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To: Senate of Puerto Rico
From: Policy Analyst, Enith Sanchez
Subject: Department of Education of Puerto Rico: School Finance Reform

Introduction: At this point and time is no surprise to hear that Puerto Rico is experiencing an economic crisis. The great recession hit hard the island, which has not recovered yet. In addition, to high rates of poverty and crime in the past 19 months Puerto Rico has defaulted on their debt payments three times, thousands of people have migrated to the mainland, and unemployment is at all time high. Although, the government has defaulted in its debt so far the general obligation bond payments have been meet. However, Puerto Rico's governor Alejandro Garcia Padilla has recently and publicly expressed that the debt is simply "unpayable". The future of the island is uncertain and different departments have the challenge to balance their budget, cut expenses, find new and innovative ways to create revenue, and provide basic services. One of the agencies that have been impacted the most is the Education Department. This department is responsible of guaranteeing the constitutional right to students of a "free primary and secondary education of quality".

Problem: The government of Puerto Rico has about 73 billion of outstanding debt and the debt to GDP ratio is about 68%. The debt of the island territory is higher than almost any U.S. state; the only exception is California and New York ¹. Most of the debt was issued through the years in the form of municipal bonds and large fraction of the debt is labeled as general obligation bonds. Currently, every month the central government needs to come up with \$93 million each month to pay its general obligation bonds only. In a fiscal year the payments for just the general obligation bonds account for \$1.116 billion. This amount is

¹ <http://www.bloombergview.com/quicktake/puerto-ricos-slide>

very close to the \$1.6 billion that the central government allocated this past year to fund schools. A very important thing to notice about the general obligation bonds is that coming up with this figure monthly is not an option or a suggestion, it is compulsory because the constitution of Puerto Rico requires that meeting general bonds obligation payments must come before meeting any other expenses including education, health services, and payments to retirees ².

Meeting the payments and providing the services the residents of Puerto Rico need has become the biggest challenge for the island. The administration of the Republican Governor Luis Fortuño took a conservative approach during the years of 2009 and 2012. The primary focus during these years was to make the government small and privatizing public assets to cut expenses. Although, these moves helped the government to meet the debt payments the administration of Governor Fortuño also contributed to increased the debt by another 250,000 millions³. Privatizing public assets, particularly the roads, long-term represent a loss in revenue for the government and it showed that is not a long-term solution to decrease government spending. This has translated into difficulties for all departments in the island to cover their expenses because they have seen a decrease in the revenue they are allocated.

Then came Governor Padilla, who campaigned as a candidate that would put people first. He does not believe in privatization or in making government small. During his first months of tenure he said that he was not going to fire anyone even if it means that his administration would default in debt payments ⁴. Later that year Governor Padilla faced unprecedented issues, his administration did not know how to keep his promises and make the payments to at least the general obligation bondholders. The administration was not able to find ways to

² <http://www.nytimes.com/2015/06/29/business/dealbook/puerto-ricos-governor-says-islands-debts-are-not-payable.html>

³ <http://www.univision.com/noticias/gobierno/alejandro-garcia-padilla-asegura-que-vencera-la-crisis>

⁴ <http://www.elnuevodia.com/noticias/politica/nota/mensajecompletodelgobernadoralejandrogarciapadilla-1498229/>

meet with the debt payments other than general obligation municipal bonds and in the past 19 months the government has defaulted three times and the bonds are currently rated “junk” by three of the primary credit rating companies Moody’s, Standard & Poor’s, and Fitch ⁵.

Department of Education Finance: Although all of the different agencies in the island have been affected the Department of Education is currently seeing a dramatic reduction in their budget and operating schools have become very hard. Due to the fiscal cuts in 2015 alone 100 schools were closed, another dozen were consolidated, teachers have been laid off, and schools are often lacking of school supplies like books and other materials ⁶. A very important thing to notice is that there are 7 school districts but the government is highly centralized and policymaking happens at the state level. So there are no districts that receive more money than others and property taxes do not directly fund education. Also, students and parents are free to choose to attend any school of their choice. There are some municipalities, for example Cayey, which only counts with one High School and one Vocational school. Therefore, the choices sometimes are limited. Yet the fact that students and parents are choosing what schools to attend is not really a problem. According to Rafael Roman, Secretary of Education, on average and due to population declines, mass migration, and lower fertility rate schools are currently operating at 72% of their capacity ⁷.

When it comes to the budget and the ways schools are financed in Puerto Rico the system looks very similar to Hawaii. In both cases Hawaii and Puerto Rico the government has a general fund “bucket” and this money is allocated to cover the expenses for many services. Property taxes, sale taxes, and other sources of revenue are not necessarily allocated to a given agency or expense. In the case of Puerto Rico in the past 5 years there has been a

⁵ http://www.gdbpr.com/investors_resources/commonwealth.html

⁶ <http://www.elnuevodia.com/videos/noticias/politica/educacionanunciaelcierrede100escuelas-157588/>

⁷ <http://www.telemundopr.com/noticias/local/100-escuelas-en-58-municipios-van-a-cerrar-como-parte-del-plan-de-reorganizacion-del-DE.html>

dramatic reduction in operational budget and the Department of Education is struggling to provide all the services needed ⁸. However, another very distinctive feature of the financing of schools in Puerto Rico is that each school is allocated an equal amount of money per pupil. In the academic year of 2013-2014 this amount was equal to \$7,934 per pupil. The way this money is calculated is by dividing the total budget by the number of students in public schools ⁹.

Role of Municipalities: Currently municipalities are not directly responsible for contributing financially to fund schools. The property taxes in the island are called CRIM and these taxes were last assessed in 1958. Depending on the municipality the tax rate is between 3-10% of the assessed property value (as of 1958). In addition, rental properties are exempted of this tax. When municipalities collect this property tax they must use the revenue to cover the payments for the municipal general obligation debt payments. The residual is then transfer to the central government and it is added to the general budget ¹⁰.

Policy Recommendation: Municipalities should reassess their property values. Even though the island is facing a fiscal crisis, there are a lot of things that have changed since the 60s. One of the most important being the shift from an agricultural based economy towards a more industrial economy. During the early 90s a lot of new development sparked and this is one of the main reasons property taxes should be reassessed. Meeting the general obligation bond payments is a must and is prioritized by the constitution. Therefore, there is no way around it and the amount that was previously collected before reassessing property values should be the minimum tax charged to households and this amount should still be allocated to

⁸ <http://www2.pr.gov/presupuestos/presupuestoaprobado2015-2016/Pages/default.aspx>

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¹⁰ <http://www.gdbpr.com/spa/affiliates/municipal-finance-agency.html>

meet general obligation bond payments. The residual and increase in revenue after the reassessment should be allocated for a fund to be used only to fund education. The office of the CRIM within each municipality already counts with staff and property assessors who are responsible of collecting the tax. This staff should be on charge of designing of reassessing property values and setting up the tax rate.

Conclusion: An alternative to increase revenue sources for the Department of Education is creating a fund in order to fund education by using property taxes (after general obligation payments are meet). There is also a potential to increase the revenue from property taxes by reassessing the property values because right now the taxes are based on values from 1958.

