



For Puerto Rico, There is a Better Way

A Second Look at the Commonwealth's Finances and Options Going Forward

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Bios

Jose Fajgenbaum is Director of Centennial Group Latin America. Prior to joining the Centennial Group, he worked at the IMF for more than 30 years, where he advanced from economist to Deputy Director. His key role included leading missions to surveillance countries, such as Brazil, Israel, Russia and South Africa, as well as to countries with economic countries supported by the IMF, such as Brazil in the early 1990s, the Dominican Republic, Kenya, Malawi, Peru and Trinidad and Tobago. He holds a BA from the National University of Cuyo, an MA in economics from the University of Chicago, and completed his Doctoral studies in economics at the University of Chicago.

Jorge Guzman is a consultant for Centennial Group Latin America. He worked at the IMF for 27 years as a macroeconomist, including as mission leader to countries with IMF-supported structural adjustment programs in Latin America and the Caribbean. He holds a B.S. in Electrical Engineering from the U.S. Military Academy (“West Point”) and a Ph.D. in Economics from Georgetown University.

Claudio Loser is Founding Director and Chief Executive Officer of Centennial Latin America. He is a well-known authority on Latin American economies and institutions. During his career at the International Monetary Fund he held many senior positions, including Director of the Western Hemisphere Department. Under his leadership, the Department was actively involved in a wide range of surveillance, technical assistance, and research activities. Recently he has worked closely with the G-24, the Andean Finance Corporation (CAF), the Rio Group of Latin American Cooperation, and with a number of other financial corporations, dealing with developments in Latin America and the evolving relations between these countries and the IMF. He is a Senior Fellow at the Inter-American Dialogue, a Washington-based forum for opinion leaders and policymakers on Western Hemisphere affairs. He teaches international economics and finance at the George Washington University. He has published in many journals, mostly on Latin American economic issues. He graduated from the University of Cuyo, Argentina and received his Masters of Arts and PhD from the University of Chicago in 1967 and 1971, respectively.

Executive summary

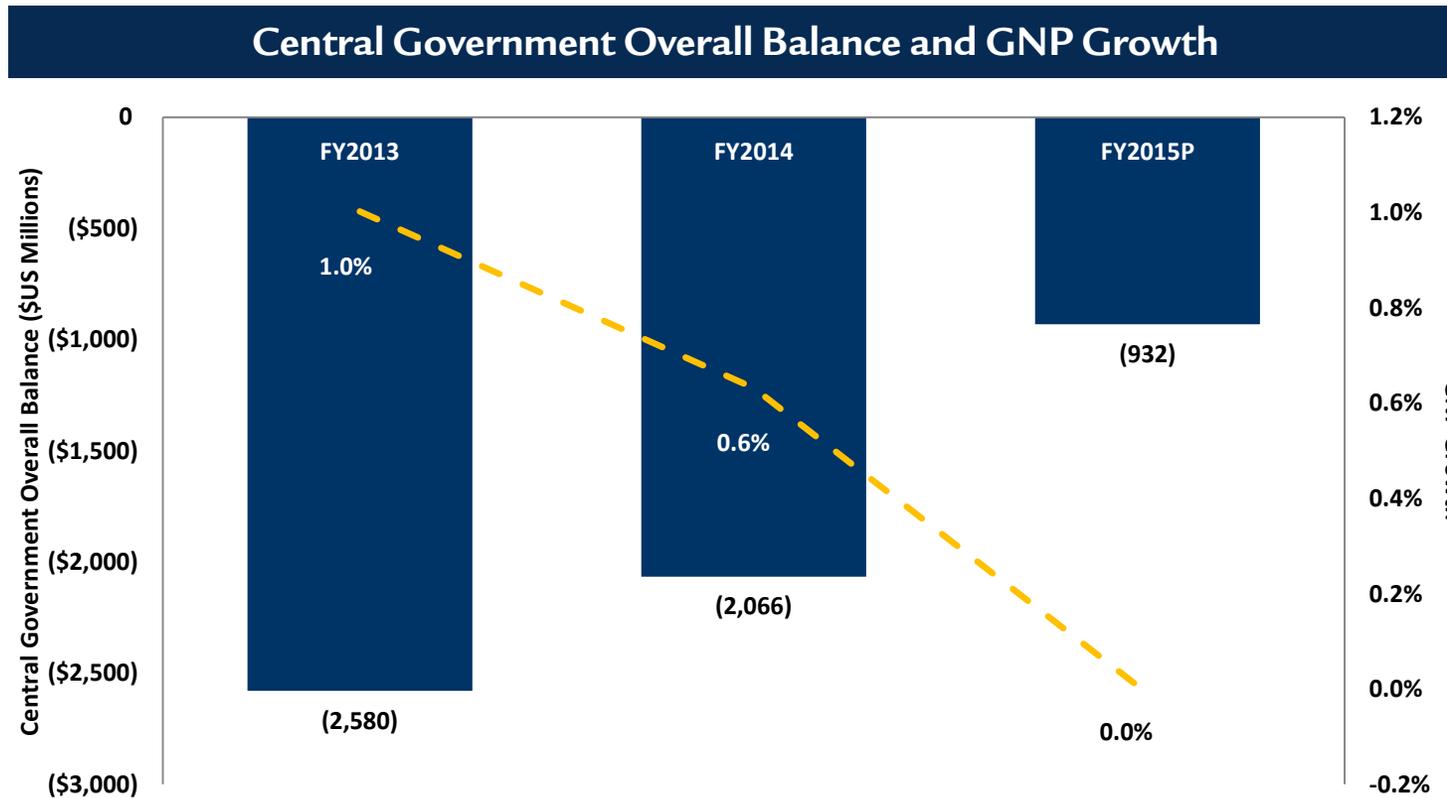
Puerto Rico can avoid a costly default even after consideration of the Krueger Report (the “Report”)

