Fiscal Rules for Puerto Rico

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The obvious truth

- Puerto Rico is over-indebted: $73 billion in public debt

- Puerto Rico has more debt than any US state government except California and New York, while its economy is smaller than Kansas´

- Puerto Rico's debt vastly surpasses Detroit's $19 billion, and Detroit is the largest municipal bankruptcy in US history

However…

- The $73 billion debt reveals a financial failure

- It also reveals an institutional failure

- Puerto Rico had plenty of rules to limit fiscal deficits and debt accumulation

- But again and again they were circumvented or finessed out of existence

Therefore…

- The problem requires a comprehensive solution
- Debt reduction and restructuring is part of that solution
- Institutional reform is also a key part of that solution
- Puerto Rico needs a new fiscal policy framework
- That is where fiscal rules come in

Puerto Rico is not alone…

Fiscal policy: the problems

- Deficit bias and debt
- Procylicality

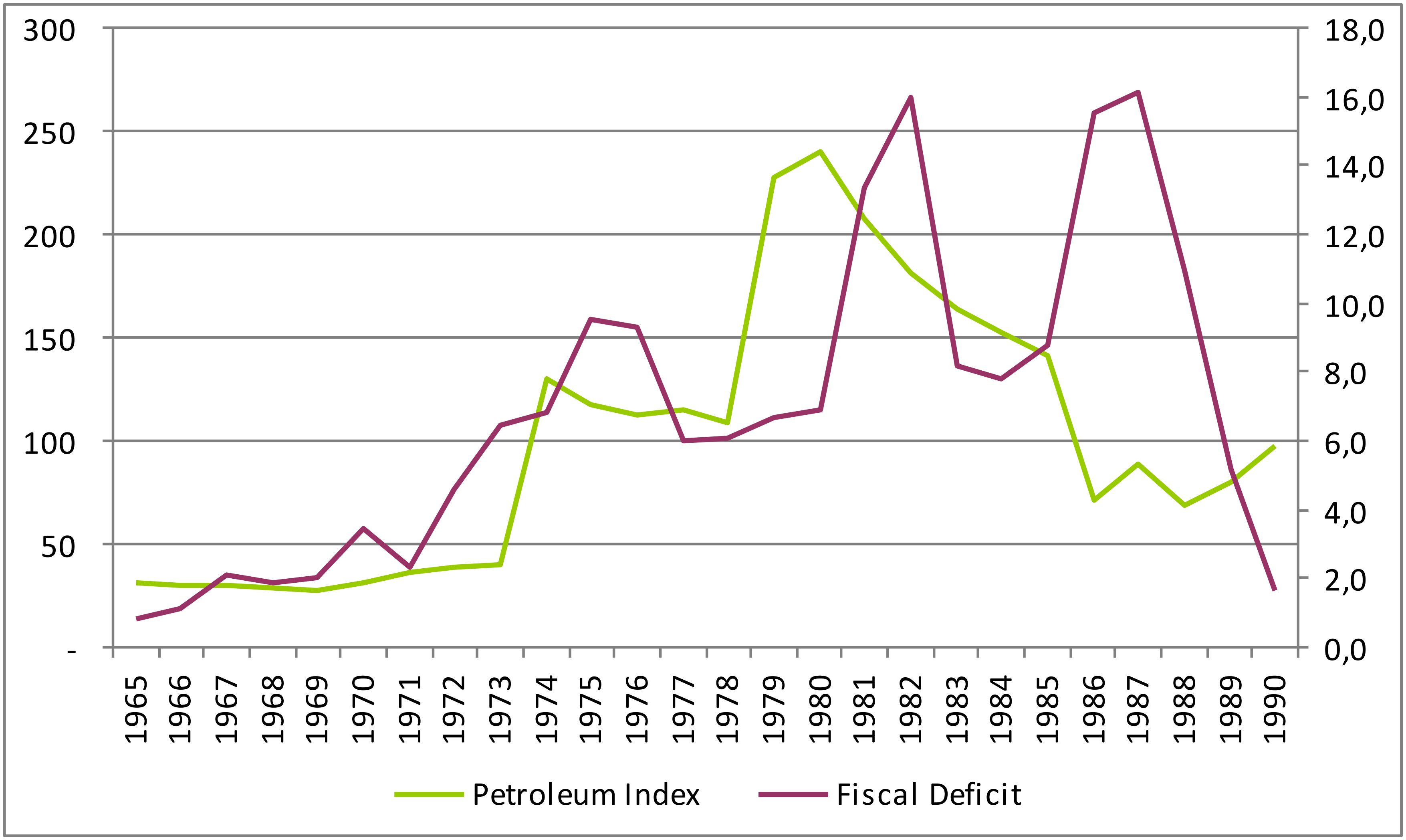
Deficit Bias

- Standard theory: run surpluses in good times and deficits in bad times
- Common problem: run deficits in good and bad times
- Drop in government net assets even when standard smoothing considerations suggest the opposite
- Consequence: inefficiently large debt

Procyclicality

- Common practice: let policy be dictated by terms of access to capital markets
- In good times better access, borrow more: in bad times, worse access, borrow less
- So instead of moderating the economic cycle, fiscal policy magnifies it

Mexico: an extreme example of procyclicality



Deficit bias and procyclicality: what can you do?

- One possibility: adopt fiscal rule that guides expenditure over long horizons, and constraints its over the cycle
- Fiscal rules helps with deficit bias: by setting surplus targets, it helps reduce debt
- Fiscal rules help with procyclicality: targets expressed in terms of cyclically-adjusted variables, so there is room for spending more in recessions (and less in booms)

Fiscal rules: some definitions

