

Fiscal Situation Update



Fiscal Year 2008-2009 Budget
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I. Fiscal Year 2007-08

General fund revenues have fallen short of the budgeted amount every month so far during the current fiscal year. According to the budget documents submitted by the Governor on March 13th, the Puerto Rico Treasury Department now expects net general fund revenues to total \$8.821 billion, an amount that is \$406 million, or 4.40%, below the budgeted amount of \$9.227 billion.

On the expenditure side, the Governor stated in his budget address to the legislative assembly that all government agencies are expected to keep spending within their respective budget limits, with the sole exception of the Health Insurance Administration (ASES) which according to published estimates is expected to be \$116 million over budget. Thus, total general fund expenditures are expected to be around \$9.343 billion.

As shown on Table I below, if these projections are realized, then the general fund deficit for the current fiscal year should be around \$522 million, a figure that is \$191 million, or 57.70%, higher than the \$331 million budget deficit registered during fiscal year 2006-07.¹

General fund revenues	\$ 8,671,000,000
Other income	\$ 150,000,000
Total general fund revenues	\$ 8,821,000,000
General fund expenditures	\$ 9,343,000,000
Projected budget deficit	\$ (522,000,000)

If we analyze the Commonwealth's structural balance, that is the difference only between its recurring revenues and recurring expenditures, the picture is very similar. According to an analysis carried out by Standard & Poor's, recurring general fund revenues for the current fiscal year total \$8.671 billion, while recurring expenditures are projected to add up to \$9.227 billion. This gap between recurring revenues and recurring expenditures is known as the Commonwealth's structural deficit and it is expected to be around \$556 million this year. According to S&P's, this amount would be \$190 million, or 25.47%, less than the structural deficit of \$746 million registered during the past fiscal year.

In our view, however, the Commonwealth's structural deficit for fiscal year 2007-08 will probably be higher than \$556 million because the revenue figure used by S&P's, \$8.671 billion, includes \$654 million in non-recurring revenues, namely, (1) \$300 million in CFC payments to Hacienda; (2) \$190 million from the Children's Trust; (3) \$86 million that

¹ On a cash basis, the general fund deficit for fiscal year 2006-07, which includes expenses accrued during the previous fiscal year but paid during fiscal year 2007, was \$478.67 million. See Commonwealth of Puerto Rico, *Official Statement*, issued in connection with the offering of \$1,010,000,000 Tax and Revenue Anticipation Notes, October 2007, p. 13, footnote (a).

were supposed to be deposited in the Budgetary Fund; and (4) \$78 million that were supposed to be deposited in the Emergency Fund. Thus, recurring revenues amount to only \$8.017 billion.

On the expenditure side, S&P's analysis assumes that recurring expenditures amount to \$9.227 billion, however, as we mentioned above, the government has already stated publicly that the State Health Insurance Administration currently faces a \$116 million deficit. This is a recurring expenditure as the health insurance program is a Puerto Rico entitlement for the benefit of its medically indigent population. Thus, recurring expenditures amount to \$9.343 billion. By this accounting, the structural deficit will increase by \$580 million, or 77.75%, from \$746 million in fiscal year 2007 to a projected \$1.326 billion in fiscal year 2008.

In summary, the bottom line for the current fiscal year is that the general fund deficit is expected to exceed \$500 million, regardless of whether we analyze it on an accrual or on a structural basis. This would be the Commonwealth's sixth general fund deficit in a row.²

II. Fiscal Year 2008-09

The Governor announced a \$9.488 billion general fund budget for fiscal year 2008-09, an amount that is \$261 million, or 2.83%, higher than last year's general fund budget of \$9.227 billion. However, net general fund revenues are forecast to add up to only \$8.488 billion. The government plans to cover this gap with non-recurring revenues from several sources.

² The deficits recorded in the prior years are: \$250 million in FY2002-03; \$233 million in FY2003-04; \$550 million in FY2004-05; \$741 million in FY2005-06; and \$331 million in FY2006-07.

