STATEMENT

of

MELBA ACOSTA-FEBO

on behalf of the

GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

before the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

WASHINGTON, D.C.

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SEPTEMBER 29, 2015

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(“FINANCIAL AND ECONOMIC CHALLENGES IN PUERTO RICO”)

Chairman Hatch, Ranking Member Wyden, and Members of the Committee:

My name is Melba Acosta-Febo, and I am the President of the Government Development Bank for Puerto Rico (the "GDB"). Before assuming this position in October 2014, I was the Secretary of Treasury of the Commonwealth of Puerto Rico.

I want to thank the Committee for giving the Commonwealth of Puerto Rico ("Puerto Rico") and the GDB the opportunity to participate in this hearing. The GDB is charged with safeguarding the long-term fiscal stability of Puerto Rico and promoting its economic competitiveness. The GDB is also charged with serving as the fiscal agent and financial advisor for Puerto Rico and all of its instrumentalities. The GDB has a significant interest in and knowledge of the subject matter of this hearing.

The Crisis in Puerto Rico

The fiscal, economic, and liquidity crisis in Puerto Rico has passed the tipping point. The Legislative Assembly has declared a state of emergency, Puerto Rico has lost access to the capital markets on sustainable terms, and Puerto Rico faces an economic and liquidity crisis beyond what any jurisdiction in the United States has faced in generations. This crisis threatens the health, safety and welfare of the 3.5 million Americans living in Puerto Rico, many of whom are moving to the mainland – notably to Florida – at a rate of almost 100,000 per year. As I describe below, this crisis did not develop overnight, and it is not the result of any one factor, political decision or political party. Rather, this crisis is the culmination of decades of ill-advised public policy – both in San Juan and in Washington – coupled with a persistent stagnating economy, seemingly unlimited access to easy credit, and a market willing to lend.

While the United States economy as a whole has recovered from the recent financial crisis, Puerto Rico's economy never came out the other side of that crisis, having contracted more than 20 percent in real terms over the last eight years, which few countries in the world have experienced. Federal policy towards Puerto Rico has, if anything, exacerbated the situation. For example, the repeal and phase-out by Congress of Section 936 of the U.S. Internal Revenue Code, which provided tax benefits for certain businesses (including large pharmaceutical companies) operating in Puerto Rico, has led to a significant contraction in employment in Puerto Rico's manufacturing sector. By some estimates, between 1996-2014 the phase-out of Section 936 itself caused the loss of 270,000 jobs when its total effect is calculated. Chairman Hatch, to his credit, worked with Puerto Rico and introduced a replacement to Section 936 in 2001. Had that legislation been enacted, the crisis we find ourselves facing today may well have been avoided.

Puerto Rico's fragile fiscal state and the breakdown of its healthcare system has also been adversely affected by chronic underfunding of Medicare and Medicaid. Under Medicaid, for example, Congress both caps the amount of Medicaid funding that the federal government provides annually to Puerto Rico ($329 million in 2015) and limits the share of federal matching funds (known as Federal Medical Assistance Percentage (FMAP) at a fixed percentage (55 percent)). The Patient Protection and Affordable Care Act (ACA) provided some relief from these formulaic limitations but those funds are scheduled to be depleted in fiscal year 2017. Several members of this Committee introduced S. 1961, which would address many of the inequities in how federal healthcare programs are applied to Puerto Rico.

The contraction of Puerto Rico's economy has resulted in rising budget deficits at all levels of government, including at Puerto Rico's municipal or "public" corporations.

Historically, to close unanticipated operating deficits, Puerto Rico and its public corporations relied on debt financing, and the credit markets had been willing to supply the funds. So while the economy has contracted by more than 20 percent over the past eight years, outstanding public debt has increased by more than 60 percent. Today, Puerto Rico and its public agencies, divisions, instrumentalities and public corporations collectively have amassed approximately $73 billion in public debt. In addition, Puerto Rico's public pension funds, although subject to a major overhaul in 2013 that reduced future accruals, still face significant unfunded actuarial accrued liabilities – approximately $45 billion by some estimates – and will run out of funds altogether to pay benefits to their 166,000 beneficiaries by 2018 without substantial additional governmental contributions, contributions that will put further strain on Puerto Rico's budget.

Beyond these economic and fiscal constraints, Puerto Rico's labor and demographic characteristics are bleak. Unemployment has remained at elevated levels since the financial crisis: Puerto Rico's unemployment rate as of June 2012 was 14.6% but has since dropped to 11.6% as of June 2015 while unemployment in the rest of the United States has dropped to 5.1%. While the labor participation rate in the United States was 62.6% as of July 2015, the labor participation rate in Puerto Rico was 39.5% as of July 2015, which is a symptom of deeper structural problems and a combination of local and federal policies that often incentivize individuals not to work. In 2014 there were 660,500 non-farm jobs in Puerto Rico, which is approximately 100,000 fewer jobs than in 2005 or a 13% decline over the period; an economy with a total labor force of about 1.2 million persons lost more than 100,000 jobs in less than a decade. By contrast, the number of non-farm jobs in the mainland increased by 4% over the same period. Poverty levels are also extremely high. Indeed, the median annual household income is $19,000, which is only 36.7 percent of the median income in the United States.

Moreover, due to outmigration to the mainland, Puerto Rico's population has declined every year since 2006; the same year of the phase-out of Section 936.

Puerto Rico's demographic trends are also deeply troubling. The remaining population is becoming increasingly elderly and outside the labor force. Persons 60 years and older represent more than 20% of the population (the highest in the United States) and children aged five years or less have decreased from approximately 295,406 in 2000 to approximately 187,371 in 2014, a reduction of 37%. This means Puerto Rico will have fewer people participating in the economy going forward, shrinking the tax base and making it more challenging to service its outstanding debt and finance necessary public services.

<u>Actions Taken by Puerto Rico to Address the Crisis</u>

Puerto Rico's Governor, the Hon. Alejandro García-Padilla, took office in 2013. Governor García-Padilla has been honest and forthcoming about the crisis that Puerto Rico faces and has forcefully responded to these unprecedented challenges in an effort to achieve fiscal sustainability and to place Puerto Rico on a path for long-term success. Since taking office, the Governor and the Legislature have materially reduced budget deficits by raising revenues and cutting expenses; imposed unprecedented cost-control measures at the central government and public corporations (including suspension of economic clauses of collective bargaining agreements, across-the-board freezes of wages and salaries, prohibiting extraordinary labor bonuses); established strict limits on government payroll (as of May 2015, there were 116,000 Central Government employees, compared to 158,000 in May 2008, a 27 percent reduction in central government employment); eliminated subsidies to public corporations such as the Puerto Rico Water and Sewer Authority; implemented comprehensive pension reform that sought to shift all government employees from defined benefit to defined contribution pension plans, and increased employee contributions to the retirement systems; enacted a law known as the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "Recovery Act") to create an orderly process to restructure the debt of Puerto Rico's public corporations; approved and overseen ongoing debt restructuring negotiations at the Puerto Rico Electric Power Authority ("PREPA"); prohibited GDB from providing deficit-financing loans; completed and is actively exploring public-private partnerships for state-owned assets and operations; and reformed rates at certain public corporations.

These measures build on the work of successive administrations that have tried to address Puerto Rico's stagnant economy through a mix of policies that have increased taxes, reduced the size of the public sector, reduced pensions to current employees, and increased water rates and highway tolls. In each case, however, economic growth has failed to materialize, and budget deficits have persisted as Puerto Rico's tax base has shrunk, creating an even greater dependence on deficit financing. As a result of persistent economic stagnation, more than half a million Puerto Ricans have left the island in the last ten years seeking better opportunities on the mainland. This is a trend that does not augur well for our future.

Notwithstanding ten years of tax and rate increases and the reduction of the government's workforce and reform of government wages and benefits, Puerto Rico faces an immediate liquidity crisis resulting from its inability to access the credit markets on sustainable terms to refinance upcoming debt-service obligations. In recent months, Puerto Rico has been forced to implement emergency "one time" measures to keep the government functioning, including borrowing from the state insurance companies, terminating monthly set-aside payments for debt service on the central government debt, delaying payment of tax refunds to residents and further stretching payment of accounts payables to vendors and third parties. While these emergency measures have temporarily avoided a shutdown of the Government of Puerto Rico, without access to the capital markets to refinance maturing debt, Puerto Rico may run out of emergency measures by the end of this year (and before a large general obligations payment due in January 2016), threatening the ability of the Government to continue to provide essential services to its residents and to pay its debts when due. In order to protect the 3.5 million citizens of the United States living in Puerto Rico, immediate action is required.

The Krueger Report

After it became apparent that the difficult fiscal adjustment measures taken by Puerto Rico in 2013 and 2014 were not having the desired result of restarting economic growth and stabilizing public finances, the Governor commissioned a team of economists led by Dr. Anne Krueger, the former Chief Economist at the World Bank and First Deputy Managing Director of the International Monetary Fund (IMF), to undertake a comprehensive analysis of Puerto Rico's fiscal and economic challenges with the goal of identifying a course of action that could return the island to fiscal health and economic growth.

In June 2015, Dr. Krueger published her findings in a report entitled *Puerto Rico – A Way Forward*, which is commonly referred to as the Krueger Report. I have attached a copy of the Krueger Report, for inclusion in the hearing record, as Exhibit A, which I hereby incorporate into my testimony. The Krueger Report identified a number of economic shocks – including the phase-out of Section 936 noted above, a sharp decline in home prices during the recent financial crisis, and the Great Recession, among others – that have contributed to Puerto Rico's economic stagnation. The Krueger Report further identified a number of supply side factors contributing to the weak state of the economy, including relatively high labor costs, complex labor regulation and structural disincentives to work, outmigration of 1% annually (roughly ten times the rate of West Virginia, the only state currently experiencing subzero growth), and the high costs of energy and transportation, among others. In addition to economic factors, the Krueger Report also identified a number of fiscal problems that have contributed to Puerto Rico's unsustainable debt-load. Specifically, the Krueger Report indicates that Puerto Rico's revenue projections have historically contained extremely optimistic assumptions, leading to an annual revenue shortfall of roughly $1.5 billion.

Beyond identifying the cause of Puerto Rico's crisis, the Krueger Report identified prescriptive measures to reverse these trends and created a model to project future financing gaps after implementing the recommended measures. The Krueger Report's recommendations included items that must be implemented by Puerto Rico itself, as well as items that require assistance and policy change at the federal government. Critically, the Krueger Report found that even after implementing many of the recommended economic and fiscal measures, large residual financing gaps would persist well into the next decade, implying a critical need for debt relief from a significant proportion of the principal and interest falling due in Puerto Rico over the next six years.

<u>The Fiscal and Economic Growth Plan</u>

Promptly after the Krueger Report's release, Governor García Padilla ordered the creation of the Working Group for the Fiscal and Economic Recovery of Puerto Rico (the "<u>Working Group</u>") and charged it with developing a plan for economic growth and fiscal and institutional reform. The Working Group, in conjunction with its advisors, conducted extensive due diligence on various Commonwealth funds, agencies and public corporations that are supported by taxes and appropriations and that have contributed to the fiscal deficits identified in the Krueger Report, in order to create a holistic projection of Puerto Rico's finances and to examine various measures that could be implemented to address ongoing financing gaps. I serve on the Working Group in my capacity as President of GDB, and I have intimate familiarity with its diligence and findings.

On September 9, 2015, the Working Group released its conclusions and recommendations in a document titled the *Puerto Rico Fiscal and Economic Growth Plan*. I have attached a copy of the Fiscal and Economic Growth Plan, for inclusion in the hearing record, as Exhibit B, which I hereby incorporate into my testimony. The Fiscal and Economic Growth Plan reviews the historical measures taken to increase taxes and reduce expenses; analyzes the current liquidity and fiscal position of Puerto Rico; recommends certain fiscal and economic reform and growth measures, including measures that require action by the U.S. Government; proposes a new law known as the Fiscal Responsibility and Economic Revitalization Act that authorizes the Governor to establish and appoint members, from a list provided by third parties, to a financial control board in Puerto Rico; and identifies significant projected financing gaps, even assuming the implementation of the recommended fiscal reform and economic growth measures.

Although I have already touched on the historical measures and current liquidity and fiscal position of Puerto Rico, I would like to highlight briefly certain key portions of the Fiscal and Economic Growth Plan for the benefit of the Committee.

First, the Fiscal and Economic Growth Plan calls for significant – and in many cases, painful – local reforms across nearly all aspects of the economy and government. The Fiscal and Economic Growth Plan includes reforms to labor and welfare laws, tax and permitting simplification and reform, consolidation of schools and the elimination of municipal and higher education subsidies. It also proposes the adoption of a new accounting systems, a new budgetary process, and reforms to the structure of Puerto Rico's Treasury Department in particular and fiscal decision-making processes more generally. These "structural reforms" are aimed at spurring economic growth while new revenue and expense measures are aimed at restoring Puerto Rico's long-term fiscal health.

Second, the Fiscal and Economic Growth Plan proposes legislation to be adopted by Puerto Rico's Legislative Assembly that would create an independent control board with jurisdiction over most government entities in Puerto Rico so as to assure budgetary discipline. Like control boards in other jurisdictions, Puerto Rico's control board will consist of qualified individuals who have knowledge and expertise in finance, management, and the operation of government. The control board will have the ability to monitor and ensure compliance with budgetary targets.

Third, the Fiscal and Economic Growth Plan calls on the U.S. Government to support Puerto Rico's effort to ensure long-term fiscal sustainability and growth. Specifically, the Fiscal and Economic Growth Plan calls on Congress to allow Puerto Rico access to a legal framework to restructure its liabilities in an orderly process; to provide equitable Medicare and Medicaid treatment and funding to address the humanitarian concerns tied to the healthcare crisis in Puerto Rico; to exempt Puerto Rico from the Jones Act to reduce costs and improve the ease of doing business; to modify federal minimum wages rules, welfare programs, and labor laws applicable to Puerto Rico to incentivize people to work and increase the labor participation rate; and to provide Puerto Rico with a tax treatment that encourages U.S. investment and job growth on the island. With respect to this last item, the Chairman and other members of the Committee, as well as our Resident Commissioner, the Hon. Pedro Pierluisi, have moved forward legislation that would have helped Puerto Rico compete against foreign countries and attract manufacturing investment. These pro-growth measures could include amending the U.S. Internal Revenue Code to add a new Section 933A to permit U.S.-owned businesses in Puerto Rico to elect to be treated as U.S. domestic corporations; enacting an economic activity tax credit for U.S. investment in Puerto Rico designed as a targeted, cost-efficient version of former Section 936 of the Internal Revenue Code; and exempting Puerto Rico from base erosion and/or minimum tax measures in the event the U.S. moves towards a territorial taxation system.

Finally, like the Krueger Report, the Fiscal and Economic Growth Plan recognizes that, notwithstanding implementation of key measures to restore growth in Puerto Rico, significant financing gaps will remain over the next decade necessitating debt relief across the Commonwealth's many different credits. The Working Group's advisors have already begun discussions with creditors that own significant amounts of Puerto Rico's debt. The goal of these discussions is to achieve, through consensual negotiations, an agreement with creditors to amend the payment terms of the Commonwealth's debt so as to avoid widespread defaults and to give Puerto Rico the breathing room necessary to implement the Fiscal and Economic Growth Plan.

Debt Relief and the Necessity of a Restructuring Regime for Puerto Rico

Notwithstanding Puerto Rico's best efforts to adjust its debts in a consensual manner as contemplated and discussed above in the context of the Fiscal and Economic Growth Plan, the likelihood of success would be materially improved if Puerto Rico had a legal framework within which to do so. The unavailability of any feasible legislative option to adjust debts has created an overall environment of uncertainty that makes it more difficult to address Puerto Rico's fiscal challenges and further threatens Puerto Rico's economic future. I would like to explain why this is so important for Puerto Rico, and how the lack of such a framework has already had significant adverse consequences in our ongoing restructuring efforts at PREPA.

As many of you may know, I testified in February before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary of the U.S. House of Representatives about the harmful effects associated with having no legal regime for debt restructuring in the context of a hearing on a bill to extend the protections of Chapter 9 to Puerto Rico. I described Puerto Rico's attempt to fill a statutory gap left by Congress in the Bankruptcy Code through the passage of the Recovery Act. The Recovery Act permits Puerto Rico's public corporations to adjust their debt in an orderly process – with creditor input and court supervision – much like the U.S. Bankruptcy Code while ensuring the continued provision of essential public services to residents in the event of a fiscal emergency at one of the public corporations.

Unfortunately, the Recovery Act has been held unconstitutional by the U.S. Court of Appeals for the First Circuit on the theory that the Recovery Act is preempted by section 903 of the Bankruptcy Code, which it held prohibits Puerto Rico from passing a law allowing for the adjustment of debt through a method of composition (Puerto Rico has filed a petition for *certiorari* with the Supreme Court of the United States). The practical and unfortunate result of this decision is that no legal regime is currently available for Puerto Rico to adjust debts through a court-supervised process.

The Lack of a Restructuring Framework Already Has Consequences, as Demonstrated by PREPA

The consequence of this predicament has already shown its impact in recent and ongoing debt restructuring discussions between PREPA and its creditors. I believe it is helpful to give the Committee context as to why this is so important. Specifically, PREPA has been able to reach a consensual agreement with a substantial group of its bondholders (both original and secondary market purchasers) and all of its fuel line lenders, which collectively hold nearly $4 billion of PREPA's outstanding obligations. However, a consensual restructuring has been held up by a few institutions that, in the absence of an effective debt-restructuring regime, can try to hold up or opt out of a comprehensive restructuring. The Recovery Act was specifically designed to avert this free rider situation.

What is more, even if all of the major institutional creditors with whom PREPA is currently negotiating were to agree to a consensual debt restructuring plan, the unavailability of a court to oversee the restructuring process and, ultimately, approve and validate the plan, adds complexity, cost, and delay to the process, none of which is in the interests of creditors, consumers, or PREPA's other stakeholders. Indeed, parties will be hesitant to lend new money, or buy new securities, without the finality offered by the approval of an adjustment plan by a court of competent jurisdiction as contemplated in Chapter 9 or the Recovery Act. In addition, without such a framework, even if PREPA reaches a consensual agreement with all of its key creditor groups, in the absence of an ability to bind "holdouts" such as could be achieved through a process like Chapter 9 or the Recovery Act, there is a built in incentive for "free riders" to sit on the sidelines while other creditors bear the burden of the debt adjustment. The cost of dealing with such "free riders" is ultimately borne by the creditors that participate in the restructuring. In a worst-case scenario, free-riders can drive up the costs of a restructuring to the point where no deal can be consummated, even with creditors who would otherwise be willing to participate, because the cooperative creditors are unwilling to subsidize the recoveries of the holdouts. This problem would not exist under Chapter 9 or a Recovery Act framework where a supermajority of creditors willing to compromise can bind a dissenting minority looking for a free ride.

Finally, it is worth emphasizing two of the primary benefits of a bankruptcy regime. The first is the availability of interim or "Debtor-in-Possession" financing while negotiations with creditors ensue, which has the critical benefit of avoiding a liquidity crisis. Such financing is not available under current law. With no court empowered to approve and supervise such financing, the Commonwealth and its instrumentalities will continue to deplete much-needed resources until a consensual restructuring is consummated. Access to such interim financing would help ensure that the Commonwealth and its instrumentalities can continue to provide basic government services to its residents while debt adjustments are implemented and a resolution to the debt restructuring discussions is achieved. Second, in the event that efforts to reach a consensual agreement fail, there would be a stay against creditor suits that would help protect the residents of Puerto Rico and the island's economy from the legal morass that would ensue.

In the case of PREPA, if negotiations continue for any lengthy period of time (as they have so far), or an event beyond PREPA's control occurs (such as a hurricane that generates unanticipated costs), PREPA could be left unable to provide power to millions of Americans. I need not explain the health and humanitarian consequences in such a scenario.

* * *

To be clear, I discuss PREPA only as one example of the difficulty of restructuring debts in the absence of a clear legal regime. And while PREPA is making progress towards a consensual restructuring, PREPA has been in negotiations for well over a year and a number of significant creditors continue to hold out, hoping to free ride on those creditors who have already agreed to the deal. But for Puerto Rico, PREPA is only one of the nearly seventeen Puerto Rico issuers that may need to adjust their debt as contemplated by the Fiscal and Economic Growth Plan. The absence of a legal regime to restructure the Commonwealth's liabilities in an orderly process may potentially doom the ability of the Commonwealth and its creditors to achieve a comprehensive debt restructuring that will allow Puerto Rico to jump start its stagnant economy.

Conclusion

In conclusion, I would like to reiterate that the situation in Puerto Rico has passed the tipping point, and that Puerto Rico, in the face of an immediate liquidity crisis, has no access to the capital markets on sustainable terms and faces significant financing gaps over the next decade. Puerto Rico has taken the important step of developing a clear roadmap to address these challenges, which roadmap requires the implementation of difficult and painful measures, including the creation of a control board to monitor spending and compliance with the fiscal and economic growth plan.

I stress that while reasonable minds may differ as to the propriety of the specific measures that need to be taken – both at the local and federal levels – the fact remains that Puerto Rico faces significant liquidity and financing shortfalls that require the U.S. Government to act. Congress must act now because the failure to act is not an option for the 3.5 million Americans living in Puerto Rico. Indeed, federal action is essential, as outlined in the Krueger Report and the Fiscal and Economic Growth Plan and discussed in detail above, including parity for Medicaid and Medicare funding. Puerto Rico also speaks in unison in seeking access to a legal regime to adjust its debts as one necessary and critical step to achieving the objectives of the Fiscal and Economic Growth Plan.

The current crisis in Puerto Rico has been long in the making; it is the byproduct of a now decade-long stagnation in economic activity on the island, stagnation that threatens the ability of Puerto Rico to meet the essential needs of its residents and to avoid a disorderly default on its $73 billion of indebtedness. But, as part of the United States and subject to its laws and regulations, Puerto Rico can only do so much for itself to mitigate the crisis and avoid these devastating results. It needs the assistance of the U.S. Government to get out of this crisis, to achieve equitable funding in important federal programs such as Medicaid and Medicare, to eliminate discrimination against it (versus the Virgin Islands, for example) in the application of the Jones Act and to give it access to an insolvency regime to facilitate an orderly restructuring of its debts. These areas in which we need immediate changes in federal law and policy can help to facilitate an orderly resolution of Puerto Rico's current crisis. We have been unable to forestall a more chaotic situation by executing "one time" emergency measures; however, without an insolvency regime there will be greater loses to our creditors, our economy and our people.

I thank the Committee for recognizing the urgency of these matters by holding this hearing, and for giving the Puerto Rico and the GDB the opportunity to participate here today. I look forward to working with all of the members of the Committee to ensure that the health, safety and well-being of 3.5 million United States citizens is safeguarded and to making common cause with you in creating a better future for all the residents of Puerto Rico.

<u>Exhibit A</u>

to the

Testimony of

Melba Acosta-Febo

Puerto Rico - A Way Forward

June 29, 2015

Updated as of July 13, 2015

ANNE O. KRUEGER, RANJIT TEJA, AND ANDREW WOLFE

EXECUTIVE SUMMARY

- Puerto Rico faces hard times. Structural problems, economic shocks and weak public finances have yielded a decade of stagnation, outmigration and debt. Financial markets once looked past these realities but have since cut off the Commonwealth from normal market access. A crisis looms.
- For its part, the administration has worked hard to stave off a financing crisis with important measures since 2013, including higher taxes, pension reforms and spending cuts. However, as much as these are needed, much remains to be done to build on this progress. Given the economic downdrafts, the coming years will be difficult. But it is within the power of this government, which has repeatedly demonstrated a willingness to act, to set the economy on a sustainable path.
- Puerto Rico has advantages it can parlay into market confidence and durable growth if decades-old policy failings are fully addressed. The debt cannot be made sustainable without growth, nor can growth occur in the face of structural obstacles and doubts about debt sustainability. The strategy here is an integrated package, indicative of the scope and order of magnitude of needed policies:
    - *Structural reforms*. Restoring growth requires restoring competitiveness. Key here is local and federal action to lower labor costs gradually and encourage employment (minimum wage, labor laws, and welfare reform), and to cut the very high cost of electricity and transportation (Jones Act). Local laws that raise input costs should be liberalized and obstacles to the ease of doing business removed. Public enterprise reform is also crucial.
    - *Fiscal reform and public debt*. Probably the most startling finding in this report will be that the true fiscal deficit is much larger than assumed. Even a major fiscal effort leaves residual financing gaps in coming years, which can be bridged by debt restructuring (a voluntary exchange of existing bonds for new ones with a longer/lower debt service profile). Public enterprises too face financial challenges and are in discussions with their creditors. Despite legal complexities, *all* discussions with creditors should be coordinated.
    - *Institutional credibility*. The legacy of weak budget execution and opaque data – our fiscal analysis entailed many iterations – must be overcome. Priorities include legislative approval of a multi-year fiscal adjustment plan, legislative rules on deficits, a fiscal oversight board, and more reliable and timely data.
- This is a daunting agenda politically, legally, and organizationally. It is also an urgent one: the government's cash balances can evaporate in the face of delays, reducing the room for maneuver and intensifying the crisis.

CONTENTS

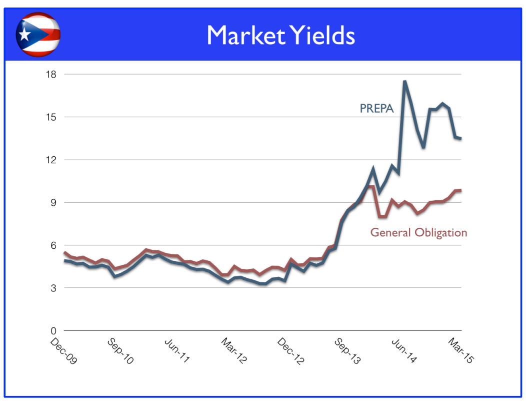
ACKNOWLEDGEMENTS. Without implicating anyone, we thank the many Commonwealth officials, business leaders and private economists – among the latter, Mohinder Bhatia, Vicente Feliciano, Jorge Freyre, Juan Lara, and Sergio Marxuach – who generously shared their insights and expertise. The report also draws on numerous studies on the structural challenges facing the Commonwealth. Rather than cite all these, we refer the reader to the analysis and references in the New York Federal Reserve's excellent *Update on the Competitiveness of Puerto Rico's Economy* (2014).

