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THE DEBT CRISIS IN PUERTO RICO

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PARTICIPANTS:

DARRELL WEST, Moderator
Vice President and Director, Governance Studies
The Brookings Institution

PALMIRA N. RIOS GONZÁLEZ
Director, Graduate School of Public Administration
University of Puerto Rico

DAVID HITCHCOCK
Senior Director, Public Finance Ratings
Standard & Poor's

BARRY P. BOSWORTH
Senior Fellow, Economic Studies
The Robert V. Roosa Chair
The Brookings Institution

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P R O C E E D I N G S

MR. WEST: (in progress) conditions since 2006 and since 2010, Puerto Rico has suffered a net population loss of almost 6 percent. But Puerto Rico has also taken several steps to attempt to get its fiscal house in order. It has expanded its sales tax base, raised additional revenues, reduced its budget deficit. Its passed a couple of pieces of legislation, the Fiscal Sustainability Act to cut the budget deficit and the Recovery Act to provide an orderly restructuring process for public corporations if needed. It has enacted public pension reform to reduce long-term liabilities and adopted a hiring freeze. And it has a government debt to GDP ratio that is below that of many nations around the world.

So to help us understand how we got to this situation and what we need to do in order to move forward, we have brought together an outstanding set of speakers.

So to my immediate right is Dr. Palmira Rios González. She is the director of the Graduate School of Public Administration at the University of Puerto Rico. She is the current president of Inter America Network of Public Administration Education. She is the co-coordinator of the Legislative Academy of the House of Representatives in the Senate of Puerto Rico. And she has written books about the organization and operations of the government in Puerto Rico.

David Hitchcock is the senior director of public finance ratings at Standard & Poor's. In his role there he's involved in state rating and the Ratings Committee. Before that he was in Standard & Poor's state and local government group. He served in the U.S. Controller General's Advisory Council on Government Auditing Standards, and he's also contributed to a number of different publications, such as *Bond Buyer*, *City and State Magazine*, and *Governing Magazine*.

And Barry Bosworth is a senior fellow of Economic Studies at Brookings.

He is currently the Robert V. Roosa chair in International Economics. His research has included work on the determinates of economic growth in developing countries, saving capital formation, and productivity growth. He was the director of the President's Council on Wage and Price Stability in 1977 through 1979. In 2006 he published a book with Susan Collins and Miguel Soto-Class called the *Economy of Puerto Rico: Restoring Growth*.

So I want to start with Palmira. You have been a long-time observer of Puerto Rico government. How did Puerto Rico reach its current fiscal situation?

MS. RIOS GONZÁLEZ: Well, first, thank you for inviting me to participate on this forum and also for taking this issue. It's very important that people in the United States understand the severity of the crisis and try to figure out ways of getting out of it.

It's an interesting situation. It is really like a story of the wolf -- it's coming, it's coming, but now it's here -- because when you look at the many stories that have been conducted on this issue, this has been a story that had been forewarned for a long time.

First, we have a governmental structure that is basically the same since 1940. So it hasn't really changed very much since over the country. And the world has changed, but our structure is highly centralized. We have a very large Executive Branch that basically has spread out throughout the Island. There are about 255 agencies or bodies spread out throughout the Island. They are not coordinated with each other.

It has focused mostly on the delivery of services, as opposed to the United States where services are delivered by local or county governments. In the case of Puerto Rico, it's the central government that delivers services. Therefore, you're going to find very little evaluation as opposed to the role of central government that don't really have any value or effectiveness on their policies. In our case, the central government --

for example, teachers, health workers -- are all employees of the central government. And that's why our structure is an exception in regards to other states where the majority of our employees are employees of the central government, whereas in the United States the majority of public employees are employees of the municipal or other local governments. So we have that kind of service.

As I said, there is very little evaluation. So there is not a tool that is used to really trim the budgets. So how will they trim the budgets? Because they're constantly increasing and that's how we got in this situation? For a long time that issue with bonds or whatever, was the way of dealing with the gaps in funding of the government of Puerto Rico. The government keeps increasing. The number of employees kept increasing. The services kept increasing. But the collection of funds through taxes and other means were not increasing accordingly.

So for a long time borrowing was the response or the answer to that growing gap. But as it happened to many of us, we have a credit card and it has a limit. And so we reached our limit. We reached a limit that many of our corporations actually are worth less than they owe and so there is a limit in our capacity to continue to borrow.

One of the reasons -- and that's why I'm glad this forum is part of the Governance Studies program -- why we cannot get our act together and really put forward a recommendation because when you look at all the studies, including the transition reports, the transition reports are issued every time a government changes in Puerto Rico. There is an evaluation of the state of the Executive Branch on the debts, et cetera. And they all have concluded that we have to change our model; that our model is obsolete, and we must really try to decentralize, consolidate against this, or even eliminate it in instances. Why we haven't been able to achieve that goal -- and this is where the politics come about. Usually politics will stop any effort, any attempt, to really

try to restructure or reorganize how we function, how the political administration functions in Puerto Rico.

There's very little merit in hiring in Puerto Rican government. They have been so politicized and have been growing that kind of politicization that many of the people working in the government, especially in the central government, come about through their political participation in the parties. So the principle of merit that is the centerpiece of public service has really been eroded and practically eliminated in Puerto Rico. And so although we keep pushing and arguing that it's necessary that we move back to that kind of system, politics keep defeating those major goals.

So we have a welfare state that essentially is promoting dependency; that people receiving services aren't necessarily working. In the introduction it was mentioned that we have a high unemployment rate. I would rather focus on the low level of participation where in Puerto Rico is at 40 percent, because I think the unemployed are those that still have hope, those are the ones looking for work. But the majority of the population in Puerto Rico is completely out of the labor force. And not since the 1950s that threshold has gone beyond 50 percent. So we have been toward the last two or three decades at a 40 percent labor force participation rate. And so the social problems that come about as a consequence of that situation are enormous and are part of the issues that we are going to try to address.

In addition to that context of the low labor participation rate, you have then a system that is not collecting and will not be collecting enough taxes to sustain that governmental structure. So the responses have been to grow the scope of taxes and that's why in 2006 the sales tax was introduced in Puerto Rico. And now we have a new tax and the government is now looking into a new tax structure to probably expand the sales tax and reduce the income tax in Puerto Rico. We'll see how the whole thing

happens, but it's still a proposal, and secondly whether it will work because we can approve laws. Whether we have the capacity to actually implement it fully is another question.