- "A fiscal rule is defined as a permanent constraint on fiscal policy through simple numerical limits on budgetary aggregates. Each of the elements in the definition is important: a rule delineates a numerical target over a longlasting time period with a view to guiding fiscal policy; it specifies a summary operational fiscal indicator to which it is applicable; and it is simple so that it can be readily operationalized, communicated to the public, and monitored." (IMF, 2009)

Fiscal rules: new fashion

- According to the IMF (2010), by 2009 exactly 80 countries had some kind of fiscal rule in place
- Many more by now
- Prominent example in Europe: Sweden
- Countries in the Eurozone are now designing and applying fiscal rules
- Examples from the emerging market world: Chile, Colombia, Peru

Political economy of fiscal rules

- Why do countries stick to fiscal rules?
- If Puerto Rico has in the past bypassed rules, why would it stick to this one?
- Key: rules can be to lax but also too strict
- Having a rule that a) prevents counter-cyclical policy and b) prevents reactions to unforeseen circumstances is an invitation to evasion
- That danger is avoided with a smart rule

The role of an oversight board

- *Setting the Surplus Target* –The principle of democratic autonomy would suggest that the surplus target, which implies the speed with which the remaining debt will be repaid, should be set by Puerto Rican elected officials. However, Puerto Rico may currently lack the required expertise to do this.
- *Monitoring Compliance* – If a surplus target is missed, then oversight board could do two things. First, require a detailed report from the government of Puerto Rico analyzing why it was missed. Second, modify the targets going forward so as to "make up" the lost ground.
- *Technical aspects of implementation* – Implementation of the fiscal rule involves many methodological and technical decisions: how to carry out cyclical adjustments, which variables to adjust and which not, how to estimate the relevant elasticities, etc. These decisions have to be made at the beginning and then reviewed and possibly updated every year.
- *Selecting Independent Experts* - The panels of experts making long term projections and forecasts could be chosen and run by the oversight board during the first years of the implementation of the fiscal rule, while training Puerto Rican experts to eventually execute these tasks.

