

## Policy Brief

# Possible Consequences of a **Default** on Puerto Rico General Obligation Bonds



May 2016



**Policy Brief:**  
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**General Obligation Bonds**

Sergio M. Marxuach  
Policy Director  
Center for a New Economy  
17 May 2016

## Introduction

Puerto Rico faces a serious fiscal and economic crisis. The island is over-indebted: with \$70 billion in public debt outstanding and an additional \$43 billion in unfunded pension liabilities, 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. The following chart compares Puerto Rico's *tax-supported debt* (excluding debt issued by state-owned enterprises) and unfunded pension burden with three of the U.S. mainland's lowest rated states.

	Pennsylvania	New Jersey	Illinois	Puerto Rico
<b>Debt</b>	\$14.3 B	\$37.0 B	\$34.5 B	\$55.5 B
<b>Unfunded Pension Liabilities</b>	\$20.6 B	\$37.3 B	\$111.0 B	\$43.6 B
<b>Personal Income</b>	\$358.0 B	\$313.4 B	\$375.2 B	\$38.2 B
<b>GDP</b>	\$662.9 B	\$549.1 B	\$745.9 B	\$103.1 B
<b>Debt and Pensions-to-GDP Ratio</b>	5.3%	13.5%	19.5%	96.1%
<b>Debt and Pensions-to-Personal Income Ratio</b>	9.7%	23.7%	38.8%	259.6%

Sources: Comprehensive Annual Financial Reports for Pennsylvania, New Jersey, Illinois and Puerto Rico; U.S. Census Bureau; Federal Reserve Bank of St. Louis.

Source: Nuveen Asset Management, *Puerto Rico's Course Forward*, February 2016.

Furthermore, since 2006, Puerto Rico's economy has shrunk by 14% in real terms, its population has declined by 9% and total employment has decreased by approximately 19%. A recent analysis by Barclays concludes that under its base and weak growth scenarios Puerto Rico's "debt-to-GNP ratio climbs steadily over the forecast horizon, reaching 151% and 166% of GNP in 2025. Both outcomes result in a doubling of the debt ratio over a ten-year horizon, as a combination of weak growth and persistent primary deficits pushes the debt ratio higher."<sup>1</sup> These debt ratios would be comparable to those of Greece.

<sup>1</sup> Barclays, Cross-Asset Research, *Puerto Rico's Debt Sustainability Analysis*, 12 May 2016.

In simple terms, Puerto Rico owes a significant amount of debt and its economy has been stagnant or contracting since 2006. Therefore, it does not have the ability or financial resources to pay all its obligations as they become due and, under the most realistic scenarios, Puerto Rico is not expected to be able to do so in the near future.

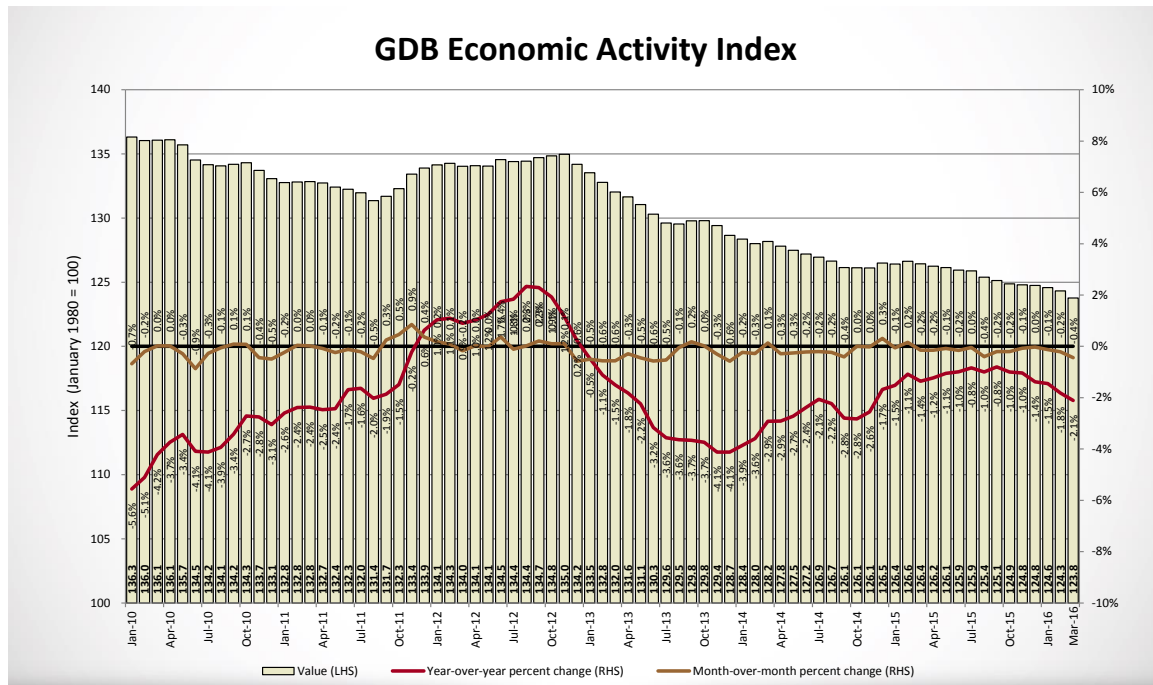
In this policy brief we will (1) provide a succinct summary of the current situation in Puerto Rico and (2) describe some of the possible consequences of a Puerto Rico default on its General Obligation bonds (“GO”) and other government guaranteed debt.

