

Fiscal Situation Update



Fiscal Year 2010-2011 Budget
Volume IV, No.1
May 2010

I. Fiscal Year 2009-10

A. Budget Deficit

As of March 2010 general fund net revenues totaled \$5.158 billion, some \$285 million or 5.2 per cent, below actual receipts of \$5.443 billion as of the same date for the previous fiscal year. Yet, according to the budget documents submitted by the Governor, the Puerto Rico Treasury Department still expects net general fund revenues to total \$7.670 billion, an amount that is only \$90 million, or 1.2 per cent, below actual receipts of \$7.760 billion reported last fiscal year.

On the expenditure side, the Governor stated in his budget address to the legislative assembly that total expenditures for the current fiscal year are expected to be around \$10.170 billion, perhaps a little bit less. As shown on Table 1 below, the projected general fund deficit for the current fiscal year should be around \$2.500 billion, a figure that is \$733 million, or 22.7 per cent, less than the \$3.233 billion budget deficit registered during fiscal year 2008-09.

Table 1

Budget Deficit FY 09-10

General fund revenues	\$7,670,000,000
General fund expenditures	\$10,170,000,000
Projected budget deficit	\$ (2,500,000,000)

B. Structural Deficit

We use the term “structural deficit” as it has been defined by the credit rating agencies, which define it as the excess of recurring expenditures over recurring revenues. If we analyze the Commonwealth’s structural balance for fiscal year 2009-10, we find that recurring general fund revenues for the current fiscal year total \$7.670 billion, while recurring expenditures are projected to add up to \$9.170 billion.¹ This gap between recurring revenues and recurring expenditures, commonly known as the Commonwealth’s structural deficit, is expected to be around \$1.5 billion this year. This amount would be \$1.379 billion, or 47.9 per cent, less than the structural deficit of \$2.879 million registered during the previous fiscal year.

In sum, both the budget and structural deficits have experienced significant reductions during fiscal year 2010. However, both deficits are still in excess of \$1 billion and 2010 marks the Commonwealth’s eighth year in a row showing a general fund deficit.

¹ Total general fund spending for fiscal year 2010 is \$10.170 billion but \$1 billion is accounted as non-recurring because those funds will be used to pay special one-time benefits to workers who choose to voluntarily resign or that are laid off during the course of the fiscal year.

II. Fiscal Year 2010-11

The Governor announced an \$8.195 billion general fund budget for fiscal year 2010-11. This amount would be \$525 million, or 6.85 per cent, higher than last year's general fund budget of \$7.670 billion. However, some expenditures traditionally charged to the general fund will be charged instead against the Fiscal Stabilization Fund, a special fund set up with the proceeds of COFINA bond offerings, and these are estimated to total \$1.000 billion. Therefore, total general fund spending for the next fiscal year is estimated to be around \$9.195 billion, some \$975 million, or 9.59 per cent, lower than last year's total general fund expenditures of \$10.170 billion.

However, recurring general fund revenues are forecast to add up to only \$7.954 billion. The government plans to cover this gap with non-recurring revenues from two sources.

FY 09-10	Amount
Fiscal Stabilization Fund	\$2,500,000,000
Budgetary fund deposit	\$76,000,000
Emergency fund deposit	\$76,000,000
Total non-recurring revenues	\$2,652,000,000
General fund expenditures FY09-10	\$10,170,000,000
% non-recurring revenues	26.07%
FY 10-11	Amount
Fiscal Stabilization Fund	\$1,000,000,000
Tax enforcement measures	\$241,000,000
Total non-recurring revenues	\$1,241,000,000
General fund expenditures FY10-11	\$9,195,000,000
% non-recurring revenues	13.50%

As shown on Table 2 above, the general fund budget for fiscal year 2010-11 includes \$1.241 billion in non-recurring revenues, an amount that is \$1.411 billion, or 53.2 per cent, lower than the \$2.652 billion in non-recurring revenues included in the general fund budget for the fiscal year 2009-10.

We note, in addition, that the consolidated budget includes another \$1.025 billion in non-recurring revenues from the American Recovery and Reinvestment Act (ARRA). Thus, total non-recurring revenues included in next year's consolidated budget amount to \$2.266 billion, a reduction of \$2.113 billion, or 48.3 per cent, in comparison with the \$4.379 billion in non-recurring funds that were included in the current year's consolidated budget.

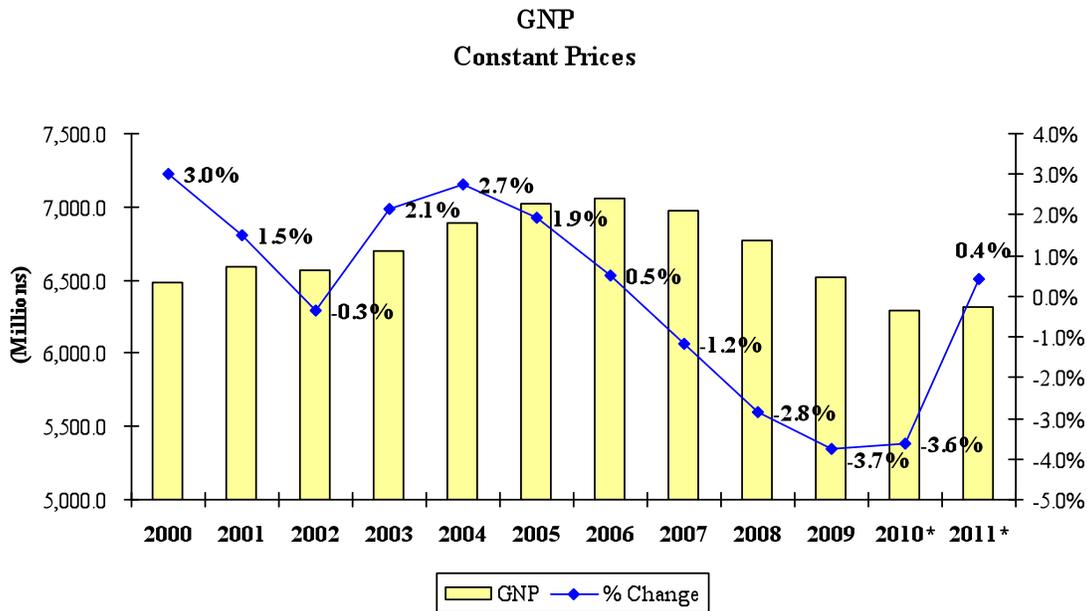
The proposed budget reflects a significant reduction in the use of non-recurring funds in comparison with the current budget. However, in our opinion, the amount of non-

recurring revenues as a portion of total general fund revenues is still relatively high at 13.5%, or roughly 1 out of every \$7.5 spent from the general fund.

