There Is Another Way

A Fiscal Responsibility Law for Puerto Rico

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A Fiscal Responsibility Law for Puerto Rico

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Introduction

Puerto Rico's drawn-out economic and fiscal crisis has prompted a series of debates, within the island and in federal circles, on how to address a rapidly deteriorating socioeconomic situation. Efforts to include a support package for Puerto Rico in the December 2015 Omnibus bill did not succeed, yet lobbying campaigns by different groups led to the drafting of two bills and a commitment from U.S. House Speaker Paul Ryan to address the island's situation by the end of March of 2016. Amongst the options being discussed in the federal sphere, is the establishment of a fiscal control board for Puerto Rico, similar to the one adopted in Washington DC, that would essentially command and control all aspects pertaining to government budgeting and spending.

A federally imposed control board with broad decision-making powers is not desirable given its clear colonial and imperialistic overtones and would likely face strong opposition in the island. In addition, a strong federal control board (1) would be inconsistent with the mainstream philosophical current in the Republican party that advocates for a smaller federal government and devolving authority and power to the states, counties and municipalities; and (2) given past interventions, would probably try to enforce the kind of strict, inflexible, and static budget control measures that, as we will demonstrate below, have already failed in Puerto Rico.

Nonetheless, it has become clear that any federal proposal that allows for a much needed debt restructuring mechanism will include the imposition of a supervisory body that enforces financial discipline and exerts some control over fiscal policy. We strongly believe that this is not the only way forward. There is much that Puerto Rico's democratically elected officials and appointed policymakers can do to correct and avert past mistakes and regain credibility. But so far, very little has been discussed with regards to the specific mechanisms needed for doing so.

In this brief, we introduce a series of policy proposals that could lay the groundwork for a broad overhaul of Puerto Rico's fiscal infrastructure. Our approach is predicated on the notion that a locally driven effort to overhaul key institutions, and the adoption of a well-designed fiscal rule, can transform Puerto Rico's fiscal position and introduce much needed governance reforms that ensure the Commonwealth's long-term fiscal solvency and sustainability, while addressing legitimate federal concerns and recognizing valid political qualms on the island.

Principal Characteristics of Fiscal Rules and Fiscal Responsibility Laws [2]

Fiscal rules may be broadly defined as mechanisms that allow for the establishment of monitorable fiscal targets and strategies. Although they vary substantially across countries, they have become popular since the 1990s as governments sought comprehensive institutional mechanisms to assure fiscal stability and improve economic outcomes. One of their primary targets is controlling fiscal populism: a regrettably common strategy whereby public officers engage in irresponsible borrowing and spending to guarantee political wins.

While many countries have adopted stand alone fiscal rules (balanced budget requirements, enhanced transparency measures, etc.) with varying results, the desire to establish a permanent institutional mechanism that provides a credible and comprehensive framework to promote and sustain fiscal discipline has led to the adoption of Fiscal Responsibility Laws (FRLs).

New Zealand adopted one of the first FRLs in 1994, yet these legal frameworks are currently a common feature in countries throughout Europe, Asia and Latin America. FRLs adopted across the globe vary substantially, as they must be tailored to specific political, institutional and economic contexts. Nonetheless, most FRLs include two key features: procedural and numerical rules (see Table 1). Procedural rules usually provide principles for sound fiscal management, reporting requirements, and accountability measures, while numerical rules offer precise fiscal targets that need to be met, most commonly regarding deficits, debt levels, and savings.

In most cases, FRLs include both numerical and procedural rules. For example, Brazil's Fiscal Responsibility Law of 2000 included a comprehensive framework for determining and executing the national budget, reporting guidelines and specific numerical targets regarding debt and expenditure levels. Similar laws combining procedural and numerical rules were also adopted in Sri Lanka, India, Peru and Argentina, to name a few. In some cases the jurisdictional scope of the FRL can extend to subnational governments, as is the case in Colombia, Brazil, Peru and Argentina. One key insight from the literature is that for these rules, both procedural and numerical, to be effective it is important that they be objectively determined, simple and easy to explain, and intuitive for the public at large to understand.

