

Fiscal Situation Update

Fiscal Year 2008 Review
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I. A preliminary look at the fiscal 2007-08 balance

About a month ago the Puerto Rico Treasury Department released the preliminary revenue figures for fiscal year 2008. General fund net revenues totaled \$8.252 billion, which is \$610 million, or 6.88 per cent, less than the \$8.862 billion collected during the previous fiscal year.

If we compare the actual revenues received with the originally budgeted amount, we find that general fund net revenues fell \$825 million, or 9.09 per cent, short of the initially expected amount of \$9.077 billion. This original revenue estimate, however, was revised in March 2008. At that time, the Treasury announced it expected net general fund revenues to come in at the level of \$8.671 billion. Still, actual receipts were \$419 million, or 4.83 per cent, below the revised forecast and even the adjusted projections were missed.

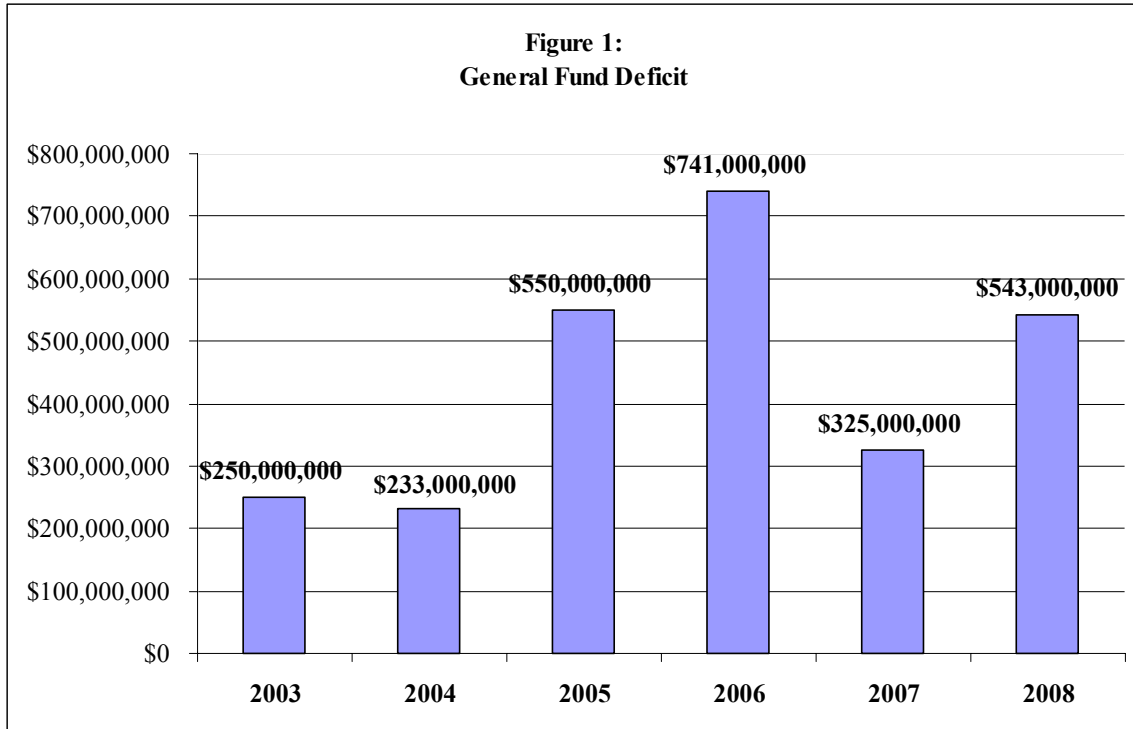
On the expenditure side, general fund expenditures were budgeted at \$9.227 billion. To that amount we have to add overspending in the amounts of \$69 million at ASES and \$53 million at the Education Department. Therefore, while the final figures will not be available for a couple of months, we can estimate general fund expenditures at least at \$9.349 billion.

The budget deficit for fiscal year 2008, thus, is initially estimated at **\$1.097 billion**, which is the difference between net general fund revenues of \$8.252 billion and expenditures of \$9.349 billion. The government plans to partially cover this deficiency with revenues from three sources:

- First, during fiscal 2008 the Commonwealth recovered approximately \$287 million in federal funds in excess of what it had budgeted. These funds were in essence a reimbursement from the federal government for amounts already advanced by the Commonwealth to the Department of Education during fiscal years 2006 and 2007.
- Second, the Government Development Bank advanced \$150 million to the Treasury in anticipation of funds to be received from the sale of certain surplus government real estate property.
- Third, the GDB lowered debt service requirements for the current fiscal year, through refinancing transactions, by \$117 million.

