15 November 2016

Mr. José B. Carrión, III
Chairman
Financial Oversight and Management Board for Puerto Rico

VIA E-MAIL

Dear Mr. Carrión:

I am writing on behalf of the Center for a New Economy ("CNE"), a Puerto Rico, non-partisan, not-for-profit, independent think tank, to convey our analysis of the Fiscal Plan presented by the government of the Commonwealth of Puerto Rico on October 14, 2016 (the "Fiscal Plan"), pursuant to the formal Invitation to Comment issued by the Financial Oversight and Management Board for Puerto Rico (the "FOB"), which you preside. We thank you and the FOB for this opportunity to present our analysis and comments on the Fiscal Plan.

Introduction

Section 201 of the Puerto Rico Oversight, Management, and Economic Stability Act (the "Act") [1] compels the Government of Puerto Rico to present a fiscal plan in accordance with the requirements set forth therein. The list of requirements is long and entails the careful analysis and consideration of several economic, fiscal, financial, and public policy variables that will affect and have a material impact on the lives of thousands of Puerto Ricans.

Therefore, while we appreciate the opportunity to present our analysis and commend the FOB's efforts to reach out to the population at-large for comments and input with respect to the Fiscal Plan, we believe the medium chosen, essentially a four-page, eight-question survey, is inadequate and unsuitable for properly executing this task in a thoughtful and thorough manner. Fiscal policy is too complicated to be analyzed by answering a simple questionnaire. That is why we have decided to submit our comments in written form.

In this letter we will (1) present the principles we believe should govern the preparation of any fiscal plan for Puerto Rico; (2) detail our concerns with the current version of the Fiscal Plan; and (3) conclude with some recommendations for the FOB.

[1] Public Law 114-187

Principles Applicable to Any Fiscal Plan for Puerto Rico

The preparation of a fiscal plan requires weighing and analyzing complicated trade-offs among and between oftentimes-conflicting objectives. That is why we believe it is important to set forth at the outset a set of clear principles that should govern the preparation of the Puerto Rico Fiscal Plan.

1. The assumptions underlying the economic model of the fiscal plan must be absolutely transparent.

At the core of any fiscal plan is a baseline scenario that is a function of an economic growth forecast. The projected rate of economic growth, assuming no changes in current law or economic policy, will determine, in turn, the *baseline* amount of tax revenues available for financing government services and the payment of the public debt. That is why it is absolutely essential that the economic model used to make this forecast be made available to the public and that the governing assumptions (including the calculation of the relevant elasticities and coefficients, as well as the specification of important parameters and other key variables) be explicitly stated, explained, and justified.

In this regard the selection of an appropriate macroeconomic model is complicated by Puerto Rico's political status as an un-incorporated territory of the United States. Given that Puerto Rico is neither an independent country nor a state of the United States, any model imported from, say, the International Monetary Fund ("IMF") or from consulting firms based in the US must be carefully calibrated to take into account the specific characteristics of the Puerto Rican economy.

Unfortunately, the Fiscal Plan presented on October 14th contains very few details about the macroeconomic model used to derive the economic forecast underlying the baseline scenario. This lack of information renders it impossible to offer a thoughtful judgment of the accuracy and reasonableness of the assumptions embedded in the model, as well as about the baseline scenario itself.

2. Restoring economic growth should be the primary objective.

Robust economic growth is *the* key to adequately funding government services, including pensions, and to debt sustainability. Therefore, once the baseline scenario has been properly estimated, the next step should be the development of a short to medium-term strategy for economic growth. This strategy should (1) be based on sophisticated analyses of Puerto Rico's economy to identify sectors in which Puerto Rico has or may develop a comparative advantage and (2) set forth the structural policy changes necessary to reduce the costs of doing business in the island and generate much-needed new investment.

The objective would be to "test" the impact of these policy changes against the baseline scenario and develop a new economic forecast based on the expected impact of selected policy interventions. Hopefully, the set of chosen policies would not only jumpstart growth, but result in new investment, the creation of new jobs, increased wages and salaries, additional tax revenues, and a positive primary balance (after funding government operations and pensions but before payment of principal and interest on the debt) that would serve as a new baseline for negotiations with bondholders.

In this regard we find the Fiscal Plan to be in partial compliance with this principle because, while it minimizes additional austerity policies, it fails to set forth a coherent economic growth strategy

and the amount of proposed new investment over a ten-year horizon is too low to sustain economic growth over the medium to long-term.