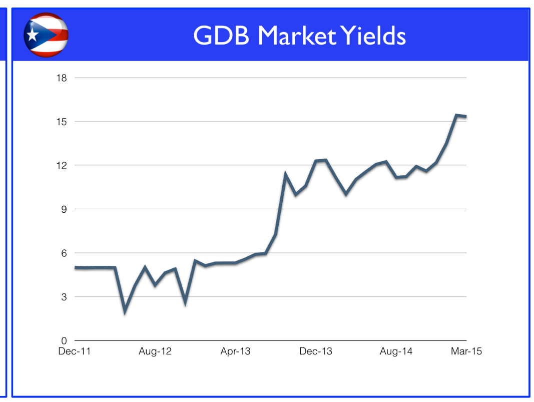
DISCLAIMER. This report was prepared at the request of legal counsel, and is for discussion purposes only. It is based on publicly available information, as well as reports and discussions with experts engaged by the Commonwealth of Puerto Rico (the "Commonwealth"), the Government Development Bank for Puerto Rico ("GDB"), and certain other government instrumentalities of the Commonwealth. The information contained in this report has not been reviewed by any auditors (independent or otherwise), nor have such auditors been consulted. The authors of this report have made no independent verification as to the accuracy or completeness of the information contained herein, and they assume no responsibility for independently verifying the information contained herein. Accordingly, they make no representation or warranty as to the accuracy, completeness, or reasonableness of the information herein, and this report, including any analysis or description of any possible recommended measures, is subject to reconsideration and modification at any time. ◆ The description of potential fiscal or structural measures set forth herein is not exhaustive, nor should it be viewed as an unqualified recommendation or endorsement of any specific measure, and that there may be compelling policy and other reasons not to adopt such recommendations. The authors acknowledge that any specific recommendation may be impractical or impossible to implement for a variety of reasons and that the authors do not possess all of the information that may be relevant to the consideration of any specific measure. Any statements contained in this report, whether forward-looking or historical, are not guarantees of future performance and involve certain risks, uncertainties, estimates and assumptions made in this report. The economic and financial condition of the Commonwealth and its instrumentalities is affected by various financial, social, economic, environmental, and political factors. These factors can be very complex, may vary from one fiscal year to the next, and are frequently the result of actions taken or not taken, not only by the Commonwealth and its agencies and instrumentalities, but also by entities such as the government of the United States. Because of the uncertainty and unpredictability of these factors, their impact cannot be included in assumptions in this report. Future events and actual results may differ materially from any estimates, projections or statements contained herein. ◆ Nothing in this report should be considered as an express or implied commitment to do or take, or to refrain from taking, any action by the Commonwealth, the GDB or any government instrumentality in the Commonwealth. Nothing in this report shall be considered a solicitation, recommendation or advice to any person to participate, pursue or support a particular course of action or transaction, to purchase or sell any security, or to make any investment decision. Nothing contained herein may be used or offered into evidence in any legal, administrative or other proceeding.

I. THE CRISIS OF CONFIDENCE

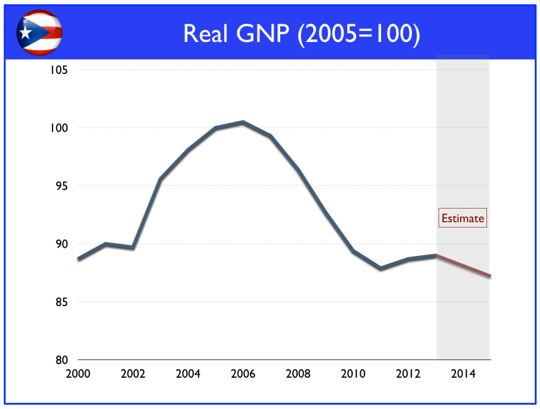
The shut off from normal market access risks a more pronounced crisis than the slow-motion deterioration the island has endured since 2005. The loss of confidence stems from protracted economic stagnation and weak public finances, which feed each other.

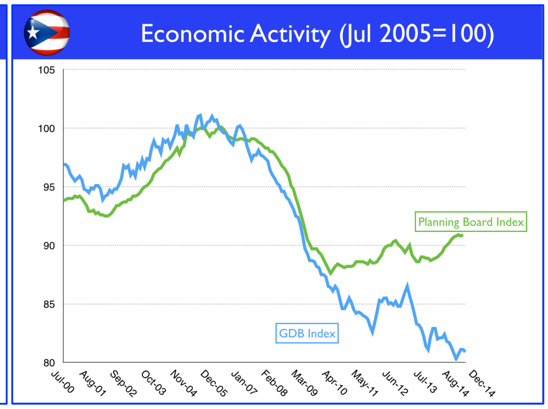
1. **Market confidence in the sustainability of public debt has deteriorated markedly**. Starting in 2013, risk premia on general obligation bonds began moving up steadily, as did those on the obligations of public enterprises. The traditional base of municipal bond investors narrowed after ratings agencies downgraded Puerto Rico debt to below investment grade in early 2014, with new investors demanding higher risk premia, shorter maturities, and greater seniority. The mid-teen yields of the government's fiscal agent, the Government Development Bank (GDB), also confirm that the market sees a weak liquidity position and puts a high probability on the risk of default. As a result, the Commonwealth is now virtually shut off from normal market access.





2. **Sections II-III explore the main factors – economic stagnation and persistent fiscal deficits – behind the market's negative assessment of debt sustainability**. Few countries have been able to establish debt sustainability with low growth, which limits revenues and raises debt ratios. In Puerto Rico, growth has not just been low but output has actually been *contracting* for almost a decade now, which is remarkable for an economy suffering neither civil strife nor overt financial crisis. GNP data for the fiscal year ending June 2014 suggest that the economy shrank by about 1% in FY2014. More recent data are not available but our reading of the indicators is that the economy continues to contract at a rate of *at least* 1% per annum, likely more, in FY2015. As discussed in Section II, the drivers of economic decline have been years in the making: the problems are structural, not cyclical, and as such are not going away. Further, as discussed in Section III, fiscal deficits are much larger than assumed. The actions to date are insufficient, and fiscal deficits too are not going away. The economy is in a vicious circle where unsustainable public finances are feeding into uncertainty and low growth, which in turn is raising the fiscal deficit and the debt ratio.





3. **Section IV-VI explain the urgency in the current situation and the case for an alternative approach**. The cash flow position of the government is fast deteriorating. In Section IV, we estimate the fiscal financing gap that must be filled just on current trends (let alone on a deterioration of prospects). This is followed in Section V by a discussion of possible measures to rein in deficits in a manner that is least harmful to growth prospects – certainly less harmful than the alternative of an overt crisis – and the need for debt service relief until such time as the reform program can restore growth and the sustainability of public finances. Section VI subjects the analysis to some skeptical questions.

II. ECONOMIC ORIGINS

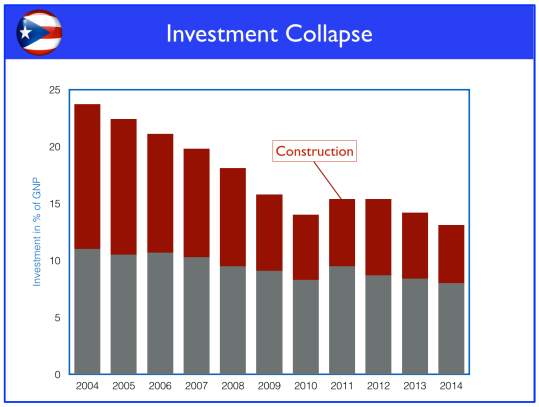
Both economic shocks and flawed policies have played a role in Puerto Rico's decline. After a decade of stagnation, negative growth is now mostly a supply side problem.

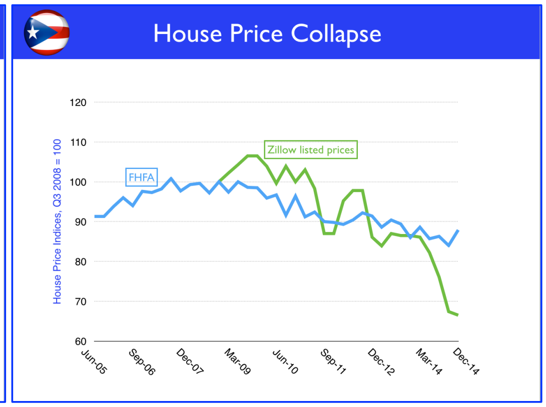
4. **The economic shocks have been numerous**. Because negative growth coincided with the final phase-out of IRS Section 936 provisions for mainland manufacturers on the island, it is customary to cite the loss of tax preferences as the original sin behind Puerto Rico's travails. The loss undoubtedly hollowed out the manufacturing base but was hardly the only blow. Many other forces, perhaps collectively more important, also bore down:

- *Investment/housing bust*. Investment fell by 10% points of GNP in the decade to FY2014, with construction accounting for three-quarters of the overall reduction in the investment ratio. Much of the damage came from the sharp fall in house prices[1], which preceded the one on the mainland and may be larger than commonly cited indices suggest. Lower home prices reduced the net wealth of individuals and small

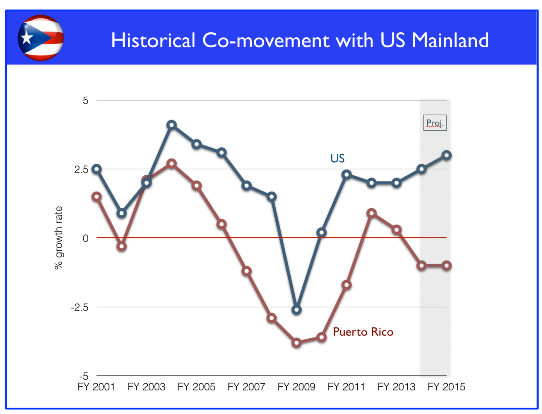
[1] The Federal Housing Finance Administration (FHFA) produces a "repeat sale" index that, by definition, excludes new home sales. But unsold *new* homes have been a big part of the housing boom-bust in Puerto Rico. The figure below on the right therefore also shows a broader index: Zillow's median list prices for new and existing homes. The 38% decline in the latter is large and indicative of on-going market pressures.

firms, and thus their capacity to borrow. The resulting weakness in consumption and investment, in turn, fed back into housing weakness – another vicious cycle.

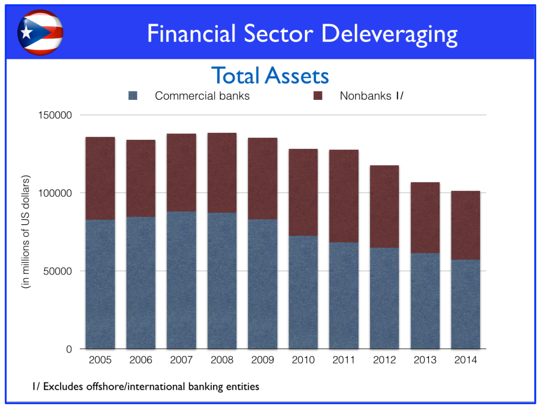




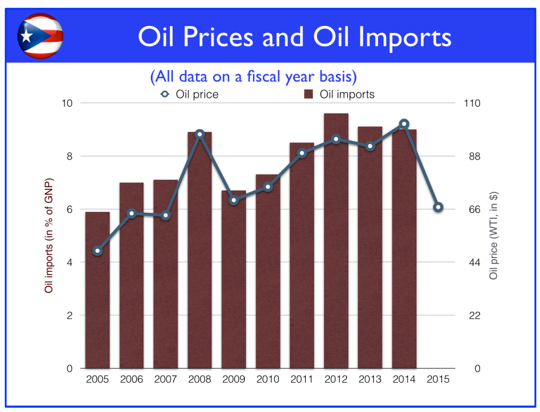
- *Recession on the US mainland*. Until recently, economic activity in Puerto Rico tracked that on the US mainland, the island's largest trade partner and investor. As such, the downturn in US activity during 2007-09 had a significant negative effect. The subsequent recovery in US demand should have lifted key sectors such as manufacturing, which is overwhelmingly geared to the US. The fact that this has not happened suggests a structural problem with competitiveness.



- *Bank distress and credit crunch.* The fall in the economy and housing was amplified by the associated distress in the banking sector and vice versa. Commercial bank assets have fallen by 30% since 2005, as banks reduced their balance sheets in response to the hit to their capital from lower asset prices. The distress in the banking sector would have been worse were it not for the backstop provided by FDIC, which had to intervene several banks, and for initiatives such as TARP.



- *Oil prices*. The doubling in oil prices during 2005-12 was a major setback, given Puerto Rico's dependence on imported oil for virtually all of its power generation. The 3% of GNP increase in the oil bill represented an equivalent loss of income for Puerto Rico that could have supported the local economy.



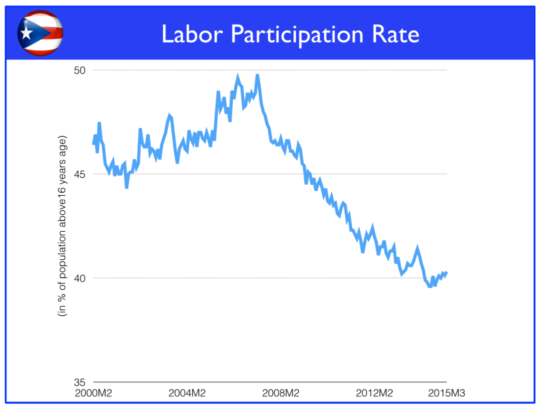
5. **But even more significant forces on the supply side have been gnawing at growth:**

- *Employment and labor costs*. The single most telling statistic in Puerto Rico is that only 40% of the adult population – versus 63% on the US mainland – is employed or looking for work; the rest are economically idle or working in the grey economy. In an economy with an abundance of unskilled labor, the reasons boil down to two.

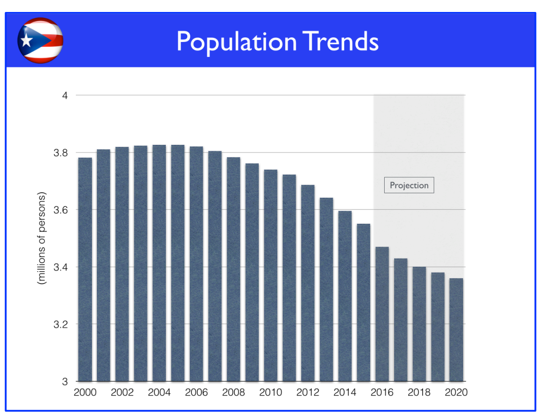
  - Employers are disinclined to hire workers because (a) the US federal minimum wage is very high relative to the local average (full-time employment at the minimum wage is equivalent to 77% of per capita income, versus 28% on the mainland) and a more binding constraint on employment (28% of hourly workers in Puerto Rico earn $8.50 or less versus only 3% on the mainland); and (b) local regulations pertaining to overtime, paid vacation, and dismissal are costly and more onerous than on the US mainland.

- Workers are disinclined to take up jobs because the welfare system provides generous benefits that often exceed what minimum wage employment yields; one estimate shows that a household of three eligible for food stamps, AFDC, Medicaid and utilities subsidies could receive $1,743 per month – as compared to a minimum wage earner's take-home earnings of $1,159.

The result of all of the above is massive underutilization of labor, foregone output, and waning competitiveness.



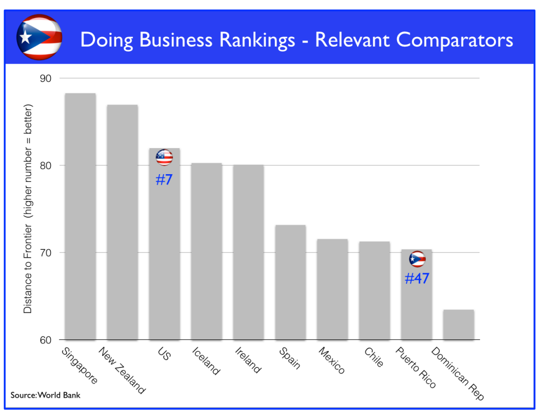
- *Outmigration and population loss*. Diminished job opportunities have also prompted a sharp rise in outmigration, greater even than that in the 1950s. As a result, after growing continuously for almost two centuries, Puerto Rico's population declined for the first time in 2006, and has since shrunk from its peak to about 3.5 million in 2015. Even if there is no intensification in economic problems, which is a big if, the Planning Board projects that the population will continue to fall through 2020. The loss of 1% of population each year – ten times more than the rate in Japan or West Virginia, the only US state with subzero growth – obviously decreases demand on the island but also potential growth as the labor force shrinks.



- *Energy costs*. Although they have fallen with oil prices, electricity costs of 22 cents per kilowatt hour are exceedingly high – similar to levels in less developed islands and several times the prices on the US mainland. As a key input cost, this cascades down to locally produced goods and services and stunts potential growth sectors such as tourism. Electricity is produced and distributed by an inefficient and over-staffed public enterprise (PREPA) using technologies decades out of date. A failure to tackle these issues satisfactorily has greatly undermined competitiveness.

- *Transport costs*. All islands, remote from the centers of economic activity, suffer from high transportation costs. But Puerto Rico does so disproportionately, with import costs at least twice as high as in neighboring islands on account of the Jones Act, which forces all shipping to and from US ports to be conducted with US vessels and crews. Even those that consider the negative effects of the Jones Act to be exaggerated – e.g., outbound cargo rates are lower than inbound ones, as ships would rather not return empty – concede it is a clear net negative. Puerto Rico also has local laws that add to transportation costs – specifically, prices and licensing requirements set by the Public Service Commission for ground transportation.

- *Barriers to competition and business activity*. A number of local laws and regulations restrict domestic competition and business investment. Puerto Rico's rankings in the World Bank's Doing Business Index slipped to 47 of 189 in 2015 (versus a #7 ranking for the US as a whole); in some areas, the rankings are decidedly bottom tier.



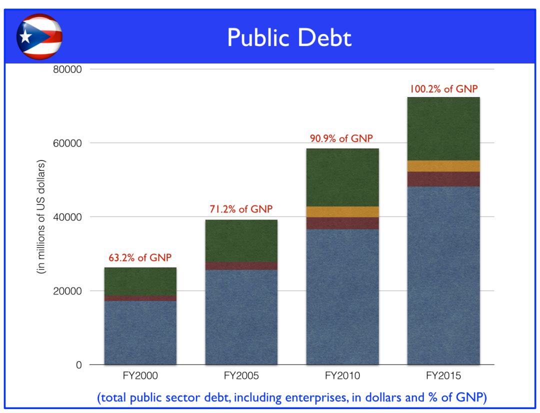
6. **These problems have shaped Puerto Rico's economic structure, policies, and growth**. High minimum wages and welfare benefits have mostly hit unskilled employment in labor intensive sectors such as tourism; the number of tourist arrivals today is in fact lower than a decade ago, and the number of hotel beds about the same as in the 1970s. The high costs of labor and transportation have meant that Puerto Rico's manufacturing sector is forced into high-value/low-weight/capital-intensive industries such as pharmaceuticals, bio-technology and software. The high cost of energy and water supply problems have also dissuaded numerous firms and industries from locating in Puerto Rico. To offset this high

input-cost structure, the government has had to resort to tax breaks to attract mainland and foreign direct investment – to the detriment of the tax system and the budget.

III. FISCAL ORIGINS

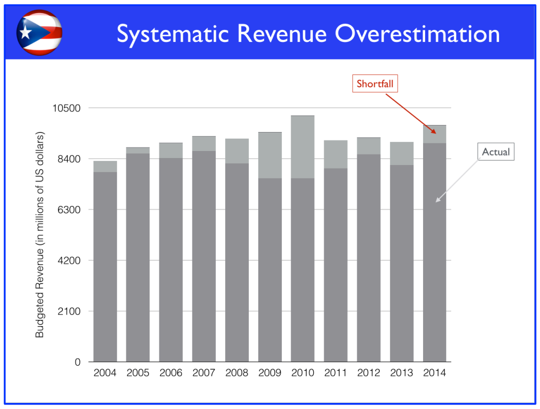
It is not just low growth that is casting a shadow over debt sustainability. Using standard IMF metrics, the overall deficit is larger than recognized, its true size obscured by incomplete accounting. This means that any fiscal adjustment program to restore market confidence starts in a deeper-than-assumed hole.

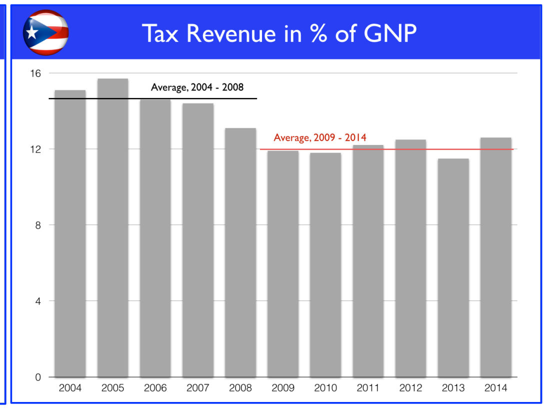
7. **Public sector debt has risen every year since 2000, through good years and bad ones, reaching 100 percent of GNP by end-FY 2014**. The central government and the three large public enterprises – the water and sewerage utility (PRASA), the state electricity company (PREPA), and the highway authority (HTA) – have been responsible for most of the increase in public debt. The fact that debt was rising even in years before the economy started to contract says something about the weakness in public finances. And how could debt continue climbing in the face of one emergency measure after another to "balance the budget" – from the sales tax in FY2006 to staff cuts in FY2009 to pension reform in FY2013?



8. **Persistent deficits reflect institutional factors, not just the weak economy:**

- *Overly optimistic revenue projections and budget formulation*. The Commonwealth's budget is based on extremely optimistic revenue projections. Over the period FY2004-2014, and even excluding the Lehman shock year FY2009, revenue forecasts have systematically exceeded actual collections by some $1.5 billion each year (15% of the original budget). The budget also systematically underestimates tax refunds due to the public from previous year filings. Revenue over-estimation happens in other places too – but rarely is it so consistently large. Moreover, tax revenues have slid markedly relative to nominal GNP, from over 15% of GNP prior to 2006 to around 12% of GNP, despite new measures implemented in the intervening period.





- *Lack of expenditure control and the buildup of payables*. Midway in the fiscal year, the Office of Budget Management lowers its revenue forecast and assigns lower spending targets to agencies. But it has no enforcement power to oversee cuts. As a result, spending agencies continue to spend, accumulating unpaid bills that remain in their offices or sit temporarily unpaid at the Treasury. These payables used to be cleared at the start of the next fiscal year with fresh appropriations and debt issuances. But the stock of payables has been rising in recent years, lengthening the queue of unhappy suppliers and the time they must wait to be paid. There are also other problems with expenditure control, including lax verification of payrolls.

- *Cash crunch and tax bargaining*. The near continuous pressure on the Treasury often brings government cash deposits down to precarious levels. To deal with this problem, in addition to delaying payables, the Treasury also tries to manage tax receipts. Sometimes, it offers tax amnesties; at other times, it offers a negotiated discount on the anticipated tax obligation if taxpayers pre-pay (closing agreements). While such practices raise needed cash, they also reduce incentives for prompt tax compliance and over time erode the tax base.

- *Tax expenditure*. Although statutory tax rates are comparable to federal ones, Puerto Rico grants extensive tax credits and exemptions to attract investment – to alleviate the problem of the island's high cost structure. For example, it is normal for firms to pay only 0-4% on their profits for 15 years (renewable); in addition, there are numerous tax credits and exemptions from income and excise taxes during and after the construction phase. Not surprisingly, collections have lagged behind the growth in manufacturing income. We have not quantified the foregone revenue/tax expenditure but there are estimates of $250-500 million per year.

- *Deficit monitoring*. The accounting systems in Puerto Rico do not permit timely and reliable monitoring of fiscal trends. The dense and hard-to-penetrate Consolidated Annual Fiscal Report (CAFR) is reliable but not timely – the latest accounts still relate to FY2013. By contrast, information on the Treasury's General Fund operations is timely but partial, as explained below.

9. **The standard measure of the fiscal balance in Puerto Rico, using General Fund accounts, greatly understates the true deficit and the challenge ahead**. There are three fundamental problems. First, the General Fund is on a cash basis: if, say, the education department delays payments for school supplies, the purchase is not recorded as spending, thus understating the deficit. (Only a year later, after boxes of missing invoices have been hauled to the Treasury and recorded for the CAFR audit, does a truer picture emerge of the fiscal deficit on an accruals basis.) Second, the General Fund excludes numerous agencies – some 150 in total, including large ones like the health insurer ASES and smaller ones like the public buildings administration – that also run deficits, as well as the GDB, which operates like an arm of the government. Third, the General Fund excludes some $300-400 million per year of capital expenditure; these too deplete cash balances or raise debt and must be counted. These missing items – missing due to the conceptual framework of the General Fund rather than any intention to mislead – are not accounting niceties but directly impact government operations. For example, if the interest payments the GDB has to make depletes its cash balances, this impacts the Commonwealth's credit rating and market access – even if the General Fund cash deficit were zero. Similarly, if the numerous small agencies run large deficits, these reduce the cash balances available to the Commonwealth. An analysis of fiscal and debt sustainability cannot be conducted on so narrow a measure as the balance in the General Fund.

10. **Accordingly, we construct a measure of the deficit incorporating estimates of non-cash spending and a broader definition of central government**. First, to ensure that both cash and non-cash spending are captured in our metric, we begin by using the fact that the flow deficit must add up to (1) net debt issued to the private sector by the Commonwealth and the GDB; (2) the accumulation of payables (due to suppliers and tax refunds)[2]; (3) the run down of cash balances, and (4) other non-debt creating financing such as asset sales. This measure of the deficit, as used by the IMF, includes all of these financing items.[3] Second, we use a wider definition of the central government, which here is comprised of the Treasury and other primary government units (as defined in Puerto Rico), including those receiving formula-based budgetary transfers (e.g., University of Puerto Rico), the GDB and COFINA. To get the central government primary deficit, we add General Fund revenues, COFINA revenues, and the net operating surplus of the GDB (revenue less administrative expenses) and deduct General Fund expenses (excluding debt service), the net operating deficits (excluding debt service) of the primary units, non-enterprise component units (e.g., ASES), and capital expenditures; federal transfers and spending cancel out but are included as an indicator of the size of the central government in the economy. Effectively, the central government includes all parts of the public sector except the municipalities, the retirement funds, and the three large enterprises (PREPA, PRASA, and HTA).

[2] The payables here refer to macro-relevant arrears (e.g., for suppliers, wages, and tax refunds) and differ from the accounting concept (which includes items like accumulated vacation benefits).

[3] In principle, the GAAP analysis of the CAFR too incorporates the financing sources cited here – but it also includes asset and liability valuation effects, which are not really financing sources for the government and obscure the flow deficit relevant to fiscal policy. Our estimates for past years remove the latter effects.

11. **The primary and overall deficits estimated in Table 1 are larger and more problematic than generally understood**. The original budget objective in FY2015 was to run a surplus of revenue over non-debt expenditure (a primary surplus) sufficient to cover interest and amortization – what in the Commonwealth is called "balancing the budget". In theory, had this occurred, cash balances and payables would have been unchanged and the debt stock would have declined by the amount of amortization. In practice, Table 1 shows that FY2015 will witness an alarming decline in cash balances and a further buildup of payables due to the fact that the $0.75 billion primary surplus is a far cry from interest and amortization costs of some $2.75 billion. The problem is not just that revenues are falling short while General Fund spending trundles along. It is also that there is other spending – on goods, services, interest and amortization – by entities other than the General Fund that is draining cash balances. This underlines the importance of using metrics that capture the full financing needs of the Commonwealth. Doing so brings the realization that the central government will be starting FY2016 in a deeper hole than understood, with the room for maneuver constrained by the loss of market access, dwindling cash balances, and a longer queue of disgruntled suppliers.

Table 1. Puerto Rico: Central Government Accounts

(In millions of dollars)

	2013	2014	Proj. 2015
Total revenue	15,881	16,468	16,439
Tax Revenue	7,889	8,551	8,724
Nontax revenue	775	590	621
GDB net operating revenue	25	25	25
Cofina	607	630	655
Federal transfers	6,586	6,671	6,414
Total Noninterest Expenditure	16,363	16,797	15,686
GF budget, less total debt service	8,946	9,135	8,425
Net operating deficit non-GF governmental funds 1/	357	359	359
Net operating deficit of non-enterprise comp.units 2/	78	139	200
Capital	396	493	288
Federal programs	6,586	6,671	6,414
Financing gap in retirement funds (ERS, TRS, and JRS)	0	0	0
Primary balance	**-481**	**-329**	**752**
Interest expenditures	2,099	1,736	1,685
Overall balance	**-2,580**	**-2,065**	**-933**
Amortization	1,597	2,606	1,060
Gross Financing Needs	**4,178**	**4,671**	**1,993**
Identified financing	4,178	4,671	1,993
Disbursements	2,535	3,255	0
Change in stock of payables	591	-124	491
Change in stock of deposits	436	1,540	1,501
Privatization	615	0	0
Memorandum items (% of GNP, unless indicated):			
Nominal GNP (millions of dollars)	68,768	69,202	69,195
Revenue, ex-federal	13.5	14.2	14.5
Noninterest expenditure, ex-federal	14.2	14.6	13.4
Primary balance	-0.7	-0.5	1.1
Interest expenditure	3.1	2.5	2.4
Overall balance	-3.8	-3.0	-1.3
Stock of deposits and investments (millions of dollars)	4,554	3,014	1,512
Stock of payables (millions of dollars)	3,302	3,178	3,669

1/ Includes primary government agencies such as Public Buildings, the Medical Services Administration, and the Infrastructure Financing Authority (PRIFA).
2/ Includes non-primary, non-enterprises, such as ASES.

