Final Version

TESTIMONY BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE PUBLIC HEARING ON FINANCIAL AND ECONOMIC CHALLENGES IN PUERTO RICO

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Tuesday, September 29, 2015
Washington, DC

The paths of progress in history have proved to be more devious and unpredictable than the putative managers of history could understand.

—Reinhold Niebuhr, *The Irony of American History*, (1952)

Good morning, Chairman Hatch, Ranking Member Wyden, and Members of the United States Senate Committee on Finance. For the record, my name is Sergio Marxuach and I am the Policy Director at the Center for a New Economy, Puerto Rico's only, not-for-profit, independent, and non-partisan think tank. I thank you for the opportunity to appear today before this Committee to discuss Puerto Rico's financial and economic challenges.

Puerto Rico, usually invisible to the U.S. media, has been in the news recently, especially since the governor announced that the island's public debt of $72 billion, equivalent to 103% of its GNP, was "unpayable" and needs to be restructured.[1]

The island, a U.S. territory since 1898, has experienced severe economic problems for several years now. Its economy has been contracting or stagnant at least since 2006, and unemployment, poverty, and inequality levels are extremely high, especially in comparison with the fifty states in the mainland.[2]

Furthermore, decades of fiscal and economic mismanagement have engendered an economy characterized by: (1) chronic primary deficits; (2) high debt-to-GNP ratios; (3) low employment levels in the formal economy; (4) a large informal economy, encompassing both legal and illegal activities; (5) significant government corruption and predatory rent-seeking behavior in

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[1] In Puerto Rico, GNP, which measures income earned by residents or by locally-owned production factors, is a more accurate measure of economic activity than GDP due to distortions induced by the transfer pricing practices of multinational companies operating in the island. For a technical analysis of the GNP/GDP gap in Puerto Rico see "Economic Growth" by Barry P. Bosworth and Susan M. Collins in *The Economy of Puerto Rico: Restoring Growth*, (Brookings Institution Press: Washington, DC, 2006), p. 17-81.

[2] To put the situation in perspective, consider that Puerto Rico's per capita income is one third of United States' and close to one half of the poorest state, Mississippi; its poverty rate is 46% in comparison with 15% in the United States as a whole; and 38% of its population receives nutritional assistance, while only 13% of the population in the fifty states receives such assistance.

both the public and private sectors [3]; (6) substantial tax evasion; (7) a hollow productive base; and (8) high levels of private consumption and indebtedness enabled by having access to a stronger currency than its economic fundamentals would warrant. In our opinion, the parallels with Greece are quite evident for all to see and none to misunderstand.

Notwithstanding this dismal economic situation, the island managed to *triple* its public debt from $24 billion in 2000 to $72 billion in 2015. Indeed, during this period Puerto Rico's public indebtedness grew at a compound annual rate of 7.6%, while its income (GNP) grew at a nominal rate of only 3.6%.

Given that Puerto Rico's indebtedness grew at an average annual rate two times faster than the growth rate of its GNP during the past fifteen years, it should not be surprising that Puerto Rico's public debt currently exceeds its GNP. To be fair, however, for decades the borrowed money was put to good use to finance the construction of public schools, hospitals, highways, and other essential infrastructure. The problem is that during the last twenty years or so, a large portion of the money borrowed by issuing long-term debt was used to finance budget deficits, operating expenses, and classic pork-barrel spending.

We at CNE had warned for years that Puerto Rico's levels and rates of indebtedness were not sustainable.[4] In February 2014, the three principal rating agencies ratified our analysis by downgrading the Commonwealth's debt, as well as debt issued by several of its agencies and instrumentalities, to speculative or non-investment grade. Since then, the Commonwealth and its agencies and instrumentalities have been downgraded further by the three main rating agencies.

The rating downgrades had a material adverse effect on the Commonwealth's finances because they essentially shutdown its access to the capital markets, at least at reasonable rates. This, at a time when the

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[3] "Rent-seeking" can be defined as the pursuit of uncompensated value from other economic agents; in contrast with profit-seeking, where economic agents seek to create value through mutually beneficial economic activity

[4] See, for example, CNE's Policy Brief—Municipal Fiscal Crises in the United States: Lessons and Policy Recommendations for Puerto Rico, published in April 2006.

central government is still running a sizeable budget deficit, several of the Commonwealth's agencies and instrumentalities face significant maturities in the near term, the economy is contracting at an estimated annual rate of 1.2%, liquidity is running extremely tight, and net outmigration has increased to levels not seen since the 1960s.

Given the magnitude and multiplicity of challenges faced by Puerto Rico it should be obvious that there are no quick fixes to solve the island's fiscal and economic problems.

In our opinion, what is needed in the *short-term* is a two-prong action program, both at the federal level and in Puerto Rico. In Washington, Congress needs to implement a comprehensive program, remove some of the disadvantages imposed on Puerto Rico under the current political arrangement, and eliminate some long-standing discriminatory policies. The current situation simply does not allow for piecemeal action by Washington, a wide-ranging plan is needed.

Specifically, this Committee could introduce legislation on two issues that could have a positive and significant short-term impact on both the fiscal and economic growth parts of the problem.

On the fiscal side, the cost of the Government Health Plan is one of the principal drivers of Puerto Rico's budget deficit.[5] Providing Puerto Rico equal treatment under federal health programs, such as Medicare, Medicaid, and the Affordable Care Act would provide the Commonwealth with some much-needed fiscal space and address a long-standing injustice inflicted on Puerto Ricans. For the truth of the matter is that Puerto Rican workers and employers pay the same payroll taxes as workers and employers in the mainland, yet benefits to Puerto Rico are unfairly rationed by federal legislation.[6]

On the economic growth side of the equation, we recommend extending the federal Earned Income Tax Credit (EITC) program to Puerto Rico. The federal EITC is the most effective anti-poverty program in the

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[5] *Commonwealth of Puerto Rico Quarterly Report,* dated May 7, 2015, p. 20-21 and 37-40.

[6] See United States Government Accountability Office, *U.S. Insular Areas: Multiple Factors Affect Federal Health Care Funding,* GAO-06-75, (October 2005), and *Puerto Rico: Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources,* GAO-14-31, (March 2014).

United States. Recent research also shows that it encourages work, promotes savings, helps poor families smooth out the effect of unexpected financial shocks, and builds a strong sense of future orientation among recipients.[7] Extending this program to Puerto Rico, which would provide a significant wage supplement to Puerto Rican working families, could be expected to stimulate aggregate demand in the short-run.

Outside the scope of this Committee's jurisdiction a federal comprehensive policy package could include approving legislation to authorize the Puerto Rican government to allow its distressed agencies and municipalities to file for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code; exempting Puerto Rico from coastwise shipping laws (Jones Act), which require the use of relatively expensive U.S. vessels for trade between Puerto Rico and the U.S. and approving legislation to relax the overly binding income and asset limits that apply to recipients of certain social assistance programs.

This federal assistance would be conditioned on Puerto Rico agreeing to (1) increase tax revenues by improving enforcement efforts, closing down ineffective tax loopholes, and modernizing its property tax system; (2) crackdown on government corruption; (3) significantly improve its Byzantine and unduly opaque financial reporting; (4) reform an unnecessarily complicated permitting and licensing system that stifles innovation; (5) undertake affirmative actions to materially lower energy and other costs of doing business in the island; and (6) substantially improve educational standards.

In addition to all of the above, Puerto Rico also needs to obtain some debt relief. After years of relying on accounting gimmicks, forward refundings; back-loaded "scoop and toss" refinancings, capitalized interest

[7] See Bruce D. Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms" in *Tax Policy and the Economy*, Volume 24, Jeffrey R. Brown, ed., (University of Chicago Press, 2010); Sara Sternberg Greene, *The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair*, New York University Law Review, Vol. 88, No. 2, May 2013; V. Joseph Hotz, Charles H. Mullin, and John Karl Scholz, *Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare*, NBER Working Paper 11968, (National Bureau of Economic Research: Cambridge, MA, 2006); and Chuck Marr, Chye-Ching Huang, and Arloc Sherman, *Earned Income Tax Credit Promotes Work, Encourages Children at School, Research Finds*, (Center on Budget and Policy Priorities: Washington, DC, 2014), among others.

payments, and other short-term, expensive liquidity fixes, the Commonwealth has finally admitted that its debt is unsustainable.

While it is true that Puerto Rico's capacity to repay its debt ultimately depends on restoring economic growth in the island, there can be no economic recovery without debt sustainability and that, in turn, is not possible without significantly restructuring at least some of the debt.

According to a recent paper by Carmen Reinhart and Christoph Trebesch "'kicking the can down the road' via cash flow relief and debt rescheduling does not facilitate economic recovery in debtor countries. In protracted crises, growth only picks up after deeper debt relief, such as after the Brady plan."[8]

Analyzing 35 debt relief episodes in 30 middle and high-income countries during period between 1978 and 2010, these researchers found (1) that "sovereign debt relief averaged…16% of GDP and 36% of external debt in the middle- high-income emerging markets [crises]" during that period and (2) emerging market countries that received significant debt relief reported, on average, an 11% increase in per capita income during the five years following "decisive debt relief".

They conclude that "softer forms of crisis resolution, such as debt rescheduling, temporary payment standstills, and bridge lending operations were not generally followed by higher growth and better ratings. [And] These crisis resolution tools were ineffective in solving debt crises that had been dragging on for several years."[9] Therefore, obtaining significant debt relief for Puerto Rico appears to be a necessary condition to restore economic growth in the island.

On the other hand, it should be obvious that obtaining debt relief is not sufficient, in and by itself, to jumpstart economic growth. The important point in the case of Puerto Rico, is that any savings derived from a reduction in debt service be used exclusively to advance and implement a renewed industrial policy, broadly defined, based on horizontal policies such as the

[8] Carmen M. Reinhart and Christoph Trebesch, *Sovereign Debt Relief and Its Aftermath*, Faculty Research Working Paper Series, John F. Kennedy School of Government, RWP 15-028 (June 2015), p. 33.
[9] Id. at p. 34.

ones described above, discovering new sectorial opportunities through a process of dialogue and consultations with key stakeholders in the private and civic spheres, and "identifying spillovers, externalities, and other areas where society could learn more."[10]

This new learning, in turn, would lead to: new investment in R & D, increased productivity, identifying new areas of comparative advantage for Puerto Rican firms, higher economic growth and the creation of high-quality jobs, which at the end of the day is what will categorically end Puerto Rico's economic stagnation. We at the Center for a New Economy are currently working with experts from Columbia, Brown, MIT, and Brookings, among other institutions, to develop this medium to long-term industrial policy for Puerto Rico.

Finally, I would be negligent if I did not raise the question of whether Puerto Rico has reached the limits of what it can do to improve the quality of life of its people within the constraints imposed by its subordinate political status. Neither a sovereign country nor a state of the union, Puerto Rico has no authority to negotiate international treaties, no access to emergency financing from multilateral institutions, no monetary policy instruments, limited fiscal policy tools, nominal representation in Congress, and the U.S. Supreme Court has determined it is constitutionally permissible for Congress to discriminate against Puerto Rico in the application of federal programs as long as there exists a "rational basis" for doing so.

Thus, Puerto Rico lives in a state of permanent limbo, a status that is both humiliating to Puerto Ricans and unworthy of the United States. Simply stating that it is up to Puerto Ricans to decide their political status, while true, is insufficient because the United States' Congress has long-standing legal and moral obligations with respect to Puerto Rico that it has failed to honor. Congressional failure to act not only highlights a shameful lack of political will, it also weakens the United States' moral standing and its ability to effectively utilize its "soft power" in the international arena,

[10] Joseph E. Stiglitz and Bruce C. Greenwald, *Creating a Learning Society: A New Approach to Growth, Development, and Social Progress*, (Columbia University Press: New York, 2014), p. 489.

when it argues for better treatment for Hong Kong by China, for the Palestinians by Israel, or for Greece by members of the Eurozone.[11]

In this context I would like to quote from the remarks made just a few days ago by an extraordinary man who came to this magnificent building to address a rare joint session of Congress. Drawing from a deep well of wisdom that has accumulated for over twenty centuries, he stated:

"Your own responsibility as members of Congress is to enable this country, by your legislative activity, to grow as a nation. You are the face of its people, their representatives. You are called to defend and preserve the dignity of your fellow citizens in the tireless and demanding pursuit of the common good, for this is the chief aim of all politics. A political society endures when it seeks, as a vocation, to satisfy common needs by stimulating the growth of all its members, especially those in situations of greater vulnerability or risk. Legislative activity is always based on care for the people. To this you have been invited, called and convened by those who elected you."[12]

In conclusion, Mr. Chairman, I thank you and the Committee once again for the opportunity to participate in this important public policy debate and look forward to answering any questions that you or Committee Members may deem appropriate.

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[11] See Joseph S. Nye, Jr., *Soft Power: The Means to Success in World Politics*, (Public Affairs: New York, 2005)
[12] Pope Francis, *Remarks Before the Congress of the United States of America*, 24 September 2015.

Puerto Rico Fiscal Balance 1998-2013

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29 September 2015

Puerto Rico Fiscal Balance 1998-2013

Trends in Puerto Rico's Fiscal Balance (1)	Fiscal Years																
($U.S. Thousands)	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	CAGR
Revenues (2)	9,830,784	10,342,439	10,854,821	11,208,442	11,658,874	12,183,423	12,099,666	13,681,709	14,155,224	14,988,612	13,572,589	14,676,309	15,266,436	15,463,887	15,812,086	15,985,930	
Interest Revenue	116,030	97,880	91,525	67,020	90,940	85,565	58,914	116,686	117,080	176,674	160,926	114,699	56,145	28,529	28,659	(6,230)	
Non-Interest Revenues	**9,714,754**	**10,244,559**	**10,763,296**	**11,141,422**	**11,567,934**	**12,097,858**	**12,040,752**	**13,565,023**	**14,038,144**	**14,811,938**	**13,411,663**	**14,561,610**	**15,210,291**	**15,435,358**	**15,783,427**	**15,992,160**	3.4%
Total Expenditures (3)	9,382,657	8,731,896	9,663,259	9,900,315	13,217,832	14,596,201	14,648,379	16,033,758	15,510,239	16,253,409	16,134,376	17,713,069	17,604,942	17,403,585	19,163,860	18,870,467	
Non-Interest Expenditures	**8,787,604**	**8,289,282**	**9,218,664**	**9,355,314**	**12,603,485**	**13,437,452**	**13,910,877**	**15,299,827**	**14,688,005**	**15,438,686**	**15,097,240**	**16,618,927**	**16,235,497**	**15,801,598**	**17,480,058**	**17,009,212**	4.5%
Interest Expenditures	595,053	442,614	444,595	545,001	614,347	1,158,749	737,502	733,931	822,234	814,723	1,037,136	1,094,142	1,369,445	1,601,987	1,683,802	1,861,255	
Net Interfund Transfers (4)	(1,040,397)	(1,848,663)	(1,620,151)	(2,107,827)	187,183	279,060	203,258	492,776	242,642	342,743	309,815	251,170	265,852	230,551	219,794	246,908	
Primary Fiscal Balance (5)	(113,247)	106,614	(75,519)	(321,719)	(848,368)	(1,060,534)	(1,666,867)	(1,242,028)	(407,219)	(284,005)	(1,375,762)	(1,806,147)	(759,354)	(135,689)	(1,476,837)	(770,144)	
Overall Fiscal Balance (6)	(708,300)	(336,000)	(520,114)	(866,720)	(1,462,715)	(2,219,283)	(2,404,369)	(1,975,959)	(1,229,453)	(1,098,728)	(2,412,898)	(2,900,289)	(2,128,799)	(1,737,676)	(3,160,639)	(2,631,399)	
Nominal GNP (7)	35,110,700	38,281,200	41,418,600	45,102,400	45,999,700	48,492,200	51,826,500	54,861,900	57,854,300	60,642,700	62,703,100	63,617,900	64,294,600	65,720,700	68,085,700	68,768,200	4.6%
Primary Fiscal Balance/GNP (%)	**-0.3%**	**0.3%**	**-0.2%**	**-0.7%**	**-1.8%**	**-2.2%**	**-3.2%**	**-2.3%**	**-0.7%**	**-0.5%**	**-2.2%**	**-2.8%**	**-1.2%**	**-0.2%**	**-2.2%**	**-1.1%**	
Overall Fiscal Balance/GNP (%)	-2.0%	-0.9%	-1.3%	-1.9%	-3.2%	-4.6%	-4.6%	-3.6%	-2.1%	-1.8%	-3.8%	-4.6%	-3.3%	-2.6%	-4.6%	-3.8%	

Source: CAFR 2005, 2012 and 2013; GNP is from the PRPB

(1) Includes the central government and certain blended component units, notably COFINA and PBA, but excludes other public corporations.

