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I. INTRODUCTION

- On behalf of the Center for a New Economy I want to thank the staff of the Committee on Natural Resources for the invitation to share with you some of the things we have learned over the last decade or so with respect to Puerto Rico's complicated capital structure.
- We recognize the Committee has devoted a considerable amount of time, effort, and resources to this issue and understand progress has been made in developing a comprehensive legislative solution to Puerto Rico's debt crisis.
- In spite of this progress, we believe that work remains to produce a bill that addresses the concerns of all stakeholders—both in Puerto Rico and in the mainland—in a balanced, equitable, and fair manner.
- We look forward to continue working with you as the Committee adjusts the legislative text currently under consideration.

II. SUBSTANTIVE ARGUMENTS

1. Puerto Rico's Debt Load is Unsustainable

- Puerto Rico is over-indebted: it has $70 billion in public debt plus an additional $43 billion in unfunded pension liabilities. Puerto Rico's debt vastly surpasses Detroit's $19 billion—the largest municipal bankruptcy in U.S. history.
- Indeed, Puerto Rico has more debt, in absolute terms, than any U.S. state government except California and New York, while its economy is smaller than Kansas.
- Since 2006, Puerto Rico's economy has shrunk by 14% in real terms, population has declined by 9% and total employment has decreased by approximately 17%.
- Puerto Rico simply does not have the ability to pay this massive debt accumulated over the last half-century.

2. Letting the Normal Legal Process Work Would Be Extremely Inefficient

- Puerto Rico's public debt is spread across a variety of debtors (18 issuers in total) representing a complex web of claims in an uncertain regulatory and legal framework. This situation makes it very difficult for creditors to work as a class because one set of creditors will worry that any relief they provide the island will simply make it easier for a different set of creditors to recover a larger amount of their claims.
- In game theory terms, Puerto Rico faces a game in which there are multiple players, which sometimes have common and sometimes-opposing interests, and not making a deal leaves everyone worse off. In this type of game the final outcome could be one of any number of possible "Nash equilibria", which would generate sub-optimal results for all parties involved. *In other words, this can get very complicated and quite messy really fast.*
- An orderly court-supervised process would help ensure fair treatment to all parties, including small, retail investors currently not "at the table".
- The alternative—an untested and potentially disorderly process with numerous creditor lawsuits and years of scorched-earth litigation—would further depress the local economy, increase restructuring costs, and make long-term recovery harder to achieve. When it comes to restructuring, *clarity is always better than uncertainty.*
- In short, no one benefits from the chaos of a disorderly default, years of nonpayment, protracted multi-forum litigation, and social unrest in Puerto Rico.

3. This is not a Bailout

- Providing Puerto Rico with an effective debt restructuring mechanism is not a bailout. On the contrary, it is a sensible way to protect both investors and taxpayers from the unforeseen consequences of a cascade of chaotic, disorganized defaults.
- Delaying a necessary restructuring of Puerto Rico's debt will only lead to the destruction of bondholder value and lower recovery levels through additional unsustainable borrowings, high interest rates, and restrictive fiscal policies that amplify the economic contraction.
- Furthermore, according to Professor Simon Johnson from MIT "attempting to repay all of Puerto Rico's debts would involve either large further tax increases or significant cuts in public services or both. Either way, the incentive to leave the island will be stronger—and the tax base (people who earn income) will literally fly away. The odds of full repayment in that scenario are almost zero. And the social costs—in terms of lower living standards for those who remain—would be dramatic."
- If that scenario were to become a reality, then the probability of a federal bailout *would increase significantly* as bondholder groups would insist that Congress intervene to rescue them.

4. The Proposed Debt Restructuring Mechanism Does Not Apply to the States

- While people may disagree as to what Puerto Rico's current political status is, we know with absolute certainty that it is not a state of the Union.
- It is long-settled law that state governments cannot provide debt restructuring relief because the Contracts Clause of the U.S. Constitution (Article I, section 10, clause 1) prohibits states from enacting "any bill of attainder, ex-post facto law *or law impairing the obligation of contracts*" and Article I, section 8, clause 4 grants Congress the power to establish "uniform laws *on the subject of bankruptcies throughout the United States*."
- On the other hand, the Tenth Amendment to the Constitution grants state sovereignty over the governance of subnational units of government. Thus, *state* municipal bankruptcy laws would violate the Contract and Bankruptcy clauses, while *federal* municipal bankruptcy legislation would violate state sovereignty under the Tenth Amendment.
- In fact, the U.S. Supreme Court invalidated the first municipal bankruptcy law (enacted in 1934) on constitutional grounds in 1936. Congress then enacted a revised Municipal Bankruptcy Act in 1937, which was subsequently upheld by the Court.
- In the case of Puerto Rico, the Constitutional predicate for H.R. 4900 is Article IV, section 3, clause 2 of the United States' Constitution, which states "Congress shall have power to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the United States."
- Thus, it would be extremely difficult for a *state government* to avail itself of the debt restructuring mechanism included in H. R. 4900 because (1) any such action would violate the Contract and Bankruptcy clauses; (2) Congress has already enacted a law to address state municipal bankruptcy (thus, the field is pre-empted by federal law); and (3) the Territorial Clause does not apply to states.

5. Allowing Puerto Rico to Restructure its Debt Would Not Raise Borrowing Costs for the States

- The available evidence simply does not support the argument that there will be widespread market contagion in the event of a Puerto Rico debt restructuring.
- According to a recent report published by Nuveen Asset Management "Market differentiation between Puerto Rican bonds and other high yield municipal bonds started even before the rating agencies downgraded Puerto Rico debt to below investment grade. Since then, divergence between Puerto Rico and the rest of the high yield market can been seen in credit spreads, fund flows and total returns."
- Furthermore, "since the beginning of 2014, high yield credit spreads excluding Puerto Rico securities narrowed 30 basis points, while spreads including Puerto Rico

securities widened over 120 basis points. The market has clearly identified elevated risk for Puerto Rico debt, while spreads for other high yield municipals are more in line with historic norms."

