HOW CONGRESS CAN SAVE PUERTO RICO FROM INSOLVENCY[i]

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Executive Summary

The U.S. Commonwealth territory of Puerto Rico is very near financial collapse.[ii] The island's $72 billion debt now eclipses 100% of its GNP. The government is already in technical default on many of its bonds and San Juan now says it may not be able to make its next $400 million bond repayment on May 1st and then another $2 billion payment that comes due this summer.

The economic woes of Puerto Rico stand at the heart of the crisis. The island's unemployment rate is near 12%, the labor force participation rate is close to an abysmally low 41%, and its population has fallen by almost 10% over the past decade. Puerto Rico is losing its greatest asset: its people.

So as the debt has doubled, the economy has shrunk and there are 10% fewer island residents to pay for the borrowing and spending. Welfare benefits in Puerto Rico have been a severe impediment to work, investment and growth. One estimate shows that a household of three eligible for food stamps, AFDC, Medicaid and utilities subsidies could receive $1,743 per month—as compared to a minimum wage earner's take-home earnings of $1,159. With work discouraged, non-work encouraged and employers fleeing, the poverty rate in Puerto Rico is above 40% (and above 50% for children), almost double the rate in the poorest states, such as Mississippi, West Virginia, and Arkansas. Liberal welfare policies in Puerto Rico have impoverished the island.

The danger Puerto Rico faces is that the continuing outflow of people and capital could turn into a stampede from the island if the financial/economic crisis isn't resolved with urgency and in the most economically constructive and equitable way possible. Making matters worse, the mosquito-borne Zika virus may infect as many as one-in-five Puerto Ricans over the next year, which is scaring away from and conventions.[iii]

Puerto Rico has been to this barbecue before.

As a result of the high-tax rate policies pursued in the late 1960s and early 1970s, Puerto Rico was an economic basketcase in the early 1970s. Just like the United States at that time, and in fact even before Reagan took office, Puerto Rico had the wisdom to begin pursuing pro-growth, supply side economic policies in the late 1970s on the advice of Dr. Laffer. Puerto Rico's then Governor Carlos Antonio Romero Barceló assumed office in 1977, inheriting a top marginal income tax rate of 87.1%, a 5% surcharge tax on personal incomes, referred to as La Vamparita or "little vampire" by Puerto Ricans, an estate tax rate of 70%, and an unemployment rate of 20%.

Then, just as now, supply side reform was the antidote. And then just as now, proposals for supply side reform were met with claims that the United States was pursuing colonialist policies.[iv]

To their credit, House Republicans are engaged in a good faith, and in many ways thankless, effort to resolve the crisis in a way that is timely, economically wise, and equitable to all the stakeholders directly affected by the debt crisis. Nancy Pelosi and the Democrats, who profess to care deeply about the residents of Puerto Rico, have been obstacles to reform by insisting on federal bailouts, unconstitutional bankruptcy protections, and business as usual governance in Puerto Rico. These are all, thankfully, total non-starters. Democrats know this, but they seem far less focused on finding a workable solution and far more focused on politicizing the issue with, for example, language that accuses the GOP's plans of an oversight control board of being forms of "colonialism." This has made the Republicans' fix-it job all the more difficult.

We agree with the major direction of the House bill, but we have some remaining concerns. These concerns are generally shared by the large faction of conservative House members inside the Republican Study Committee and the Freedom Caucus. The hang up in the House appears to be a so-called "cram down" provision forcing certain categories of bondholders to give up constitutional protections—which is not fair, equitable, or economically wise.

We believe that any bill to help Puerto Rico must abide by the following six principles of good economics and respect for the rule of law:

1. No federal taxpayer bailout of Puerto Rico. This means no federal funds appropriated directly or indirectly (for example, through Medicaid or Obamacare expansions) to pay Puerto Rico's bills. Just as federal taxpayers should never be required to repay the debts of Illinois or California or Alaska, Puerto Rico's government and its residents are primarily responsible for their debts.

2. A federal control board. Almost all parties agree that a strong and independent financial control board must be established by Congress. The control board would have financial authority over the debts, finances, budgets, and taxing authority in Puerto Rico with the goal of restoring the island to a firm financial footing. The control board would also have broad authority to restructure Puerto Rico's debt subject to the legal safeguards listed below. This control board model worked very well to turn around Washington, D.C. when it was financially insolvent in the 1990s. The assignment of this control board is a de facto declaration of bankruptcy—though under federal law, Puerto Rico as a Commonwealth territory of the United States is not permitted to declare Chapter 9 bankruptcy.

3. Any rescue plan for Puerto Rico must have "buy in" from the local government. Hence, the legislature in Puerto Rico should vote up or down on establishing the control board and ceding control of its financial affairs to the outside control board. Congress should make it clear that voting down the control board will not under any circumstances lead to a taxpayer bailout.