Chile´s fiscal rule

- The rule in operation (since 2001)
- Some consequences
  - Fiscal
  - Macro

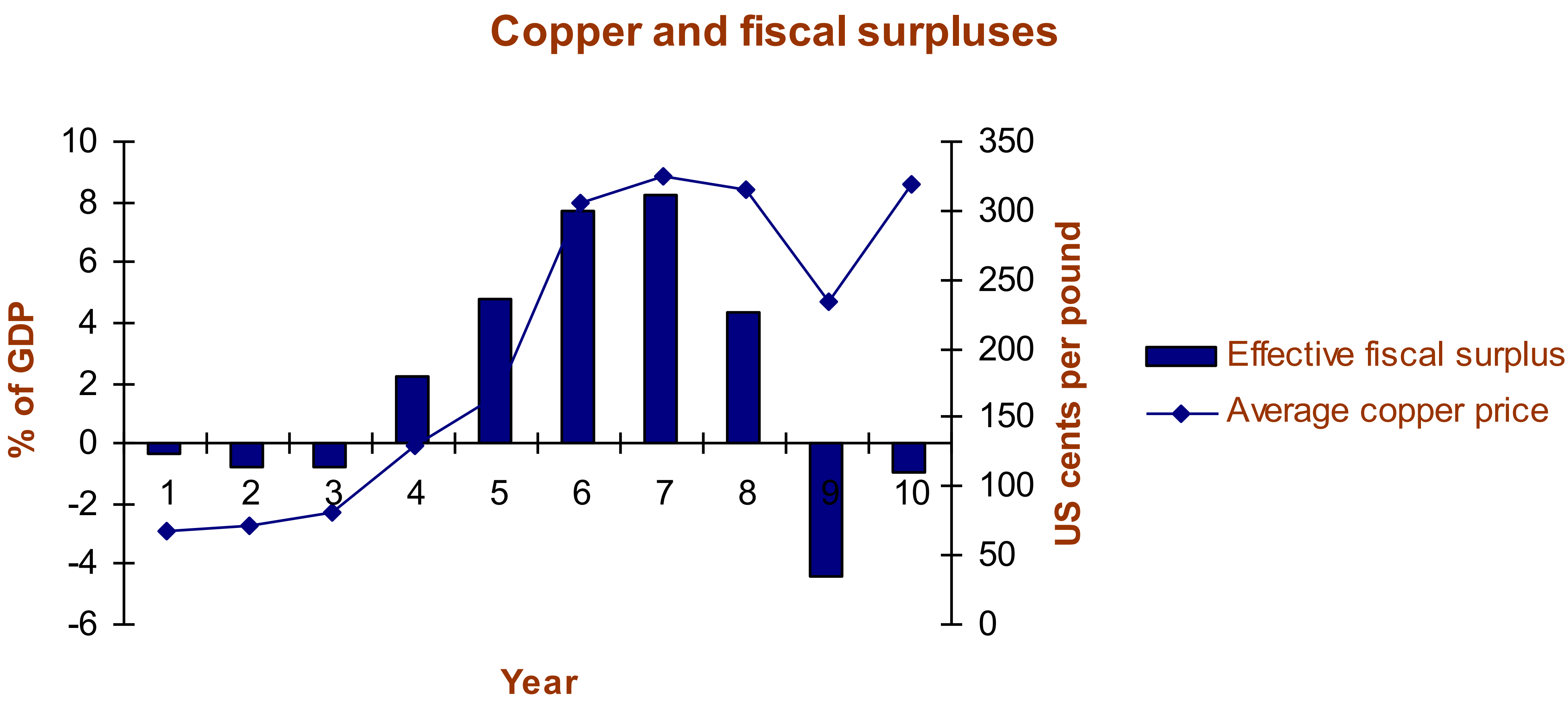
The structural balance approach

- Come up with parameters for cyclical adjustment using independent committees
  - Copper
  - Trend GDP growth
- Apply cyclical adjustment methodology: close to OECD procedure
- Arrive at estimate of “structural” or long term income
- Spend X% of GDP less than long term income