III. Economic Perspectives

It is in the progressive state, while the society is advancing to the further acquisition, rather than when it has acquired its full complement of riches, that the condition of the laboring poor, of the great body of the people, seems to be the happiest and the most comfortable. It is hard in the stationary, and miserable in the declining state. The progressive state is in reality the cheerful and the hearty state for all the different orders of the society. The stationary is dull; the declining melancholy. —ADAM SMITH

Puerto Rico currently is in the fourth year of a recession. As shown on the chart below, real GNP in Puerto Rico decreased by 1.2 per cent in 2007; 2.8 per cent in 2008; 3.7 per cent in 2009; and is forecast to decrease by a further 3.6 per cent during fiscal year 2010.



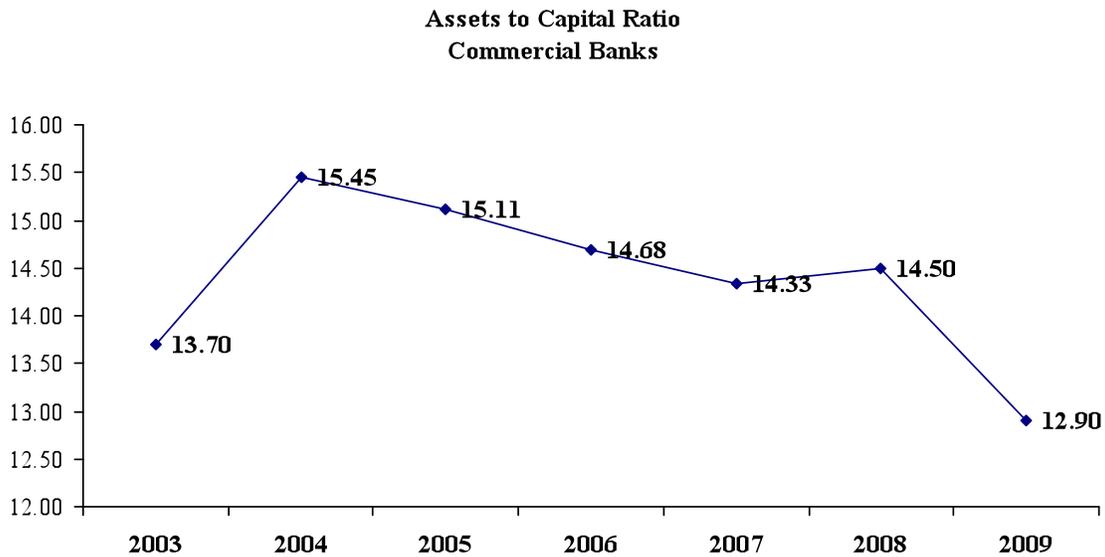
For fiscal year 2011, which commences on July 1, 2010, the Planning Board is projecting a rebound to positive territory and forecasts that nominal GNP will increase by 5.9%, while real GNP is forecast to increase by 0.4%. The Planning Board bases this economic recovery “partly on the economic restructuring measures that will be implemented by the current administration and on the impact of Public Private Partnerships.”

In our opinion this is an aggressive forecast for several reasons. First, fiscal policy in Puerto Rico is still in a contractionary mode. The consolidated budget for fiscal year 2011 is \$26.970 billion², which amounts to a net reduction of \$1.703 billion, or 5.94 per cent, when compared with the \$28.673 billion budgeted for the current fiscal year. While reining-in and cutting government spending will undoubtedly be good for the

² This amount includes \$1.025 billion in new ARRA funds.

Commonwealth's finances and credit rating, it is a terrible thing for an economy in midst of a multi-year recession.

Second, private financial institutions in Puerto Rico are under great strain. Total commercial bank assets in Puerto Rico have declined from \$101.5 billion as of December 2005 to \$89.6 billion as of December 31, 2009, a decline of \$11.9 billion, or 11.7 per cent. This means Puerto Rico is experiencing a significant credit contraction as the local financial industry is de-levering to bring the asset side of balance sheets into line with capital requirements.



As shown on the chart above, the ratio of assets to capital for commercial banks in Puerto Rico has declined from 15.45 in 2004 to 12.9 in 2009.

Furthermore, according to data from the Office of the Commissioner for Financial Institutions, commercial banks in Puerto Rico reported aggregate losses of \$567.4 million in 2009. This means that since commercial banks in Puerto Rico, on average, are leveraged 12.9 to 1, banks would have to decrease assets by \$7.3 billion just to keep their leverage stable. Obviously, it is extremely unlikely that all banks will choose to reduce their balance sheets in order to make up the losses; it is probable that some will seek to raise new capital or to establish alliances with strategic partners to strengthen their balance sheets. Nonetheless, this exercise gives us an idea of how terrible the process of de-leveraging is.

Recently, the Puerto Rico Commissioner of Financial Institutions closed three local banks, Eurobank, R-G Premier, and Westernbank, and appointed the FDIC as receiver for each of the closed institutions. The FDIC, in turn, entered into separate purchase and assumption agreements with each of Oriental Bank and Trust, Scotiabank, and Banco Popular to acquire the assets and deposits, respectively, of each of the closed banks. In total an aggregate of \$17.87 billion in assets and \$14.84 billion in deposits changed ownership pursuant to the terms of the purchase and assumption agreements.

In addition, the acquiring banks also entered into loss-share agreements with the FDIC on \$15.76 billion of assets, pursuant to which the FDIC would bear 80% of the losses arising out of the covered assets and the acquiring banks would bear the other 20%. The FDIC estimates its share of the losses on these assets to be approximately \$5.284 billion. If all those losses were to be realized, then the acquiring banks could be expected to bear a total of \$1.321 billion in losses related to the covered assets.