And I think that is one of the issues that we have to raise here is: With our governmental structure, can we actually implement these major structural changes that are needed in Puerto Rico. So we are facing many serious structural problems, governmental problems, but we still don't have the governance relations to really put forward an agenda that will really transform the Island. That's why this kind of discussion is so important to really start pushing for different directions to bring forward those changes that are needed.

MR. WEST: Thank you very much. It's very helpful to get that background on the situation. So, David, in February Standard & Poor's downgraded Puerto Rican debt to below junk level. So what went into that decision?

MR. HITCHCOCK: When we're looking at our speculative grade credits, we're generally looking at very short-term factors and our focus narrows in terms of the length that we're looking for future events. So our primary focus in February when we downgraded back then the rating to below investment grade was liquidity. And in particular we're worried about the access to the external debt markets for cash flow notes. The year before, I believe, they sold about \$1.2 billion in cash flow notes. As you know, they've recently sold cash flow notes about \$900 million recently at a very high rate. But they do need cash flow notes to get them through the fiscal year apart from financing operating deficits. And also the concern was that if operating deficits continued, there would be a potential need to access the debt market again to be able to finance police and fire and necessary services that had been going on for about 12 years. So there continues to be concerns that if there are deficits, what's the fallback? Can they find

access to the external market to pay ongoing expenses?

Then in addition at that time, there was also some significant concern about contingent risk, what we call contingent risk, or things that could happen very quickly based on other events. So there could be an acceleration of debt. There could be interest rate swap agreements that terminate with a large termination fee. There's variable rate demand bonds that could come due all at once. The credit lines behind them could expire. These are credit events.

Those concerns have largely been taken care of since with the \$3.5 billion general obligation bond issue they sold in March. However, we still have continuing concerns, particularly as to what got them to having the weak liquidity to begin with and that is the economic trends in the long run that's driving a lot of this, the operating deficits, and some of the weak results that they've been having recently financially.

So we continue to be worried about the potential for operating deficits. They passed essentially a balanced budget for fiscal 2015, which ends June 30, 2015. It's balanced in the sense that they don't require additional financing if all those budget assumptions turn true other than the cash flow notes. However, we see implementation risks. In the past budgets have been frequently missing their budget targets on the revenues and the spending side.

So far, the first quarter of this year they're off somewhat, but not nearly at the level that they've been in previous years. So we'll see how the year progresses, if they can meet that. But even if they meet the budget targets, we see structural imbalances going forward in future years. There's, in particular, capitalized interest from the geobond issue that they sold in March, slightly over \$300 million that will have to be paid -- additional interest costs -- out of the general fund in fiscal 2016. The general fund also gets excess sales taxes after first the deduction from the Puerto Rico Sales Tax

Financing Corporation or COFINA, and the COFINA debt service goes up about 3 or 4 percent a year. So without any growth in the sales tax, you'd be getting less and less sales tax into the general fund in future years.

We're also concerned in the future years by an increase in the pension costs. They're very close to running out of pension assets altogether. If the Employees Retirement System and the Teachers Retirement System go to a pay-as-you-go system sometime in the short term, the most recent disclosure comments that would be the near term -- without an actuary report I can't say exactly when that would happen, but it will be relatively soon at the current trend -- they'll have a large increase in the pension contributions that they'll have to make. Those are contractual obligations to pensioners.

Then in addition we feel that there's going to be a significant increase in health care costs. Now, health care isn't necessarily all paid out of the general fund, but if there's a significant deficit in the health care system, the general fund might be called upon to make up those differences. They've accelerated some one-time federal funds into recent years, so the current projection is beginning in 2018, there will be a large increase in health care costs. Nobody knows where that deficit's going to be made up from, so they're going to have to tackle that.

So there are some very significant long-term cost increases that will have to be tackled in the next few years. So while the budget might be balanced this year, we're worried about structural imbalance in the next couple of years. So we see some very significant issues there. They'll still have to access the external debt market for cash flow notes. That's because there's an imbalance between when revenues come in and expenditures go out within the year. They had to pay a very high interest rate compared to the rest of the market for the cash flow notes this year.

Now, to the extent that they can move toward structural balance, then

we'll feel better about it and that's the key. And also the liquidity -- we're also concerned about the liquidity from the Government Development Bank because that's been a primary source of liquidity in the past. Their access to the external market has been constrained and so that also affects the ability of Puerto Rico's general fund to borrow from the Government Development Bank for cash flow purposes and other purposes.

So we see some of these long-term trends. Now, we do believe that the economy is one of the key factors that's going to affect some of these trends because they'll need additional revenue to cover some of these increased costs. And you can increase taxes, but it becomes more difficult politically. We're rating both ability and willingness to pay. And so to the extent that there's additional revenues because of organic real economic growth, that will be to their benefit.

We're coming out with a publication. We expect to come out tomorrow morning on interaction between the economy and credit quality. So I would encourage you to take a look at that. We can send you or email you a copy of that if you're interested later. But it is a key factor. Economy tends to point to long-term trends. I wouldn't say that our current rating is focused particularly on short-term trends, liquidity, but some of these longer term factors will affect that liquidity.

MR. WEST: Thank you. So, Barry, you literally wrote the book about the Puerto Rico economy. And I know you've talked a lot about the link between the fiscal problems, but the more general economic problems facing the Island. So how do you see the situation?

MR. BOSWORTH: Well, I kind of hate to pile on. I think what we've heard is already a pretty dismal outlook. But I do think that the fundamental fiscal problems in Puerto Rico reflect a lot of mistakes by the government. I don't disagree with that. But fundamentally, Puerto Rico's problem is just a collapsing economy and it's been

collapsing now relative to the rest of the country for over 25 years.

I think it's very hard to devise a strategy for turnaround at this point. And Puerto Rico, the sad thing is, that it's caught in a downward spiral of both the economy and the government. The economic growth is negative. Incomes are declining. Employment is falling. So naturally the government revenue falls off, right? But there's increased needs of people on the Island, so there's a lot of pressure to increase expenditures at the same time. The deficit widens and the consequence of that is that it increases the pressure on the economy for further deterioration.