12. **A similar narrative of large flow deficits applies to the wider public sector:**

- The three big state enterprises and the employee and teacher retirement funds are also running deficits. Operational data and projections of the enterprises were made available and indicate that the enterprises are generally running overall deficits. The shutoff of market financing means that needed capital improvements, including those mandated by federal environmental laws, have been delayed.

- Although reforms have raised contribution rates and shifted the system away from a defined benefit regime, the continuing payout of previously accumulated rights has fully drained the liquid assets of the employee retirement system for government workers (ERS) and brought those of the teachers and judicial workers to low levels. The combination of high payouts for those with accumulated rights and few new contributors implies shortfalls that will ultimately fall on the central government.

Puerto Rico: Fiscal Balances of Key Public Enterprises and Retirement Funds

(In millions of US$s)	2014	Proj. 2015		2014	Proj. 2015
PREPA			ERS		
Operating revenue	4,660.5	4,124.0	Contributions	893.1	925.0
Noninterest expenditure	4,211.7	3,563.0	Pensions & admin costs	1,537.0	1,629.0
Primary balance	448.8	561.0	Primary balance	-643.9	-704.0
Interest expenditures	458.4	414.6	Interest expenditures	179.4	166.5
Financing needs	298.5	764.0	Financing need	823.2	870.5
Deficit	9.6	-146.4	Deficit	823.2	870.5
Amortization	288.9	910.4	Amortization	0.0	0.0
Financing sources	816.9	764.0	Financing sources	854.2	872.5
Payables	479.3	0.0	Payables	0.0	0.0
Changes in deposits and inve	-337.4	342.3	Net asset movements	853.2	870.5
Disbursements	675.0	0.0	Disbursements	1.0	2.0
Arrears on debt service	0.0	421.7	Debt stock	2,947.6	2,947.6
Debt stock (includes arrears)	8,526.7	8,969.5	Assets	2,021.7	1,151.2
Deposits	1,465.9	1,123.6			
PRASA			TRS		
Operating revenue	1,045.5	1,105.6	Contributions	...	383.4
Noninterest expenditure	985.5	951.6	Pensions & admin costs	...	671.8
Primary balance	60.1	153.9	Primary balance	...	-188.4
Interest expenditures	241.1	284.6	Interest expenditures	...	0.0
Financing needs	258.4	234.4	Financing need	...	188.4
Deficit	181.0	130.7	Deficit	...	188.4
Amortization	77.4	103.7	Amortization	...	0.0
Financing sources	432.8	234.4	Financing sources	...	188.4
Payables	230.5	0.0	Payables	...	0.0
Changes in deposits and inve	-39.3	-560.6	Net lending	...	0.0
Disbursements	241.5	795.0	Net asset movements	...	188.4
Debt stock	4,095.5	4,786.8	Debt stock	0.0	0.0
Deposits	462.9	1,023.5	Assets	1,303.8	1,115.4
HTA					
Operating revenue	826.9	918.9			
Noninterest expenditure	438.7	639.3			
Primary balance	388.2	279.6			
Interest expenditures	435.8	255.1			
Financing needs	380.8	80.7			
Deficit	47.7	-24.5			
Amortization	333.1	105.2			
Financing sources	380.8	80.7			
Payables	298.8	285.0			
Changes in deposits and inve	-20.6	-204.3			
Disbursements	102.7	0.0			
Debt stock	4,824.7	4,719.5			
Deposits	769.4	973.7			

13. **These flow deficits have worsened prospects for debt sustainability**. Consolidating the full public sector – central government, three enterprises, and two retirement funds – yields an overall deficit averaging 5% of GNP in FY2013 - FY2014. As nominal GNP growth is

barely 1%, flow deficits of this magnitude imply rising debt ratios, and explain the growing – if belated – concern in financial markets about the sustainability of public debt.

IV. PROSPECTS UNDER CURRENT POLICIES

Even if the recent sub-crisis situation could somehow persist (rather than worsen), current policies imply an unsustainable fiscal situation.

14. **The near-term prospects for growth are poor – but we begin by positing something less bleak**. The reason is that we want to avoid drawing a strong negative conclusion about the fiscal outlook by *assumption* – i.e., by assuming a deteriorating growth outlook. The baseline scenario thus assumes that intermittent access to liquidity forestalls an overt financing crisis, and that real GDP growth somehow remains around -1%. The implied assumption of zero per capita income growth does not strike us as too pessimistic – if anything, it is probably *too optimistic*:

- The international experience is that financial market shocks have far more profound effects on economic activity than real shocks. Therefore, it is likely that investment will remain severely depressed on account of the financial turmoil and uncertainty.

- The forced contraction in the fiscal deficit, as well as the restriction of spending to the revenues coming in each month, will depress aggregate demand.

- The key housing/construction sector remains under pressure. The stock of vacant homes is still high and home prices may have further to fall. Given the centrality of home values as collateral, this will add to the downward pressure on credit.

- The longer-term structural problems persist: the labor force is still shrinking and there is little reason to think that competitiveness has improved.

- The one positive development, a significant one, is lower oil prices. However, the fact that activity indicators have continued to sink in spite of lower oil prices leads us to judge it inadequate to overcome all of the above.

The muddle-through-baseline with -1% real growth and 2% inflation is merely an analytical construct to assess the *minimum* financing needs that arise over the next five years. A more realistic macro scenario might consist of a much sharper decline in output if a crisis were to materialize; alternatively, an early decline might be followed by recovery if pre-emptive actions are taken. We will return to the latter.

15. **Against this backdrop, central government deficits and amortizations over the coming years imply an unsustainable trajectory of large financing gaps (Table 2)**. The projections focus on FY2016-2020 but, to better convey the challenges, have been extended to FY2025. The baseline uses OMB projections for coming years but does not include the

progress on the sales tax reform (which is taken into account later on). The result is overall deficits of some \$2½ billion per year (3½ % of GNP) over the next five years; this projection includes budgetary support for the Employee Retirement Fund starting in FY2017, for the judiciary starting in FY2019, and for teachers starting in FY2020. Further, there are: (i) amortizations; (ii) gradual pay down of arrears to suppliers and taxpayers (\$450 million per year); and (iii) downside risks from a potential loss of federal funding for the Affordable Care Act and from a decline in Law 154 excises (due to modified source income accounting rules for firms operating in multiple tax jurisdictions). After factoring these in, the total financing gap ranges from \$3½-7½ billion per year through FY2025. If market access were open, central government debt would more than double by FY2025. But since that is neither sustainable nor feasible, financing gaps will have to be closed through policy action.

Table 2. Puerto Rico: Central Government Outlook
(In millions of dollars)

	Proj. 2015	Proj. 2016	Proj. 2017	Proj. 2018	Proj. 2019	Proj. 2020	Proj. 2021	Proj. 2022	Proj. 2023	Proj. 2024	Proj. 2025
Total revenue	16,439	15,875	16,120	16,426	16,628	16,813	16,981	17,154	17,341	17,537	17,738
Tax Revenue	8,724	7,960	8,038	8,117	8,196	8,277	8,358	8,440	8,522	8,606	8,690
Nontax revenue	621	627	632	638	644	650	656	662	669	675	681
GDB net operating revenue 1/	25	130	200	329	352	353	335	321	317	320	324
Cofina	655	682	709	737	767	799	831	864	899	934	972
Federal transfers	6,414	6,477	6,540	6,604	6,669	6,734	6,800	6,867	6,934	7,002	7,071
Total Noninterest Expenditure	15,686	15,631	16,086	17,179	17,900	18,594	19,117	19,450	19,794	20,097	20,446
GF budget, less debt serv., plus unacc. funds	8,425	8,142	8,259	8,910	9,598	10,070	10,415	10,644	10,884	11,158	11,409
Net operating deficit of non-GF governmental funds 2/	359	362	366	370	373	377	381	384	388	392	396
Net operating deficit of non-enterprise comp.units 3/	200	350	353	357	360	364	367	371	375	378	382
Capital	288	300	300	300	300	300	300	300	300	300	300
Federal programs	6,414	6,477	6,540	6,604	6,669	6,734	6,800	6,867	6,934	7,002	7,071
Financing gap in retirement funds (ERS, TRS, and JRS)	0	0	268	638	599	748	853	883	913	867	888
Primary balance	**752**	**243**	**34**	**-753**	**-1,271**	**-1,781**	**-2,137**	**-2,295**	**-2,454**	**-2,560**	**-2,708**
Interest on pre-2015 debt	1,685	1,920	1,986	1,942	1,879	1,810	1,763	1,719	1,692	1,653	1,659
Overall balance	**-933**	**-1,677**	**-1,953**	**-2,695**	**-3,150**	**-3,590**	**-3,899**	**-4,014**	**-4,146**	**-4,213**	**-4,367**
Amortization of pre-2015 debt	1,060	1,561	873	846	1,517	1,186	1,132	921	888	1,408	898
Gross Financing Needs	**1,993**	**3,238**	**2,825**	**3,541**	**4,667**	**4,776**	**5,031**	**4,934**	**5,034**	**5,620**	**5,265**
Identified financing	1,993	-438	-450	-450	-450	-450	-450	-450	0	0	0
Disbursements	0	0	0	0	0	0	0	0	0	0	0
Change in stock of payables	491	-450	-450	-450	-450	-450	-450	-450	0	0	0
Change in stock of deposits	1,501	12	0	0	0	0	0	0	0	0	0
Privatization	0	0	0	0	0	0	0	0	0	0	0
Financing gap on current policies	**0**	**3,676**	**3,275**	**3,991**	**5,117**	**5,226**	**5,481**	**5,384**	**5,034**	**5,620**	**5,265**
Added margin for downside risks	**0**	**0**	**894**	**1,903**	**1,912**	**1,921**	**1,930**	**1,939**	**1,948**	**1,957**	**1,967**
Loss of ACA funding 4/			0	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Law 154 excise losses			894	903	912	921	930	939	948	957	967
Total financing gap		**3,676**	**4,169**	**5,893**	**7,028**	**7,147**	**7,410**	**7,323**	**6,981**	**7,577**	**7,231**
Memorandum items (% of GNP, unless indicated):											
Nominal GNP (millions of dollars)	69,195	69,873	70,558	71,249	71,947	72,652	73,364	74,083	74,809	75,542	76,283
Revenue, ex-federal, on current policies & risks	14.5	13.4	12.3	12.5	12.6	12.6	12.6	12.6	12.6	12.7	12.7
Noninterest expenditure, ex-federal, on current policies & risks	13.4	13.1	13.5	16.2	17.0	17.7	18.2	18.3	18.5	18.7	18.8
Primary balance on current policies & risks	1.1	0.3	-1.2	-3.7	-4.4	-5.1	-5.5	-5.7	-5.9	-6.0	-6.1
Interest expenditure on current policies & risks	2.4	2.7	2.8	2.7	2.6	2.5	2.4	2.3	2.3	2.2	2.2
Overall balance on current policies & risks	-1.3	-2.4	-4.0	-6.5	-7.0	-7.6	-7.9	-8.0	-8.1	-8.2	-8.3
Stock of deposits and investments (millions of dollars)	1,512	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Stock of payables (millions of dollars)	3,669	3,219	2,769	2,319	1,869	1,419	969	519	519	519	519

1/ Includes petroleum tax (PET) net receipts as a revenue source for the GDB in 2016-2025.
2/ Includes primary government agencies such as Public Buildings, the Medical Services Administration, and the Infrastructure Financing Authority (PRIFA).
3/ Includes non-primary non-enterprises, such as ASES (healthcare agency) and the bus and ferry mass transit authority (from 2016 on).
4/ As in many of the projections, the actual outturn could be worse. For example, in the absence of reform of the healthcare system the cost here could reach \$2 billion by 2019 and the gap in the retirement funds could be larger in the absence of strict adherence to increasing contribution rates.

16. **The financial situation of the public sector enterprises is also precarious**. The projections assume that the central government will have to assume loss-making operations of the highway authority to keep it afloat. The electric utility PREPA is already operating on

a pure cash basis; until its situation with its creditors is regularized, it accumulates interest and amortization arrears of over $600 million per year. The water and sewage company PRASA is not projected to generate enough revenues to cover EPA-mandated investments.

V. A STRATEGY FOR GROWTH AND CONFIDENCE

The restoration of confidence and growth requires ambitious measures in three inter-locking areas: structural reform, fiscal consolidation/debt restructuring, and institutional reform. All are important, and the exclusion of any one reduces the chances of success of the others.

17. **The key to turning around Puerto Rico's situation is a revival of growth**. The island has many problems but they all result in the same outcome – a lack of growth. Structural rigidities have compromised competitiveness and yielded stagnation. Weak fiscal discipline has resulted in uncertainty that is further depressing economic activity and employment. Low growth feeds back to strains on revenue and spending. It is a vicious circle.

18. **A comprehensive approach is needed**. The problems are too interdependent. For example, fiscal adjustment alone might strengthen confidence in long-term public finances and thereby support demand. But too much fiscal tightening could also depress demand in the near-term and would do nothing to address the supply side problems at the root of Puerto Rico's growth problem. Similarly, structural reforms alone would still leave large fiscal financing gaps. Hence the need for complementary structural reforms to boost growth and debt restructuring to avoid an economically harsh and politically unviable cut in the fiscal deficit. A combination of structural reforms, fiscal adjustment, and debt restructuring ensures that all problems are addressed. And, importantly, it shares the costs and benefits of adjustment across all stakeholders.

19. **Puerto Rico's record of failed partial solutions also argues for a comprehensive approach**. Over the years, successive administrations put in place important and even lasting policy responses. However, they focused on fiscal deficits, not economic growth. Moreover, even the narrow approach was implemented in an ad hoc manner in response to immediate pressures rather than in a forward-looking way that acknowledged the scope of fiscal problems. Thus, the introduction of the sales tax in FY2006 was followed by a fiscal emergency to cut government staffing in FY2009, by reform of public employee and teacher pensions in FY2013, by the petroleum tax in FY2014, and most recently by the attempted VAT reform – each presented as a durable solution to the island's problems. Puerto Rico's current predicament reflects its unsustainable policies but also a lack of confidence in its preparedness to change course.

20. **Establishing a new and credible strategy will be challenging**. The needed measures face domestic political resistance (e.g., on labor laws and cutting fiscal deficits), federal inertia (e.g., on exemptions to the minimum wage and the Jones Act), legal challenges (e.g., on debt restructuring), and organizational difficulties in keeping the program on track. New institutions to establish budget discipline and data transparency will need to be created. All

this will fully occupy the administration. But so would *not* implementing a comprehensive solution, which might usher in an even more severe and harder-to-manage crisis.

A. STRUCTURAL REFORMS

Supply-side reforms are fundamental to any lasting economic recovery but will take time to implement and to bear fruit.

21. **Puerto Rico has many advantages to build on but also important disadvantages, some within its power to tackle and some requiring federal help**. Among the advantages are its natural gifts as a tropical island, the size of its college-educated and bilingual population, its sizable manufacturing base, its situation as an integral part of the United States, with all the attendant benefits in terms of currency stability, legal system, property rights, and federal backing of welfare, education, defense, and banking. That is a lot. At the same time, there are numerous policy failures that raise input costs and stifle growth. While some of these are within the Commonwealth's power to fix (such as local labor regulations), others lie in the remit of the federal government and the US Congress (the minimum wage and welfare rules, the Jones Act, and Chapter 9 bankruptcy eligibility). If these could be overcome, there is no reason why Puerto Rico could not grow in new directions – likely ones like tourism, possible ones like serving as a financial/services hub between North and South America, and entirely unpredictable ones because that is how reforms have played out elsewhere. Reducing input costs for labor, energy and transport is key to regaining competitiveness, so that production can be geared to more buoyant external markets.

22. **A fresh start on structural reforms should begin with the recognition that supply-side reforms take time**. Partly this is because reforms are hard to formulate and legislate. Partly it is because, even after being implemented, it takes time for people to perceive the change and to gain confidence that reforms will stick and not be reversed by the next administration. The impact on growth could take 2-4 years to become apparent, less when (a) there is a prior history of successful reforms; (b) the strategy and details are effectively communicated; (c) all segments of society share in the reform effort's near-term costs and long-term gains; and (d) the program as a whole is credible, with upfront delivery of key reforms. Experience also teaches that while the goals should be clear at the start, structural reform is more a process than a check-list: the details need to evolve with circumstances.

23. **To raise employment, it is imperative to remove the disincentives for firms to hire workers and for workers to accept jobs**. As suggested earlier, the key issues are as follows:

- The US federal minimum wage of $7.25 per hour is too high relative to local incomes and regional competitors. Puerto Rico should seek an exemption until such time as its per capita income approaches that of the poorest US state, which currently is still 50% higher than Puerto Rico's. If full exemption is not possible, then an alternative might be to set the rate for Puerto Rico at one-third the general rate (per capita income in Puerto Rico is about one-third that on the mainland).

- Local labor laws magnify employment costs. Undoing this entails: (i) redefining overtime as on the mainland (excess over a 40-hour week, not 8-hour day); (ii) cutting paid vacation days to mainland levels (for public sector workers, from 30 days to 15 days); (iii) eliminating the mandatory end-of-year bonus; (iv) reducing onerous requirements for proving just cause in layoffs to mainland levels; (v) extending the probationary period for new employees from 3 months to 1-2 years; and (vi) relaxing labor laws for youth/new entrants for the first few years.

- Federal welfare payments are generous relative to the low incomes in Puerto Rico, and as such are a disincentive for the unskilled to accept work (lest they lose benefits). Welfare needs to be made consistent with local labor market conditions rather than with US mainland conditions. The federal government should therefore give the Commonwealth more latitude to adjust welfare requirements and benefits – e.g., to continue food stamps for a while even after a person returns to work; or to provide lower housing benefits to more people rather than higher benefits to a few (the Commonwealth block grant is capped and insufficient for all those who qualify). Puerto Rico too can act here, cutting back the Medicaid benefits it pays out over and above the Federal minimum standard (thus saving some $150 million per year).

24. **Exempting Puerto Rico from the US Jones Act could significantly reduce transport costs and open up new sectors for future growth**. In no mainland state does the Jones Act have so profound an effect on the cost structure as in Puerto Rico. Furthermore, there are precedents for exempting islands, notably the US Virgin Islands. Puerto Rico should also eliminate its own self-imposed costs by freeing up the scope for competition in ground transportation and liberalizing the associated prices set by the Public Service Commission.

25. **The drive for competitiveness must include a cut in high energy costs, which cascade down to the rest of the economy**. The silver lining in PREPA's financial difficulties is that it has forced the public enterprise to confront its problems of over-staffing and inefficiency. The specifics of upcoming reforms, and the associated debt relief to make it viable, are still being worked out by PREPA and its creditors. Whatever the details, they should build to a solution where PREPA focuses on transmission and distribution, while electricity generation is opened up to competition from newer and more efficient suppliers.

26. **A lot can be done to lighten the burden of doing business, which is particularly important when reforms are aiming to move the economy in new directions**. To date, the term business-friendly in Puerto Rico has referred to efforts to offset high input costs with tax breaks and subsidies. As input costs are brought down, the focus should shift to ensuring a level playing field and greater ease of doing business, including permits for new businesses. This is always an on-going task but a start could be made by addressing the three weakest areas identified by the World Bank: the difficulty in registering property, in paying taxes, and in obtaining construction permits. There is already some progress to build on, notably a plan to modernize property registration. Lest this sort of work slip into

obscurity in the press of a crisis, the task should be assigned to a high-level official held accountable for pulling up the Commonwealth's score in future Doing Business rankings.

B. FISCAL ADJUSTMENT AND PUBLIC DEBT

Given looming revenue and spending pressures, eliminating the fiscal deficit will take substantial measures. Reforms should aim more at broadening tax bases than raising rates, and at targeted expenditure reduction rather than across-the-board cuts. But even a major fiscal effort leaves large residual financing gaps that will need to be bridged with debt relief.

27. **Table 3 illustrates a scenario where revenue and expenditure substantially reduce the total financing gap in coming years**. The measures set out below, along with the revenue enhancing effects of structural reform, would eliminate the overall budget deficit by FY2020. Given the starting point of fiscal unsustainability, this is important. At the same time, the adjustment scenario tries to be as growth friendly as possible, avoiding too sharp a contraction in the near-term, and focuses more on broadening tax bases than on raising tax rates. The measures below are, in our view, sensible and feasible. But there are undoubtedly other sensible and feasible options the government will also want to explore.

Table 3. Puerto Rico: Central Government Outlook

(In millions of dollars)

	Proj. 2015	Proj. 2016	Proj. 2017	Proj. 2018	Proj. 2019	Proj. 2020	Proj. 2021	Proj. 2022	Proj. 2023	Proj. 2024	Proj. 2025
Total financing gap		**3,676**	**4,169**	**5,893**	**7,028**	**7,147**	**7,410**	**7,323**	**6,981**	**7,577**	**7,231**
Additional reform measures		**1,157**	**1,822**	**3,315**	**4,174**	**4,913**	**5,191**	**5,482**	**5,758**	**6,047**	**6,352**
Revenue measures		1,157	1,576	2,073	2,439	2,827	3,005	3,194	3,394	3,604	3,827
Rise in income taxes from labor reform		0	56	142	248	376	527	689	860	1,043	1,237
Revamp property tax		100	200	350	350	350	357	364	371	379	386
Elimination of tax amnesties and closings		0	50	50	50	50	50	50	50	50	50
Overhaul of corporate tax system		0	250	500	750	1,000	1,010	1,020	1,030	1,040	1,050
VAT/sales tax		1,057	1,021	1,031	1,041	1,051	1,061	1,072	1,082	1,093	1,104
Expenditure measures		0	246	1,242	1,735	2,086	2,186	2,288	2,364	2,443	2,525
Renewal of Law 66		0	0	568	800	1,051	1,072	1,093	1,115	1,138	1,160
Resizing of education services		0	50	200	300	400	450	500	523	547	571
Bring down medicaid benefits to federal standards		0	75	150	150	150	157	164	171	179	187
Reduced subsidization of UPR		0	121	323	485	485	507	530	554	579	606
Increased revenue from reform-induced increase in GNP growth		0	509	632	791	988	1,227	1,479	1,745	2,025	2,319
Residual financing gap after measures	**0**	**2,519**	**1,838**	**1,946**	**2,063**	**1,246**	**992**	**362**	**-521**	**-494**	**-1,440**
Total debt service	**2,745**	**3,481**	**2,859**	**2,788**	**3,395**	**2,995**	**2,894**	**2,639**	**2,580**	**3,060**	**2,557**
Principal amortization	1,060	1,561	873	846	1,517	1,186	1,132	921	888	1,408	898
Interest	1,685	1,920	1,986	1,942	1,879	1,810	1,763	1,719	1,692	1,653	1,659
Memorandum items (% of GNP, unless indicated):											
Nominal GNP in reform scenario (millions of dollars)	69,195	69,873	71,270	73,423	76,014	79,085	82,684	86,446	90,379	94,491	98,791
Real GNP growth (in %)	-1.0	-1.0	0.0	1.0	1.5	2.0	2.5	2.5	2.5	2.5	2.5
Inflation (in %)	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Revenue,ex-federal, in reform scenario	14.5	15.1	15.1	15.8	16.2	16.4	16.3	16.2	16.2	16.1	16.0
Noninterest expenditure in reform scenario	13.4	13.1	13.0	14.1	13.8	13.6	13.5	13.1	12.7	12.3	12.0
Primary balance in reform scenario	1.1	2.0	2.1	1.8	2.3	2.8	2.8	3.2	3.4	3.8	4.0
Overall balance in reform scenario	-1.3	-0.7	-0.7	-0.9	-0.1	0.5	0.7	1.2	1.6	2.0	2.4
Stock of deposits and investments (millions of dollars)	1,512	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Stock of payables (millions of dollars)	3,669	3,219	2,769	2,319	1,869	1,419	969	519	519	519	519

28. **On the revenue side, there is scope to raise receipts by $1 billion in FY2016, around $3 billion annually by FY2020 and $4 billion annually by FY2025**. Some possible measures:

- Adoption of a sales tax as proposed by the administration; this could yield just over $1 billion in FY2016.

- A surcharge on the corporate income tax that would also cover firms currently paying only 0-4% (versus the statutory 35%). This should be seen as a first step to an eventual overhaul that replaces widespread exemptions with a low flat rate of 10-15%; this is assumed to yield $250 million starting in FY2017 and to rise quickly after that.

- A step up in property taxes (currently based on real estate values from 1954); updating the registry and adjusting down tax rates could yield $100 million in FY2016 and more in later years as the project takes off (a target of 1% of GNP is reasonable). This is shown in Table 3 as a revenue measure but could equally be treated as a spending measure: since municipalities normally retain property taxes, the central government revenue could cut its transfers to municipalities by the amount of additional property tax receipts.

- Rising income tax collections from higher worker participation due to labor reforms; the amount raised is assumed to be a modest $50 million in early years but grows quickly.

The payoffs from the above are indicative and obviously will depend on details that have yet to be worked out. Substantial additional revenue might also accrue from improved tax collection, which is low relative to statutory rates not just due to exemptions but also due to poor compliance; no assumptions regarding improved compliance are made at this stage.

29. **On the expenditure side, there is scope to save over $2 billion per year by FY2020 and $2½ billion per year by FY2025**:

- Renewing Law 66 (freeze of certain formula-based transfers from the general fund) and freezing remaining spending in real terms saves $1 billion by FY2020. Capital/ infrastructure is assumed flat but could be raised if revenues exceed expectations.

- Puerto Rico currently has 40% fewer students but 10% more teachers than a decade ago. Teacher-student ratios are high, higher than in the mainland and many of its wealthiest and best-performing counties. A gradual cut in the number of teachers saves $400 million per year by FY2020 – more if sparsely attended schools are also consolidated. The one-off costs of retrenchment should be met by one-off revenues, e.g., if valuable/cash-rich enterprises like the state insurance fund are privatized.

- A reduction in the subsidy for the University of Puerto Rico. College students currently pay a low flat rate that for many is far lower than on the mainland and far lower than what well-off UPR students paid for private high school. Rather than a blanket subsidy, support should be provided through need-based scholarship. A program along these lines could save up to $500 million by FY2020.

- Cuts in Medicaid benefits in excess of minimum standards on the US mainland. This could save an estimated $150 million per year.

Despite these cuts, total expenditure would still rise in dollar terms and relative to GNP as it is assumed that the government makes up for any cash shortfalls of the retirement funds.

30. **The fiscal benefits of comprehensive reform should also be factored in**. The bottom of Table 3 sets out a higher growth path than assumed so far. The difference between a trend real GNP growth of -1% and of +2.5% delivers additional revenue of some 2½% of GNP by FY2025, which is built into the projections of the residual financing gap after measures.

31. **The quantitative estimates in Table 3 are subject to great uncertainty and do not reflect the full menu of policy options**. Apart from known unknowns such as the size of declines in Law 154 excise receipts, the baseline financing gap projections are subject to numerous other assumptions (e.g., the rate at which payables are brought down) and do not cover all government reform needs (e.g., retirement system funding). The impact of measures also hard to predict and depend on the timing and specifics. Could the measures be enhanced or made more front loaded? Perhaps but not easily. Even if enacted quickly, it would be imprudent to assume large revenue increases in the first year of an adjustment program, when economic pressures and implementation difficulties are at their most intense. The payoff is especially unclear with regard to the corporate tax surcharge – although the need to claw back decades of exemptions and tax spending is acute.