3. Debt relief must be in an amount sufficient to avoid a second round of restructuring in the short-term.

Although the Fiscal Plan does not include a formal debt sustainability analysis, it is highly probable—given the complicated nature and the time necessary to implement the structural reforms that are required to jumpstart economic growth—that Puerto Rico will not be able to generate a primary surplus in an amount sufficient to pay all the debt service due on its *tax-supported debt* during the next ten years. Therefore, negotiations with bondholders to reach agreement on a sustainable amount of debt appear to be inevitable at this point.

In general, debt sustainability is a function of three key determinants: (1) the public debt-to-GNP ratio; (2) the differential between the interest rate on public debt and GNP growth—this differential represents the rate at which the debt ratio would increase (or decrease if negative) if the primary budget was balanced; and (3) the primary fiscal balance, which is a function of the effects of budget operations and GNP growth. The common variable to all three determinants is the *GNP*.[2]

Therefore we would argue that while reducing or eliminating Puerto Rico's primary deficit is important, the short-term policy focus for any fiscal plan should be on generating GNP growth since that is the key to stabilizing Puerto Rico's debt dynamics. Myopically focusing on short-term deficit reduction in an economy that is not growing risks giving way to *vicious cycles* where fiscal contraction reduces output and tax revenues and in turn generates calls for more fiscal retrenchment.

The second point to keep in mind is the magnitude of debt relief required to avoid the need for another round of restructuring in the short-term, which would generate additional significant uncertainty. According to Martin Guzman and Joseph Stiglitz, "52 percent of sovereign restructurings with private creditors since 1980 have been followed by another restructuring or default within five years. Greece, the most recent example, restructured its debt in 2012, and only a few years later it is in desperate need of more relief."[3]

Needless to say this outcome is clearly suboptimal and extremely disruptive of economic growth. According to a paper by Carmen Reinhart and Christoph Trebesch "'kicking the can down the road' via cash flow relief and debt rescheduling does not facilitate economic recovery in debtor countries. In protracted crises, growth only picks up after deeper debt relief, such as after the Brady plan."[4]

As set forth in the table below, after analyzing 35 debt relief episodes in 30 middle and high-income countries during period between 1978 and 2010, these researchers found (1) that "sovereign debt relief averaged…16% of GDP and 36% of external debt in the middle- high-income emerging markets [crises]" during that period and (2) emerging market countries "that

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[2] In Puerto Rico, GNP, which measures income earned by residents or by locally-owned production factors, is a more accurate measure of economic activity than GDP due to distortions induced by the transfer pricing and profit-shifting practices of certain 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.

[3] Martin Guzman and Joseph Stiglitz, "How to Hold a Country for Ransom", *The New York Times*, April 1, 2016, p. A25.

[4] Carmen M. Reinhart and Christoph Trebesch, *Sovereign Debt Relief and Its Aftermath*, Faculty Research Working Paper Series, John F. Kennedy School of Government, RWP 15-028 (June 2015), p. 33.

received significant debt relief reported, on average, an 11% increase in per capita income during the five years following "decisive debt relief".