- Puerto Rico has a deficit problem, not a debt problem
- Deficit is fixable and extensive history exists of other governments that made similar or greater fiscal adjustments and subsequently grew their economies
- Path laid out by the Governor has significant risks and is not the answer to Puerto Rico’s deficit problem
 - Ignores legal limitations and the priority granted to GO and Commonwealth guaranteed debt by the Puerto Rico Constitution
 - Ignores large and long lasting economic costs
 - Ignores significant costs to on-island retail and institutional investors who hold substantial amounts of the Commonwealth’s obligations
- Puerto Rico has ~18 different debt issuing entities that make up the \$72 billion of outstanding debt. Each entity has its own legal particularities and financial capacities and thus each should be considered individually

Puerto Rico government has begun to make a fiscal adjustment

Puerto Rico's true deficit has been shrinking

- Deficit estimated to be only 1.3% of GNP in FY2015



Source: "Puerto Rico – A Way Forward" - 7/13/2015

Krueger Report shows path forward without need for a default

Report demonstrates the ability of Puerto Rico to generate a growing surplus

- Report suggests several measures for both fiscal and structural reform
- Fiscal reform measures
 - Revenue increases of \$3 billion per year by 2020, \$4 billion per year by 2025
 - Adoption of increased SUT
 - Income tax surcharge on corporations receiving exemptions, eventual move to flat rate
 - Step up in property taxes (real property values were last assessed in 1958)
 - Increased individual income taxes from higher labor participation
 - Expense cuts of \$2 billion per year by 2020, \$2.5 billion by 2025
 - Freeze formula-based General Fund appropriations
 - Reduce number of teachers to fit the size of the student population
 - Reduce subsidy to University of Puerto Rico
 - Cut excess Medicaid benefits
- Structural reform measures
 - Amend local labor laws regarding overtime, vacation time, mandatory bonuses, and others
 - Make welfare benefits consistent with local labor market conditions
 - Reduce transportation costs by seeking Jones Act exemption
 - Reduce energy costs via PREPA reform
 - Modernize / improve processes to facilitate new business startups in Puerto Rico
 - Specifically, property registrations, new business permits and tax collections