This contingent liability, in addition to the fact that other banks operating in Puerto Rico still hold toxic assets on their books, leads us to believe that the restructuring of the banking industry is only beginning with the FDIC-assisted transactions and further de-leveraging can be expected to continue in the immediate short-term. Therefore, while the FDIC-assisted consolidation should strengthen the financial system in the long term, it will take some time for the banking sector to stabilize and settle.

Third, any significant increases in oil prices or in short-term interest rates, due to the exploding federal deficit in the United States, could stifle any recovery. Finally, Public Private Partnerships take time to negotiate and it is not by any means clear that they will generate enough new economic activity in fiscal year 2011 to offset the negative impact of the budget cuts and tax increases enacted by the current administration.

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 100 inhabitants.

Table 3
Budget Indicators 2007-2011

	<u>Fiscal Year</u>					<u>CAGR</u>
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	
1. Consolidated Budget (CB)	\$26,471,705,000	\$27,568,459,000	\$28,670,274,000	\$28,673,475,000	\$26,970,356,000	0.47%
CB per capita	\$6,716.45	\$6,971.32	\$7,226.67	\$7,205.86	\$6,757.58	
CB/GNP	44.47%	44.81%	45.68%	44.90%	39.87%	
2. Federal funds*	\$4,949,715,000	\$5,560,761,000	\$5,756,071,000	\$7,467,101,000	\$6,929,725,000	8.78%
Federal funds/CB	18.70%	20.17%	20.08%	26.04%	25.69%	
3. General fund budget (GF)	\$9,488,000,000	\$9,242,000,000	\$9,483,792,000	\$7,670,000,000	\$8,195,125,000	-3.60%
GF/GNP	15.94%	15.02%	15.11%	12.01%	12.11%	
4. GF Payroll	\$5,189,846,000	\$5,189,758,000	\$5,528,570,000	\$2,259,500,000	\$2,716,700,000	-14.94%
Payroll/GF	54.70%	56.15%	58.29%	29.46%	33.15%	
5. Tax revenues GF	\$7,995,100,000	\$7,412,200,000	\$6,948,100,000	\$6,861,000,000	\$7,201,000,000	-2.58%
Tax revenues/GF	84.27%	80.20%	73.26%	89.45%	87.87%	
Tax revenues GF/GNP	13.43%	12.05%	11.07%	10.74%	10.64%	
6. GF recurring revenues	\$8,621,000,000	\$8,017,000,000	\$7,600,000,000	\$7,670,000,000	\$7,954,000,000	-1.99%
GF recurring expenditures	\$9,367,000,000	\$9,343,000,000	\$10,479,000,000	\$9,170,000,000	\$9,195,000,000	-0.46%
GF structural deficit	(\$746,000,000)	(\$1,326,000,000)	(\$2,879,000,000)	(\$1,500,000,000)	(\$1,241,000,000)	
Structural deficit/GF	-7.86%	-14.35%	-30.36%	-19.56%	-15.14%	
7. Non-recurring funds	\$506,000,000	\$804,000,000	\$1,173,107,000	\$4,379,000,000	\$2,266,171,000	45.47%
Non-recurring funds/CB	1.91%	2.92%	4.09%	15.27%	8.40%	
8. Debt service GF	\$594,474,000	\$554,126,000	\$834,189,000	\$893,740,000	\$832,887,000	8.80%
Debt service/recurring revenues GF	6.90%	6.91%	10.98%	11.65%	10.47%	
Debt service consolidated budget	\$3,501,988,000	\$3,041,344,000	\$3,184,823,000	\$3,773,817,000	\$4,378,763,000	5.74%
Debt service/CB	13.23%	11.03%	11.11%	13.16%	16.24%	
Debt service per capita	\$888.53	\$769.07	\$802.77	\$948.39	\$1,097.12	
Debt service CB/GNP	5.88%	4.94%	5.07%	5.91%	6.47%	
9. Total public debt	\$46,183,300,000	\$ 53,392,900,000	\$ 58,415,000,000	\$ -	\$ -	
Public debt per capita	\$ 11,717.71	\$ 13,501.63	\$ 14,724.16	\$ -	\$ -	
GNP**	\$59,520,500,000	\$61,527,000,000	\$62,758,900,000	\$63,866,000,000	\$67,653,000,000	3.25%
Total public debt/GNP	77.59%	86.78%	93.08%	-	-	
10. Government employees***	216,386	212,879	213,502	196,990	194,065	-2.69%
Government employees per 100 persons	5.49	5.38	5.38	4.95	4.86	
Population****	3,941,325	3,954,553	3,967,288	3,979,190	3,991,127	0.31%

* Includes ARRA funds for 09, 10, & 11

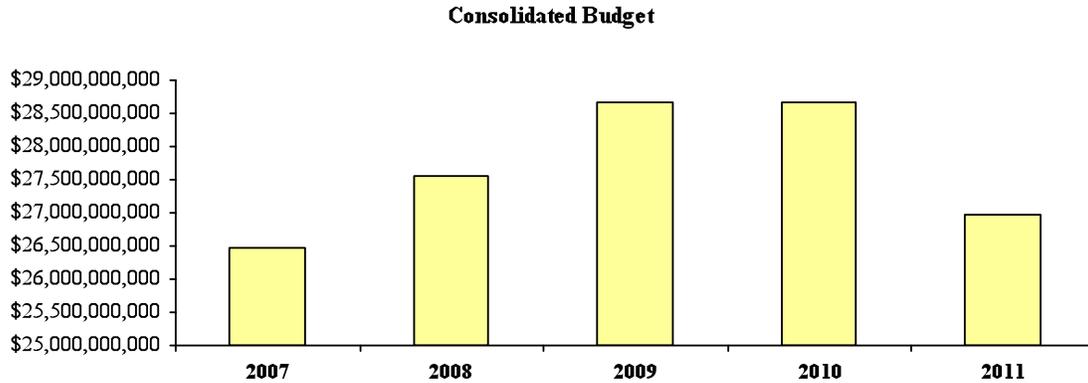
** Figures for 2010 and 2011 are PBPR estimates