Table 2: Debt Relief in Middle-High Income Emerging Market Episodes, 1978-2010

Country	*Full episode*	*Debt affected*	*Debt affected/ GDP*	*Full episode haircut (C&T)*	*Debt relief as % of external public debt*	*Debt relief to GDP (in %)*
	(1)	(2)	(3)	(4)	(5)	(6)
Algeria	1991-1996	4,657	9.9	0.054	0.9	0.5
Argentina	1982-1993	67,891	28.7	0.477	80.1	24.0
Argentina	2001-2005	60,572	33.4	0.425	25.7	14.2
Bosnia and H.	1992-1997	1,300	24.6	0.896	n.a.	22.1
Brazil	1983-1994	130,493	23.9	0.375	59.9	14.3
Bulgaria	1990-1994	7,910	98.7	0.563	45.9	55.6
Chile	1983-1990	21,731	64.8	0.379	n.a.	35.6
Costa Rica	1983-1990	2,433	42.6	0.791	59.9	43.4
Croatia	1992-1996	858	3.7	0.11	n.a.	0.4
Dominican Rep.	1982-1994	1,910	13.6	0.731	42.2	13.3
Dominican Rep.	2005	1,280	3.8	0.016	0.3	0.1
Dominica	2003-2005	144	39.9	0.54	34.6	21.6
Ecuador	1982-1995	12,714	54.3	0.512	83.1	31.2
Ecuador	1999-2000	6,700	35.9	0.334	16.8	12.0
Ecuador	2008-2009	3,190	5.5	0.528	16.7	2.9
Gabon	1986-1994	226	5.3	0.054	0.5	0.3
Grenada	2004-2005	210	30.2	0.339	20.5	10.2
Jamaica	1978-1993	1,452	31.1	0.516	24.4	24.4
Jordan	1989-1993	1,289	23.3	0.227	4.1	5.3
Macedonia, FYR	1992-1997	229	6.1	0.346	9.2	2.1
Mexico	1982-1990	177,771	61.8	0.42	105.1	36.2
Panama	1983-1996	4,967	53.3	0.389	52.3	22.9
Peru	1980-1997	11,320	19.1	0.64	40.4	13.8
Poland	1981-1994	30,912	29.8	n.a.	n.a.	15.1
Romania	1981-1986	2,965	6.2	0.158	6.5	0.9
Russia	1991-2000	68,683	26.4	0.495	n.a.	11.3
Serbia & Montenegro	2003-2004	2,700	11.5	0.709	23.1	8.1
Seychelles	2008-2010	320	32.9	0.562	25.4	18.5
Slovenia	1992-1996	812	3.9	0.033	n.a.	0.1
South Africa	1985-1993	23,400	17.9	0.377	n.a.	9.2
Trinidad & Tobago	1988-1989	446	10.3	0.155	n.a.	1.6
Turkey	1978-1982	5,067	5.8	0.316	18.0	0.9
Uruguay	1983-1991	5,913	47.8	0.46	n.a.	34.3
Uruguay	2003	3,127	26.0	0.079	n.a.	2.1
Venezuela	1983-1990	60,230	124.5	0.387	105.9	41.6
Averages		**20,738**	**30.2**	**0.39**	**36.1**	**15.7**

Sources: Cruces/Trebesch (2013), Reinhart/Rogoff (2009, 2011), Appendix Table B.1 and sources cited therein.
Note : Debt relief to external debt can exceed 100% since public debt numbers often do not include arrears.

Source: Reinhart and Trebesch, p. 11.

They conclude that "softer forms of crisis resolution, such as debt rescheduling, temporary payment standstills, and bridge lending operations were not generally followed by higher growth and better ratings. [And] These crisis resolution tools were ineffective in solving debt crises that had been dragging on for several years."[5] Therefore, obtaining significant debt relief for Puerto Rico appears to be a necessary, if insufficient, condition to restore economic growth in the island. However the Fiscal Plan presented by the Commonwealth's government is silent as to how much

[5] Id. at p. 34.

debt relief is required or as to how this relief would be obtained. This situation makes it impossible for us to thoughtfully comment on this issue at this time.

4. Fiscal austerity policies should be avoided.

This principle would appear to be nothing more than common sense or a restatement of the obvious. Yet the idea that austerity policies can somehow be expansionary has had a storied intellectual pedigree—from the so called British "Treasury View", much criticized by Keynes in the 1930s, to the "Washington Consensus" of the 1990s—and a remarkable long life. For example, as recently as 2010 Greek creditors were demanding "a primary surplus target of 4.5% of GDP, to be reached through large increases in the value added tax (VAT) and spending cuts. The difficulty was that any such attempt was self-defeating: the more you raise taxes and cut spending in a depressed economy, the smaller your GDP and the higher your debt-to-GDP ratio."[6]

Galbraith's analysis is exactly on point in the case of Greece:

> In 2010 Greece had to swallow an austerity program that would be—as Poul Thomsen of the IMF promised the IMF Board—"though, difficult, and painful." Although the program called for an unprecedented "fiscal adjustment" of 16 percent of GDP, it also predicted that Greece would suffer a fall of GDP on the order of only 5 percent, to be followed by recovery beginning in 2013. Meanwhile the debt-to-GDP ratio would rise to 150 percent by 2013 and decline thereafter. In fact, the fall in Greek GDP was *five times* as large, the debt-to-GDP ratio today stands above 180 percent. And there has been no recovery at all.[7]