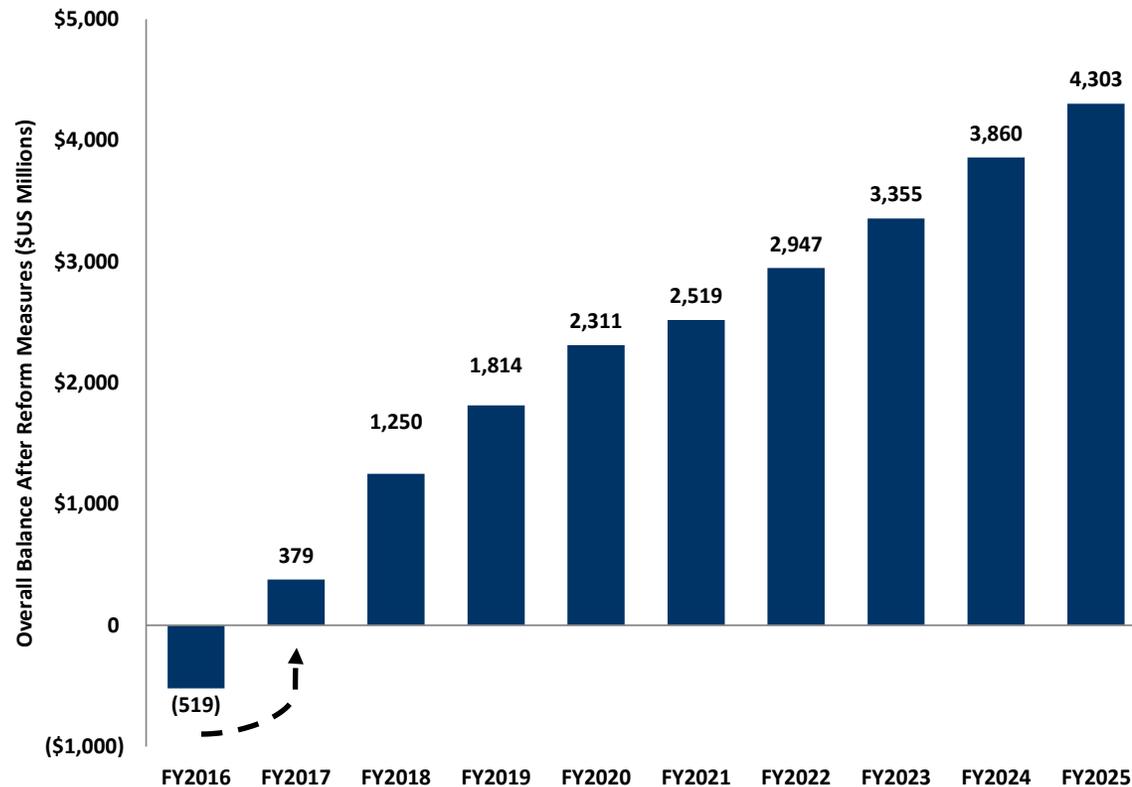
Source: Commonwealth reports

Krueger Report shows path forward without need for a default (continued)

Report includes reform measures that can lead the Commonwealth to fiscal surpluses

- Below chart shows central government overall balance after including revenue and expenditure reforms and the GNP effects of such reform as included in the Report
 - Assumes status quo with respect to ACA and Act 154
- Financing should be utilized to provide bridge to implement reform measures

Central Government Overall Balance After Reform Measures



- Transition to fiscal surplus, after payment of interest, by FY2017
- Positive overall balances (i.e. FY2017 and later) allow debt levels to be paid down

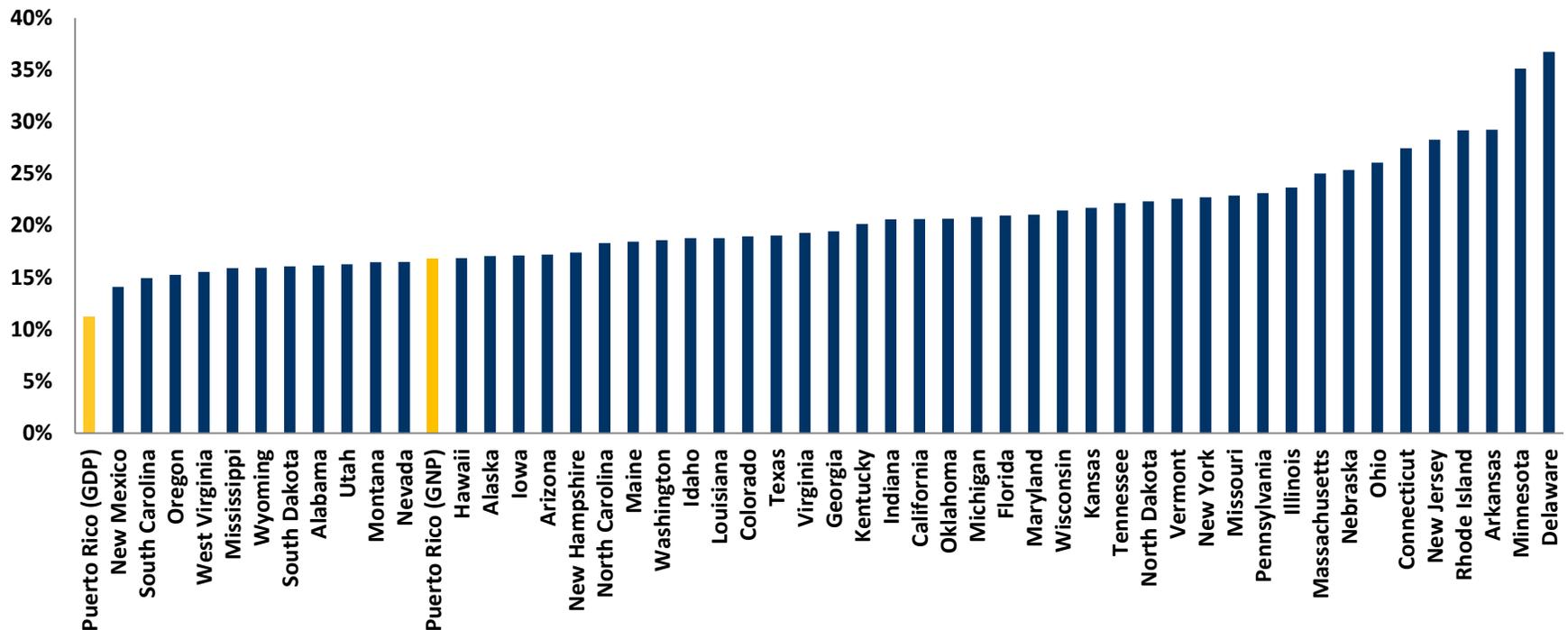
Source: "Puerto Rico – A Way Forward" - 7/13/2015

