Fiscal Situation Update

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I. Fiscal Year 2008-09

As of March 31, 2009, general fund net revenues for the current fiscal year were $278 million, or 4.9 per cent, below actual receipts as of the same date for the previous fiscal year. General fund net revenues are also $335 million, or 5.8 per cent, below the originally budgeted amount. According to the budget documents submitted by the Governor, the Puerto Rico Treasury Department now expects net general fund revenues to total $7.600 billion, an amount that is $888 million, or 10.46 per cent, below the originally budgeted amount of $8.488 billion.

On the expenditure side, the Governor stated in his budget address to the legislative assembly that total expenditures are expected to be around $10.833 billion. As shown on Table 1 below, the projected general fund deficit for the current fiscal year—as "certified" by the Office of Management and Budget—should be around $3.233 billion, a figure that is $2.690 billion, or 495.39 per cent, higher than the $543 million budget deficit registered during fiscal year 2007-08.[1]

Table 1
Budget Deficit FY 08-09

General fund revenues	$ 7,600,000,000
General fund expenditures	$10,833,000,000
Projected budget deficit	$ (3,233,000,000)

Before moving on to analyze the Commonwealth's structural balance, it is appropriate to differentiate among and between three different definitions of the term "deficit", which, unfortunately, oftentimes are erroneously used interchangeably in the public debate. In order to clarify our analysis we pause briefly to explain each one of these definitions:

Budget Deficit – Is defined as the excess of spending over income for a government, a corporation, or an individual during a particular period of time.[2] For purposes of this calculation the recurrence or non-recurrence of income and spending is not material. Similarly, the timing of the cash receipts or disbursements associated with a particular income or expense stream is irrelevant for purposes of this calculation. The important thing is to correctly and timely recognize income and expenses during the appropriate fiscal year.

[1] Since January 2009, at least three different deficit calculations have been made public, all of which add up to $3.2 billion but using different figures. See (1) the *Informe al Gobernador de Puerto Rico sobre Reconstrucción Fiscal* submitted by the Governor's Advisory Council for Economic and Fiscal Reconstruction, dated January 8, 2009; (2) *Investor Presentation* by the Government Development Bank, dated March 12, 2009; and (3) Letters to the Hon. Thomas Rivera Schatz and the Hon. Jenniffer González, both dated April 29, 2009.

[2] *Barron's Dictionary of Finance and Investment Terms*, 4th edition, p.63.

Cash Deficit – Is defined as the excess of actual expenditure payments over actual collected revenues during a particular period of time. This cash deficit is by definition equal to the government's borrowing requirement (from domestic or foreign sources).[3] For purposes of calculating the cash deficit the relevant criterion is when was the cash actually disbursed; the recurrence or non-recurrence of the expenditure and the timing of its accrual or authorization are irrelevant.

Structural Deficit – According to Dr. Ramón Cao, perhaps Puerto Rico's pre-eminent fiscal economist, the term "structural deficit" has two definitions in the formal economic literature, none of which coincides with the local usage of the term. First, according to Nobel Prize-winning economist Joseph Stiglitz, a structural deficit is that which occurs even when the economy is operating at full employment. The term is thus used to differentiate between cyclical budget deficits, which are the product of normal fluctuations in the economic cycle, and chronic deficits that persist even when the economy is operating at full throttle. The second definition was coined during the 1980s and was used to describe the economic situation of several Latin American countries. In that case, the adjective "structural" referred to the difficulty of Latin American governments to comply with their external debt service obligations due to the large amount of those debts, the high interest rates then prevailing, and the large deficits generated by state-owned enterprises.[4] The accepted operating definition of the term in Puerto Rico appears to be adopted from the practice of the credit rating agencies, which define structural deficit as the excess of recurring expenditures over recurring revenues. Defined in this way, the term appears to have some analytical value as it may reveal the existence of a core deficiency in government finances by stripping away all one-time or special items, both from the income and expenditure sides. However, there are no hard and fast, black letter rules for determining what constitutes recurring revenues or recurring expenses. It thus may become necessary, at some points in the analysis, to make subjective analytical judgments as to what items should or should not be included in calculating the structural deficit.