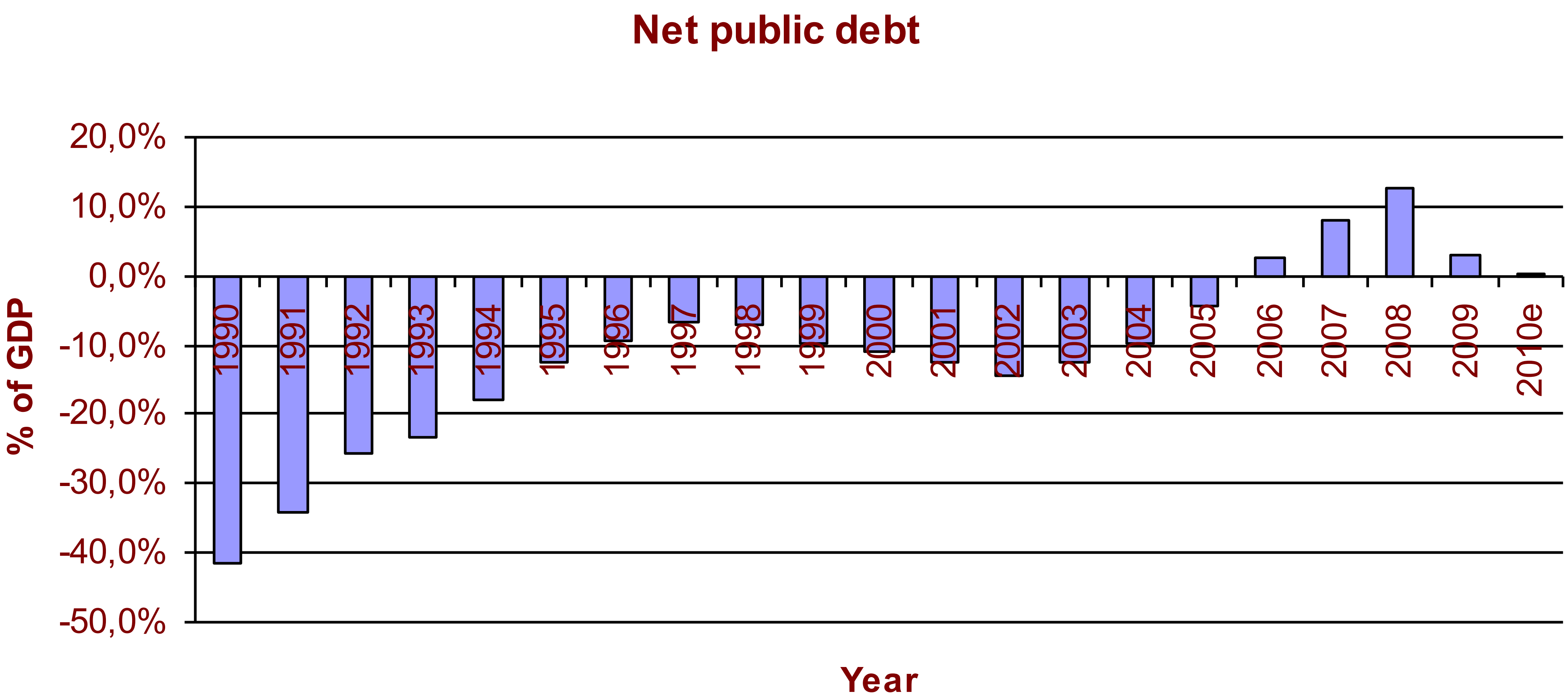
Chile: fiscal results

- Fiscal surpluses and the price of copper
- Falling public debt
- Rising financial savings