I just don't think it's a stable situation in Puerto Rico at the present time. The government debt has reached the limit where if it was a state in the union, I think everybody would agree you couldn't possibly repay all that debt. It's not sustainable. It is a mixture of situations because the one big advantage people on the Island have is that they don't have to pay federal income taxes. But that's not a very big advantage anymore if you don't have any income, and a lot of these people wouldn't owe taxes even if they lived on the Mainland.

Population is shrinking, mainly I think, because it's increasingly attractive for people to move to the Mainland, just as you said. I don't think there's a particular bias. A New York Fed article recently on the population of Puerto Rico shows everybody's leaving the Island. It's not just the highly skilled. In fact, surprisingly, some pretty skilled people are staying in Puerto Rico because it's an attractive place to live. A lot of unskilled workers -- because another way to think of this is the minimum wage in Puerto Rico is the same as on the Mainland, but incomes in Puerto Rico are less than a third of what they are on the Mainland. So that means the effective minimum wage in Puerto Rico is three times higher than it is on the Mainland. It is a very real constraint on hiring anybody given the cost. So at the bottom of the labor skill level, a lot of workers find no job opportunities

so they move to the Mainland. There's a better opportunity for them on the Mainland as much as there is for skilled people.

It's a very difficult economic situation. I don't think there have been any great proposals of what would turn this around. Why would a business want to move to Puerto Rico? Why is there an attractive place to do business in Puerto Rico? I think it's hard to identify a rationale for that, and that's the fundamental problem that the government faces. It's not a problem of just collecting revenue. It's trying to collect revenue in a declining economy and that's a very difficult situation for them.

I think increasingly the Island situation is degenerating into basically a battle between a lot of hedge funds and financial institutions who have bet on both sides of this. Some of them think there's going to be a default, so they are betting that they can buy debt in the future at a very low price and others are betting the opposite way. But this is giving rise to a lot of proposals in Puerto Rico, particularly with respect to the budget situation, that are not good ideas for Puerto Ricans. They're instead proposals that come forth because they benefit one side or the other in this speculative bet over what's the future of Puerto Rico.

But the focus is not on coming up with a credible economic program for Puerto Rico that might have some chance of success. So I look at it not so much as a budget problem; I think it's an economic problem of the Island as a whole and how are we going to turn this situation around. And people on the Mainland might say they don't care, but look at those income figures. Poverty levels are just incredible in Puerto Rico. I mean poverty rates are much, much higher than in the U.S. The number of people that are below the poverty line is about three to four times higher than it is on the Mainland. What's the country going to do since these are American citizens? I think we have to feel some sense of obligation for coming up with some solution to the economic problems of

the Island other than just encouraging everybody to immigrate. That doesn't seem a very satisfactory answer either.

MR. HITCHCOCK: I'd just like to make one other point, too, in that credit quality isn't necessarily exactly the same as looking at the economy because somewhere between a fifth to a quarter of their general fund revenue actually comes from taxes on offshore manufacturing companies that do offshore manufacturing and the federal excise tax on rum. So close to a quarter of the general fund revenues don't really depend so much on what the unemployment rate is on some of the poorer people. It certainly affects the costs that you're talking about.

But our focus is sometimes a little bit different, but certainly the economy, particularly for the installed manufacturing is obviously important, but our focus sometimes is a little bit different than perhaps employment is itself because manufacturing is a very small level of employment overall.

MR. WEST: So, Palmira, I know you mentioned the governance issues in your opening remarks, and you said that right now the Puerto Rican government is very centralized, has a large Executive Branch, lots of agencies with little coordination. And you mentioned your view that the government needs to decentralize. So could you just talk a little bit about that? Like what would be involved in that and how would that help either the budget problem or these more general economic problems that David and Barry talked about?

MS. RIOS GONZÁLEZ: Since 1991, the policy of the government of Puerto Rico has been to decentralize, to transfer some services to local governments or to nonprofit organizations, et cetera. Actually, just last year a report was issued -- I was part of that commission -- that recommended the creation of regions, which would congregate several municipalities to provide services in a more effective and efficient

manner. But it was based on what had been the longstanding policy to try to transfer services to local governments under the principle that services should be delivered closer to the people that are receiving those services, but that really hasn't happened.

So we think and actually a small number of people think because many people would rather eliminate local governments or consolidate them and have a stronger central government and that tendency should be adopted or that proposal should be adopted, that the services, direct services, should be like in the states be transferred to local or regional organizations that could probably be more efficient. Actually the numbers that we looked at in terms of services were more cost effective than the services provided at the central government. So it is really mostly a matter of politics rather than really cost effectiveness or efficiency that has kept the government from moving forward on this proposal.

The second thing that should be done is to really pay a very close look at that structure and determine which agencies should remain, consolidate or eliminate one. For a long time the policy was to create an agency for every problem and that was also sustained by federal funds that kept financing that structure. And to the extent that federal funds represents about a fourth of the consolidated budget of Puerto Rico, that really kind of kept us afloat and it obscured the fact that the funding generated through taxes and other funds was not sufficient to support the structure of the government.

So now is a good time to start looking at how do we really restructure where we have a more moderate, agile, effective structure to really deliver the services that are demanded by a population or as a people, but also on a more efficient level. So, again, it's another example of politics, really in the way of good, sound, public policy that for a long time this policy had been stopped or limited, had been applied on a very limited basis, and so we have not really moved forward.

As Dr. Bosworth mentioned and I agree with him, this problem is a long-term problem. The Commonwealth of Puerto Rico has been on a freefall for a long time. And so I think federal funds kind of kept us from realizing how deep the problem is. Now that the situation has really gotten to a very severe state, I think we also have to start discussing the impact of the new Congress on funding some of those services in Puerto Rico because we may face an even more complicated scenario in the next few years.

MR. WEST: So, David and Barry, each of you kind of enumerated the challenges -- the economic climate, the debt servicing issues, pension costs, health care costs, structural imbalances, and the budget. Now, the U.S. economy has been improving, so one question for each of you is: does that offer hope going forward when thinking about Puerto Rico?