After applying these one-time items to the budget deficit of \$1.097 billion, the deficiency for fiscal year 2008 is reduced to **\$543 million**. The government has not yet disclosed how it expects to address this remaining shortfall.

This is the Commonwealth's sixth general fund deficit in a row. As shown in Figure 1 below, the total accumulated deficit, on an accrual basis, during the past six fiscal years is \$2.642 billion, equivalent to an annual average of \$440.33 million. This figure is equal to approximately 5 per cent of the annual general fund budget during this six year period.



II. Structural Deficit

Calculating the government's structural deficit is a little bit more complicated. The structural deficit is defined as the difference between recurring revenues and recurring expenditures. However, deciding what is recurrent and what is not sometimes is more of an art than a science. In addition, during fiscal year 2008 the Commonwealth used a significant amount of non-recurring revenues to finance recurring expenditures as well as non-general fund revenues to cover certain general fund expenses. The following analysis is, therefore, our initial attempt at calculating the fiscal year 2008 structural deficit.

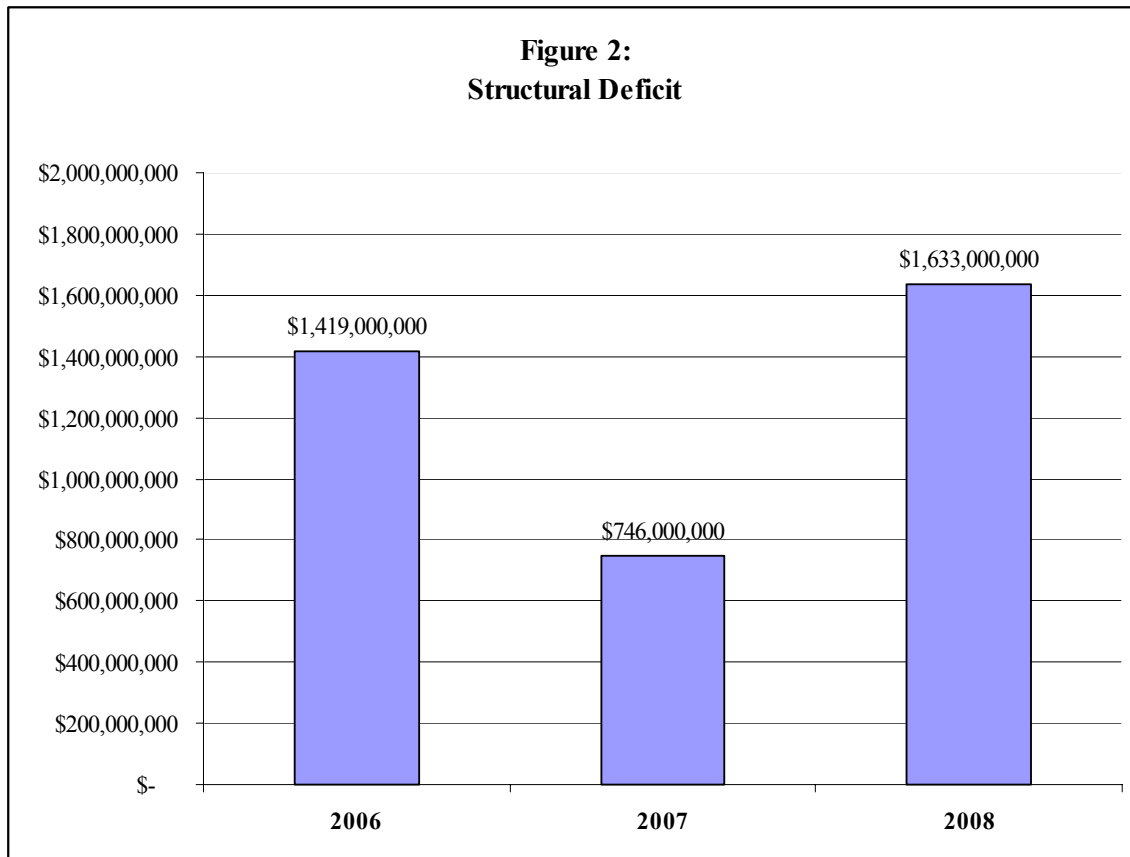
On the revenue side, we estimate the Commonwealth had total resources of \$8.995 billion available to cover general fund expenses during fiscal year 2008. From this amount we have to subtract the following non-recurring items:

- Some \$300 million budgeted by the Treasury and which were to be paid by certain controlled foreign corporations as a result of an IRS audit;
- The \$287 million reimbursed by the federal government;
- \$189 million transferred from the Children's Trust and which were used to cover payroll expenses at the Family Department;
- The \$150 million advanced by the GDB in anticipation of the sale of government property;
- \$86 million which were supposed to be deposited in the Budgetary Fund; and

- \$78 million which were supposed to be deposited in the Emergency Fund.

Thus, we estimate recurring general fund revenues at \$7.905 billion.

On the expenditure side, we estimate recurring general fund expenditures at \$9.538 billion, which is the sum of (1) general fund expenditures of \$9.349 billion plus (2) \$189 million in payroll at the Family Department and which were covered with non-recurring revenues from the Children’s Trust. Therefore, we estimate the Commonwealth’s current structural deficit at **\$1.633 billion**, the difference between recurring revenues of \$7.905 billion and recurring expenditures of \$9.538 billion.



As shown in Figure 2 above, the Commonwealth’s structural gap worsened considerably during fiscal year 2008. Indeed, the island’s structural deficit increased from \$746 million in 2007 to \$1.633 billion in 2008, an increase of \$887 million, or 118 per cent.

III. Public Debt Trend

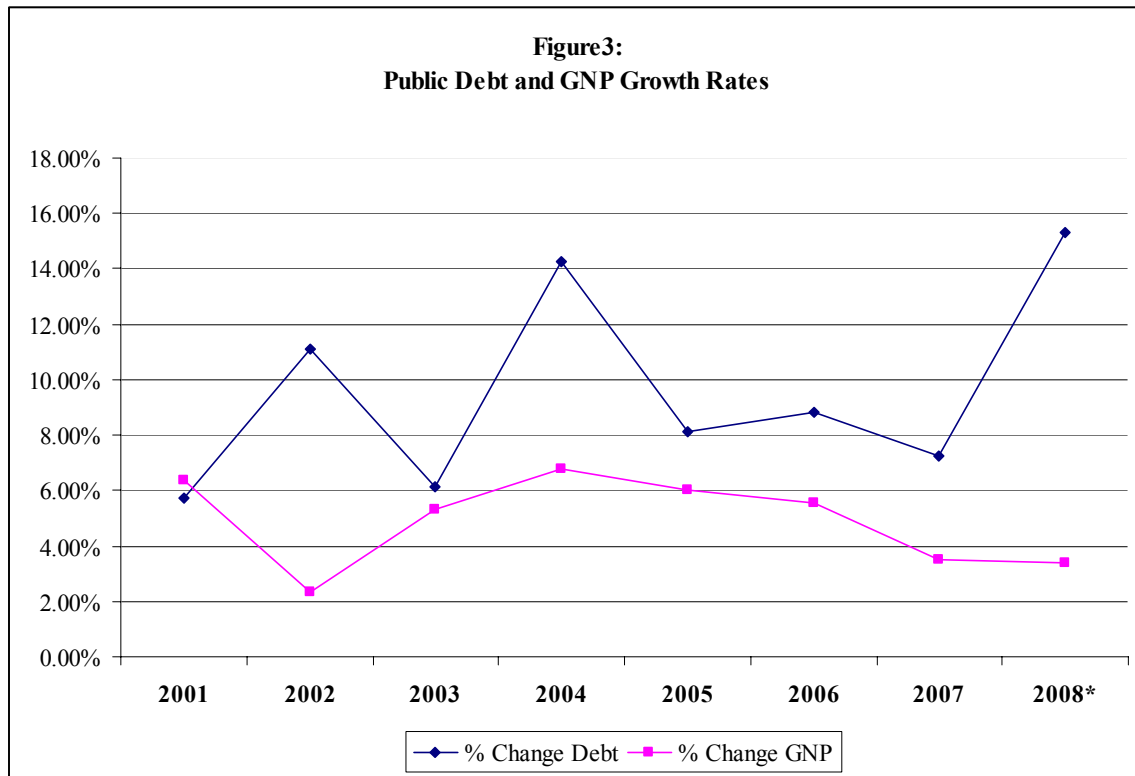
Puerto Rico’s public debt has increased considerably during the last eight fiscal years. As shown on Table 1 below, between June 2000 and June 2008, total public debt increased from \$23.821 billion to an estimated \$49.368 billion, an increase of \$25.547 billion, or 107 per cent. To put this increase in perspective, *Puerto Rico issued more debt in the last eight years than what it issued during the 25 years between 1975 and 2000.*