32. **Even after factoring in a major fiscal effort, a large residual financing gap persists into the next decade – implying a need for debt relief**. On the assumptions embodied in Table 3, to close the residual financing gap, the government would need to seek relief from a significant – but progressively declining – proportion of the principal and interest falling due during FY2016-22 the residual financing gap disappears by FY2023. The precise amount of debt relief will need to be calibrated to the specifics of the reform and the likely path of the economy, both of which are uncertain at this stage.

33. **Debt relief could be obtained through a voluntary exchange of old bonds for new ones with a later/lower debt service profile**. To agree to it, bondholders would need to be convinced that the specific reforms on the table are indeed a best use of debt relief, and that – by keeping the government functioning as it phases in organizationally and politically difficult measures – the reform program will increase the expected value of their claims. Negotiations with creditors will doubtlessly be challenging: there is no US precedent for anything of this scale and scope, and there is the added complication of extensive pledging of specific revenue streams to specific debts. But difficult or not, the projections are clear that the issue can no longer be avoided.

34. **Any discussion with creditors on general obligation debt should be coordinated with the parallel one being conducted by public enterprises**. The government will need to coordinate its own discussions on general obligation debt with those already in progress for public enterprises – not least because creditors too, like the government, will look at the overall resource envelope and investment needs in public enterprises. To facilitate a more orderly discussion of debt, it would help if the US Congress were to remove the explicit exclusion of Puerto Rico from the provisions of Chapter 9 of the US bankruptcy code.

C. INSTITUTIONS AND CREDIBILITY

The legacy of budgetary laxity, non-transparency, and unreliable/dated statistics must be overcome if the reform program is to work and command credibility. The priorities include a rolling 5-year budgetary plan approved by the legislature, legislative rules to limit changes to the plan, an independent fiscal oversight board to advise on the budget and control its implementation, and strengthening the quality and timeliness of economic data.

35. **The first step must be legislative approval of a long-term fiscal plan**. Broad political backing for the fiscal adjustment plan – for all five years of the adjustment, not just for FY2016 – will be crucial to its credibility. To limit the scope for deviations, the legislature should consider adopting rules that either force across-the board spending cuts (a Gramm-Rudman rule) or else some combination of spending cuts and tax increases (a PAYGO rule) if any subsequent measure or event causes the projected fiscal deficit to deviate from its planned path. Experience shows that such legislative rules can improve fiscal discipline, but cannot ensure it, as they work by restraining fiscal plans rather than fiscal outcomes.

36. **An independent fiscal oversight board can improve fiscal outcomes**. The group, comprised of experienced individuals from inside and outside the Commonwealth, would vet the current year's budget and the rolling 5-year fiscal plan prior to submission to the legislature; it would also have special powers to enforce approved budgets. These powers are needed because of Puerto Rico's legacy of overly-optimistic budget estimates and of failure to control spending even when it is clear that revenue targets will not be met. Effective expenditure control will take more than an oversight board at the top. It will also take uniform data and reporting requirements across all spending agencies – spending units currently employ different IT systems – as well as internal coordination. The existing single treasury account needs to be employed as an expenditure control mechanism as well as its current use as a centralized payment system. Notwithstanding the logistical challenges, consideration should be given to merging the operations of the Government Development Bank and the Commonwealth Treasury (Hacienda). The functional overlap is significant, while coordination is hindered by differences in formal roles and governance structures.

37. **Greater transparency in the provision of fiscal data could also enhance market discipline**. As discussed earlier, the published quarterly figures are too narrow in scope to provide an accurate picture, while the CAFR consolidated accounts appear with a long lag and are difficult to interpret. Analysts should not have to engage in jujitsu with the data in order to figure out the fiscal deficit. The data will need to be put in a standardized format, as has been done in this report, and published in regular updates.

38. **Finally, statistics on the wider economy need to be strengthened – urgently**. The problems with the national accounts are severe. The US Bureau of Economic Analysis has a report on what needs to be fixed but a lack of resources has limited progress. Consideration should be given to consolidating the relevant statistics providers and giving them necessary funding. Better statistics are not a luxury. Without them the Commonwealth is flying blind

and market uncertainty about underlying developments is reflected in the risk premium on government debt. Improved statistics and data transparency could pay for themselves.

VI. OBJECTIONS AND RESPONSES

This section subjects some of the above arguments to a stress test of counterarguments – not to pre-empt objections but to probe into the thinking behind the analysis.

39. *Objections – growth.* Some might wonder if the report is too pessimistic on near-term prospects. After all, there are positive signs. Private employment has stopped falling; the GDB's economic activity index has improved; and many individual sectors are doing well, including tourism, agriculture, and increasingly aeronautics. It could also be argued that official figures underestimate growth on account of overestimated price deflators.

40. *Response*. Fine but the improvements are too small, narrowly focused, recent – and dwarfed by the gorilla in the room: the damage from a decade of stagnation and the cutoff of market access, which experience tells us has severe negative effects on credit, investment, and consumption. More generally, Puerto Rico is suffering from protracted supply side problems, its growth potential eroding in the face of a shrinking labor force, narrowing manufacturing base and depreciating capital stock. Turning this around will take time and more ambitious action. Finally, on GNP statistics, the overestimation of price deflators is not the only problem: *nominal* GNP may also be overstated, in which case lower price deflators do not necessarily yield higher real growth estimates.

41. *Objections – Puerto Rico structural reforms*. Many will doubt that upfront action in so many structural areas is feasible in Puerto Rico. The reforms are difficult enough individually. Attempting all at once risks overloading the political circuits.

42. *Response*. The government is better positioned than we are to assess political feasibility. Certainly, many countries have found ways to muster support for comprehensive reforms, albeit usually in the context of international support. But, support or no support, the island has little choice now but to press ahead. It has tried gradual and partial solutions to no avail. The crisis can concentrate minds in the political system to suspend "business as usual" and attend to all that has gone untended for years – it ought to get on with this regardless of the speed of federal action. Not all action need be up front but there should be enough up front to make it credible, with a clear road map of further reforms and where they lead. Importantly, the proposed package shares the costs of reform – lower wages for labor, fewer tax exemptions for business, debt re-profiling for creditors – while holding out the prospect of renewed confidence and growth, which benefits all.

43. *Objections – federal structural reforms*. Why not focus on something simpler like reviving US tax preferences? Many consider it naïve to think that the US Congress would modify labor and transportation laws intended for all of the United States just to help out

Puerto Rico. It may be easier to push for something that the Congress has agreed to before – tax preferences, the loss of which is anyway the original sin behind the island's travails.

44. *Response.* Reforms in labor, transport, and bankruptcy laws are economically essential. They may face political resistance in Washington DC but Puerto Rico has a case to make. On reinstating US tax preferences, it is not clear that this is an easier ask for the US Congress. Or that mainland firms would necessarily be lured to the island, as exemptions can – and have – been withdrawn before. Or indeed that a growth model founded on tax advantages is better in the long run than one based on genuine competitiveness.

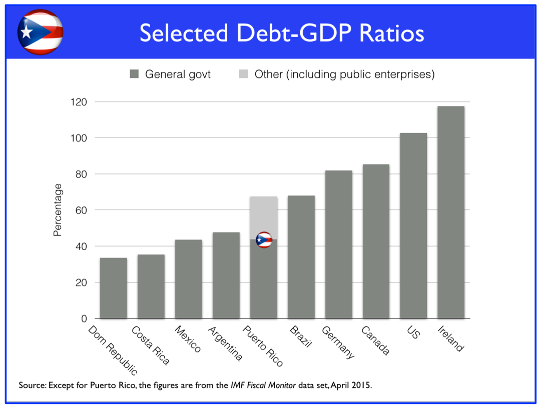
45. *Objections – minimum wage*. Even if one accepts that there may eventually be positive effects on hiring from lower wages, one has also to take into account that lower wage earnings by the currently employed will reduce domestic spending and growth.

46. *Response*. First, it is unlikely that a reduction in the minimum wage will induce an instantaneous fall in all wages in Puerto Rico. The downward pressure on wages, like the upward pressure on employment, will take time to play out; and anyway, below minimum-wage market wages already exist in the large informal sector. Second, even if currently employed workers reduce their spending by some fraction of lost earnings, this should be offset – more than offset – by the higher spending of the newly employed. Third, labor reform should be seen in a wider context of the effort to restore confidence in future growth, which should raise consumption and investment.

47. *Objections – pace of fiscal adjustment*. Some observers might point to the contrasting experiences of Ireland and Greece with fiscal adjustment. Ireland, in many ways similar Puerto Rico (a large resident base of multinational firms, a recent housing bust, low corporate taxes), had much better growth outcomes partly because it had a more gradual fiscal adjustment than Greece. Puerto Rico should heed the lesson that fiscal multiplier effects are high in crisis situations, and so reduce its fiscal deficit only gradually.

48. *Response.* There was scope for slower fiscal adjustment in Ireland because off-market financing was made available to it by Euro zone partners and the IMF. Ireland's policy credibility was also enhanced by quarterly EC/IMF monitoring of program implementation, and by the fact that its fiscal problem was not decades old but the result of a banking crisis. These points do not apply to Puerto Rico, thus limiting its options. That said, Puerto Rico does have scope to generate some financing by reprofiling part of the debt service falling due, and having the adjustment effort overseen by a fiscal oversight board. Ultimately, Puerto Rico needs to strike a balance between the demands of financing, credibility and growth – which is what the fiscal adjustment scenario here tries to do.

49. *Objection – debt burden*. Many people argue that Puerto Rico's debt ratios aren't bad by international standards, especially if the Commonwealth's ratio is calculated relative to *GDP* (not GNP, which is much lower) and public enterprises are excluded (as in other countries). They argue that Puerto Rico's problem is not too high debt but too high deficits.



50. *Response.* Regardless of whether public enterprise debt is included or not, or deflated by GDP rather than GNP, the fact is that Puerto Rico's situation is worse than simple debt ratios suggest because the island is laboring under near-zero *nominal* GNP/GDP growth. This inevitably forces up debt ratios over time. None of the other countries in the chart is in this situation. On inclusion of enterprises in public debt statistics, that hinges on whether the government can, as a practical matter, maintain a hands off financial relationship with enterprises. Could Puerto Rico countenance an interruption – prolonged by the absence of Chapter 9 bankruptcy provisions – in the electricity, water and transportation services provided by public enterprises? Probably not.

51. *Objection – restructuring general obligation debt.* To some, it seems quixotic to try to restructure Puerto Rico central government debt given that (1) the Commonwealth's constitution prioritizes these obligations; (2) the task is complicated by the extensiveness of pledged revenues; and (3) no US state has restructured its general obligation debt in living memory. Any attempt faces unprecedented legal challenges. Moreover, in the absence of an IMF or debtor-in-possession creditor for Puerto Rico during a potentially drawn out legal process, the government's capacity to provide essential services would be compromised. Rather than a formal restructuring process, it would be preferable to raise taxes and cut spending by a lot more, thus inducing creditors to voluntarily roll over maturing debt.

52. *Response.* A decision to restructure debt, even via a market-friendly debt exchange, is never taken lightly. The legal challenges are indeed a complex issue for the government's legal advisors. But from an economic perspective, the fact remains that the central government faces huge financing gaps even *with* substantial adjustment efforts. There are limits to how much more expenditures can be cut or taxes raised. A tax to GNP ratio of 12-13% may seem low by US standards (it is similar to states, but the latter also pay federal taxes from which Puerto Rico is exempt). However, statutory *tax rates* are high in Puerto Rico, similar to federal rates, and – before contemplating further hikes – one has to be mindful of the already large informal economy, and the hit to near-term growth from a sharper fiscal contraction; if output falls significantly, tax receipts will decline. Too much fiscal adjustment also raises questions about fair burden sharing between creditors and taxpayers, and puts at risk the political viability of the overall reform effort. These thoughts

will also occur to creditors when they assess the credibility of a sharper fiscal response – a mere show of fiscal austerity will not necessarily induce them to roll over maturing debt. Yes formal debt restructuring without an IMF or debtor-in-possession lender in the background carries risks. But so does unrealistically high fiscal adjustment and the rollover of debt at unaffordable interest rates and seniority.

VII. CONCLUDING THOUGHTS

The situation is acute in the face of faltering economic activity, faltering fiscal and debt sustainability, and faltering policy credibility. A comprehensive program that tackles all three has a better chance of success than a partial approach, and the advantage of sharing the costs and benefits of reform across government, workers, businesses, and creditors.

53. **The measures to date are important first steps that need to be built on to deal with a situation years in the making**. Credit must be given to the current administration for putting in place important measures – higher taxes, pension reforms and spending cuts and freezes – to try and stabilize public finances. These measures were necessary but incomplete. The shortcoming has been to view the problem as one of cash flow: if only the Commonwealth had more time and loans, fiscal efforts would turn around confidence and the economy. But the problem of negative growth, a non-starter for debt sustainability, is structural. The problem of the fiscal hole is larger than recognized and set to deteriorate. The problem of policy credibility – from poor fiscal control to inaccurate and dated statistics to lack of political consensus – is as severe as ever.

54. **The debt crisis is not just a fiscal one but also reflects structural problems that have held back growth – both need to be tackled together**. There will be a temptation to focus on the fiscal side because it is more in the administration's direct control. This is not surprising and, indeed, has been the norm in the last decade, which has seen a series of fiscal measures presented as complete answers to the island's ills. Structural reform is harder: explaining that real wages are too high is a hard sell, as is getting the US Congress to exempt Puerto Rico from federal laws that especially disadvantage it (minimum wage, Jones Act, Chapter 9 bankruptcy). Many will dismiss structural reforms as too difficult, too wooly or too long term. But we are convinced that structural reforms are critical to growth, and that without growth, the chances of success are dim. The problems of growth, of credibility, of public debt – all cast a shadow on each other and must be tackled together.

55. **The policy agenda is daunting but similar challenges have been overcome elsewhere and can be in Puerto Rico too**. It will be especially important to establish the credibility of the reform effort early on in the process. This will require up front action and new institutional mechanisms such as a fiscal oversight board. The government should also consider appointing a senior official to coordinate the effort, as well as specific individuals to deliver reforms that would otherwise fall between the cracks in the press of a crisis (e.g., reforms to strengthen the business climate and the provision of data). All this is a heavy lift but also one within the capacity of Puerto Rico to accomplish.

Exhibit B

to the

Testimony of

Melba Acosta-Febo

Working Group for
the Fiscal and
Economic
Recovery
of Puerto Rico

Puerto Rico Fiscal and Economic Growth Plan

Prepared by the Working Group for the Fiscal and Economic Recovery of Puerto Rico Pursuant to Executive Order 2015-022

September 9, 2015

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Working Group for the Fiscal and Economic Recovery of Puerto Rico

Executive Summary

Executive Summary

This document contains the key findings of the Working Group for the Fiscal and Economic Recovery of Puerto Rico (the "Working Group") established by Governor Alejandro García Padilla by executive order (EO 2015-022), and the measures recommended by the Working Group to reduce the Commonwealth's projected financing gaps. Such measures comprise the "Fiscal and Economic Growth Plan" or "FEGP".

- Despite the significant historical measures undertaken by the Commonwealth since the onset of the financial crisis in 2007 to reduce expenses, increase revenues and address structural challenges, the Working Group projects that, absent meaningful additional fiscal and structural reforms, the consolidated government will incur significant financing gaps for at least the next five years
  - The cumulative financing gap for the Commonwealth is projected to be $27.8 billion from fiscal year ("FY") 2016 to FY 2020 absent corrective action
  - In addition, the Puerto Rico Treasury's single cash account (the "TSA"(1)) and the Government Development Bank for Puerto Rico (the "GDB") are each expected to exhaust their liquidity before the end of calendar year 2015
- In connection with this fiscal and economic emergency, the Working Group and its advisors examined the various causes of the fiscal and economic challenges facing the Commonwealth, and potential reform measures to address these challenges
- Following this review, the Working Group developed the FEGP, setting forth economic development, structural, fiscal and institutional reform measures intended to meaningfully reduce the Commonwealth's projected financing gaps
  - The Working Group believes that the Commonwealth could reduce its cumulative financing gap by over $11.9 billion from FY 2016 to FY 2020, through a combination of revenue increases and expense reductions(2)
    - Economic growth, if achieved, could reduce the cumulative financing gap another $1.9 billion

(1) The TSA account is the account through which General Fund's (as that term is used in the Commonwealth's comprehensive annual financial reports) expenses flow as well as certain other governmental funds. It excludes GDB balances and public corporations such as HTA (though certain tax revenues collected by the Commonwealth before transfer to a public corporation do flow through the TSA).
(2) Net of assumed incremental costs associated with these measures.

Executive Summary

- In order to ensure compliance with the FEGP measures, the Working Group proposes the implementation of a control board and new budgetary regulations, pursuant to proposed legislation known as the Fiscal Responsibility and Economic Revitalization Act ("FRERA")
- In addition to the local policy reforms, the Working Group believes that meaningful changes to US federal policies are critical to the ability of the Commonwealth to meet its debt service costs while providing funding for essential services to its residents, most particularly changes in the areas of health care funding and tax policies for economic development. Moreover, the Working Group believes Puerto Rico must have an orderly process to restructure its liabilities
- Even after the implementation of the FEGP, which is subject to significant political and execution risks, the Working Group's projections suggest that the Commonwealth cannot meet all of its debt service requirements as currently scheduled and must restructure its liabilities
  - After accounting for the estimated impact of all measures *and* including the benefit of potential economic growth spurred by structural reforms, the Working Group still projects the Commonwealth to have a cumulative financing gap from FY 2016 to FY 2020 of $14 billion
- While the Working Group recognizes that a restructuring of the Commonwealth's debt would result in hardship to individual bondholders, unless the persistent stagnation of Puerto Rico's economy that has helped fuel the increase in Government debt over the past decade can be reversed, the public debt is not sustainable
  - Further, paying debt service as currently scheduled in the face of significant financing gaps could severely impair the Commonwealth's ability to provide essential services to its residents

Executive Summary

- As difficult as debt restructuring is likely to be (particularly in the absence of an effective federal or Commonwealth public debt restructuring legal framework), the Working Group recommends that the Commonwealth advisors begin work on a voluntary exchange offer to be made to its creditors as part of the implementation of the FEGP
  - The Working Group has directed the Commonwealth's advisors to take into account the priority accorded to various debt instruments across the Puerto Rico debt complex while recognizing that, even assuming the clawback of revenues supporting certain Commonwealth tax supported debt, available resources may be insufficient to service all principal and interest on debt that has a constitutional priority
  - Therefore, a consensual compromise of the creditors' competing claims to the Commonwealth's revenues to support debt service will be required in order to avoid a disorderly default on the Commonwealth's debt and a legal morass that will further destabilize the Commonwealth's economy and finances
- Accordingly, the Working Group recommends that the Commonwealth advisors meet with the creditor groups that have already been organized (and those that may be formed hereafter) to explain the Fiscal and Economic Growth Plan and to begin negotiation of the terms of a voluntary exchange offer that can garner widespread creditor acceptance
- **It is the Working Group's belief that a voluntary adjustment of the terms of the Commonwealth's debt that allows the measures contained in the FEGP to be implemented is the best way to maximize all creditor recoveries**

Working Group for the Fiscal and Economic Recovery of Puerto Rico

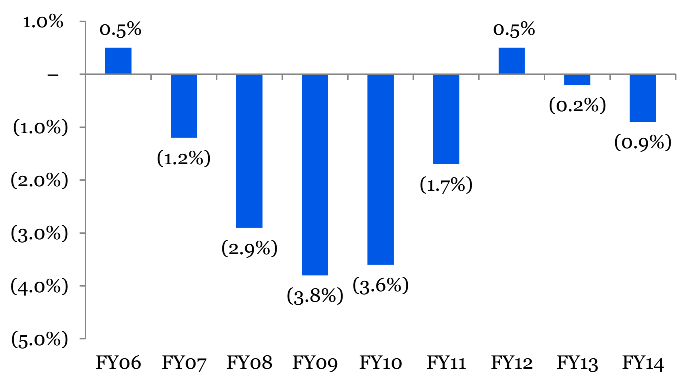
Historical Reform Measures and Current Liquidity and Fiscal Position

Economic Decline of Puerto Rico

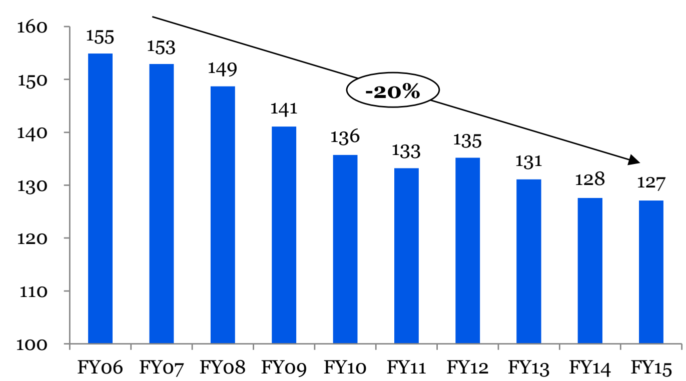
Since the expiration of Section 936 of the US Internal Revenue Code in 2006[(1)] and the onset of the global financial crisis in 2007, the Commonwealth has faced virtually continuous economic decline, in spite of substantial stimulus spending

- GNP growth has been negative nearly every year since FY 2007; little growth was recorded in the prior decade
- The lower rate of GNP decline since FY 2009 is due in large part to the large amount of stimulus and deficit spending injected into Puerto Rico's economy during the same period
  - For example, the Commonwealth was allocated approximately $7.1 billion of funds through the American Recovery and Reinvestment Act ("ARRA") and, using the Puerto Rico Sales Tax Financing Corporation ("COFINA") bond proceeds from offerings in 2009 and 2010, the Commonwealth created a $500 million "Local Stimulus Fund"
  - Furthermore, tax reform enacted in 2011 sought to jumpstart the economy by reducing individual and corporate taxes by approximately $706 million, some of the provisions of which were later modified to deal with resulting revenue shortfalls

Real GNP Growth[(2)]



GDB EAI Index[(2)(3)]



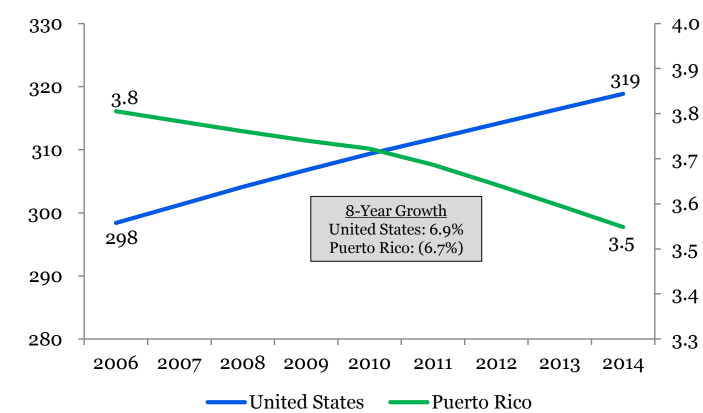
(1) Insofar as is relevant to Puerto Rico, Section 936 of the US Internal Revenue Code exempted from US taxation certain income derived by US companies from the active conduct of a trade or business in Puerto Rico and certain Puerto Rico sourced investment income.
(2) Source: Economic Activity Index ("GDB – EAI") report for June 2015.
(3) Values are as of June 30 of each year. The apex in FY 2006 occurred at 158.0 in July. EAI is comprised of four indicators: total payroll employment; total electric power generation; cement sales and gas consumption. The index is highly correlated to Puerto Rico's real GNP. For additional details on the EAI, see the GDB website under "Economy."

Deteriorating Economic Prospects & Demographic Trends

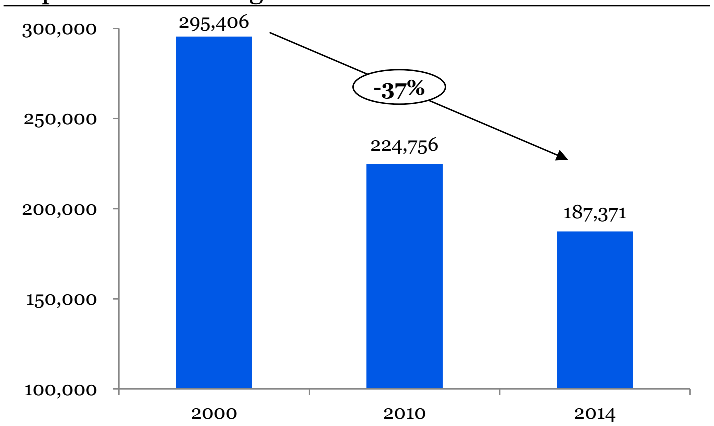
Reduced economic activity has had a marked effect on the residents of the Commonwealth, leading to stagnating incomes and increasing outmigration to the mainland

- As multinational corporations moved out of the Commonwealth following the expiration of Section 936 and without substantial job creation, cumulative per capita income growth of 5.5%(1) from 2006 to 2013 has failed to keep pace with cumulative inflation of ~15%(2) over the same time period
- Deteriorating economic conditions have therefore led to many Puerto Ricans emigrating to the mainland
- The Commonwealth averaged net outmigration of approximately 48,000 residents per year from 2010 to 2013(3), with 42% of emigrants stating that their primary reason for moving was job-related; in 2013, approximately 74,000 residents emigrated to the mainland(4)
- The remaining population is also becoming increasingly elderly and outside the labor force
  - Persons 60 years and older represent more than 20% of the population (the highest in the United States) and their labor participation rates range from 10.7% to 13.3%(5); children aged five years or less have decreased from 295,406 in 2000 to approximately 187,371 in 2014, a reduction of 37%(6)

Population Data (millions)(6)



Population Under Age Five(6)



(1) Per capita income from World Bank. 2013 is the most recent year for which data is available for both Puerto Rico and the US.
(2) Inflation calculated using CPI as presented by GDB and sourced to Dept. of Labor and Human Resources.
(3) Puerto Rican Population Declines on Island, Grows on US Mainland, Pew Research Center, August 11, 2014.
(4) Puerto Rico Statistics Institute, "Perfil del Migrante 2013", February 8, 2015.
(5) Puerto Rico Planning Board, "Resumen Economico de Puerto Rico", December 2013.
(6) US Census Bureau.