And then Palmira just mentioned the impact of the 2014 election and the fact there now will be Republican majorities both in the House and Senate. Is there going to be any impact of that either in terms of federal funds, federal investments, transfer payments, that might particularly impact Puerto Rico? Either one of you want to address those issues?

MR. HITCHCOCK: Well, first I'll say a reigning doesn't incorporate anticipation of any extraordinary federal aid other than what's in current law. To the extent there was, it would be a positive factor and we'd have to look at that when it actually was enacted if it was. But we're not anticipating that there will be at this point.

MR. WEST: But what about the negative? What about cuts in federal funds?

MR. HITCHCOCK: Well, we are focused on the health care law, and they're using -- they're accelerating some one-time funds into current years. And so when that runs out, I know there's a hope that that could be extended and they could get

additional federal funds. But to the extent that that's more difficult, that could make their task for balancing or solving some of these health care issues in the future more difficult. But we're talking 2018; I don't know what the makeup of Congress will be in 2018.

MR. WEST: Or do we? (Laughter)

MR. HITCHCOCK: And to the extent that the U.S. economy improves, it's only going to be a positive. The question is how much? They've delinked a little bit since the Section 936 federal tax breaks for the manufacturers expired in terms of the economic growth of the Mainland affecting Puerto Rico, but that's now getting to be a decade gone. So the question is what can grow the economy? I'd like to hear more from our distinguished economists here, but Puerto Rico is pointed towards tourism, some other areas that might be subject to tax advantages. They've also touted themselves as being able to manufacture under the U.S. flag for defense industries, pharmaceuticals, where there might be regulatory or other reasons why it might be advantageous to have lower cost labor, but under the U.S. flag as opposed to say Mexico under NAFTA. They've pointed to certain tax breaks to high net worth individuals. As was pointed out, you don't necessarily pay federal income tax in Puerto Rico if you're a resident. They've touted medical tourism, various things. None of these seem like large areas. Tourism is a relatively small part of their economy, but to the extent that it grows and to the extent that the U.S. economy grows health side, that could provide incremental benefit.

MR. WEST: Barry, your thoughts on that? Would an improving U.S. economy help and do you see any impact of the 2014 elections?

MR. BOSWORTH: It's pretty much decoupled in recent times. Puerto Rico is actually a long ways away from the Mainland. I think tourism is difficult because tourism's basically low skill job opportunities. And in the Caribbean. Puerto Rico is a high labor cost Island because of the U.S. federal minimum wage, which was imposed on

them several decades ago in response to pressures here on the Mainland. So I think they could do a little bit more on making tourism more attractive, but it's not going to be a big boom for the Island.

In terms of threats that it faces in the short run from the government, remember the biggest transfers that people always say the federal government transfers a lot of money to Puerto Rico. The two biggest things are Social Security and Medicare and they are American citizens and workers who earned the rights to those. That's not a gift from the U.S. government and so Medicare will continue. There's no challenge to that. Social Security will continue.

The one David raises that I think is a problem is Medicaid and probably the change of government here in Washington will change that. They have never received Medicaid under the same formula that was given to the states. They get a much reduced amount and they used it to finance sort of an Island-wide health care program. They basically had a public health care program for a lot of low-income people a long time ago. The system now can't be sustained anymore with current financing. I think the outlook is in the U.S. Congress now. The chance that the Congress would be willing to expand the transfer of payment under Medicaid to the Island is probably zero. So I agree with David. They face a major coming crisis on the medical care costs front.

The other one I can think of is in 2012. The Island in some respects with its tax policy had just become a tax haven. It's a real shame about the degeneration of any sort of normal form of taxation. But what they did to cover their budget crisis back then was they imposed an excise tax on multinational corporations, but said don't worry. You'll be able to deduct that against the federal income tax. Well, there have been a lot of questions about that, whether they would. What's happened? IRS says we're studying the issue. We'll make a determination, but if we do, it will not be retroactive. A

lot of taxpayers would like that kind of uncertainty with respect to IRS, right, if you could make a decision, but it's never retroactive. I think there's going to be pressure on IRS to resolve this issue one way or the other. And if they rule that the tax is not deductible against federal, it will be a major crisis. It's about \$2 billion a year that sort of by indirect means Puerto Rico has been allowed to get like an increased fiscal transfer, I guess you would say, a tax deduction that went to the multinationals. I think that's threatened.

The other one I wonder about is because we hear increased things about Americans moving abroad for tax reasons and stuff like that. This Act 22, which allows you -- as long as you've never lived in Puerto Rico in the past, you could move to Puerto Rico and not have to pay any taxes on dividends, interest, or capital gains that you had earned. It's sort of an outrageous proposal, particularly because a normal Puerto Rican has no access to it. It's only if you move newly to the Island. But that's the sort of erosion of the federal tax base that also offends people on the Mainland. It reduces sympathy, you might say, for the situation in Puerto Rico when they do these sorts of things. I wonder about the future of that tax law. I don't think it's very important as it turns out. I'm not completely up to date, but I don't think they've got a lot of revenue from this. It's just that it changes the atmosphere for whether or not the federal government would be willing to step in and help the Island.

So I would agree. On balance, I think the election intensifies the pressures on the Island to do something about its problems, the fiscal problems in particular.

MR. WEST: Let's open the floor to questions and comments from the audience. So if you have a question, you can now raise your hand. There's a question here upfront. We have a microphone that's coming up to you. If you can just give us your name and your organization, please.

QUESTIONER: Mark Roskey, retired physicist and CEO. My question has to do with Cuba. What happens if the Cuban situation changes and Cuba opens up to their near neighbor of Puerto Rico? Is that a plus or a minus on the economy?

MS. RIOS GONZÁLEZ: I was thinking when we were talking about Cuba in terms of tourism would be a big competition for Puerto Rico, also in terms of labor. So while it may encourage some collaboration of businesses, I think it would be a very tough competition for Puerto Rico. And we really don't have any strategy to deal with the opening of that market, just as we didn't have a strategy to deal with the growth in the Dominican Republic's economy, which is not even a Communist country. And it's also having a very significant impact on the Puerto Rican economy.