(2) Includes taxes, charges for services, intergovernmental revenues, interest and investment earnings, and other. Excludes proceeds from debt issues.

(3) Includes current expenditures and capital outlays but excludes amortization payments.

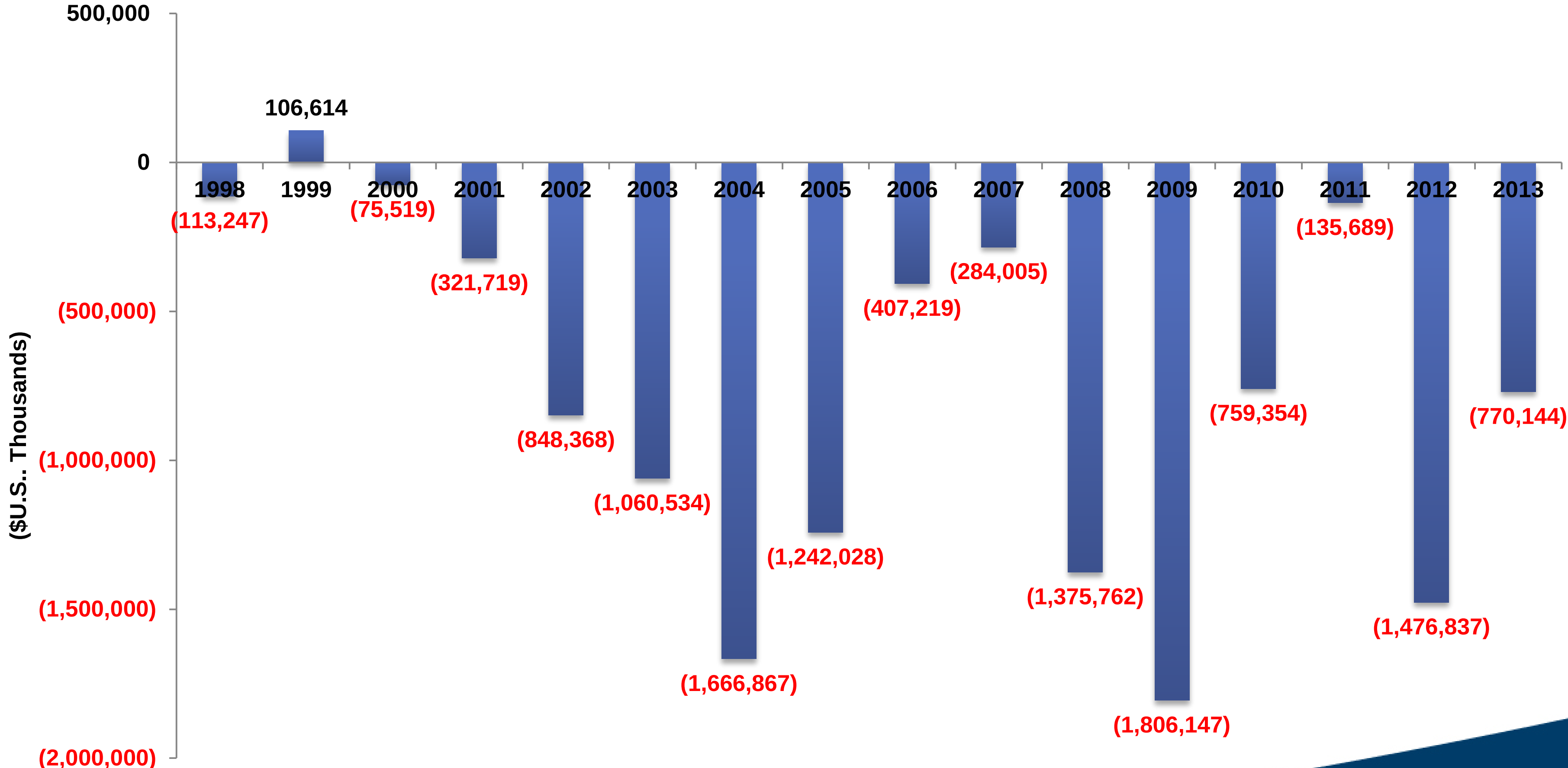
(4) Equals "Transfers in" minus "Transfers out".

(5) Equals non-interest revenues minus non-interest expenditures plus net interfund transfers.

(6) Equals primary fiscal balance minus interest expenditures.

(7) As updated by the PRPB 2015.

Primary Fiscal Balance 1998-2013



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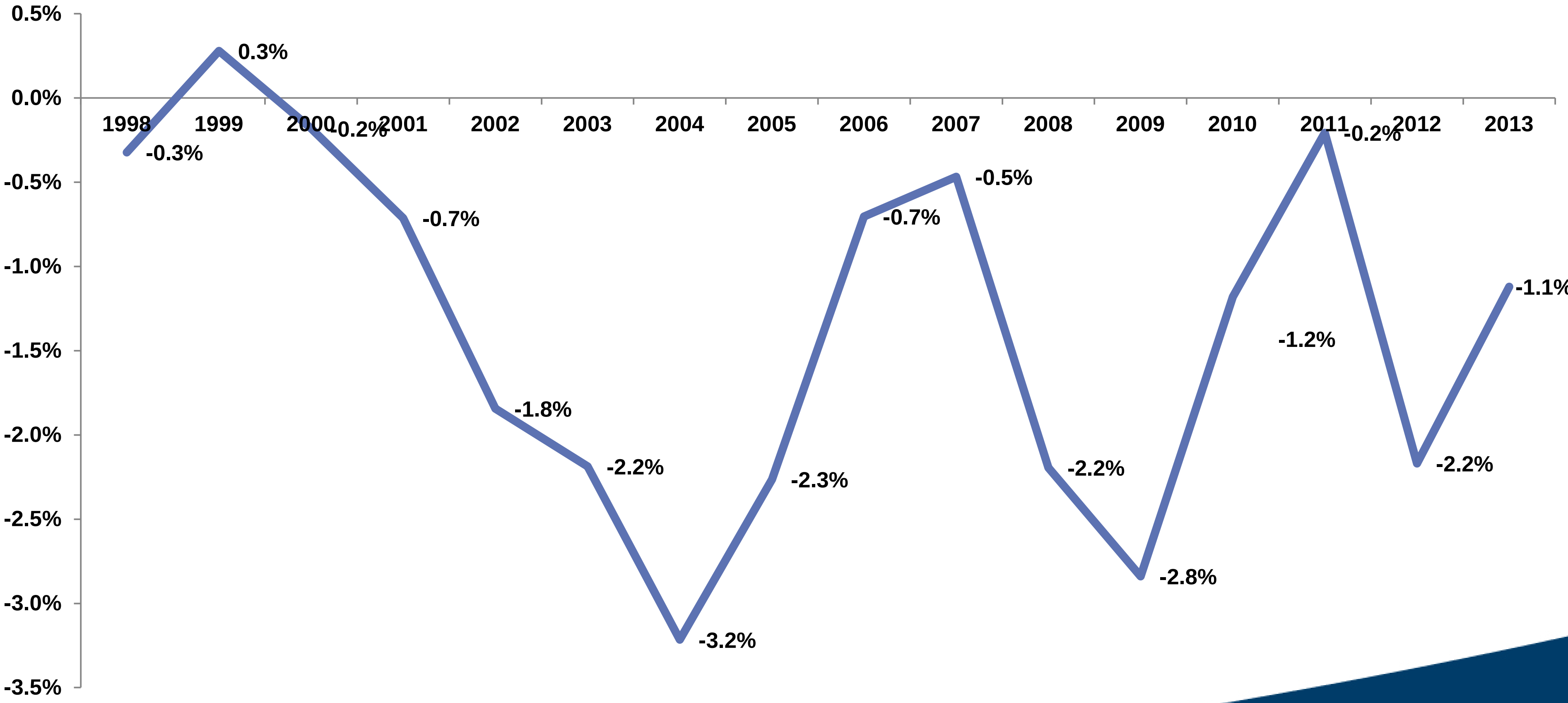
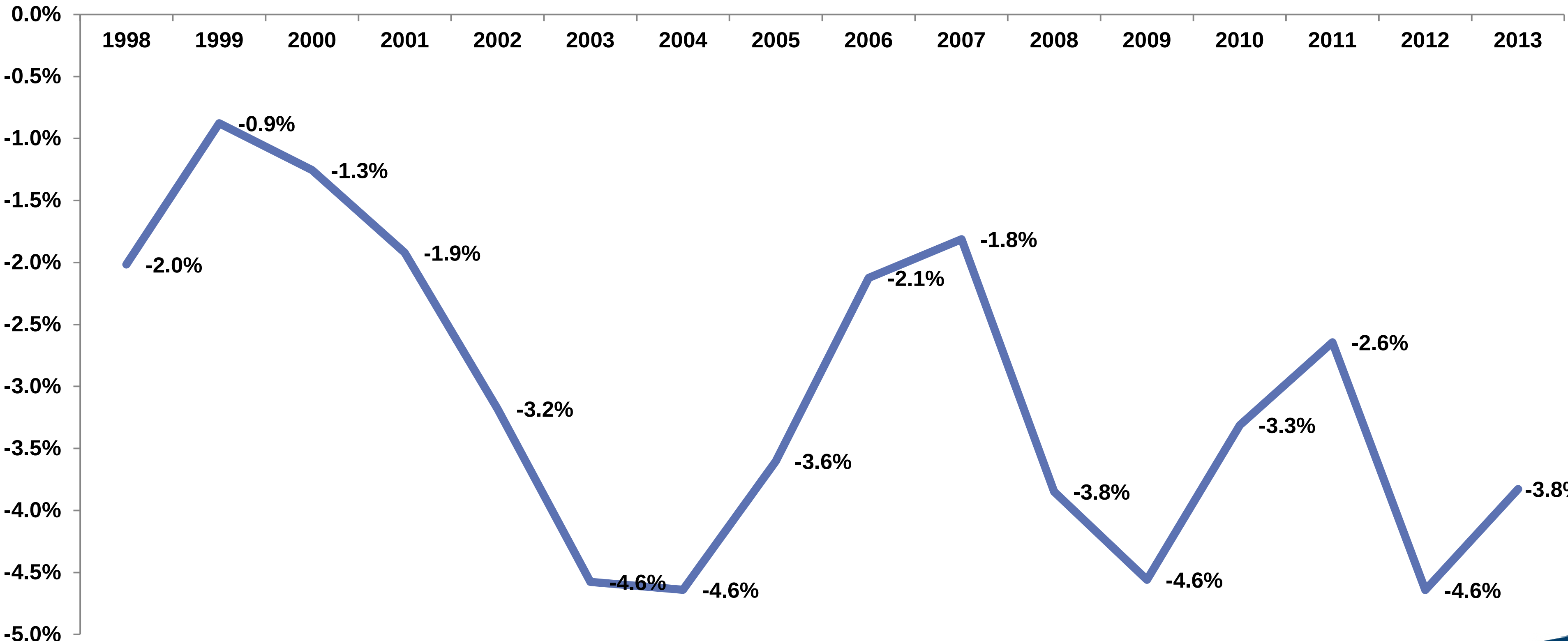
Primary Fiscal Balance/GNP (%)



Overall Fiscal Balance/GNP (%)



FISCAL SITUATION **UPDATE**

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Analysis of the Governor's Budget Request
for Fiscal Year 2016

Analysis of the Governor's Budget Request for Fiscal Year 2016

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San Juan, PR
June 2015

Ad Majorem Dei Gloriam

"The truth is sometimes a poor competitor in the market place of ideas – complicated, unsatisfying, full of dilemmas, always vulnerable to misinterpretation and abuse."

— George F. Kennan

Introduction

This Fiscal Update Report prepared by the Center for the New Economy ("CNE") presents our independent analysis of the proposals contained in the Governor's budget request for fiscal year 2016. The analysis set forth below is based on CNE's own independent evaluation and interpretation of the budget data, rather than the Administration's, and may incorporate estimates made by CNE's staff or by other private sector analysts. Our analysis also includes a review of the fiscal trends for the fiscal year 2015, which ends on June 30, as well as an update of ten budget indicators that we have followed over the past nine eight years. The analysis presented in this Report is based on data available as of June 8, 2015.

Fiscal Year 2015

Revenues – General fund net revenues for the first ten months of fiscal year 2015 (comprising the period from July 1, 2014 through April 30, 2015) amounted to $7.335 billion, approximately $62 million, or 0.8%, more than the $7.273 billion recorded for the same period during the previous fiscal year. Nonetheless, it must be noted that actual revenues as of April 30, 2015 include $371.4 million of one-time, non-recurring revenues, the product of special legislation that, among other things, granted preferential tax treatment to certain financial transactions, such as early withdrawals from IRA accounts and dividend distributions, and a tax amnesty, which allowed certain delinquent taxpayers to pay their overdue tax obligations without any fees, interest, or penalties.

Furthermore, notwithstanding such one-time revenue measures, general fund net revenues as of April 30, 2015 were still $250.6 million, or 3.3%, *below* the official forecast of $7.586 billion. According to the official budget documents, the Puerto Rico Treasury Department expects this downward trend to continue during the last two months of this fiscal year. Therefore, the Puerto Rico Treasury has revised its estimate of general fund net revenues for fiscal year 2015 from $9.565 billion to $9.065 billion, a reduction of $500 million or 5.2%.