If we analyze the Commonwealth's structural balance for fiscal year 2008-09, we find that the government of Puerto Rico claims that the structural deficit of the Commonwealth is identical to its budget deficit of $3.233 billion. Table 2 below breaks down this amount into its component parts.

[3] Anwar Shah, *Budgeting and Budgetary Institutions*, The World Bank, 2007, p.255.

[4] Ramón Cao, *Impuestos en Puerto Rico: Treinta Años de Estudios y Experiencias*, Grupo Editorial Akron, 2004, p. 170.

Table 2 Government's Calculation of the Structural Deficit		
Recurring revenues	**$**	**7,600,000,000**
Budgeted expenses	$	9,484,000,000
Early retirement plan EQB	$	15,000,000
Interest payment $1 billion L/C Treasury	$	27,000,000
Financial expenses -- TRANs	$	54,000,000
Utility payments from previous year	$	60,000,000
Other deficits	$	88,000,000
Financial expenses -- Swaps	$	111,000,000
Rent owed to PBA	$	145,000,000
Debt service owed to GDB	$	174,000,000
Debt service PIF owed to GDB	$	175,000,000
Deficit -- ASES & Education	$	500,000,000
Total recurring expenses		**$ 10,833,000,000**
Structural deficit	$	(3,233,000,000)

While we concur that most of the items set forth on Table 2 should be included in the calculation of the structural deficit, we respectfully differ as to the inclusion of some of the items listed therein. Specifically, we believe the following items should be excluded from the structural deficit calculation:

- The $15 million associated with the implementation of an early retirement plan at the Environmental Quality Board. This is clearly a one-time item, the fact that it is carried over from the previous year does not make it recurrent.
- The $54 million interest payment on the TRANs. The TRANs are short-term notes with a maturity of less than 1 year. Therefore, the interest payable on those notes, by definition, cannot be described as recurrent. Again, the fact that the obligation to pay this amount is carried over from the previous year does not make it recurrent.
- The $111 million associated with certain swap transactions, mostly due to collateral calls. These calls are subject to changes in market conditions; therefore, we are not sure they can be properly described as recurrent.
- The $174 million owed to GDB in connection with various loans. It is not clear to us whether this is a one-time payment carried over from the previous year, or part of a multi-annual amortization schedule.

Therefore, according to our analysis, recurring general fund revenues for the current fiscal year total $7.600 billion, while recurring expenditures are projected to add up to $10.479 billion. This gap between recurring revenues and recurring expenditures is commonly known as the Commonwealth's structural deficit and it is expected to be around $2.879 billion this year. This amount would be $1.553 billion, or 117.12 per cent, more than the structural deficit of $1.326 million registered during the previous fiscal year.

In sum, we (1) concur with the government's estimated *budget* deficit of $3.233 billion for fiscal year 2009, but (2) respectfully dissent with respect to the amount of the *structural* deficit, which we believe to be around $2.879 billion. In any event, the bottom line for the current fiscal year is that the general fund deficit is expected to be in the billions, regardless of whether we analyze it on an accrual or on a structural basis. This would be the Commonwealth's seventh general fund deficit in a row.

II. Fiscal Year 2009-10

The Governor announced a $7.670 billion general fund budget for fiscal year 2009-10. At first glance, this amount would be $1.814 billion, or 19.13 per cent, lower than last year's general fund budget of $9.484 billion. However, upon closer analysis it becomes evident that some expenditures traditionally charged to the general fund will be charged instead against the Fiscal Stabilization Fund, a special fund to be set up with the proceeds of a COFINA bond offering that is estimated to total $2.500 billion. Therefore, actual general fund spending for the next fiscal year is estimated to be around $10.170 billion, some $686 million, or 7.23 per cent, higher than last year's general fund budget.

However, as we stated above, net general fund revenues are forecast to add up to only $7.670 billion. The government plans to cover this gap with non-recurring revenues from several sources.

Table 3
Non-recurring Revenues (General Fund)

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	$9,484,000,000
% non-recurring revenues	12.36%
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 FY07-08	$10,170,000,000
% non-recurring revenues	26.07%

As shown on Table 3 above, the general fund budget for fiscal year 2009-10 includes $2.652 billion in non-recurring revenues, an amount that is $1.479 billion, or 126.08 per cent, higher than the $1.173 billion in non-recurring revenues included in the general fund budget for the fiscal year 2008-09. We note, in addition, that the consolidated budget includes an additional $1.727 billion in non-recurring revenues from the American Recovery and Reinvestment Act (ARRA). Thus, total non-recurring revenues included in next year's budget amount to $4.379 billion.