Significant Fiscal Responsibility Measures

The Commonwealth has repeatedly taken difficult measures to reduce its consolidated financing gaps

- The following chart represents a select subset of the various measures that the Commonwealth has taken since the onset of the economic crisis

Revenues	Expenditures	Other Fiscal Responsibility Measures
2007: 7% Sales and Use Tax ("SUT") implemented ~$1.1bn per year	**2010:** Voluntary resignation and work-day reduction programs ~$91mm	**2011:** Gradually increase employer contribution to ERS from 9.275% to 20.525%
2011: Act 154-2011 institutes annually declining 4% excise tax on multinationals operating in Puerto Rico ~$1.9bn per year	**2010:** Temporary suspension of certain laws, collective bargaining agreements and other contractual agreements ~$187mm	**2011:** Gradually increase employer contribution to TRS from 8.5% to 19.75% per employee
2011: UPR(1) stabilization fee ~$40mm per year (later repealed)	**2011:** Involuntary layoffs ~$367mm	**2011:** Complete public-private partnership ("P3") of PR-22
2013: Act 154 excise tax reset at 4% rate	**2013:** Eliminate subsidies to PRASA(2) (due to PRASA rate increase) ~$340mm	**2013:** Complete P3 of LMM International Airport
2013: Petroleum products tax increase from $3.00 to $9.25 per barrel ~$190mm per year	**2014:** Reduction in non-salary benefits ~$51mm (prohibited December bonus above $600 and liquidations of unused vacation or sick leave); government merit bonuses eliminated	**2013:** Increase employee contribution to ERS(3) from 8% to 10%; eliminate special law benefits to ERS retirees; increase retirement age
2014: Gross profits tax on corporations ~$300mm per year	**2014:** Judicial and legislative budget reductions ~$45mm	**2013:** Increase employee contribution to TRS(4) from 9% to ~13%; eliminate special law benefits to TRS retirees; increase retirement age (ruled unconstitutional in part)
2014: SUT charged at point of entry ~$70mm per year	**2014:** UPR, Judicial and Municipality appropriation levels frozen from 2015-2017; CBA salary increases frozen	**2013:** Eliminate "scoop and toss"(5) of PBA(6) debt service ($175mm in FY 2013)
2015: Petroleum products tax raised from $9.25 to $15.50 per barrel, providing an incremental ~$170mm per year	**2015:** School transportation cost reductions and school consolidations ~$110mm	**2014:** Eliminate "scoop and toss"(5) of GO(7) debt service ($575mm in FY 2014)
2016: SUT increased from 7% to 11.5% and VAT(8) instituted; projected ~$1.1-$1.3bn per year	**2013-2015:** 3% annual payroll reduction	**2014:** Prohibit deficit financings by GDB

(1) University of Puerto Rico ("UPR").
(2) Puerto Rico Aqueduct and Sewer Authority ("PRASA").
(3) Employees Retirement System ("ERS").
(4) Teachers Retirement System ("TRS").
(5) "Scoop and Toss" generally refers to the elimination of annual debt principal and interest through a refinancing with delayed payment dates.
(6) Public Buildings Authority ("PBA").
(7) General Obligation ("GO").
(8) Value Added Tax ("VAT").

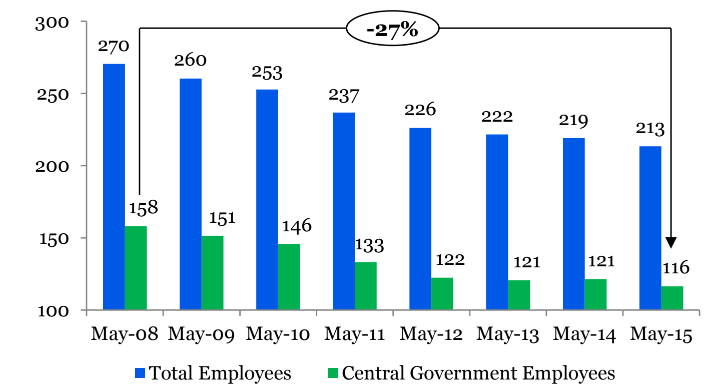
Select Results of Historical Measures to Date

As a result of the Commonwealth's expense reduction measures, central government employee headcount is down 27% (4.3% compounded annual decline) since 2008; further, revenue measures have allowed projected General Fund revenues for FY 2016 to grow by 23% since a recession low in FY 2009

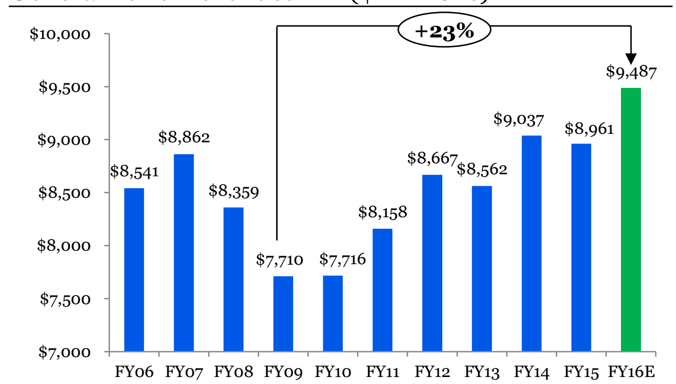
- Note that the General Fund revenue numbers shown below do not account for the incremental revenues that were also added at PRASA (through a rate increase), Puerto Rico Highways and Transportation Authority ("HTA") (through increased petroleum products taxes), Puerto Rico Infrastructure Financing Authority ("PRIFA") (also through petroleum products taxes) and other entities on the island which received governmental subsidies from the General Fund or GDB

- According to US Government Accountability Office, in 2012 government employment as a share of the population was 8.7% in Puerto Rico vs. 8.9% in the states[(1)]. Since 2012 there has been a further reduction of approximately 13,000 in the number of Puerto Rican government employees through attrition

Government Employee Headcount Reduction[(2)] (thousands)



General Fund Revenues[(3)(4)] ($ millions)



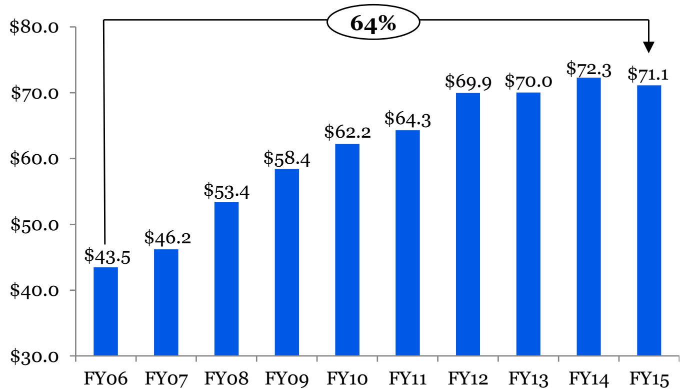
(1) US Government Accountability Office, Information on How Statehood would Potentially Affect Selected Federal Programs and Revenue Sources, March 2014.
(2) Source: Puerto Rico Statistics Institute, May 2015 Employment Report. Central government employees include Office of the Governor, Departments and Agencies, Judicial Branch and Legislative Branch as described in the report.
(3) Source: Puerto Rico Treasury website. Note that the numbers shown correspond to "Total Revenues" and not "Total Budgetary Revenues." See page 100 of the Commonwealth's Financial Information and Operating Data Report from October 30, 2014 for a historical reconciliation of "Total Revenues" to "Total Budgetary Revenues."
(4) FY 2016 General Fund revenue represents projections based on the work of Conway MacKenzie ("CM") and is inclusive of incremental SUT/VAT taxes projected to be collected on account of tax reform.

Debt Accumulation

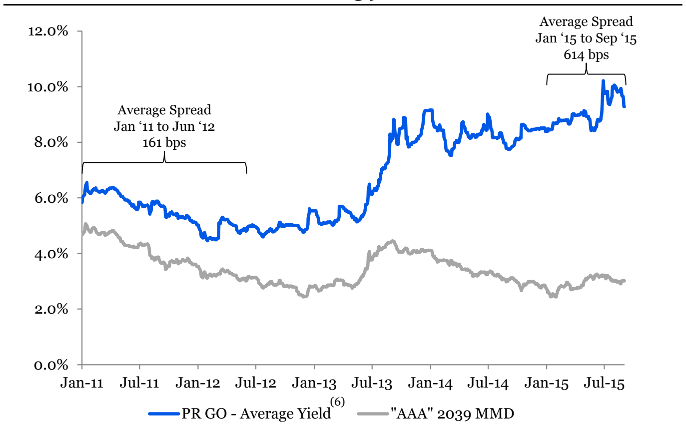
Notwithstanding the Commonwealth's liquidity-enhancing measures, total debt has grown by approximately 64% since FY 2006

- This rising debt burden has increased total debt financing costs and has resulted in an increasing percentage of the budget being redirected from investment and essential services to debt service
- Increased financing costs are reflected in the rising yields of Puerto Rico GO bonds as compared to similar municipal bonds
  - Whereas in 2006, GO bonds with 20 years to maturity were priced to yield 4.8%, the March 2014 GOs due in 2035 (approximately 20 years to maturity) were issued to yield 8.7% and currently yield 11.3%[(1)]
- Given these yields, market access on sustainable terms is not currently available to the Commonwealth

Historical Public Sector Debt[(2)(3)(4)] ($ billions)



Puerto Rico GO Yields vs. 2039 MMD[(5)]



(1) Yield on 2006 issuance from Public Improvement Bonds of 2006, Series A Offering Statement and 2014 GO current yield from Bloomberg.
(2) For more detail see the appendix for total public sector debt as of June 30, 2015. Data per GDB.
(3) Balances shown do not include the accreted value of capital appreciation bonds ("CABs"). As of July 1, 2015, the incremental accreted value of the CABs was $2.6 billion, with another $31.3 billion of accretion remaining.
(4) Does not include unfunded pension liabilities. Based on preliminary valuation reports as of June 30, 2014, the Employees Retirement System, Teachers Retirement System and Judiciary Retirement System ("JRS") net pension liabilities were $30 billion, $13 billion and $442 million, respectively. See the May 7, 2015 Commonwealth of Puerto Rico Quarterly Report for more details.
(5) Puerto Rico GO bond valuation from Standard & Poor's (J.J. Kenny Evaluated Pricing Service). "AAA" MMD based on 2039 maturity, which was chosen as the benchmark as it is within the maturity range of the uninsured PR GO bonds included.
(6) Simple average of the historical Standard & Poor's (J.J. Kenny Evaluated Pricing Service) valuations for seven long-duration, tax-exempt, uninsured, current interest PR GO Bonds (CUSIPs: 74514LB71, 74514LB89, 74514LE86, 74514LWA1, 74514LKE6, 74514LXH5, 74514LYW1).

Working Group for the Fiscal and Economic Recovery of Puerto Rico

Extraordinary Liquidity Measures Taken in FY 2016

Despite historical attempts to strengthen the Commonwealth's liquidity, the TSA account would have exhausted its liquidity had certain extraordinary liquidity measures not been taken for FY 2016, including:

- Funding $400 million of its working capital needs through emergency "intra-governmental" loans funded by requiring its proprietary insurance companies to liquidate their securities portfolios(1);
- Withholding GO set asides totaling approximately $93 million per month;
- Requiring its insolvent pension systems to pre-fund benefit payments to retirees, which improved cash flow by approximately $295.0 million in July 2015 and an expected $141.0 million in each of October 2015, December 2015 and February 2016;
- Having GDB refinance the 2015 C-Series tax revenue anticipation notes ("TRANs") ($300 million) in July 2015, notwithstanding GDB's fragile liquidity position; and
- Delaying payment of approximately $291.0 million in income tax refunds from the 2014 tax year
  - These refunds will not be paid in full until February 2016, at the earliest

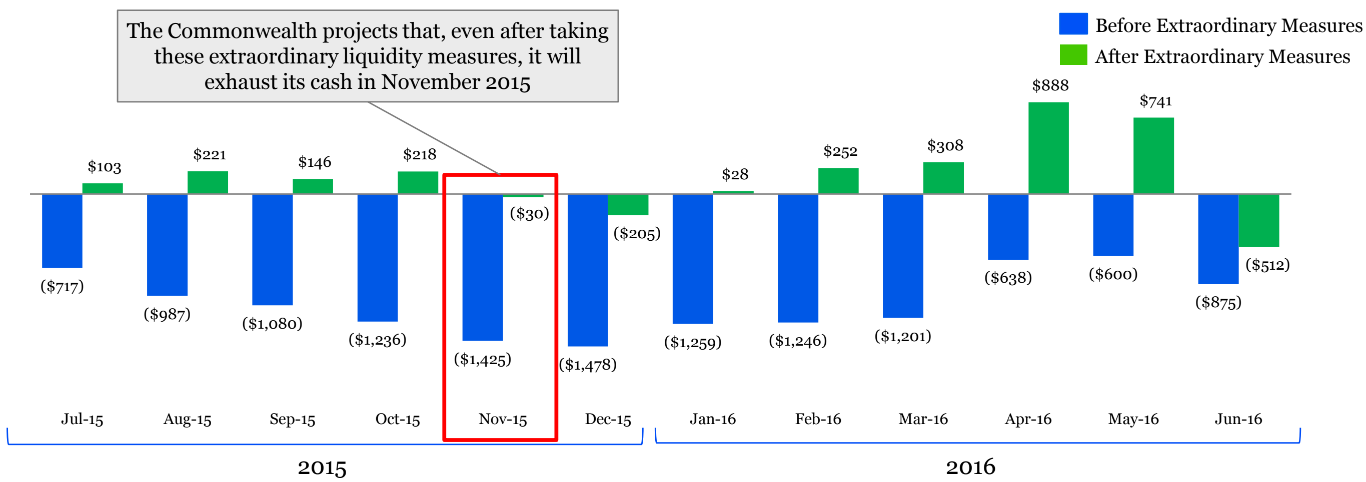
- Moreover, the measures described on the following page do not account for any shortening of outstanding days payable to third parties that today exceed $1.6 billion at Commonwealth agencies (excludes amounts owed by public corporations and agencies with independent treasuries)(2)
- **These extraordinary liquidity measures cannot be maintained on a long-term basis**

(1) Proprietary insurance companies include State Insurance Fund ("SIF"), Automobile Accidents Compensation Administration ("ACAA") and Temporary Non-Occupational Incapacity Insurance ("SINOT").
(2) Based on preliminary estimates subject to material revision; moreover, may not account for all payables as there is typically a substantial lag between the incurrence of an expense and that expense being recorded.

Projected Near-Term TSA Liquidity

Absent the Commonwealth's extraordinary and unsustainable liquidity measures described on the previous page, the TSA would have already exhausted its cash

Projected TSA Liquidity – Ending Cash Balance (1)(2) ($ millions)



- GDB cannot be a source of liquidity for the Commonwealth or the public corporations
  - As of May 31, 2015, GDB had $778 million of total net liquidity, which is before any reduction for GDB's minimum liquidity requirement
  - During FY 2016, GDB has $876 million of maturing notes, $267 million of which are GO guaranteed (the payment of which is not included in the TSA projections above), and $188 million of interest due

(1) Defined in the August 25, 2015 report Commonwealth of Puerto Rico: Conway MacKenzie Liquidity Update as cash in the bank and does not reflect outstanding checks, which may represent a substantial amount.
(2) Projections do not assume any working capital impact from a reduction in days payable outstanding to trade creditors or a catch-up in the payment of overdue tax refunds.

Overview of Commonwealth Projected Financing Gaps

Building on the work done in the report *Puerto Rico – A Way Forward*, updated as of July 13, 2015 (the "Krueger Report"), the Working Group developed a revised view of the future Commonwealth financing gaps (the revised view constituting the "Adjusted Estimates")

- As explained in the Krueger Report, which was authored by a team of former International Monetary Fund economists headed by Anne Krueger, the General Fund alone (which is the primary account associated with the TSA presented on the previous page) does not adequately capture the total financing needs of the Commonwealth

- The Working Group adopted the comprehensive approach outlined in the Krueger Report, along with many of the same key assumptions, such as an assumed baseline for real economic growth of negative 1%

- While the general approach to the financing gap projections is the same as in the Krueger Report, the Working Group conducted its own diligence and refined certain estimates based in large part on information that was not available at the time the Krueger Report was prepared

- These updates include:
  - Updated revenue projections that incorporate preliminary actual results from 2015
  - Updated component unit projections based on detailed work undertaken by the Working Group and its advisors (the Krueger Report did not have detailed individual unit projections)
  - Revised estimates of budgeted expenses and the resultant impact of Act 66
  - Revised capital expenditure estimates

Overview of Commonwealth Projected Financing Gaps

- In addition to these updates, the Adjusted Estimates include two changes to the approach taken in the Krueger Report:
  - HTA is now included in the projections, due to its reliance on taxes collected by the Commonwealth and the Commonwealth's support of HTA historically through the assignment of new revenue sources and the provision of over $2 billion of loans from GDB
  - Rather than showing estimates of retirement system shortfalls once they were projected to take place, the FEGP assumes the Commonwealth makes the additional uniform contribution (the "AUC") required by Act 3-2013 and Act 160-2013 to prevent full asset depletion. Both the Krueger Report and the Adjusted Estimates show the financing gap effectively assuming no interruption of current benefits[1]
- Additional details on the variances of the Adjusted Estimates to the Krueger Report are available in the appendix

(1) See the appendix for additional details on assumed asset balances in the retirement systems.

Projected Financing Gaps Based on Adjusted Estimates

The Working Group's revised projections indicate that the Commonwealth as a whole will face significant financing gaps for at least the next five years, absent additional measures

Central Government Outlook ($ millions)	2016P	2017P	2018P	2019P	2020P	Total
Revenues						
General Fund and Other Select Revenues[1]	$8,503	$8,519	$8,561	$8,604	$8,648	$42,835
GDB Net Operating Revenue[2]	(96)	(21)	248	307	269	706
COFINA[3]	696	724	753	783	815	3,771
Federal Transfers[4]	6,477	6,540	6,604	6,669	6,734	33,025
HTA Revenues[5]	677	636	643	645	648	3,249
Total Revenue	**16,257**	**16,399**	**16,809**	**17,009**	**17,114**	**83,587**
Noninterest Expenditure						
General Fund Budget (ex. Debt Service and Additional Uniform Contributions)[6]	(7,957)	(8,251)	(8,697)	(9,236)	(9,614)	(43,756)
Additional Uniform Contribution and Catch-up[7]	(314)	(299)	(300)	(797)	(798)	(2,509)
Net Operating Deficit of Non-General Fund Governmental Funds[8]	(235)	(237)	(240)	(242)	(244)	(1,199)
Net Operating Deficit (Surplus) of Component Units (ex. Capex and ACA Loss Impacts)[9]	(120)	59	(101)	192	324	354
Capital Expenditures[10]	(386)	(585)	(545)	(503)	(338)	(2,358)
Federal Programs[11]	(6,477)	(6,540)	(6,604)	(6,669)	(6,734)	(33,025)
HTA Expenditures (ex. Debt Service and Capex)[12]	(279)	(189)	(149)	(150)	(151)	(918)
Total Noninterest Expenditure	**(15,769)**	**(16,044)**	**(16,636)**	**(17,405)**	**(17,556)**	**(83,410)**
Additional Expenses Based on Current Policies						
Loss of Affordable Care Act ("ACA") Funding[13]	–	–	(526)	(1,597)	(1,730)	(3,853)
Act 154 / Foreign Company Tax Losses[14]	–	–	(538)	(1,075)	(1,075)	(2,688)
Total Additional Expenses Based on Current Policies	–	–	**(1,064)**	**(2,672)**	**(2,805)**	**(6,541)**
Debt Service						
Consolidated Interest[15]	(2,320)	(2,370)	(2,320)	(2,239)	(2,170)	(11,419)
Consolidated Principal[15]	(1,810)	(1,044)	(957)	(1,628)	(1,299)	(6,738)
Total Debt Service	**(4,130)**	**(3,415)**	**(3,277)**	**(3,867)**	**(3,469)**	**(18,157)**
Identified Financing Sources (Uses)						
Change in Stock of Payables[16]	–	(827)	(501)	(501)	(501)	(2,331)
Net Deposit Draw/(Replenishment)[17]	(538)	(500)	–	–	–	(1,038)
Inflows from Other Entities[18]	105	–	–	–	–	105
Identified Financing Sources (Uses)	**(433)**	**(1,327)**	**(501)**	**(501)**	**(501)**	**(3,264)**
Total Estimated Financing Gap before Measures	**($4,075)**	**($4,386)**	**($4,670)**	**($7,437)**	**($7,217)**	**($27,786)**
Memo: Debt Service as a % of Total Revenue ex. Federal Transfers[19]	*42%*	*35%*	*32%*	*37%*	*33%*	*36%*

Note: Revenues do not include any incremental tax revenues attributable to the increased SUT or transition to the VAT which would reduce the projected financing gap by $6.350 billion (See page 56). For footnotes and additional details on the projections included herein, please see the appendix.

Working Group for the Fiscal and Economic Recovery of Puerto Rico

Fiscal and Economic Growth Measures

Scope & Process of the Fiscal and Economic Growth Plan

In order to address the challenges facing the Commonwealth, Governor García Padilla tasked the Working Group to develop a Fiscal and Economic Growth Plan

- The creation of the Working Group was in direct response to the Krueger Report regarding the fiscal and economic situation of the Commonwealth and the sustainability of its debt
- The Governor's executive order mandates that the Working Group evaluate the measures outlined in the Krueger Report and ultimately design a plan to address short and long-term fiscal challenges facing the Commonwealth by recommending measures to:
  - Address financing gaps and the debt load;
  - Ensure budget compliance;
  - Provide greater financial transparency; and
  - Carry out structural reforms necessary to restore economic competitiveness and growth
- The Working Group, in conjunction with its advisors, conducted due diligence on various Commonwealth funds, agencies and public corporations that are supported by taxes and appropriations and contributed to the fiscal deficits identified in the Krueger Report, in order to create a holistic projection of Commonwealth finances
- After identifying and estimating key contributors to historical and future Commonwealth-wide deficits, the Working Group also examined various measures outlined on the following pages that will help address the financing gaps identified in the Krueger Report

FEGP Measures

"The situation is acute in the face of faltering economic activity, faltering fiscal and debt sustainability, and faltering policy credibility. A comprehensive program that tackles all three has a better chance of success than a partial approach, and the advantage of sharing the costs and benefits of reform across government, workers, businesses, and creditors." –The Krueger Report p.26

1. Economic Growth and Structural Reform

1.1 Stimulate Employment and Labor Force Participation
1.2 Diversify Fuel Base and Stabilize Energy Rates
1.3 Implement Pro-Growth Corporate Tax Regime
1.4 Reduce Costs and Improve Ease of Doing Business
1.5 Invest in Strategic Infrastructure

2. Fiscal Stability

Revenue Enhancing Measures

2.1 Complete Transition to VAT
2.2 Stabilize Corporate Tax Revenue Base
2.3 Improve Tax Administration and Enforcement

Expense Reduction Measures

2.4 Reduce Operating Costs
2.5 Cut Governmental Subsidies
2.6 Right-Size Department of Education
2.7 Control Health Care Costs
2.8 Leverage P3s to Deliver Quality and Cost-Efficient Services

3. Institutional Reform and Transparency

3.1 Install New Accounting and Financial Systems
3.2 Establish Centralized Treasury Functions
3.3 Improve Fiscal and Economic Decision-Making
3.4 Implement New Budgetary Rules
3.5 Institute Control Board for Policy Continuity and Compliance

Economic Growth and Structural Reform

"Restoring growth requires restoring competitiveness. Key here is local and federal action to lower labor costs gradually and encourage employment (minimum wage, labor laws, and welfare reform), and to cut the very high cost of electricity and transportation (Jones Act). Local laws that raise input costs should be liberalized and obstacles to the ease of doing business removed." –The Krueger Report p.1

Economic Growth and Structural Measures	Target Date

1.1 Stimulate Employment and Labor Force Participation

Only 40% of Puerto Rico's adult population (vs. 63% in the US) is employed or looking for work. A significant portion of the population is either receiving welfare, informally employed or both. The Commonwealth must **adopt pro-growth labor market policies, reform welfare programs and determine policy with respect to its minimum wage**

Private Sector Labor Reform — January 2016

- Enact legislation to reform current labor laws to incentivize growth and boost labor participation
  - Establish a uniform work day and enable employers to provide flexible work week schedule
    - 8-hour work day based on calendar days, not consecutive 24 hour periods
    - Provide option for overtime to be calculated based on hours worked in excess of 40 hours per week, not in excess of 8 hours per day
  - Incentivize businesses, including small and medium enterprises ("SMEs"), to expand job opportunities
    - Ease December bonus payment waiver process
    - To incentivize youth employment and reverse emigration trends, make discretionary December bonus payment to employees 25 and under
    - Modify mandatory vacation days for all new hires based on sliding scale tiered off an employee's years of employment
    - Extend employment probation period to one year

Economic Growth and Structural Reform

Economic Growth and Structural Measures	Target Date

1.1 Stimulate Employment and Labor Force Participation (cont.)

- Reform mandatory severance; allow performance-based retention
  - Apply Act 80-1976 only to "non-exempt" employees
  - Limit mandatory severance pay at six months; exclude non-cash benefits from severance calculations
  - Allow businesses to retain employees based on performance in the event of a downsizing or reorganization of operations
- Simplify and make uniform other labor market regulations, including establishing a one-year uniform statute of limitations for labor claims

- Create maternal benefits fund, funded by employer premiums, to reduce incentives for discrimination and increase labor participation while maintaining current maternity benefit level — January 2016

Welfare Reform and Stimulating Work

- Establish an Earned Income Tax Credit ("EITC") — March 2016
  - Establish an EITC that, like the federal EITC, targets families with children, headed by working age persons, to stimulate employment among low-wage workers, reduce informal economy activities, bring families into the tax system and offset sales tax regressivity
    - Cost after full implementation will be ~$150 million per year
    - Former Commonwealth EITC program (2006-2014) did not differentiate among claimants by filing status, presence of dependents or age of the tax filers

- Reform Nutritional Assistance Program ("NAP") Benefits — March 2016
  - Request US Department of Agriculture ("USDA") to extend gross income exception for the receipt of NAP benefits from 12 to 18 months to allow more time for employees to experience salary and benefits increases that outweigh loss of NAP benefits
  - Modify NAP income thresholds for the Commonwealth so that program participants experience a more gradual and income-targeted reduction in NAP benefits when entering the workforce to eliminate the current cliff effect on benefit reduction

Economic Growth and Structural Reform

Economic Growth and Structural Measures	Target Date
1.1 Stimulate Employment and Labor Force Participation (cont.)	
▪ Public Housing and Section 8 - Apply to US Department of Housing and Urban Development ("HUD")'s "Moving to Work" program to receive waivers of rules that govern public housing and federal Section 8 voucher program ❖ Program's goal is to give incentives to families with children, where the head of household is working, seeking work, or is preparing for work to obtain employment, becomes economically self-sufficient and increase housing choices for low income families • After receiving waiver, local Housing Department to develop rent structures that allow residents to increase their earnings through work without penalty	June 2016
- Apply to HUD's "Jobs Plus Pilot Program" ❖ Program incentivizes employment through income-disregards for working families, and provides a set of services designed to support work including employer linkages, job placement and counseling, educational advancement, and financial counseling	October 2015
▪ Integrate Childcare Services - Integrate Family Department's child care and Head Start programs with the Puerto Rico Department of Education's Pre-K program in local public schools in order to reduce transportation costs for working families with multiple children and provide such families with full day childcare options ❖ Cost of program under evaluation	July 2016
Minimum Wage	
▪ To promote the hiring of young workers, request Congress to grant a 10-year waiver from future minimum wage increases for workers aged 25 and younger. This increase to the minimum wage would apply to any individual worker after 2 years	November 2015
▪ Grant the petition by the Commonwealth to exempt Puerto Rico from the US Department of Labor proposal to increase the salary level for required exemption under the Fair Labor Standards Act ("FLSA") referred to as "EAP" or "white collar" exception, which would increase the salary threshold for exempt employees that are full time salaried employees to $50,440 annually	January 2016

Economic Growth and Structural Reform

Economic Growth and Structural Measures	Target Date
1.2 Diversify Fuel Base and Stabilize Energy Rates	

Lack of fuel diversification, mismanagement and lack of energy policy continuity have resulted in **high energy costs**, **eroding the Commonwealth's competitiveness** and increasing the cost of doing business

- Complete restructuring of Puerto Rico Electric Power Authority's ("PREPA") capital structure and operations to produce cash flow relief during next five years to invest in necessary infrastructure and stabilize rates — To be determined
  - On September 1, 2015, PREPA announced that it had reached an agreement in principle with the Ad Hoc Group of PREPA bondholders – comprised of traditional municipal bond investors and hedge funds that hold approximately 35% of PREPA's outstanding bonds – regarding the economic terms of a restructuring of a significant portion of PREPA's bond debt. PREPA's agreement with the Ad Hoc Group marks PREPA's first agreement with a significant financial stakeholder regarding the substantive terms of its financial transformation. PREPA will continue negotiating with its financial guaranty bond insurers and revolving fuel line lenders, with the goal of reaching an agreement on a consensual recovery plan among all of its major financial stakeholders
- Issue request for proposal ("RFP") to third-party investors to upgrade existing generation capacity and build new, more efficient generation plants, allowing PREPA to transition into a transmission and distribution company — 2016 [(1)]
- Depoliticize PREPA by attracting professional external management and directors — 2016 [(1)]
- PREPA to invest more than $2 billion over the next five years to upgrade vital generation, transmission and distribution infrastructure — 2015-2020

(1) Contingent on timing of PREPA's restructuring.

