Econews

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Puerto Rico

The Fiscal Oversight Board: A reality and a new beginning?

A BRIEF HISTORY

After months of intense political struggles, opposition, and uncertainty, the Federal Fiscal Oversight Board became a reality on June 30th.

It was first proposed at the end of last year, as part of a bill introduced on December 9th by three U.S. Republican senators, dubbed the Puerto Rico Assistance Act. The measure would have provided short-term tax relief with $3.0 billion that would have come from the Obamacare funds, and proposed the creation of the "Financial Responsibility and Management Assistance Authority". The authority would be vested with broad investigative powers, and had the aim of "helping Puerto Rico attain financial and economic stability," through a six-member entity. It would review budgets and other financial information of the Commonwealth and public corporations to determine whether further measures were necessary.

What's more, the proposed entity would have had the power to issue new debt for the use of the Commonwealth, yet the full faith and credit of the U.S. would not be pledged to these obligations. And it did not include Puerto Rico in Chapter 9 of the Federal Bankruptcy Code, which was the main request of the government of Puerto Rico.

The initial proposal evolved in the following months and on April 12th, a new and more detailed and revised proposal (H.R. 5278) was introduced, known as the "Puerto Rico Oversight, Management, and Economic Stabilization Act," or "PROMESA." The Act established an Oversight Board with five members, with more broad powers, establishing a mechanism for debt restructuring, and eliminated the $3.0 billion in funds. It made compulsory its application to Puerto Rico, but voluntary to the other territories (when needed).

On May 19th the House Committee on Natural Resources presented the revised proposed legislation (HR 5278) for an oversight board that would effectively approve all decisions regarding the Island's finances. The fiscal oversight board's authority would include: negotiating debt restructuring with creditors, approving budgets and laws passed by the legislature, measuring the actual level of debt, and reviewing the structure and efficiency of all of the Commonwealth's agencies and departments. Creditors would not be able to sue the current government, as all negotiations regarding the debt would have to be conducted with the fiscal oversight board. The bill passed in the House on June 9th, and was approved in the Senate on June 29th. It is identical to that approved in the House. Finally, on June 30th the President signed the bill making it law.

The Act provides identical debt restructuring for any other U.S. territory (i.e., Guam, American Samoa, U.S. Virgin Islands, Commonwealth of the Northern Mariana Islands) but only if the territory adopts a resolution signed by its governor requesting the establishment of an Oversight Board in accordance with PROMESA.

PRECEDENCE OF FISCAL BOARDS

A federal financial control board for Puerto Rico was first proposed in 2014 by supporters of Doral Bank, in its dispute with the Puerto Rican government over a $230.0 million tax refund. The board approved for Puerto Rico is not the first in US jurisdictions.

According to an investigation by Deborah Kobes (2009), from MIT, since New York City's highly publicized board in 1975, 119 municipalities of all sizes have been assigned control boards, in which a state appointed team oversees the budgetary decisions of a municipality in a fiscal emergency.[1] Among the study's conclusions:

- Evidence suggests that boards were implemented in most large cities with fiscal crisis and that those cities recover.
- Control boards improve the finances of large cities in fiscal crises.
- The literature suggests these institutions can bring technical expertise to ill-equipped governments; offer credibility to governments needing access to resources; and provide a scapegoat for unpopular policies.
- Conversely, disadvantages include diminished sovereignty; increased power to external political actors; favorable concessions to the private market; and uncertain benefits.
- By reducing the authority of locally elected officials, fiscal control boards inhibit access to local democratic government in the short term.
- Case studies of Miami and Washington, DC between 1995 and 2001 highlight the fiscal and local democracy benefits

of control boards as well as the risk of exacerbating inter-governmental political imbalances.

- Local fiscal control boards in the US have also served as an international model.

The 2008 recession in the U.S. had a very negative impact on the fiscal health of many municipalities and a few states. In 2009, *Moody's Investors Service* put all local governments in the United States on negative credit outlook. It was the first time such a blanket report was ever issued for cities, towns, counties, and school districts. The negative outlook remained until 2012.