Furthermore, even the IMF, or at the very least some economists in its research division, has questioned the effectiveness of austerity policies. A paper published in its *World Economic Outlook* in October 2010, concluded that: "The idea that fiscal austerity triggers faster growth in the short term finds little support in the data. Fiscal retrenchment typically has contractionary short-term effects on economic activity, with lower output and higher unemployment. A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point."[8] These findings were further confirmed, using different data and methodologies, by the IMF staff in two papers that were published in July 2011 and July 2012.[9]

In sum, in the words of Mark Blyth, professor of international political economy at Brown University, "austerity is a dangerous idea for three reasons: it doesn't work in practice, it relies on the poor paying for the mistakes of the rich, and it rests upon the absence of a rather large fallacy of composition that is all too present in the modern world."[10]

Austerity has indeed been tried in Puerto Rico with the enactment of Act 7 of 2009 and Act 66 of 2014 and has been found ineffective. Since 2009 Puerto Rico has implemented a myriad of austerity measures, including budget cuts, tax increases, salary freezes, suspensions of collective

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[6] James K. Galbraith, *Welcome to the Poisoned Chalice: The Destruction of Greece and the Future of Europe*, (Yale University Press: New Haven, CT, 2016), p. 12.
[7] Id. at p. 132.
[8] Daniel Leigh, Pete Devries, Charles Freedman, Jaime Guajardo, Douglas Laxton, and Andrea Pescatori, "Will it Hurt? Macroeconomic Effects of Fiscal Consolidation" in *World Economic Outlook*, October 2010, (International Monetary Fund: Washington, DC), p. 113.
[9] See: Jaime Guajardo, Daniel Leigh, and Andrea Pescatori, *Expansionary Austerity: New International Evidence*, IMF Working Paper 11/158, July 2011; and Nicoletta Batini, Giovanni Callegari, and Giovanni Melina, *Successful Austerity in the United States, Europe and Japan*, IMF Working Paper 12/190, July 2012.
[10] Mark Blyth, *Austerity: The History of a Dangerous Idea*, (Oxford University Press: New York, 2013), p. 10.

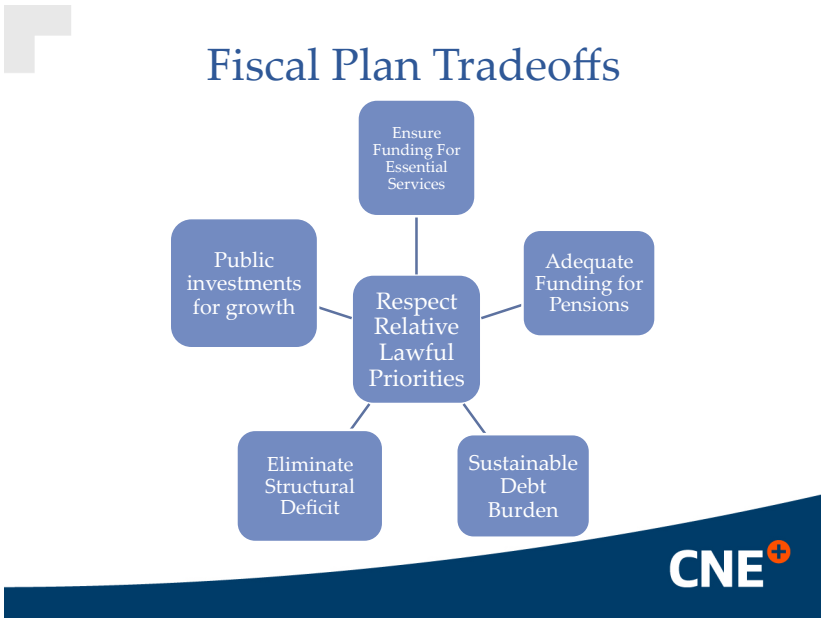
bargaining agreements, decreases in other post-employment benefits, and reductions in government employment—among other similar measures—with all too predictable results: a deepening of the economic depression, rising unemployment, lower labor force participation rates and large scale migration flows to the mainland United States. In turn, these forces result in lower tax revenues, leading to calls for more budget cuts and tax increases, and so on, generating a never-ending negative feedback loop.

In this aspect, the Fiscal Plan tries to achieve a balance between austerity and growth-inducing measures, offsetting $10.4 billion in expenditure cuts with $9.9 billion in spending increases over ten years. However, given that spending cuts and increases essentially cancel each other out, it should not be surprising then that economic growth is expected to remain subpar throughout the ten-year forecast period, in the absence of new and/or continued federal funding.

