural deficit is also expected to decrease significantly, from 15.5% in 2011 to a projected 6.0% in 2015.
- In our view, the trend with respect to the structural deficit is generally positive because it shows a striking reduction over the last five years, both in absolute and relative terms. However, we should also note that structural balance still remains an elusive goal for the Commonwealth.

Use of Non-Recurring Funds



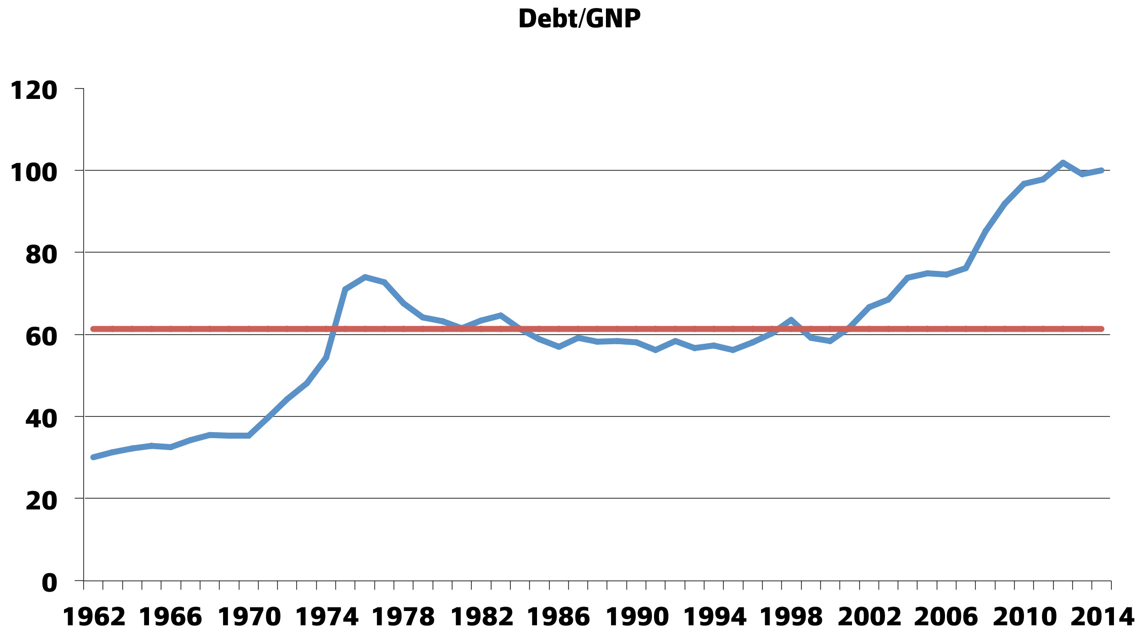
- To cover its yearly deficits the Commonwealth government has turned to using non-recurring revenues. Total non-recurring revenues included in the *consolidated budget* have decreased significantly from $2.266 billion in fiscal year 2011 to an expected $768 million for 2015, a decrease of $1.498 billion, or 66.1%.
- The *general fund* budget for fiscal year 2014-15 includes at least $578 million in non-recurring revenues, an amount that is $967 million, or 62.5%, lower than the $1.545 billion in non-recurring revenues included in the general fund budget for the fiscal year 2013-14.
- 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 15% in 2014 to a projected 5.7% in 2015.
- 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. This reduction is due to (1) the phase-out of ARRA funds and (2) the cessation of deficit financing through COFINA bond offerings.