So to the extent that we have not been able to develop a strategy, we cannot really respond effectively to changes such as Cuba, which very likely will probably be more a part of the market. But it also happened in the Dominican Republic. Now we're trying to set up some kind of relation with Colombia, but again, there are political -- the question of our political status to them limits our capacity to engage in those kinds of international exchanges.

MR. WEST: Question right there on the aisle.

QUESTIONER: Gerald Chandler. How big a factor are remittances to Puerto Rico from Puerto Ricans living in the U.S., and is that increasing because so many are moving to the U.S.?

MS. RIOS GONZÁLEZ: One of the problems that was raised by the report by the New York Fed is the lack of statistics and the fact that we really don't know much about the remittances from the states to the Island, so it is really hard to answer your question. But I think that is a market that we haven't tapped yet. There are more Puerto Ricans in the states than on the Island and it is a market that I think we should

start pursuing more aggressively just as exports and production in Puerto Rico. But in terms of remittances, it's not something that I do have data on it and it is one of the major problems in analyzing and devising policies when your data system is really very unreliable.

MR. WEST: On the other side of the aisle, right there.

QUESTIONER: Thank you. I'm Arturo Porzecanski with American University. We have seen this situation before with a number of municipalities where the tax base has eroded by flight to the suburbs or other reasons and eventually the public sector unions capture the governments, so it's very difficult to do things on the spending side and so on. But in the case of municipalities, there have been two instruments that have been put to work that have really worked. One is the imposition of a financial control board and the other is a bankruptcy process through Chapter 9, which doesn't directly apply to Puerto Rico.

I was wondering, do you think that even a Puerto Rican perspective, do you think the time is coming where a lot of people in Puerto Rico realize that this administration or maybe even the next one can't solve the problems on its own and it's time for a financial control board imposed by Congress?

MS. RIOS GONZÁLEZ: Actually, there are quite a few agencies now under some kind of control and monitoring on the part of the federal government. That is the case of the Police Department. That's the result of a lawsuit. It's been monitored by the federal government, by the Department of Justice. It is also the case for environmental areas and also in education, special ed. So that has been actually a trend of the past few decades of more and more agencies because they cannot meet their obligations or they are violating the laws. They have been put under some kind of direct monitoring by the federal government.

Whether the whole country, as it happened in New York and other cities, will have to accept some kind of fiscal commission is something that many people don't like in terms of the autonomy of the country, et cetera. Whose interest is that fiscal commission going to be serving or addressing? But many people are talking about that possibility, but that would be the best evidence of a total collapse of governance; that we cannot on our own really address that.

I may also add that even the electrical authorities are under some kind of monitoring. They call it differently, but it's some kind of form of monitoring by the lenders. So many more agencies of the Island are under some kind of direct control or indirect control by some of this kind of commission. The whole government? That would be a political issue. I may want to add that one form the governance is proposing is that the federal government buys out the debt of Puerto Rico. But the question is why should the federal government do that? I mean what's the interest behind doing it? But those are the kind of answers that are coming up. We really don't have yet a very definite answer.

As to whether people are understanding the gravity of the issue, I thought we were. When I was part of the Transition Commission, we actually publicized a lot of information on the situation of government and how the bad the situation was of our public corporations. And many people said yes, I understand things are bad except when it comes to them personally. They understand that we have to make cutbacks in our arrangements, et cetera, except when it comes directly to me. So, for example, I think my own workplace at University, yes, people are in favor of doing something elsewhere. And that is probably one of the major roadblocks that makes me very worried about our ability to respond to this deepening crisis.

MR. WEST: The gentleman right here.

QUESTIONER: Good morning. Julio Cabral Corrada from Stone Lion

Capital and Bondholder Ad Hoc Group. Quick question regarding -- as you know, with only 66 percent of the sales and use tax being captured and the need to avoid another \$1 billion plus deficit, do you believe that the change from the sales and use tax with a value-added tax across a supply chain will produce over a \$1 billion plus in surplus for the next fiscal year? Thank you.

MR. HITCHCOCK: Addressed to me?

MR. WEST: Anyone who wants to address it.

MR. HITCHCOCK: I mean we've seen various tax reform proposals.

The current sales and use tax was billed as a tax reform a few years ago. It was going to improve their coffers. And I remember that being presented as a bipartisan proposal that was going to solve a lot of problems. Now they're talking about moving back to taxing at port of entry to reduce tax evasion. Before, the idea was that if you made big retailers collect the sales and use tax, it could reduce tax evasion.

I can't say whether a new regime would change the tax evasion percentage. All I would say is that we look skeptically at any projection that you're going to have a substantial increase in revenue because of increased enforcement or a change in tax regimes. We've seen various changes. It hasn't always produced the hoped for amount of additional revenue. We just don't want to see that as some sort of manna from heaven that's going to solve problems because it's easy to put in a line item in your budget. There should be some real justification for whatever amount that would be, and at the end of the day we're looking at actual revenue as opposed to the percentage of collections.

So anything that improves that revenue is to the good, but I think we'd be skeptical about another change that would produce substantial amounts of new revenue. It might or it might not, but I think -- all I'm saying is we'd be a little skeptical and we'd

want to see the justification for that. It would have to be something more than a back-of-the-envelope calculation.

MR. WEST: There's a gentleman along the wall who has his hand up.

QUESTIONER: My name is Roland Roebuck, community activist. I'm interested in knowing what is the level of reception from government to attempt to eliminate the level of political corruption that has been manifested for many years?

And the second question directly to Dr. Palmira is how the economic destabilization in Puerto Rico is impacting the Afro-Puerto Rican community since we know that in Puerto Rico itself there is a high level of racism that manifests itself at different fears? Thank you.

MS. RIO GONZÁLEZ: Well, addressing corruption -- while there are many laws in Puerto Rico that supposedly will fight against corruption or prohibit it, it is still very much a part of the political scene or the governmental scene. In some cases maybe it would be a legal form of corruption to the extent that you have, to give you an example, reduce the criteria for hiring and promoting public employees. Before you were required to have a master's degree personally; now any degree will be sufficient. So that would be a way, a legal way, of hiring and retaining people from the political party. So really it's the politicization of the public service and also in the granting of contracts that you find what would be considered corruption, but it's legal. So that is one of the main problems.