Table 2
Non-recurring Revenues

FY 08-09	Amount
Lottery concession	\$ 500,000,000
Sale of accounts receivable	\$ 500,000,000
Budgetary fund deposit	\$ 86,710,000
Emergency fund deposit	\$ 78,397,000
Catastrophic illness fund deposit	\$ 8,000,000
Total non-recurring revenues	\$ 1,173,107,000
General fund expenditures FY08-09	\$ 9,488,000,000
% non-recurring revenues	12.36%
FY 07-08	Amount
CFC payments to Hacienda ³	\$ 300,000,000
Children's Trust	\$ 190,000,000
Sale of idle properties	\$ 150,000,000
Budgetary fund deposit	\$ 86,000,000
Emergency fund deposit	\$ 78,000,000
Total non-recurring revenues	\$ 804,000,000
General fund expenditures FY07-08	\$ 9,227,000,000
% non-recurring revenues	8.71%

As shown on Table 2 above, the general fund budget for FY2008-09 includes \$1.173 billion in non-recurring revenues, an amount that is \$369 million, or 45.90%, higher than the \$804 million in non-recurring revenues included in the general fund budget for the current fiscal year.

This reliance on non-recurring revenues is quite worrisome as it shows no signs of abating. Indeed, the amount of non-recurring revenues as a portion of total general fund revenues is expected to increase from 8.71% (1 out every 12 dollars) during the current fiscal year to a projected 12.36% (roughly 1 out of every 8 dollars) for the next fiscal year. In other words, the next administration will have to find an additional \$1.173 billion *just to keep general fund expenditures at the same level*.

III. Economic Perspectives

The Puerto Rico Planning Board has released its analysis of the performance of Puerto Rico's economy during fiscal year 2007 and its forecast for fiscal years 2008 and 2009. According to the Planning Board, the local economy grew by 3.5% at current prices during fiscal year 2007. However, after taking into account the effect of inflation, the real growth rate for Puerto Rico was negative 1.8%, which is considerably below the positive 0.8% that was previously forecast.

³ This amount corresponds to a tax deficiency assessed on certain Puerto Rico subsidiaries of U.S. companies that were audited by the IRS. See *El Nuevo Día*, Thursday, August 23, 2007, p. 50.

In terms of the current fiscal year, the Planning Board forecasts Puerto Rico's GNP to decrease by an additional 2.1% in real terms. Thus, fiscal year 2008 would be second recessionary year in a row for the Commonwealth.

For fiscal year 2009, which commences on July 1, 2008, the Planning Board is projecting a rebound to positive territory and forecasts that nominal GNP will increase by 7.1%, while real GNP is forecast to increase by 2.1%. However, we believe that this 200% year-over-year increase in real GNP will be difficult to achieve because (1) the United States, Puerto Rico's largest trading partner, is basically in a recession; (2) oil prices are forecast to hover around the \$100 per barrel level for the near future and Puerto Rico is heavily dependent on oil; and (3) tightening credit conditions by local banks in response to their own balance sheet weakness and liquidity restrictions in the secondary market for mortgages in the United States.

IV. Budget Indicators

The Center for the New Economy, in fulfillment of its mission to provide rigorous, independent analysis to policymakers, the press, and the public at large, has established a fiscal analysis program to monitor and keep track of important fiscal trends affecting the Puerto Rican economy.

Table 3 below sets forth a series of budget indicators that we plan to update every year around the time when the governor submits the recommended budget to the legislature for its enactment. Among the indicators included in the table we 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 1,000 inhabitants.