Puerto Rico has room to increase revenues

Puerto Rico's federal and state tax collections are low compared to US states

- Commonwealth has opportunity to increase revenue while maintaining tax levels inline with the US states
- Below chart shows state and federal taxes as a percent of GDP for the US states, Puerto Rico is shown both as a percent of GNP and GDP

State and Federal Tax Collections as a % of GDP/GNP ⁽¹⁾



Sources: Commonwealth reports, IRS and US Bureau of Economic Analysis

Notes:

(1) For FY2013.

Puerto Rico has room to increase revenues (continued)

Improve tax collection rates

- Estimated that Puerto Rico sales tax compliance is 56% ⁽¹⁾ compared with an average of 83% ⁽²⁾ in the 50 states
- Extrapolation would suggest an incremental \$1.1 ⁽³⁾ billion available if Puerto Rico sales tax collection rates could be improved to the 50 state average
 - Sales tax is only a small part of the broader tax collections
- An increase in compliance rates would provide additional revenue to the government without increasing the burden on the existing tax base
- Increased fiscal flexibility associated with improved tax compliance can be used to facilitate further GNP growth in the medium-term

Source: Commonwealth reports , KPMG and IRS

Notes:

(1) KPMG - Commonwealth of Puerto Rico Tax Reform Assessment Project Unified Tax Code of Puerto Rico: Tax Policy Implementation Options General Explanation of Principal Options 10/31/2014.

(2) IRS gross tax compliance rate.

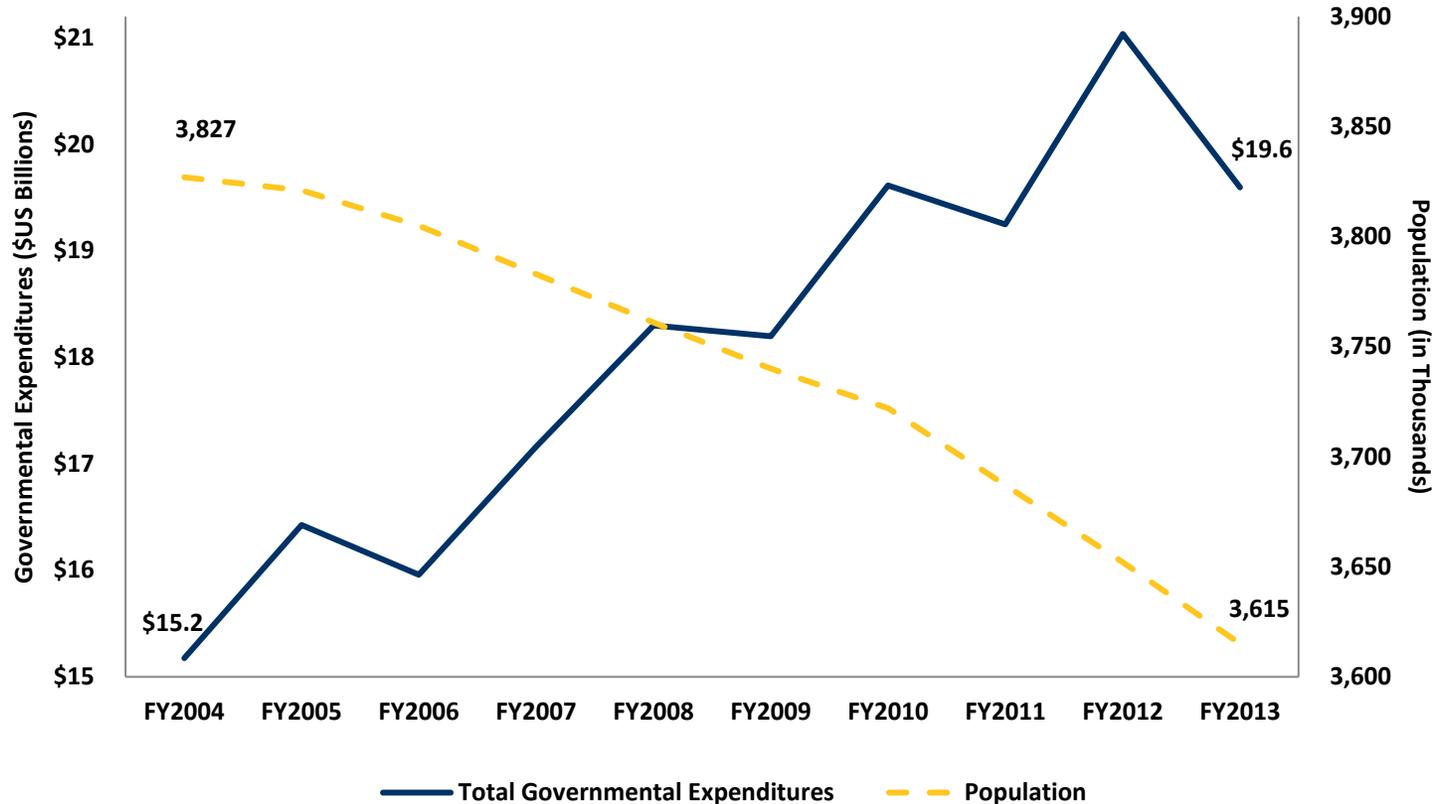
(3) \$1.1 billion equals difference between the 10.5% SUT collected at 56% and 83% compliance levels assuming ~\$40.3 billion in tax base.