**Table 1:
Public Debt and GNP**

(\$millions) June 30,	Public Debt				%Δ	Nominal GNP	%Δ GNP	Debt/ GNP
	Central Govt.	Municipalities	Public Corp.	Total Debt				
2000	\$5,348.9	\$1,464.4	\$17,008.3	\$23,821.6	-	\$41,418.6	-	57.51%
2001	\$5,837.9	\$1,632.2	\$17,714.6	\$25,184.7	5.72%	\$44,046.6	6.34%	57.18%
2002	\$6,115.3	\$1,795.8	\$20,075.8	\$27,986.9	11.13%	\$45,071.3	2.33%	62.09%
2003	\$6,886.2	\$1,955.1	\$20,866.0	\$29,707.3	6.15%	\$47,479.4	5.34%	62.57%
2004	\$8,519.3	\$2,046.0	\$23,377.0	\$33,942.3	14.26%	\$50,708.7	6.80%	66.94%
2005	\$9,017.6	\$2,181.0	\$25,504.0	\$36,702.6	8.13%	\$53,752.4	6.00%	68.28%
2006	\$10,393.0	\$2,330.0	\$27,210.0	\$39,933.0	8.80%	\$56,732.9	5.54%	70.39%
2007	\$10,559.0	\$2,463.0	\$29,796.0	\$42,818.0	7.22%	\$58,712.4	3.49%	72.93%
2008*	\$10,924.8	\$2,420.5	\$36,023.5	\$49,368.8	15.30%	\$60,690.0	3.37%	81.35%
CAGR	9.34%	6.48%	9.83%	9.54%	-	4.89%	-	-

*Estimate

The increase in public debt has been driven mostly by the growth of public corporation debt, which has increased at a compound annual growth rate (CAGR) of 9.83 per cent since 2000. Following closely is the growth rate of the central government's debt, which has increased at a CAGR of 9.34 per cent.



During the same period, Puerto Rico's nominal gross national product (GNP)—the income that accrues to the island's production factors—has increased at a CAGR of 4.89 per cent. Therefore, the island's total indebtedness has increased at a rate almost twice as fast as the growth rate of its income. Indeed, as shown on Figure 3 above, total debt has increased at a faster rate than GNP every year since 2002.

This rapid increase in total public debt has led to a substantial increase in the island's debt to GNP ratio. This ratio increased from 57.51 per cent in 2000 to 81.35 per cent in 2008, the highest level since 1976, when it was 73.88 per cent.

Interestingly, the increase in total indebtedness has not produced the expected stimulus in aggregate demand. Indeed, fixed investment in Puerto Rico has remained essentially flat since 2000 and the island has been in a recession at least since February 2006. The reasons as to why Keynesian stimulus has failed to materialize have not been fully analyzed. We believe that two factors might be at play. First, we suspect that a large amount of government spending goes to imports, thus, lessening the multiplier effect in the island. In addition, we suspect that government debt issuance is crowding out private investment. That is, instead of supplementing private investment, government debt offerings actually substitute for other capital investment. This is probably due to the attractiveness of buying government bonds, which are tax exempt and essentially risk-free. Thus, they are more attractive than investing in the real economy.

IV. Recommendations

Most economic analysts and politicians would agree, if only in private, that Puerto Rico's current fiscal situation is due as much to a revenue shortfall as to excessive spending. Due to the proliferation of tax incentives, an enormously complex and unfair tax system, and inadequate tax collection efforts that miss millions of dollars in owed taxes every year, revenues *are* too little. Due to government programs that continue in existence beyond their usefulness, government hiring based on political connections rather than on policy needs, and rent-seeking behavior by the private sector, spending *is* too high.