Table 3
Budget Indicators

	<u>Fiscal Year</u>				<u>CAGR</u>
	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	
1. Consolidated budget (CB)	\$ 26,518,449,000	\$ 26,472,162,000	\$ 26,874,250,000	\$ 26,332,576,000	-0.23%
CB per capita	\$ 6,782.44	\$ 6,742.83	\$ 6,818.35	\$ 6,654.30	
Consolidated budget/GNP	46.74%	45.09%	44.28%	40.53%	
2. Federal funds – Total	\$ 5,092,757,000	\$ 4,949,998,000	\$ 5,447,417,000	\$ 5,561,293,000	2.98%
Federal funds/CB	19.20%	18.70%	20.27%	21.12%	
3. General fund budget (GF)	\$ 9,596,085,000	\$ 9,224,266,000	\$ 9,227,000,000	\$ 9,488,000,000	-0.38%
General fund/GNP	16.91%	15.71%	15.20%	14.60%	
4. General fund payroll	\$ 5,257,706,000	\$ 5,189,846,000	\$ 5,189,758,000	\$ 5,528,570,000	1.69%
Payroll/GF	54.79%	56.26%	56.25%	58.27%	
5. Tax revenues general fund	\$ 7,735,669,000	\$ 8,044,093,000	\$ 7,822,000,000	\$ 7,628,000,000	-0.47%
Tax revenues/GF	80.61%	87.21%	84.77%	80.40%	
Tax revenues GF/GNP	13.64%	13.70%	12.89%	11.74%	
6. GF Recurring revenues	\$ 8,545,000,000	\$ 8,621,000,000	\$ 8,017,000,000	\$ 8,315,000,000	-0.91%
GF Recurring expenditures	\$ 9,964,000,000	\$ 9,367,000,000	\$ 9,343,000,000	\$ 9,488,000,000	-1.62%
GF structural deficit	\$ (1,419,000,000)	\$ (746,000,000)	\$ (1,326,000,000)	\$ (1,173,000,000)	
Structural deficit/GF	-14.79%	-8.09%	-14.37%	-12.36%	
7. Non-recurring funds	\$ 891,000,000	\$ 506,000,000	\$ 804,000,000	\$ 1,173,107,000	9.60%
Non-recurring funds/GF	9.29%	5.49%	8.71%	12.36%	
8. Debt service general fund	\$ 623,515,000	\$ 594,474,000	\$ 554,126,000	\$ 392,924,000	-14.27%
Debt service/recurring revenues	7.30%	6.90%	6.91%	4.73%	
Debt service consolidated budget	\$ 3,305,189,000	\$ 3,501,988,000	\$ 3,465,021,000	\$ 2,839,068,000	-4.94%
Debt service/CB	12.46%	13.23%	12.89%	10.78%	
Debt service per capita	\$ 845.35	\$ 892.01	\$ 879.12	\$ 717.44	
Consolidated debt service/GNP	5.83%	5.96%	5.71%	4.37%	
9. Total public debt	\$ 43,136,300,000	\$ 46,183,300,000	\$ -	\$ -	
Total public debt per capita	\$ 11,032.68	\$ 11,763.54	\$ -	\$ -	
GNP*	\$ 56,732,900,000	\$ 58,712,400,000	\$ 60,690,000,000	\$ 64,969,000,000	4.62%
Total public debt/GNP	76.03%	78.66%	\$ -	\$ -	
10. Government employees**	224,021	216,386	212,890	213,741	-1.55%
Employees per 1,000 inhabitants	57.30	55.12	54.01	54.01	
Population***	3,909,866	3,925,971	3,941,459	3,957,225	0.40%

* Figures for 2008 and 2009 are estimates from the Puerto Rico Planning Board

** Includes central government and public corporations only; excludes municipal and federal government employees in Puerto Rico

*** Figure for 2009 is an estimate

The following is a brief analysis of each of the indicators set forth in Table 3:

1. *Consolidated budget* – The Commonwealth’s consolidated budget has decreased from \$26.518 billion in fiscal year 2006 to a projected \$26.332 billion for fiscal year 2009, a decrease of \$186 million, or 0.70%. This reduction is equivalent to a compound annual growth rate (CAGR) of negative 0.23% during the period between fiscal years 2006 and 2009. On a per capita basis, consolidated budget expenditures have also declined slightly, from \$6,782 in 2006 to a projected \$6,654 for fiscal year 2009. However, relative to per capita personal disposable income, government expenditure per capita in Puerto Rico remains fairly high. In 2006, per capita personal disposable income in the island was \$12,247; thus, per capita government spending of \$6,782 represented 55.38% of per capita personal disposable income. In contrast, federal expenditure per capita in the U.S. is approximately \$10,300, which is equivalent to roughly 31% of per capita personal disposable income of \$33,683. Finally, consolidated budget expenditures have also declined slightly relative to GNP, from 46.74% in 2006 to a projected 40.53% in 2009. Overall, the trend with respect to the consolidated budget is positive as it reveals that government has achieved a modicum of success in controlling government spending since 2006.
2. *Federal funds* – Grants from the U.S. federal government to the various government agencies of the Commonwealth are expected to total \$5.561 billion during fiscal year 2009, an increase of \$469 million, or 9.21%, relative to the \$5.092 billion received during fiscal year 2006. Thus, federal funds are expected to account for 21.12% of all consolidated budget expenditures during fiscal year 2009, an amount that is slightly higher than the 19.20% registered in 2006. This means that 1 out of every 4.75 dollars spent by the Commonwealth’s central government during the next fiscal year will come from Washington. This increase in the relative weight of federal transfers is negative 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. In this sense, our dependence on federal funds has increased moderately since 2006.
3. *General fund budget* – The Commonwealth’s general fund budget has decreased from \$9.596 billion in fiscal year 2006 to a projected \$9.488 billion for fiscal year 2009, a decrease of \$108 million, or 1.13%. This reduction is equivalent to a CAGR of negative 0.38% for the period between fiscal years 2006 and 2009. Relative to the island’s GNP, the general fund budget has declined from 16.91% in 2006 to a projected 14.60% during fiscal year 2009. Overall, the trend with respect to the general fund budget is positive as it reveals that government has achieved some success in slowing down the growth rate of government spending since 2006.
4. *General fund payroll* – The amount of the general fund allocated to payroll has increased from \$5.257 billion for fiscal year 2006 to a projected \$5.528 billion during fiscal year 2009, an increase of \$271 million, or 5.16%. This increase is equivalent to a CAGR of 1.69%. In relative terms, the portion of the general