4. In granting the control board the authority to restructure the island's multiple tiers of debt obligations, the legislation should explicitly instruct the board in its charter to respect the legal prioritization of debt repayment. While it is a virtual certainty that every class of bondholder will take a haircut under any plausible repayment plan, the full faith and credit debt, or general obligation (GO) bonds, which account for about one quarter of the debt, should have first claims on assets and revenues—as consistent with the laws of Puerto Rico.

5. No tier of bondholders should be forced to participate in the control board solution—a "cram down"—as the current House legislation would require. The proposed legislation includes a "stay" provision, which would mean bondholders would effectively lose their right to sue in court to protect their claims. This would amount to a government-imposed "taking" of their legal rights as creditors. There is no guarantee that claimholders would fare better in court than under a settlement—and they may fare worse if claims are tied up in litigation for years.

6. The fundamental problem facing Puerto Rico is a slow motion economic meltdown that started a decade ago and is accelerating. The control board solution won't work without sweeping economic reforms initiated by the control board and/or Congress. We advocate an "Enterprise Zone" solution for Puerto Rico with sweeping tax, workplace, regulatory, and welfare reforms at the federal and Commonwealth territory level to restore investment, growth and repopulation of the island. Growth is an absolute precondition to restoring financial stability to Puerto Rico.

This study lays out a case for each of these recommendations and summarizes the urgent need for reform.

Introduction: Overview of the Crisis

Governor Alejandro Garcia Padilla says the Commonwealth territory is out of cash to meet its bond payments. If the island were a company, it would be insolvent. There are worries of a run on Puerto Rico banks if this debt-repayment crisis is not resolved soon.

Puerto Rico's economic free fall is making the crisis worse and debt repayment more precarious.

On top of all the money woes, the island's setbacks have been exacerbated in recent weeks by the spread of the mosquito-borne Zika virus that could infect as many as one in five Puerto Ricans. This will lead to a further exodus from the island and keep tourists away. Things have gone from bad to worse.

How did Puerto Rico get to this stage of economic paralysis and financial chaos?

While the cancellation in 2006 of a generous federal tax break for Puerto Rico offered to companies locating on the island has played a role in the rapid economic and fiscal decline, most all of the responsibility for the island's troubles rests with Puerto Rico's government itself.

Though some on the left have tried to spin the blame in other directions (e.g. by blaming "vulture funds" who buy distressed bonds), the truth is irrefutable: overspending, over-reliance on welfare, excessive public hiring, anti-growth tax hikes, and some of the most irresponsible borrowing practices in modern times have all crashed the economy and the island's finances.

This is, alas, a crisis of self-government in Puerto Rico—which is why an independent control board is a constructive first step to alleviating the crisis.

The U.S. Government did not cause this crisis. Nor did Congress. While the bond buyers and hedge fund managers acted foolishly in buying up the Puerto Rican bonds and may be fairly criticized as "enablers," they are not the root cause of the debt crisis, as some in the media have argued. No one forced Puerto Rico to borrow at unsustainable and reckless levels.

Puerto Rico's welfare statism has collapsed under its own weight—just as happened in other places around the world, such as Greece. Without fundamental policy redirection in San Juan away from over-reliance on government, any short term federal intervention to stem the current debt crisis will be followed only by future crises and demands for further rescue plans. As a Heritage Foundation study puts it succinctly: "Even wiping Puerto Rico's debt slate clean wouldn't solve the island's crisis. Any workable plan must address the island's failing economy."[v] We agree.

The Case for Federal Intervention

The Obama Administration and some members of Congress are calling the Puerto Rico financial calamity a "humanitarian crisis," and it is nearing that point. The financial chaos has reached an emergency level, and citizens of Puerto Rico may lose access to very basic public services, including schools, education, hospitals, and infrastructure like clean water. Basic public health and safety are in jeopardy.

It seems increasingly unlikely that the politicians in San Juan are capable of dealing with the economic contraction. The policy decisions by the government so far have been almost entirely in the wrong direction. For example, last year the Puerto Rican government raised the import tariff on crude oil by 68%, from $9.25 per barrel to $15.50 per barrel.[vi] This has increased energy costs. Worse, last May, the government raised the sales tax from 7.0% to 11.5%—a 64% hike. This is the highest sales tax rate in the nation.

Bill Isaac, a former director of the FDIC, testified before Congress: "Previous efforts by the commonwealth government to reform have had only a marginal impact and it appears the existing government does not have the expertise or the political willpower to institute needed reforms."[vii]

The best solution to the immediate debt/bond repayment crisis would be for Puerto Rico's government to work out a mutually-agreeable restructuring of the debt with its creditors and without an intervention by Congress or the White House. Some of that is going on already. *The Wall Street Journal* reports that the Puerto Rico Electric Authority and its creditors have worked out a restructuring of $9 billion of debt.[viii]

While we would like to see more of these voluntary restructuring deals, it looks increasingly certain that in the weeks ahead, Washington will throw some sort of a financial life raft to Puerto Rico.