Puerto Rico has room to lower expenses

Total governmental expenditures increased 29% or \$4.4 billion in the past decade while population declined 6%

- Government expenditures have not been adjusted to reflect Commonwealth’s current situation

Total Governmental Expenditures and Population (1)



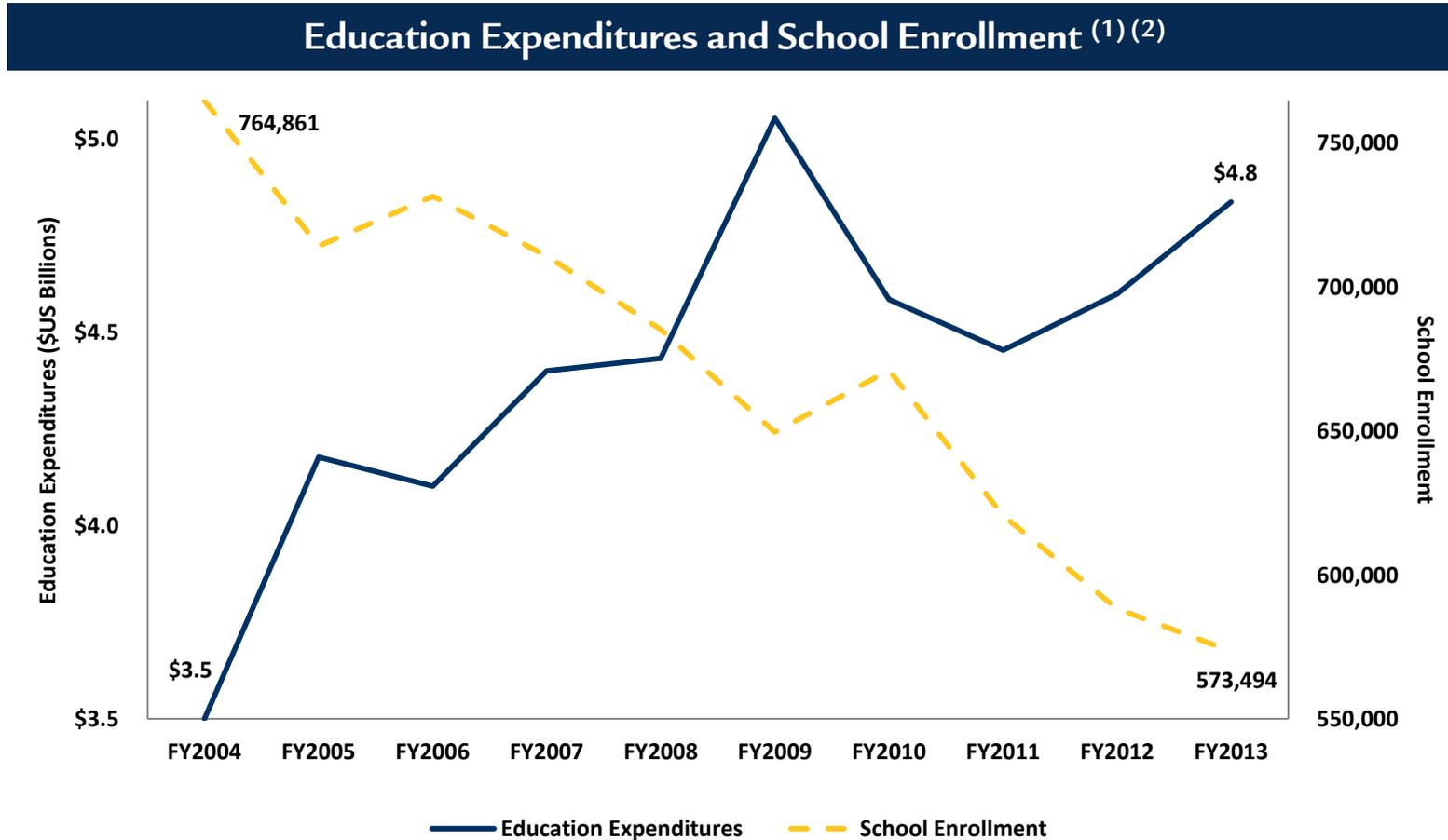
Sources: Commonwealth reports

Notes:

(1) Total governmental expenditures equal to Governmental Funds total expenditures as reported in the Commonwealth’s annual audited financials.

Puerto Rico has room to lower expenses (continued)

Education expenditures increased 39% or \$1.4 billion in the past decade while total school enrollment declined ~25%



Sources: Commonwealth reports

Notes:

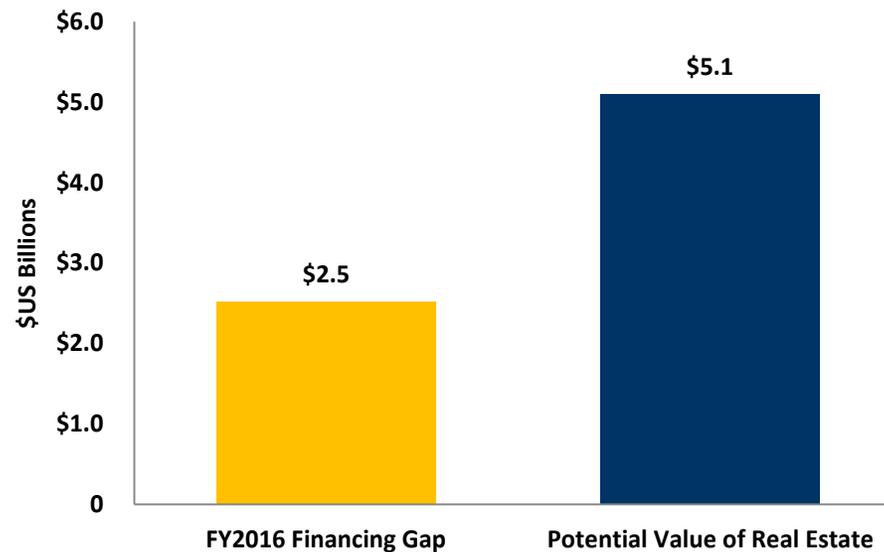
(1) Education expenditures equal to Governmental Funds education expenditures as reported in the Commonwealth's annual audited financials.

(2) FY2004 – FY2012 school enrollment per the Commonwealth's 6/30/2012 audited financials, FY2013 total enrollment unavailable and estimated based on historical growth rates, i.e. 573,494 = 588,384 * (100% – 2.5%).

Puerto Rico has other additional opportunities to improve liquidity

Public private partnerships and real estate value

- Commonwealth should consider the successful public private partnership precedents set by PR-22/PR-5, the Luiz Munoz Marin International Airport, and the Teodoro Moscoso Bridge as a roadmap for additional PPP's
- Government real estate such as buildings and ports has the potential for billions in additional revenue
 - PBA, PRCCDA, and PRIDCO owned buildings total ~\$4.1 billion in carrying value
 - Ports Authority and Port Authority of the Americas capital assets not already under a concession agreement total ~\$1.0 billion



Source: Commonwealth reports and press reports

Puerto Rico can make a fiscal adjustment and grow

Countries in comparable situations have grown after fiscal adjustment

- Contrary to conventional wisdom that fiscal adjustment programs cause recessions and political costs to governments, the Independent Evaluation Office of the IMF found that the average growth rate in the first program year improved over the previous year and in the second year improved further, surpassing the average of the pre-program decade
 - Based on a review of 133 programs with an average targeted fiscal adjustment of 2% of GDP over two years
- IMF has found that
 - Fiscal adjustment programs generally have had a positive effect on GDP growth
 - Fiscal balances in program countries improved substantially faster than in the non-program countries
- Puerto Rico should eliminate its fiscal deficit in order to regain normal market access
 - Given lack of economic growth, Puerto Rico must bring the Governmental Funds into full balance using fiscal adjustment measures
 - Recent and proposed measures, if implemented, would allow Puerto Rico to obtain fiscal surpluses