As to your second question, as you know there is very little data on race in Puerto Rico or is it collected because we deny it exists in Puerto Rico. We can only project that yes that is the case, that it will be a negative impact. Whatever information I've seen it shows or indicates that there's a higher percentage of poverty rates among that population. So we can only expect that this kind of economic crisis will deepen the

inequalities on the Island. There has also been a case of some women and other sectors. We really haven't spoken about the informal economy of Puerto Rico because how people survive when you only have 40 percent labor participation rate, there must be a very big informal economy. When you look at the reports from the Department of Treasury, a very small number of people report to have income over \$100,000.

And as I said, you cannot expect all these very high, very expensive, houses in Puerto Rico with that kind of data. So there must be a very significant, a very large informal economy I think. As to your stated estimates about 24 percent of the economy, that is a big issue and partly is drug trafficking, but also all the ways of avoiding paying taxes. For example, many professionals only now accept cash in payment. So if you're going to go to a doctor or lawyer or an engineer, they won't accept any kind or form of payment that could be traced. So it is a very complicated situation.

MR. WEST: This woman right there.

QUESTIONER: Hi. My name is Irene Thomas with the Service Employees International Union. This question is for you, Dr. Rios. You mentioned a group or commission that is working on regionalizing services from the central government to municipalities. It is common understanding that most municipalities are bankrupt, so you're taking into consideration decentralizing the services and sending them to municipalities that are bankrupt. It looks like we're spreading the misery. Does this new structure that you guys are working on, are they considering particularly that economic part of it?

And also workers in municipalities don't have the right as central government workers to unionize. So that's another issue that will come up as a problem with this structure.

MS. RIOS GONZÁLEZ: Yes, there are two issues here that actually

remains a question. One is the fact that public service unions are all concentrated in the central government because that's what the laws have allowed. There's only one effort right now to organize workers in San Juan, the capital city, those employees. And that's why labor has opposed systematically any proposal of decentralization. While you're organizing municipal and regional employees in the states have no position because there's that kind of legal limitation.

One of the reasons municipal governments in Puerto Rico are in such a dire fiscal situation is because we have legislative obligations and forced them to provide services without actually transferring the funds. And so that has been an ongoing issue that municipalities have constantly raised that you cannot force municipal governments to provide services and not assign the funding for it, or oftentimes tax exemptions are approved that would directly affect their funding. Every time the government grants a tax exemption to the airport, those are funds that the municipality would not be receiving.

So really that's why we think that the delegation must come also with the funding to provide those services. And that's why the labor issue, which was -- I remember in that report that we should address how that will be dealt with because the report really understood the labor question and whether there would be an amendment to the law to allow the organization of union in local government will actually come true. It is something -- I'll be very honest -- mayors do not want and they're really variable from both political parties, very much dead set against it. But it's something that may be negotiated.

MR. WEST: There's a woman along the wall, back there? There's a microphone coming over to you.

QUESTIONER: Hi. Gretchen Sarzarata. I have a question. When we speak of federal intervention to deal with this crisis, we're mostly thinking about bailouts

which will not fly or financial control boards which are really intended to safeguard the interests in the investors. It's not going to anything to protect or look into the future of structural changes that we need in Puerto Rico. So we're looking at extremes.

But in the middle there's this whole area that we're not exploring -- and it's a two-part question. One question is why are we not thinking more creatively? For instance, you give loan guarantees to other countries. We do bond guarantees for other countries. We can buy debt and increase liquidity. There are a lot of creative ways. So question one is why is the federal government not intervening in a more creative fashion?

And then question two is what can we do to change the perception of Puerto Rico as competition to the 50 states because every time we contemplate any little change, it's going to say well, how is this going to take jobs from Arkansas or Texas or whatever. We are not competition -- and I am Puerto Rican -- in the sense that one, we don't have representation; two, we don't have the same resources; three, we're bounded by laws that do not benefit, maritime law being one, trade pacts that are damaging to us.

So those are my two questions. Why are we stuck in this very, very rigid box of ideas and what can we change to see that? You know, it's not only an obligation to U.S. citizens that live there, but it's really a hamstrung situation that we cannot extricate ourselves from. Thank you.

MS. RIOS GONZÁLEZ: I agree with what you said. We should be looking at alternatives. And one of those -- I know the Senate has conducted a study on amending the Jones Act of Puerto Rico that forces Puerto Rico to use U.S. flagged ships and that really makes other transportation between the Island and the shipping of commodities, et cetera, between the Island and the Mainland of the United States much more expensive. And this is one area, too, where labor has opposed that amendment.

So there could be other ways of really being more creative, but I think the

federal government does not see yet Puerto Rico as a problem or as a priority. And, therefore, it hasn't moved as aggressively as it did during the fifties when it really moved aggressively to restructure the government, to really promote an economic development, and the kind of things that we are saying now are needed were things that took place about 50 or 60 years ago. It's that kind of sense of priority and commitment to change that is lacking right now, probably for the reasons you say, because too often we are portrayed as getting federal funds, but we don't pay taxes or the emphasis on dependency or the emphasis only on the welfare state.

So it is really important that people start seeing the Island as a place for opportunities and assume the responsibility that America has for allowing us to continue for such a long time.

MR. WEST: Right here, the gentleman with his hand up.

QUESTIONER: Hello. My name is Max Torhiga from Tony Burriss and Associates. I want to see if we can shift a little bit in terms of next steps. What can Puerto Rico do? There seems to be a lot of confusion in terms of the debt crisis. Puerto Rico is not like the states. They cannot use certain features of the bankruptcy code. They're not technically a sovereign, but they're perceived to be a sovereign for certain debt. That confusion needs to have some clarity in terms for investments or investors who want to invest in Puerto Rico, for corporations to understand the nuances so they can invest in Puerto Rico. What needs to be done to clarify that aspect of things and from Wall Street on?

And the other point is in terms of, again, people wanting to invest in Puerto Rico or corporations wanting to move to Puerto Rico, I want to touch on the point that you raised regarding the minimum wage. The minimum wage is an issue that is picking up steam in the political debate in Congress and even after the elections of this

week, there are several states that are actually saying yes, we should really consider raising the minimum wage. So that debate will still take place in Congress.