- It appears, then, the current pricing and yield of Puerto Rico debt indicates the market is fully anticipating an event of default and/or a significant restructuring.
- According to recent testimony by John Miller before this Committee: "The highest valued security, General Obligation or GO debt, is currently priced at between $58 and $64 per $100 of outstanding debt. Yields for Puerto Rico's debt average above 12% while the yields of AAA municipal securities average 2.6%." Other important market players, such as Alliance Bernstein and PIMCO, agree with this assessment.
- Finally, we need to keep in mind that, while Puerto Rico's $70 billion debt is overwhelming in relation to its capacity to pay, it accounts for only 1.8% of the $3.7 trillion municipal debt market in the United States.

6. Puerto Rico is Not Asking Congress to Change the Rules—The Problem is there are No Rules

- It was *Congress* that inexplicably changed the rules applicable to Puerto Rico back in 1984 when it drafted language carving out Puerto Rico from the provisions of Chapter 9. Up until 1984, that part of the Bankruptcy Code applied to Puerto Rico in the same manner as it applied to the fifty states.
- According to Judge Torruella's concurring opinion in *Franklin California Tax-Free Trust v. Puerto Rico* "there is no legislative record on which to rely for determining Congress's reasons behind the 1984 Amendments. A tracing of its travels through the halls of Congress **sheds less light than a piece of coal on a moonless night regarding the reason for its enactment**."
- As a result, Puerto Rico is currently in legal limbo. The provisions of Chapter 9 of the Bankruptcy Code do not apply to Puerto Rico and its municipalities, while federal courts have decided that Puerto Rico cannot legislate its own bankruptcy law because the field has been pre-empted by Congress. Puerto Rico is only asking that Congress *fill the existing legal gap*.
- Some people have made the argument that there are potential rule-of-law issues at stake when we talk about legislative action to retroactively alter the terms of debt contracts. However, we have not seen any evidence that protection from bankruptcy or restructuring was, *ex ante*, a material fact influencing the investment decision of any buyers of Puerto Rico debt *when it was originally issued*.
- In our view, it was probably the *triple tax exemption* enjoyed by Puerto Rico bonds since 1917 that drove so many investors to buy Puerto Rico's municipal securities. In other words, it was the search for high yields and the desire to avoid taxes, not protection from bankruptcy or some form of financial patriotism, which led people to gorge on Puerto Rico debt.

7. The Problem is not the Debt; the Problem is the Lack of Economic Growth

- This argument is partially true: Puerto Rico's economy has been either stagnant or contracting since 2006. However, while it is true that Puerto Rico's capacity to repay its debt ultimately depends on restoring economic growth in the island, *there can be no economic recovery without debt sustainability and that, in turn, is not possible without significantly restructuring at least some of its debt.*
- Simply put, Puerto Rico will not get the new investment it needs to grow its economy in a sustainable manner until it deals with the current debt overhang.
- With respect to economic growth it is important to keep in mind two additional factors. First, Puerto Rico, which is neither a sovereign country nor a state of the union, has no authority to negotiate international investment treaties, no access to emergency financing from multilateral institutions, no monetary policy instruments, no international trade policy, limited fiscal policy tools, nominal representation in Congress, and the U.S. Supreme Court has determined it is constitutionally permissible for Congress to discriminate against Puerto Rico in the application of federal programs as long as there exists a "rational basis" for doing so. Therefore, its ability to implement economic policy is quite limited.
- Second, economic growth is not simply a race to the bottom among countries to offer the lowest wages or the most preferential tax treatment for corporations.
- Ever since the days of Adam Smith, economists have struggled to understand the process of economic growth. While this effort has produced a better understanding of the sources of growth, the subject has proven elusive and many puzzles remain unsolved. At the beginning of the 21st century it has become clear that there is no "silver bullet" or "cookbook recipe" for economic growth. Rather, the process of growth is quite complex, involving the interplay of many factors and variables that must be present if a country is to succeed.
- A survey of recent research in this area indicates that the story of economic growth revolves around four main themes:
- First, the *accumulation of capital*—financial, physical and human—is important, but it only accounts for a fraction of the variation across countries in income per capita levels and their rate of growth. This means that other factors are also at play.
- The second theme is the efficiency with which inputs are utilized in the production process. Economists refer to this element as *total factor productivity* ("TFP"). Differences in TFP growth play a major role in accounting for the observed cross-country variation in income per worker and patterns of economic growth.
- Third, the degree of *openness to the world* has become increasingly important because knowledge flows across national borders and foreign trade and investment affect the incentives to innovate, to imitate, and to use new technologies.

- Finally, during the past two decades economists noted that countries that start with similar labor and capital endowments can follow dramatically different developmental paths, even after accounting for differences in investment, trade patterns, and technological change.
- This puzzle led some scholars to hypothesize that differences in growth rates across countries are caused by differences in *institutional structures*, because institutions affect incentives to innovate and develop new technologies, the incentives to reorganize production in order to exploit new opportunities, and the incentives to accumulate physical and human capital.
- In sum, any serious attempt to design a new economic growth strategy for Puerto Rico has to address each of these areas if it is to be successful over the long-term. A joint U.S.—P.R. economic reform and growth commission could be charged with developing this new economic growth strategy for the island.