Economic Growth and Structural Reform

Economic Growth and Structural Measures	**Target Date**

1.3 Implement Pro-Growth Corporate Tax Regime

The Commonwealth's current corporate tax regime is too complex, distorts economic choices and produces horizontal inequities. Puerto Rico must **institute a pro-growth tax regime** applicable to all companies doing business on the island that **lowers nominal tax rates and eliminates loopholes and unnecessary complexity**

- Enact legislation to amend Puerto Rico's Internal Revenue Code to implement flatter, lower-rate corporate tax regime for both new and existing companies — March 2016
  - Reduce nominal corporate tax rates
  - Eliminate inefficient corporate deductions and tax credits; eliminate or reduce alternative minimum tax
    - Simplified corporate tax regime would reduce unnecessary compliance burdens on entrepreneurs
- Enact legislation, after dialogue with existing multinationals, to retain and attract foreign direct investment — March 2016
  - Legislation would amend Act 154-2011 to extend the 4% excise tax for an additional 5-year period to stabilize the General Fund's revenue base[1]
  - With respect to foreign multinationals, legislation would also amend Act 73-2008 and be applicable to new companies coming to Puerto Rico, existing companies wishing to convert to new tax regime and all firms after the expiration of their current tax grants
  - New regime would seek to substitute Act 154-2011 excise tax and its revenues without increasing overall tax liability to existing companies, including foreign companies that currently do not credit the excise tax against federal income

(1) For Act 154 extension 5-year revenue projections, please refer to measure 2.2 of the Fiscal Stability section.

Economic Growth and Structural Reform

Economic Growth and Structural Measures	Target Date
1.3 Implement Pro-Growth Corporate Tax Regime (cont.)	
▪ Request Congress to provide Puerto Rico with tax treatment that encourages US investment on the island, such as:	November 2015
- Section 933A: Amend US Internal Revenue Code to add new Section 933A to permit US-owned businesses in Puerto Rico to elect to be treated as US domestic corporations	
- Economic Activity Tax Credit: Enact an economic activity tax credit for US investment in Puerto Rico designed as a targeted, cost-efficient version of former Section 936 of the US Internal Revenue Code	
- Base Erosion: In the event the US moves towards a territorial taxation system, exempt Puerto Rico from base erosion and/or minimum tax measures	

Economic Growth and Structural Reform

Economic Growth and Structural Measures	Target Date
1.4 Reduce Costs and Improve Ease of Doing Business	

Puerto Rico has been losing competitiveness as measured by global reports produced by the World Economic Forum and the World Bank. To jumpstart its economy, **Puerto Rico must be equipped with a business-friendly environment that is conducive to sustained economic growth**

- Centralize and streamline permitting process
  - Submit legislation to: — January 2016
    - Centralize all permit application processes in the Office of Management of Permits ("OGPe"), providing a single access point and electronic permit interface for all agencies and municipalities
    - Where a federal environmental review procedure is required, integrate concurrent local agency review and make the federal record of decision ("ROD") binding on local agency ruling to lower costs and avoid inconsistent administrative rulings
    - Provide for a 7-day agency response period for "Categorical Exclusions" (e.g. minor lot designation variations for low impact environmental construction works); applications deem granted if agency has not ruled on permit during said period
    - Require municipalities to adopt simplified uniform general permitting regulations ("*Reglamento Conjunto*")
  - Issue Executive Order to expedite planning, permitting and environmental review procedure for high-priority projects, including high-impact infrastructure projects outlined in the FEGP — November 2015
  - Consolidate Environmental Quality Board, Solid Waste Authority and Natural and Environmental Resources Department in order to simplify and streamline the environmental review process — April 2016
  - Adopt a joint general construction permit and expedited application procedure for "low impact" construction projects — April 2016

Economic Growth and Structural Reform

Economic Growth and Structural Measures	Target Date
1.4 Reduce Costs and Improve Ease of Doing Business (cont.)	
▪ Modernize property registry	November 2015
- Pass House Bill No. 2479 to implement 100% digital, electronic and paperless property registry platform	
❖ Platform expected to be effective upon legislative approval	
▪ Reduce transportation costs	
- Ask Congress to repeal Jones Act's application to the Commonwealth in order to reduce maritime transport costs to the island	October 2015
• Request temporary administrative waiver from US Government in energy related transports	November 2015
- Review current ground transportation regulatory framework	

Economic Growth and Structural Reform

Economic Growth and Structural Measures	Target Date

1.5 Invest in Strategic Infrastructure

The Commonwealth's infrastructure assets (ports, roads, bridges) are in need of substantial capital investments due to limited financial resources and historically insufficient maintenance. In order to grow the economy, the Commonwealth must **increase spending on capital expenditures** to strengthen its infrastructure system and allow it to continue to serve as a pillar of economic growth. **Given the tight fiscal situation, the Commonwealth should leverage P3s to help achieve its capital expenditure goals**

- Central government to use cash from operations to invest approximately $3.3 billion[1] during the five-year growth and adjustment period to improve infrastructure, boost aggregate demand and implement structural and fiscal measures — 2015-2020 (annual targets)
  - Government to begin budgeting for capital expenditures as part of General Fund budget
  - Capital expenditures ("capex") program designed to leverage federal matching funds, prioritize projects with economic impact and provide adequate maintenance to public infrastructure, including buildings, roads and bridges
    - Total investment including federal matching funds, amount to ~$7.7 billion
- In addition to directly funding its capital improvement program, the Commonwealth will seek to leverage P3s to build, maintain and operate new and legacy infrastructure, including electricity generation plants and transportation assets — 2015-2020 (annual targets)
- Strategic infrastructure projects (financed by government, federal and/or private funds) include: — 2015-2020 (annual targets)
  - Roads: Extension of Northwest Highway Corridor, PR-10
  - Airports and Ports: Upgrade Piers 1 and 4, Terminal, Roadway and Taxiways in Aguadilla Airport, Port of the Americas, Dry Dock, Army Terminal, Maintenance Dredging in San Juan Bay
  - Health: Science District (including cost to complete Comprehensive Cancer Center)
  - Strategic: Roosevelt Roads; investments in other strategic sectors (e.g. aerospace)
  - Other: Flood control projects, necessary rehabilitation and maintenance of roads and other public assets

(1) FEGP projections contemplate this investment in maintenance and strategic capex.

Economic Growth and Structural Reform

Economic Growth and Structural Measures	Target Date
1.5 Invest in Strategic Infrastructure (cont.)	
▪ Independent public enterprises, such as PREPA and PRASA, will separately undertake significant capex programs	2015-2020 (annual targets)
- PREPA plans to invest more than $2 billion over the next five years to upgrade vital generation, transmission and distribution infrastructure, including the Aguirre Offshore Gas Port ("AOGP")	
❖ PREPA restructuring process expected to release sufficient resources to undertake capex program	
❖ PREPA submitted a loan application to the US Department of Energy ("DOE") 1703 Program to finance a portion of AOGP	
- PRASA also contemplates financing approximately $1.4 billion in capex during the same period for water/waste water infrastructure renewal and replacement, water loss control and technology, among others	
▪ Leverage federal resources through the Build America Transportation Investment Center on transportation related infrastructure projects and P3 proposals	

Fiscal Stability – Revenue Enhancing Measures

"Given looming revenue and spending pressures, eliminating the fiscal deficit will take substantial measures. Reforms should aim more at broadening tax bases than raising rates, and at targeted expenditure reduction rather than across-the-board cuts. But even a major fiscal effort leaves large residual financing gaps that will need to be bridged with debt relief." –the Krueger Report p.19

Revenue Enhancing Measures	Target Date	Estimated Incremental Impact FYs ($ millions)

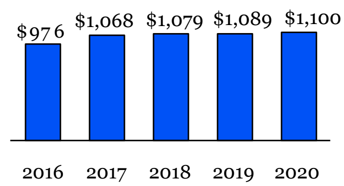
2.1 Complete Transition to VAT

In order to decrease tax evasion and increase the revenue capture rate, the Commonwealth must place greater reliance in consumption taxes and move towards VAT. **On May 29, 2015, the Government enacted Act 72-2015, which increases the SUT rate from 7.0% to 11.5%, expands the tax base by taxing certain business to business ("B2B") services and provides for a VAT** to substitute the Central Government's portion of the SUT

Increase SUT Rate

- Starting July 2015, transactions that were subject to the 7% SUT are now subject to an 11.5% SUT, with the entire 4.5% increase going to the Central Government(1)

Target Date: Completed



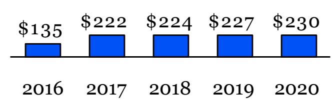
Taxing B2B Services and Transitioning to VAT System (Incremental to SUT Rate)(1)

- Starting October 2015, B2B transactions that are currently taxable will be subject to an 11.5% SUT; B2B transactions and professional services that were previously exempt from the SUT will be subject to a 4% SUT

Target Date: October 2015

- Starting April 2016, all transactions subject to the SUT will be subject to a new VAT of 10.5% plus a 1% municipal SUT

Target Date: April 2016



(1) Numbers shown are the estimated benefit to the General Fund.

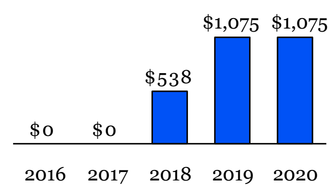
Fiscal Stability – Revenue Enhancing Measures

Revenue Enhancing Measures	Target Date	Estimated Incremental Impact FYs ($ millions)

2.2 Stabilize Corporate Tax Revenue Base

The Commonwealth is currently highly dependent on Act 154-2011 excise tax receipts (approximately 20% of general fund revenues). The 4% excise tax is due to be replaced by a "Modified Source Income Rule" tax in December 2017 (FY 2018) and an extension of the 4% tax rate is necessary to ensure revenue certainty during fiscal and economic adjustment period

- Extend Act 154-2011 4% excise tax for an additional 5-year period as existing multinationals transition to a new corporate tax regime — March 2016
- Amend, after consultation with existing multinationals, the Internal Revenue Code and Act 73-2008, to establish a new corporate tax regime that substitutes the Act 154-2011 excise tax and its revenues without increasing overall tax liability to existing companies



Note: Incremental impact vs. Krueger Report's "Loss of Act 154" downside risk as modified by Adjusted Estimates

Fiscal Stability – Revenue Enhancing Measures

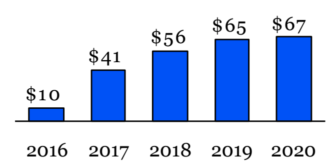
Revenue Enhancing Measures	Target Date	Estimated Incremental Impact FYs ($ millions)

2.3 Improve Tax Administration and Enforcement

The Commonwealth lacks a robust, modern and effective tax administration, resulting in significant tax evasion and high taxpayer compliance and administrative costs

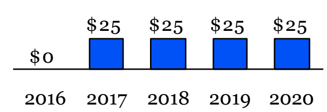
- Leverage technology and training in order to increase capture rates and improve tax administration and enforcement, including:
  - Improve Integrated Merchant Portal System ("PICO")
  - Implement Automated System for Customs Data ("ASYCUDA")
  - Expand alternative delivery and payment channels' capabilities
  - Transform Collection Centers into Integrated Service Centers
  - Joint-ventures with Municipalities for SUT oversight
  - Implement performance management, develop work plans and create Professional Development Institute

2016-2020
(annual targets)



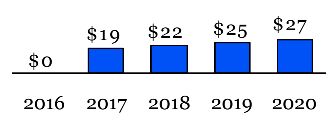
- Restrict use of tax amnesties and closing agreements to increase revenue certainty and reduce tax evasion

June 2016



- Tackle widespread use of illegal video lottery machines that erode Puerto Rico's tax base by implementing and enforcing tax on, and regulating, video lottery games(1)

March 2016



Note: All impact estimates are net of investments.
(1) Net of transfers as required by law.

Fiscal Stability – Expense Reduction Measures

Expense Reduction Measures	Target Date	Estimated Incremental Impact FYs ($ millions)

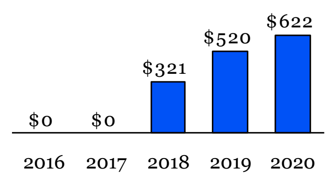
2.4 Reduce Operating Costs

Despite significant efforts to **reduce central government expenses** through headcount attrition, freezing formula-based appropriations, service costs and collective bargaining agreements, among other measures, the Commonwealth's upcoming fiscal challenges, including unfunded retirement systems and increasing health care costs, **will require further expense cuts in governmental subsidies, a gradual reduction in payroll expenses and the implementation of additional operational efficiencies**

Act 66

- Extend until FY 2021 Act 66-2014's freeze of new hires, formula-based appropriations, service costs, increase in salaries and collective bargaining agreements[1]

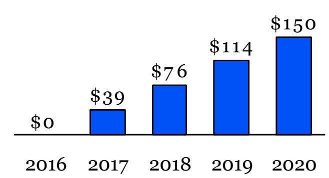
December 2015



Human Resources

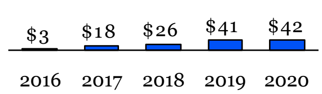
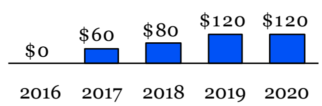
- Reduce payroll costs by implementing a 2% annual attrition target[1][2]
  - To achieve attrition target, the Office of Management and Budget ("OMB") may offer early retirement window to selected public sector employees
  - Commonwealth may use a portion of the proceeds of P3 initiatives to incentivize voluntary retirement

2016-2020
(annual targets)



(1) Impact does not include the negative effect on Additional Uniform Contribution to the public pension systems.
(2) Totals excludes Puerto Rico Department of Education ("PRDE"). Attrition target with respect to PRDE is included in Section 2.6 hereto.

Fiscal Stability – Expense Reduction Measures

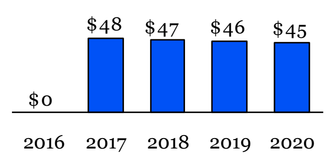
Expense Reduction Measures	Target Date	Estimated Incremental Impact FYs ($ millions)
2.4 Reduce Operating Costs (cont.)		
▪ Align public sector vacation and sick leave benefits for new hires with the highest benefits for the private sector	November 2015	Estimated impact to be determined
▪ Implement new government-wide employee classification program to improve mobility, better allocation of human resources and uniform salaries for the same positions across all government so as to continue benefiting from headcount attrition	June 2016	Estimated impact to be determined
Operational Efficiencies		
▪ Adopt and complete implementation of both: (i) Government reorganization and Efficiency Plan[(1)], as developed by the OMB and the Department of State, so as to consolidate local government offices, increase use of technology and shared services, and (ii) redesign of governmental structures proposed by OMB and UPR	2016-2020 (annual targets)	
Procurement		
▪ Achieve ~4% economies of scale and efficiencies by establishing a modern, centralized procurement system in the Puerto Rico General Services Administration ("GSA") for all purchases greater than $25,000 (currently $195,000) ▪ Federal legislation granting the Commonwealth and its agencies access to the GSA Cooperative Purchasing program and all federal supply schedules	June 2016	

(1) Executive Order OE-2015-23.

Fiscal Stability – Expense Reduction Measures

Expense Reduction Measures	Target Date	Estimated Incremental Impact FYs ($ millions)
2.4 Reduce Operating Costs (cont.)		
Teacher's Retirement System	June 2016	

- Supreme Court opinion ruled that certain sections of Act 160 can only be applied prospectively to newly hired teachers. Further changes to the TRS are required to ensure the payment of benefits for years to come. Accordingly, TRS is working closely with actuaries towards a reformed proposal that ensures payment of benefits to existing retirees while passing constitutional scrutiny and that considers increases to employee contributions and/or modifications to special law benefits



Fiscal Stability – Expense Reduction Measures

Expense Reduction Measures	Target Date	Estimated Incremental Impact FYs ($ millions)

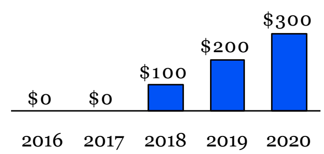
2.5 Cut Government Subsidies

The central government's precarious fiscal situation is exacerbated by the **sizable appropriations to independent government entities including municipalities and UPR.** For FY 2015, the government allocated almost 18% of its General Funds in appropriations to independent entities while significantly reducing the budget for the central government

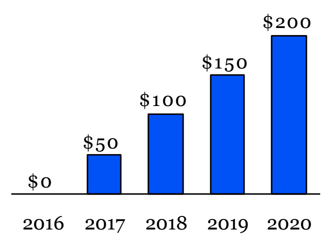
Municipalities

- Enact legislation to, beginning FY 2018, gradually adjust subsidies provided to municipalities by the central government, while empowering municipalities with the proper legal, administrative and operational tools for them to offset such decrease
  - Municipalities may present revenue generation and expense reduction initiatives, that may include changes to municipal license fees, modernization of property tax regime and municipal consolidations, among others
  - Central government to commission a study to provide analysis of, and recommendations with respect to, the relevant alternatives

March 2016



Fiscal Stability – Expense Reduction Measures

Expense Reduction Measures	**Target Date**	**Estimated Incremental Impact FYs** ($ millions)
2.5 Cut Government Subsidies (cont.)		
University of Puerto Rico		
▪ The UPR shall develop, in consultation with GDB as fiscal agent, a plan to ensure the continuous delivery of a world-class education in the context of its institutional autonomy, the fiscal environment of the Commonwealth and its historical role as a promoter of the island's economic development ❖ The UPR has alternatives to operate in a more cost-effective manner, without impacting low-income students, such as means-testing tuition, operational efficiencies, employment attrition and maximizing federal funding	January 2016	
▪ Enact legislation to gradually adjust revenue base underlying general fund formula-based appropriations to the UPR in order to exclude debt service and pension costs ❖ For FY 2016, the Commonwealth budget provides an $834 million subsidy to the UPR (in addition to ~$62 million from casino slot revenues plus $35 million in other direct appropriations), which constitutes over two thirds of the UPR's total budget ❖ Effect of adjustment on UPR's formula is additive to the effect of the proposed extension of Act 66-2014, which freezes the formula-based appropriation to the UPR	June 2016	
▪ Pass legislation to redirect to Health Insurance Administration ("ASES") the casino slot revenues currently assigned to the UPR in order to fund current Commonwealth health care coverage to medical poor beneficiaries who do not qualify for Medicaid[1]	June 2016	

(1) Casino slot machine revenue has been declining over the last years.

Fiscal Stability – Expense Reduction Measures

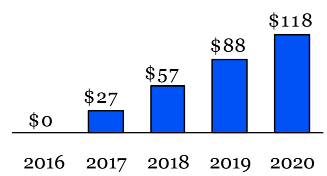
Expense Reduction Measures	**Target Date**	**Estimated Incremental Impact FYs** ($ millions)

2.6 Right-Size Department of Education

Since 1980, **enrollment at public schools has declined 41% and, due to demographic trends, it is expected to fall an additional 25% (~317,000 students) by 2020.** This decline has led to a reduction in school utilization and a decrease in the **student to teacher ratio to 12:1 (US average is 16:1).** The Puerto Rico Department of Education has made significant progress during the last two years by **consolidating 135 schools** and reducing the number of temporary teachers by more than **1,000**

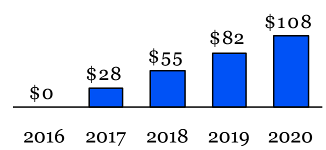
- Consolidate public schools based on specific parameters such as enrollment, school utilization and distance to adjust PRDE's facilities to current demographic trends and improve student-to-teacher ratio for both underutilized and overcrowded schools
  - The PRDE has made significant progress over the last two years in adjusting its human capital and physical infrastructure to its fiscal and demographic reality. As it continues to right-size its resources, the PRDE will ultimately position itself to deliver high quality education with well compensated teachers

2017-2020
(annual targets)



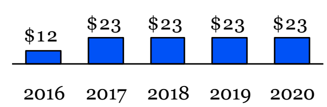
- Reduce PRDE's payroll through 2% attrition[(1)]

2017-2020
(annual targets)



- Complete remaining phases of PRDE's ongoing restructuring plan, which requires overhauling the PRDE's management and operations and reducing expenditures on select private services

2016-2020
(annual targets)



- Consider selected asset sales, including the Commonwealth's real estate asset portfolio, to finance retirement windows for teachers and/or capitalize severely underfunded Teachers Retirement System

2016-2020

Estimated impact should be determined by March 2016

(1) Attrition calculated net of impact attrition measure in Section 2.4 hereto; impact does not include the negative effect of Additional Uniform Contribution to Teachers Retirement System.

Fiscal Stability – Expense Reduction Measures

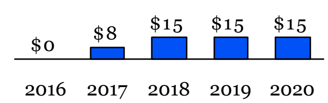
Expense Reduction Measures	Target Date	Estimated Incremental Impact FYs ($ millions)

2.7 Control Health Care Costs

The Commonwealth's public health care plan covers approximately 1.6 million beneficiaries (all but 180,000 of which are not covered by Medicaid) and is financed by a combination of federal and local funds.[1] Puerto Rico ranks #14 nationally in terms of total Medicaid enrollment and #1 as a percentage of population enrolled (48%). While the Commonwealth **is subject to a federal spending cap that limits federal dollars for Medicaid to approximately $260 million (excluding $150 million for the Children's Health Insurance Program "CHIP"), there is no cap for US states. Puerto Rico also faces a "health care cliff," currently estimated to grow to $1.7 billion dollars by 2020, upon the exhaustion of Affordable Care Act funding in FY 2018**

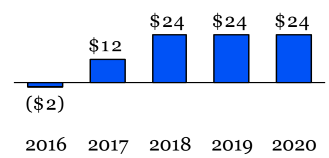
- Implement "STAR"-like[3] rating system and establish a provider payment scale based on performance

October 2015



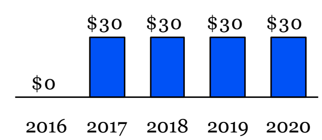
- Implement functional P3s at state hospitals (billings, admissions, maintenance and food services among other support services), to bring best in class practices, centralize functions and streamline processes (e.g. surgery cancellations; efficient emergency room management)[4]

July 2016



- Standardize health protocols and establish uniform fee schedules
  - Create uniform guide for medical procedures and corresponding medical service fee schedule

July 2016



(1) Federal funds would include funds from Medicaid, CHIP and Medicare Advantage programs.
(2) Coverage will be suspended to those who do not pay the premium; impact is net of incremental operation costs.
(3) Centers for Medicare and Medicaid Services ("CMS") Five Star Quality Rating System.
(4) Estimates are based on current P3 billing experience at University District Hospital ("UDH"). Estimates are net of incremental operating costs.

Working Group for the Fiscal and Economic Recovery of Puerto Rico

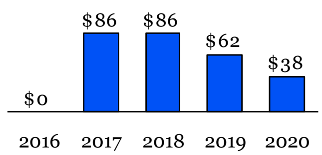
Fiscal Stability – Expense Reduction Measures

Expense Reduction Measures | **Target Date** | **Estimated Incremental Impact FYs** ($ millions)

2.7 Control Health Care Costs (cont.)

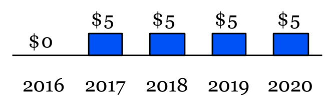
- Amend Act 72-1993 to ensure transfer of municipal contributions to ASES (preventing withholding contributions), along with their corresponding federal match[1], and clarify FY 2005 as the base year to calculate municipal contributions

February 2016



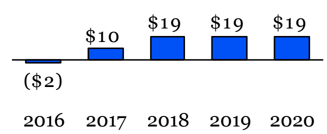
- Rationalize number of federally qualified health care centers receiving grants under Section 330 of the Federal Pubic Health Service Act that are located near existing hospitals or clinics

July 2016



- Create the Puerto Rico Medical Center Campus organized around specialty institutions by integrating all government hospitals into a single organization[2]
  - Phase 1 contemplates merging Administration of Medical Services of Puerto Rico ("ASEM"), the University Hospital and University Pediatric Hospital ("HOPU")
  - Phase 2 would merge the Industrial Hospital ("Hospital Industrial") currently run by the State Insurance Fund, along with other government run hospitals

December 2016



(1) Federal matching decreases as ACA funds deplete over time.
(2) Savings are obtained by economies of scale in purchasing, maintenance and other central support functions. Saving are estimated at 5% of each hospital's budget.