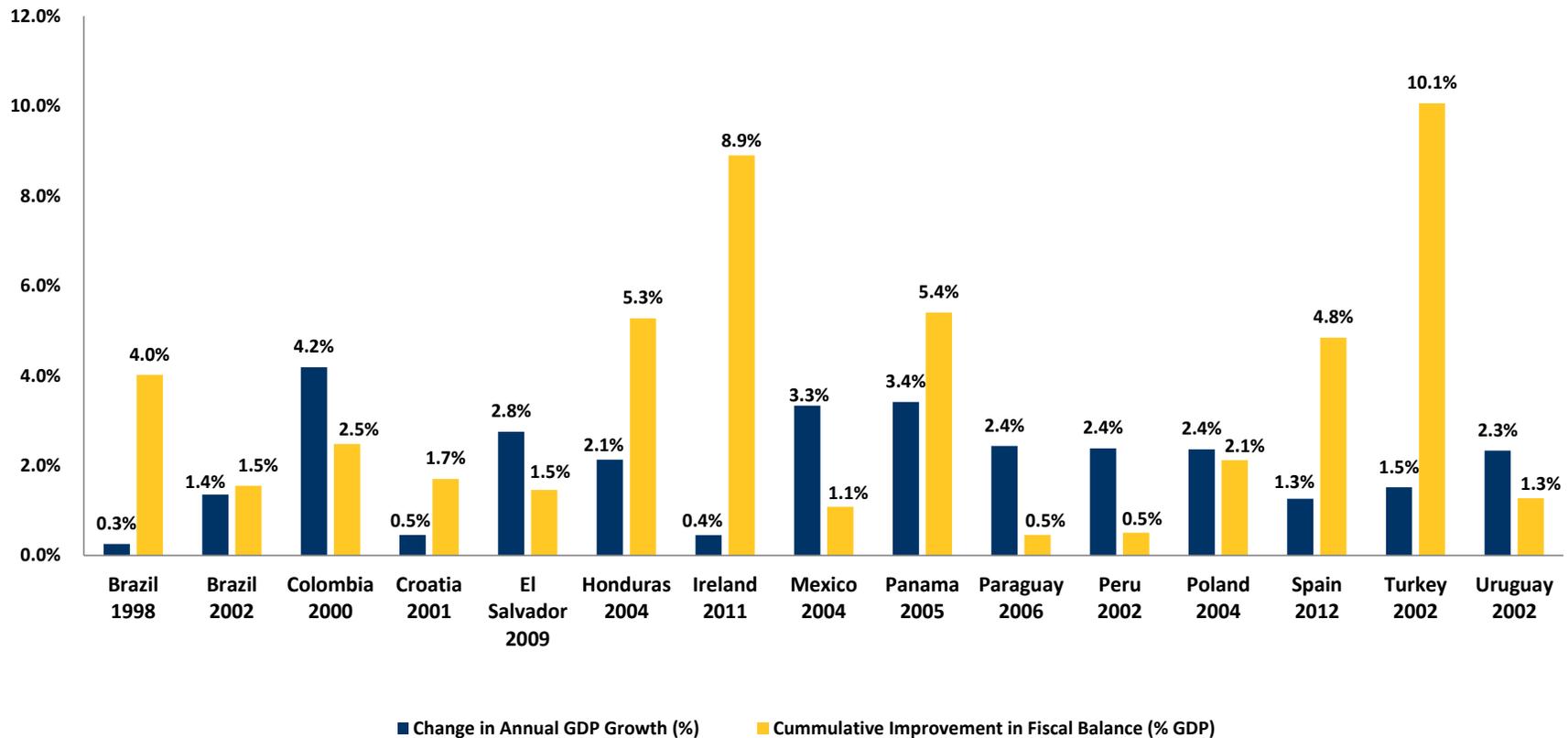
Source: IMF and Commonwealth reports

Puerto Rico can make a fiscal adjustment and grow (continued)

Below examples show that deficit reductions of ~2% of GDP can be accompanied with strong positive economic growth

- All countries included in the chart below made a fiscal adjustment without recourse to debt restructuring

Improvements in GDP Growth and Fiscal Performance ⁽¹⁾ ⁽²⁾



Sources: IMF and J.P. Morgan

Notes:

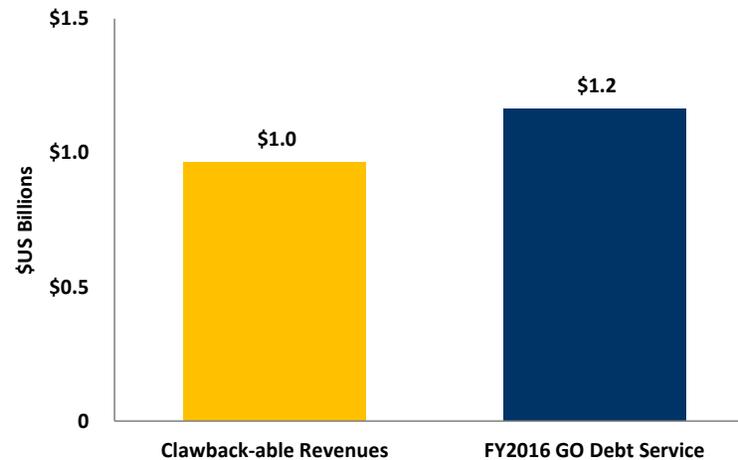
- (1) Shows cumulative improvement in fiscal balance from year prior to program to year after program and improvement in average GDP growth before and after program.
- (2) Paraguay had an initial fiscal surplus position. Panama, Poland and Spain did not have programs with the IMF when they engaged in their adjustment effort.

Path laid out by the Governor has significant costs and risks

An attempt to impair GO bonds would be costly and unsuccessful

- GO constitutional priority
 - Puerto Rico’s Constitution provides that GO and Commonwealth guaranteed debt service shall be paid first before other expenditures
 - Priority granted by Article VI of the Puerto Rico Constitution
 - No state in recent history has defaulted on its GO bonds

- Disregards ability to clawback ~\$1.0 billion of revenues annually
 - Revenue currently appropriated to HTA, PFC, PRCCDA and PRIFA totals ~\$1.0 billion annually
 - Commonwealth obligated to redirect revenue for payment of GO debt service
 - Clawback-able revenues could cover the vast majority of the ~\$1.2 billion in annual GO debt service



Source: Commonwealth reports, Bloomberg and EMMA

Costs of default will be high

Restructuring will come at the expense of the Commonwealth and its people

- Argentina, as a result of its fight with creditors and ensuing uncertainty regarding economic policy in the country has seen foreign direct investment collapse and large capital flight of well over \$150 billion
 - Locked out of international capital markets after pursuing a unilateral restructuring and as a result still cannot obtain foreign financing at reasonable interest rates
 - Only financing by China at undisclosed rates is preventing a sharp decline in international reserves
 - Combination of non-market and non-creditor friendly policies has resulted in a collapse in confidence and economic recession
- Detroit's bankruptcy fees totaled ~\$180 million or 17% of FY2013 general fund revenue
 - Costs to Puerto Rico expected to be much higher due to larger, more complex capital structure, lack of established bankruptcy process, and GO and Commonwealth guaranteed constitutional protections
 - Puerto Rico has ~18 different debt issuing entities each with different complexities and structural issues
- Three major banks, Banco Popular, First BanCorp and Oriental, lost \$900 million in combined market cap in the week following the Governor's announcement
 - Stocks were down 10%, 26% and 31% respectively in four days following the Governor's speech
- Creditors that may be impacted by the Governor's plan are largely on-island, and include many retail holders
 - Local investor who bought GDB bonds worth \$10,000 has seen the value of those holdings shrink to ~\$4,000
 - Local investor who bought GO bonds worth \$10,000 has seen the value of those holdings shrink to ~\$6,500
 - Reported that UBS no longer allows clients to use Puerto Rico bond funds or closed-end fund shares as collateral
 - Significant amount of these clients are on-island

Source: City of Detroit financials, press reports, Bloomberg, and EMMA

Government should take the initiative to create a better Puerto Rico

Reforms should be coupled with measures to grow the economy

- Government has opportunity to consolidate entities, improve IT systems, and strengthen controls and accounting
- Additionally the government can focus on growing underutilized parts of the economy and improving areas the World Bank 'Doing Business' profile ⁽¹⁾ cites as opportunities to enhance competitiveness
- Tourism industry
 - Growth in tourism has lagged many Caribbean peers and Puerto Rico's status affords it large advantages over other destinations that require a passport to travel to
- Agriculture industry
 - Agriculture represents 1% of GNP currently and opportunity exists to replace the large amount of imported food consumed with food grown/raised on-island
 - Potential to generate billions in local revenue by utilizing greater amount of farmland
- Existing port infrastructure
 - Puerto Rico has one of the largest port systems in the Caribbean
 - Infrastructure exists to receive Post-Panamax size ships

Source: Commonwealth reports and press reports

Note:

(1) [http://www.doingbusiness.org/data/exploreconomies/puerto-rico/~media/giawb/doing%20business/documents/profiles/country/PRI.pdf](http://www.doingbusiness.org/data/exploreconomies/puerto-rico/~/media/giawb/doing%20business/documents/profiles/country/PRI.pdf)

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