The way it worked in the US, control boards are essentially an intensification of a state's existing authority over local governments. In normal times, states regulate local governments' finances by providing aid; capping local income, sales, and property taxes; requiring balanced local budgets; limiting local investment options; and mandating specific services. A control board is a mechanism by which states can impose, alter, or suspend such financial regulations to address the emergency needs of a particular local government.

As the evaluation by Kobes shows, control boards are not meant to be democratic, but efficient. Their focus is on re-establishing long-term fiscal stability. The wishes of citizens and elected officials for particular services are often ignored. Today, at least 18 states have a law that allows it to take control of cities enmeshed in fiscal chaos. These laws first emerged in the 1870s and continued to gradually surface in various states, usually during times of recession.

BACKGROUND ON DEBT AND FISCAL SITUATION

The following numbers highlight the debt situation:

- Total debt increased from $24.2 billion in fiscal 2000, to $69.2 billion by the end of 2015 (Excluding interest).
- The level of public debt has increased at a rate faster than revenues and GNP.
- It should be noted that the amounts here indicated correspond to the principal. Total debt including interest amounted to $101.8 billion by September 30, 2015.
- It represents 101.1% of the nominal GNP, the highest ratio among all states, a decline from 105.6% in 2014, as the Commonwealth has been cut off from capital markets.
- The total public debt is divided betwen that corresponding to public corporations, such as PREPA and PRASA, that corresponding to the central government (including COFINA), and that of the municipalities.
- On January 1st the government faced a debt service payment of $902.0 million, part of the $3.8 billion in debt service payments owed between January and July 1st. It decided to pay all but $37.3 million. Over $400.0 million in GDB bonds came due on May 1st, with the government incurring a partial default, and a further $1,923 million were due on July 1st, $779 million of these corresponded to GO bonds, with another default incurred.
- Over time, although the level of GO debt increased, from $5,349 million in fiscal 2000, to $13,061 million in fiscal 2015, its share in the total central government debt went down, from 60.0%, to 40.0%, as a result of the introduction of COFINA in 2007, and its rapid increase since, which now represents 46.5% of the total debt of the central government. Since fiscal 2009, the level of GOs has been lower than that of COFINA.

WHAT IS PROMESA

Many interpretations have been offered as to what it is or is not, and politically what it entails for Puerto Rico's future. These are some of its key provisions:

- The Board will be comprised of seven members (from the original five members) appointed under procedures that ensure Republican leaders in Congress effectively comprise a voting majority of the entire Board.
- The bill will put Puerto Rico's financial affairs under a powerful federal Oversight Board, and establish a legal framework for reducing its $69.0 billion debt ($101.8 billion including interest as of September 2015), not counting that of the pension system. The Oversight Board will have the authority to enforce actions to promote financial stability and economic growth.
- With respect to the restructuring of debt the Law takes note of the fact that Puerto Rico has a constitutional debt that has priority over other spending (and other, non-constitutional debt) in its constitution. It also has public corporation debt backed by pledges of specific tax revenue sources. COFINA is an example. Also, the security pledges on some of the bonds can be clawed back to help make payments on the constitutional debt. Different groups of creditors can easily come up with arguments for why they can be paid even if others cannot be paid, as indeed has already happened.

  The following debt restructuring provisions and procedures were enacted:

  - Bondholders will not be able to seek remedies even if the Board elects to suspend debt service payments. It imposes an automatic stay on litigation upon enactment through February 15, 2017, or six months after establishment of the Oversight Board (Title IV, Section 405(I)). The Commonwealth will continue to make interest payments.
  - As mentioned previously, the Board will also guide Puerto Rico through a court-supervised process of debt reduction. It would first sort through Puerto Rico's array of bonds and put similar creditors together in classes, honoring Puerto Rico's existing bond priorities. Each class would then get a settlement offer and have the chance to vote on it. The offers would come from the board, not the government of Puerto Rico. It also contains a so-called collective action clause, making it possible to impose binding settlements on holdout creditors, that would avoid a situation similar to what happened in the case of Argentina, where holdouts prevented resolution for years.
  - Through its Debt Restructuring Provisions, it authorizes debt-issuing entities in Puerto Rico to restructure their debts in a federal court-supervised process under certain terms and conditions, if efforts to reach a consensual or voluntary agreement have not borne fruit.