Procedural rules help improve institutional weaknesses, increase transparency and help curb agency problems by increasing voter accountability of public officers. In addition, process improvements may also accelerate the transformation of the overall fiscal environment. Better reporting guidelines and more accurate information, for example, can

[2] The information provided in this section was taken from: Ana Corbacho & Gerd Schwartz, *Fiscal Responsibility Laws*, pp. 58-105, in Manmohan S. Kumar and Teresa Ter-Minassian, eds. *Promoting Fiscal Discipline,* (Washington, DC: International Monetary Fund, 2007); Lili Liu & Steven B. Webb, *Laws for Fiscal Responsibility for Subnational Discipline: International Experience*, Policy Research Working Paper, (Washington, DC: The World Bank, 2011); Elva Bova et al., *Fiscal Rules at a Glance*, Update for IMF Working Paper 12/273, (Washington, DC: International Monetary Fund, 2015); Allen Schick, *Can the U.S. Government Live Within Its Means? Lessons From Abroad*, Policy Brief #141, (Washington, DC: The Brookings Institution, 2005); Andrés Velasco & Eric Parrado, *The Political Economy of Fiscal Policy: The Experience of Chile,* in Javier Santiso and Jeff Dayton-Johnson eds., *The Oxford Handbook of Latin American Political Economy*, (Oxford: Oxford University Press, 2012).

go a long way to improve the decision making process of key public agents. Numerical rules are often associated with reductions in expenditure bias and providing clear targets that limit the discretion of creative budget makers with political biases. But assigning and adhering to hard numerical targets also raises some problems especially during periods of economic downturns when fiscal flexibility is warranted.

Table 1: International Examples of Procedural and Numerical Rules

Country	Procedural Rules	Numerical Rules
Colombia: 2011	An independent advisory commission was set up to operationalize a structural balance rule and assess its implementation. […] Annual targets are framed by a medium-term fiscal framework.	Structural balance rule for the central government sets a path for fiscal consolidation that lowers the structural deficit of the central government to 2.3 percent of GDP in 2014 and sets a ceiling for the deficit at 1 percent effective in 2022.
Ireland: 2011	A Fiscal Advisory Council has been in place since July 2011 […] A Fiscal Responsibility Act was approved by Parliament in November 2012.	0.5 of GDP structural deficit ceiling and debt reduction rule (i.e. that debt in excess of 60 percent will be reduced by 1/20th every year).
Chile: Since 2001[3]	Structural balance with independent body providing key inputs. Under the structural balance rule, government expenditures are budgeted ex ante in line with structural revenues, i.e. revenues that would be achieved if: (i) the economy were operating at full potential; and (ii) the prices of copper and molybdenum were at their long-term levels.	From 2001-07 a constant target for the structural balance (surplus of 1 percent of GDP) was defined; in 2008 a new constant target was specified (surplus of 0.5 percent of GDP).

Source: Direct quotes from Elba Bova et al. (2015)

Sanctions for non-compliance with FRLs also vary substantially by country. In the case of Brazil, strict sanctions are laid out, not just for particular jurisdictions or governmental

[3] Grater details on the Chilean experience are provided in a subsequent section.

entities, but also public officials and even lenders. For example, the Fiscal Crimes Law, which accompanies the Brazilian FRL, stipulates that officials who violate the law can be charged fines and could face jail time. In addition, debt and labor contracts that contravene the FRL can be considered null and void. Institutional sanctions can lead to the payment of fines, the withholding of transfers and limited access to credit. In Ecuador, according to the FRLs approved in 2002 and 2005, failure to provide required information within a determined time period could lead to the suspension of the transfer of budget appropriations.