How does Puerto Rico handle that dilemma? That population needs to have some increment in terms of revenue, in terms of their salaries and then they can buy more things in Puerto Rico that will stimulate the economy. But at the same time you have a business community in Puerto Rico that barely can afford to pay the salaries that they're paying now.

What will be the next steps that in Puerto Rico and in the states we need to take in order to address those two points? Thank you.

MR. WEST: Barry?

MR. BOSWORTH: Well, I think it needs to be multiple things. I completely agree with you that it's time to move forward and try and develop a positive plan. I think the federal government would like to play a role in that. The difficulty is nobody's been able to come up with any very positive sounding suggestions, right? The frustration is not that there's a plan out there that somebody is blocking its implementation. The problem is it's very difficult from an economic point of view to see why it would be attractive to establish a business and jobs on the Island of Puerto Rico.

And I think when you get to the minimum wage it's not a complete solution. I think politically it's probably very hard to cut the minimum wage. Cutting wages is hard, much less -- but if the Mainland did decide to increase the minimum wage, Puerto Rico could ask to go back to what it was in 1975 and be exempted from that increase.

I think a smart decision for the Island would then be don't increase the minimum wage when it goes up on the Mainland. You will increase the opportunities for low-wage jobs. I think the fundamental problem in Puerto Rico is nobody's got a job.

People like to talk about oh; I don't have any income as if somebody owes them some income. They don't have a job, so you have to start with a notion of how do you create jobs on the Island.

For other people, the Island's got a couple of big advantages. It is bilingual, although it seems to be moving rapidly to try to not be bilingual in the future. But you had a well-educated population that was bilingual and very appealing to business communities. You're located at an Island part way between North America and South America and Europe. It looks like a natural business gateway, doesn't it? We suggested that over five years ago. I think nothing has happened. But in the meantime, Miami has decided that's a great idea and Miami has moved rapidly to take over that aspect of the market, by increasing its role as an interlocker in North and South America.

So I think there is, though, still a business services opportunity in Puerto Rico if it moved aggressively. If it put forth a plan, part of it I think would be to get rid of the Jones Act just as part of it because the Jones Act is trivial. It's a stupid law and it disadvantages people, but it wouldn't make a big difference to get rid of it if you're thinking of an economic plan.

What would be more, if Puerto Rico could become an open airport where people can fly, where planes -- right now when you fly in from another country to an American airport, you cannot pick up passengers to go on in the United States? That's not allowed. You can take your own passengers and go on. Like if you came from Paris and you land in New York, you can continue on to San Francisco. But you can't pick up passengers in New York to take to San Francisco, so it makes that second leg quite expensive. If it was open air competition, which has been proposed, then airlines coming in to San Juan could use it like a hub, right, to move people from Europe, South America, North America, all mixed in. And so one proposal has been as part of business services

center is to open up Puerto Rico to free competition in airlines -- by itself, not a big thing, but if you tried to put together five to ten of these sort of measures, if someone had an overarching plan, I think it would help.

Another part of it has to be -- I would be skeptical about the tax increases as well, but it badly needs tax reform. It needs a tax system that has a broad base and a low rate, and it's particularly important for business in trying to inject jobs to the Island to have business tax reform.

So there's a long list of things to do, but I don't see any pressure to do anything. Nobody wants to step forward and take the lead on those sorts of ideas.

MR. WEST: Here on the front row we have a question?

QUESTIONER: (inaudible), Inter American Law School. Two questions: What happens if we accept the premise this is a downward spiral, what happens the day when Puerto Rico defaults? It does not pay, just as you predicted might happen. It can't because it can't pay. Whatever the government in power is, it doesn't matter. It just can't pay. What happens to your bond markets in the U.S., if anything? Where do we go from there?

Second, when you do your analyses and we're all used to analyses that are based on data that we have, but also data that we don't have. What happens to the underground economy in Puerto Rico, which is very vibrant, which is employing hundreds, if not thousands, of people on a daily basis, transferring successfully drugs from South America to North America? No one talks about how well they do that in the economies of scale, et cetera, and, of course, the violence, corruption, and crime that comes with that.

When they put forth this idea of the sales tax, part of that was well, you know these drug dealers, et cetera, are not paying any taxes because they weren't

paying any income taxes, but certainly they would be buying stuff. Maybe they will be adding to the sales tax as a way of taxing this very vibrant, major part of the economy on the Island. Are the analyses taking -- I mean do they know where are they? Do they understand that the property tax rates in Puerto Rico go back to 1952 assessments, which means it's meaningless? That if an individual making \$100,000 there may be paying \$1,000 in taxes? Maybe property tax, if that much. Is that part of the analysis? How much are you really looking into what's actually going on in terms of the microeconomic activity of that Island?

MR. HITCHCOCK: Directed to me again? (Laughter) Well, we have to look at it as it is. I mean our bond rating isn't looking at hypotheticals. We have to look at the Island as it is. And so I'm not sure that we would agree that they're necessarily going to have a downward spiral. They've had stagnation basically recently. Our negative outlook reflects the trends and we actually need some growth to improve their rating quality. If we thought there was going to be a default, I mean our rating would be much lower. It is in the speculative grade category because we see very significant risks. It could go up or it could go down depending on how the economy goes and some of these other factors.

In terms of whether there's going to be more revenues or not, again, it depends on willingness to pay. There's certain sectors of the economy that might be difficult to tax. There might be certain areas in education that might be difficult to cut. I've seen places like the city of Denver where it's difficult to cut the Denver School District, close a school, because nobody wants to see their neighborhood school close. The demographics are such in Puerto Rico that you might have to reduce the number of teachers, and they are reducing the number of teachers, but that's not to say that this isn't difficult to do.

So we're looking at it as it is. We realize that there are some difficulties to cutting expenses. There's some perhaps issues of willingness to increase the tax rates. They have been making some actions. They expanded the base for the sales and use tax, which has increased the sales tax even though the real economic growth hasn't changed, but the sales tax revenues have gone up. So we're looking at the absolute levels of revenues and basically our concern is whether they meet budget. It's not necessarily whether a certain area is taxed or not taxed. We'd just like to see them meet budget. And secondly, we'd like to see long-term structural balance in ongoing revenues, meeting ongoing expenditures.