According the Commonwealth's Quarterly Report, dated May 7, 2015, the main causes of this revenue shortfall are:

- A reduction on corporate income taxes of approximately $230 million, of which $200 million are related to the mid-fiscal year repeal of the gross receipts tax ("Patente Nacional") for taxable year 2015, which was originally supposed to become effective at the same time as the enactment of the proposed Tax Reform Bill in order to offset the loss of revenues from the repeal of the "Patente Nacional" with the new revenues arising from the proposed Tax Reform Bill.

- A reduction in sales and use taxes in the point of entry of approximately $120 million, mainly attributable to lower than expected economic activity and delays in the implementation of the sales and use tax at the point of entry.

- A reduction of approximately $90 million in motor vehicle excise taxes as a result of the decrease in the sale of motor vehicles in Puerto Rico due to lower than expected economic activity, and the rate of such taxes pursuant to Act 186-2014. As of October 31, 2014, prior to the enactment of Act 186-2014, revenues for motor vehicle excise taxes had decreased by approximately $30 million.

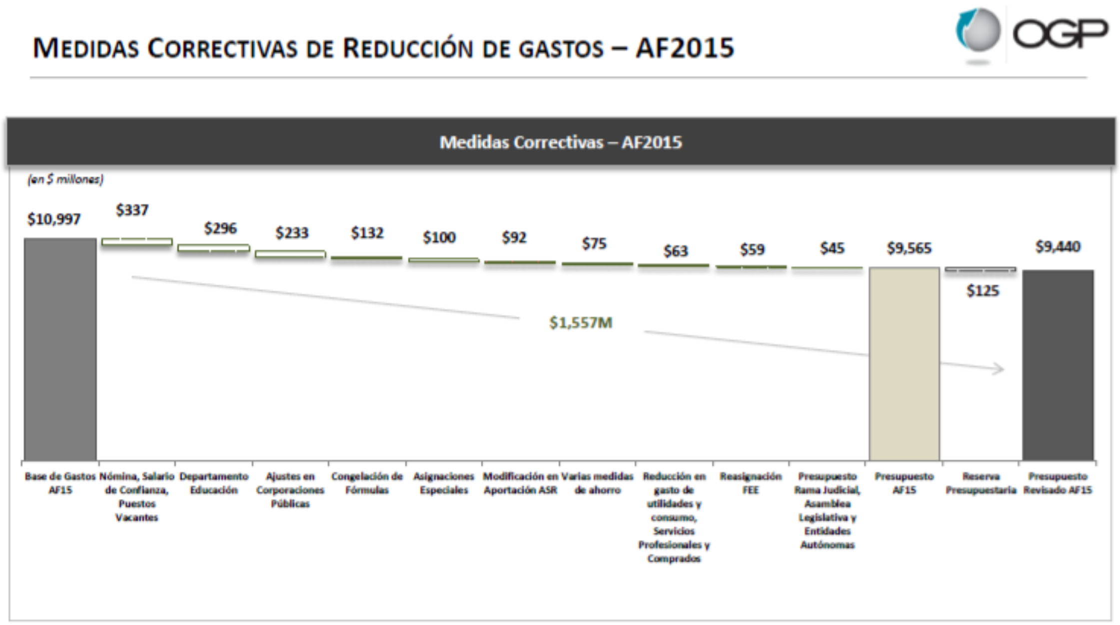
- A reduction of approximately $60 million on individual income taxes, mainly as a result of lower than expected economic activity.

- A reduction of approximately $46 million in rum-cover over tax revenues resulting in part from the non-extension by the U.S. Congress for calendar year 2015 of the increase from $10.50 to $13.25 per proof gallon, in the federal excise tax rate on rum produced in Puerto Rico and exported into the U.S., which the federal government transfers (or "covers over") annually to the Commonwealth. The original estimates assumed that the cover over excise tax rate of $13.25 per proof gallon would have been extended for calendar year 2015.

- An aggregate reduction of approximately $105 million in other miscellaneous taxes, primarily due to the reduction in economic activity and other factors. [1]

Expenditures – As shown on the chart below, expenditures for FY2015 were initially estimated at $10.997 billion (excluding $344 million in capitalized interest payable on certain general obligation bonds). However, after the enactment of the Fiscal Sustainability Act ("Act 66"), which suspended the effectiveness of several automatic cost escalators for a period of three fiscal years, and the implementation of other non-recurring measures, such as delaying employer contributions to the Commonwealth's pensions systems, total spending was brought down to $9.565 billion.

[1] Commonwealth of Puerto Rico, *Quarterly Report*, dated May 7, 2015, p. 27



Source: Puerto Rico Office of Management and Budget

However, given the expected shortfall in general fund revenues, the Puerto Rico Office of Management and Budget ("OMB") identified and took an additional "budget reserve" in the amount of $125 million, to bring down spending to an estimated $9.440 billion for the current fiscal year.

Deficit Estimate – Therefore, in the absence of other actions, the budget deficit for the current fiscal year would be $375 million, consisting of the difference between revenues of $9.065 billion and expenditures of $9.440 billion.

However, according to the budget documents, the Puerto Rico Treasury expects to receive an additional $185 million in non-recurring revenues before the end of the fiscal year. This additional revenue consists mostly of (1) a one-time $100 million "dividend" payable by the State Insurance Fund to the General Fund; and (2) an additional $75 million from the settlement of several "closing agreements" between certain taxpayers and the Puerto Rico Treasury.

If we assume those $185 million in additional revenue *are indeed realized*, then the total budget deficit for fiscal year 2015 would be approximately $190 million, consisting of the difference between revenues of $9.250 billion and expenditures of $9.440 billion.

It is important to note, however, that the Commonwealth's structural deficit (the difference between recurring revenues and recurring expenditures) is significantly larger. The reason for the difference between the budget and the structural deficits is that to calculate it we have to subtract $556 million in non-recurring revenues

($371 million plus $185 million) from the revenue side and add (1) $1.557 billion in recurring spending that has been mostly delayed or postponed and (2) $344 million of capitalized interest to the expenditure side. The net result is a structural deficit of $2.647 billion, the difference between recurring revenues of $8.964 ($9.250 billion less $556 million) and recurring spending of $11.341 billion (recurring expenditures of $10.997 billion plus $344 million in capitalized interest).

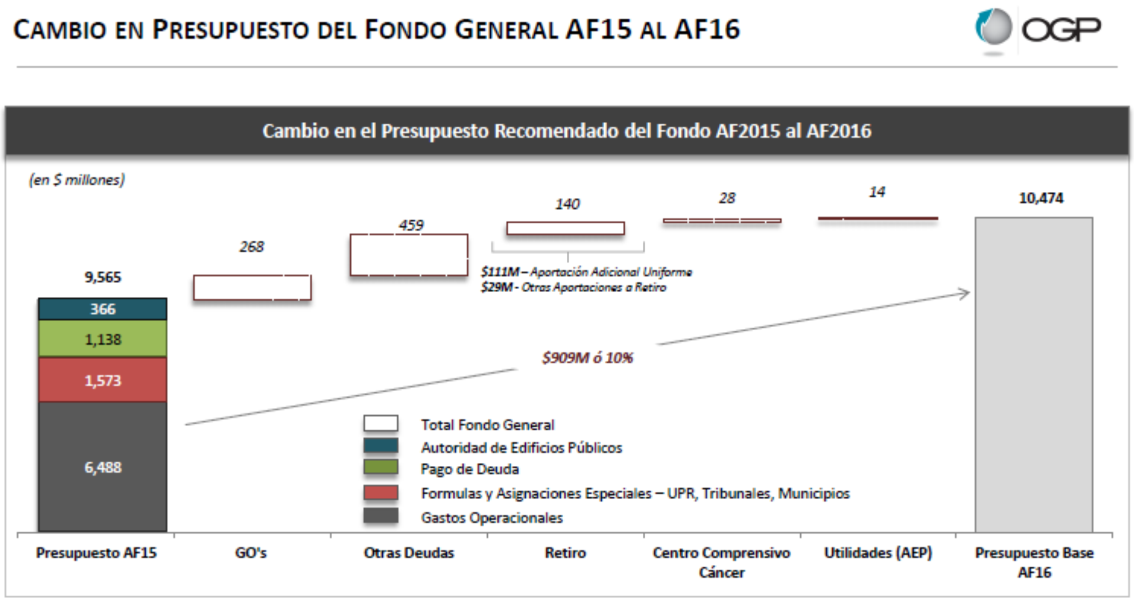
To be fair to the administration, it is our understanding that some of the expenditure adjustments made during FY2015 are permanent and thus should not be included in the expenditure side of the structural budget calculation. However, given the lack of specific information regarding these adjustments in the budget documents, it is analytically difficult to determine which adjustments are permanent and which are not. Therefore, we are taking the conservative position that all such cuts represent one-time savings. In this sense, we stress that our estimate of the structural deficit should be interpreted as a kind of *worst-case scenario*.

Fiscal Year 2016

Revenues – The Governor announced a general fund budget of $9.800 billion for fiscal year 2016. This amount would be $235 million, or 2.4%, higher than this year's general fund budget of $9.565 billion. However, when compared against actual expected general fund revenues of $9.250 billion for fiscal year 2015, the proposed budget represents an increase of $550 million, or 5.9%.

According to the official budget documents, the government bases its estimate on the following premises: (1) a recurring revenue base of $8.600 billion; (2) additional revenues of $1.121 billion product of the increase in the sales and use tax rate from 7% to 11.5% and the eventual transition in April 2016 to a value added tax ("VAT") of 11.5% with a significantly broader base; and (3) $115 million from a new tax on intercompany transactions.

Expenditures – As shown on the chart below, OMB estimates recurring expenditures for fiscal year 2016 to be $10.474 billion. However, due to the continuing application of the provisions of Act 66 and the delay of certain expenditures, including $327 million in payments to the Government Development Bank, total general fund spending is estimated to be $674 million less than initially estimated, thus bringing it in line with expected revenues of $9.800 billion.



Source: Puerto Rico Office of Management and Budget

Deficit Estimate – At first glance, then, the governor's proposed general fund budget for the next fiscal year appears to be balanced at $9.800 billion. However, there are several risks that, if realized, could have a material adverse effect on the proposed budget and the deficit estimate.

First, there is the implementation risk associated with the change from the current sales and use tax to a VAT. According to the Secretary of the Treasury this transition is to occur in three stages:

1. Commencing on July 1, 2015, all goods and services subject to the current sales and use tax ("SUT") will be taxed at a rate of 11.5%. The revenues generated by 10 percentage points of this tax will accrue to the central government; while revenue equal to 1 percentage point of the SUT will accrue to the municipalities; and revenue amounting to 0.5% points will be deposited in the Municipal Administration Fund.

2. Commencing on October 1, 2015, business-to-business services and certain designated professional services that are not currently subject to the SUT would be taxed at a rate of 4% under the current sales tax structure.

3. Finally, commencing on April 1, 2016, all goods and services then subject to the sales and use tax (including business-to-business and professional services taxed at 4%) would be taxed at a rate of 11.5% under a VAT system.

The risk is that the Puerto Rico Treasury Department may not have all the required personnel and operational and information systems ready in time to fully implement the VAT system, especially with regard to services, on April 1, 2016. The unfortunate fact is that for decades the Puerto Rico Treasury Department has been woefully underfunded, inadequately staffed and largely ineffective at enforcing the Puerto Rico Tax code. Thus, while the Secretary is confident that with the assistance of outside contractors (especially from the information technology sector) the Treasury Department will be able to successfully and timely manage the roll-out of the new VAT system, there is, in our opinion, a significant risk that general fund revenues may fall short by a substantial amount if there are significant delays in the implementation of the VAT.

Second, according to a recent report from Standard & Poor's:

> Introduction of VAT legislation has negative implications for COFINA's sales tax-secured bonds in our view due to the uncertainty over the amount of pledged revenues that would replace the sales tax, and whether the new structure maintains the separation of pledged revenue from what is pledged to the GO bondholders. COFINA bond covenants allow replacement of sales taxes pledged to bonds by a "substitute like or comparable security," but only if it does not impair an obligation of COFINA. In addition, bond covenants prohibit substitution unless the bond trustee shall have been provided with written confirmation of all bond ratings outstanding from rating agencies maintaining a rating on the bonds, taking such substitution into account. If approved, we will evaluate the new VAT implementation plan and its impact on credit quality.[2]

In our opinion, this veiled warning from S&P means that there is a significant risk that the transition to a VAT system may fail if S&P or any of the other rating agencies do not provide the written confirmation required by the COFINA Trust Agreement. Should that event come to pass, the government of Puerto Rico would then have to decide whether to (1) take the tax reform law back to the drawing table; (2) incur in an event of default under the COFINA Trust Agreement; or (3) negotiate with COFINA bondholders to obtain their agreement to the collateral substitution. In any event, even with the rating agency confirmations, in our opinion the risk of litigation is high due to doubts about "whether the new structure maintains the separation of pledged revenue from what is pledged to the GO bondholders."

Third, some of the proposed budget cuts, such as the closing of public schools, the merger of agencies that perform similar functions, and funding reductions for the judiciary branch, will engender significant political opposition and thus the legislature may have second thoughts about enacting them.

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[2] Standard & Poor's Ratings Services, *Puerto Rico General Obligation Debt Rating Lowered to 'B' From 'BB' On Potential Inability to Meet Debt Commitments*, February 2, 2015, p. 2

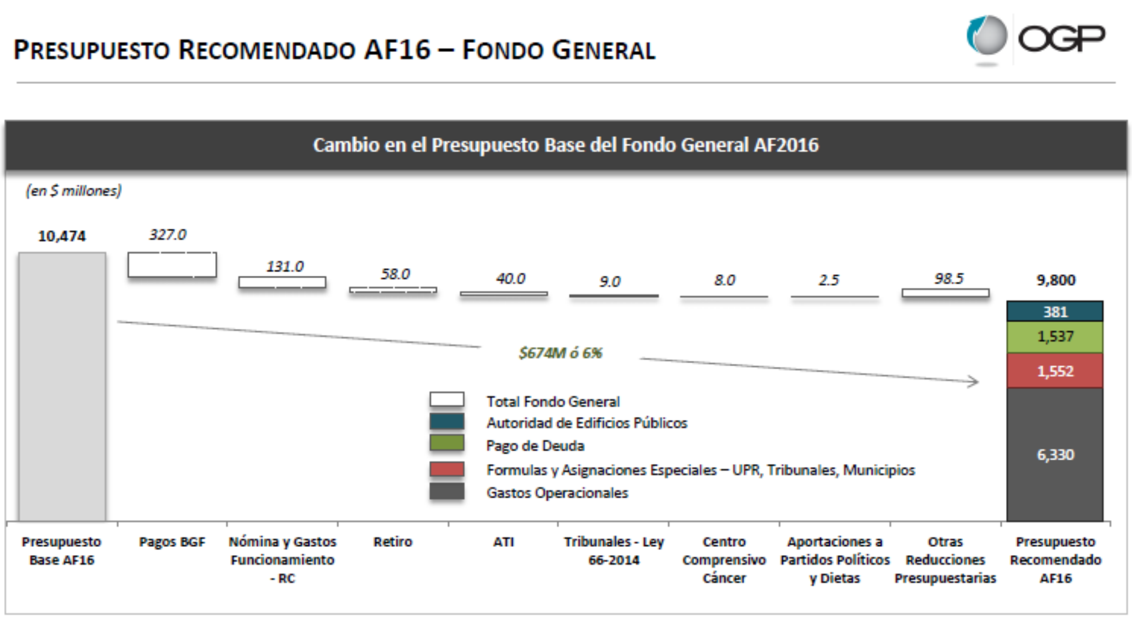
Finally, while the proposed general fund budget does not include, at least at first glance, any non-recurring revenues, many of the proposed adjustments on the expenditure side consist essentially of delaying or postponing the payment of certain obligations that would eventually need to be paid. That is why we believe that even if the transition to the VAT system goes off without a hitch, the structural deficit for fiscal year 20l6 would still amount to approximately $674 million, which is the difference between recurring revenues of $9.800 billion and expenditures of $10.474 billion.