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 12.36 per cent (1 out every 8 dollars) during the current fiscal year to a projected 26.07 per cent (roughly 1 out of every 4 dollars) for the next fiscal year.

III. Economic Perspectives

The Puerto Rico Planning Board has released its analysis of the performance of Puerto Rico's economy during fiscal year 2008 and its forecast for fiscal years 2009 and 2010. According to the Planning Board, the local economy grew by 3.8 per cent at current prices during fiscal year 2008. However, after taking into account the effect of inflation, the real growth rate for Puerto Rico was negative 2.5 per cent.

In terms of the current fiscal year, the Planning Board forecasts Puerto Rico's GNP to decrease by an additional 3.4 per cent in real terms. Thus, fiscal year 2009 would be the third recessionary year in a row for the Commonwealth.

For fiscal year 2010, which commences on July 1, 2009, the Planning Board is projecting a rebound to positive territory and forecasts that nominal GNP will increase by 3.4%, while real GNP is forecast to increase by 0.1%. However, we believe that this 100% year-over-year increase in real GNP will be difficult to achieve because (1) the United States, Puerto Rico's largest trading partner, is in a deep recession; (2) 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 will limit new lending; and (3) the expected layoffs of government workers will put downward pressure on consumer spending in Puerto Rico.

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 4 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 4
Budget Indicators 2006-2010

	Fiscal Year 2006	2007	2008	2009	2010	CAGR
1.Consolidated Budget (CB)	$26,518,449,000	$26,471,705,000	$27,568,459,000	$27,434,320,000	$29,263,500,000	2.49%
CB per capita	$6,751.13	$6,717.00	$6,972.30	$6,903.85	$7,327.53	
CB/GNP	46.74%	45.20%	45.35%	44.46%	45.87%	
2. Federal funds	$5,092,757,000	$4,949,715,000	$5,560,761,000	$5,642,673,000	$5,586,355,000	2.34%
Federal funds/CB	19.20%	18.70%	20.17%	20.57%	19.09%	
3. General Fund budget(GF)	$9,596,085,000	$9,488,000,000	$9,242,000,000	$9,483,792,000	$7,670,000,000	-5.45%
GF/GNP	16.91%	16.20%	15.20%	15.37%	12.02%	
4. General fund payroll	$5,257,706,000	$5,189,846,000	$5,189,758,000	$5,528,570,000	$ 2,259,500,000	-19.03%
Payroll/GF	54.79%	54.70%	56.15%	58.29%	29.46%	
5. Tax revenues general fund	$7,735,669,000	$7,995,100,000	$7,412,200,000	$6,775,000,000	$6,867,000,000	-2.93%
Tax revenues/GF	80.61%	84.27%	80.20%	71.44%	89.53%	
Tax revenues GF/GNP	13.64%	13.65%	12.19%	10.98%	10.76%	
6. GF recurring revenues	$8,545,000,000	$8,621,000,000	$8,017,000,000	$7,600,000,000	$7,670,000,000	-2.66%
GF recurring expenditures	$9,964,000,000	$9,367,000,000	$9,343,000,000	$10,479,000,000	$9,170,000,000	-2.05%
GF structural deficit	($1,419,000,000)	($746,000,000)	($1,326,000,000)	($2,879,000,000)	($1,500,000,000)	
Structural deficit/GF	-14.79%	-7.86%	-14.35%	-30.36%	-19.56%	
7. Non-recurring funds	$891,000,000	$506,000,000	$804,000,000	$1,173,107,000	$4,379,000,000	48.89%
Non-recurring funds/CB	3.36%	1.91%	2.92%	4.28%	14.96%	
8. Debt service GF	$623,515,000	$594,474,000	$554,126,000	$392,924,000	$520,600,000	-4.41%
Debt service/recurring revenues GF	7.30%	6.90%	6.91%	5.17%	6.79%	
Debt service consolidated budget	$3,305,189,000	$3,501,988,000	$3,041,344,000	$2,837,744,000	$3,534,486,000	1.69%
Debt service/CB	12.46%	13.23%	11.03%	10.34%	12.08%	
Debt service per capita	$841.44	$888.60	$769.18	$714.12	$885.03	
Debt service CB/GNP	5.83%	5.98%	5.00%	4.60%	5.54%	
9. Total public debt	$43,136,300,000	$46,183,300,000	$ 53,392,900,000	$ -	$ -	
Public debt per capita	$ 10,981.75	$ 11,718.68	$ 13,503.52	$ -	$ -	
GNP*	$56,732,300,000	$58,563,100,000	$60,787,200,000	$61,701,000,000	$63,792,000,000	2.98%
Total public debt/GNP	76.03%	78.86%	87.84%	-	-	
10. Government employees**	224,021	216,386	212,879	213,502	211,469	-1.43%
Government employees per 100	5.70	5.49	5.38	5.37	5.30	
Population***	3,928,000	3,941,000	3,954,000	3,973,770	3,993,639	0.42%