Strict enforcement mechanisms are crucial to the effectiveness of FRLs. While it is expected that legislators and other public officials monitor compliance, the press and non-governmental watchdog organizations can also play an important role in making sure that benchmarks are met and that sanctions are swiftly applied. In countries with a weak enforcement track record, independent monitoring and oversight may be required. In addition, FRLs require broad political buy-in. If the public agents and political actors who will be at the center of ensuring implementation and monitoring are not in agreement with the law, or do not agree on the need for deep fiscal reforms, then enforcement will be weak and sanctions ineffectual.

Moreover, fiscal rules and FRLs are not a cure-all for a country's fiscal woes. Experts agree that the quality of the underlying institutional framework that supports the FRL is of utmost importance. Weak or badly designed public financial management (PFM) systems will certainly threaten the efficacy of an FRL. The existence of transparent and accountable practices for preparing budgets, independent monitoring agencies, medium term fiscal frameworks, reliable accounting and statistical standards, amongst other institutional requirements, are essential to the efficient implementation of the provisions contained within a FRL. Thus, in terms of sequencing, countries that aim to adopt and implement an FRL should begin by reforming and improving its PFM systems, and gradually introducing procedural and numerical targets.

Puerto Rico's History with Traditional Budget Control Provisions

At first glance, it appears that Puerto Rico has had strong budget and debt control provisions on the books for many years. But as we shall argue, these simple yet inflexible and badly monitored specifications opened the door to creative accounting practices and loose interpretations, which led to all sorts of financial shenanigans and ultimately undermined their effectiveness.

Starting in 1900, the Foraker Act limited the issuance of public indebtedness by the insular and municipal governments of Puerto Rico, to "seven per centum of the aggregate tax valuation of its property."[4] A decade and a half later, the drafters of the Jones – Shafroth Act of 1917, which superseded the Foraker Act, initially kept this cap on the amount of public debt that could be legally issued by Puerto Rico, (later amended in 1937 to increase the limit to 10% of the aggregate assessed tax valuation of property), and included several additional legal provisions that remain important to this day. For example, the Jones Act established a balanced budget requirement; granted the U.S.-appointed governor line-item veto power

[4] First Organic Act of Puerto Rico (Foraker Act), 31 Stat. at L. 77, §38, April 12, 1900.

with respect to appropriation bills; provided triple-tax exemption (federal, state and local) for Puerto Rico debt; established a methodology to separate general obligation debt from revenue bonds issued by state-owned enterprises for purposes of the debt limitation; and set forth a statutory order of preference for the payment of expenses in the event that revenues turned out to be insufficient in any given year. [5]

The 1952 Constitution

In 1950 the U.S. Congress enacted legislation authorizing the people of Puerto Rico to draft and enact a Constitution for the government of its internal affairs. The drafters of the Constitution incorporated into that document many of the restrictions regarding the public debt set forth in the Organic Laws (Foraker and Jones Acts).

The drafters maintained the 10% cap on the amount of public debt that could be issued and provided an absolute preference to the payment of general obligation debt for which the full faith and credit of the Commonwealth had been pledged.[6] Therefore, if during any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year then priority shall be given to the payment of interest on and amortization of the public debt and then to other disbursements in accordance with priority norms to set forth by law.

The 1952 Constitution also preserved the balanced budget requirement and the Governor's line item veto. Finally, enactment of the Constitution did not change the tax-exempt status of debt issued by Puerto Rico or its agencies and instrumentalities.

By 1962, the constitutional debt limitation was constricting the ability of the Popular Democratic Party to execute its program of industrialization and modernization. Therefore, the Constitution was amended to eliminate the 10% cap. Instead, Section 2 of Article VI of the Constitution currently states that direct obligations of the Commonwealth evidenced by full faith and credit bonds or notes shall not be issued if the amount of the principal of, and interest on, such bonds and notes and on all such bonds and notes theretofore issued that is payable in any fiscal year, together with any amount paid by the Commonwealth in the fiscal year preceding the fiscal year of such proposed issuance on account of bonds or notes guaranteed by the Commonwealth, exceed 15% of the average annual revenues raised under the provisions of Commonwealth legislation and deposited into the treasury in the two fiscal years preceding the fiscal year of such proposed issuance.