- The Oversight Board has the authority to force the sale of government assets and establish efficiency measures that will consolidate agencies and reduce the public workforce.
- The governor will develop a fiscal plan—covering at least the next five fiscal years—that meets broad standards set forth in the law. The oversight board will be required to certify the fiscal plan (Section 201). Once a fiscal plan is in place, the governor will prepare an annual budget that complies with the fiscal plan (Section 202). Once the board approves the budget adopted by the legislative assembly, the certified budget will take effect.
- At the end of each quarter during the fiscal year, the governor will provide a report to the oversight board, describing the revenues, expenditures and cash flows for the preceding quarter, as compared to what was projected to be spent and received in the certified budget.
- Under the bill, the governor will send each legislative act to the board, estimating the impact of the act on expenditures and revenues, and a certification from the Puerto Rico OMB that the law is not significantly inconsistent with the certified fiscal plan. If this information is not provided then the law will be subjected to review.
- The Board has the authority to enforce a balanced budget and government reform, if the local government fails to do so, as it has the authority to prevent the adoption of legislative acts, executive orders, regulations, rules, and contracts that violate the Act.
- The bill would give the Board authority to investigate what went wrong on the island, to demand reforms and to enforce credible budgets and fiscal plans.
- The bill bars Puerto Rico's governor or legislature from exercising "any control, supervision, oversight or review over the Oversight Board or its activities."
- It also exempts Puerto Rico from the Overtime Rule of the U.S. Department of Labor which became final on May 18th, but requires the GAO—within two years—to prepare a report analyzing the impact of including Puerto Rico in the rule. If the US Department of Labor, based on the study, determines that including it in the rule will not have a negative impact, then it will be included.

The fiscal oversight board's authority would include: negotiating debt restructuring with creditors, approving budgets and laws passed by the legislature, measuring the actual level of debt, and reviewing the structure and efficiency of all of the Commonwealth's agencies and departments.

- Through Section 409, a "Congressional Task Force on Economic Growth in Puerto Rico" will be established. By December 31, 2016, the Task Force shall issue a report to Congress regarding impediments in federal law to economic growth in Puerto Rico and recommended changes to federal law to promote economic growth and job creation.
- It would also annul for all practical purposes the bill enacted by the Legislature on April 6th, allowing the government to default on debt payments.

Several amendments were introduced in the House version, and retained in the final bill approved by the US Senate, but they do not change the substance and key provisions:

- To promote economic development in Puerto Rico by eliminating a statutory cap through the federal HubZones program that does not allow the population of "qualified census areas" in a "Metropolitan Statistical Area" to exceed 20% of the total population of the MSA, lifting the cap in Puerto Rico for 10 years or until the Oversight Board established by PROMESA ends, whichever comes first. This amendment ensures that small businesses located in more than 80% of the "qualified census areas" in Puerto Rico are eligible to compete.
- Requiring the Congressional Working Group on Economic Growth in Puerto Rico, created by Section 409 of the Act, to report on the recommended federal public policy changes that would reduce child poverty in Puerto Rico.

One important amendment that failed to pass sought to eliminate the minimum wage provision that calls for allowing Puerto Rico businesses to pay workers under 25 an hourly rate of $4.25. This measure, though, can be activated by the governor if he considers it necessary, it is not compulsory.

Once a Board has been appointed, which is expected to be by September 1st, it will begin to fulfill two of its key duties, which are the development of budgets and fiscal plans for Puerto Rico. The development of these documents *will require Puerto Rico to balance its budgets, incorporate pro-growth reforms, and ensure that legislative acts advance Puerto Rico towards the goal of fiscal responsibility and regaining access to the capital markets.*

The Board's powers, also include the following:

1. The legislation sets out two distinct and complicated legal paths to restructuring. One based on using clauses to vote on new terms, the other based on a special court-supervised restructuring process. The former (Title VI) is the only one available for the next several months (until February 15, 2017, and can be extended). If the clauses-based process fails to produce an agreement within the requisite time frame (and any agreement has to be reviewed by the oversight board to make sure it fits into an overall fiscal framework that provides for a return to sustainability), then the oversight board can vote to put Puerto Rico in the court-supervised process (Title III). That is why the restructuring process will be complicated and probably long.
2. The imposition of legislative or executive recommendations, the requirement that Puerto Rico "score" (estimate the costs of) its legislative acts, and the authority to review and veto new contracts, rules, regulations, or executive orders that are inconsistent with the fiscal plans and budgets.