fund allocated to payroll has increased from 54.79% in 2006 to a projected 58.27% in 2009. This trend with respect to general fund payroll expenditures is worrisome for two reasons. First, during the period between 2006 and 2009, general fund payroll has increased by \$271 million, while general fund revenues have decreased by \$108 million. Second, the payroll component is increasing at a much faster rate (1.69% per year) than overall general fund expenditures (which are decreasing at a rate of -0.38% per year). Thus, while overall general fund expenditures are down, the trend with respect to payroll is the opposite: general fund payroll spending has increased in absolute terms since 2006 and keeps rising at a fairly healthy annual rate.

5. *Tax revenue trend* – General fund tax revenues, the principal component of the general fund, have decreased slightly from \$7.735 billion in fiscal year 2006 to a projected \$7.628 billion during fiscal year 2009, a decrease of \$107 million, or 1.38%. This decrease is equivalent to a CAGR of negative 0.47%. During that same period, tax revenues as a percentage of general fund revenues have stayed essentially flat, barely decreasing from 80.61% in 2006 to a projected 80.40% during fiscal year 2009. General fund tax revenues have also declined relative to GNP, from 13.64% in 2006 to a projected 11.74% during fiscal year 2009. This erosion in the tax revenue base of the general fund could be attributed to the interplay among three different factors: (1) the recessionary environment, which tends to adversely affect government revenues; (2) lax administration of the tax laws; and (3) new legislation granting credits and deductions to specific groups. We strongly suspect that the recession is the main culprit in the case of Puerto Rico. It remains to be seen however whether the other two factors would adversely affect tax revenues once the recession is over, given that Puerto Rico does not have a strong tradition of strictly enforcing its tax laws and its government has a traditional predisposition for enacting special tax breaks. In our view, therefore, the overall trend with respect to general fund tax revenues is negative.
6. *General fund structural deficit* – The structural deficit is defined as the excess of recurring expenditures over recurring revenues. According to our analysis, the Commonwealth's structural deficit decreased from \$1.419 billion in 2006 to a projected \$1.173 billion for fiscal year 2009, a decrease of \$246 million, or 17.34%. As a percentage of total general fund expenditures, the structural deficit has also decreased, from 14.79% in 2006 to a projected 12.36% in 2009. In our view, the trend with respect to the structural deficit is mixed, as it remains to be seen whether the structural deficit will continue its downward trend after 2009.
7. *Use of non-recurring funds* – To cover its yearly deficits the Commonwealth government has turned to using non-recurring revenues. Non-recurring revenues included in the general fund have increased from \$891 million in fiscal year 2006 to the \$1.173 billion expected for 2009, an increase of \$282 million, or 31.65%. Furthermore, as discussed in section II above, the general fund budget for the current fiscal year includes \$804 million in non-recurring revenues, which is equivalent to 8.71% of the total. This amount is projected to increase to \$1.173 billion, or 12.36% of the total general fund budget, during

fiscal year 2009. Therefore, the trend with respect to the use of non-recurring revenues is negative, as every year the Commonwealth's government has to run harder just to keep in the same place.