Our analysis is based on the following assumptions:

- The government of Puerto Rico decides to prioritize the provision of essential government services over debt payments.
- The Governor utilizes the powers granted to him by the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act (“Act 21 of 2016”).
- The validity of Act 21 is challenged on constitutional grounds, either in Puerto Rico or Federal Courts, and the Court enjoins enforcement of the Act while the case is heard on its merits.
- Congress does not enact any legislation before July 1 granting Puerto Rico the authority to restructure its debt.
- The government of Puerto Rico does not reach a forbearance agreement with its creditors.
- Puerto Rico does not obtain short-term financing to rollover any of the of the July 1<sup>st</sup> maturities.

## Summary of the Current Situation

*Economic Contraction Continues* – Puerto Rico does not publish quarterly GNP figures. However, the Government Development Bank (“GDB”) publishes a monthly Economic Activity Index (“EAI”) that is highly correlated with Puerto Rico’s GNP growth.

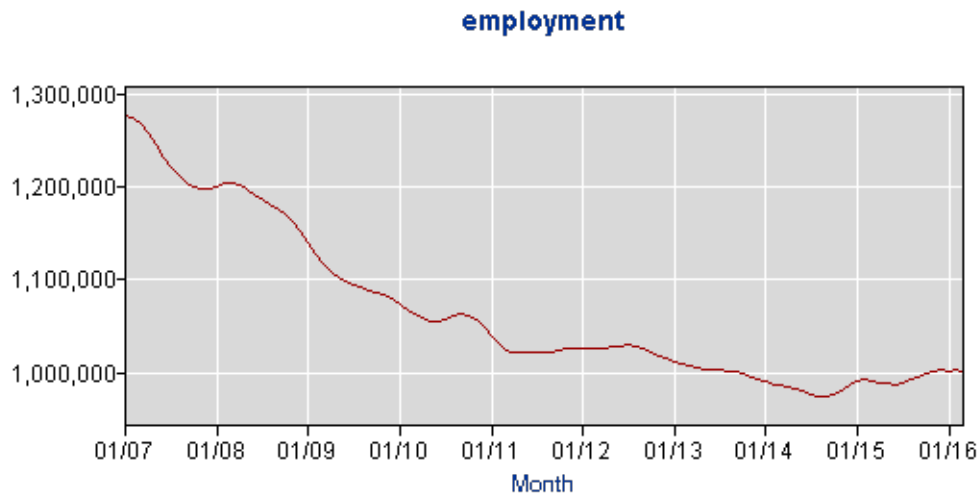


Source: Government Development Bank, Economic Activity Index for March 2016

As shown in the chart above, the value of the GDB Economic Activity Index for March 2016 was 123.8, a 2.1% reduction compared to March 2015, and a 0.4% reduction compared to February 2016. On a year-to-date basis (July 2015 to March 2016) the EAI declined by 1.3% with respect to the same period for the previous fiscal year.

The EAI has been in negative territory since January 2013. This is consistent with official Puerto Planning Board figures that indicate real GNP contractions of 0.1%, 1.7%, and 0.6%, during fiscal years 2013, 2014, and 2015, respectively. The estimate for the current fiscal year is for the Puerto Rican economy to contract by a further 1.2% in real terms.

*Massive Employment Losses* – According to data from the Bureau of Labor Statistics, shown in the chart below, average annual total employment in Puerto Rico decreased from 1,232,000 in 2007 to 994,000 in 2015, a reduction of 238,000 jobs, or 19.3%.



Source: Bureau of Labor Statistics, Series Id: LASST72000000000003


The unemployment rate in Puerto Rico for March 2016 was 11.8%, more than double the unemployment rate in the U.S. mainland.

*Emergency Cash Management Measures* – The government of Puerto Rico has been implementing emergency cash management measures since 2015. Those measures include postponing the payment of tax refunds, suspending the effectiveness of collective bargaining agreements, withholding the disbursement of appropriations for government entities such as the University of Puerto Rico, and delaying payment to various suppliers. The most recent estimate is that the Commonwealth government has accounts payable of approximately \$2 billion in arrears. The failure of the government to pay its suppliers has a negative effect in the Puerto Rican economy, as those suppliers are unable, in turn, to meet their own obligations such as payroll and payments due on working capital lines.