Debt Service



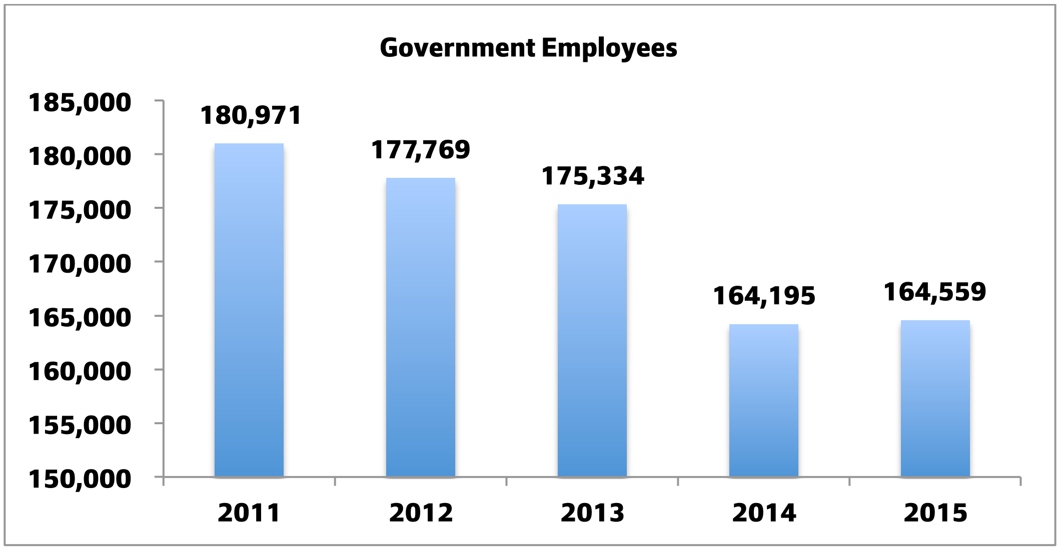
- The amount of the *general fund* allocated to debt service has increased significantly during the last four fiscal years, from $578 million for fiscal year 2011 to a projected $1.273 billion during fiscal year 2015, an increase of $695 million, or 120.2%. This increase is equivalent to a CAGR of 21.8%.
- In relative terms, the amount allocated to general fund debt service has also increased significantly from 7.3% of general fund recurring revenues in 2011 to a projected 13.2% of recurring revenues in 2015.
- This trend is the product of the elimination, for now, of "scoop and toss" refinancing due to the Commonwealth's credit ratings. Nonetheless, we note that the current budget does not include some $269.8 million of interest payments that have been capitalized.
- With respect to *consolidated budget*, the amount allocated for debt service has increased from $3.499 billion in 2011 to a projected $4.552 billion in 2015, an increase of $1.053 billion, or 30.1%. This increase is equivalent to a CAGR of 6.8%.
- In relative terms, the portion of the consolidated budget allocated to debt service has increased significantly, from 12.5% of the total consolidated budget in 2011 to a projected 16.2% in 2015. This means that approximately $1 out of every $6 spent by the government of Puerto Rico is allocated for debt service during fiscal year 2015.
- On a per capita basis, total public debt per capita in 2014 amounted to $20,334 which is equal to 121.2% of the island's per capita disposable personal income of $16,776.

Public Debt/GNP Ratio



- The Commonwealth's total public indebtedness increased from $64.279 billion in 2011 to $72.796 billion as of March 2014, an increase of $8.517 billion, or 13.2%. During that same period, Puerto Rico's GNP, at current prices, increased from $65.720 billion to a projected $72.821 billion, an increase of $7.101 billion, or 10.8%.
- Relative to GNP, Puerto Rico's total public debt increased from 97.8% of GNP in 2011 to 99.9% in 2014. The red line in the graph above shows the 61% historical average Debt/GNP ratio for Puerto Rico during the 52-year period between 1962 and 2014. The current ratio is well above the historical trend.
- In our view, the overall trend with respect to total public indebtedness is unsustainable. Reversing this trend will require, (1) not merely "balancing" the budget, but actually running a primary budget surplus—that is, keeping expenditures (net of the cost of debt service) below revenues—on a regular basis for many years into the future; and (2) Puerto Rico's GNP to grow at a nominal rate that consistently exceeds the interest rate on Puerto Rico's debt.
- Although Puerto Rico is not a "sovereign" borrower in the classical sense, it does appears to us that it exhibits some of the pre-default dynamics described by the economic literature, namely, elevated levels of uncertainty, high interest rates, restrictive fiscal policies that have intensified the contraction of the economy, and an electorate that has suffered from a long period of austerity policies and that may be reaching the limits of its endurance.