8. *Debt service* – The amount of the general fund allocated to debt service has decreased from \$623 million for fiscal year 2006 to a projected \$392 million during fiscal year 2009, a decrease of \$231 million, or 37.07%.⁴ This decrease is equivalent to a CAGR of negative 14.27%. In relative terms, the amount allocated to general fund debt service has decreased from 7.30% of general fund recurring revenues in 2006 to a projected 4.73% of recurring revenues in 2009. The picture is similar with respect to consolidated budget. The amount of the consolidated budget allocated to debt service has decreased from \$3.305 billion in 2006 to a projected \$2.839 billion in 2009, a decrease of \$466 million, or 14.10%. This reduction is equivalent to a CAGR of negative 4.94%. In relative terms, the portion of the consolidated budget allocated to debt service has decreased from 12.46% of the total consolidated budget in 2006 to a projected 10.78% in 2009. Relative to GNP, consolidated budget debt service has also decreased, from 5.83% of GNP in 2006 to a projected 4.37% in 2009. In general terms, therefore, the debt service indicators show a positive trend as both the absolute and relative amounts dedicated to debt service have decreased since 2006.
9. *Total indebtedness* – The Commonwealth's total public indebtedness increased from \$43.136 billion as of June 30, 2006 to \$46.183 billion as of June 30, 2007, an increase of \$3.047 billion, or 7.1%. This growth rate is twice the 3.5% growth rate for the island's GNP (at current prices) reported during fiscal year 2007. This means that during fiscal year 2007 Puerto Rico's public indebtedness increased twice as fast as its national income. Relative to GNP, Puerto Rico's total public debt increased from 76.03% of GNP in 2006 to 78.66% in 2007. On a per capita basis, total public debt per capita in 2007 amounted to \$11,763, which is 93.16% of the island's per capita personal disposable income of \$12,627. In our view, therefore, the overall trend with respect to total public indebtedness is negative, as it is still growing at a much higher rate relative to the growth in Puerto Rico's GNP.
10. *Government employment* – According to data published by the Office of Management and Budget, the number of people employed by the Commonwealth (central government and public corporations) has decreased from 224,021 in 2006 to a projected 213,741 in 2009, a reduction of 10,280 workers, or 4.58%. This decrease is equivalent to a CAGR of negative 1.55%. In relative terms, the number of government employees per 1,000 inhabitants has also shown a slight decrease, from 57.30 government workers per 1,000 people, to a projected 54.01 government workers per 1,000 people in 2009. When compared to the United States, however, Puerto Rico still has relatively large

⁴ According to sources at the Government Development Bank, this decrease is due to the proposed refinancing of certain general obligation indebtedness, including the Commonwealth's outstanding auction rate debt.

government sector, as the rate of government employment in the U.S. (federal employees, excluding armed forces, per 1,000 people) is 8.95. Therefore, Puerto Rico has a government employment rate that is 6 times higher than the rate in the United States. Nonetheless, the overall trend regarding government employment is positive as the government has been able to control the growth of government employment in recent years.

V. Conclusion and Recommendations

As of April 2008 the Commonwealth's fiscal situation remains complicated. With respect to the current fiscal year, all projections are for the Commonwealth government to close the books with a general fund deficit in excess of \$500 million, which would be the Commonwealth's sixth general fund deficit in a row.

With respect to next year's general fund budget, the governor has submitted a budget that is structurally unbalanced in the amount of \$1.173 billion, or 12.36% of proposed general fund expenditures. The government plans to cover this gap by using \$1.173 billion in non-recurring revenues (roughly 1 out of every 8 general fund dollars). It is an open question whether the legislature will back such a plan.

In terms of the budget trends we discussed above, we find that the Commonwealth's overall fiscal picture is mixed at best. Several of the indicators, such as consolidated budget expenditures, general fund spending, public debt service ratios, and the government employment rate, show a relatively positive trend. On the other side of the balance sheet, we find that the reliance on federal funds, general fund payroll spending, general fund tax revenues, the use of non-recurring funds, and total public indebtedness all show clearly negative trends. One indicator, the structural deficit, shows a mixed trend.

In sum, then, we can conclude that while the government of Puerto Rico has made some advances in several areas, a lot of work still remains to be done to put our public finances in order.

In order to keep making progress to achieve that goal, we recommend the following:

- The Office of Management and Budget should publish monthly expenditure reports and improve its overall disclosure with regard to government spending.
- GNP data should be published quarterly in order to improve economic decision making.
- Budgeting should be done on a multi-year basis to reduce the reliance on non-recurring revenues and better match government resources with multi-annual obligations, such as those arising out of collective bargaining agreements negotiated under Law 45.