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Fiscal Responsibility Law for Puerto Rico

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Need for a Comprehensive Solution

- Debt Restructuring
  - No use pretending that debt reduction can be avoided
  - Whether it is orderly or chaotic, it will happen
- Federal Oversight
  - The cost of restructuring
- Short-term Economic and Fiscal Stabilization
- Fiscal Responsibility Law
  - Fiscal Rule
  - Reform of Public Finance Management System
- Medium-term Economic Growth Strategy
  - Sectorial Opportunities
  - Horizontal Policies

Fiscal Responsibility Law

- This presentation is about our proposal for a Fiscal Responsibility Law for Puerto Rico. It has two components:
  - (1) a simple, intuitive, and objective fiscal rule; and
  - (2) a large-scale overhaul of Puerto Rico's public financial management systems, institutions, and practices.

Problems with Fiscal Policy

- Deficit Bias:
  - Standard theory: run surpluses in good times and deficits in bad times
  - Common problem: run deficits in good and bad times
  - Drop in government net assets even when standard smoothing considerations suggest the opposite
  - Consequence: inefficiently large debt
- This bias is the product of a collective action failure:
  - The political process is such that the benefits of deficit spending are internalized by agency heads and legislators while the costs are socialized. Therefore, deficits tend to be too large and debts tend to accumulate too quickly.

Problems with Fiscal Policy

- Pro-Cyclicality:
  - Common practice: let policy be dictated by terms of access to capital markets
  - In good times better access, borrow more: in bad times, worse access, borrow less
  - So instead of moderating the economic cycle, fiscal policy magnifies it

How to Deal with These Problems?

- One option: adopt fiscal rule that guides expenditure over long term horizons, and constraints it over the cycle
- Fiscal rules helps with deficit bias: by setting surplus targets, it helps reduce debt
- Fiscal rules help with pro-cyclicality: targets expressed in terms of cyclically-adjusted variables, so there is room for spending more in recessions (and less in booms)

Fiscal Rule - Definition

- “A fiscal rule is defined as a permanent constraint on fiscal policy through simple numerical limits on budgetary aggregates. Each of the elements in the definition is important: a rule delineates a numerical target over a long-lasting time period with a view to guiding fiscal policy; it specifies a summary operational fiscal indicator to which it is applicable; and it is simple so that it can be readily operationalized, communicated to the public, and monitored.” (IMF, 2009)

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Fiscal Rule – Adopted in Many Countries

- According to the IMF (2010), by 2009 exactly 80 countries had some kind of fiscal rule in place
- Many more by now
- Prominent example in Europe: Sweden
- Countries in the Eurozone are now designing and applying fiscal rules
- Examples from the emerging market world: Chile, Colombia, Peru

Doesn’t PR Already Have a Fiscal Rule?

- Existing legal provisions in Puerto Rico requiring a balanced budget and a ceiling on debt service have constrained neither deficits nor debt.
- Furthermore, requiring a balanced budget at all points across the economic cycle is economically inefficient and costly from a political perspective.
- Thus, these legal provisions created strong incentives to find clever ways—new institutional mechanisms, accommodating legal interpretations—to circumvent deficit and debt limits.
- The problem with these types of legal provisions is that “innovations” to deal with temporary fiscal shortfalls can have permanent effects, long after the causes of the temporary liquidity crunch are gone.

Doesn't PR Already Have a Fiscal Rule?

- Old *ad hoc* policies permanently influence the future path of the economy. For example, once a constitutional clause is reinterpreted (e.g., to allow debt proceeds to count as "available resources" to balance the budget), it is very difficult to reverse that reinterpretation, thereby producing a permanent bias in favor of deficits and debt.
- A more flexible—**but credible**—set of rules eliminates the incentive to invent ways around them.
- Whereas inflexible rules lead to the ineluctable weakening of public finance, smart and flexible rules lead to stronger institutions.

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Doesn’t PR Already Have a Fiscal Rule?

- Furthermore, a fiscal rule utilizes a long-term perspective to manage fiscal policy:
  - It is based on independent estimates of long-term sustainable revenues and long-term spending plans are subject to a strict sustainable revenue constraint.
  - For nations that are heavily indebted—and Puerto Rico is clearly such a case—a fiscal rule usually includes a target for a structurally adjusted or cyclically adjusted fiscal surplus: that is, on average (across the economic cycle) the nation would run a fiscal surplus and use the proceeds to pay down debt.