# Emergency Liquidity Measures - First Half FY 2016

## The Commonwealth was only able to pay GO debt service in January because it took emergency liquidity measures above and beyond those described in the Conway Mackenzie (“CM”) Liquidity Update, dated August 25, 2015 (the “Liquidity Update”)

- The Liquidity Update described a number of emergency liquidity initiatives necessary to keep the government open until at least November 2015, including:
  - Borrowing \$400 million in emergency loans from its proprietary state insurance companies and workers compensation funds<sup>(1)</sup>
  - Halting the payment of monthly GO set asides (\$93 million per month)
  - Requiring its insolvent pension systems to pre-fund benefit payments to retirees through the remainder of FY 2016<sup>(2)</sup>
  - Deferring tax refunds for the 2014 tax year (originally due on or before July 2015) and past-due payments to suppliers
    - ☞ As of June 2015, A/P was already estimated at \$1.7 billion and 99 days outstanding (during FY 2014 days outstanding were 47 days)
- For the period ended December 31, 2015, TSA inflows<sup>(3)</sup> were lower than projected in the Liquidity Update by approximately \$347 million<sup>(4)</sup>, requiring the Commonwealth to take even more extreme cash preservation measures to extend its liquidity runway post November:
  - Commonwealth further deferred payments on 2014 income tax refunds, projected to be paid by December 31, 2015, by \$101 million
    - ☞ As of December 31, 2015, the balance of unpaid 2014 tax year refunds was approximately \$330 million
  - Stretched projected payments to suppliers for services rendered by an additional \$163 million
    - ☞ A/P is estimated to have increased to over \$1.8 billion<sup>(5)</sup> as of December 31, 2015 and A/P days outstanding has increased significantly as a result
  - Withheld approximately \$309 million in appropriations from governmental entities, including UPR, HTA/GDB, PBA and PRIDCO
  - Implemented constitutional “clawback” of revenues assigned to certain government entities for the payment of GO debt
    - ☞ \$164 million of such “clawed-backed” funds were used to pay January 1 GO maturity
- GDB has also taken substantial steps to preserve liquidity during the first half of FY 2016
  - GDB has materially slowed disbursements under its outstanding loan commitments and is not approving any new loans

 (1) Proprietary insurance companies include State Insurance Fund (“SIF”), Automobile Accidents Compensation Administration (“ACAA”) and Temporary Non-Occupational Incapacity Insurance (“SINOT”).  
(2) Recent accelerations include a \$400 million deposit made in December 2015 by the Employee Retirement System in the GDB to exclusively pre-fund pension benefit payments for FY 2016 and \$180 million of TRS pension benefit payments which were pre-funded during November / December 2015. Pre-funded balances are drawdown periodically for the payment of pension benefit on a bi-weekly basis.  
(3) TSA inflows include General Fund inflows, non-General Fund inflows, collections on behalf of component units, advances from net pension benefits, proceeds from net debt issuance, and other inflows.  
(4) Reduced inflows primarily include General Fund inflows, non-General Fund inflows, GDB line of credit, federal funds, and Act 105 inflows. Explanation of inflows variance is outlined on the following page.  
(5) Based on preliminary estimates subject to material revision; moreover, may not account for all payables as there is typically a substantial lag between the incurrence of an expense and that expense being recorded.

Source: Government Development Bank, *Puerto Rico Fiscal and Economic Growth Plan – Update Presentation*, January 18, 2016

These emergency cash management measures have already (1) had a negative impact on the economy as “delayed tax refunds and contractor payments have strained the liquidity of many households and businesses” and (2) adversely affected the provision of educational and health services.<sup>2</sup>

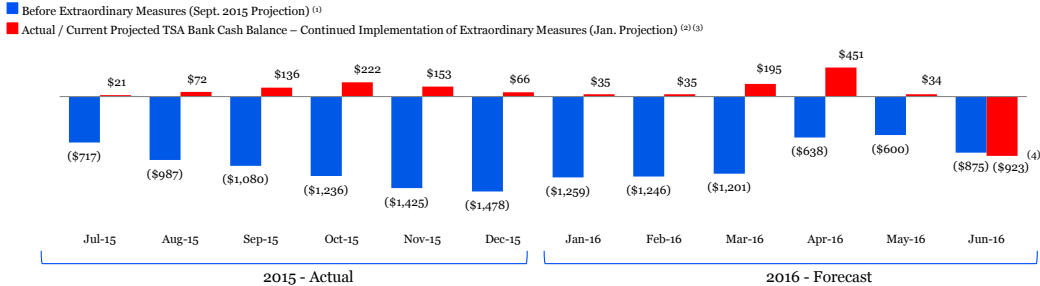
Notwithstanding these extraordinary and unsustainable cash management measures, the Puerto Rico Treasury expects the balance of its Treasury Single Account (“TSA”), the Puerto Rican government’s principal “checkbook”, to reach \$34 million by the end of May 2016 and go deep into negative territory in June.