3. It also means that the Board can modify the budget for fiscal 2017 just enacted. In this sense, the fiscal plans represent the cornerstone to the Board's powers. Not only are budgets based on this document, but any debt-restructuring plan authorized under Title III must comply with it as well.
4. If Puerto Rico's government fails to comply with a fiscal plan, then the Oversight Board may impose mandatory cuts on Puerto Rico's government and instrumentalities – a power far beyond that exercised by the Control Board established for the District of Columbia, as the DC Control Board's power was exercised mainly by cutting federal funding for the city government.
5. The Board will only terminate after Puerto Rico has produced audited financials and a balanced budget for four consecutive years.

WHAT TO EXPECT

Much is expected from the Oversight Board. It would be naïve to assume that its work will proceed in a straightforward manner, and that it will complete its tasks and objectives on schedule by fiscal year 2021. The complexity and scope of Puerto Rico's situation, the knowledge the board members will have to acquire, plus the budgeting and fiscal supervision, and the restructuring procedures, all will contribute to make the tasks extremely complicated, particularly if the voluntary restructuring negotiations fail, or there is a significant number of holdouts.

In the case of New York City, Washington DC, and Miami, it took their respective control boards between five and eleven years to finish their work. The case of Detroit is different, and comparatively less complicated, as it involved a bankruptcy procedure.[2]

Duration of Fiscal Emergency for the Most Prominent Cases

	Period
New York City	1975 - 1986
Washington DC	1995 - 2001
Miami	1996 - 2001
Detroit*	March 2013 - December 10, 2014

Sources: Deborah I. Kobes (2009), p. 29; Monica Davey, "Detroit is Out of Bankruptcy, but Not Out of the Woods," NYT (December 14, 2014).

* The city's case was one of bankruptcy. The period covers from the moment a fiscal emergency was declared to the end of bankruptcy.

But there is more involved than procedural and administrative aspects. Of greater importance is the economic and social impact its decisions will have during its term, and afterwards. The process of restructuring debt, public finances and the economy will take time:

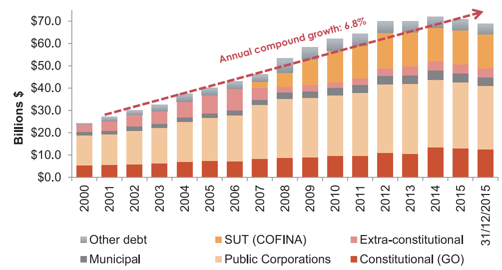
- Since one of its main tasks is related to making permanent a balanced budget, enforcing balanced budgets almost inmmediately will cause further cuts in public spending and thus in employment, which could deepen the current contraction. Already Puerto Rico is in the midst of a ten-year contraction in real GNP (an accumulated decline of 15.0% in the period).
- Return of the Comonwealth to capital markets will take time; thus limits to public spending in infrastructure will continue.

A positive side is that the oversight board will add certainty and an improved fiscal panorama in the short and long-term – if accompanied by the implementation of an economic growth plan. Hopefully, the report from the Congressional Task Force on Economic Growth in Puerto Rico (Sections 409 – 412 of the Law) should provide the basis for that. Yet, there is still a major gap, namely, it does not address one of the key problems: the need for funds to cover current operations and short-term financing, and for investment to stimulate long-term growth.