5. Specify negotiating "redlines" and the criteria for making trade-offs upfront.

Given prior experience in other countries and in Chapter 9 proceedings in the United States, bondholders will probably make economically unreasonable and socially perverse demands regarding the size of the primary surplus, pension cuts, privatization of state assets, and labor market and health care reforms as they seek to shift the full burden of fiscal adjustment on to the people of Puerto Rico.[11] The government of the Commonwealth should clearly specify upfront in its fiscal plan how much it is willing to concede, if anything, in each of these areas in exchange for significant debt relief, and should do so certainly prior to the commencement of any negotiations with bondholders. If the economic effects of thoughtless austerity are dangerous, the political and social consequences could be outright explosive.

As shown in the figure below, the Act requires the government of the Commonwealth to make difficult tradeoffs:



[11] For example, during the Detroit Chapter 9 proceedings, financial advisor Steven Spencer from the firm Houlihan Lockey, suggested selling the collection of the Detroit Institute of Arts, including priceless paintings acquired throughout the 20th century, to pay certain bondholders. See Nathan Bomey, *Detroit Resurrected: From Bankruptcy and Back*, (W. W. Norton & Company: New York, 2016), p. 167.

The problem is that *there is no value-free, non-ideological, purely technocratic methodology* to make these trade offs, which normally would be made through the normal push and pull of the democratic political process.[12] As different groups undertake actions to protect what they perceive to be their best interests in a contracting economy, it is incumbent upon the government of Puerto Rico to state clearly, for all to see and none to misunderstand, where it stands with respect to pension cuts, health care reform, debt restructuring, new investment, and economic growth. Otherwise, the FOB should be prepared to face increased migration, political instability, and, potentially, social unrest.

In this respect, the Commonwealth's Fiscal Plan is quite clear: it seeks to minimize austerity; preserve pension funding; maintain healthcare coverage for the poorest Puerto Ricans; and renegotiate the payment terms of approximately $50 billion in outstanding debt.

Specific Comments

With respect to the Fiscal Plan presented on October 14, we have the following specific comments:

1. IN GENERAL – We agree with and support the general objectives of the Fiscal Plan, especially (1) the desire to minimize the impact of austerity policies; (2) the requirement to improve budgetary controls and fiscal transparency; and (3) the need to rationalize tax policy, enact structural reforms to promote growth, and design a sustainable debt structure for the Commonwealth.
2. LIMITED EMPHASIS ON THE IMPROVEMENT OF ECONOMIC DECISION-MAKING – The current Fiscal Plan lacks a sophisticated vision to promote sustained economic growth, partly because of its limited emphasis on the improvement of economic decision-making institutions that is crucial for this endeavor. Devising economic development opportunities for Puerto Rico should be one of the most pressing goals for both U.S. and local policymakers, as reversing the island's economic decline will ensure that further rounds of default and restructuring are not needed. This is often the case when restructuring and growth are not part of a common agenda. The government needs to set forth a clear vision and a rigorous strategy for the implementation of this new growth agenda. As proposed by the Working Group of the CNE Growth Commission, it should be based on rigorous analyses and the strengthening of the appropriate government institutions to create a diversified portfolio of high value-added activities and the develop new comparative advantages.
3. LONG-TERM GROWTH PROJECTIONS/MODELING OF STRUCTURAL REFORMS – The Fiscal Plan sets forth a series of structural reforms under the control of the Commonwealth government. However, it is difficult to evaluate their impact on long-term real GDP growth projections (see pp. 89-90). In our opinion, the assumptions and the analyses to generate these projections are not properly explained in the Fiscal Plan (or in the Appendix). Following consultations with officers of the consulting firm tasked with creating these, the steps taken to create these are still not fully clear. The Fiscal Plan should be more transparent as to these long-term growth

[12] See, for example, David G. Skeel, Jr., *Debt's Dominion: A History of Bankruptcy Law in America*, (Princeton University Press: Princeton, 2001) for a good analysis of how U.S. bankruptcy law has evolved as the result of the political interaction among and between different interest groups.

projections, as this analysis is crucial to evaluate the sustainability of *any* plan. Given the importance of promoting long-term growth via structural reforms, it would be appropriate to specify precisely how the policy proposals of the Fiscal Plan would impact the long-term growth trajectory of the Puerto Rican economy relative to the baseline scenario. Devising a plan that maximizes the odds of success—generating sufficiently large sustained growth to avoid further fiscal problems and a need for further restructuring—should have prominence in the plan's projections.