Again, we emphasize that it is our understanding that some of the expenditure adjustments are permanent and thus should not be included in the recurring expenditure side of the structural budget calculation. However, given the lack of specific information regarding these budget adjustments it is difficult to determine which adjustments are permanent and which are not. Therefore, we are taking the conservative position that all such cuts represent one-time savings. In this sense, we stress that our estimate of the structural deficit should be interpreted as a kind of worst-case scenario.

Use of Non-Recurring Revenues

For many years the Commonwealth relied on non-recurring revenues to plug any gap between revenues and spending. Indeed, the consolidated budget for the current fiscal year includes $971 million in non-recurring revenues, consisting of: (1) $556 million from one-time revenue measures to prop up the general fund; (2) $344 million in interest payments due on general obligation bonds that were capitalized; and (3) $71.1 million of federal ARRA funds that surprisingly have not yet been spent.

The proposed budget for fiscal year 2016 does not include any non-recurring revenues, except for a statistically insignificant $2 million remainder of federal ARRA funds. We are concerned, however, that, as shown on the chart below, a significant amount of the adjustments on the expenditure side are equivalent to the "scoop and toss" refinancing technique used by the Commonwealth for many years. In other words, we are worried that some of these alleged spending cuts are nothing more than a delay of spending to later fiscal years, thus, alleviating a problem today but creating another potentially larger one for the future.



Source: Puerto Rico Office of Management and Budget

For example, of the $674 million in total expenditure adjustments for FY2016, some $394 million ($327 million owed to GDB, $58 million in delayed employer contributions to the Employees Retirement System, and $9 million in funding for the judiciary branch), or 58% of the total amount, presumably are just being delayed and will have to be made at some point in the future.

Public Debt

Table 1 Puerto Rico Public Debt and GNP					
(US$BN)					
FY	Debt	%Δ	GNP	%Δ	PD/GNP
2000	24.19	--	41.42	--	58.40%
2001	27.16	12.28%	45.10	8.89%	60.22%
2002	30.03	10.58%	46.00	1.99%	65.29%
2003	32.53	8.30%	48.49	5.42%	67.07%
2004	37.43	15.09%	51.83	6.88%	72.23%
2005	40.27	7.57%	54.86	5.86%	73.40%
2006	43.14	7.12%	57.85	5.45%	74.56%
2007	46.18	7.06%	60.64	4.82%	76.16%
2008	53.39	15.61%	62.70	3.40%	85.15%
2009	58.41	9.40%	63.62	1.46%	91.82%
2010	62.21	6.49%	64.29	1.06%	96.75%
2011	64.28	3.33%	65.72	2.22%	97.81%
2012	69.95	8.82%	68.09	3.60%	102.73%
2013	70.04	0.14%	68.77	1.00%	101.85%
2014	72.27	3.17%	69.20	0.63%	104.43%
2015*	72.20	-0.09%	70.08	1.26%	103.04%
CAGR	**7.56%**		**3.57%**		

* As of March 31, 2015

Source: GDB, PRPB, and CNE Analysis

Debt Overhang? – Since fiscal year 2000, Puerto Rico's total public debt has exploded both in absolute terms and relative to the size of the Puerto Rican economy. At the end of fiscal year 2000 total Puerto Rico public debt amounted to approximately $24.2 billion, while as of March 2015 it amounted to $72.2 billion, an aggregate increase of $48 billion, or 198.3%. During this period public indebtedness increased at a compound annual growth rate of 7.6%.

Meanwhile, Puerto Rico's Gross National Product (GNP), at current prices, increased from $41.42 billion in 2000 to an expected $70.08 billion at the end of fiscal year 2015, an aggregate increase of $28.66 billion, or 69.2%.[3] During this period Puerto Rico's nominal GNP increased at a compound annual growth rate of 3.6%.

[3] In Puerto Rico, GNP, which measures income earned by residents or by locally owned production factors, is a more accurate measure of economic activity than GDP due to distortions induced by the

Given that Puerto Rico's indebtedness has grown at an average annual rate that is two times faster than the growth rate of its GNP during the past fifteen years, it should not be surprising that Puerto Rico's total public debt currently equals its GNP.

We at CNE have been warning for years that, in our view, Puerto Rico's levels and rates of indebtedness were not sustainable. In February 2014, the three principal rating agencies agreed with our analysis by downgrading the Commonwealth's debt, as well as debt issued by several of its agencies and instrumentalities, to speculative or non-investment grade. Since then, the Commonwealth and its agencies and instrumentalities have been downgraded further by the three main rating agencies.

The following table sets forth the ratings of the Commonwealth and certain of its public corporations after giving effect to these downgrades:

Table 2

Public Corporation	S&P	Moody's	Fitch
Commonwealth of Puerto Rico (General Obligations)	CCC+	Caa1	B
Government Development Bank	CCC	Caa1	
COFINA			
Senior Lien	CCC+	B3	B
First Subordinate Lien	CCC+	Caa1	B
PR Electric Power Authority	CCC-	Caa3	CC
PR Highways and Transportation Authority			
Highways Revenue Bonds	CCC+	Caa2	
Senior Transportation Revenue Bonds	CCC+	Caa2	
Subordinate Transportation Revenue Bonds	CCC+	Caa2	
PR Aqueduct and Sewer Authority			
Revenue Bonds	CCC+	Caa1	B
Guaranteed Bonds	CCC+	Caa1	B
PR Public Buildings Authority	CCC+	Caa1	B
PR Employees Retirement System	CCC+	Caa2	B
PR Public Finance Corporation (Commonwealth Appropriation Bonds)	CCC+	Caa2	
PR Municipal Finance Agency	CCC+	Caa1	
PR Convention Center District Authority	CCC+	Caa2	
PR Industrial Development Company	CCC+	B3	
PR Infrastructure Financing Authority			
Special Tax Revenue Bonds	CCC+	Caa2	
PR Ports Authority Project	B-	Caa1	
University of Puerto Rico			
Revenue Bonds	CCC+	Caa2	
AFICA – Plaza Universitaria Project	CCC+	Caa3	

Source: Commonwealth of Puerto Rico Quarterly Report dated May 7, 2017

To understand the reasons underlying these downgrades we need to analyze Puerto Rico's debt dynamics. According to Drelichman and Voth, who use the IMF

transfer pricing practices of multinational companies operating in the island. For a technical analysis of the GNP/GDP gap in Puerto Rico see "Economic Growth" by Barry P. Bosworth and Susan M. Collins in *The Economy of Puerto Rico: Restoring Growth*, (Brookings Institution Press: Washington, DC, 2006), p. 17-81.

framework to analyze debt sustainability, “the basic idea is that debts will be serviceable as long as the growth rate of debt does not exceed the growth rate of output. This requires a primary surplus—keeping expenditure (net of the cost of debt service) below revenue. Thus, revenue growth combined with cheap borrowing can lead to a favorable outcome even if debts continue to increase.”[4]

In mathematical terms, they express the relationship as follows:

$$\Delta d_t = pd_t + \frac{(r_t - g_t)}{(1+g_t)} d_{t-1}$$

where Δd is the change in the debt as a percentage of GDP, r is the (nominal) rate of interest, g is the growth rate of GDP, and pd is the primary deficit as a percentage of GDP. In essence, “the increase in the debt to income ratio equals the current period primary deficit plus the interest on previous period debt, adjusted by the growth rate of the economy.”[5]

The problem is that the growth rate of Puerto Rico’s debt between 2000 and 2015 has been twice the growth rate of its output. In addition, Puerto Rico has also been running substantial primary budget deficits during this period.

Therefore, both factors point to a significant increase in the debt stock, both in absolute terms and as a percentage of GNP, which is what has actually happened since 2000. Indeed, Puerto Rico’s public debt to GNP ratio has increased from a relatively manageable 58.4% in 2000 to a close to unsustainable 103.4% in 2014. Furthermore, relative to GNP, consolidated budget debt service has increased significantly, from 5.2% of GNP in 2012 to 6.8% in 2015.

Reversing this trend will require:

(1) Not merely “balancing” the budget, but actually running a primary budget surplus—that is, keeping expenditures (net of the cost of debt service) below revenues—on a regular basis for many years into the future; and

(2) Puerto Rico’s GNP to grow at a nominal rate that consistently exceeds the interest rate on Puerto Rico’s debt.

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[4] Mauricio Drelichman and Hans-Joachim Voth, *Lending to the Borrower from Hell: Debt, Taxes, and Default in the Age of Philip II*, (Princeton University Press: Princeton, 2014), p. 120.
[5] Id.

The probabilities of Puerto Rico actually achieving these two objectives in the near future are decidedly low, not to say essentially zero.

Given Puerto Rico's (1) history of chronic primary deficits; (2) the magnitude of the economic effort required to service its debt, estimated at 6.8% of GNP for fiscal year 2016; and (3) its rather feeble economic performance, it would be reasonable to conclude that Puerto Rico is facing a significant debt overhang.

The term "debt overhang" first appeared in the international finance literature during the debt crises of the 1980s. Authors such as Paul Krugman and Jeffrey Sachs argued that high debt levels imply an increase in the private sector's future tax burden because governments service their debts mostly by taxing households and businesses. In a debt overhang situation, the future debt burden is perceived to be so high relative to the size of the economy so as to act as a disincentive to *current* investment because investors assume that any future profits from new ventures will be significantly taxed away to service existing debt. This situation leads to lower investment in the short-run, which in turn leads to lower growth, lower tax revenues, reduced ability to pay, and lower expected debt values.

In this situation, it would be rational for debtors to accept: (1) a reduction in the face value of their debt (a "haircut" in financial jargon); (2) a reduction in the interest payments they are entitled to receive; or (3) a combination of both, because such actions would result in lower future debt service payments, which in turn implies a lower expected future tax burden and therefore should lead to higher levels of current investment and growth, higher tax revenues, increased ability to pay, and higher debt values. In this scenario, debt forgiveness benefits both creditors and debtors.

However, even though creditors would be better off by accepting debt forgiveness, this scenario requires a coordination mechanism that forces all creditors to accept some nominal losses. In the absence of such a mechanism, each individual creditor would prefer to hold out while others negotiate reductions of their claims.

Puerto Rico's debt is spread across of variety of debtors representing a complex web of claims in an uncertain regulatory and legal framework. This makes it very difficult for creditors to work as a class. Thus, one set of creditors will worry that the relief that they provide the island will simply make it easier for a different set of creditors to recover more from their claims.

In sum, if Puerto Rico wants to address its debt overhang problem in an orderly fashion it is imperative that it develop a rational framework to address coordination and information failures that so far have precluded the island from reaching agreement with its manifold creditors on a debt restructuring mechanism that would in the end benefit both Puerto Rico and its creditors.

Budget Indicators

Table 3 below sets forth the series of budget indicators that we update every year around the time the governor submits his budget request to the legislature for enactment. Among the indicators included in the table you will find the following:

(1) The trend for the consolidated budget, both in absolute and per capita terms;

(2) The trend for federal funds, both in absolute terms and relative to the consolidated budget;

(3) The trend for the general fund budget;

(4) The trend for payroll expenditures relative to the general fund;

(5) The tax revenue trend, both relative to the general fund and to GNP;

(6) The trend for recurring and non-recurring revenues;

(7) Various indebtedness and debt service ratios; and

(8) The trend in government employment, both in absolute terms and per 1000 inhabitants.

Table 3

Budget Indicators 2012-2016

	Fiscal Year					
	2012	2013	2014	2015	2016	CAGR
1.Consolidated Budget (CB)	$28,895,380,000	$28,555,928,000	$28,428,718,000	$28,105,212,000	$28,820,188,000	-0.07%
CB per capita	$7,933.32	$7,941.38	$8,011.71	$8,024.86	$8,337.39	
CB/GNP	42.44%	41.52%	41.08%	40.11%	40.60%	
2. Federal funds*	$6,867,916,000	$6,585,616,000	$6,679,448,000	$6,375,518,000	$6,872,764,000	0.02%
Federal funds/CB	23.77%	23.06%	23.50%	22.68%	23.85%	
3. General Fund budget (GF)	$8,650,000,000	$9,076,529,000	$9,554,419,000	$9,440,000,000	$9,800,000,000	3.17%
GF/GNP	12.70%	13.20%	13.81%	13.47%	13.81%	
4. GF Payroll	$3,595,934,000	$3,659,652,000	$3,548,437,000	$4,366,853,000	$4,289,705,000	4.51%
Payroll/GF	41.57%	40.32%	37.14%	46.26%	43.77%	
5. Tax revenues GF	$8,036,000,000	$7,695,000,000	$8,970,000,000	$9,094,000,000	$9,275,000,000	3.65%
Tax revenues/GF	92.90%	84.78%	93.88%	96.33%	94.64%	
Tax revenues GF/GNP	11.80%	11.19%	12.96%	12.98%	13.07%	
6. GF recurring revenues	$8,650,000,000	$8,305,000,000	$9,205,000,000	$8,694,000,000	$9,800,000,000	3.17%
GF recurring expenditures	$10,099,000,000	$9,907,000,000	$10,175,000,000	$11,341,000,000	$10,474,000,000	0.92%
GF structural deficit	($1,449,000,000)	($1,602,000,000)	($970,000,000)	($2,647,000,000)	($674,000,000)	
Structural deficit/GF	-16.75%	-17.65%	-10.15%	-28.04%	-6.88%	
7. Non-recurring funds (CB)	$1,958,672,000	$2,310,419,000	$1,770,619,000	$971,105,000	$2,054,000	-82.00%
Non-recurring funds/CB	6.78%	8.09%	6.23%	3.46%	0.01%	
8. Debt service GF	$574,074,000	$514,070,000	$359,277,000	$1,138,328,000	$1,537,996,000	27.94%
Debt service/recurring revenues GF	6.64%	6.19%	3.90%	13.09%	15.69%	
Debt service consolidated budget	$3,486,254,000	$3,961,075,000	$3,794,916,000	$4,346,096,000	$4,820,063,000	8.44%
Debt service/CB	12.07%	13.87%	13.35%	15.46%	16.72%	
Debt service per capita	$957.16	$1,101.57	$1,069.47	$1,240.94	$1,394.40	9.86%
Debt service CB/GNP	5.12%	5.76%	5.48%	6.20%	6.79%	
9. Total public debt**	$69,947,800,000	$70,043,000,000	$72,266,700,000	$72,204,000,000	--	
Public debt per capita	$19,204.39	$19,478.90	$20,366.01	$20,616.36	--	
GNP***	$68,085,700,000	$68,768,200,000	$69,201,600,000	$70,075,000,000	$70,988,000,000	1.05%
Total public debt/GNP	102.73%	101.85%	104.43%	103.04%	--	
10. Government employees****	177,769	175,334	165,437	159,346	154,838	-3.39%
Government employees per 1000 persons	48.81	48.76	46.62	45.50	44.79	
Population*****	3,642,281	3,595,839	3,548,397	3,502,268	3,456,738	-1.30%