<sup>2</sup> D. Andrew Austin, *Puerto Rico’s Current Fiscal Challenges*, Congressional Research Service, R44095, April 11, 2016, p. 7.

# Projected Near-Term TSA Liquidity

**Absent the Commonwealth's extraordinary and unsustainable liquidity measures described on the previous pages, the TSA would have already exhausted its available cash**

## Projected TSA Liquidity – Ending Bank Cash Balance (\$ millions)



- The measures taken in the first half of FY 2016 have significantly increased the economic burden on taxpayers and third-party suppliers; continued stretching of payables will further jeopardize the delivery of essential services
- The TSA cash flow above thus assumes that the Commonwealth begins catching up on payments to suppliers and taxpayers during the second half of the current fiscal year <sup>(5)</sup>
  - The Commonwealth makes payments to suppliers during the second half of FY 2016 so that the A/P balance as of June 30, 2016 is equal to the amount outstanding as of June 30, 2015 (approximately \$1.7 billion)
  - The balance of income tax refunds related to the 2014 tax year (\$330 million as of December 31, 2015) are paid by June 30, 2016
  - However, accrued but unpaid tax refunds for the 2015 tax year, due on or before July 30, 2016, are estimated to amount to \$500 million by June 30, 2016, which will require payment during the first months of FY 2017 and continue to place a material strain on Commonwealth finances
  - Deferrals to government entities (primarily UPR, HTA/GDB, PBA, PRIDCO, budgetary stipends), totaling approximately \$309 million as of December 31, 2015, decrease to \$105 million by June 30, 2016
- Projection assumes pension payments to retirees of approximately \$580 million that are due during the second half of FY 2016 are paid from outside the TSA from restricted funds advanced by ERS and TRS
- GDB cannot be a source of liquidity for the Commonwealth or the public corporations
  - As of January 10, 2016, GDB had \$667 million of total net liquidity and has \$535 million <sup>(6)</sup> in debt service payments during the next 6 months
  - GDB also needs to disburse material TSA and non-TSA deposits during the period in order to maintain essential government services

<sup>(1)</sup> Extraordinary measures include the Intragovernmental TRANs (\$400 million), GDB line of credit (\$300 million), suspension of GO sinking fund payments (\$93 million per month), pension fund advances, deferral of income tax return refunds during fiscal 2016. As of December 31, 2015 the book cash balance was \$209 million lower than the bank cash balances, which is expected to continue through FY 2016. January's projections have been adjusted to reflect disbursement for General Obligation debt service in December.

<sup>(2)</sup> Projection prepared by the Puerto Rico Treasury Department as of January 27, 2016. Cash balance includes TSA operating account and investment account; excludes amounts in clawback account and pension fund advances. General Fund inflow assumptions do not account for the potential risk of a material negative impact (- \$115 million in FY 2016) from the ongoing Walmart litigation.

<sup>(3)</sup> June outflows include General Obligation debt service and assume that \$184 million accrued in the clawback account is used as payment for the GO debt service.

<sup>(4)</sup> Deferrals are calculated based on CMA's Liquidity Update dated August 26, 2015, as compared to the latest cash flow projection.

<sup>(5)</sup> Includes \$400 million of principal and \$135 million of interest payments.

<sup>(6)</sup>

Source: Government Development Bank, *Puerto Rico Fiscal and Economic Growth Plan – Update Presentation*, January 18, 2016

Therefore, the probability of Puerto Rico defaulting on the GO debt service payment due July 1 is extremely high.

*Puerto Rico has Already Defaulted* – While Puerto Rico has managed, so far, to avoid defaulting on GO bonds or on obligations expressly guaranteed by the Commonwealth government, it has already defaulted on four different types of debt:

- The Puerto Rico Electric Power Authority (“PREPA”)** – Executed a forbearance agreement with its creditors in August 2014 to avoid an event of default on its credit lines for the purchase of fuel. This led to a lengthy and complicated negotiating process among and between PREPA, bondholder groups, monoline insurers, and bank lenders. As of this writing, PREPA’s debt restructuring agreement had not been finalized.

- **The Public Finance Corporation** – Defaulted on a \$58 million payment due at the beginning of August 2015.
- **The Puerto Rico Infrastructure Administration** – Failed to make a \$36 million payment on its Series 2005A–C and Series 2006 bonds due on January 1, 2016.
- **The Government Development Bank** – Had to make a \$422 million payment on May 2, 2016. The GDB paid \$22 million in interest; reached a forbearance agreement with holders due some \$33 million in principal payments; and defaulted on the other \$367 million. The GDB’s strained liquidity situation is already affecting the ability of municipalities and government agencies to operate as their deposits at GDB are essentially frozen and can only be accessed in limited weekly amounts.