* Figures for 2009 and 2010 are PRPB estimates

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

*** Figures for 2009 and 2010 are estimates

The following is a brief analysis of each of the indicators set forth in Table 4:

1. *Consolidated budget* – The Commonwealth's consolidated budget has increased from \$26.518 billion in fiscal year 2006 to a projected \$29.263 billion for fiscal year 2010, an increase of \$2.745 billion, or 10.35%. This increase is equivalent to a compound annual growth rate (CAGR) of 2.49% during the period between fiscal years 2006 and 2010, which is roughly equal to the CAGR of 2.98% of nominal GNP during the same period.[5] On a per capita basis, consolidated budget expenditures have also increased slightly, from \$6,751 in 2006 to a projected \$7,327 for fiscal year 2010. Yet relative to per capita personal disposable income, government expenditure per capita in Puerto Rico remains fairly high. In 2008, per capita disposable personal income in the island was \$13,445; thus, per capita government spending of \$6,972 represented 51.85% of per capita disposable personal income. In contrast, federal expenditure per capita in the U.S. is approximately \$12,854, which is equivalent to roughly 32.33% of per capita disposable personal income of \$39,751. Finally, consolidated budget expenditures have declined slightly relative to GNP, from 46.74% in 2006 to a projected 45.87% in 2010. In our view, the overall trend with respect to the consolidated budget is positive as it reveals that government has achieved a modicum of success in restraining the growth of 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 \$5.586 billion during fiscal year 2010, an increase of \$494 million, or 9.70%, relative to the \$5.092 billion received during fiscal year 2006. Thus, federal funds are expected to account for 19.09% of all consolidated budget expenditures during fiscal year 2010, an amount that is essentially the same as the 19.20% registered in 2006. 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 \$1.727 billion in ARRA funds, total federal funds increase to \$7.313 billion, or 24.99% of all consolidated budget expenditures during fiscal year 2010. 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 significantly 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 \$7.670 billion for fiscal year 2010, a decrease of \$1.926 billion, or 20.07%. This reduction is equivalent to a CAGR of negative 5.45% for the period between fiscal years 2006 and 2010. 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 to be set up with the proceeds of a COFINA bond offering that is estimated to total \$2.500 billion.

[5] However, the consolidated budget for 2010 includes \$2.5 billion from the Stabilization Fund and \$1.727 billion in ARRA funds. Without these special items the consolidated budget would be \$25.037 billion.

Therefore, actual general fund spending for the next fiscal year is estimated to be around $10.170 billion, some $686 million, or 7.23 per cent, higher than last year's general fund budget of $9.484 billion. Relative to the island's GNP, the general fund budget has declined from 16.91% in 2006 to a projected 12.02% during fiscal year 2010. However, if we use the real spending number, relative to GNP the general fund has decreased only slightly from 16.91% in 2006 to 15.94% in 2010. 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 decreased from $5.257 billion for fiscal year 2006 to a projected $2.259 billion during fiscal year 2010, a decrease of $2.998 billion, or 57.02%. This decrease is equivalent to a CAGR of negative 19.03%. In relative terms, the portion of the general fund allocated to payroll has decreased from 54.79% in 2006 to a projected 29.46% in 2010. 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 $3 billion reduction in payroll would entail the layoff of approximately 100,000 government workers—the equivalent of 47% of all government workers—and the government has not announced (at least not yet) 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.