Both sides, then, are partially right and partially wrong. They have to recognize, however, that policy proposals that address only one side of the equation are unlikely to be successful in fixing our fiscal situation. If Puerto Rico is ever going to put its public finances in good working order, then policy solutions must transcend party lines, go beyond traditional policy labels, and address comprehensively both sides of the issue.

On the revenue side, we need to:

Expand the Tax Base – The current proliferation of credits, deductions, exclusions and exemptions narrows the tax base and induces all sorts of distortions in the capital allocation process. Replacing the plethora of existing tax breaks with a universal refundable credit (for individuals) of 15 per cent would go a long way towards eliminating these distortions.

Simplify the Tax Code – Puerto Rico’s current tax code is complicated, unfair, and inefficient. These defects hamper administration, compliance, and enforcement efforts, and, in the aggregate, they decrease the overall amount of tax revenues collected. A simpler tax code, if done correctly, would generate lower enforcement and compliance costs and higher tax collections.

Lower Marginal Tax Rates – This may sound counter-intuitive at first, but recent research, especially in the field of behavioral economics, shows that high marginal tax rates make it worthwhile for people to change their economic activities and to spend considerable resources to both legally avoid and unlawfully evade taxes. Lowering marginal tax rates reduces the incentive to engage in this kind of behavior and if complemented with an expanded tax base could actually lead to higher tax collections.

Impose Green Taxes – These are taxes on activities that are harmful to the environment. They help reduce some of the most noxious effects of economic activity and provide an incentive to invest in environmentally friendly technology. In addition, they provide a new revenue stream for government.

On the spending side, we need to:

Enact Pay As You Go Procedures – The Governor should propose, and the legislature should enact, legislation requiring that (i) any bill increasing expenditures must include an offsetting decrease in other expenditures or an increase in taxes and (ii) 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. Sunsetting is the process of automatically terminating government agencies and programs after a period of time unless they are specifically reauthorized. A sunset commission could review Commonwealth government programs on a rotating basis and recommend major overhauls, privatization or elimination of programs that have outlived their usefulness.

Limit General Fund Outlays to Growth in Nominal GNP – Growth in general fund expenditures should be limited to the growth rate of nominal GNP. For example, if the Planning Board forecasts nominal GNP growth for fiscal year 2009 to be 5.0%, then the growth in government expenditures for that fiscal year should be capped at that level too.

Prepare a Three Year Financial Plan – This plan should be prepared by the Office of Management and Budget, the Department of the Treasury, and the Government Development Bank. It should establish clear and measurable financial, revenue and expenditure objectives to be achieved during the next three years. This plan would then be submitted to the governor, who will declare it to be the public policy of the Commonwealth of Puerto Rico.

Require Zero-Based Budgeting – Zero-based budgeting would end the current practice of baseline budgeting. Under baseline budgeting procedures, government programs can exist on autopilot, since budgets are written assuming an expected annual growth rate in all government programs. Zero-based budgeting would assume that every government program starts the fiscal year with zero taxpayer money and every program would have to justify its budget request from the bottom up.

We should think of the list above as a menu of policy options for our policy makers. As such, it is necessary to choose among them according to what is fiscally effective, economically reasonable, and politically possible in the current context. This task is quite difficult, but we have to start somewhere.

V. Conclusions

Our analysis leads us to the following conclusions. First, fiscal year 2008 was the sixth year in a row the Commonwealth closed the books with a deficit—a situation that differentiates Puerto Rico from the U.S. states, which have experienced deficits only during the last two fiscal years.

Second, the Commonwealth has achieved a modicum of control over expense growth. However, we note that for fiscal year 2009 general fund payroll expenses, the largest expense item in the general fund, have increased \$339 million, or 6.53 per cent, relative to the previous year. According to OMB this is due mostly driven by the obligation to honor recently negotiated collective bargaining agreements. If true, then this is cause for concern because it means the government has little flexibility to control the growth rate of its most important cost driver.

Third, government revenues have stopped growing. This situation is due largely to the current recession. However, it remains to be seen what impact the new Tax Incentives Law will have on revenues, if and when the economy resumes growth.

Fourth, Puerto Rico's indebtedness continues to increase at unsustainable levels, with little or no impact on real economic activity.

Finally, structural balance remains elusive. We need policy solutions that transcend party lines, go beyond traditional policy labels, and address comprehensively both the revenue and the spending sides of the issue.