Notwithstanding these seemingly strong legal limitations, the Commonwealth's government has run a budget deficit during each of the past fifteen years and managed to increase its public debt *threefold* from approximately $24 billion in 2000 to close to $72 billion in 2015.

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[5] Organic Act of 1917 (Jones-Shafroth Act), 39 Stat. at L. 951, March 2, 1917.

[6] Ironically, in this regard, the provisions of the Constitution are stricter and less flexible than those set forth in the Jones Act, which (1) gave expenses of the legislative, executive, and judicial departments of the State government the same standing or preference as interest payments on the public debt and (2) allowed the governor, at his discretion, to modify the order of preference.

Indeed, during this period Puerto Rico's public indebtedness grew at a compound annual rate of 7.6%, while its income (GNP) grew at a nominal rate of only 3.6%.[7] Given that Puerto Rico's indebtedness grew at an average annual rate two times faster than the growth rate of its GNP during the past fifteen years, it should not be surprising that Puerto Rico's public debt currently equals its GNP.

This dubious feat of financial trickery was made possible and enabled, as it oftentimes is, by the work of creative bankers selling the alluring charms of easy money, clever lawyers who devised wily schemes to circumvent legal limitations, and pusillanimous, shortsighted politicians willing to surrender to them.

Perhaps the best example is the debt issued by the Puerto Rico Sales Tax Financing Corporation, otherwise known as COFINA. Bonds issued by COFINA are secured by Act 91-2006, as amended ("Act 91"), which allocates a portion of the Commonwealth sales and use tax to pay debt service on the bonds issued by COFINA.

The issue is that COFINA bond proceeds were explicitly used to circumvent the restrictions set forth in Article VI, Section 7 of the Puerto Rico Constitution, which states that "The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year *unless the imposition of taxes sufficient to cover said appropriations is provided by law.*"

Notwithstanding this Constitutional requirement, which as we have seen can be traced back to the Jones Act of 1917, most of the proceeds of COFINA bond offerings were in fact used for deficit financing or to cover current expenses.

For example, the "authorized uses" of the proceeds of a $4 billion COFINA debt offering in June 2009, included paying or financing:

> […] in whole or in part, or fund[ing], in addition to the 2006 Appropriation Debt: (i) the debt of the Secretary of the Treasury of the Commonwealth ("Secretary of the Treasury") with Government Development Bank for Puerto Rico ("Government Development Bank") in the amount of $1 billion, a portion of the proceeds of which were used to cover the budgetary deficit of the Commonwealth for Fiscal Year 2008-2009, (ii) certain financing granted to the Secretary of the Treasury by Government Development Bank payable from future Commonwealth general obligation bonds, and any debt of the Commonwealth outstanding as of December 31, 2008 that did not have a source of repayment or was payable from budgetary appropriations, (iii) a portion of the accounts payable to suppliers of the Commonwealth, (iv)

[7] 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.

> operational expenses of the Commonwealth for Fiscal Years 2008-2009, 2009-2010, and 2010-2011, (v) operational expenses of the Commonwealth for Fiscal Year 2011-2012, to the extent included in the annual budget of the Government of Puerto Rico, (vi) the Puerto Rico Economic Stimulus Fund, (vii) the Commonwealth Emergency Fund in order to cover expenses resulting from catastrophic events such as hurricanes or floods, and (viii) the Economic Cooperation and Public Employees Alternatives Fund (all such uses, together with the 2006 Appropriation Debt, the "Authorized Uses").[8]

Most of these uses appear to be Constitutionally prohibited, given the previously quoted Constitutional language. However, in the absence of a binding court decision this legal issue remains open to judicial interpretation.

The *important point* for our purposes is that Puerto Rico, despite having deceptively strong budget provisions on the books that were designed to promote fiscally responsible practices, has been unable to implement them in an effective fashion, at least during the last twenty years or so. This failure is due, in our opinion, to a combination of weak institutions, widespread rent seeking by the private sector, the breakdown of public finance coordination mechanisms and the inability to effectively solve collective action problems. The implementation of a well-designed fiscal rule, in conjunction with significant reform of public finance institutions, addresses these problems by forcing government secretaries, agency heads, and legislators to fully internalize the social costs of additional expenditures.