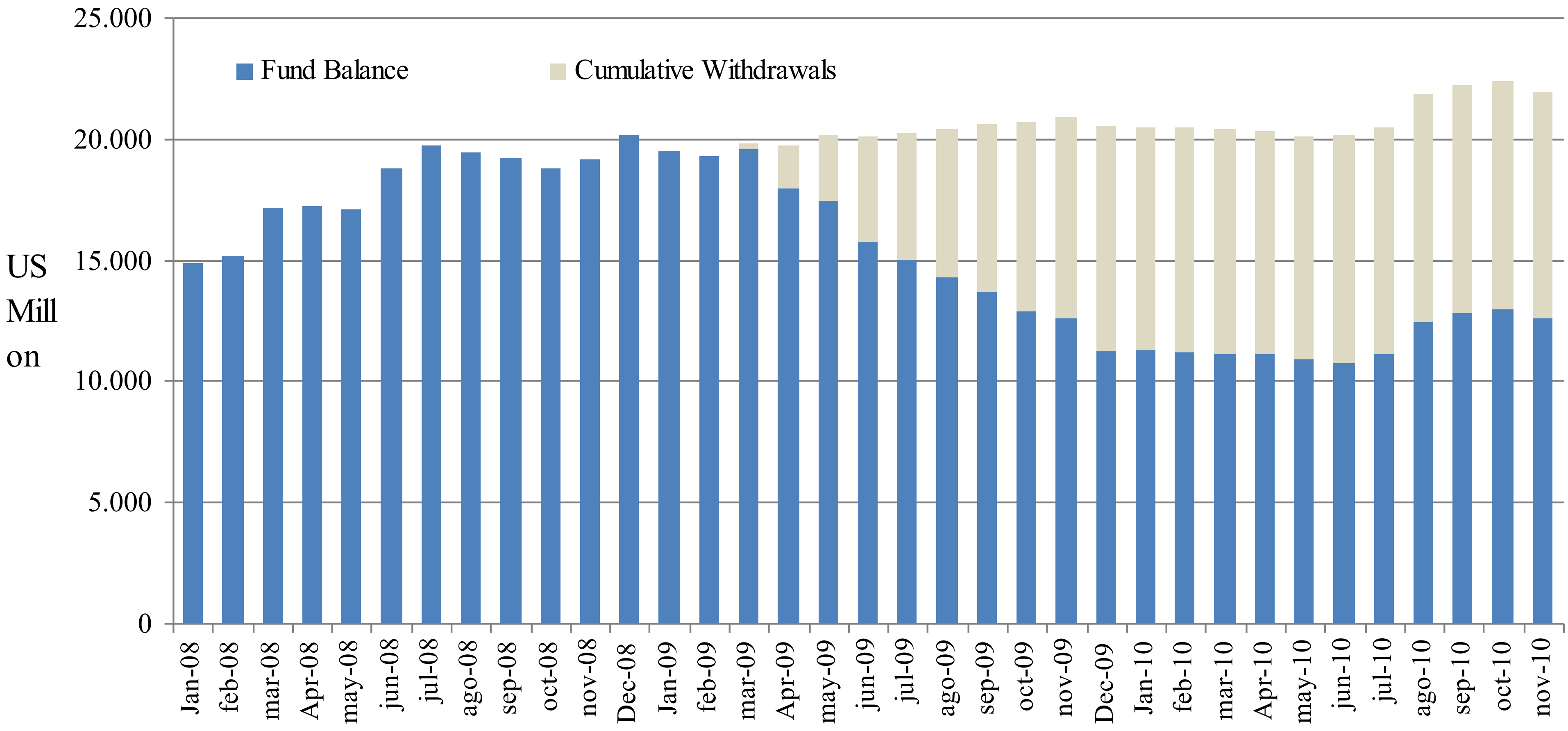
The end of procyclicality



The end of over-indebtedness



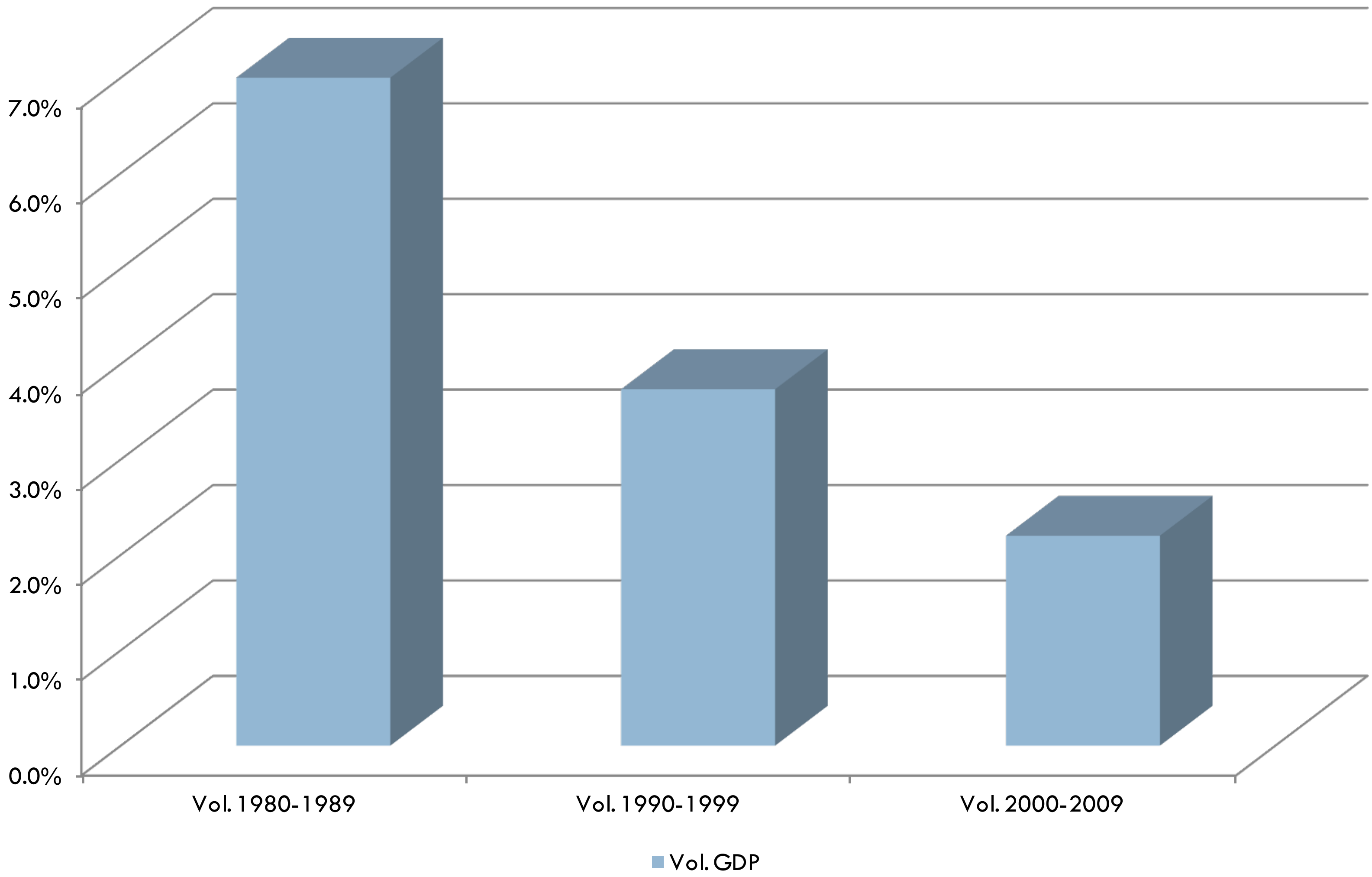
A stabilization fund that stabilizes



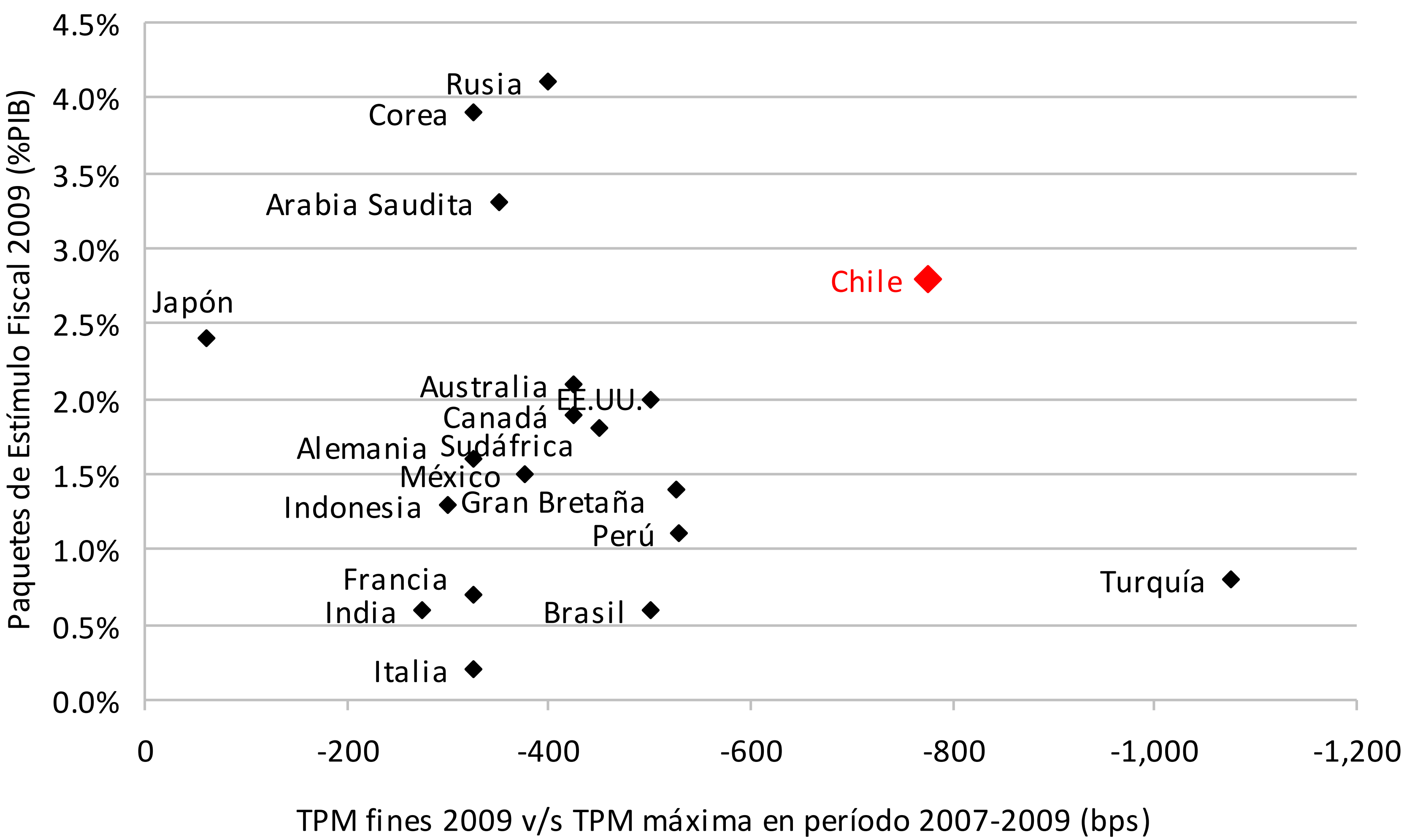