*** Central government and public corporations only

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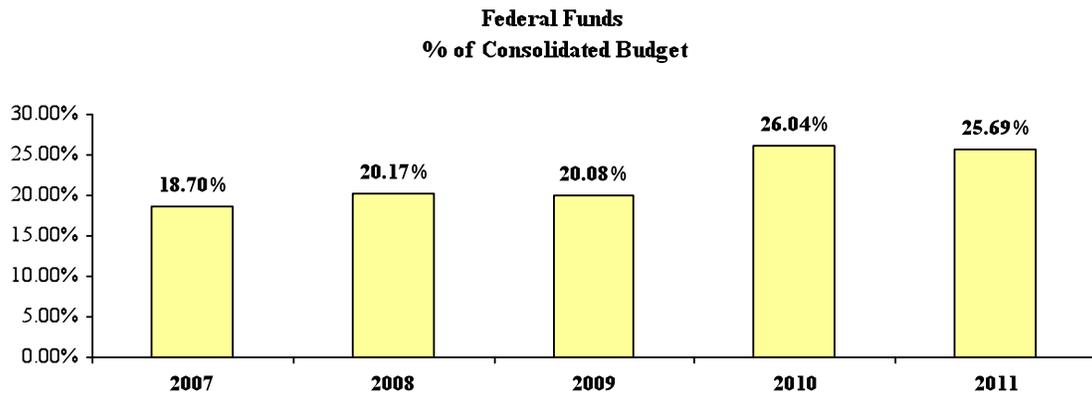
The following is a brief analysis of each of the indicators set forth in Table 3:

Consolidated Budget



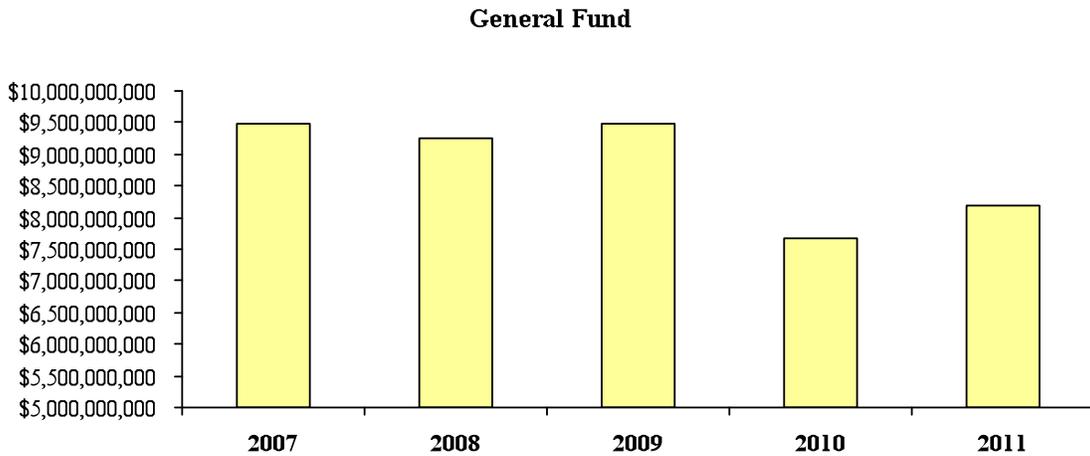
- The Commonwealth's consolidated budget has increased from \$26.471 billion in fiscal year 2007 to a projected \$26.970 billion for fiscal year 2011, an increase of \$499 million, or 1.88%. This increase is equivalent to a compound annual growth rate (CAGR) of 0.47% during the period between fiscal years 2007 and 2011, which is significantly lower than the 3.25 % CAGR of nominal GNP during the same period.
- However, relative to the consolidated budget for the current year the proposed budget for fiscal year 2011 shows a net reduction in spending of \$1.703 billion, or 5.94%.
- On a per capita basis, consolidated budget expenditures have stayed essentially flat, increasing from \$6,716 in 2007 to a projected \$6,757 for fiscal year 2011. Yet relative to per capita personal disposable income, government expenditure per capita in Puerto Rico remains fairly high. In 2009, per capita disposable personal income in the island was \$14,164; thus, per capita government spending of \$7,226 represented 51% of per capita disposable personal income. In contrast, federal expenditure per capita in the U.S. is approximately \$11,459 which is equivalent to roughly 35.32% of per capita disposable personal income of \$32,440.
- Finally, consolidated budget expenditures have declined significantly relative to GNP, from 44.47% in 2007 to a projected 39.87% in 2011.
- In our view, the overall trend with respect to the consolidated budget reveals that the Puerto Rican government has achieved significant success in restraining the growth of government spending since 2007.

Federal Funds



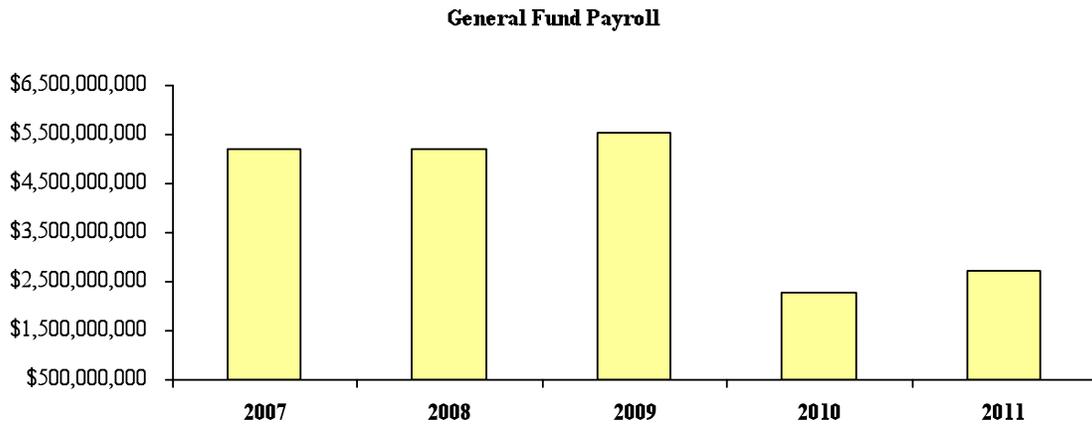
- Grants from the U.S. federal government to the various government agencies of the Commonwealth, excluding ARRA funds, are expected to total \$5.904 billion during fiscal year 2011, an increase of \$84 million, or 1.44%, relative to the \$5.820 billion received during fiscal year 2010.
- Thus, federal funds are expected to account for 21.89% of all consolidated budget expenditures during fiscal year 2011, an amount that is slightly higher than the 20.29% registered in 2010. This means that 1 out of every 5 dollars spent by the Commonwealth's central government during the next fiscal year will come from Washington.
- However, if we add the \$1.025 billion in non-recurrent ARRA funds, total federal funds increase to \$6.929 billion, or 25.69% of all consolidated budget expenditures during fiscal year 2011. This means that 1 out of every 4 dollars spent by the Commonwealth's central government during the next fiscal year will come from Washington.
- Furthermore, federal grants to the government have increased at a CAGR of 8.78%, significantly higher than the rate of growth of the overall consolidated budget, which in the period under study was only 0.47%.
- In our opinion, 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 simple terms, our dependence on federal funds has increased significantly over the last five years.