Recommendations for a Puerto Rico Fiscal Responsibility Law

As we have seen, Puerto Rico's past experience with traditional budget control provisions of the kind likely to be implemented by a strong federal fiscal control board has been quite unsatisfactory. Thus, it is highly improbable that adopting similar fiscal discipline measures will lead to a different outcome.

That is why we propose that the Commonwealth's legislative assembly enact a comprehensive Fiscal Responsibility Law with two components: (1) a simple, intuitive, and objective fiscal rule; and (2) procedural guidelines that support a large-scale overhaul of Puerto Rico's public financial management systems, institutions, and practices.

For the purposes of this analysis, "institutional overhaul" refers not only to particular administrative and management fixes that need to occur within public agencies, but also to broader changes in the legal, policy and regulatory frameworks that affect social and economic behaviors within Puerto Rican society. As numerous economists have argued, having quality institutions (in the broader sense of the term) is central to the task of achieving economic development and growth, in large part because they help shape the

[8] Puerto Rico Sales Tax Financing Corporation, *Official Statement*, issued in connection with the offering of $4,118,153,700 Sales Tax Revenue Bonds, First Subordinated Series 2009A, dated June 10, 2009, p. 1.

different arrangements that support production and exchange.[9] Given that institutions are "social choices",[10] they can be reformed and realigned given a collective disposition to do so.

Chile's experience implementing and executing a robust fiscal rule and a subsequent FRL is an illustrative example.[11] Having suffered a massive banking and currency crisis in 1982, and a debt increase during Pinochet's brutal dictatorship—to turn social security benefits into an individual capitalization system and bail out affected banks—the country faced serious obstacles to establishing a fiscally strong economy from the 1990s onwards, as it transitioned towards a democratic system. Nonetheless, efforts by the Patricio Aylwin (1990-1994) and Eduardo Frei (1994-2000) administrations began to establish a trend towards fiscal prudence in the copper rich nation. But it was under President Ricardo Lagos (2000-2006) that a self-imposed structural balanced budget rule was introduced for the central government, where "annual fiscal expenditure is equal (except for a target surplus [...]) to the central government's structural income. Therefore, expenditure is independent of short-term fluctuations in revenues caused by cyclical swings in economic activity, the price of copper, and other variables that determine effective fiscal income." [12] To avoid biases, an independent committees of experts estimated the long-term variables used to calculate revenues—long-term growth of GDP, copper and molybdenum.

In addition, the rule established a surplus target set at 1% of GDP that allowed them to tackle their debt obligations, contingent liabilities associated with pension guarantees and public works commitments, and external challenges. These measures transformed Chile from a net debtor into a creditor in a relatively short time period.

With the passing of an FRL in 2006, the savings accumulated were placed in two sovereign wealth funds: A Pension Reserve Fund (PRF) and an Economic and Social Stabilization Fund (ESSF). The FRL contained specific guidelines regarding the use of assets, investment policy, and monitoring of risk. The fiscal rule and the FRL adopted by Chile have been credited with reducing GDP volatility (common in commodity rich countries) and with providing the country with the necessary tools to weather external shocks. Without much public debt, and having accrued significant fiscal resources, they were able to implement a robust countercyclical fiscal policy during the global crisis of 2008-2009. The ESSF was put to good use during the economic downturn to provide increases in public investments with transfers, credit and employment subsidies, the capitalization of state enterprises, and tax discounts. GDP fell by only 1% in 2009, and growth had swollen to 5.8% in 2010.

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[9] For a good overview of the principal arguments made by institutionalists, see Claude Menard & Mary M. Shirley, *Handbook of New Institutional Economics*, (The Netherlands: Springer, 2005).