Chile: macro results

- Falling Output volatility
- Room for countercyclical policy during the crisis

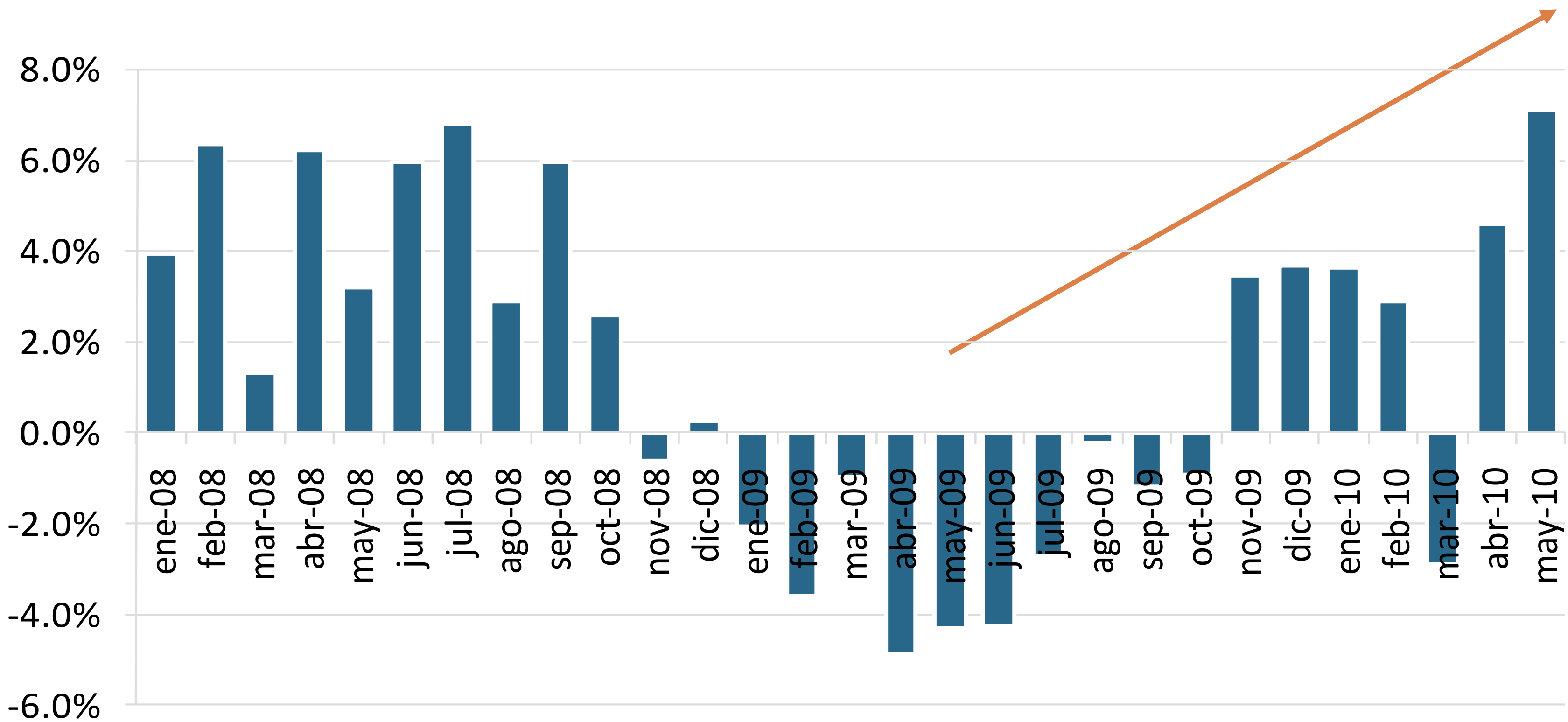
Falling output volatility



Fiscal and monetary stimulus in the crisis



Result: quick recovery from the crisis



Some conclusions

- A smart fiscal rule coupled with a fiscal oversight board could help Puerto Rico get out of its debt crisis
- The formula combines a financial solution and long-term institution-building
- There are good reasons to think rule would be credible and enforceable
- End of the deficit bias and the procylicality problem

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