Puerto Rico's Fiscal Crisis:

Understanding the Revenue Trends

April 4, 2018

Puerto Rico needs fundamental policy reforms to change its economic destiny. Puerto Rico levies a progressive, and complicated, income tax with abysmal compliance rates. Its business climate is notoriously uncompetitive. And, the energy sector is in desperate need of reform. Restoring prosperity requires broad based reforms that comprehensively address these problems.

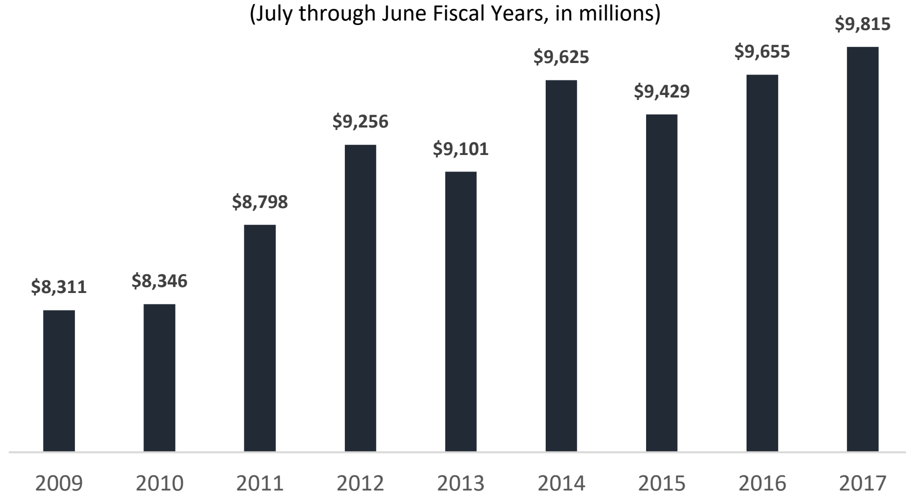
The near-term priority, however, is sustainably resolving the fiscal and debt crises. Resolving these crises are complicated by the zero-sum nature of the situation – Puerto Rico is simply unable to meet all current obligations. The importance of resolving Puerto Rico's crisis is amplified because Puerto Rico is not alone in facing an insurmountable fiscal crisis. Illinois and California, along with municipalities across the U.S., are facing unsustainable long-term fiscal futures as well. Thus, how Puerto Rico's fiscal crisis is resolved has implications well beyond its borders.

Meeting its future financial obligations requires growth in government revenues. While government revenues were one of the many casualties of Hurricane Maria, and despite the Commonwealth's continued pessimistic revenue outlook, there is possibly clearer skies forming. To see why, it is helpful to examine Puerto Rico's General Revenue trends since Fiscal Year 2009, which are summarized in Figure 1.

Figure 1: Total General Fund Revenues

2009 - 2017

(July through June Fiscal Years, in millions)



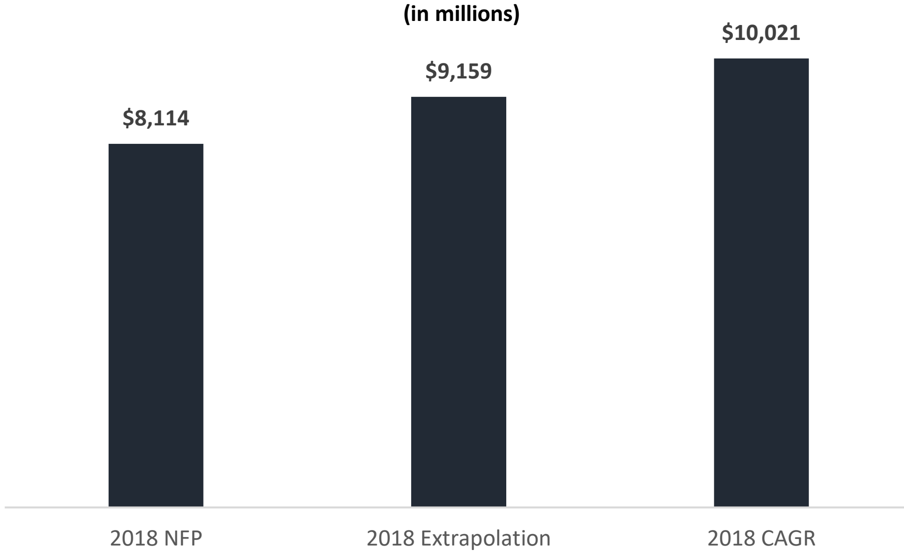
Between 2009 and 2017 (prior to Hurricane Maria), total General Fund revenues were growing 2.1 percent per year (as calculated on a compound annual growth rate, CAGR, basis). While growing, Figure 1 illustrates that this growth was volatile, which reflects the economic troubles plaguing Puerto Rico. Since the Hurricane a fundamental question is: What is Puerto Rico's revenue outlook now?

Projecting revenues based on the 2.1 percent CAGR between 2009 and 2017, Puerto Rico should have raised $10.0 billion in General Fund revenues in 2018 without Hurricane Maria (2018 CAGR). But, Hurricane Maria did hit the Island. According to the *New Fiscal Plan for Puerto Rico* published in March 2018 (2018 NFP),[i] Fiscal Year 2018 General Fund revenues are currently estimated to be $8.1 billion, which would be a 17.3 percent decline in revenues for Puerto Rico compared to FY2017, and a 19.0 percent decline compared to the CAGR baseline. If correct, then these revenue projections are devastating. However, these revenue estimates may be overly pessimistic if the assumption that the worst of the hurricane's impacts have already occurred.

Puerto Rico has reported four months of revenue data since the Hurricane hit in September. General Fund revenues in September 2017 were 90 percent of the average revenues raised in September over the prior 9 years. In October 2017, when the worst General Fund revenue impacts from the Hurricane were felt, revenues were 74 percent of the average revenues raised in October over the prior 9 years. Presumably, these revenue disappointments are the basis for the $8.1 billion revenue estimate.

Prior to the Hurricane (July 2017 and August 2017), revenues were 118 percent of the historical average; and, in November 2017 and December 2017, revenues were 101 percent of the historical average. If just the 101 percent revenue experience holds for the remainder of the fiscal year, then total General Fund revenues in FY2018 should be $9.2 billion, or a 6.7 percent decline from FY2017 revenues (2018 Extrapolation). Compared to the baseline revenues of $10.0 billion, revenues will be 8.6 percent lower. These trends are illustrated in Figure 2.

Figure 2: 2018 General Fund Revenues -- Alternative Estimates
(in millions)



The implication for Puerto Rico from these alternative revenue estimates is meaningful. While the lost revenues relative to the baseline estimate illustrate the large impact from Hurricane Maria, current trends indicate that the revenue estimates contained in the *New Fiscal Plan* may be overly-pessimistic.

Prior to Hurricane Maria government revenues were growing. Should current trends bear out, Maria's negative impact on government revenues will have proved to be temporary, indicating that Puerto Rico will be better positioned to meet its current obligations than the current government estimates are recognizing.

[i] (2018) "New Fiscal Plan for Puerto Rico" *Government of Puerto Rico*, March 23.