[10] Acemoglu et al., *Institutions as a Fundamental Cause of Long-Run Growth*, 385-472, in Philippe Aghion & Steven N. Durlauf, Handbook of Economic Growth, Volume 1A, (The Netherlands: Elsevier, 2005).

[11] For a detailed account of Chile's experience establishing a fiscal rule and a FRL, see Andrés Velasco & Eric Parrado, *The Political Economy of Fiscal Policy: The Experience of Chile,* 68-99, in Javier Santiso and Jeff Dayton-Johnson eds., *The Oxford Handbook of Latin American Political Economy*, (Oxford: Oxford University Press, 2012); Luis Felipe Céspedes et al., *Fiscal Rules and the Management of Natural Resources Revenue: The Case of Chile*, 6 Annu. Rev. Resour. Econ. 105-32 (2014).

[12] Velasco & Parrado, *supra* at 77.

A Fiscal Rule for Puerto Rico

A well-designed, robust fiscal rule takes into account the cyclicality of government revenues while providing for debt sustainability over the long-term. Therefore, we propose a rule for Puerto Rico requiring that annual General Fund spending shall not exceed (1) cyclically adjusted revenues, as determined and certified by an independent panel of professional economists and other fiscal policy experts, minus (2) a small structural surplus. Within that limitation the Puerto Rican legislative assembly would assign funds among and between the Commonwealth's government agencies and departments according to its own spending priorities.[13]

The implementation of this type of fiscal rule has several advantages. First, government spending is by definition limited to its structural income, minus the structural surplus target. Thus, government spending would be independent of short-term fluctuations in revenues caused by cyclical swings in economic activity and other financial vagaries that affect government revenues. Furthermore, this type of fiscal rule would force Puerto Rico to substantially improve its methodology for forecasting government revenues. According to Céspedes, Parrado, and Velasco, "forecasting mistakes, by definition, should be random and short-lived."[14] In Puerto Rico, revenue forecasts are biased towards the high side on a consistent basis.

Second, according to Velasco and Parrado, this type of fiscal rule, by limiting spending to permanent fiscal income, smoothes out government spending over the economic cycle. In essence, the government saves during upswings and dissaves during downturns. Therefore, the fiscal rule precludes both sizeable spending upswings when the economy is booming and drastic fiscal tightening when there is a substantial economic slowdown. "Hence, the growth of public expenditures becomes much more stable over time."[15]

Third, the fiscal rule we are proposing requires the Commonwealth to run a small surplus (to be determined as a percentage of GNP) *over the life of the economic cycle*. This requirement is necessary because (1) Puerto Rico's debt burden is not sustainable over the long term; (2) the Commonwealth's government faces potentially crippling contingent liabilities arising out of unfunded public pensions and expenses related to the government healthcare program; and (3) the Puerto Rico Government Development Bank (GDB), which has provided significant deficit financing in the past, is essentially insolvent and needs to be recapitalized.

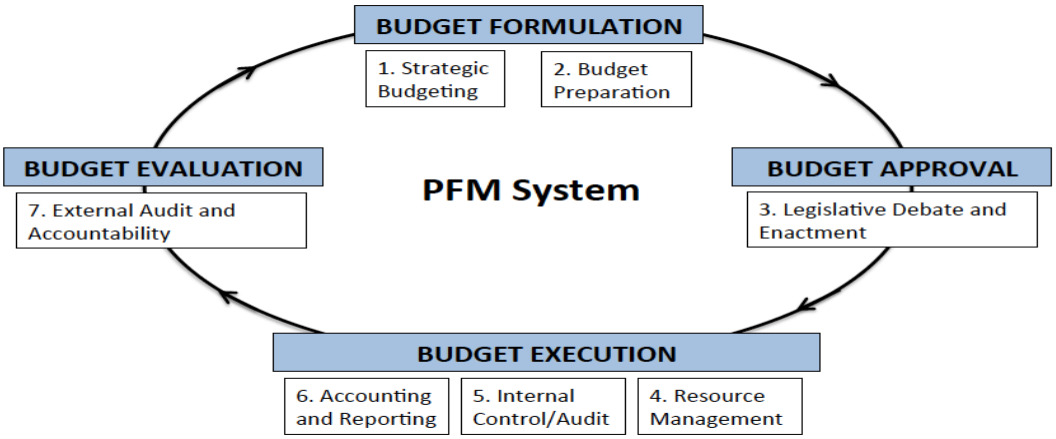
Overhaul of Public Financial Management (PFM) Systems