So we're not prescriptive in the sense of you should tax certain things or not tax certain things or that a certain tax system is ideal. We have ratings on high tax; high service states and low tax, low service states that are in some cases the same. So we're just observers and observing as it is, changes I think in our view are going to be difficult. We don't see the minimum wage as it affects Puerto Rico changing anytime soon. We don't see the Jones Act changing anytime soon. I've talked with politicians in both parties. As we see it in our view and incorporated in our rating, we see these negative trends that we actually have a negative rating outlook. That means in the short term, if current trends continue, there could be a downgrade in that space on the economic factors.

So I'm going to leave to these two --

MR. BOSWORTH: What's below a junk?

MR. HITCHCOCK: Well, there are a lot of different variations. We have them at double-D right now. But if we thought they were going to default, we'd have a level C. And there are ranges in between there. So it would be different levels of speculation.

MR. WEST: The gentleman here with a question? There's a microphone right here.

QUESTIONER: Yes, this question is for David. My name is Ramon Contaro Frau. David, as you know, they're disclosing right now in Puerto Rico a surcharge on (inaudible) to \$15 as an increase from \$6.25. That's being used to bundle out what the Government Development Bank has of the \$2.2 billion of highways. How will you look at it if they do not approve that increase?

MR. HITCHCOCK: Well, the willingness to tax as opposed -- if they had these loans out there with no way to support it, obviously that would be a negative rating factor. So there is a willingness it looks like to increase the tax to support that debt, so to that extent that's positive from a credit perspective. The effect on the economy? Hard to say, but from a credit perspective, we like to see the ability to pay your debts. Additional revenue, to the extent it comes in, would be a positive factor.

Well, the loans right now the GDB holds are subordinate to the existing Highways Authority debt. It affects GDB liquidity, so that's the main concern. So because the GDB provides liquidity also to the Commonwealth, there is an impact. So all I can say is it's positive the GDB -- if they can replenish their liquidity, it could have a potentially beneficial effect, but on the margin. I mean it's indirect in terms of the Commonwealth.

MR. WEST: The gentleman right here with a question.

QUESTIONER: Hi. Elliot Muth with FDI Consulting. Mr. Bosworth, you pointed out that Miami has positioned itself as a great center for doing business as opposed to Puerto Rico who should be. But do you see Puerto Rico getting the motivation to reobtain that position as opposed to Miami? What I'm trying to say is do you see Puerto Rico being the main central place to do business in between South

America, North America, and Europe as opposed to Miami?

MR. BOSWORTH: Well, I think it's still got an opportunity there. I would suggest, try to avoid making it a zero-sum game. There is room for expansion of business service activities in Puerto Rico without implying that somehow Miami's got to shut down. There's room for both. Economies grow. I think economists always want to emphasize it's not a zero-sum game. So I think there is room for Puerto Rico to do this, but one of the difficulties it has in coming up with economic strategies is the political system so evenly balanced. One party comes up with an economic plan immediately, just as here on the Mainland, the other party's opposed to that plan. And as I look back at the history of Puerto Rico, there's been all these plans and then the government changes and it's cancelled and they move on to another plan.

And so I don't see any bipartisan consensus on the Island that things have to change in moving forward with a coherent plan. So I'm very skeptical. I think Miami and Florida in general is just much more supportive of this notion, that this is where their future was. They wanted to encourage these bilingual activities, and they've done it very effectively. I don't see the same thing happening in Puerto Rico at the present time, but it could.

MR. WEST: I think we have time for one more question. The gentleman in the front row.

QUESTIONER: On a less gloomier note, recently Lufthansa, Abbott, Hewlett Packard, Microsoft, have expanded operations in Puerto Rico. So what are they seeing that others are not seeing?

MR. WEST: A great closing question, thank you. It's such a good question, we can't answer it.

MR. BOSWORTH: I would argue that another area that's had some

expansion is in aerospace services. And so it's not all negative. In any economy firms grow and firms contract. The problem for Puerto Rico is that the average is contraction. Nobody should be thinking that every single company in Puerto Rico agrees its economic situation is worse. So no, there is some growth. It's still true that in the pharmaceuticals, Puerto Rico did develop a fair degree of expertise in the manufacturing of pharmaceuticals. It still even though it doesn't have quite as much edge as it had before, it's like Ireland, so it's basically competing with Ireland and maybe Singapore for centers of that. And I think some of the drug companies still find it attractive. One of the things that will make a difference to those multinational firms is what the ruling is in the IRS on this excise tax. If they can't take it as a tax deduction on U.S. Treasury, it will make a big difference to them.

So no, it is diverse. It's still a pretty skilled workforce. I think it's been deteriorating in recent years, but it's not like it's unskilled. So there are still opportunities in Puerto Rico at the margin. I just don't see the overall change in atmosphere that would make it -- I remember when I started and this interesting thing was Puerto Rico had an economic history of being thought of as one of the new tigers. You've heard this term about Asian tigers with double-digit rates of income growth. Puerto Rico was in that category back in the 1950s and 1960s with an extremely successful governor who sort of revitalized the whole system. But since then it hasn't performed well. I think it needs some energy like that again.

MR. HITCHCOCK: I would just point out we have to be careful from a rating perspective we're not rating based on anecdote, but again we have to look at the overall numbers. Some of the overall numbers have been depressed by layoffs from government. I mean we see essentially a flat trend recently. There's been some growth in the private sector, but it's been offset by declines in the government. But those

declines in the government at one time or another, hard to say. But to the extent that the private sector continued to grow and the government stopped shrinking, you could see some small gains. I think we see it as basically flat right now and we'd like to see growth. From a rating perspective, that's our concern. And also growth in higher wage manufacturing industries as opposed to lower wage workers.

MS. RIOS GONZÁLEZ: I think it's too early to respond to your question. The Lufthansa proposal really took advantage of some regional advantages of that area. It's nearby some transportation. But as many other investment or tax exemptions of the past, we still have to see if they produce what they promise. We had been always -- a question I've always been raising that we invest a lot of tax exemptions and exclusions, et cetera, where we don't see the product or the full product. So that's something that we hope we can see in the future, but it would take a few years to see the results of the Lufthansa project in Puerto Rico.

MR. WEST: So on that note I want to thank Palmira, David, and Barry. We appreciate your sharing your thoughts and thank you very much.

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