



Research

The Economic and Budgetary Outlook for Puerto Rico: A Primer

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INTRODUCTION

Puerto Rico's governor Alejandro García Padilla has declared that the Commonwealth's debts are "not payable" and that the Island is confronting a "death spiral." This has generated greater media and policymaker attention on the economic and fiscal conditions confronting Puerto Rico, and possible solutions to those challenges.

The Commonwealth's difficulties pose interesting challenges to federal policymakers. A default by the Commonwealth on its debts would directly impact its creditors and investors. However, it would also impose hardship on nearly 4 million Puerto Rican American citizens. Should the Commonwealth's struggles persist, the current outmigration of the Puerto Rican population to the U.S. mainland will continue or accelerate, and economic conditions on the island will deteriorate.

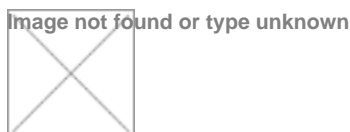
This primer seeks to describe the economic and budgetary context; specifically the historical and recent trends as well as the projected trajectory for the Commonwealth's economy and budget. This is an essential first step in order to properly evaluate the policy proposals that could ameliorate Puerto's Rico outlook. An examination of the economic and budgetary woes confronting the Commonwealth reveals that its challenges have been long in coming and cannot be assigned to any specific federal policy such as shuttering of federal facilities or changes in highly preferential tax policies. Such an examination also reveals that while the island's challenges are substantial, fundamental structural changes at a local level and sensible changes from the federal government to allow for economic growth would go a long way to promote a Puerto Rican recovery and a sustainable budgetary trajectory. In a forthcoming piece, we will examine policy prescriptions for the island.

ECONOMIC OUTLOOK

The Puerto Rican economy has been in steady decline for over a decade, which has and will continue to exacerbate the Commonwealth's fiscal challenges. The strict mathematical and practical reality is that any sustainable solution to Puerto Rico's must involve an economic growth component that boosts output, employment rolls, and income.

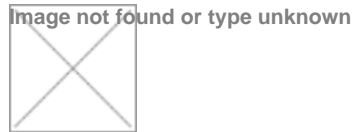
Economic Output

FIGURE 1: HISTORICAL AND PROJECTED OUTPUT



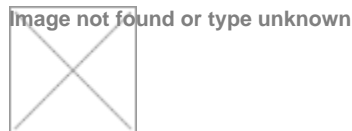
Puerto Rico has seen real output plummet since 2005, while Moody's predicts essentially stagnant territorial income for the next decade. This growth assumption incorporates an expectation of the inability of the Commonwealth to strike the proper balance between fiscal consolidation and economic growth. Pure austerity – poorly targeted tax increases and indiscriminate cessation of services – would have anti-growth effects and could contribute to tepid growth in the future, while more innovative fiscal consolidation approaches could be buttressed by enhanced revenues from stronger growth.

FIGURE 2: UNEMPLOYMENT



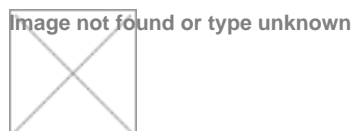
The unemployment peaked in 2010, with an increase of nearly 50 percent from 2005. While this high rate of joblessness has attenuated, it is projected to remain at persistently high levels – averaging nearly 13 percent over the next 10 years.

FIGURE 3: LABOR FORCE TRENDS



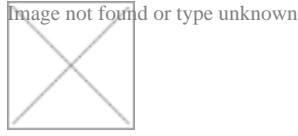
A key contributor to Puerto Rico's economic challenge has been net emigration. Over 300,000 Puerto Ricans have left since 2005, with net emigration and population decline expected to persist for the next decade, albeit at a slower pace. This has significantly curtailed the Commonwealth's labor force as a whole. Despite a declining population, the labor force participation rate has declined apace, highlighting structural weakness in labor markets beyond net emigration.

FIGURE 4: EMPLOYMENT



Echoing other indicators of the labor markets, payrolls have declined precipitously in the past ten years, while a policy-agnostic outlook assumes flat employment levels over time. Stable payrolls however, compared to recent experience, are a positive sign and could provide policymakers with a predictable wage and tax base in the contemplation of future fiscal policies.

FIGURE 5: TOTAL PERSONAL INCOME



Personal Income growth has remained under 3 percent since 2008 and is projected to average about 2 percent over the next 10 years. While far from ideal, stable income growth paired with steady payrolls could again provide a predictable wage and tax base around which to design pro-growth, fiscal consolidation.

Summary of Economic Outlook

Every major economic indicator of Puerto Rico's economic wellbeing shows a Commonwealth in a protracted retrenchment. However, there are indications that major emigration flows and steep economic declines may have passed, leaving a trajectory of tepid though predictable growth. How Puerto Rico addresses its fiscal challenges, however, could radically alter this outlook for good or for ill.

BUDGET OUTLOOK

By any objective measure, the budget outlook for Puerto Rico is troubling. The Commonwealth, through policy choices compounded by economic difficulty, has seen its debt obligations grow inexorably over the past decade and is projected to continue. Addressing these dual challenges is essential to an improved budgetary trajectory. This necessity must also reconcile immediate concerns over liquidity with the need for longer-term structural reforms.