According to Matt Andrews, et al., governments use PFM systems to manage public resources and assess the immediate and medium-to-long-term impact of the use of those

[13] By definition, the term "cyclically adjusted revenues" does not include the proceeds of debt financing or any non-recurrent revenues.
[14] Luis Felipe Céspedes et al., p. 107.
[15] Velasco and Parrado, p. 7.

resources on the economy or society.[16] While PFM systems vary significantly across countries, several processes and systems are similar across most countries. Figure 1 below illustrates these.

Figure 1. The Basics of a PFM System



Source: Andrews et. al., p.2

First, in terms of the budget formulation process, Puerto Rico needs to adopt strategic budgeting practices, these include: implementing performance based budgeting, utilizing medium-term expenditure frameworks, reforming the current government procurement process that encourages rent seeking by the private sector, and applying and executing the fiscal rule explained above.

Furthermore, the Government Development Bank (GDB) has to gradually evolve from its deficit-financing role and become a true development bank that finances private sector projects that are unable to obtain private sector financing and that have strategic importance from an economic development perspective. *Under the new regime there will be absolutely no bailouts* for state agencies that overspend, for insolvent state-owned corporations, or for bankrupt municipalities.

Second, in terms of the budget approval process, the analytical capabilities of the legislative branch need to be substantially improved, perhaps by creating a legislative budget office with the capabilities to double-check and challenge macroeconomic and fiscal assumptions utilized by the executive in the preparation of the budget document.

Third, in terms of budget execution, there is a significant amount of work to be done. The Commonwealth has to fix longstanding problems with its shambolic accounting, financial and fiscal controls and with its financial reporting in general. According to the most recent Commonwealth Report:

[16] Matt Andrews et al., *This is PFM*, Faculty Research Working Paper Series, Harvard Kennedy School, RWP14-034, July 2014, p. 2.

> The Commonwealth's accounting, payroll and fiscal oversight information systems have deficiencies due to obsolescence and lack of compatibility that have adversely affected the Commonwealth's ability to supervise and control expenditures. Agencies often incur expense overruns that are not detected in time to permit the implementation of corrective measures during the same fiscal year. At the present time, three of the Commonwealth's agencies which are responsible for over 50% of the General Fund expenses have separate accounting systems that are unable to interact on a timely basis with the Commonwealth's central accounting system. In addition, the Commonwealth's central accounting system still relies *on various manual processes* for recordkeeping that are only reviewed and updated at the end of the fiscal year in connection with the issuance of the audited financial statements. These deficiencies also affect the Commonwealth's ability to timely and accurately report financial information to the market, and to complete its audited financial statements in a timely manner. (emphasis is ours).[18]

Furthermore the three agencies in charge of the Commonwealth's public finances—the Government Development Bank (financing), the Treasury Department (tax policy), and the Office of Management and Budget (spending policy)—need to establish new procedures to coordinate policies among themselves, as well as upgrading their operational and execution capabilities, including the hiring of qualified human resources, establishing integrated financial management information systems, and improving internal control, internal audit, and real-time monitoring capabilities.

Finally, in terms of budget evaluation the Commonwealth has been incapable of publishing externally audited financial statements for fiscal years 2014 and 2015, a situation that is clearly unacceptable from an accountability and good governance perspective. Puerto Rico should publish its CAFR for fiscal year 2014 as soon as possible, or at the very least provide a detailed, clear, and coherent public explanation for its failure to do so. In addition it has to implement whatever policies are necessary to assure the timely preparation and publication of these audited statements in the future.