5. *Tax revenue trend* – General fund tax revenues, the principal component of the general fund, have decreased from $7.735 billion in fiscal year 2006 to a projected $6.867 billion during fiscal year 2010, a decrease of $868 million, or 11.22%. This decrease is equivalent to a CAGR of negative 2.93%. During that same period, curiously, tax revenues as a percentage of general fund revenues increased from 80.61% in 2006 to a projected 89.53% during fiscal year 2010. This decline is explained by the artificial reduction in nominal general fund spending budgeted for 2010. More significantly, general fund tax revenues have declined relative to GNP, from 13.64% in 2006 to a projected 10.76% 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 increased slightly from $1.419 billion in 2006 to a projected $1.500 billion for fiscal year 2010, an increase of $81 million, or 5.70%. The projected structural deficit of $1.5 billion is the difference between recurring revenues of $7.670 billion and recurring expenditures of $9.170 billion.[6] The government estimates the structural deficit for fiscal year 2010 will be around $500 million. The $1 billion difference between our estimate and the government's is due to the government's recognition in fiscal 2010 of a $1 billion expense reduction that will not be realized until fiscal 2011. We believe the premature recognition of this $1 billion expense reduction is aggressive, given the contingent nature of at least a part of those savings. Therefore, we respectfully disagree with the government's estimate of the structural deficit for fiscal year 2010. Finally, as a percentage of total general fund expenditures, the structural deficit has also increased, from 14.79% in 2006 to a projected 19.56% in 2010. 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.

7. *Use of non-recurring funds* – 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 $891 million in fiscal year 2006 to $4.379 billion for 2010, an increase of $3.488 billion, or 391.47%. Furthermore, as discussed in section II above, the general fund budget for fiscal year 2009-10 includes $2.652 billion in non-recurring revenues, an amount that is $1.479 billion, or 126.08 per cent, higher than the $1.173 billion in non-recurring revenues included in the general fund budget for the fiscal year 2008-09. 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 12.36 per cent (1 out every 8 dollars) during the current fiscal year to a projected 26.07 per cent (roughly 1 out of every 4 dollars) for the next fiscal year.

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 $520 million during fiscal year 2010, a decrease of $103 million, or 16.53%. This decrease is equivalent to a CAGR of negative 4.41%. In relative terms, the amount allocated to general fund debt service has decreased slightly from 7.30% of general fund recurring revenues in 2006 to a projected 6.79% of recurring revenues in 2010. The picture is somewhat different with respect to consolidated budget. The amount of the consolidated budget allocated to debt service has increased from $3.305 billion in 2006 to a projected $3.534 billion in 2010, an increase of $229 million, or 6.92%. This increase is equivalent to a CAGR of 1.69%. In relative terms, the portion of the consolidated budget allocated to debt service has stayed essentially flat, decreasing slightly from 12.46% of the total consolidated budget in 2006 to a projected 12.08% in 2010. Relative to GNP, consolidated budget debt service has also decreased slightly, from 5.83% of GNP in 2006 to a

[6] 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.

projected 5.54% in 2010. In general terms, the debt service indicators show a neutral trend because both the absolute and relative amounts dedicated to debt service have not changed much since 2006.