* Includes ARRA funds

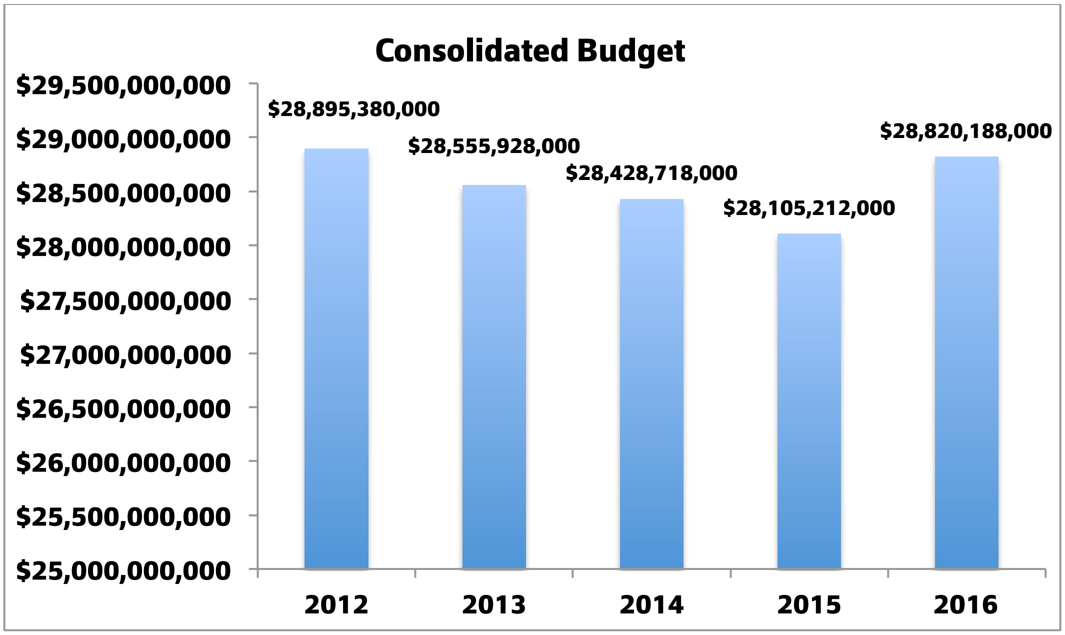
** Data is as of June 30, except for FY 2015 which is as of March 2015

*** Data for 2015 and 2016 are the official estimates from the PRPB

**** Central government and state-owned enterprises only

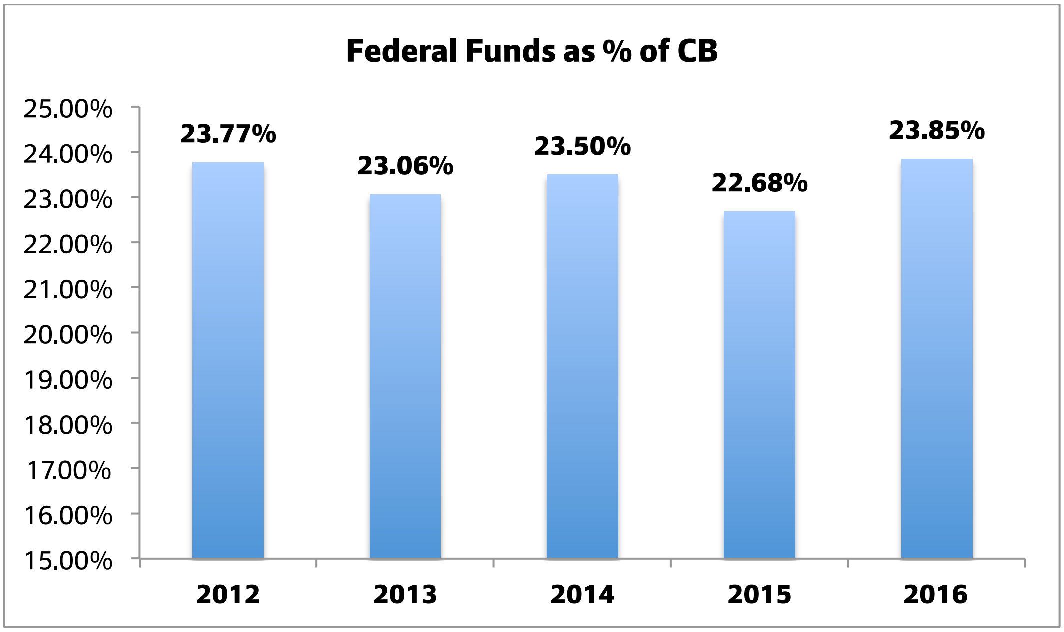
***** Data for 2015 and 2016 are CNE estimates

Consolidated Budget



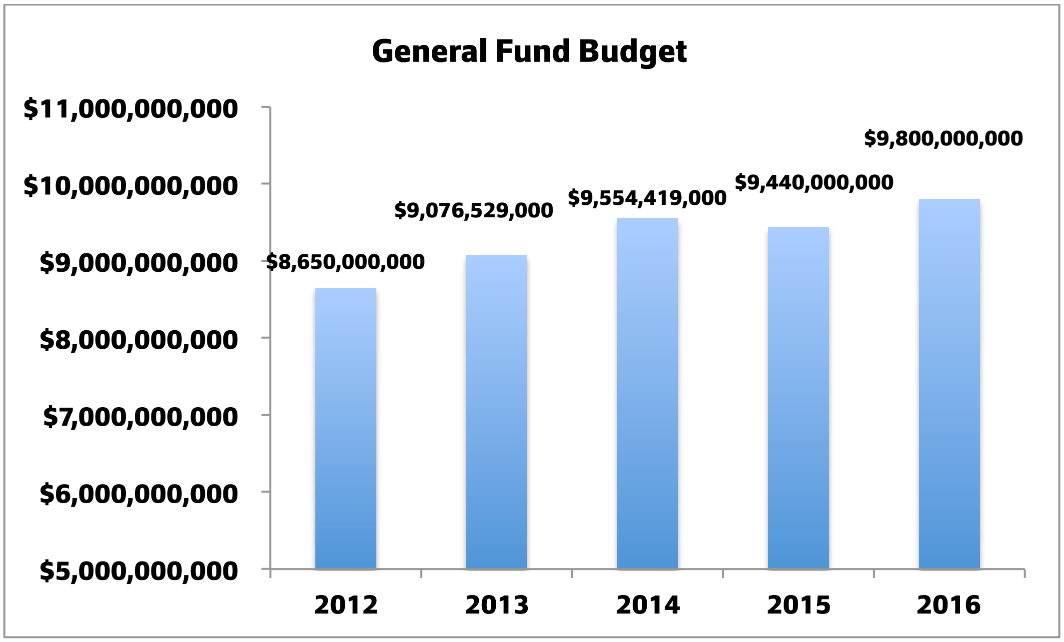
- The Commonwealth's consolidated budget has remained flat in nominal terms, decreasing slightly from $28.895 billion in fiscal year 2012 to a projected $28.820 billion for fiscal year 2016, a decrease of $75 million, or 0.25%. This decrease is equivalent to a compound annual growth rate (CAGR) of negative 0.07% during the period between fiscal years 2012 and 2016, which is significantly lower than the 1.05% CAGR of nominal GNP during the same period.
- Relative to the consolidated budget for the current fiscal year the proposed budget for fiscal year 2016 shows a net increase in spending of approximately $715 million, or 2.5%. Thus, this is essentially another austere budget.
- On a per capita basis, consolidated budget expenditures show an increase, from $7,933 in 2012 to a projected $8,337 for fiscal year 2016. This increase, however, is driven mostly by a reduction in Puerto Rico's population instead of increasing expenditures.
- Relative to per capita personal disposable income, government expenditure remains fairly high. In 2014, per capita disposable personal income in the island was $17,098; thus, per capita government spending of $8,011 represented 46.8% of per capita disposable personal income. In contrast, federal expenditure per capita in the U.S. is approximately $11,488, which is equivalent to 27.6% of per capita disposable personal income of $41,603.
- Finally, consolidated budget expenditures at current prices have declined relative to GNP, from 42.4% in 2012 to a projected 40.6% in 2016. Furthermore, in real terms government spending has decreased significantly over the last four fiscal years.

Federal Funds



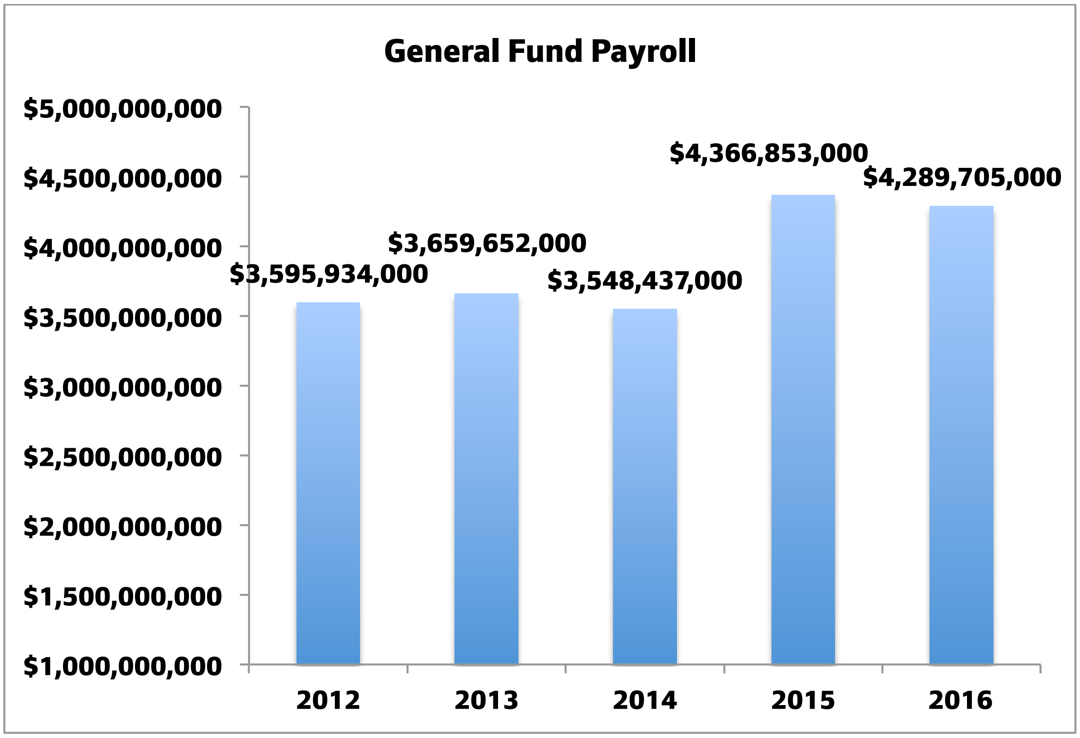
- Grants from the U.S. federal government to the various government agencies of the Commonwealth, including some remainder ARRA funds, are expected to total $6.872 billion during fiscal year 2016, an increase of $5 million, or 0.07%, relative to the $6.867 billion received during fiscal year 2012.
- Federal funds are expected to account for 23.85% of all consolidated budget expenditures during fiscal year 2016, a proportion that is slightly higher than the 22.68% recorded in 2015. This means that slightly less than 1 out of every 4 dollars spent by the Commonwealth's central government during the next fiscal year will come from Washington.
- Since 2012, federal grants to the government have decreased at a CAGR of 0.02%, while the overall consolidated budget during the period under study decreased at a CAGR of 0.07%. This decrease is due mostly to the phase-out of ARRA funds and certain deficit reduction measures implemented at the federal level.
- In our opinion, the high relative weight of federal funds in the consolidated budget is a negative factor because the amount of federal funds received by the island depends solely on the fiscal and political dynamic in Washington DC, where Puerto Rico has limited representation.

General Fund



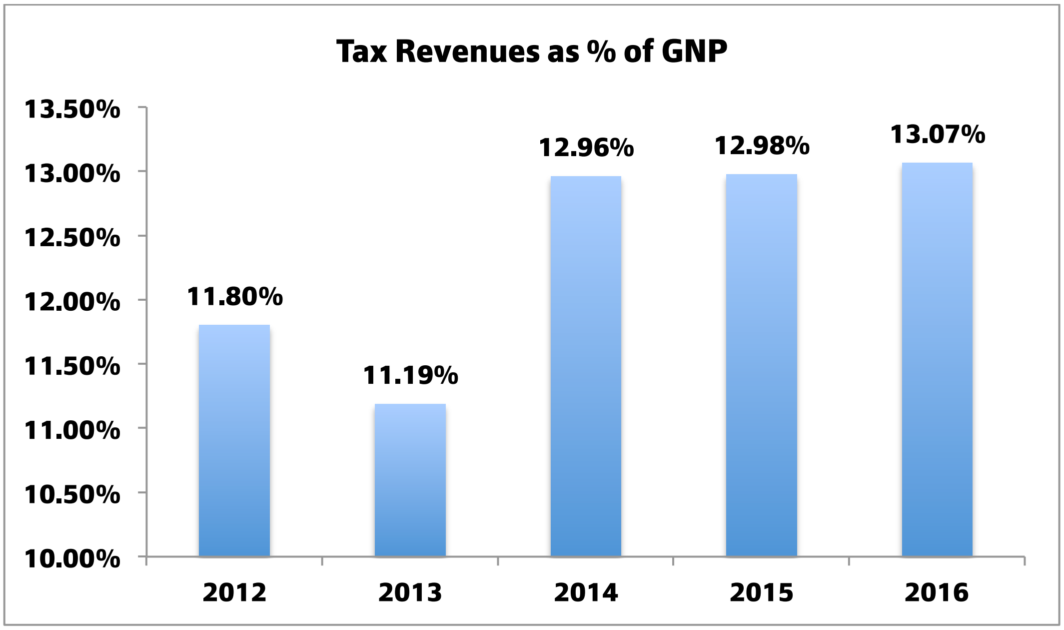
- The Commonwealth's general fund budget has increased from $8.650 billion in fiscal year 2012 to a projected $9.800 billion for fiscal year 2016, an increase of $1.150 billion, or 13.3%. This increase is equivalent to a CAGR of 3.17% for the period between fiscal years 2012 and 2016.
- However, the magnitude of this increase could be somewhat deceptive because between FY2010 and FY2013 some expenditures traditionally charged to the general fund were charged instead against the Fiscal Stabilization Fund, a special fund set up with the proceeds of COFINA bond offerings. For example, during fiscal year 2013 the general fund received $332 million from this special fund.
- General fund spending as a percentage of GNP has increased modestly from 12.7% in fiscal year 2012 to 13.8% during fiscal year 2016. In our view, however, this increase is due mostly to the anemic growth of Puerto Rico's GNP rather than to unusual or out of control increases in general fund spending.
- Overall, the general fund budget shows an increasing trend since 2012. We warn, however, that this trend can be deceiving since the use of ARRA funds, the Stabilization Fund, and significant debt refinancing during the recent past means that the 2012 base may be artificially low.