General Fund Budget



- The Commonwealth's general fund budget has decreased from \$9.488 billion in fiscal year 2007 to a projected \$8.195 billion for fiscal year 2011, a decrease of \$1.293 billion, or 13.62%. This reduction is equivalent to a CAGR of negative 3.6% for the period between fiscal years 2007 and 2011.
- However, the magnitude of this decrease is deceptive because, as we noted above, some expenditures traditionally charged to the general fund will be charged instead against the Fiscal Stabilization Fund, a special fund set up with the proceeds of COFINA bond offerings. During fiscal year 2011 the general fund is slated to receive \$1.000 billion from this special fund.
- Actual general fund spending for the next fiscal year is estimated to be around \$9.195 billion, some \$293 million, or 3.08 per cent, higher than fiscal year 2007 general fund budget of \$9.488 billion.
- Relative to the island's GNP, the general fund budget has declined from 15.94% in 2007 to a projected 12.11% during fiscal year 2011. If we use the actual spending figure, relative to GNP the general fund has also decreased significantly from 15.94% in 2007 to 13.6% in 2011.
- Overall, the trend with respect to the general fund budget reveals that government has significantly reduced general fund spending. However, we note that implementing this reduction during a recessionary period may have induced procyclical effects, generally worsening Puerto Rico's economic situation.

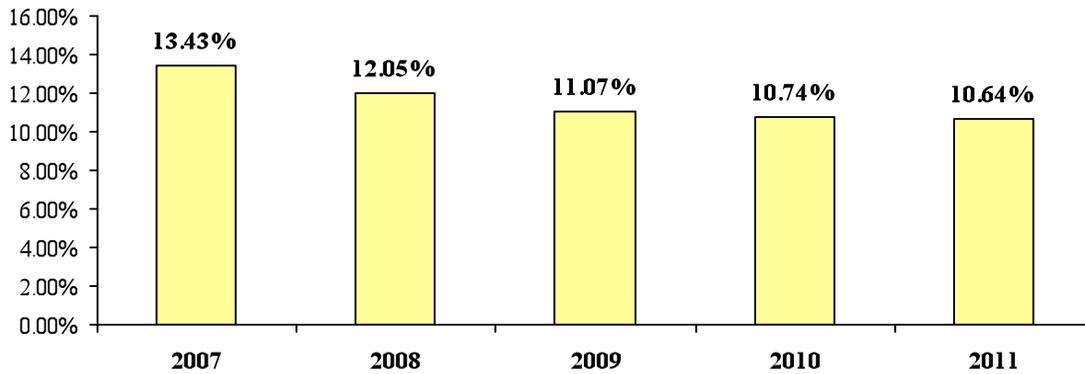
General Fund Payroll



- The amount of the general fund allocated to payroll has decreased from \$5.189 billion for fiscal year 2007 to a projected \$2.716 billion during fiscal year 2011, a decrease of \$2.473 billion, or 47.65%. This decrease is equivalent to a CAGR of negative 14.94%.
- While the general fund payroll has been decreasing during the last few years, it is important to note that relative to fiscal year 2010 the proposed budget includes a net increase in these expenditures, from \$2.259 billion to \$2.716 billion, an increase of \$457 million, or 20.23%.
- In relative terms, the portion of the general fund allocated to payroll has decreased from 54.7% in 2007 to a projected 33.15% in 2011. Again, the amount of this reduction needs to be taken with a grain salt as it is evident that the government is charging a significant amount of this “saving” to the Fiscal Stabilization Fund. We can state this with certainty because a \$2.5 billion reduction in payroll would entail the layoff of over 60,000 government workers and the government has not announced layoffs of that magnitude.
- Therefore, the trend with respect to payroll is uncertain at this time, as we are not able to discern how much of the Stabilization Fund will be used to defray general fund payroll expenditures this fiscal year.