Fiscal Stability – Expense Reduction Measures

Expense Reduction Measures	Target Date	Estimated Incremental Impact FYs ($ millions)
2.7 Control Health Care Costs (cont.)		
▪ Obtain equitable Medicare and Medicaid treatment and funding from US Government	December 2017	Financial impact subject to timing and nature of federal policy

Medicaid

- Remove statutory limits on Medicaid funding, including not setting the Federal Medical Assistance Percentage ("FMAP") at a fixed percentage
  - Puerto Rico's Medicaid funding level is capped at approximately $260 million and its FMAP rate set at 50%, which per Puerto Rico's income levels should be 83%

Medicare

- Reimburse Puerto Rico hospitals who admit patients under the Inpatient Prospective Payment System ("IPPS") at the same rate as mainland hospitals
- Make Puerto Rico hospitals eligible for bonus payments under Medicare
- Automatically enroll in Medicare Part B individuals enrolled in Medicare Part A
- Provide Puerto Rico doctors fair treatment under the Practice Expense Geographic Practice Cost Index ("GPCI") payment formula
- Ensure adequate per member per month ("PMPM") payments to Medicare Advantage plans in Puerto Rico
- Allow adequate utilization of Enhanced Allotment Program ("EAP") prescription drug funding

Medicaid and Medicare

- Extend to Puerto Rico Medicaid and Medicare disproportionate share hospital ("DSH") program allotments

Fiscal Stability – Expense Reduction Measures

Expense Reduction Measures	Target Date
2.8 Leverage P3s to Deliver Quality and Cost-Efficient Services	

The need for **proper infrastructure construction and maintenance, necessary for economic growth, can be met by leveraging public private partnerships**. Recent positive experience with the LMM Airport and PR-22 Highway demonstrate that P3s are a viable model and an effective tool to rehabilitate and develop necessary infrastructure, reduce operational costs and improve governmental services for the Commonwealth

- Concession remaining toll roads, including PR-20, PR-52 and PR-66 in consultation with US Department of Transportation — (estimated impact subject to terms of concession)
  - Improve, intra-Island connectivity, road and bridge quality, and travel safety. Continuous investment in and maintenance of the roads would be mandatory as set forth in a Concession Agreement
  - Concessions would help transform HTA into a contract administrator and limit its construction role
- Merge Public Building Authority and Office for the Improvements of Public Schools ("OMEP") — (estimated impact subject to terms of concession)
  - Transform PBA into a more efficient and effective public corporation; consider transferring the construction function to ("PRIFA") to avoid duplication of functions
- P3 maritime transport and bus system operations — (estimated impact subject to terms of concession)
  - Maritime: 5-year minimum concession agreement for the operation and maintenance of the public maritime transportation services
  - AMA: currently evaluating possible transfer of operations to municipalities and potential P3 transactions
- Evaluate potential concessions for ports and airport operations or facilities, and work with the Federal Aviation Administration ("FAA") to consolidate underutilized or geographically unnecessary airports — (estimated impact subject to terms of concession)
- Identify and pursue additional P3 opportunities

Institutional Reform and Transparency

"The legacy of budgetary laxity, non-transparency, and unreliable/dated statistics must be overcome if the reform program is to work and command credibility. The priorities include a rolling 5-year budgetary plan approved by the legislature, legislative rules to limit changes to the plan, an independent fiscal oversight board to advise on the budget and control its implementation, and strengthening the quality and timeliness of economic data." –The Krueger Report p.22

Institutional Reform and Transparency Measures	Target Date
3.1 Install New Accounting and Financial Systems	
The central government's financial and payroll systems are obsolete and can not communicate with the systems of principal agencies, such as the PRDE and the Health Department. Lack of integration of agencies under the same platform hinders the ability to timely monitor expenses, complete annual audits and publish accounting financial statements	
▪ Implement new financial/accounting and payroll system that unifies the patchwork of governmental platforms, which affect the government's ability to properly monitor its fiscal situation and result in material delays in the preparation of financial information	July 2017
- Contract system provider (implementation schedule is expected to be approximately 18 to 24 months)	November 2015
- Requires an approximate investment of at least $25 million to $40 million	
3.2 Establish Centralized Single Treasury Function	
The Commonwealth currently has a **highly fragmented treasury system** that places **weak emphasis on ensuring fiscal and financial controls** and provides little visibility of the Government's consolidated financial position. The centralization of treasury functions in the central government can provide significant communication, visibility and efficiency benefits	
▪ Establish by legislation centralized single treasury functions across Commonwealth agencies and dependent public corporations to enhance visibility, reduce financing costs and improve cash flow	June 2016
- Identify agencies and component units that would be part of the centralized structure	January 2016
- Build the necessary infrastructure for the monitoring and projection of cash flows	June 2016
- Enact legislation to create centralized treasury with provisions that would allow for enforcement	June 2016

Institutional Reform and Transparency

Institutional Reform and Transparency Measures	Target Date
3.3 Improve Fiscal and Economic Decision-Making	
Investors, bondholders, policymakers, and academics have repeatedly pointed to the need of equipping the Commonwealth with more **transparent, reliable and timely macroeconomic data** that complies with global standards. A methodological modernization of the Commonwealth's national accounts is long overdue, along with a **centralized and well-structured approach towards financial and economic development decisions**	
▪ Adopt the Institute of Statistics and the Planning Board 5-year plan to strengthen the economic statistical system and analysis by modernizing national accounts with an estimated investment of $3 million per year	2015-2020 (annual targets)
- Reorganize and expand Puerto Rico's current 5 national accounts into 7 accounts (Net Income and Gross Product, Personal Income and Outlays, Government Receipts and Expenditures, Foreign Transactions-Current, Foreign Transactions-Capital, Gross Savings and Investment and Private Sector Income)	
- Present the national accounting statistics in accordance with the 2008 United Nations standards	
- Develop a new forecasting model for Puerto Rico's national accounts	
- Publish official full-set of quarterly national accounting statistics that is consistent with annual estimates	
- Request technical assistance from the US Bureau of Labor Statistics and the US Bureau of Economic Analysis	
▪ Consolidate the functions of the Treasury Department, OMB and the GDB's non-core banking operations into new Finance and Public Credit Department to better manage and coordinate fiscal and financial policy	June 2017
- Existing fiscal and financial policy is heavily fragmented; international best practices typically consolidate revenue, budget and financial functions to obtain a government-wide visibility and improve execution	
▪ Reorganize the Department of Economic Development and Commerce to better deploy economic promotion resources and shared corporate services	
- Complete DDEC organizational diagnostic with respect to corporate governance, organizational structure, decision-making processes and return on investment philosophy	February 2016
- Submit and pass legislation to implement new DDEC organizational structure and business plan	January 2017

Institutional Reform and Transparency

Institutional Reform and Transparency Measures	Target Date
3.3 Improve Fiscal and Economic Decision-Making (cont.)	
▪ Merge strategic public corporations into a real estate development agency that supplements the Department of Economic Development to improve economic and business planning - Centralized entity will serve as a project management coordinator while leveraging resources from current entities and minimizing operational costs via shared services - Request to the US Census Bureau that Puerto Rico be included in the Census of Governments and that the National Agricultural Statistical Service provide technical assistance developing agricultural surveys	September 2016

3.4 Implement New Budgetary Rules

Given that the Commonwealth has suffered from chronic **budget deficits** and has repeatedly failed to meet budgetary estimates, it should institute new budgetary rules and practices to impose budgetary discipline and help achieve FEGP targets

- Refer to Summary of Fiscal Responsibility and Economic Revitalization Act of the FEGP

3.5 Institute Control Board for Policy Continuity and Compliance

An independent **fiscal control board, comprised by experienced individuals** from inside and outside the Commonwealth, **shall oversee the implementation of the 5-year FEGP** with the powers necessary to ensure compliance

- Refer to Summary of Fiscal Responsibility and Economic Revitalization Act of the FEGP

Requests to the US Government

Federal action is necessary to place Puerto Rico on a sustainable path

Type	Request	Needed for Measure
Long-Term Sustainability	▪ Access to a legal framework to restructure the Commonwealth's liabilities in an orderly process	Financing Gaps
	▪ Equitable Medicare and Medicaid treatment and funding <u>Medicaid</u> - Remove statutory limits on Medicaid funding, including not setting the Federal Medical Assistance Percentage ("FMAP") at a fixed percentage ❖ Medicaid funding level is capped at ~$260 million and the FMAP rate set at 50%, which equals an effective rate of 15% to 20%, whereas according to Puerto Rico's income levels should be 83% <u>Medicare</u> - Reimburse Puerto Rico hospitals who admit patients under the Inpatient Prospective Payment System ("IPPS") at the same rate as mainland hospitals - Make Puerto Rico hospitals eligible for bonus payments under Medicare - Automatically enroll in Medicare Part B individuals enrolled in Medicare Part A - Provide Puerto Rico doctors fair treatment under the Practice Expense Geographic Practice Cost Index ("GPCI") payment formula - Ensure adequate PMPM payments to Medicare Advantage plans in Puerto Rico - Allow adequate utilization of Enhanced Allotment Program ("EAP") prescription drug funding <u>Medicaid and Medicare</u> - Extend Medicaid and Medicare disproportionate share hospital ("DSH") program payments	2.7 Control Health Care Costs
	▪ Maintain Act 154-2011 excise tax creditability for the duration of the FEGP period	2.2 Stabilize Corporate Tax Revenue Base
	▪ Exemption from Jones Act application to reduce transportation costs and increase competitiveness	1.4 Reduce Costs and Improve Ease of Doing Business

Requests to the US Government (cont.)

Federal action is necessary to place Puerto Rico on a sustainable path

Type	Request	Needed for Measure
Long-Term Growth	▪ Provide Puerto Rico with a tax treatment that encourages US investment on the island, such as: - Section 933A: Amend US Internal Revenue Code to add new Section 933A to permit US-owned business in Puerto Rico to elect to be treated as US domestic corporations - Economic Activity Tax Credit: Enact an economic activity tax credit for US investment in Puerto Rico designed as a targeted, cost-efficient version of former Section 936 of the US Internal Revenue Code - Base Erosion: In the event the US moves towards a territorial taxation system, exempt Puerto Rico from base erosion and/or minimum tax measures	1.3 Implement Pro-Growth Corporate Tax Regime
	▪ Flexibility on minimum wage with respect to young workers ▪ "White collar" exemption under Fair Labor Standards Act ("FLSA") ▪ Pro employment requests with respect to NAP and public housing programs	1.1 Stimulate Employment and Labor Force Participation
Near-Term Impact Measures	▪ FAA approval for any airport consolidations ▪ Executive approval or Congressional authorization to sell accumulated Federal Highway toll credits	2.8 Leverage P3s to Deliver Quality and Cost-efficient Services
	▪ Technical assistance from the Census Bureau and National Agricultural Statistical Service	3.3 Improve Fiscal and Economic Decision-Making
	▪ DOE financing for Aguirre Offshore Gas Port. Finalize remaining AOGP federal permits ▪ Technical Assistance from the Build America Transportation Investment Center on transportation related infrastructure projects and P3 proposals	1.5 Invest in Strategic Infrastructure
	▪ Federal legislation granting the Commonwealth and its agencies access to the GSA Cooperative Purchasing program and all federal supply schedules	2.4 Reduce Operating Costs

Summary of Measures – Revenue

A summary of the annual impact of the various revenue measures as determined by the Working Group is presented below

$ millions	2016P	2017P	2018P	2019P	2020P	Total
Revenue Measures						
2.1 Complete Transition from Original SUT to Increased SUT/VAT	**$1,111**	**$1,290**	**$1,303**	**$1,316**	**$1,330**	**$6,350**
2.2 Stabilize Corporate Tax Revenue Base	**–**	**–**	**538**	**1,075**	**1,075**	**2,688**
2.3 Improve Tax Administration & Enforcement						
Leverage Tech and Training to Increase Capture Rates and Improve Tax Admin	10	41	56	65	67	239
Restrict Use of Tax Amnesties and Closings	–	25	25	25	25	100
Video Lottery	–	19	22	25	27	93
Improve Tax Administration & Enforcement	**10**	**85**	**103**	**115**	**119**	**432**
Total Revenue Measures	**$1,121**	**$1,375**	**$1,943**	**$2,506**	**$2,524**	**$9,469**
Memo: Total Revenue Measures ex. Increased SUT/VAT Already Enacted	*$10*	*$85*	*$640*	*$1,190*	*$1,194*	*$3,119*

Summary of Measures – Expense

A summary of the annual impact of the various expense measures as determined by the Working Group is presented below

$ millions	2016P	2017P	2018P	2019P	2020P	Total
Expense Measures						
2.4 Reduce Operating Costs						
Extend Law 66	–	–	$321	$520	$622	$1,463
Employee Attrition	-	39	76	114	150	378
Reclasification of Positions	-	-	-	-	-	-
Reduction in Licenses	-	-	-	-	-	-
Operational Efficiencies	3	18	26	41	42	130
Centralized Procurement	-	60	80	120	120	380
Retirement Plans	-	48	47	46	45	186
Reduce Operating Costs	**3**	**165**	**550**	**840**	**979**	**2,537**
2.5 Cut Governmental Subsidies						
Municipalities	-	-	100	200	300	600
UPR	-	50	100	150	200	500
Cut Governmental Subsidies	**-**	**50**	**200**	**350**	**500**	**1,100**
2.6 Right-Size Department of Education						
Consolidate Schools	-	27	57	88	118	290
Reduce Department's Payroll through Attrition	-	28	55	82	108	272
Complete Remaining Phases of PRDE Restructuring Plan	12	23	23	23	23	104
Right-Size Department of Education	**12**	**78**	**135**	**193**	**249**	**666**
2.7 Control Health Care Costs						
Implement STAR Ratings System and Scale Payments	-	8	15	15	15	53
Implement Functional P3s at State Hospitals	(2)	12	24	24	24	82
Standardize Health Protocols and Impose Uniform Fee Schedules	-	30	30	30	30	120
Restore Municipal Contributions and Corresponding Federal Match	-	86	86	62	38	272
Reduce Number of 330s as IPAs Under Mi Salud	-	5	5	5	5	20
Create the Puerto Rico Medical Center Campus	(2)	10	19	19	19	65
Control Health Care Costs	**(4)**	**151**	**179**	**155**	**131**	**612**
Total Expense Measures	**$11**	**$443**	**$1,064**	**$1,538**	**$1,859**	**$4,914**

Summary of Measures – Growth, Costs and Total Impact

A summary of the annual impact of the incremental revenue from GNP growth, which is spurred by economic development and structural reforms as determined by the Working Group, is presented below along with a summary of the estimated cost of implementing all of the measures and then the total impact of the growth and measures

- Consistent with the approach taken in the Krueger Report, incremental revenue from economic development and structural reforms is calculated as the difference between a high-growth and a base-case scenario for General Fund revenue sources(1)
- The base-case scenario assumes approximately -1% real growth in GNP while the high-growth scenario assumes structural reforms lead to GNP growth of 2% by 2020 (2% inflation is assumed in both cases)
  - In addition, labor reforms are assumed to lead to a greater increase in revenues from personal income taxes, which is calculated using an elasticity factor of 1%, which is also consistent with the Krueger Report
- Incremental costs of the various measures are also shown below and consist of estimates of incremental capex necessary for the measures and growth, incremental pension contributions associated with the measures, cost of earned income tax credits, investment in a new accounting system and the implementation of a new Institute of Statistics plan

$ millions	2016P	2017P	2018P	2019P	2020P	Total
Total Est. Incremental Rev. from Econ. Dev. and Structural Reforms	–	$115	$322	$584	$907	$1,929
Estimated Incremental Cost of Measures	($262)	($549)	($569)	($616)	($538)	($2,533)
Total Impact of Measures						
Revenue Measures	1,121	1,375	1,943	2,506	2,524	9,469
Expense Measures	11	443	1,064	1,538	1,859	4,914
Incremental Cost of Measures	(262)	(549)	(569)	(616)	(538)	(2,533)
Total Impact of Measures	$870	$1,269	$2,439	$3,428	$3,845	$11,850
Est. Incremental Rev. from Economic Development and Structural Reforms	–	115	322	584	907	1,929
Total Impact of Measures and Growth	$870	$1,384	$2,761	$4,012	$4,752	$13,779

(1) General Fund revenue sources include personal income, corporate, SUT/VAT, property, Act 154, alcoholic beverages, cigarettes, motor vehicles, excises on off-shore shipment rum and other taxes. Act 154 taxes are assumed to be held constant in both base- and high-growth scenarios.

Working Group for the Fiscal and Economic Recovery of Puerto Rico

Summary of Fiscal Responsibility and Economic Revitalization Act

Fiscal Responsibility and Economic Revitalization Act

In order to ensure maximum benefit from the FEGP, the Working Group has drafted the Fiscal Responsibility and Economic Revitalization Act (FRERA) that includes measures that will ensure compliance with the FEGP, including the creation of a control board (and other oversight and compliance measures) as well as new budgetary rules

Selected Highlights of FRERA: The Control Board (or the "Board") Generally

- Establishes the Board, which will consist of five individuals appointed by the Governor that must have knowledge and expertise in finance, management, or the operation of business or government and must be independent from other governmental entities
- Provides that Board members will serve for 4-year staggered terms
- Requires that a majority of the nominated Board members be selected from a list provided to the Governor by independent third parties
- Gives the Board oversight authority over most governmental entities, including the Commonwealth, GDB and the public corporations (except PREPA and PRASA)
- Assures the Board's independence by
  - Giving it its own revenue source for operations
  - Allowing it to hire its own independent staff and professionals
  - Removing a board member only for cause
  - Giving it extensive subpoena powers
  - Authorizing it to levy sanctions for non-compliance with approved budgets

Fiscal Responsibility and Economic Revitalization Act

Selected Highlights of FRERA: Fiscal and Economic Growth Program

- Requires that a Commonwealth-wide consolidated 5-year FEGP be submitted to the Board for approval no later than the end of the 2nd Quarter of FY 2016
- Requires the Board to evaluate whether the proposed FEGP complies with the objectives and requirements provided in the FRERA
- Mandates that the objectives of the FEGP include:
  - Implementing structural reforms that restore economic growth and competitiveness
  - Eliminating, over time, the financing gaps and reducing the debt burden of most governmental entities, including the Commonwealth and public corporations (except PREPA and PRASA)
  - Improving institutional credibility by improving budget formulation and execution and data transparency

Fiscal Responsibility and Economic Revitalization Act

Selected Highlights of FRERA: FEGP (cont.)

- Requires the FEGP to:
  - Include specific proposals to improve and diversify the economy
  - Incorporate structural and economic reforms to ensure long-term fiscal sustainability and economic development
  - Incorporate best practices for making reliable revenue estimates
  - Require that budgets be prepared and calculated pursuant to the modified accrual basis of accounting according to generally accepted standards
  - Require governmental entities to reduce annually, and by FY 2021, eliminate budget deficits
  - Ensure a material reduction in expenditures through more efficient delivery of services
  - Ensure that pension obligations are sustainable and can be honored over the long term
  - Require that the Commonwealth-wide debt load be adjusted to sustainable terms
  - Require that financial controls and accounting systems be improved to monitor fiscal developments on a timely basis
  - Identify automatic budgetary stabilizers to ensure compliance with the proposed FEGP

Fiscal Responsibility and Economic Revitalization Act

Selected Highlights of FRERA: Approval of, and Monitoring Compliance with, the FEGP

- Requires the Board to review and approve the consolidated Fiscal and Economic Growth Plan if it complies with the objectives and requirements set forth in FRERA
- Requires certain entities to submit annual budgets to the Board to ensure that they comply with the approved Fiscal and Economic Growth Plan
- Requires the Board to evaluate whether the budgets comply with the Fiscal and Economic Growth Plan
- Requires the Board to issue non-compliance findings if the budgets do not comply with the Fiscal and Economic Growth Plan
- Requires the Board to monitor compliance with the approved budgets throughout each fiscal year
- Requires the Board to issue non-compliance warnings during the fiscal year or findings at the end of the fiscal year if the entities' actual revenues and expenditures vary from the approved budget in an amount that exceeds a permitted variance determined by the Board
- Imposes severe sanctions for failing to comply with approved budgets, which may include:
  - A prohibition on entering into contracts
  - Automatic hiring freezes
  - Automatic expense cuts (see next slide)

Fiscal Responsibility and Economic Revitalization Act

Selected Highlights of FRERA: New Budgetary Rules for the Commonwealth General Fund

- Provides that the Commonwealth budget be based on a "Revenue Projection" validated by third parties
- Requires that the budget include a 5-year revenue and expense projection
- Prohibits the creation or use of budgetary funds without an identified source of revenues and cancels several existing budgetary funds that do not have identified sources of revenues
- All purchase orders and contracts with third-party suppliers will be subject to OMB budgetary oversight and uniform procedures for approval and recording
- Creates a special fund that may only be used to pay the government's accounts payable, including tax refunds; amounts to be deposited in such fund shall not be included in the Revenue Projection
- Provides that the Secretary of the Treasury shall adjust each fiscal year's actual revenue numbers by the difference between the projection of tax refunds made at the beginning of the fiscal year and the revised projections of tax refunds made near the end of the fiscal year
- Provides that a specified amount of each fiscal year's budget be allocated to a "Budgetary Reserve Fund" until amounts credited to such fund reach a specified percentage of the then-current fiscal year's Revenue Projection
- Provides that budgetary expenditures for each fiscal year cannot exceed such fiscal year's Revenue Projection less the amount allocated to the "Budgetary Reserve Fund" amount
- Provides that the Budgetary Reserve Fund may only be used for certain specified purposes
- Mandates that the budget identify a specified amount of operating expenditures that may not be incurred unless OMB (and in some cases the Board) authorizes the use of such funds (known as the "Sequestered Expenditures")
- Provides that a portion of the Sequestered Expenditures shall be released by the OMB or the Board at the end of each fiscal quarter if actual revenues meet or exceed the Revenue Projection
- Provides that if actual revenues are below the Revenue Projection, the Sequestered Expenditures shall not be released
- Provides that the OMB or the Board may also decide not to release the Sequestered Expenditures to specific entities if it determines that such entities' actual expenditures will exceed its budgeted expenditures

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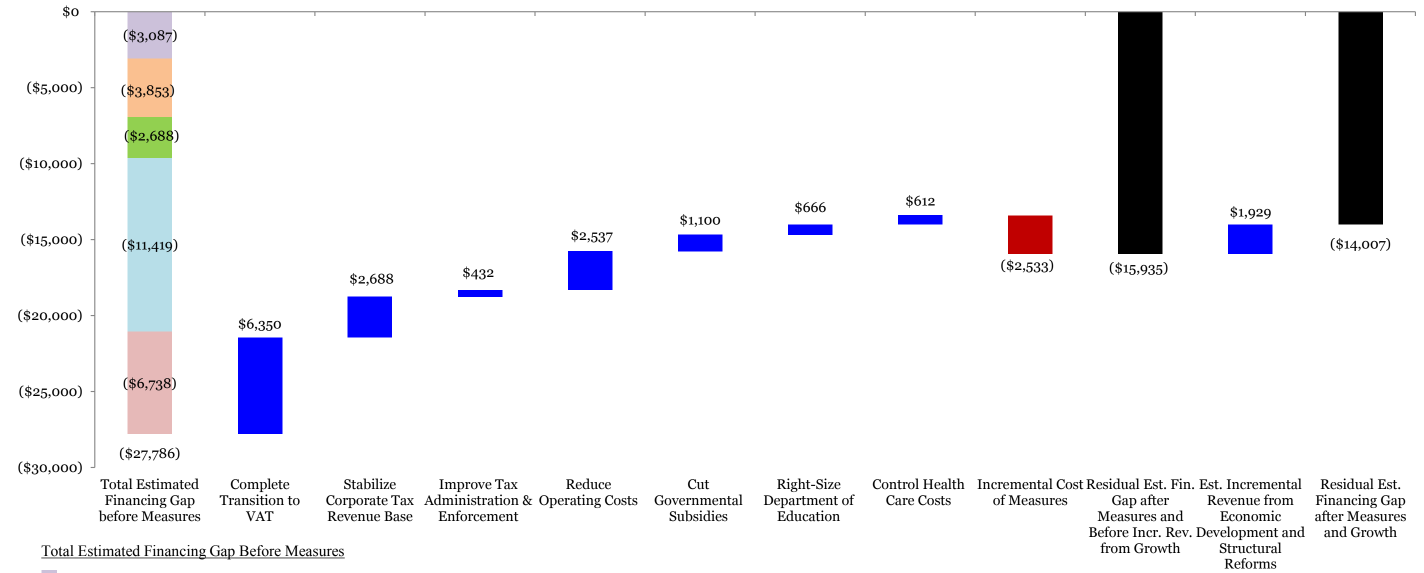
Summary of Projected Financing Gap After Measures

Cumulative Financing Gap Before and After Measures

A summary of the cumulative financing gap before measures from FYs 2016 to 2020(1) and the total benefit from each measure over the same period, as determined by the Working Group, is shown below

Cumulative 5-Year Financing Gap ($ millions)



Total Estimated Financing Gap Before Measures

- Base Financing Deficit before Loss of ACA, Loss of Act 154 and Debt Service and after AUCs and Catch-up Payments to Retirement Systems
- Loss of ACA Funding
- Loss of Act 154 / Foreign Company Tax Losses
- Debt Service - Interest
- Debt Service - Principal

(1) Note that the financing gap before measures has been updated from the Krueger Report, based on new information obtained through diligence by the Working Group. The variances to the Krueger Report are detailed in the appendix.

Annual Financing Surplus (Gap) Before Debt Service

Based on the Working Group's diligence and the measures previously outlined, the following presents a summary of the estimated annual financing gaps prior to the payment of debt service, but after the implementation of the measures previously outlined

Projected Financing Surplus/(Gap) before Debt Service ($ millions)

	2016P	2017P	2018P	2019P	2020P	Total
Total Estimated Financing Gap before Measures (incl. Debt Service)	($4,075)	($4,386)	($4,670)	($7,437)	($7,217)	($27,786)
Consolidated Interest	2,320	2,370	2,320	2,239	2,170	11,419
Consolidated Principal	1,810	1,044	957	1,628	1,299	6,738
Pre-Measures & Pre-debt Service Financing Surplus/(Gap)	55	(972)	(1,392)	(3,571)	(3,749)	(9,628)
Revenue Measures						
Complete Transition to VAT	1,111	1,290	1,303	1,316	1,330	6,350
Stabilize Corporate Tax Revenue Base	–	–	538	1,075	1,075	2,688
Improve Tax Administration & Enforcement	10	85	103	115	119	432
Total Revenue Measures	1,121	1,375	1,943	2,506	2,524	9,469
Expense Measures						
Reduce Operating Costs	3	165	550	840	979	2,537
Cut Governmental Subsidies	–	50	200	350	500	1,100
Right-Size Department of Education	12	78	135	193	249	666
Control Health Care Costs	(4)	151	179	155	131	612
Total Expense Measures	11	443	1,064	1,538	1,859	4,914
Incremental Cost of Measures(1)	(262)	(549)	(569)	(616)	(538)	(2,533)
Fin. Surplus before Debt Serv. ex. Economic Growth	**$924**	**$298**	**$1,046**	**($143)**	**$97**	**$2,222**
Est. Incremental Revenue from Economic Development and Structural Reforms	–	115	322	584	907	1,929
Financing Surplus before Debt Service	**$924**	**$413**	**$1,369**	**$442**	**$1,003**	**$4,150**

(1) Includes estimates of incremental capex necessary for the measures and growth, incremental pension contributions associated with the measures, cost of earned income tax credits, investment in a new accounting system and the implementation of a new Institute of Statistics plan.

Unsustainability of Existing Debt Service Absent Economic Growth

Even after taking the measures outlined on the previous pages, the FEGP suggests that the Commonwealth cannot service all of its debt as currently scheduled

- Since economic growth is dependent in many ways on elements outside of the Commonwealth's control (such as changes to certain federal government policies), the following exhibit presents the forecasted financing gaps after debt service excluding the estimated impact of GNP growth from economic development and structural reforms
- The financing gap below is shown for illustrative purposes only based on consolidated debt service and with GO bond and GO guaranteed bond debt service[1] separately delineated

Total Projected Financing Surplus/(Gap) Excluding Economic Growth ($ millions)

	2016P	2017P	2018P	2019P	2020P	Total
Financing Gaps Based on Consolidated Interest and Principal						
Fin. Surplus before Debt Serv. and Est. Incr. Rev. from Econ Dev. And Struct. Reforms	$924	$298	$1,046	($143)	$97	$2,222
Consolidated Interest[2]	(2,320)	(2,370)	(2,320)	(2,239)	(2,170)	(11,419)
Financing Gap after Consolidated Interest	(1,396)	(2,073)	(1,274)	(2,382)	(2,073)	(9,197)
Consolidated Principal[2]	(1,810)	(1,044)	(957)	(1,628)	(1,299)	(6,738)
Total Financing Gap before Economic Growth	**($3,205)**	**($3,117)**	**($2,231)**	**($4,010)**	**($3,372)**	**($15,935)**
Financing Gaps with GO and GO Guaranteed Debt Service Delineated						
Fin. Surplus before Debt Serv. and Est. Incr. Rev. from Econ Dev. And Struct. Reforms	$924	$298	$1,046	($143)	$97	$2,222
GO and GO Guaranteed Interest[1]	(920)	(953)	(932)	(895)	(860)	(4,561)
GO and GO Guaranteed Principal[1]	(925)	(526)	(433)	(483)	(553)	(2,920)
Financing Surplus after GO and GO Guaranteed Debt Service	(921)	(1,182)	(319)	(1,521)	(1,317)	(5,259)
Interest Excluding GO and GO Guaranteed	(1,400)	(1,418)	(1,387)	(1,345)	(1,309)	(6,859)
Financing Gap after GO and GO Guaranteed and All Interest	(2,320)	(2,599)	(1,707)	(2,865)	(2,626)	(12,118)
Principal excluding GO and GO Guaranteed	(885)	(518)	(524)	(1,144)	(746)	(3,818)
Total Financing Gap before Economic Growth	**($3,205)**	**($3,117)**	**($2,231)**	**($4,010)**	**($3,372)**	**($15,935)**

(1) GO and GO guaranteed debt service includes debt service payments related to GO, GDB GO guaranteed bonds, PBA and PRIFA Bond Anticipation Notes ("BANs"). Excludes PRASA and GDB guaranteed intragovernmental loans.
(2) Includes any debt service payments related to debt at GO, GDB, PBA, Public Finance Corporation ("PFC"), COFINA, PRIFA, UPR, Puerto Rico Convention Center District Authority ("PRCCDA"), Puerto Rico Industrial Development Company ("PRIDCO"), GSA, PRIFA BANs, ERS and HTA.