General Fund Payroll



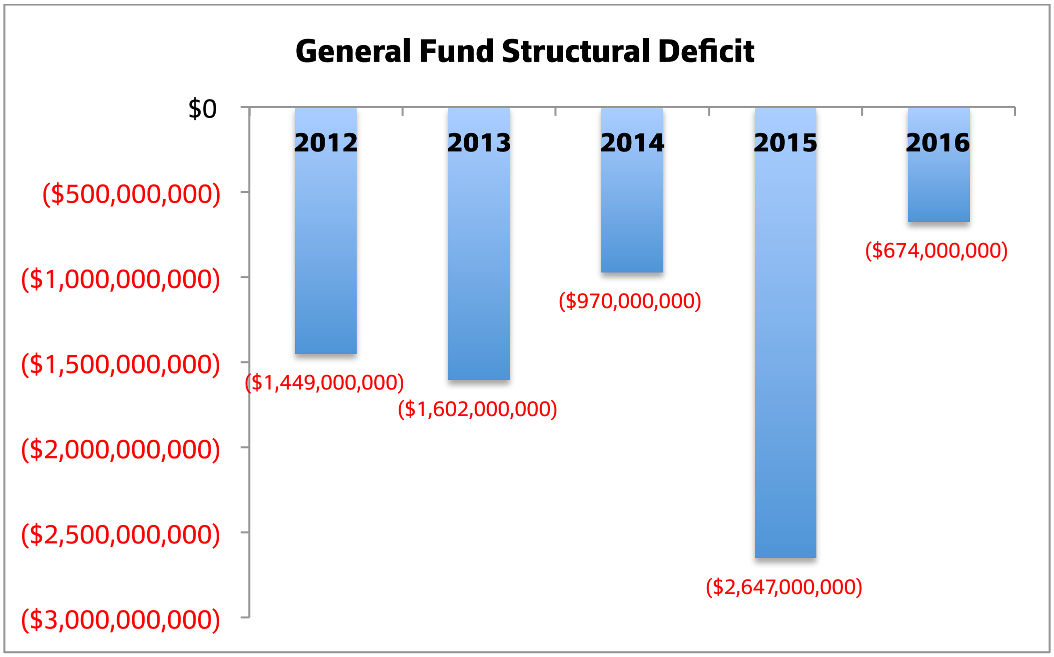
- The amount of the general fund allocated to payroll has increased from $3.595 billion during fiscal year 2012 to a projected $4.289 billion during fiscal year 2016, an increase of $694 million, or 19.3%. This increase is equivalent to a CAGR of 4.5%. We warn, however, that this trend can be deceiving since the use of ARRA funds, the Stabilization Fund, and significant debt refinancing during the recent past means that the 2012 base may be artificially low.
- Relative to the current fiscal year, general fund payroll is expected to decrease slightly from $4.366 billion during fiscal year 2015 to $4.289 billion during fiscal year 2016, a decrease of $77 million, or 1.7%.
- In relative terms, the portion of the general fund allocated to payroll has increased from 41.5% in 2012 to a projected 43.7% in 2016.
- General fund payroll expenditures have stayed relatively flat at approximately 40% of total general fund spending since 2012. In our view, this means that there are relatively little additional savings that remain to be squeezed from the payroll component of the general fund—without adversely affecting government services.

Tax Revenue Trend



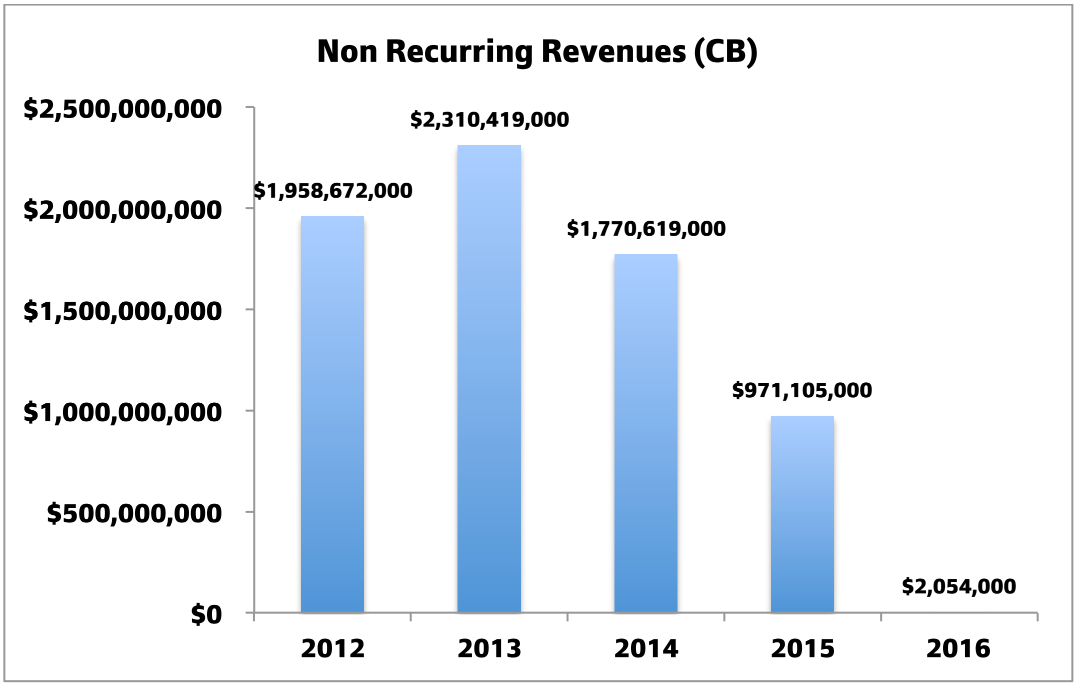
- Tax revenues, the principal component of the general fund, are expected to increase from \$8.036 billion in fiscal year 2012 to a projected \$9.275 billion during fiscal year 2016, an increase of \$1.239 billion, or 15.4%. This increase is equivalent to a CAGR of 3.65%.
- In our view, the estimated year-over-year increase in sales tax revenues allocated to the general fund is subject to significant downside risk due to the transition to the VAT system, and could be revised downward during fiscal year 2016.
- General fund tax revenues have increased relative to GNP, increasing from 11.8% in 2012 to a projected 13.07 % during fiscal year 2016. To put this data in perspective, total federal tax receipts in the U.S. currently amount to approximately 17.5% of GDP.
- In sum, tax revenues in Puerto Rico remain low in Puerto Rico relative to GNP. This is due to (1) a plethora of tax loopholes that have been legislated through the years; (2) lackadaisical tax enforcement; and (3) several consecutive years of anemic economic growth (in nominal terms).
- Nonetheless, general fund tax revenues have increased at a CAGR of 3.65% since fiscal year 2012, while GNP at current prices has grown at a rate of 1.05%. This difference could be explained by the several tax increases legislated over the last five fiscal years and somewhat more effective enforcement efforts.

Structural Deficit



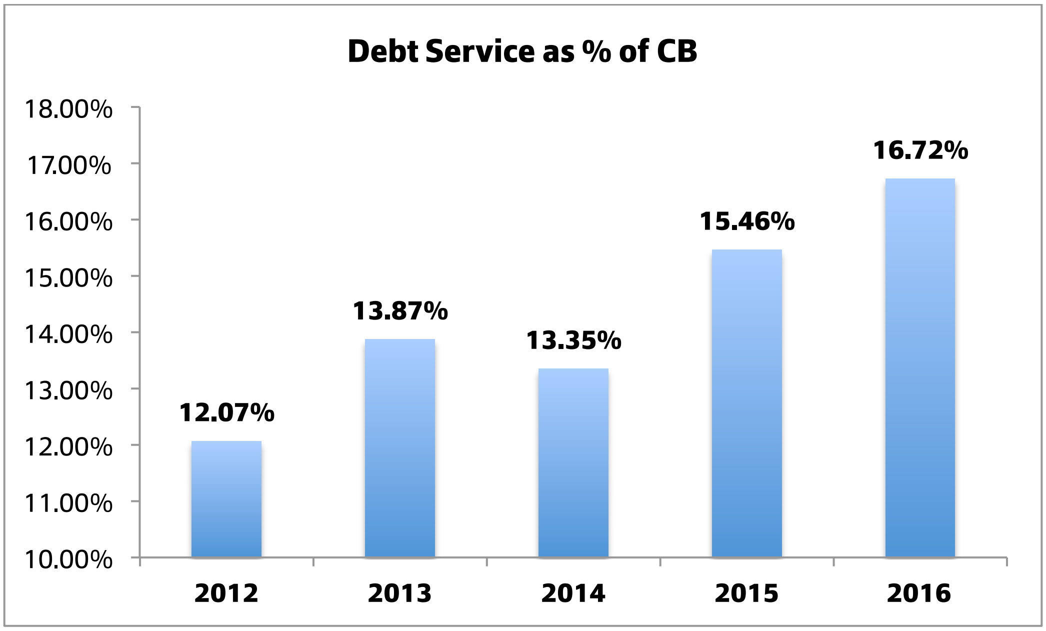
- The credit rating agencies define the structural deficit as the excess of recurring expenditures over recurring revenues. According to our analysis, the Commonwealth's structural deficit has decreased significantly, from $1.44 billion in 2012 to a projected $674 million for fiscal year 2016, a decrease of $775 million, or 53.4%. For fiscal year 2016, the projected structural deficit of $674 million equals the difference between expected revenues of $9.800 billion and recurring expenditures of $10.474 billion.
- Relative to the current fiscal year, the general fund structural deficit is expected to decrease from $2.647 billion to $674 million in fiscal year 2016, a decrease of $1.973 billion, or 74.5%.
- Finally, as a percentage of total general fund expenditures, the structural deficit is also expected to decrease significantly, from 16.7% in 2012 to a projected 6.8% in 2016.
- In our view, the trend with respect to the structural deficit is generally positive because it shows a striking reduction over the last five years, both in absolute and relative terms. However, we should also note that authentic structural balance still remains an elusive goal for the Commonwealth.

Use of Non-Recurring Funds



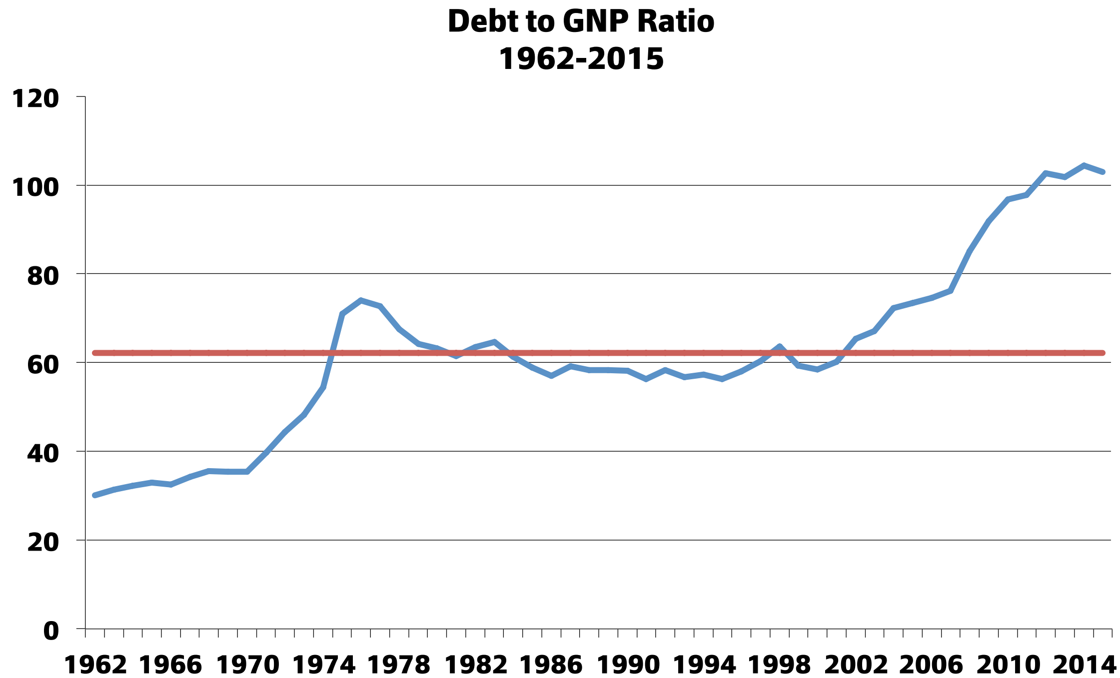
- To cover its yearly deficits the Commonwealth government has turned to using non-recurring revenues. However, total non-recurring revenues included in the *consolidated budget* have essentially disappeared, decreasing from $1.958 billion in fiscal year 2012 to an expected $2 million for 2016, a decrease of $1.956 billion, or 99.8%.
- The *general fund* budget for fiscal year 2016 does not include any non-recurring revenues. If the government does in fact realize this objective, it would constitute a significant step in achieving fiscal discipline.
- Overall, this indicator shows a positive trend, as the reliance on non-recurring revenues appears to have been eradicated. This reduction is due to (1) the phase-out of ARRA funds; (2) the cessation of deficit financing through COFINA bond offerings; (3) the closing of the capital markets to Puerto Rico at reasonable rates, which has precluded "scoop and toss" refinancing; and (4) significant tax increases.