Historical and Recent Developments

Puerto Rico has maintained structural deficits for some time, driven by economic conditions, policy choices, and unrealistic revenue and expenditure estimates.^[1] Accounting for timing shifts and non-recurring budget events, structural deficits have been and will remain considerable.

FIGURE 6: STRUCTURAL DEFICITS

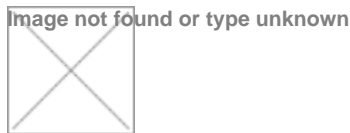


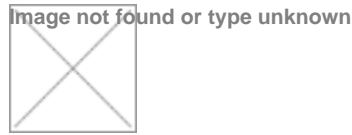
FIGURE 7: GENERAL FUND DEBT SERVICE BURDEN



With persistent borrowing, debt service has grown as a share of general fund expenditures. More indicative of a borrower's ability to repay debt however, is debt service as a share of revenues. This simple metric incorporates

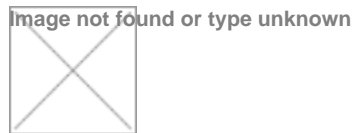
many elements that signal a borrower's wherewithal to manage debt: interest reflects not only past borrowing, but the terms and credit worthiness of the borrower demonstrated by the interest rate underlying debt service costs; revenue reflects the strength of the economy and the ability of a government to harness national resources through tax policy. A common bright-line for identifying distressed sovereign borrowers is when interest exceeds 10 percent of revenues. The Commonwealth reached this level as of March 2015.

FIGURE 8: PUBLIC DEBT



General fund debt has risen rapidly, but is only part of the problem. Puerto Rico's debt portfolio is largely driven by entities other than the central government. The Commonwealth's public sector debt has more than tripled over the last 15 years, rising to over \$72 billion today.^[2] The composition of this debt however, is instructive, and reveals the complicated nature of financing the Commonwealth's expenditures.

TABLE 1: COMPOSITION OF PUBLIC DEBT^[3]



As of June 2015, the public sector debt for Puerto Rico stood at \$71.1 billion. Over \$48 billion of this total is attributed to debt issued by Puerto Rico's public corporations^[4].

TABLE 2: DEBTS OF PUBLIC CORPORATIONS



These entities provide public and business-like services to Commonwealth residents, with the bulk of the indebtedness comprised of debt of the Sales Tax Financing Corp (COFINA), which in itself was originally created to finance existing debts; the Island's power utility (PREPA), which has recently agreed to a restructuring of some of its mature obligations; the Highway and Transportation Authority (PRHTA); the Aqueduct and Sewer Authority (PRASA); and the Public Buildings Authority (PBA).

TABLE 3: BOND RATINGS OF PUBLIC CORPORATIONS



The major ratings agencies have continuously downgraded the general obligations of the Commonwealth as well as issuances of Puerto Rico's principal public corporations, which are rated below investment grade by Fitch, Moody's and S&P.[5]

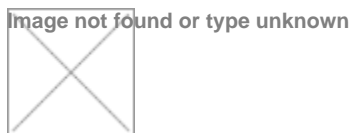
Near Term Challenges and Outlook

Prospectively, the Commonwealth faces significant challenges in both the near and long term. Of most immediate concern is the claim that Puerto Rico is facing a liquidity crisis, and will be unable to meet its payment obligations beginning in November of this year.[6] The financial advisor to the Government Development Bank for Puerto Rico estimates that this cash constraint will persist through December before improving until June. At that point Puerto Rico is again expected to face a liquidity challenge. It is important to note that this advisor also expects that the Commonwealth will be able to manage the immediate challenge. Moreover, the June challenge does not appear insurmountable, as the cash flow analysis that underpins the June shortfall assumes certain payments that should not take priority over existing obligations such as deferred tax refunds and "economic development fund" expenditures. Given these near term challenges, taking action to address the budgetary challenges and economic growth on the island is imperative.

Longer Term Challenges

As noted above, the GDP outlook is poor, with growth remaining depressed over the foreseeable future. The Commonwealth's future financing gap is also a source of serious concern.

FIGURE 9: PROJECTED BORROWING NEEDS



According to a recent estimate by former first deputy managing director of the International Monetary Fund, Anne Krueger and others, under current policy and accounting for other factors, the Commonwealth faces a financing gap of over \$64 billion over the next 10 years.[7] Under current conditions, capital markets are highly unlikely to supply this financing to the Commonwealth. Accordingly, long-lasting and meaningful policies must be pursued to confront the dual challenge of tepid growth and an unsustainable fiscal outlook and assure future access to capital markets.

CONCLUSION

The Commonwealth of Puerto has long struggled with tepid economic growth, while continuing to issue debt at multiple layers of administration. These factors have conspired force the Commonwealth into a series of reform initiatives that have as yet proven inadequate to fundamentally alter the island's flat growth prospects and deteriorating labor force trends, nor the structural imbalances in Puerto Rico finances, which if left to persist indefinitely would require unrealistic future borrowing. It is in this context that policy options for the Commonwealth must be evaluated. Policy options that would fundamentally put Puerto Rico on a sustainable path and promote much-needed growth may be difficult to implement, but they will be necessary to get the island back on its feet financially.

[1] <http://www.bgfpr.com/documents/puertoricoawayforward.pdf>