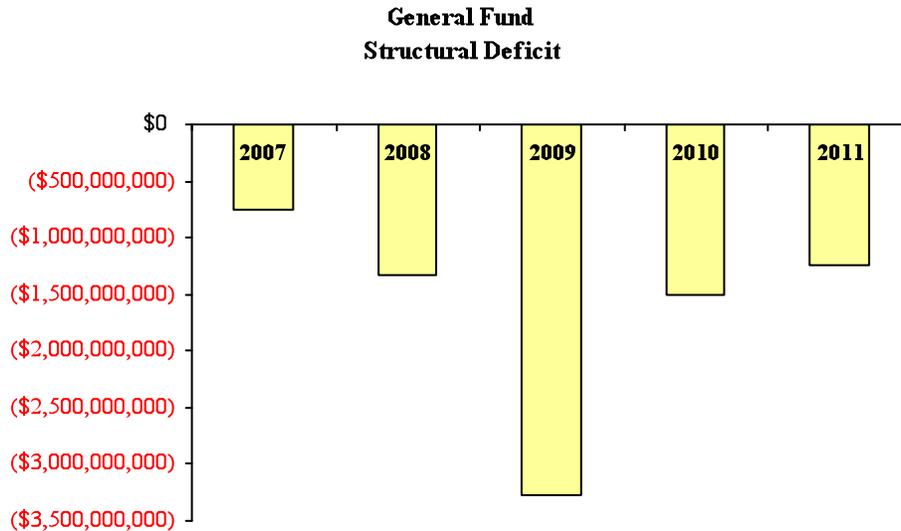
Tax Revenue Trend

GF Tax Revenues as % of GNP



- General fund tax revenues, the principal component of the general fund, have decreased from \$7.995 billion in fiscal year 2007 to a projected \$7.201 billion during fiscal year 2011, a decrease of \$794 million, or 9.93%. This decrease is equivalent to a CAGR of negative 2.58%.
- During that same period tax revenues as a percentage of general fund revenues increased from 84.27% in 2007 to a projected 87.87% during fiscal year 2011.
- More significantly, general fund tax revenues have declined relative to GNP, from 13.43% in 2007 to a projected 10.64% during fiscal year 2011, notwithstanding the tax increases, both temporary and permanent, enacted last year. 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 have a material adverse effect on government revenues; (2) lax administration of the tax laws; and (3) new tax legislation granting new tax privileges.
- 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.

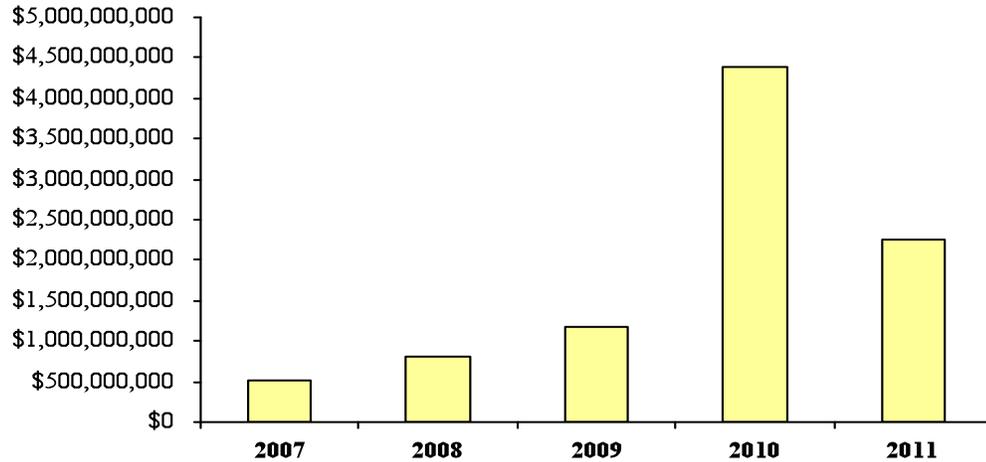
General Fund Structural Deficit



- The structural deficit is defined as the excess of recurring expenditures over recurring revenues. According to our analysis, the Commonwealth’s structural deficit has increased from \$746 million in 2007 to a projected \$1.241 billion for fiscal year 2011, an increase of \$495 million, or 66.4%. The projected structural deficit of \$1.241 billion is the difference between recurring revenues of \$7.954 billion and recurring expenditures of \$9.195 billion.
- The government estimates the structural deficit for fiscal year 2011 will be around \$1.000 billion. The \$241 million difference between our estimate and the government’s is due to the government’s recognition in fiscal 2011 of some \$241 million in revenue from tax enforcement measures that we do not consider to be recurrent. We also note that we are counting as recurrent revenues for fiscal year 2011 revenues derived from several temporary tax measures that became effective this fiscal year and which are expected to terminate in fiscal year 2013.
- Relative to the current fiscal year, the general fund structural deficit decreases from \$1.5 billion to \$1.241 billion in fiscal year 2011, a reduction of \$259 million, or 17.27%.
- Finally, as a percentage of total general fund expenditures, the structural deficit has also increased, from 7.86% in 2007 to a projected 15.14% in 2011. In our view, the trend with respect to the structural deficit is negative because it has increased considerably as a percentage of the general fund over the last few years.

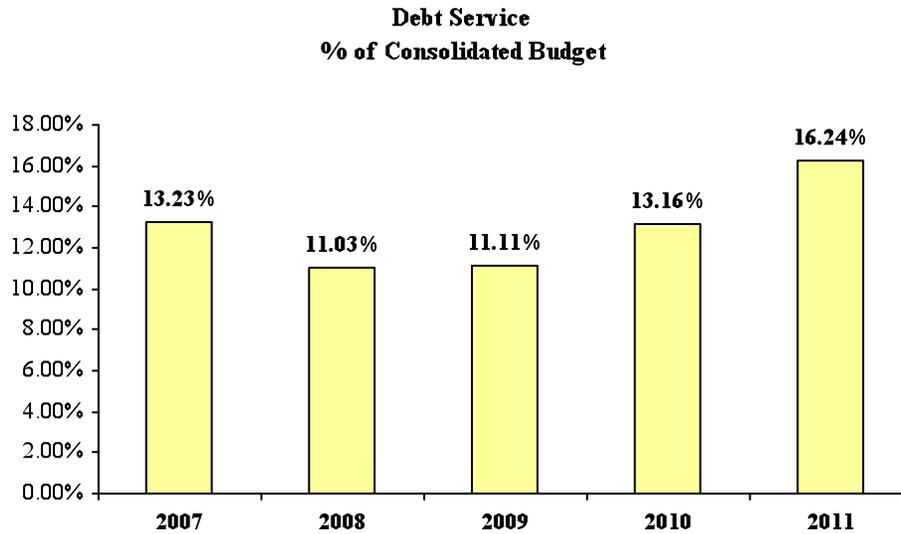
Use of Non-recurring Funds

Non-Recurring Revenues



- To cover its yearly deficits the Commonwealth government has turned to using non-recurring revenues. Total non-recurring revenues included in the *consolidated budget* have increased from \$506 million in fiscal year 2007 to \$2.266 billion for 2011, an increase of \$1.760 billion, or 347.8%.
- However, the *general fund* budget for fiscal year 2010-11 includes \$1.241 billion in non-recurring revenues, an amount that is \$1.411 billion, or 53.21 per cent, lower than the \$2.652 billion in non-recurring revenues included in the general fund budget for the fiscal year 2009-10.
- Therefore, the proposed general fund budget reflects a considerable reduction in the use of non-recurring funds in comparison with the current budget and that is a positive trend. However, in our opinion, the amount of non-recurring revenues as a portion of total general fund revenues remains relatively high at 13.5%, or roughly \$1 out of every \$7.5 spent from the general fund.