This record is not a good omen as Puerto Rico faces debt payments of \$1.9 billion in July 2016, including \$779 million of GO bonds and \$177 million of Public Building Authority Bonds that are guaranteed by the Commonwealth.

### **Possible Consequences of a GO Default**

If Puerto Rico fails to make the payment due on July 1<sup>st</sup> on its General Obligation (“GO”) bonds and other debt expressly guaranteed by the Commonwealth, it would be the first state-level default of “full faith and credit” bonds in the United States since the Great Depression (Arkansas, 1933).<sup>3</sup>

The opinion of the U.S. Treasury and some significant market players (Alliance Bernstein, Nuveen, and PIMCO, for example) is that the market is already pricing-in a default and/or a significant restructuring of this debt. Therefore, according to this line of analysis, the impact on the broader municipal market should be marginal, if any.

Other analysts are skeptical of the Treasury view (“they said the same thing with housing prices”) and question the motives of the financial firms making these statements, as they may have pecuniary interests at stake.

Our view is that a GO default by Puerto Rico would generate a significant amount of negative headlines and could have a short-term moderate adverse effect on the prices of the

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<sup>3</sup> George Henry Hempel, *The Postwar Quality of Municipal Bonds*, dissertation submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy in the University of Michigan, 1964, p. 102.

weakest municipal issuers, such as Illinois and New Jersey. In general, however, we tend to agree with the Treasury in that the market has already priced this credit event and the probability of widespread contagion is low (although not zero).

In terms of the impact in Puerto Rico, there are five critical areas that could be particularly affected if GO bondholders obtain a court order requiring the Commonwealth government to use “all available resources” to make GO holders whole: (1) healthcare; (2) education; (3) public safety; (4) public pensions; and (5) migration.

**Healthcare**

Puerto Rico offers a very generous Government Health Insurance Plan (“GHP”) that covers approximately half the population in the island. Running the GHP costs approximately \$2.8 billion a year. During fiscal year 2015, 57% of that amount was financed with non-recurring funds authorized by Congress in 2010 when the American Care Act was enacted. The other 43% is paid mostly from the general fund and with municipal taxes, as patient deductibles and copayments are extremely low. The following chart presents selected financial data for the Puerto Rico Health Insurance Administration, which administers the GHP, for fiscal years 2014 and 2015:

	<u>June 30, 2015</u> (Selected financial data) (Unaudited)	<u>June 30, 2014</u> (Selected financial data) (Audited)
Average insured lives	1,686,000	1,600,000
Federal reimbursements	\$1,611,553,014	\$1,283,747,024
Cost of medical premiums and claims	\$ 2,805,503,136	\$2,494,805,333
Federal funds effective share	57.44%	51.46%
Change in net position for the year	\$ 2,315,176	(\$59,092,691)

Source: Commonwealth of Puerto Rico, *Financial Information and Operating Data Report*, November 6, 2015, p. 67

Given its tight liquidity situation, the Commonwealth is currently having difficulties making payments due to health insurance companies, which in turn reimburse doctors, hospitals, laboratories, pharmacies and other medical suppliers for their services. This situation has already affected services as health insurers are reluctant (in some cases taking

more than a month) to approve even life saving treatments such as chemotherapy, complicated surgeries, and respiratory therapy sessions.

Furthermore, according to some analysts, the combination of weak economic conditions, low liquidity, and fiscal austerity has lead (1) to weaker financial conditions for hospitals, some of which have already laid-off nurses and other medical assistants and at least three have closed off entire floors, and (2) to the increase migration of medical personnel—the Puerto Rico Physicians and Surgeons Association estimates that over 850 doctors have migrated during the past two years.<sup>4</sup>

This situation would worsen significantly if Congress does not renew the non-recurring ACA funds currently allocated to Puerto Rico, which are expected to be exhausted in March 2018. In that event, the *annual* deficit of the health insurance program could rise to as much as \$2 billion by 2020.

If the Commonwealth defaults in July and bondholders obtain a court order in their favor, then it is foreseeable that the cash flow available for health care could be severely affected. Indeed, Puerto Rico's Centro Médico, the island's only supra-tertiary medical facility, is currently facing difficulties paying its suppliers and is already making contingency plans to prepare for a default in July. These contingency plans include the postponement of all elective surgery, reducing services at outpatient clinics, and rationing treatment for even some of the most acute cases (burn victims, patients experiencing cerebro-vascular events or kidney failure, and persons that need certain types of neurosurgery or orthopedic procedures).

In addition, summer is the high season for certain mosquito-borne tropical diseases such as dengue fever, chikungunya, and now zika. To the extent funds for citizen education, prevention, and treatment are significantly cut, the spread of these diseases could reach epidemic proportions in Puerto Rico by the late summer.