Debt Service



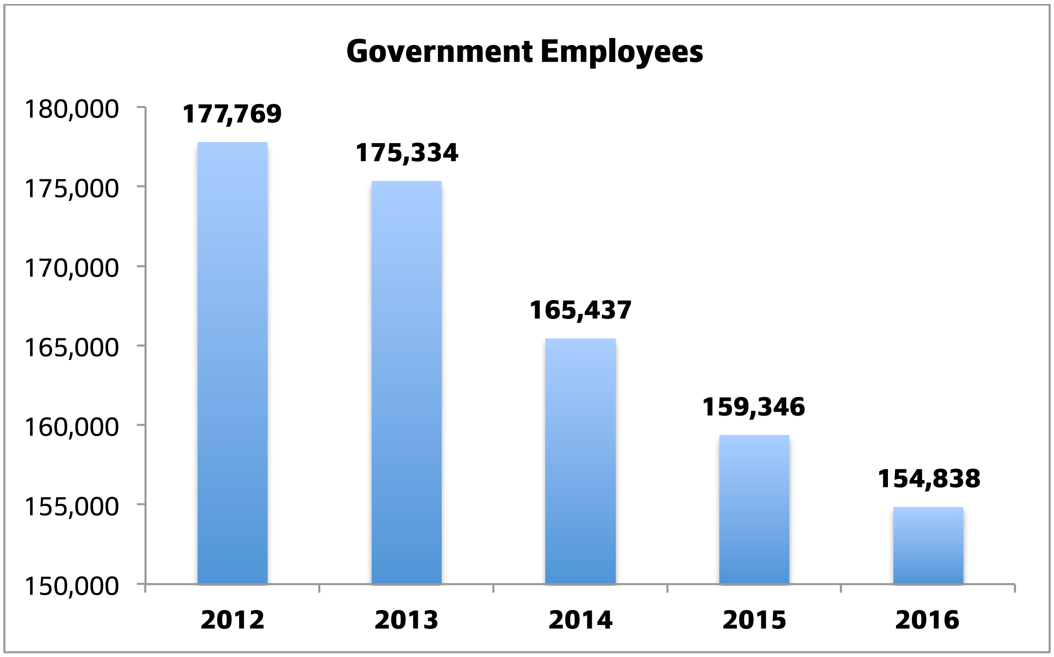
- The amount of the *general fund* allocated to debt service has increased significantly during the last four fiscal years, from $574 million for fiscal year 2012 to a projected $1.537 billion during fiscal year 2016, an increase of $963 million, or 167.7%. This increase is equivalent to a CAGR of 27.9%.
- In relative terms, the amount allocated to general fund debt service has also increased significantly from 6.7% of general fund recurring revenues in 2012 to a projected 15.7% of recurring revenues in 2016.
- This trend is due mostly to the elimination, for the time being, of "scoop and toss" refinancing due to the Commonwealth's inferior credit ratings.
- With respect to the *consolidated budget*, the amount allocated for debt service has increased from $3.486 billion in 2012 to a projected $4.820 billion in 2016, an increase of $1.334 billion, or 38.2%. This increase is equivalent to a CAGR of 8.4%.
- In relative terms, the portion of the consolidated budget allocated to debt service has increased significantly, from 12.07% of the total consolidated budget in 2012 to a projected 16.7% in 2016. This means that approximately $1 out of every $6 spent by the government of Puerto Rico will be allocated for debt service during fiscal year 2016.
- On a per capita basis, total public debt per capita in 2014 amounted to $20,366 which is equal to 119.1% of the island's per capita disposable personal income of $17,098.

Public Debt/GNP Ratio



- The Commonwealth's total public indebtedness increased from $69.947 billion in 2012 to $72.204 billion as of March 2015, an increase of $2.257 billion, or 3.22%. During that same period, Puerto Rico's GNP, at current prices, increased from $68.085 billion to a projected $70.075 billion, an increase of $1.990 billion, or 2.9%.
- Relative to GNP, Puerto Rico's total public debt increased from 102.7% of GNP in 2012 to 103.04% in 2015. The red line in the graph above shows the 62.1% historical average Debt/GNP ratio for Puerto Rico during the 53-year period between 1962 and 2015. The current ratio is significantly above the historical trend.
- In our view, the overall trend with respect to total public indebtedness is unsustainable. Reversing this trend will require, (1) not merely "balancing" the budget, but actually running a primary budget surplus—that is, keeping expenditures (net of the cost of debt service) below revenues—on a regular basis for many years into the future; and (2) Puerto Rico's GNP to grow at a nominal rate that consistently exceeds the interest rate on Puerto Rico's debt.
- Puerto Rico exhibits some of the classic pre-default dynamics described by the economic literature, namely, elevated levels of uncertainty, high interest rates, restrictive fiscal policies that have intensified the contraction of the economy, and an electorate that has suffered from a long period of austerity policies and that may be reaching the limits of its endurance.

Government Employment



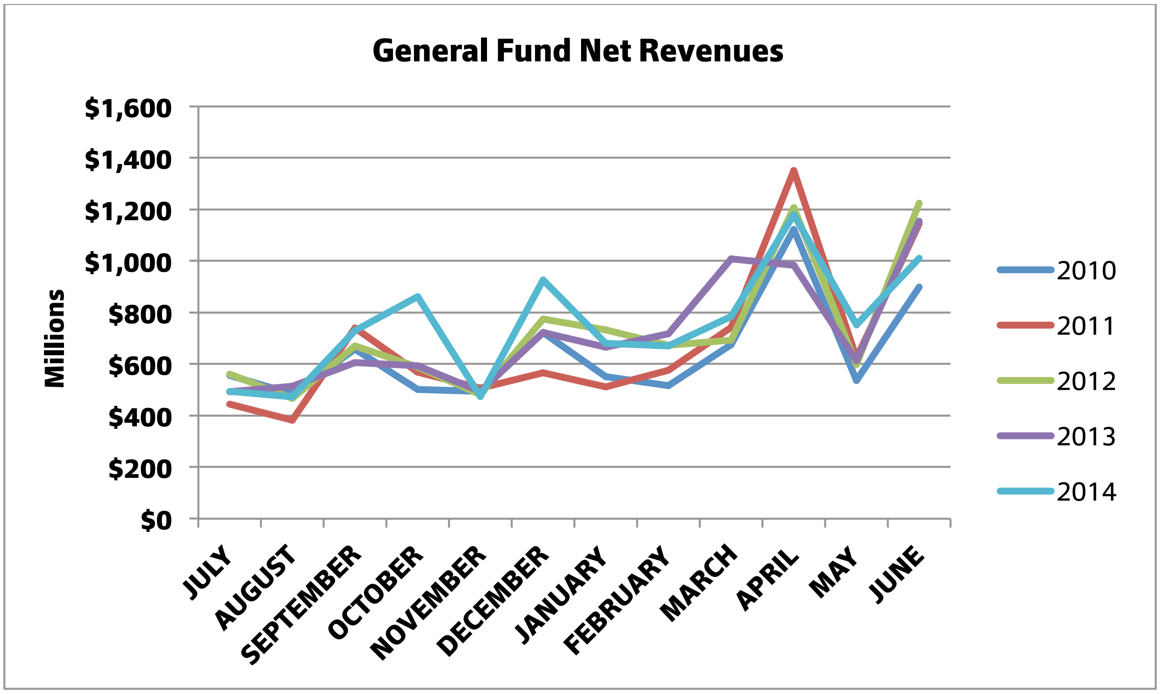
- According to statistics published by the Office of Management and Budget as part of the Governor's budget request, the number of people employed by the Commonwealth (central government and state-owned enterprises only) has decreased significantly from 177,769 in 2012 to a projected 154,838 in 2016, a reduction of 22,931 workers, or 12.9%. This decrease is equivalent to a CAGR of negative 3.39%.
- In relative terms, the number of central government employees per 1000 inhabitants has shown a modest reduction, from 48.81 government workers per 1000 people in 2012 to a projected 44.79 government workers per 1000 people in 2016.
- Furthermore, contrary to popular belief, government employment in Puerto Rico, as a share of the population older than 15, is quite similar to that of the states. Government employment as a share of the population over the age of 15 was 8.7% in Puerto Rico and 8.9% in the states, respectively, (sic) based on Census Bureau population estimates for July 2012.[6]

[6] United States Government Accountability Office, *Puerto Rico: Information on How Statehood Would Affect Selected Federal Programs and Revenue Resources*, March 2014, p. 13 and footnote 27. Government employment, in this instance, includes employment at the federal, state, and local government levels.

Short and Medium-Term Risks

It is beyond dispute that the repeated downgrades of the Commonwealth's credit ratings has further complicated Puerto Rico's already delicate financial situation, limited the options and the flexibility available to its financial managers, and increased the likelihood and potential impact of several short and medium term risks linked to Puerto Rico's fiscal and economic situation.

Liquidity – As shown on the table below, general fund net revenues fluctuate significantly on a month-to-month basis.



Source: Puerto Rico Treasury Department and Government Development Bank

In order to smooth out those monthly cash flow fluctuations the Puerto Rico Treasury Department has traditionally relied on two sources of funding (1) the issuance of Tax Revenue Anticipation Notes ("TRANs") and the (2) cash advances from the GDB.

For example, as shown on the chart below, during fiscal year 2015 GDB placed $900 million in GDB Senior Notes with a syndicate of banks and utilized an additional $300 million from internal sources to provide the Puerto Rico Treasury with a total of $1.2 billion in short-term liquidity. However, Puerto Rico paid quite a steep price for this liquidity, well in excess of 7% for what was essentially a 9-month loan.

On October 10, 2014, $900 million in GDB Senior Notes were placed with top-tier banking institutions

- Participation from top-tier banks demonstrates continued access to traditional sources of financing:
  - **J.P. Morgan**
  - **Morgan Stanley**
  - **Bank of America**
  - **Banco Popular de Puerto Rico**
  - **Barclays**
  - **Amalgamated Bank**
- The FY 2015 TRANs need, which was unchanged from FY 2014, was funded by GDB as follows:
  - $900 million from the issuance of the GDB Senior Notes; and
  - $300 million from internal liquidity sources (consistent with recent practice).
- GDB Senior Notes' issuance repaid $400 million in TRANs purchased by GDB, increasing GDB liquidity.
- GDB Senior Notes contain a $200 million revolving tranche, which provides cash flow flexibility to the Commonwealth and reduces aggregate financing costs.

Total Facility Size:	$900 million: • $700 million non-revolving with a fixed interest rate of 7.75% • $200 million revolving with a floating interest rate of 1M Libor + 7.55%
Maturity Date:	June 30, 2015 (six semi-monthly amortizations commencing April 16, 2015)
Use of Proceeds:	Purchase up to $900mm aggregate principal amount of TRANs of the Commonwealth

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Source: Government Development Bank, Commonwealth of Puerto Rico: Update on Fiscal and Economic Progress, FY2015 Q1 Investor Webcast – October 2014

The problem is that for fiscal year 2016 GDB may not be able to provide the necessary liquidity to issue a new set of TRANs or advance any cash to the Treasury because its own liquidity is severely constrained. First, most of GDB's loans are to the Commonwealth government, its agencies and instrumentalities and to the extent those entities have been unable to pay their obligations on time GDB's liquidity has been adversely affected. In addition, approximately $876 million in outstanding GDB bonds and/or notes mature during fiscal year 2016.[7] According to GDB sources, $476 million of the total $876 million is due during the first six months of fiscal year 2016.

However, the most significant problem, by far, involves loans made by the GDB to the Puerto Rico Highways and Transportation Authority ("PRHTA"), which owes GDB approximately $2.2 billion that it is currently unable to repay. GDB sought to address this problem by using one of its affiliates, the Puerto Rico Infrastructure Financing Authority ("PRIFA"), to issue up to $2.95 billion in bonds backed by a new tax on petroleum products. PRIFA would then use the proceeds of the bond offering to pay off loans made by GDB to PRHTA and certain variable rate debt obligations

[7] Commonwealth of Puerto Rico, *Quarterly Report*, dated May 7, 2015, p. 32.

("VRDOs") issued by PRHTA to third parties but currently owned by GDB. The consummation of this transaction would enable GDB to provide significant liquidity support to the Commonwealth government during fiscal year 2016.

However, recent statements made by the president of the GDB cast doubt on the viability of the PRIFA transaction. According to testimony by Melba Acosta before the Budget and Treasury Committee of the Puerto Rico House of Representatives on May 30, 2015, the terms and conditions required by lenders to execute the PRIFA transaction "are not acceptable to the Government and could be interpreted as not being in the best interests of the Commonwealth."[8] Therefore, while the PRIFA deal may not have been completely ruled out, the probability of it being executed within the next 90 days are decidedly low.

The consequences of not executing the PRIFA transaction are serious. According to the Commonwealth's most recent quarterly report:

> In the absence of such bond issuance, an alternative financial transaction or other emergency liquidity enhancing or preservation measures, GDB is currently projected to have insufficient liquidity to meet its legal reserve requirement by the first quarter of fiscal year 2016 and may be unable to support the operations and liquidity needs of the Commonwealth, its public corporations and instrumentalities and municipalities. In such a scenario, the Commonwealth may also be unable to obtain intra-year short-term financing for fiscal year 2016 through the issuance of Tax Revenue Anticipation Notes ("TRANs"). The Commonwealth currently projects that absent TRANs financing, the Commonwealth would deplete its cash resources in full during the first quarter of fiscal year 2016, even after considering the implementation of extraordinary short- term administrative measures to conserve cash. As a result, the failure to consummate the proposed PRIFA bond issuance or an alternative financing transaction would likely cause the Commonwealth, GDB and other instrumentalities to be unable to continue funding all governmental programs and services as well as debt service obligations on a timely manner.[9]

The inability of the Commonwealth government to continue funding its operations as well as its debt service on a timely manner, which may well occur before September 30, 2015, would trigger constitutional and statutory provisions to address such a contingency.

First, Article VI, section 8 of the Puerto Rico Constitution states that "In case the available revenues including surplus for any fiscal year are insufficient to meet the appropriations made for that year, interest on the public debt and amortization

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[8] Melba Acosta Febo, Testimony Before the Treasury and Finance Committee of the Puerto Rico House of Representatives, May 30, 2015, p. 7.
[9] Commonwealth of Puerto Rico, *Quarterly Report,* dated May 7, 2015, p 13.

thereof shall first be paid, and other disbursements shall thereafter be made in accordance with the order of priorities established by law."[10]

Second, section 4(c) of the OMB organic law sets forth the following priorities in the event that available revenues are not sufficient to meet the appropriations for a given fiscal year:

1. The payment of interest on and amortization requirements of the public debt.
2. The fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain cases, and other unavoidable obligations to protect the credit, reputation and the good name of the Commonwealth.
3. Payment of current expenditures related to (a) the preservation of public health, (b) the protection of persons and property, (c) public education programs, (d) public welfare programs, and (e) employer contributions to the retirement systems and the payment of pensions granted to individuals by special laws and then to other public services in the order to be determined by the governor.
4. The construction or improvement of public works, whose contracts have been duly executed; it being understood that preference shall be given to emergency public works arising out of catastrophes or acts of nature or fortuitous accidents (sic); and then to others required to restore normal life and the economy of Puerto Rico.
5. The fulfillment of payments related to contracts or commitments funded by special appropriations, and then those related to programs in development or planning stages, the postponement of which would directly or indirectly adversely affect the interests of the program beneficiaries.

Notwithstanding the language of the OMB organic act, the Commonwealth states on page 13 of its most recent report that since it "will seek to maintain essential government operations, even during a period of government-wide limited liquidity, the Commonwealth may seek to implement emergency measures, which could include administrative measures to reduce appropriations, a moratorium on the payment of debt service, a debt adjustment for the Commonwealth, GDB and other instrumentalities, or the payment of the Commonwealth's debt service with certain taxes and other revenues previously assigned by law to certain public corporations to secure their indebtedness."

[10] It should be noted that this Constitutional preference applies only to General Obligation bonds and other debt *expressly* guaranteed by the Commonwealth government.

It is not clear to us at this time how the Commonwealth would reconcile its intentions, as embodied in this statement, with the priority requirements of the OMB organic act.