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 180,971 in 2011 to a projected 164,559 in 2015, a reduction of 16,412 workers, or 9.06%. This decrease is equivalent to a CAGR of negative 2.35%.
- In relative terms, the number of central government employees per 100 inhabitants has shown a modest reduction, from 4.91 government workers per 100 people in 2011 to a projected 4.64 government workers per 100 people in 2015.
- Furthermore, contrary to popular belief, government employment in Puerto Rico, as a share of the population older than 15, is quite similar to that of the states. Government employment as a share of the population over the age of 15 was 8.7% in Puerto Rico and 8.9% in the states, respectively, (sic) based on Census Bureau population estimates for July 2012.[12]

[12] United States Government Accountability Office, *Puerto Rico: Information on How Statehood Would Affect Selected Federal Programs and Revenue Resources*, March 2014, p. 13 and footnote 27. Government employment, in this instance, includes employment at the federal, state, and local government levels.

Short and Medium-Term Risks

It is beyond dispute that the downgrade of the Commonwealth's credit rating to speculative grade has further complicated Puerto Rico's already delicate financial situation, limited the options and the flexibility available to its financial managers, and increased the likelihood and potential impact of several short and medium term risks linked to Puerto Rico's fiscal and economic situation.

Liquidity – According to the March 11 Official Statement, "the liquidity of the Commonwealth has been adversely affected by the ratings downgrades described above, by the significant increase in credit spreads for obligations of the Commonwealth and its instrumentalities, by the limited market access experienced by the Commonwealth and its instrumentalities during the second half of 2013, and by a significant reduction of liquidity in the local Puerto Rico capital markets."[13] This situation has forced the Commonwealth to rely even more on financing from the Government Development Bank ("GDB"), which in turn has also adversely affected GDB's ability to continue providing liquidity to the Commonwealth.

That is the reason why in our analysis of the FY2014 budget we recommended 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.

Health Care Costs – Financing the health insurance coverage for low-income residents of Puerto Rico is one of the most significant budgetary challenges faced by the Commonwealth. The cost of this health insurance plan is substantial. The budget for fiscal year 2014 is $2.383 billion, of which $885 million are paid from the General Fund, representing approximately 9.1% of General Fund expenditures, approximately $1.16 billion are paid from federal funds, and the balance is paid from municipal and other funding sources. However, for fiscal year 2014, the Puerto Rico Health Insurance Administration ("PRHIA") currently projects a shortfall of $60

[13] Commonwealth of Puerto Rico, Official Statement, dated March 11, 2014, issued in connection with the offering of $3,500,000,000 General Obligation Bonds of 2014, Series A, p. 6.

million with actual revenues projected at $2.355 billion and actual expenses projected at $2.415 billion.

The financial situation gets even more complicated when we take into account the fact that the federal funds currently used by the PRHIA include non-recurring funds provided pursuant to the American Affordable Care Act ("AACA")—which are expected to be depleted sometime in 2019—as well as recurring Medicaid funds, which in the case of the Commonwealth are capped while the funds received by the 50 states are not subject to such a cap. The non-recurring AACA federal funds drawn by the PRHIA during fiscal year 2014 are projected to be $720 million, while the recurring capped Medicaid funds are projected to be approximately $288 million.

The Commonwealth is currently considering several options to control health care costs and to strengthen the PRHIA's financial situation. However, no official decisions have been made with respect to the future of the PRHIA as of this writing.

Economic Statistics – The Commonwealth disclosed in the March 11 Official Statement that Puerto Rico's macroeconomic data may not be accurately reflecting the performance of the economy. The Commonwealth specifically stated that

> The Puerto Rico Planning Board ("Planning Board") recently acknowledged the existence of certain significant deficiencies in the deflators of some of the gross national product components. As a result, the historical rate of change in gross national product at constant prices (real gross national product change) could have been either overstated or understated for several years. These deficiencies have also led to the delay in the publication of periodic economic data in order to provide the Planning Board with sufficient time to determine the particular deficiencies included in the calculation of the "deflators" and the procedures to fix such deficiencies. It is still too early to determine how these deficiencies have affected, or will affect, Puerto Rico's macroeconomic data. Until such time as these revisions are finalized and fully applied to Puerto Rico's macroeconomic data, there is no assurance that previously reported macroeconomic data accurately reflect the performance of the economy of Puerto Rico.[14]

This situation is quite worrisome as it implies that Puerto Rico's economic policymakers could have been essentially flying blind for years. We strongly recommend that the necessary adjustments are made promptly and publicly disclosed immediately when completed.

[14] Commonwealth of Puerto Rico, Official Statement, dated March 11, 2014, issued in connection with the offering of $3,500,000,000 General Obligation Bonds of 2014, Series A, p. 15.