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<sup>4</sup> Morgan Stanley, Muni Macro Report, *Puerto Rico: The Wait*, 2 May 2016, p. 2.

## **Education**

A default in July could also endanger the beginning of the new school year in August. Puerto Rico's public education system provides services to approximately 400,000 students and employs over 50,000 people (including both teachers and non-teaching staff). A significant percentage of public school students require treatment for conditions such as attention deficit disorder, autism, and hyperactivity, among other learning disabilities. Providing these services is extremely expensive and requires especially trained staff. Pursuant to a 2005 consent decree with the U.S. Department of Justice, the Puerto Rico Department of Education is required to provide these services, or, if unable, to pay a private provider to do so. If the Department fails to comply with the consent decree it could face fines of up to several thousand dollars per day per student.

To the extent funding for education is cut, the Department will have to make difficult decisions allocating funds between mainstream and special education students and perhaps cut back on art, music, physical education, other elective classes, and some after-school programs. If the cash flow situation becomes extreme, the Department may also have to consider reducing the school week in order to keep functioning at all.

## **Public Safety**

Recently the fuel supplier to the Puerto Rico Police Department threatened to cut off supplies if the government did not pay the \$10,000,000 it was owed. The supplier and the government eventually reached an agreement and the Commonwealth made a partial payment to avoid gasoline supplies being cut off. Maintaining public safety—broadly defined to include police, firefighting, corrections, and emergency management—to protect the life, liberty, and property of citizens is one of the core functions of modern government. To the extent Puerto Rico is forced by the courts to give priority to debt service, then essential services such as these could be adversely affected—for example, there could be reductions in police patrols, cutbacks on the maintenance of firefighting equipment, or less spending in preparedness and loss mitigation efforts during hurricane season—further deteriorating the quality of life in Puerto Rico.

## Pensions

Puerto Rico's three main retirement systems (the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System) currently provide benefits to over 165,000 retirees and their beneficiaries. The following table shows the number of active members, retired members, disabled members, beneficiaries and terminated vested members for each of the Retirement Systems as of June 30, 2014.

### Participant Data (as of June 30, 2014)

	Active Members	Retired Members	Disabled Members	Beneficiaries	Terminated Vested Members <sup>(1)</sup>	Total
<b>Employees Retirement System</b>						
Act 447 Participants	19,281	86,925	14,933	13,362	7,219	141,720
Act 1 Participants	42,882	7,470	1,680	91	3,439	55,562
System 2000 Participants	63,508	-	36	-	-	63,544
<b>Total</b>	<b>125,671</b>	<b>94,395</b>	<b>16,649</b>	<b>13,453</b>	<b>10,658</b>	<b>260,826</b>
<b>Teachers Retirement System</b>	39,343	35,278	2,235	3,088	689	80,633
<b>Judiciary Retirement System</b>	364	372	0	58	59	853

<sup>(1)</sup> Represents generally members who ceased employment without the right to a retirement annuity and are due a refund of member contributions and, if applicable, employer contributions, plus interest thereon.

Source: Commonwealth of Puerto Rico, *Financial Information and Operating Data Report*, November 6, 2015, p. 161.

As of June 2014, these systems had a combined pension liability of \$45.5 billion and aggregate assets of \$1.9 billion, for an unfunded pension liability of \$43.6 billion, equivalent to a funding ratio of 4.16%.

**Funding Status**  
**Actuarial Valuations as of June 30, 2014**  
**(\$ in millions)**

	Fiduciary Net Position (1)	Total Pension Liability <sup>(2)</sup>	Net Pension Liability <sup>(3)</sup>	Fiduciary Net Position as a Percentage of Total Pension Liability (4)	Covered Payroll <sup>(5)</sup>	Net Pension Liability as a Percentage of Covered Payroll <sup>(6)</sup>
Employees Retirement System.....	\$ 127	\$30,219	\$30,092	0.42%	\$3,489	862.46%
Teachers Retirement System .....	1,704	14,808	13,104	11.51	1,171	1118.89
Judiciary Retirement System .....	62	504	442	12.31	32	1,394.97
Total.....	\$1,893	\$45,531	\$43,638	4.16%	\$4,692	930.05%

<sup>(1)</sup> The fiduciary net position of each of the Retirement Systems is set forth in the actuarial valuation relating to each Retirement System and is equal to the full market value of the assets held by the Retirement Systems, including expected receivable contributions from the Commonwealth, municipalities and participating public corporations, less bonds payable and other liabilities.

<sup>(2)</sup> The total pension liability of each of the Retirement Systems is set forth in the actuarial valuation relating to each Retirement System and is an estimate based on demographic and economic assumptions of the present value of benefits that the Retirement System will pay during the assumed life expectancies of the applicable retired members and active members after they retire.