Debt Service

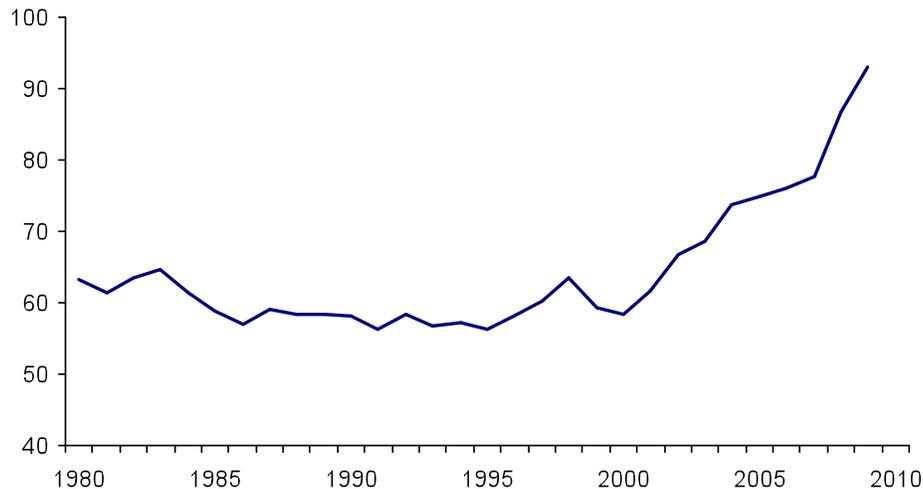


- The amount of the general fund allocated to debt service has increased from \$594 million for fiscal year 2007 to a projected \$832 million during fiscal year 2011, an increase of \$238 million, or 40.06%. This increase is equivalent to a CAGR of 8.80%.
- In relative terms, the amount allocated to general fund debt service has increased significantly from 6.90% of general fund recurring revenues in 2007 to a projected 10.47% of recurring revenues in 2011. This trend is cause for concern because general fund recurring revenues have decreased at an average rate of 1.99% over the last five fiscal years, yet debt service from the general fund has grown at 8.8% per year.
- The picture is similar with respect to consolidated budget. The amount of the consolidated budget allocated to debt service has increased from \$3.501 billion in 2007 to a projected \$4.378 billion in 2011, an increase of \$877 million, or 25.05%. This increase is equivalent to a CAGR of 5.74%.
- In relative terms, the portion of the consolidated budget allocated to debt service has increased significantly, increasing from 13.23% of the total consolidated budget in 2007 to a projected 16.24% in 2011. This means that \$1 out of every \$6 spent by the government of Puerto Rico is allocated for debt service.
- Relative to GNP, consolidated budget debt service has increased slightly, from 5.88% of GNP in 2007 to a projected 6.47% in 2011.
- In general terms, the debt service indicators show a negative trend because both the absolute and relative amounts dedicated to debt service have increased significantly since 2007.

Total Indebtedness

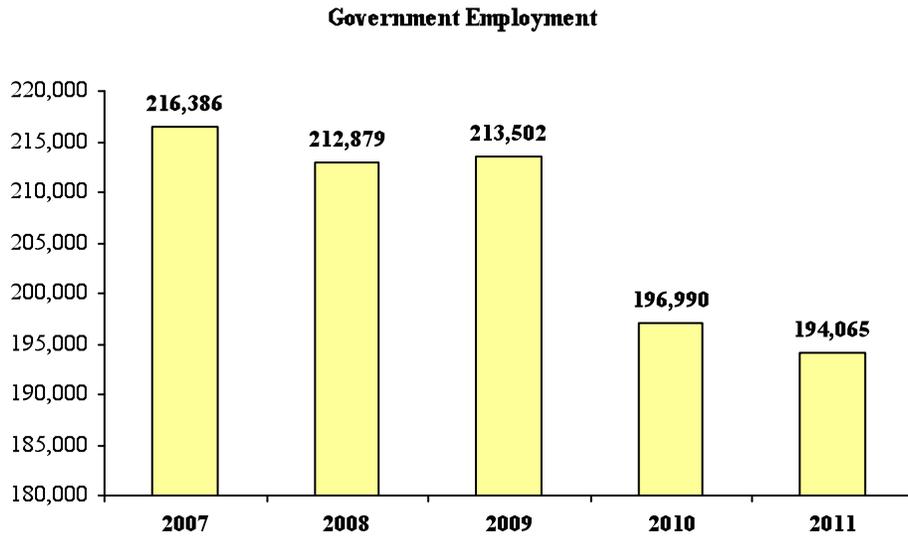
- The Commonwealth's total public indebtedness increased from \$46.183 billion as of June 30, 2007 to \$58.415 billion as of June 30, 2009, an increase of \$12.232 billion, or 26.49%. This growth rate is almost five times the 5.4% growth rate for the island's GNP (at current prices) reported during the same period. This means that during this period Puerto Rico's public indebtedness increased five times as fast as its national income.

Public Debt (%GNP)



- Relative to GNP, Puerto Rico's total public debt increased from 77.59% of GNP in 2007 to 93.08% in 2009. On a per capita basis, total public debt per capita in 2009 amounted to \$14,724 which is 103.95% of the island's per capita personal disposable income of \$14,164.
- In our view, 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.

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 only) has decreased from 216,386 in 2007 to a projected 194,065 in 2011, a reduction of 22,321 workers, or 10.32%. This decrease is equivalent to a CAGR of negative 2.69%. In relative terms, the number of central government employees per 100 inhabitants has also shown a decrease from 5.49 government workers per 100 people to a projected 4.86 government workers per 100 people in 2011.
- Contrary to popular belief, if we compare Puerto Rico's rate of state and local employees per 100 inhabitants with the United States the difference is not significant. According to the U.S. Census Bureau, in 2008 there were 16,668,184 state and local government employees in the United States out of a total population of 307,006,550. This amounts to 5.43 state and local workers per 100 people.

V. Public Debt

Puerto Rico's public indebtedness continues growing at an unsustainable pace.

