

**There Is Another Way:
A Fiscal Responsibility Law for Puerto Rico**
Executive Summary

Introduction

Puerto Rico's drawn-out economic and fiscal crisis has prompted a series of debates on how to address a rapidly deteriorating socioeconomic situation. 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 all aspects pertaining to government budgeting and spending. We strongly believe that this is not the only way forward.

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.

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.

Principal Characteristics of Fiscal Rules and Fiscal Responsibility Laws

Fiscal rules may be broadly defined as mechanisms that allow for the establishment of monitorable fiscal targets and strategies. They have become popular since the 1990s and are currently a common feature in countries throughout Europe, Asia and Latin America. The desire to establish a permanent institutional mechanism has led in turn to the adoption of Fiscal Responsibility Laws (FRLs). These legal frameworks FRLs vary substantially, as they must be tailored to specific political, institutional and economic contexts.

Most FRLs include two key features: procedural and numerical rules. 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.

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 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.

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.

Recommendations for a Puerto Rico Fiscal Responsibility Law

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.

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 revenue. Furthermore, this type of fiscal rule would force Puerto Rico to substantially improve its methodology for forecasting government revenues.

(1) A Fiscal Rule for Puerto Rico

A well-designed, robust fiscal rule takes into account the cyclical nature 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.

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(2) Overhaul of Public Financial Management (PFM) Systems

First, in terms of the budget formulation process, Puerto Rico needs to adopt **strategic budgeting practices**: 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 economic and fiscal assumptions utilized by the executive in the preparation of the budget document.

Third, in terms of budget execution, the Commonwealth has to fix longstanding problems with its shambolic accounting, financial and fiscal controls and with its financial reporting in general.

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, Puerto Rico should **publish its CAFR for fiscal year 2014 as soon as possible**. In addition it has to implement whatever policies are necessary to assure the timely preparation and publication of these audited statements in the future.

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 public 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 experiences and knowledge accumulated over time are effectively internalized within the larger bureaucratic infrastructure.

Finally, 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.

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