<sup>(3)</sup> The net pension liability of each of the Retirement Systems is set forth in the actuarial valuation relating to each Retirement System and reflects the amount of the excess of the total pension liability of a Retirement System over its fiduciary net position. The indicated amounts reflect the net pension liability as calculated pursuant to the requirements of the Government Accounting Standards Board ("GASB") for purposes of presentation in the CAFR.

<sup>(4)</sup> The Fiduciary Net Position as a Percentage of Total Pension Liability of each of the Retirement Systems is presented in the actuarial valuation relating to each Retirement System and reflects the quotient obtained by dividing Fiduciary Net Position of the Retirement System by the total pension liability of the Retirement System. The indicated percentages reflect the Fiduciary Net Position as a Percentage of Total Pension as calculated pursuant to the requirements of GASB for purposes of presentation in the CAFR.

<sup>(5)</sup> The covered payroll of each of the Retirement Systems is presented in the actuarial valuation relating to each Retirement System and is equal to the annual salaries paid to active employees on which contributions to the Retirement System are made. Please note that covered payroll is as of July 1, 2013.

<sup>(6)</sup> The Net Pension Liability as a percentage of covered payroll is presented in the actuarial valuation relating to each Retirement System and reflects the quotient obtained by dividing the Net Pension Liability of the Retirement System by the covered payroll of the Retirement System. Totals may not add due to rounding.

Source: Commonwealth of Puerto Rico, *Financial Information and Operating Data Report*, November 6, 2015, p. 168.

This massive unfunded pension liability is in addition to Puerto Rico's \$70 billion public debt. These pension funds, depending on the actuarial assumptions used, are currently estimated to deplete their assets as soon as 2018. To the extent the government of Puerto Rico is unable to make the corresponding employer contributions because it is required by the courts to give priority to the public debt, the depletion date will be accelerated. Puerto Rico would then have to choose between paying elderly pensioners or its bondholders. We note that any significant reduction in pension benefits would have a devastating effect on retirees' quality of life given that the average monthly basic system benefit for the largest of the three pension systems is only \$1,059.<sup>5</sup>

This dire situation is the result of years of inadequate planning; the lack of discipline on the part of the policy makers in charge; the failure to make actuarially required contributions on a consistent basis; the enactment of new benefits and cost of living increases without properly analyzing or understanding the long term financial consequences; and the failure to provide adequate funding for health care benefits for retirees. The bottom line is a \$43 billion problem that keeps on growing.

<sup>5</sup> Milliman, *Puerto Rico Government Employees Retirement System Actuarial Valuation Report (revised)*, June 30, 2014, p. 41.

Addressing this problem raises issues of extraordinary financial, political, legal, and moral complexity. The financial dimensions of the problem are simply staggering. The Net Pension Liability is equivalent to 62% of Puerto Rico's GNP as of 2015. An obligation of this size cannot be fulfilled with accounting gimmicks or financial engineering tricks. The money has to come from somewhere; otherwise benefits would have to be reduced.

On the political side, pensioners have always been an influential and well-organized voter bloc. However, the potential blowback from Puerto Rican taxpayers should not be ignored and we should expect a growing number of people in Puerto Rico questioning why are they stuck with the bill for pension benefits that they often lack themselves. This conflict appears almost inevitable given the extent of the unfunded liability. Puerto Rico, collectively as a society, owes approximately two-thirds of its GNP to 10% of its population. *Wealth transfers of this magnitude do not occur without serious political consequences.* In addition, dedicating financial resources to adequately fund pension plans entails reducing resources for other important government activities such as health, education, and public safety that address other compelling social needs.

The legal issues related to pension reform can also be quite complex. While it is generally assumed that retiree benefits cannot be reduced due to constitutional and/or statutory protections, the state of Colorado has recently enacted legislation doing just that. In addition, the legality of changing the terms and conditions of plan benefits applicable to current employees appears to be an open issue and there is little case law that can be of guidance.