9. *Total indebtedness* – The Commonwealth's total public indebtedness increased from $46.183 billion as of June 30, 2007 to $53.392 billion as of June 30, 2008, an increase of $7.209 billion, or 15.60%. This growth rate is four times the 3.8% growth rate for the island's GNP (at current prices) reported during fiscal year 2008. This means that during fiscal year 2008 Puerto Rico's public indebtedness increased four times as fast as its national income. Relative to GNP, Puerto Rico's total public debt increased from 78.86% of GNP in 2007 to 87.84% in 2008. On a per capita basis, total public debt per capita in 2008 amounted to $13,503 which is 100.43% of the island's per capita personal disposable income of $13,445. 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 211,469 in 2010, a reduction of 12,552 workers, or 5.60%. This decrease is equivalent to a CAGR of negative 1.43%. In relative terms, the number of central government employees per 100 inhabitants has also shown a slight decrease from 5.70 government workers per 100 people to a projected 5.30 government workers per 100 people in 2010. Contrary to popular belief, if we compare Puerto Rico's state and local employees per 100 inhabitants with the United States the difference is not that significant. In 2006 (the most recent year for which data is available) there were 19,327,000 state and local government employees in the United States out of a total population of 299,157,000. This amounts to 6.46 state and local workers per 100 people. According to the Planning Board, in 2006 there were 287,700 state and municipal workers out of a total population of 3,928,000 in Puerto Rico. This amounts to 7.32 state and municipal workers per 100 people in Puerto Rico. Thus, while the rate is slightly higher in Puerto Rico the difference is not a big as usually portrayed. This data supports the assertion that the problem in Puerto Rico is that the private sector is relatively small, not that the government is too big.[7]

[7] We note, however, that while the relative size of the government may not be the fundamental problem in Puerto Rico's economy, there is significant evidence that indicates the distribution of government employees is far from optimal.

V. Public Debt

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

Table 5
Total Public Debt and GNP
($MM)

June 30,	Const. Debt	Municipal Debt	Public Corps	Extracon. Debt	Moral Obl. Debt	Total Debt	%Δ	GNP	%Δ	Debt/ GNP
2008	$8,758.7	$2,819.4	$26,342.4	$9,011.7	$6,460.7	$53,392.9	15.61%	$60,787.2	3.80%	87.84%
2007	$8,167.2	$2,463.0	$24,159.4	$8,028.7	$3,365.0	$46,183.3	7.06%	$58,563.1	3.23%	78.86%
2006	$7,276.3	$2,330.3	$20,449.5	$9,557.5	$3,522.7	$43,136.3	7.12%	$56,732.3	5.54%	76.03%
2005	$7,307.1	$2,181.4	$19,234.2	$7,980.3	$3,565.3	$40,268.3	7.57%	$53,752.4	6.00%	74.91%
2004	$6,878.7	$2,046.0	$18,040.6	$6,977.3	$3,491.0	$37,433.6	-	$50,708.7	-	73.82%
CAGR	**6.23%**	**8.35%**	**9.93%**	**6.61%**	**16.64%**	**9.28%**		**4.64%**		

As shown on Table 5 above, between June 30, 2004 and June 30, 2008, Puerto Rico's public debt increased at a compound annual growth rate of 9.28%, while GNP grew at a CAGR of only 4.64% in nominal terms. Thus, during this period Puerto Rico's debt increased at a rate exactly twice that of its GNP. Even more worrisome is the fact that during fiscal year 2008 total public debt increased by 15.61%, while Puerto Rico's GDP increased by only 3.80%. Furthermore, as of June 2008 the debt to GNP ratio stood at an all-time high of 87.84%, a significant increase from its 73.82% level in 2004. Needless to say, it is unlikely these rates of indebtedness can be sustained for much longer.

VI. Conclusion

As of May 2009 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 in excess of $2.500 billion, which would be the Commonwealth's seventh 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 $2.5 billion, or 24.58% of proposed general fund expenditures. The government plans to cover this gap with $2.5 billion in non-recurring revenues from the Fiscal Stabilization Fund.

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, and the government employment rate, show a relatively positive trend. On the other side of the balance sheet, we find that the continued reliance on federal funds, the declining trend in general fund tax revenues, the large general fund structural deficit, the increased use of non-recurring funds, and the unsustainable growth of total public indebtedness all are indicative of negative trends. Two indicators, the general fund payroll and the debt service ratios, show a mixed or neutral trend.

In sum, we conclude that while the budget for fiscal year 2010 contains several changes, in substantive terms the budget submitted by the current administration is in many ways similar to the last one submitted by the previous administration. We find the same continued reliance on (1) non-recurring revenues, (2) "savings" generated simply by shifting expenses from one fund to another, and (3) additional public borrowing to patch over fiscal troubles. In all fairness, the current administration has stated that the proposed budget is a "transition" instrument that will eventually help Puerto Rico restore its fiscal health, however at this point it remains to be seen whether that objective will be realized over the next few years.