Notes:

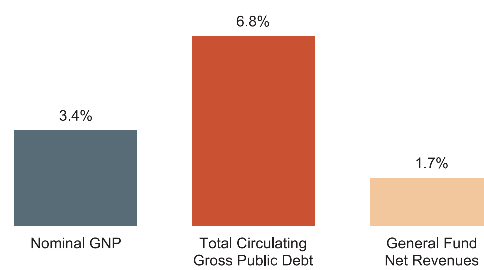
1. Debora I. Kobes, Out of Control? Local Democracy Failure and Fiscal Control Boards. PhD dissertation submitted to the Department of Urban Studies and Planning, Massachusetts Institute of Technology (September 2009). Available at: https://dspace.mit.edu/handle/1721.1/55132.
2. The principal fight in Detroit's bankruptcy concerned the order in which creditors would be paid. The city had more than 100,000 creditors, including major financial institutions, individual bond-buyers, and current and retired employees. According to federal law, priority in Chapter 9 bankruptcy goes first toward secured creditors, namely, bondholders whose loans are backed by dedicated tax revenue streams, and who thus expect full returns because of a city's unlimited tax-raising ability. There is no priority, however, for unsecured creditors, such as employees and general obligation bondholders, who fall second in line for payment. The bankruptcy settlement by the judge shed $7.0 billion out of the total debt of $18.5 billion, and the debt-cutting plan included $1.7 billion to tear down burned-out homes, buy new police cars and fire trucks, and bankroll new computer systems.

Total Public Debt in Circulation



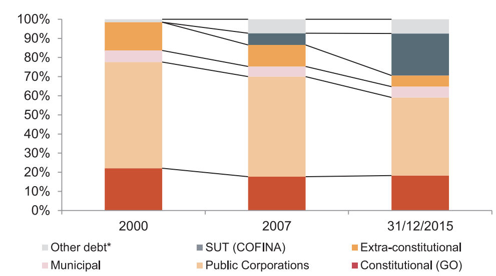
Sources: Government Development Bank; OMB, Budget

Annual Growth
Nominal GNP, General Fund Net Revenues, and Total Gross Public Debt - Fiscal Years 2000-2015*



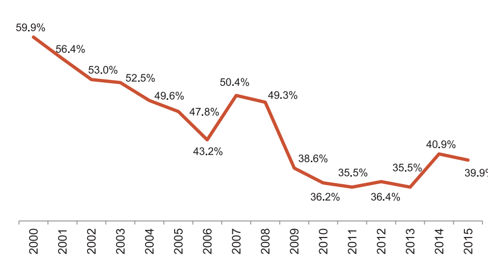
Sources: Planning Board (2016); Government Development Bank (2016).
* Compound annual rate of growth.

Distribution of Public Debt by Type



Source: OMB, Budget Requests, various years. * Include TRANS in 2015.

Share of GOs in Total Debt
Central Government



Sources: Office of Management and Budget. Budget Requests, several years; GDB.

Puerto Rico
The Economy

ECONOMY AND OUTLOOK

Besides the expected approval of PROMESA (see section above), the second quarter saw a number of significant events.

A partial default in May, the financial situation of the Government Development Bank, which ended in it being declared insolvent, and the enactment early in May of a Debt Moratorium Law are the most recent developments. All add to the prevailing uncertainty and accentuate the downside risks to the economy.

In an opinion made public on June 13th, the Supreme Court affirmed the July 2015 decision of the U.S. Court of Appeals for the First Circuit and held that the Recovery Act—enacted by the Puerto Rico government in 2014—is preempted by Chapter 9 of the federal bankruptcy code and is therefore unconstitutional under the US Constitution Supremacy Clause. Thus, it leaves PR with only one alternative for restructuring its debt, PROMESA.

Adding to these risk factors, the Treasury Department is expected to end fiscal year 2016 with a fiscal deficit that could reach $800.0 million or more. The request for the General Fund Budget for fiscal year 2017 for $9.1 billion, submitted on May 23rd, did not provide for payment of the principal of the debt charged to the General Fund budget. The budget recommended by the governor was lowered in the House to $8,562 million, and approved on June 21st. In the end a budget for fiscal 2017 of $8.9 billion was passed.

Moreover, the government has not determined how it will replace the 4% excise tax on foreign controlled corporations, which is set to expire at the end of 2017. The receipts from this source represent currently 20.3% of the total net receipts to the General Fund. And for the first time in 10 years, taxes paid in fiscal 2015 by companies under the 2008 Tax Incentives Law declined 14.5% y/y, a trend that is expected to continue, according to Hacienda. Their payments represent 10.2% of the general fund net revenues. Thus, 30.5% of the net revenues to the General Fund are under stress, leaning on the downside.