Unsustainability of Existing Debt Service Even with Economic Growth

Even if the Commonwealth were able to achieve economic growth, the estimated benefit of such growth still would not be enough to allow the Commonwealth to pay all of its contractual debt service as currently scheduled

- The financing gap presented below is shown after the estimated benefit of economic growth; as with the previous page, the financing gap is shown based on consolidated debt service and with GO bond and GO guaranteed bond debt service[1] separately delineated

Total Projected Financing Surplus/(Gap) Including Economic Growth ($ millions)

	2016P	2017P	2018P	2019P	2020P	Total
Financing Gaps Based on Consolidated Interest and Principal						
Financing Surplus before Debt Service	$924	$413	$1,369	$442	$1,003	$4,150
Consolidated Interest[2]	(2,320)	(2,370)	(2,320)	(2,239)	(2,170)	(11,419)
Financing Gap after Consolidated Interest	(1,396)	(1,958)	(951)	(1,798)	(1,166)	(7,269)
Consolidated Principal[2]	(1,810)	(1,044)	(957)	(1,628)	(1,299)	(6,738)
Total Financing Gap	**($3,205)**	**($3,002)**	**($1,909)**	**($3,425)**	**($2,465)**	**($14,007)**
Financing Gaps with GO and GO Guaranteed Debt Service Delineated						
Financing Surplus before Debt Service	$924	$413	$1,369	$442	$1,003	$4,150
GO and GO Guaranteed Interest[1]	(920)	(953)	(932)	(895)	(860)	(4,561)
GO and GO Guaranteed Principal[1]	(925)	(526)	(433)	(483)	(553)	(2,920)
Financing Surplus after GO and GO Guaranteed Debt Service	(921)	(1,067)	3	(936)	(410)	(3,331)
Interest Excluding GO and GO Guaranteed	(1,400)	(1,418)	(1,387)	(1,345)	(1,309)	(6,859)
Financing Gap after GO and GO Guaranteed and All Interest	(2,320)	(2,484)	(1,385)	(2,281)	(1,719)	(10,189)
Principal excluding GO and GO Guaranteed	(885)	(518)	(524)	(1,144)	(746)	(3,818)
Total Financing Gap	**($3,205)**	**($3,002)**	**($1,909)**	**($3,425)**	**($2,465)**	**($14,007)**
Memo: Total Financing Gap ex. Est. Incremental Revenue from Economic Development and Structural Reforms	*($3,205)*	*($3,117)*	*($2,231)*	*($4,010)*	*($3,372)*	*($15,935)*

(1) GO and GO guaranteed debt service includes debt service payments related to GO, GDB GO guaranteed bonds, PBA and PRIFA BANs. Excludes PRASA and GDB guaranteed intragovernmental loans.
(2) Includes any debt service payments related to debt at GO, GDB, PBA, PFC, COFINA, PRIFA, UPR, PRCCDA, PRIDCO, GSA, PRIFA BANs, ERS and HTA.

Working Group for the Fiscal and Economic Recovery of Puerto Rico

Conclusion

Conclusion

- Even after the implementation of the FEGP, which is subject to significant political and execution risks, the Working Group's projections suggest that the Commonwealth cannot meet all of its debt service requirements as currently scheduled and must restructure its liabilities. Further, without significant changes in federal policies, particularly in health care and economic development, the ability of the Commonwealth to meet its debt service costs while providing essential services to its residents will be severely challenged
- While the Working Group recognizes that a restructuring of the Commonwealth's debt would result in hardship to individual bondholders, the Working Group believes that, unless the persistent stagnation of Puerto Rico's economy that has helped fuel the increase in Government debt over the past decade can be reversed, the public debt is not sustainable
- Therefore, in order to make the greatest amount of the debt sustainable in the long term, priority has to be given to:
  - Reigniting Puerto Rico's economic growth in the short- and medium-term;
  - Providing essential services, including health, education and safety, to the people of Puerto Rico, the continued deterioration of which will exacerbate the Commonwealth's negative demographic trends, adversely affect its economic prospects and erode its tax base; and
  - Ensuring government can sustain its pension obligations
- The Fiscal and Economic Growth Plan was designed with these priorities in mind

Conclusion (cont.)

- As difficult as debt restructuring is likely to be, the Working Group has instructed its advisors to begin working on a voluntary exchange offer to be made to its creditors as part of the implementation of the Fiscal and Economic Growth Plan

- In the design of the voluntary exchange offer, the Working Group has directed its advisors to take into account the priority accorded to various debt instruments across the Puerto Rico debt complex, including its GO debt, while recognizing that, even assuming the clawback of revenues supporting certain Commonwealth tax-supported debt, available resources may be insufficient to service all principal and interest on debt that has a constitutional priority

- Therefore, a consensual compromise of the creditors' competing claims to the Commonwealth's revenues to support debt service will be required in order to avoid a destabilizing default on the Commonwealth's debt and to avoid a legal morass that will further destabilize the Commonwealth's economy and finances

- Accordingly, the Working Group has directed its advisors to meet with the creditor groups that have already been organized (and those that may be formed hereafter) to explain the Fiscal and Economic Growth Plan and to begin negotiation of the terms of a voluntary exchange offer that can garner widespread creditor acceptance

- **It is the Working Group's belief that a voluntary adjustment of the terms of the Commonwealth's debt that allows the measures contained in the FEGP to be implemented is the best way to maximize all creditor recoveries**

Working Group for the Fiscal and Economic Recovery of Puerto Rico

Appendix

Bridge from Budget to Conway

Risk Adjustments to FY 2016 Budget

- The FY 2016 general fund budget, which is included in the CM TSA adjusted cash flow was adjusted for the potential risks below:
  - Revenue risk shortfall of $306.4 million is primarily attributable to unfavorable revenue variances for May 2015 and June 2015
  - Litigation settlement of $5.1 million (not included in the FY 2016 budget related to the Dept. of Health)
  - Debt risk of $402.0 million is primarily related to debt obligations owed to GDB, for bonds held in the GDB portfolio, and debt service payments related to the Puerto Rico Public Finance Corporation, as follows:
    - $308.3 million – contractually obligated debt payments for FY 2016 related to obligations owed to GDB. These debt service payments were not approved by the Legislative Assembly in the FY 2016 budget. Payment of this debt on terms other than the contractual terms could have a negative impact on GDB's liquidity and its ability to pay obligations as they become due
    - $93.7 million – the Legislative Assembly may appropriate for PFC debt service in FY 2016
  - A proposed Economic Development and Obligations Payment Fund totaling $275.0 million has been created to be used for economic development initiatives and/or the payment of obligations pending legislative approval

Risk Adjustment to General Fund Budget ($ millions)

	FY 2016
Revenue	($306)
Litigation settlement	(5)
Debt	(402)
Economic Development & Obligations Payment Fund	275
Budget Adjustments	**($439)**

Source: Commonwealth of Puerto Rico Liquidity Update – Conway MacKenzie, Aug. 25, 2015.

Bridge from Conway to the Krueger Report

Reconciliation of Conway and Krueger Reports

- The Krueger Report measured a deficit under an approach that is different than Conway's approach in the following areas: the Krueger Report generally used an accrual accounting method as compared to cash; the Krueger Report's methodology included GDB debt owed to third-parties versus Conway's approach that included debt obligations owed to GDB; and finally, the Krueger Report's scope included the broader Commonwealth financial position and Conway's approach only includes inflows and outflows of the TSA account as noted below:
  - FY 2016 General Fund budget
  - Federal funds
  - Net pension benefits
  - Non-General Fund revenue/expenses through the TSA
  - CM Risk Adjustments to the TSA (debt, working capital, etc.)
  - Commonwealth's Liquidity Enhancement Measures
  - Select Component Units (ASES, PRITA, UPR, PBA, ASEM)
  - CM's analysis does not include cash flow projections for the following:
    - Component Units, aside from the five noted above
    - Non-General Fund governmental funds
    - Special revenue funds
    - Special debt funds
    - Capital project funds
    - Non-major proprietary funds
    - Other non-governmental and fiduciary funds
    - Municipalities and the Municipal Property Tax Collection Center ("CRIM")
  - Conway's analysis does not include cash flow projections for the following:
    - Litigation risk
    - Budget adjustment risk – reduction in spending from FY 2015 to FY 2016
    - Spending in excess of appropriations
    - Federal funding risk
    - Unfavorable economic factors
    - Extraordinary expenses associated with any restructuring activities

Conway to Krueger Report Bridge ($ millions)

	CM Adj. TSA CF	Liq. Outlook	FY2016
Krueger Deficit (after revenue measures)	($2,518)	–	($2,518)
Tax and Non-Tax Variance	(73)	150	77
GDB Net Operating Revenue	(130)	–	(130)
Other Fund Inflows	36	–	36
Total Inflows(1)	**(167)**	**150**	**(17)**
General Fund Budget	143	(183)	(41)
Net Op. Deficit of Non-GF Gov. Funds	362	–	362
Net Op. Deficit of Non-Enterprise Comp. Units	350	(193)	157
Capital Expenditures	300	–	300
Due to Intragovernmental	–	(500)	(500)
FY2015 Deferred Appropriations (Ex. Debt)	(124)	–	(124)
Non-debt Related Outflows(1)	**1,031**	**(876)**	**155**
Budgeted Debt + Debt Outflows	230	(150)	80
Other Debt	523	–	523
Total Debt(2)	**754**	**(150)**	**603**
Working Capital	(438)	400	(38)
Revenue Measures, Net of VAT	**63**	**–**	**63**
Total Variance	**$1,992**	**($1,277)**	**$716**
CM Liquidity Outlook (3)	**($525)**	**($1,277)**	**($1,802)**

Source: Krueger Report

Note: Terms defined herein are referenced in more detail within Conway MacKenzie's Liquidity Update of the Commonwealth of Puerto Rico (Aug. 25, 2015).
(1) Variance of inflows and outflows are net of Federal Funds which have a net zero impact. Krueger reports $6.5 billion where CM's TSA cash flow includes $3.0 billion.
(2) GDB debt variances totaling $570 million are related to a different approach in debt disbursements. CM's report includes debt due to GDB, the Krueger Report includes debt owed to third-parties.
(3) The bank to book reconciliation as of June 30, 2015 was approximately $442.6 million. This risk is not included in the reconciliation above, but is noted in Conway's report.

Adjustments to the Krueger Report

As part of its development of the FEGP, the Working Group reviewed not only the reform measures identified in the Krueger Report, but also the estimates in the Krueger Report for the Commonwealth's financing gaps before the impact of the measures

- The Working Group's estimate of the total financing gaps facing the Commonwealth generally followed the approach outlined in the Krueger Report
- However, a review of the basis for many of the estimates in the Krueger Report resulted in numerous changes, including:
  - Revised revenue forecasts that incorporated actual results for 2015 that were not available to the Krueger team at the time its report was issued
  - More detailed component unit projections developed by Conway MacKenzie after the release of the Krueger Report
  - Revised capital expenditure estimates on a by-project rather than simply based on historical numbers as was done in the Krueger Report
  - Revised budgetary expense projections from OMB as well as the adjustment of an overestimation of certain expenses (and the resulting impact of Law 66 on these expenses) included in the Krueger Report
    - The revised OMB projections included revised estimates of required additional uniform pension contributions that in turn impacted the estimated shortfalls in the retirement funds that were included in the Krueger Report

Adjustments to the Krueger Report (cont.)

- In addition, the decision was made to incorporate HTA into the projections, unlike in the Krueger Report
  - Excluding federal grants, the majority of HTA's revenues come from gas and petroleum taxes collected by the Commonwealth
  - In addition, HTA has been funded with over $2 billion of loans from GDB
  - Based on these factors, it was determined that HTA should be included in the model to capture a holistic view of Commonwealth-supported entities and resulting deficits on a consolidated basis, as was the goal of the methodology outlined in the Krueger Report
- These changes, the Adjusted Estimates, were reviewed with, and reflect the input of, members of the Krueger team
- The following pages provide a summary bridge from the Krueger Report to the Adjusted Estimates (the consolidated adjusted estimates are also presented earlier in the presentation)

Bridge from Krueger to Adjusted Estimates

The following exhibit presents a summary of the variances between the Krueger Report and the Adjusted Estimates (prior to the implementation of any measures)

Bridge from Krueger Report to Adjusted Estimates ($ millions)

	2016P	2017P	2018P	2019P	2020P	Comments
Krueger Report Fin. Gap Bef. Measures	**($3,676)**	**($4,169)**	**($5,893)**	**($7,028)**	**($7,147)**	
Variances in Adjusted Estimates						
General Fund and Other Select Revenues	(83)	(152)	(194)	(236)	(279)	Revised revenue estimates that incorporate preliminary actual 2015 results that were lower than what had been estimated in the Krueger Report; 2015 revenues form the base for future year estimates. Comparison shown is against the sum of Krueger Report tax and non-tax revenues
GDB Net Operating Revenue (including PRIFA crudita receipts and PRIFA Petroleum Receipts)	(385)	(287)	(82)	(45)	(84)	Revised forecast from GDB. Note that the differential is shown after a deduction of PRIFA BAN debt service (which, in the Adjusted Estimates, is shown in the debt service line, whereas in the Krueger Report it was embedded in the GDB Operating Revenue line). Adjusted Estimates do not include any new loans to the municipalities, only funding on existing lines
COFINA SUT Collection	15	15	16	16	16	Revised forecast based on revised revenue estimates and the development of a waterfall model that projects the SUT allocations; the Krueger Report set COFINA revenues equal to COFINA debt service

Bridge from Krueger to Adjusted Estimates (cont.)

Bridge from Krueger Report to Adjusted Estimates ($ millions)

	2016P	2017P	2018P	2019P	2020P	Comments
HTA Operating Income and Debt Service (ex. Capex)	75	124	172	191	191	HTA is included in the Adjusted Estimates but was excluded from the Krueger Report; numbers here are shown inclusive of all revenues, expenditures (ex. capital expenditures shown in the capital expenditures variance line) and debt service
GF budget (ex. Debt Service and Additional Uniform Contributions)	(102)	(280)	(75)	74	169	Revised budget per OMB as well as adjustment of an overestimation contained in the Krueger Report of certain expenses (and the resulting impact of Law 66 on these expenses). Adjusted Estimates exclude additional uniform contributions for illustrative purposes, whereas the Krueger Report had included the additional uniform contributions in this line (though at a lower amount than included in the most recent OMB projections). In the Adjusted Estimates, ERS debt service was also deducted from the ERS appropriations embedded in the General Fund budget from OMB and then included in the principal and interest lines; the Krueger Report embedded ERS debt service in the retirement shortfall

Bridge from Krueger to Adjusted Estimates (cont.)

Bridge from Krueger Report to Adjusted Estimates ($ millions)

	2016P	2017P	2018P	2019P	2020P	Comments
Additional Uniform Contributions as Compared to Retirement Shortfall	(194)	88	458	(78)	70	Adjusted Estimates run through higher additional uniform contributions, which reduce the "Retirement Shortfall"; the comparison shown here represents the Additional Uniform Contribution in the Adjusted Estimates (including certain catch-up payments) as compared to the Retirement Shortfall shown for each year in the Krueger Report as well as the AUC embedded in the Krueger Report "GF Budget" line. Adjusted Estimates exclude $58 million annually of estimated AUCs required by municipalities that have historically relied on limited GDB liquidity to fund
Non-General Fund Government Funds	127	129	130	131	132	Represents revised estimates of "non-budgeted funds." Excludes any losses from agencies with independent treasuries, which were included in the Krueger Report, based on further diligence and the inclusion of such outflows in other lines (namely, capex)
Component Units ex. Capex	230	413	256	552	687	Updated for detailed component unit projections that were not available at the time of the Krueger Report
Capital Expenditures	(86)	(285)	(245)	(203)	(38)	Krueger Report based on most recent historical estimates. Adjusted Estimates based on actual schedule of projects not available at the time of the Krueger Report. Adjusted Estimates do not include municipal capital expenditures, which have historically been largely funded by the Commonwealth and GDB

Bridge from Krueger to Adjusted Estimates (cont.)

Bridge from Krueger Report to Adjusted Estimates ($ millions)

	2016P	2017P	2018P	2019P	2020P	Comments
Change in Payables	450	(377)	(51)	(51)	(51)	Krueger Report had made a blanket assumption of a constant reduction in payables; Adjusted Estimates include a more detailed analysis that reduces payables to ~35 days payable outstanding, assumes different repayment periods for different types of payables (i.e., tax refunds are paid on an accelerated schedule as compared to certain other payables), and that the repayment of payables does not begin until FY 2017
Change in Deposits and Deposit Replenishment	(551)	(500)	–	–	–	Based on updated deposit balance information that was not available at the time of the Krueger Report; Amount required for GDB to meet its estimated minimum statutory liquidity requirement of $350 million and the Commonwealth to have $1.0 billion of total deposits on hand by FY 2016 and $1.5 billion by FY 2017
Inflows from Other Entities	105	–	–	–	–	Represents identified inflows from entities outside the model used to cover expenses in the FY 2016 budget
Loss of ACA Funding	–	–	474	(597)	(730)	Updated per revised estimates based on further diligence done on ASES that was not available at the time of the Krueger Report
Act 154 / Foreign Company Tax Losses	–	894	365	(163)	(154)	Updated based on revised diligence conducted with PRIDCO. The impact of the loss of Act 154 is not assumed to begin until halfway through FY 2018
Total Variances in Adjusted Estimates	($399)	($217)	$1,224	($409)	($70)	
Adjusted Estimates before Measures	**($4,075)**	**($4,386)**	**($4,670)**	**($7,437)**	**($7,217)**	

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Total Public Sector Debt

The following summarizes total public sector debt as of June 30, 2015

Total Public Sector Debt Outstanding ($ millions)

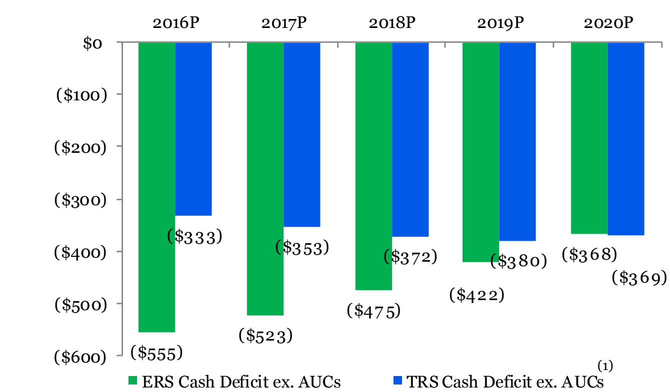
	6/30/15
Full Faith and Credit Bonds and Notes Issued by the Commonwealth	$13,061
Bonds and Notes Guaranteed by the Commonwealth	5,547
Subtotal	**18,608**
Debt Supported by Commonwealth Appropriations or Taxes	4,047
Tax and Revenue Anticipation Notes	300
Subtotal - Debt Payable from the General Fund	**22,955**
Bonds and Notes Payable from Sales and Use Tax Revenue (COFINA)	15,224
Debt Issued by Public Corporations and Other Instrumentalities	23,877
Debt Issued by Municipalities	4,126
Pension Funding Bonds (Payable from Employer Contributions to ERS)	2,948
Other Limited Obligations Debt and Non-recourse Debt	1,987
Subtotal - Other Public Sector Debt	**48,162**
Total Public Sector Debt	**$71,117**

Note: Not all entities included in the chart above are included in the Adjusted Estimates, consistent with the Krueger Report.

Retirement Systems Assumptions, Asset Balances and Cash Flows

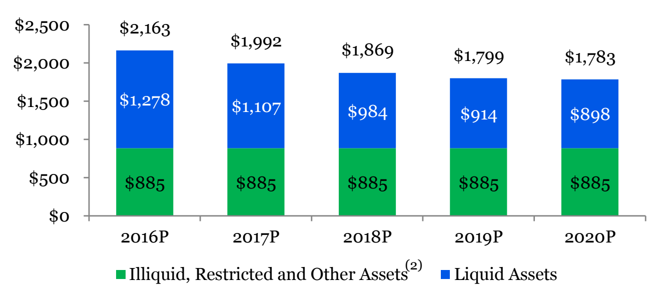
- The following charts summarize the declining asset portfolios of the retirement plans and certain assumptions embedded therein for purposes of developing the FEGP
- Key baseline assumptions include:
  - ERS: ~2% payroll growth starting in FY 2018, begin to receive AUCs of $352 mm in FY16, assuming the receipt of past-due contributions from the General Fund, municipalities and public corporations
  - TRS: ~2% payroll growth starting in FY 2018, begin to receive AUCs of $30 mm in FY17 & 18 and $510mm from FY19 forward
  - JRS: Modeled per June 30, 2014 actuarial valuation cash flows; projected ending balance in FY 2016 of ~$30 mm expected to be depleted by FY 2018, after which it is assumed that General Fund employs "pay-go" funding of ~$20 mm per year
- In a scenario that includes accelerated attrition, each retirement plan's stock of assets would decline faster, necessitating larger AUCs from the central government
- Failure of municipalities or agencies to make contributions would exacerbate asset declines; historically, agencies and municipalities have relied on, among other sources, short-term financing from GDB and others to make such payments and that funding source may not be available going forward

ERS and TRS Yearly Cash Deficits Ex. AUC ($ millions)

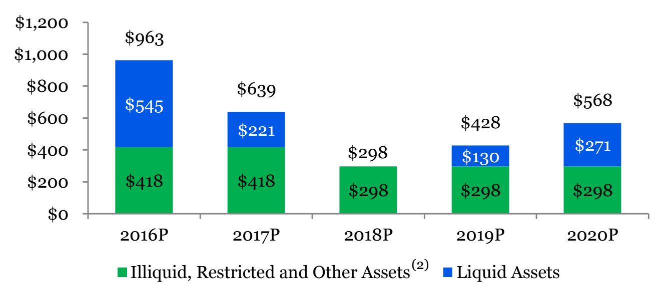


	2016P	2017P	2018P	2019P	2020P
ERS AUCs	$428	$352	$352	$352	$352
TRS AUCs	–	$30	$30	$510	$510

ERS Ending Asset Balance ($ millions)



TRS Ending Asset Balance ($ millions)(1)



Note : All data sourced by preliminary data from the actuarial firm's valuation reports and incorporating certain assumptions from ERS, TRS and GDB. All figures are preliminary in nature and subject to substantial revision pending a complete review of the retirement plans by the actuarial firm based on the latest available actual figures. Many factors affecting the pension are outside their control including actual performance of asset portfolios, plan participant attrition rates, general fund budgeting and policy decisions. These projections may not adhere to GASB accounting. None of the actuarial firm, ERS, TRS or GDB conducted a comprehensive evaluation of these projections and none of the aforementioned parties makes any representation or warranty, express or implied, as to the accuracy or completeness of the assumptions herein.

(1) Projections based valuation as of June 30, 2014, and not updated for FY 2015 performance. Important to note that actual payroll benefit payments were ~$100 mm higher in FY 2015 and projected to be ~$120 mm higher in FY 2016 than the baseline projection from the latest actuarial valuation. Potentially, this trend could continue, which could, in turn, lead to a higher AUC estimate for TRS once the June 30, 2015 valuation is performed.

(2) Illiquid, Restricted and Other Assets includes restricted cash, unrestricted cash at GDB and COFINA investments, net of accrued liabilities.

Footnotes for Financing Gaps Before Measures (p. 17)

1. General Fund and Other Select Revenues include General Fund revenues as well as transfers from the Municipal Revenues Collection Center (known as "CRIM") and hotel tax revenues received by PRCCDA, consistent with the Krueger Report. Revenue estimates were revised to reflect greater knowledge of actual collections in 2015 as well as additional diligence done on certain tax revenues, in particular, those associated with the sales and use tax ("SUT") and the foreign entity tax (Act 154).
2. GDB net operating revenue includes net cash flows from its loan portfolio to entities outside of the scope of the Adjusted Estimates as well as PRIFA petroleum tax receipts (which provide an average of $310 million per year over the projection period). The Krueger Report had netted payments on account of the PRIFA BANs, but in the Adjusted Estimates the debt service associated with the PRIFA BANs is included in the interest and principal lines. Estimates were also revised by GDB. Projections do not include any new loans to the municipalities, only funding on existing lines.
3. COFINA revenues were estimated using a SUT tax waterfall based on current policies and information developed by the Commonwealth. The revenues shown each year correspond to the Pledged Sales Tax Base Amount as defined in the COFINA bond documents. The Krueger Report had set COFINA revenues equal to COFINA debt service.
4. Unadjusted since the Krueger Report.
5. HTA revenues include gas taxes, license fees, toll receipts, investments, petroleum taxes, cigarette taxes, Tren Urbano related receipts for FY2016, and other highway and operating receipts. The HTA projections assume the Tren Urbano is transferred to PRITA in FY 2017.
6. Based on revised estimates of the budget from OMB. Excludes identified additional uniform contributions and debt service. Also adjusts appropriations to PBA and UPR to deduct debt service (which is then included in the principal and interest lines shown separately, similar to the Krueger Report).
7. Additional uniform contributions related to General Fund payments to fund the retirement systems and certain catch-up payments related to unpaid AUC amounts in FY 2014 and FY 2015. Also includes component units which have not budgeted for additional uniform contributions. Excludes $58 million annually of estimated AUCs required by municipalities which, if not funded, would further deplete assets in the retirement system.
8. Represents revised estimates of "non-budgeted funds." Excludes any losses from agencies with independent treasuries, which were included in the Krueger Report, based on further diligence and the inclusion of such outflows in other lines (namely, capex).
9. Component unit estimates exclude estimated capital expenditures (which are included in the capital expenditure line) and other delineated expenses and risks, such as the loss of ACA funding. Once these items are accounted for, the total impact of the component units on the overall financing gap is negative.
10. Capital expenditures based on GDB forecast of recommended projects not available at the time of the Krueger Report and includes maintenance capex and capex related to regulatory compliance, construction in progress, judgements, emergencies, and extraordinary maintenance and repairs. Does not include municipal capital expenditures, which have historically been largely funded by the Commonwealth via bond issuances and GDB credit facilities.
11. Unadjusted since the Krueger Report.
12. HTA expenditure includes highway and Tren Urbano disbursements, excluding capital expenditures and debt service and including the payment of past-due payables. Tren Urbano related disbursements after FY16 represent pay-down of past due payables, but not ongoing operating costs.
13. Per revised estimates based on further diligence done on ASES.
14. The currently estimated range of the impact of the loss of Act 154 is $650 million to $1,500 million. For illustrative purposes, the midpoint of this potential loss is included in the projections (with a half year impact assumed for 2018).
15. Included debt service payments related to GO, GDB, PBA, PFC, COFINA, PRIFA, UPR, PRCCDA, PRIDCO, GSA, PRIFA BANs, ERS, and HTA. PRIFA BANs are on accelerated schedule with excess cash flow sweeps as estimated by GDB. Note that the Krueger Report had netted the PRIFA BANs from the GDB net operating revenues and had embedded ERS debt service in the retirement shortfall estimate.
16. Accounts payable includes amounts owed to General Fund third parties, tax refunds, PRASA, PREPA, and police officer litigation. Excludes pay-downs by component units and HTA, which are embedded in the forecasts for those entities.
17. Amount required for GDB to meet its estimated minimum statutory liquidity requirement of $350 million and the Commonwealth to have $1.0 billion of total deposits on hand by the end of FY 2016 and $1.5 billion by the end of FY 2017.
18. Identified inflows from entities outside the model (primarily SIF) that are used to cover certain General Fund related expenses in FY 2016. These expenses are included in the "General Fund Budget" line.
19. Ratio based on total revenues shown less Federal Transfers. Note that in the build to total revenues GDB net operating revenue includes certain deposit outflows. Additionally, PRIDCO revenues are embedded in the net operating deficit of component units, not in revenues, though its debt service is included in the consolidated interest and principal line items. Also note that any UPR revenues are not included as they are assumed to be offset with other UPR expenses consistent with the Krueger Report approach (appropriations to UPR are included as outflows in the model).