The final objective of all these reforms should be the implementation of a functional PFM system in Puerto Rico. Box 1 provides a series of general goals and functions that a well-established PFM system should promote, based on international experience.

[18] Commonwealth of Puerto Rico, *Financial Information and Operating Data Report*, 6 November 2015, p. 42.

Box 1. PFM Goals and Functions

(I) Prudent fiscal decisions

- Spending decisions are affordable (deficit, debt levels, debt payments are managed),
- Public debt is taken seriously (government knows what is owed, creditors are paid on time, debt payments are treated as a first (direct) charge),
- Deficits, debts, cash and obligations are at levels not threatening solvency or economic stability in the foreseeable future.

(II) Credible budgets

- Comprehensive and regular budgets are formulated that give a binding expression to government public finance priorities and plans,
- Actual revenue policies and collection performance reflect proposals and forecasts,
- Actual spending reflects budgeted promises (in aggregate and in detailed allocations).

(III) Reliable and efficient resource flows and transactions

- Cash is provided to spending agencies when agreed, in agreed amounts,
- Salaries are paid in a timely fashion; arrears are low or non-existent,
- Goods and services are procured when planned, at appropriate quality and price,
- Contracts are paid on time; penalties are low or non-existent,
- Financing is available to capital projects when agreed and in agreed amounts,
- Corruption, nonperformance losses (with salaries, contracts, etc.) are minimal.

(IV) Institutionalized accountability

- It is possible to track fund flows to service delivery units,
- Financial reports are comprehensive, timely, allow comparison between actual spending and budget decisions; are accessible by political representatives, citizens,
- There is an independent assurance (for instance, through audit) that funds are collected, managed and spent for intended purposes, in compliance with laws and regulations and with regard for value for money,
- Concerns raised by independent assurance exercises are transparently discussed by citizens' representatives and receive timely follow-up and redress by the executive.

Source: Andrews, et al., p. 7.

By these criteria, the Commonwealth's current PFM system fails miserably and needs to be thoroughly transformed. However, implementing these kinds of thorough transformations does not happen overnight. It is important, therefore, that the Puerto Rico Fiscal Responsibility Law set forth a specific calendar and sequence for implementing PFM reforms, as well as generally accepted indicators and benchmarks to measure progress.

Moreover, proper implementation of the FRL will also require the establishment of an autochthonous, lasting and independent monitoring body that is embedded within the island's fiscal institutional landscape. One that is immune from partisan pressures but can effectively address political considerations and provide the needed technical expertise to address implementation challenges. Having a local commission that ultimately answers to the people of Puerto Rico, will not only provide political legitimacy to this exercise, but can also ensure that experience and knowledge accumulated over time are effectively internalized within the larger bureaucratic infrastructure.

Finally, while we suggest prioritizing said reforms within the three primary public institutions entrusted with administering fiscal matters of the Commonwealth, these transformations should occur as part of a broader institutional overhaul that also targets the various government agencies focused on establishing and implementing Puerto Rico's economic development plans and policies.

Conclusion

This policy brief aims to spark a series of debates regarding possible options to address the fiscal challenges faced by the government of Puerto Rico. We present a series of arguments in favor of transforming the existing legal controls and institutional landscape, and advance a series of precise recommendations for the eventual adoption and implementation of a Puerto Rico FRL.

It is our opinion that there is much that policymakers and elected officers in Puerto Rico can do to stem the current crisis and craft a pathway to socioeconomic advancement. Nonetheless, very few feasible and beneficial options have been laid out, as most of the discussions have centered on the establishment of a federal control board or the expansion of an already pernicious austerity framework. Ours is an attempt to spark a nuanced debate amidst a highly charged and polarized political environment that has obstructed the advancement of creative yet feasible responses to a protracted crisis.

The effectiveness of the proposals presented in this document will rely on the collective will and sustained commitment of public officers and the public at large, since there are no magic bullets or easy ways out of our current predicament. Furthermore, these prescriptions need to be interpreted as key pieces of a larger puzzle that still needs to be solved, namely reestablishing sustainable economic growth in Puerto Rico.