Construction loan delinquencies, as well as mortgage loans continue to be an issue affecting the financial sector. Construction-related delinquencies increased to 28.2% from 27.2% in the previous quarter. Commercial and industrial delinquencies also increased to 4.2% in Q1-16, from 3.8% in the previous quarter. The delinquency rate for residential mortgages nudged down a bit in Q1-16, to 12.6% from 13.0% in Q4-15, remaining at an average of 12.4% in 2015, while credit card delinquencies has remained at practically 1.6% since last year.

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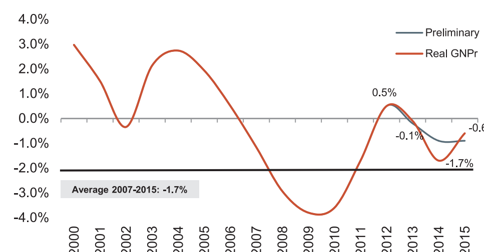
Personal bankruptcies increased by 1.9% in the first quarter, and commercial bankruptcies by 3.6%, the third consecutive quarterly increase.

On the employment side, nonfarm salaried employment declined 1.5% y/y, as private employment registered a reduction of 11,050 jobs in the period (April – May). Private employment has been trending downward since 2014, from 680,900 to 662,200 so far this year (up to May), although some sectors, such as retail trade and leisure and hospitality continue to post some gains. Manufacturing employment posted a new decline of 1.5% y/y, following a similar reduction in the first quarter.

Key economic indicators remained in negative territory, with a similar short and medium term outlook. Growth expectations for the short and medium terms continue to be on the negative side. Real GNP growth in fiscal 2015 registered another decline, in this case of -0.6% from -1.7% in 2014. Real growth in 2014 was revised up from a preliminary -0.9%. The lower contraction in 2015 was due to a positive contribution of net exports, since the contribution of other components was negative.

Real GNP Growth
Fiscal Years



Source: P.R. Planning Board (2016). *Apéndice Estadístico 2015*. Tabla 1. r =Revised and preliminar for 2015.

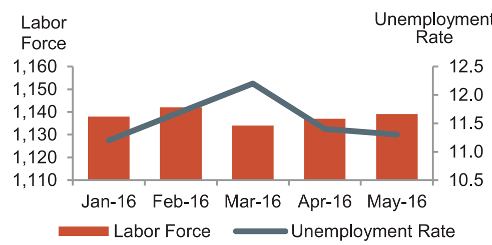
For fiscal years 2016 and 2017 the Planning Board forecast continuing and increasing declines of -1.2% and 2.0% respectively. For these years 2016 and 2017, according to the forecasts from the Puerto Rico Planning Board, construction investment will decline further, reflecting expected reductions in both, public and private investment. We believe, though, that these declines could be greater, if the debt restructuring and cuts in public spending under the proposed federal Oversight Board are implemented.

Puerto Rico
Economic Indicators

Employment

	Mar-16	Apr-16	May-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Labor Force (Household Survey, thousands)	1,134	1,137	1,139	0.4%	0.6%
Employment (Establishment Survey)	895	895	893	-1.2%	-1.2%
Private	665	665	663	-1.1%	-1.0%
Construction	22	22	22	-13.3%	-13.0%
Manufacturing	73	72	72	-2.4%	-2.9%
Public Administration	230	230	230	-1.5%	-1.9%
Unemployment Rate (Household survey, %)	12.2	11.4	11.3	-9.2%	-3.2%

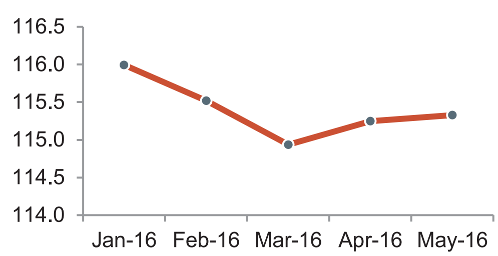
Total Employment and Unemployment Rate
(December 2006 = 100)