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Fiscal Rule

- We propose a rule for Puerto Rico requiring that annual General Fund spending shall not exceed:
  - (1) cyclically adjusted revenues, as determined and certified by an independent panel of professional economists and other fiscal policy experts, minus
  - (2) a small structural surplus.
- Within that limitation the Puerto Rican legislative assembly would assign funds among and between the Commonwealth’s government agencies and departments according to its own spending priorities.

Fiscal Rule

- The implementation of this type of fiscal rule has several advantages.
  - First, government spending is by definition limited to its structural income, minus the structural surplus target.
  - Thus, government spending would be independent of short-term fluctuations in revenues caused by cyclical swings in economic activity and other financial vagaries that affect government revenues.

Fiscal Rule

- Second, this type of fiscal rule, by limiting spending to permanent fiscal income, smoothes out government spending over the economic cycle.
  - In essence, the government saves during upswings and dissaves during downturns.
  - Therefore, the fiscal rule precludes both sizeable spending upswings when the economy is booming and drastic fiscal tightening when there is a substantial economic slowdown.

Fiscal Rule

- Third, the fiscal rule we are proposing requires the Commonwealth to run a small surplus (to be determined as a percentage of GNP*) over the economic cycle*.
- This requirement is necessary because:
    - (1) Puerto Rico's debt burden is not sustainable over the long term;
    - (2) the Commonwealth's government faces potentially crippling contingent liabilities arising out of unfunded public pensions and expenses related to the government healthcare program; and
    - (3) the GDB, is essentially insolvent and needs to be recapitalized.

Fiscal Rule - Example

- Assume:
  - Five-year GNP trend is $80 bn
  - GF structural revenue is $10 bn
  - Fiscal Rule is GF structural revenue less 0.5% of GNP
  - GF cap then is equal to $9.6 bn
- What happens if GF revenues are $10.5 bn
  - Cap is $9.6bn, the difference is saved and deposited in a special fund
- What happens if GF revenues decrease to $9.3bn
  - Cap is still $9.6bn as long as the difference can be financed with funds from the special fund

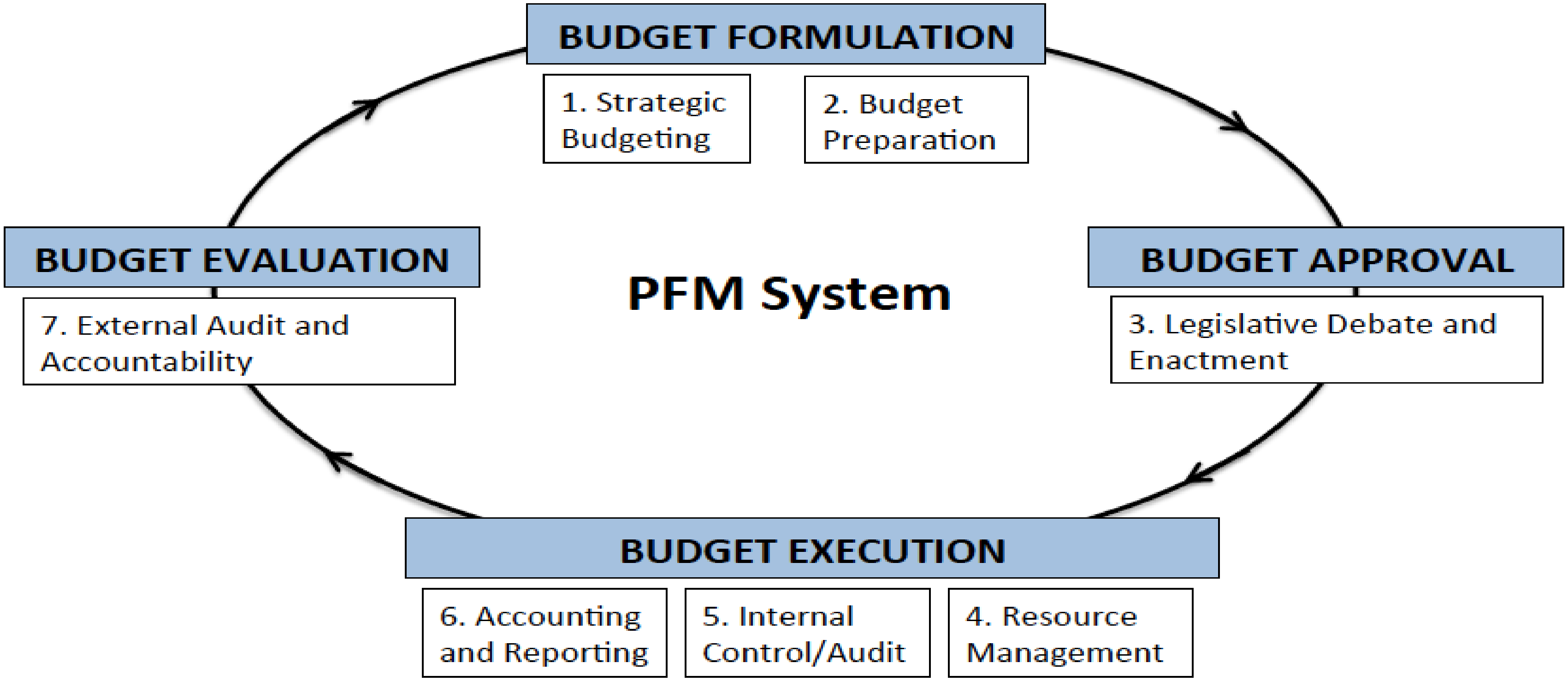
To Recapitulate:

- A smart fiscal rule:
  - keeps expenditure below what the government can raise in taxes in the long run (thereby ensuring sustainability),
  - while allowing deficits whenever the economy is operating below potential and tax revenue is abnormally low (thereby guaranteeing flexibility and contributing to macroeconomic stabilization).

Reforming Fiscal Institutions

- Imposing a strong federal control board on top of the existing institutional structure does nothing to improve Puerto Rico's fiscal management and governance capabilities.
- A locally driven effort to overhaul key institutions can:
  - transform Puerto Rico's fiscal position and introduce much needed governance reforms that ensure the Commonwealth's long-term fiscal solvency and sustainability;
  - while addressing legitimate federal concerns and recognizing valid political qualms on the island.

Reforming Puerto Rico's PFM System



Source: Andrews et. al., p.2

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Reforming Puerto Rico’s PFM System

- In general, the objectives of PFM reform should be the implementation of a functional PFM system in Puerto Rico.
- A functional PFM system leads to:
  - Prudent fiscal decisions
  - Credible budgets
  - Reliable and efficient resource flows and transactions
  - Institutionalized accountability

Reforming Puerto Rico's PFM System

- In terms of the budget formulation process Puerto Rico needs to adopt strategic budgeting practices, these include:
  - implementing performance based budgeting;
  - utilizing medium-term expenditure frameworks;
  - reforming the current government procurement process that encourages rent seeking by the private sector; and
  - applying and executing the fiscal rule

Reforming Puerto Rico's PFM System

- In terms of the budget approval process, the analytical capabilities of the legislative branch need to be substantially improved, perhaps by creating a legislative budget office with the capabilities to double-check and challenge macroeconomic and fiscal assumptions utilized by the executive in the preparation of the budget document.

Reforming Puerto Rico's PFM System

- In terms of budget execution, the Commonwealth has to fix longstanding problems with its accounting, financial and fiscal controls and with its financial reporting in general.
- The Government Development Bank, the Treasury Department, and the Office of Management and Budget need to:
  - establish new procedures to coordinate policies among themselves; and
  - upgrade their operational and execution capabilities, including
    - the hiring of qualified human resources,
    - establishing integrated financial management information systems, and
    - improving internal control, internal audit, and real-time monitoring capabilities.

Reforming Puerto Rico’s PFM System

- In terms of budget evaluation, the Commonwealth:
  - has been incapable of publishing externally audited financial statements for fiscal years 2014 and 2015
  - clearly unacceptable from an accountability and good governance perspective.
- Puerto Rico should publish its audited CAFR for fiscal year 2014 as soon as possible.
- Implement whatever policies are necessary to assure the timely preparation and publication of these audited statements in the future.

In Summary…

- Puerto needs to:
  - Restructure debt
  - Stabilize fiscal situation
- Fiscal Responsibility Law:
  - Fiscal rule
  - Institutional overhaul
- Medium-term Strategy for Economic Growth