Insolvent State-Owned Enterprises – The government of Puerto Rico owns several large corporations, among them the Puerto Rico Aqueduct and Sewer Authority (PRASA), the Puerto Rico Electric Power Authority (PREPA), the Puerto Rico Highways and Transportation Authority (PRHTA), and the Puerto Rico Ports Authority. These government-owned companies have been the main driver of public infrastructure investment in Puerto Rico over the last sixty or seventy years.

In theory, these "public corporations" are meant to be financially self-sufficient and administratively independent from the regular departments and agencies of the Commonwealth's executive branch bureaucracy. In practice, however, instead of reducing red tape, public corporations have added dozens of new bureaucratic layers to government and instead of limiting political intervention in government, public corporations have become important sources of political patronage as they provide ample employment opportunities for loyal party members and generous contracts for politically-connected suppliers.

Financial self-sufficiency has also turned out to be a chimera as many public corporations often rely on the central government to help them cover their operational deficits and in some cases the central government has been obligated to assume their debt servicing obligations in order to avoid a default. In addition, most public corporations suffer from a severe lack of accountability, oversight and transparency at all levels.

The financial situation of PRASA, PREPA, PRHTA, and the Ports Authority is particularly worrisome. Each of these entities needs to be comprehensively restructured. Such restructuring would entail: (1) increasing rates, tolls, or user fees; (2) gradually eliminating all subsidies from the general fund and/or the GDB; (3) reducing operating costs, including payroll—if necessary; (4) restructuring the terms and conditions of debt issued by each of these entities; and (5) reforming the corporate governance structure of each of these companies.

Take the case of PREPA, for example, a government-owned monopoly that provides electricity, an essential service. According to its audited financial statements its has incurred losses of $147 million; $129 million; $272 million; $346 million; and $275 million during fiscal years 2009, 2010, 2011, 2012, and 2013, respectively. As of June 30, 2013, its net assets were negative $791 million. Its long-term debt is approximately $9 billion, it is currently barely in compliance with its debt service coverage covenants, and is facing a difficult time renegotiating some $800 million in working credit lines that it needs to finance fuel purchases. It is obvious that the financial situation of this corporation is not sustainable.

Well, the inevitable denouement finally occurred on August 14, 2014, when PREPA entered into forbearance agreements with certain insurers of its bonds and beneficial owners of bonds controlling, collectively, more than 60% of the principal amount of bonds outstanding under PREPA's Power Revenue Bonds Trust Agreement, as well as with the banks that provide revolving lines of credit to PREPA, and with GDB. The forbearing creditors agreed to not exercise certain rights against PREPA resulting from certain specified defaults or potential defaults until March 31, 2015.

The forbearance agreements required PREPA, among other things, to (i) retain FTI Consulting to evaluate and make recommendations to PREPA with respect to its billing practices, receivables, and contribution in lieu of taxes by November 15, 2014, (ii) deliver a business plan to the forbearing creditors or their advisors who have executed non-disclosure agreements by December 15, 2014, and (iii) deliver a restructuring plan acceptable to at least 66 2/3% of the forbearing bond creditors as well as the forbearing banks by March 2, 2015. These forbearance agreements have been extended several times since August 2014.

On June 1, 2015, PREPA formally presented a financial and operating restructuring plan to its creditors. As of this writing negotiations continue and the forbearance agreements have been extended until June 18, 2015. However, as we stated in our discussion of the debt overhang, we believe it is highly unlikely that PREPA and its creditors will reach an agreement in the absence of a coordination mechanism, because, in the absence of such a mechanism, each individual creditor would prefer to hold out while others negotiate reductions of their claims. In this sense, PREPA is facing a classic game theory conundrum, there are more than two players, they have common as well as opposing interests, and not making a deal leaves everybody worse off.

Health Care Costs – Puerto Rico currently provides health insurance coverage to its low-income residents (close to 1.6 million beneficiaries), at an annual cost of approximately $2.5 billion. A substantial portion of these costs, approximately 51%, is funded with non-recurring resources provided pursuant to the federal Patient Protection and Affordable Care Act ("ACA"). At the current expenditure rate, these non-recurring ACA funds are expected to run out in March 2018.

At that time, absent Congressional action renewing or increasing such funding for Puerto Rico, the government health insurance plan, administered through the Puerto Rico Health Insurance Administration, would face a $2 billion deficit. In that event, the government of Puerto Rico will have to decide whether to (1) fund the program through the general fund, which would entail a significant tax increase; (2) reduce the number of people that qualify for program benefits; (3) cut back the number of medical procedures and services covered by the government health insurance plan; (4) implement a significant increase in co-payments and deductibles; or (5) put in to effect a combination of all of the above.

We note, however, that this program is very popular and it may be politically difficult to implement significant changes in qualification requirements, coverage, or the current level of deductibles and copayments. In addition, under the terms of the ACA it may prove difficult to eliminate coverage of certain procedures. How the Commonwealth plans to address this issue remains an open question.

Public Pension Systems – The government of Puerto Rico enacted significant pension reform legislation in 2013 reforming the Employees Retirement System ("ERS"), the Teachers Retirement System ("TRS"), and the Judiciary Retirement System ("JRS"). Notwithstanding said legislation, each of these retirement systems continues to be significantly underfunded. There are several reasons that account for this counterintuitive state of affairs. First, due to the Commonwealth's financial situation it has been unable to make in full the additional employer contributions required by the new legislation. Second, the Puerto Rico Supreme Court declared that several sections of the TRS and JRS reforms were unconstitutional. And, third, the Government Accounting Standards Board ("GASB") has significantly amended the financial reporting requirements for pension plans.

Thus, pursuant to the new reporting standards set forth in GASB 67, the financial status of each of the Commonwealth pension systems is as follows:

- A preliminary valuation of the ERS under GASB 67 reflects an increase in pension liabilities and a decrease in the funded level for financial reporting purposes. As of June 30, 2014, the preliminary valuation reflects a Total Pension Liability of $30.2 billion, a Fiduciary Net Position of $210 million (total assets of $3.5 billion net of liabilities of $3.3 billion, consisting principally of $3.1 billion in pension obligation bonds), and a Net Pension Liability of $30.0 billion. The Fiduciary Net Position as a percentage of Total Pension Liability (the "funded ratio") is 0.7%.[11]

[11] Commonwealth of Puerto Rico, *Quarterly Report*, dated May 7, 2015, p. 43.

- A preliminary valuation of the TRS under GASB 67 reflects an increase in pension liabilities and a decrease in the funded level for financial reporting purposes. As of June 30, 2014, the preliminary valuation reflects a Total Pension Liability of $14.8 billion, a Fiduciary Net Position of $1.7 billion, and a Net Pension Liability of $13.1 billion. The Fiduciary Net Position as a percentage of Total Pension Liability is 11.5%[12]
- A preliminary valuation of the JRS under GASB 67 reflects an increase in pension liabilities and a decrease in the funded level for financial reporting purposes. As of June 30, 2014, the preliminary valuation reflects a Total Pension Liability of $504.4 million, a Fiduciary Net Position of $62.1 million, and a Net Pension Liability of $442.3 million. The Fiduciary Net Position as a percentage of Total Pension Liability (the "funded ratio") is 12.3%.[13]

In sum, the total Net Pension Liability of the main Commonwealth pension systems amounts to $43.5 billion, equivalent to 62% of Puerto Rico's GNP. Furthermore, if we add the public debt to the total net pension liability, the sum owed by the Puerto Rican government is a staggering $115.7 billion, or 163% of GNP. Given current demographic and economic trends in the island, it is highly unlikely, in our opinion, that Puerto Rico will be able to satisfy these obligations in full.

Lack of Credibility – In our opinion, if Puerto Rico is to recuperate the trust and confidence of the capital markets it will be necessary to devise and implement several new policies. Among these we note the following:

Devise a credible five-year fiscal adjustment plan – This plan should include revenue and expenditure reform measures, to be implemented in a coherent and logical manner over five years, as well as a framework to address Puerto Rico's debt overhang problem.

Enact PAYGO rules – The Governor should propose, and the legislature should enact, legislation requiring that any bill increasing expenditures must include an offsetting decrease in other expenditures or an increase in taxes and that any bill decreasing taxes must include an offsetting decrease in expenditures or an increase in other taxes.

Establish "sunset rules" – The legislature should establish a "sunset" commission to structure the process of terminating ineffective government programs. "Sun-setting" is the process of automatically terminating government agencies and programs after a period of time unless they are specifically reauthorized. A sunset commission

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[12] Id. at p. 45.
[13] Id. at p. 46.

could review Commonwealth government programs on a rotating basis and recommend major overhauls, privatization or elimination of programs that have outlived their usefulness.

Recapitalize GDB – In our analysis of the FY2014 budget we recommended that the current administration undertake the analysis and formulation of a re-capitalization plan for the GDB. In general terms, the plan could consist of issuing GDB preferred shares. Such shares would not entail board representation or any voting rights, but would pay a preferred dividend of 5% to 6% of face (par) value. GDB would have the option to call all preferred shares, at par, after five years. Potential buyers of these shares include financial institutions operating in Puerto Rico, multinational companies that use Puerto Rico to shelter billions of dollars from federal income taxes, Act 22 beneficiaries, local high net worth individuals, and large Puerto Rican enterprises.

In our view, this type of recapitalization could generate a significant amount of emergency capital for the GDB, while providing local investors with the opportunity to make a significant contribution to solving Puerto Rico's current economic problems.

Control the growth rate of indebtedness – Enact a law limiting the issuance of new debt during any given fiscal year to the nominal GNP growth rate forecasted by the Puerto Rico Planning Board for that year, except during recessions.

Conclusion

We summarize below some of the highlights of this Report about the Governor's proposed budget for fiscal year 2016:

- The Commonwealth's consolidated budget has decreased very slightly from \$28.895 billion in fiscal year 2012 to a projected \$28.820 billion for fiscal year 2016, a decrease of \$75 million, or 0.25%.
- Federal funds are expected to account for 23.85% of all consolidated budget expenditures during fiscal year 2016, a proportion that is slightly higher than the 22.68% registered in 2015. This means that close to 1 out of every 4 dollars spent by the Commonwealth's central government during the next fiscal year will come from Washington.
- The Commonwealth's general fund budget has increased from \$8.650 billion in fiscal year 2012 to a projected \$9.800 billion for fiscal year 2016, an

increase of $1.150 billion, or 13.3%. This increase is equivalent to a CAGR of 3.17% for the period between fiscal years 2012 and 2016.

- The amount of the general fund allocated to payroll has increased from $3.595 billion during fiscal year 2012 to a projected $4.289 billion during fiscal year 2016, an increase of $694 million, or 19.3%. This increase is equivalent to a CAGR of 4.5%. We warn, however, that this trend can be deceiving since the use of ARRA funds, the Stabilization Fund, and significant debt refinancing during the recent past means that the 2012 base may be artificially low.
- Tax revenues, the principal component of the general fund, are expected to increase from $8.036 billion in fiscal year 2012 to a projected $9.275 billion during fiscal year 2016, an increase of $1.239 billion, or 15.4%. This increase is equivalent to a CAGR of 3.65%.
- In our view, the estimated year-over-year increase in sales tax revenues allocated to the general fund is subject to significant downside risk due to the transition to the VAT system, and could be revised downward during fiscal year 2016.
- According to our analysis, the Commonwealth's structural deficit has decreased significantly, from $1.44 billion in 2012 to a projected $674 million for fiscal year 2016, a decrease of $775 million, or 53.4%. For fiscal year 2016, the projected structural deficit of $674 million equals the difference between expected revenues of $9.800 billion and recurring expenditures of $10.474 billion.
- The *general fund* budget for fiscal year 2016 does not include any non-recurring revenues. If the government does in fact realize this objective, it would constitute a significant step in achieving fiscal discipline.
- The Commonwealth's total public indebtedness increased from $69.947 billion in 2012 to $72.204 billion as of March 2015, an increase of $2.257 billion, or 3.22%. During that same period, Puerto Rico's GNP, at current prices, increased from $68.085 billion to a projected $70.075 billion, an increase of $1.990 billion, or 2.9%.
- Relative to GNP, Puerto Rico's total public debt increased from 102.7% of GNP in 2012 to 103.04% in 2015. This ratio is well above the 62.1% historical average for the 53-year period between 1962 and 2015.
- The amount of the *general fund* allocated to debt service has increased significantly during the last four fiscal years, from $574 million for fiscal year 2012 to a projected $1.537 billion during fiscal year 2016, an increase of $963 million, or 167.7%. This increase is equivalent to a CAGR of 27.9%.

- In relative terms, the amount allocated to general fund debt service has also increased significantly from 6.7% of general fund recurring revenues in 2012 to a projected 15.7% of recurring revenues in 2016.
- With respect to the *consolidated budget*, the amount allocated for debt service has increased from $3.486 billion in 2012 to a projected $4.820 billion in 2016, an increase of $1.334 billion, or 38.2%. This increase is equivalent to a CAGR of 8.4%.
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- GDB may not be able to provide the necessary liquidity during fiscal year 2016 to issue a new set of TRANs or advance any cash to the Treasury because its own liquidity is severely strained.
- The inability of the government to continue funding its operations as well as its debt service on a timely manner, which may well occur before September 30, 2015, would trigger constitutional and statutory provisions to address such a contingency.
- Absent Congressional action renewing or increasing ACA funding for Puerto Rico, the government health insurance plan, administered through the Puerto Rico Health Insurance Administration, would face a $2 billion deficit sometime in 2018.
- Total Net Pension Liability of the main Commonwealth pension systems amounts to $43.5 billion, equivalent to 62% of Puerto Rico's GNP. Furthermore, if we add the public debt to the total net pension liability, the sum owed by the Puerto Rican government is a staggering $115.7 billion, or 163% of GNP. Given current demographic and economic trends in the island, it is highly unlikely, in our opinion, that Puerto Rico will be able to satisfy these obligations in full.
- In our opinion, if Puerto Rico is to recuperate the trust and confidence of the capital markets it will be necessary to devise and implement several policies, including a credible five-year fiscal adjustment plan.

In sum, Puerto Rico has been under severe economic and financial stress during the past nine fiscal years. The Commonwealth enacted a series of austerity and fiscal consolidation measures during that period. Yet, in contrast with other jurisdictions that could complement those policies with either (1) a currency devaluation to boost exports or (2) loans from emergency liquidity facilities negotiated with international multilateral institutions, Puerto Rico, due to institutional and political constraints, cannot devalue its currency nor does it have access to such emergency liquidity facilities.

In addition, the Commonwealth and its instrumentalities have lost access to the capital markets on reasonable terms. The uncertainty regarding the Commonwealth's access to short-term liquidity sources threatens the sustainability of government finances in the near term.

In this environment, Commonwealth financial managers will be hard-pressed to balance intense competing pressures on the general fund to (1) reduce the general fund deficit, (2) subsidize financially struggling public corporations, (3) keep public pension systems afloat, (4) honor all of the Commonwealth's financial obligations, and (5) finance all the health, education, and public safety services that the Puerto Rican people expect from their government.

The Center for a New Economy (CNE) is a private, independent and not-for-profit entity organized as a think-tank; as such, CNE is unique in Puerto Rico.

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