Consumer Price Index

	Mar-16	Apr-16	May-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated 2015-2016
All Items	114.9	115.2	115.3	-0.2%	0.0%
Food & Beverages	128.8	128.1	128.1	3.1%	2.7%
Housing	111.0	111.2	110.6	-1.7%	-1.3%
Apparel & Upkeep	93.8	94.7	94.1	1.5%	1.7%
Transportation	103.4	104.8	105.8	-5.7%	-5.0%
Medical Care	147.3	147.4	147.5	3.5%	3.2%
Education	113.8	114.9	114.8	3.2%	3.2%
Entertainment	113.3	113.1	113.1	4.0%	3.9%
Other Services	114.7	114.8	114.7	1.6%	0.8%

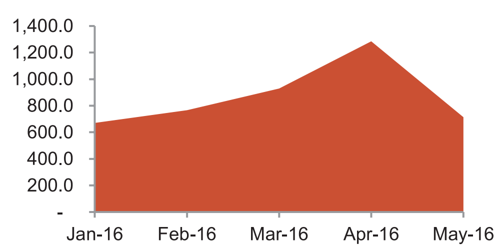
Consumer Price Index



Fiscal Revenues

	Mar-16	Apr-16	May-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Total Revenues (Mill.$)	929.7	1,284.7	713.8	5.8%	4.5%
Taxes	885.6	1,234.7	688.2	4.2%	4.5%
Income Taxes	407.0	757.2	243.2	-8.5%	-7.5%

Net Revenues to the General Fund

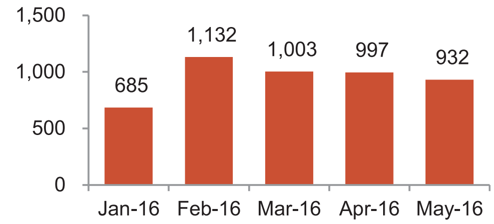


Puerto Rico
Economic Indicators

Construction

	Mar-16	Apr-16	May-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Cement Production (Thousand 94-lb Bags)	1,003	997	932	-3.4%	-2.1%
Cement Sales (Thousand 94-lb Bags)	1,043	1,000	999	-10.7%	-13.5%

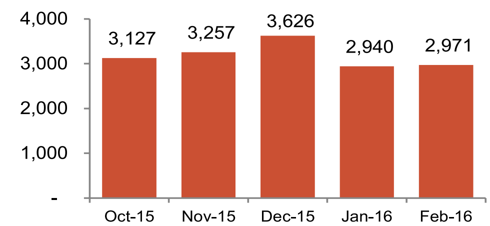
Cement Production



Retail

	Dec-15	Jan-16	Feb-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Total (Bill. $)	3,626	2,940	2,971	-2.9%	-2.39%
Department Stores (Mill. $)	649	482	464	-2.6%	0.61%
Supermarkets (Mill. $)	493	478	451	2.2%	1.98%
Used and New Autos (Mill. $)	357	268	295	-1.6%	-0.48%
Gasoline Stations (Mill. $)	418	413	403	-11.9%	-8.28%
Restaurants (Mill. $)	374	319	350	2.1%	3.54%

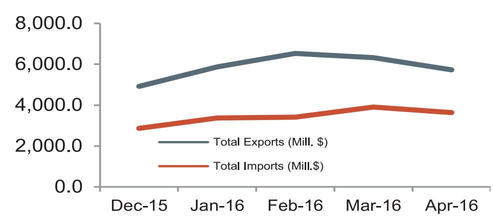
Retail Sales



Exports and Imports

	Feb-16	Mar-16	Apr-16	Percent Change Fiscal Year 2015-2016	Percent Change Accumulated year to date
Total Exports (Mill. $)	6,530.4	6,321.4	5,725.9	2.9%	0.9%
Foreign Countries	1,636.7	1,102.5	1,109.7	-8.3%	-13.6%
Total Imports (Mill.$)	3,407.2	3,906.1	3,634.4	-2.2%	1.0%
Foreign Countries	1,201.9	1,473.4	1,622.5	-14.1%	-15.5%

Exports and Imports



Manufacturing

	Mar-16	Apr-16	May-16	Percent Change Fiscal Year 2016/2015	Percent Change Accumulated year to date
Weekly Hours (#)	40.7	40.8	40.3	-1.8%	0.0%
Average Hourly Wage ($)	12.5	12.3	12.2	-7.2%	-6.3%

Average Hourly Wage ($)