4. INFRASTRUCTURE INVESTMENT – The Commonwealth's Fiscal Plan contemplates approximately $10 billion in new infrastructure investment over ten years (including PREPA and PRASA capital expenditures). This number appears to be on the low side to jumpstart economic growth in the island. There are two ways to address this issue: either (1) increase the amount of debt relief to liberate funds to finance additional public investment or (2) obtain access in the short term to the capital markets. In addition, the criteria for choosing these projects are not set forth in the document. Many of the "projects" involve building industrial parks and other infrastructure, which are necessary, but will do very little for medium to long term growth and development. The key to achieving positive *development* outcomes is identifying and moving into high value added activities, but the plan does not seem to propose strategic investments in this direction.

5. DEBT SUSTAINABILITY – The Plan does not contain a formal debt sustainability analysis ("DSA"), but it implies a simple average reduction of 44% of the debt service due by the 13 issuers included in the Plan during the next ten years. We understand this is a significant amount of debt relief and demonstrates a good faith effort to share the burden of adjustment among the different stakeholders. However, we would like to see a formal DSA included in the Plan as soon as possible given the relatively short duration of the stay on litigation under the Act.

6. ACT 154 REVENUE GAP – The Fiscal Plan states correctly that upon the termination of the 4% excise tax imposed by Act 154, the Commonwealth will transition to a "Modified Source Income Rule" that would generate approximately half the revenues generated by the excise tax. The Fiscal Plan does not address how this estimate was made nor what changes in Puerto Rico's tax policy would be necessary to replace the loss of this significant tax revenue stream.

7. CREDIT UNIONS RECAPITALIZATION – According to information presented in the Fiscal Plan, local credit unions (known as "cooperativas") would need approximately $1.2 billion in new capital to avoid a severe dislocation of this important sector of Puerto Rico's financial system. The Fiscal Plan however does state the source(s) for funding this new capital cushion.

8. PRE-RETIREMENT PROGRAM – The Fiscal Plan includes opening an early retirement window to lower payroll costs. It is not clear to us, nor does the Fiscal Plan explain, how this window affects the already dire status of the government pension systems.

9. SCHOOL CONSOLIDATION – We are concerned about the impact of school consolidation in certain communities. Given that this physical infrastructure is already in place, we suggest re-purposing these buildings to deliver other

government services, especially in distressed communities. This retrofitting program would also yield the additional benefit of creating jobs in the already depressed construction sector.

10. SEQUENCING – The plan lays out numerous measures aimed at closing the financing gap and jumpstarting growth, but there is little detail regarding the sequence in which policies would be implemented. It does not seem feasible or desirable that all measures be enacted immediately, given imperfect information and the myriad coordination challenges, so a credible implementation program should be included in future iteration of the Fiscal Plan.

Conclusion and Recommendations

We recognize the Commonwealth's government has devoted a considerable amount of time, effort, and resources to develop this Fiscal Plan and understand significant progress has been made in developing a comprehensive five-year Fiscal Plan in accordance with the terms set forth in the Act. However, in spite of this progress, we believe that work remains to be done to produce a Fiscal Plan that adequately addresses the concerns of all stakeholders—in Puerto Rico and in the mainland—in a balanced, equitable, and fair manner.

However, we stress that Puerto Rico's economy has been stagnant or contracting for ten years. This is an indication that the economy is affected by *structural*, as opposed to *cyclical*, factors. In other words, balancing the budget in five years *will not magically reignite economic growth* in the island. Furthermore, jumpstarting economic growth is a complicated endeavor and not simply a matter of lowering wages or granting preferential tax treatment to the usual rent seekers.

Therefore, we suggest the next version of the Fiscal Plan address Puerto Rico's economic and fiscal problems in the following sequence: (1) commence the implementation of structural reforms to promote growth; (2) reform budgetary, fiscal, and economic policymaking institutions; (3) work towards attaining debt sustainability by renegotiating the terms of Puerto Rico's tax-supported debt; and (4) back-load new fiscal consolidation measures, if any.

Once again we thank the Oversight Board for this opportunity to present our analysis and to comment on the Fiscal Plan. We look forward to working with you and the Oversight Board as it adjusts the Fiscal Plan currently under consideration.

Respectfully submitted,

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Center for a New Economy