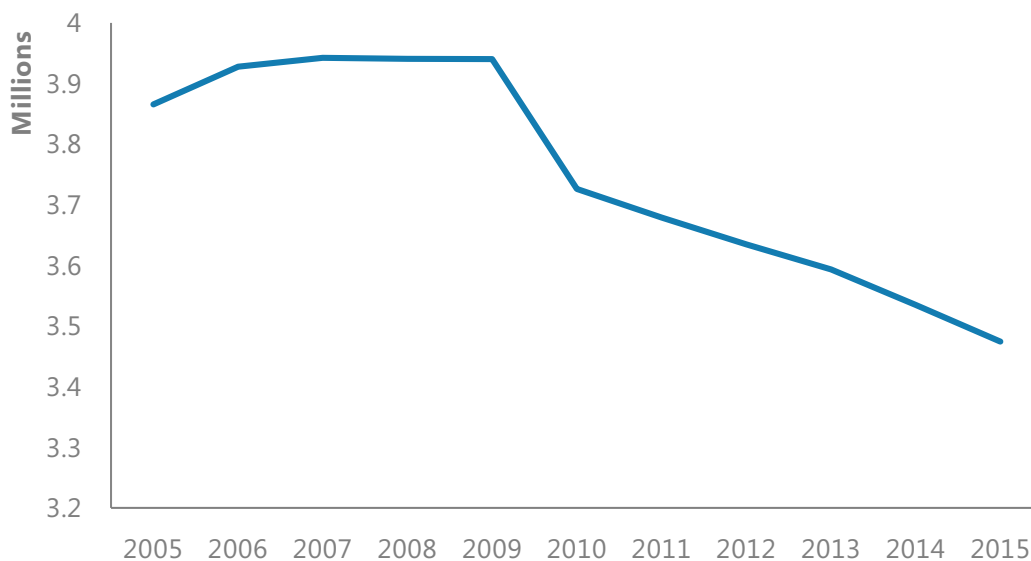
On the moral plane, vexing issues of political morality emerge. On the one hand, promises have been made to tens of thousands of government workers and they have relied on and planned their lives based on those promises. On the other hand, members of younger generations are quite right to claim it is unfair for them to pay the costs associated with the mistakes of the past. Why should younger generations pay for the failure of past policymakers to plan adequately and for their craven reluctance to adequately fund the promises they made? At the heart of this issue lies the knotty moral problem of how do binding moral and political obligations arise. Are we as individuals only subject to moral obligations we voluntarily choose to undertake or are we bound by at least some moral ties

we have not consented to, or voluntarily chosen, and that we have inherited, such as the \$43 billion liability of the Puerto Rico pension systems?

Addressing Puerto Rico’s pension problem along these four vectors will require tolerance, capacity for frank dialogue, commitment to good faith bargaining, and the willingness to make and honor concessions among retirees, current employees, bondholders, and taxpayers in general. It appears to us that any fair solution to this \$43 billion problem will require each one of those groups to make painful tradeoffs. Perhaps retirees could be asked to accept cutbacks on recently enacted benefits; current employees could be asked to increase their contributions; bondholders would have to make some concessions on their claims; and taxpayers in general could be asked to pay a special tax to be applied towards reducing the unfunded liability. In this context, Richard Lamm, former Democratic governor of Colorado, has stated that “we have to do what unions call givebacks, that is the only way to sanity. Any other alternative, therein lie dragons.” We agree.

### **Migration**

Puerto Rico’s population has declined by approximately 9% since 2005. The following chart shows the ten-year trend:



Source: Morgan Stanley, Muni Macro Report, *Puerto Rico: The Wait*, 2 May 2016.

In the event of a default, forcing Puerto Rico to repay all its debts would involve either large further tax increases or significant cuts in healthcare, education, public safety, other government services, and pensions. Either way, the incentive to leave the island will be stronger—and the tax base (the people who earn income) will continue moving to the mainland United States. The odds of Puerto Rico repaying its debt in full in that scenario are almost zero; the social costs—in terms of lower living standards for those who remain—would be dramatic; and the probability of a federal bailout *would increase significantly* as bondholder groups would insist that Congress intervene to rescue them.

### **Conclusion**

The United States Army invaded Puerto Rico in 1898 and Congress granted citizenship to Puerto Ricans in 1917. Congress cannot simply pretend those events never happened and that Puerto Rico and its inhabitants do not exist. Under the current U.S. Constitutional framework, Congress has the obligation to make all needful rules and regulations respecting the territory of the United States<sup>6</sup>, as well as the moral obligation to prevent the prolonged and unnecessary suffering of Puerto Rico's 3.5 million U.S. citizens.

Therefore, Congress needs to act *now* to provide Puerto Rico with a legal framework that provides a clear and feasible path for obtaining meaningful debt relief. Delaying an orderly restructuring of Puerto Rico's debt will only lead to fiscal and financial chaos that would deepen the current economic contraction; years of protracted multi-forum litigation; the hollowing out of essential public services; lower quality of life in the island; increased migration to the mainland; and, quite possibly, social unrest in Puerto Rico.

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<sup>6</sup> United States Constitution, Article IV, Section 3, Clause 2.



Center for a New Economy  
San Juan, PR

The Center for a New Economy (CNE) is an independent, non-partisan think-tank that advocates for the development of a new economy for Puerto Rico. Founded in 1998, CNE produces rigorous public policy research and analysis, and is one of the most credible and influential voices on Puerto Rico's economy. CNE is organized as a 501(c)(3) non-profit entity that does not solicit nor accepts government funding. It relies solely on funding by individuals, private institutions and philanthropic foundations.

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