Reform of the Teachers Retirement System – In April 2014, the Puerto Rico Supreme Court declared that several parts of Act 160, which set forth a comprehensive reform of the Puerto Rico Teachers Retirement System ("PRTRS"), were unconstitutional. The Court specifically declared that those provisions of the law that amended or modified the pension and benefit structure applicable to *currently active* teachers were in violation of Puerto Rico's Constitution. The PRTRS has an unfunded actuarial liability in excess of $9 billion. However, as of this writing the government of Puerto Rico has not announced any plans to address this liability in light of the Court's decision, other than stating that it remains "committed to addressing the PRTRS's unfunded pension liability in order to protect our retirees and ensure the Commonwealth's fiscal stability."[15]

Insolvent State-Owned Enterprises – The government of 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 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

[15] Government Development Bank for Puerto Rico and Treasury Department of the Commonwealth of Puerto Rico, "GDB CHAIRMAN AND TREASURY SECRETARY COMMENT ON SUPREME COURT'S DECISION ON TEACHERS PENSION REFORM", *Press Release*, April 11, 2014.

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.

Take the case of PREPA, for example, a government-owned monopoly that provides an essential service. According to its audited financial statements its has incurred losses of $147 million; $129 million; $272 million; $346 million; and $275 million during fiscal years 2009, 2010, 2011, 2012, and 2013, respectively. As of June 30, 2013, its net assets were negative $791 million. Its long-term debt is approximately $9 billion, it is currently barely in compliance with its debt service coverage covenants, and is facing a tough time renegotiating some $800 million in working credit lines that it needs to finance fuel purchases. It is obvious that the financial situation of this corporation is not sustainable. The current administration, however, seems reluctant to undertake the necessary measures to put PREPA's finances back in order.

Puerto Rico's Budgeting Process has Become Exceedingly Complex – The budget for fiscal year 2014 included approximately $1.4 billion in revenues from a jumble of new taxes that the Puerto Rico Treasury Department has been unable to adequately enforce and administer.

Furthermore, the proposed budget for fiscal year 2105 can be best described as an intricate spider web consisting of (1) at least $540 million in new revenues, and (2) a hodgepodge of spending cuts; the suspension of already legislated or negotiated funding and salary increases; uncertain "efficiencies" to be generated by lowering the "spending base"; and dubious "savings" from transferring funds from one government account to another, which somehow add up to $1.357 billion in "corrective measures" to balance the budget.

In our opinion, if Puerto Rico is to recuperate the trust and confidence of the capital markets it will be necessary to substantially restructure both its tax code and the structure of its expenditures.

On the tax side, for example, "the special temporary excise tax imposed by Act 154-2010, as amended ("Act 154"), has become one of the Commonwealth's principal sources of tax revenues. For fiscal years 2012 and 2013, the revenues produced by Act 154 represented 21.6% and 19.7%, respectively, of the Commonwealth's General Fund revenues. During fiscal year 2013, the special temporary excise tax was paid by 27 groups of affiliated taxpayers, of which six groups accounted for approximately 75% of collections."[16] Obviously, this kind of dependence on a small group of taxpayers to generate one-fifth of all general fund revenues represents a significant risk that needs to be addressed. It is our understanding that the Puerto Rico Treasury Department is already working on a significant revamping of the tax code, which should be ready by the end of calendar year 2014.

On the spending side, however, there is a lot of work that needs to be done. First, government officials at the policymaking level need to determine which are the key or core government services needed by the Puerto Rican people. Then, the government needs to (1) review each government program currently in effect; (2) determine which are essential to providing those key services needed by the people; and (3) identify which of those programs deemed not to be essential can be (i) executed jointly with the private sector, (ii) fully privatized, or (iii) terminated.

Second, enact PAYGO rules. The Governor should propose, and the legislature should enact, legislation requiring that any bill increasing expenditures must include an offsetting decrease in other expenditures or an increase in taxes and that any bill decreasing taxes must include an offsetting decrease in expenditures or an increase in other taxes.

Third establish "sunset rules". The legislature should establish a "sunset" commission to structure the process of terminating ineffective government programs. "Sun-setting" is the process of automatically terminating government agencies and programs after a period of time unless they are specifically reauthorized. A sunset commission could review Commonwealth government programs on a rotating basis and recommend major overhauls, privatization or elimination of programs that have outlived their usefulness.