June 30, (\$MM)	Public Debt	% Δ	GNP	% Δ	PD/GNP
2000	\$24,188.7	--	\$41,418.6	--	58.40%
2001	\$27,159.6	12.28%	\$44,046.6	6.34%	61.66%
2002	\$30,032.6	10.58%	\$45,071.3	2.33%	66.63%
2003	\$32,524.5	8.30%	\$47,479.5	5.34%	68.50%
2004	\$37,433.6	15.09%	\$50,708.7	6.80%	73.82%
2005	\$40,268.3	7.57%	\$53,752.4	6.00%	74.91%
2006	\$43,136.3	7.12%	\$56,732.3	5.54%	76.03%
2007	\$46,183.3	7.06%	\$59,520.6	4.91%	77.59%
2008	\$53,392.9	15.61%	\$61,527.0	3.37%	86.78%
2009	\$58,415.0	9.41%	\$62,758.9	2.00%	93.08%
CAGR	10.29%		4.73%		

As shown on Table 4 above, between June 30, 2000 and June 30, 2009, Puerto Rico's public debt increased at a compound annual growth rate of 10.29%, while GNP grew at a CAGR of only 4.73% in nominal terms. Thus, during this period Puerto Rico's debt increased at a rate more than twice that of its nominal GNP.

Even more worrisome is the fact that during fiscal year 2009 total public debt increased by 9.41%, while Puerto Rico's GDP increased by only 2.00%. Furthermore, as of June 2009 the debt to GNP ratio stood at an all-time high of 93.08%, a significant increase from its 58.40% level in 2004. Needless to say, it is unlikely these rates of indebtedness can be sustained for much longer.

VI. Conclusion

There are no conditions of life to which a man cannot get accustomed, especially if he sees them accepted by everyone around him. —LEO TOLSTOY

As of May 2010 the Commonwealth's fiscal situation remains complicated. With respect to the current fiscal year, projections are for the Commonwealth government to close the books with a general fund deficit of \$2.500 billion, which would be the Commonwealth's eighth 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 \$1.241 billion, or 15.14% of proposed general fund expenditures. The government plans to cover this gap with \$1.241 billion in non-

recurring revenues from the Fiscal Stabilization Fund and from new tax enforcement measures.

In terms of the budget trends we discussed above, we find that the Commonwealth's overall fiscal picture remains mixed. The highlights for this year are:

- Puerto Rico has undertaken significant efforts to bring the Commonwealth's finances under control. These efforts have yielded results in terms of reducing both the budget and structural deficits.
- The government is increasingly dependent on federal funds for its operations. During fiscal year 2011 it is forecast that \$1 out of every \$4 spent by the government will come from Washington.
- The trend with respect to the general fund budget reveals that government has significantly reduced general fund spending over the last three years.
- Tax revenues continue to sag. General fund tax revenues, the principal component of the general fund, have decreased from \$7.995 billion in fiscal year 2007 to a projected \$7.201 billion during fiscal year 2011, a decrease of \$794 million, or 9.93%.
- Structural balance remains elusive. The Commonwealth's structural deficit is projected to be around \$1.241 billion for fiscal year 2011.
- The reliance on non-recurring revenues continues to be worrisome. Total non-recurring revenues included in the consolidated budget have increased from \$506 million in fiscal year 2007 to \$2.266 billion for 2011, an increase of \$1.760 billion, or 347.8%.
- Debt service costs keep increasing faster than the economy as well as relative to the overall consolidated budget. The amount of the consolidated budget allocated to debt service has increased from \$3.501 billion in 2007 to a projected \$4.378 billion in 2011, an increase of \$877 million, or 25.05%. This increase is equivalent to a CAGR of 5.74%.
- The portion of the consolidated budget allocated to debt service has increased significantly, increasing from 13.23% of the total consolidated budget in 2007 to a projected 16.24% in 2011. Next year \$1 out of every \$6 spent by the government of Puerto Rico is allocated for debt service.
- Puerto Rico's public indebtedness continues growing at an unsustainable pace. During fiscal year 2009 total public debt increased by 9.41%, while Puerto Rico's GDP increased by only 2.00%. Furthermore, as of June 2009 the debt to GNP ratio stood at an all-time high of 93.08%, a significant increase from its 58.40% level in 2004.

The control and reduction of government spending has stabilized the Commonwealth's financial position. Unfortunately, this stabilization is not cost free. The implementation of this contractionary fiscal policy in the middle of a four year recession may have deepened and prolonged the economic recession in Puerto Rico.

Furthermore, the government's pro-cyclical fiscal policy has been implemented at the same time that commercial banks in the island are undergoing a de-leveraging process that has significantly reduced the availability of credit.

The unintended conjunction of these two events has inflicted severe damage to the Puerto Rican economy. For example:

- Bank assets have declined by \$11.9 billion between 2005 and 2009, a reduction of 11.7 %.
- Real GNP has declined by 10.9 per cent between 2006 and 2010.
- Employment has declined by 195,000 between March 2007 and March 2010, equivalent to 13.6 per cent of the labor force of 1,432,000 in March 2007.
- Finally, the inventory of unsold residential units is estimated to be around 20,000 units, while close to 50% of all construction loans in Puerto Rico are classified as non-performing.

Puerto Rico needs new investment to grow but at this point neither the government nor private banks are in a position to finance it. Issuing additional public debt is one of the few arrows left in the government's economic policy quiver to stimulate economic growth. However, with a debt to GNP ratio of 93% as of June 2009, incurring additional public indebtedness appears to be an increasingly unlikely source of financing for new investment over the short and medium term. In addition, the financial position of most, if not all, public corporations remains weak. Public Private Partnerships may bring in some new capital, but it is unlikely they will have a significant impact in the short term, and definitely not sufficient to push Puerto Rico out of the recession during fiscal year 2011.

In sum, Puerto Rico's financial and economic situation remains in flux and the times call for creative, innovative policymaking. It is also fairly obvious that it will take several years of hard work before the Puerto Rican economy is restored to anything resembling normalcy. The new normal state of affairs will be significantly different; we will have lower economic growth, higher unemployment, a smaller government, less conspicuous consumption and more saving. We need to accept this new state of affairs, adjust our behavior accordingly, and get on with our lives.