Finally, control the growth rate of indebtedness by enacting a law limiting the issuance of new debt during any given fiscal year to the nominal GNP growth rate forecasted by the Puerto Rico Planning Board for that year, except during recessions.

Conclusion

We summarize below some of the highlights of this Report about the Governor's proposed budget for fiscal year 2015:

1. Given the $320 million shortfall in revenues as of May 2014, it is highly probable that the general fund deficit for fiscal year 2014 will exceed the

[16] Commonwealth of Puerto Rico, Official Statement, dated March 11, 2014, issued in connection with the offering of $3,500,000,000 General Obligation Bonds of 2014, Series A, p. 12

Administration's \$650 million forecast; we at CNE estimate it to be closer to \$1 billion.

2. The general fund budget for fiscal year 2015 will not be structurally balanced, as the Administration plans to use \$269.8 million of borrowed money to pay the debt service due on the GOs issued on March 11, 2014.
3. In addition, the proposed \$1.357 billion in budget cuts and "other adjustments" are the product, to a significant extent, of accounting legerdemain and are subject to significant implementation risk; our conservative estimate is that at least \$309 million of those budget cuts will not be realized.
4. Thus, we estimate the Commonwealth's structural deficit for fiscal year 2015 to be *at least* \$578 million, which is equal to the difference between revenues of \$9.640 billion less expenditures of \$10.218 billion (\$9.640 billion base expenditures + \$309 million of unrealized budget savings + \$269.8 million of capitalized interest).
5. If, on the other hand, the government achieves a fiscal consolidation approximately in the amount of 2% of GNP during fiscal year 2015, then we can expect continued economic stagnation in the best case, or the return to a contractionary mode in the worst.
6. In relative terms, the portion of the consolidated budget allocated to debt service has increased significantly, from 12.5% of the total consolidated budget in 2011 to a projected 16.2% in 2015. This means that approximately \$1 out of every \$6 spent by the government of Puerto Rico is allocated for debt service during fiscal year 2015.
7. The Commonwealth's debt dynamics are unsustainable, reversing this trend will require actually running a primary budget surplus on a regular basis for many years into the future; and that Puerto Rico's GNP grow at a rate that consistently exceeds the interest rate on its debt. In our view, both of these events are extremely unlikely to occur in the near future.
8. Furthermore, Puerto Rico may be exhibiting some of the classical predefault dynamics identified in the economic literature: years of over-borrowing, reluctance to restructure its debt; and sub-optimally postponing unavoidable defaults.
9. Controlling government spending, in areas like payroll and cutting back the reliance on non-recurring revenues, has turned out to be easier than increasing recurring tax revenues, both in absolute terms and as a percentage of GNP. This is probably due to the continuing economic stagnation and

administrative and enforcement difficulties affecting the Puerto Rico Treasury Department.

10. The main cost drivers for the Commonwealth right now are expenditures for (a) education; (b) health care; (c) debt service; (d) pension costs; and (e) subsidizing economically weak state-owned enterprises.

11. Over the short to medium-term Puerto Rico faces significant risks arising from (a) continued economic weakness; (b) maintaining adequate liquidity; (c) replacing federal government funding for the Commonwealth's health insurance plan; (d) deficient and unreliable economic statistics; (e) redesigning the pension reform of the PRTRS; (f) restructuring insolvent state-owned enterprises; and (g) reforming an extremely complex budgeting process.

In sum, the Commonwealth's finances have deteriorated significantly over the past year, specifically since the downgrade in February. In this environment, 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.

The Center for a New Economy (CNE) is a private, independent and not-for-profit entity organized as a think-tank; as such, CNE is unique in Puerto Rico.

CNE is dedicated to promoting a prosperous and sustainable economy for Puerto Rico. CNE does not receive, nor does it accept, public funds; it is funded solely by individuals and private institutions.

All contributions to CNE are fully tax-deductible under Section 501(c)(3) of the IRS Code and Section 1033.10 of the Puerto Rico Internal Revenue Code.

CNE — CENTER FOR A NEW ECONOMY — CENTRO PARA UNA NUEVA ECONOMÍA

www.grupocne.org www.facebook.com/grupocne www.twitter.com/grupocne