The federal government will not allow a U.S. Commonwealth territory to fail financially and slip into a spiral of economic decline. House Speaker Paul Ryan argues persuasively that although the financial mismanagement, overspending, and a reckless pattern of borrowing by Puerto Rico's home rule government are the root causes of the crisis, Washington has a legal and moral obligation to rescue the people of Puerto Rico, who are, after all, American citizens.

It also has a constitutional authority to intervene. Article 4 of the U.S. Constitution assigns Congress the "power to dispose of and make all needful rules and regulations" for U.S. territories.

There is also a practical case for Washington to intervene now. Purely as a financial matter, a fair and workable solution to the debt crisis that includes long term financial and economic structural reforms will obviate a much more costly and intrusive intervention in the coming years.

The State of the Puerto Rico Crisis

In this section we review the economic and financial state of affairs in Puerto Rico. How did Puerto Rico get into this fiscal hole requiring a federal government intervention? The situation, unfortunately, is dire, but, we believe, through the right policy prescriptions, reversible.

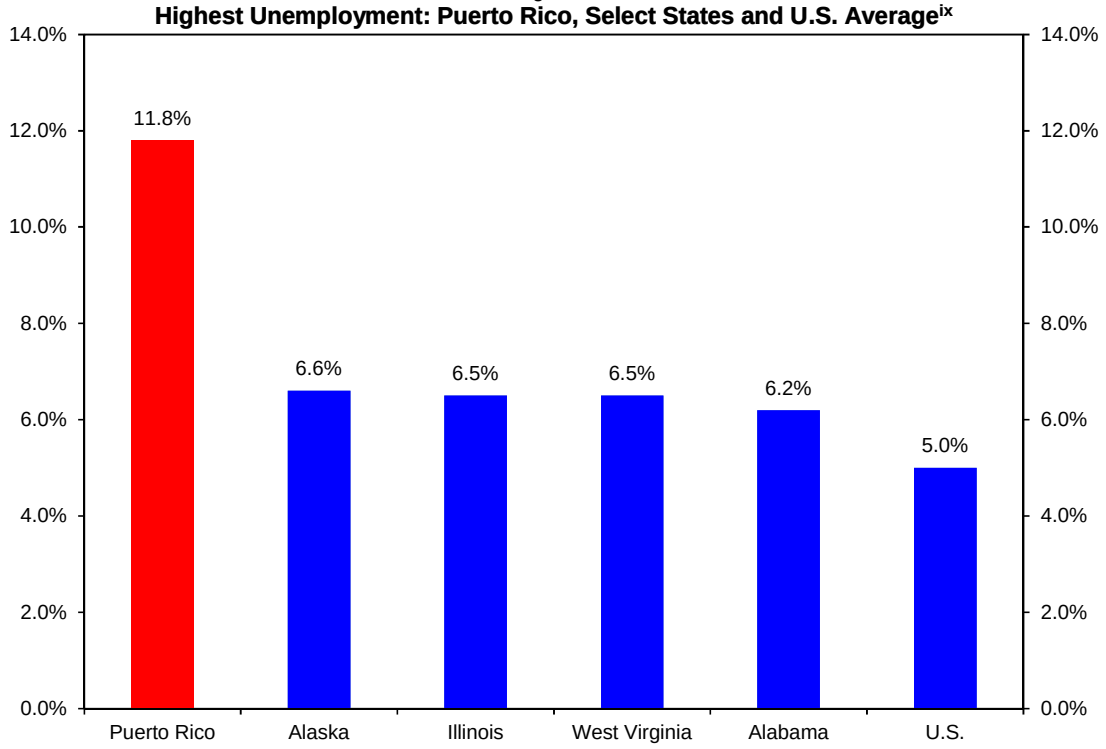
Economic Conditions

The economy is shrinking and has been in a prolonged contraction for at least the past decade. The outlook is getting worse, not better.

- **Economic growth rate**: The economy has been receding for a decade. Alarmingly, there has been only one year (2012) of positive growth over that period. While the U.S. economy has risen by about 13% in real terms since the Great Recession ended in 2009, Puerto Rico's economy has contracted by more than 5%. From a growth perspective, Puerto Rico has been in the grips of a mini-depression since the start of the 21st century 16 years ago—just like it was in the 1970s before Puerto Rico pursued pro-growth policies. Between 1975 and 1976, growth was 0%. After pro-growth reforms were enacted in 1977, the trend reversed, with growth averaging 6.1% in 1977 and 1978.

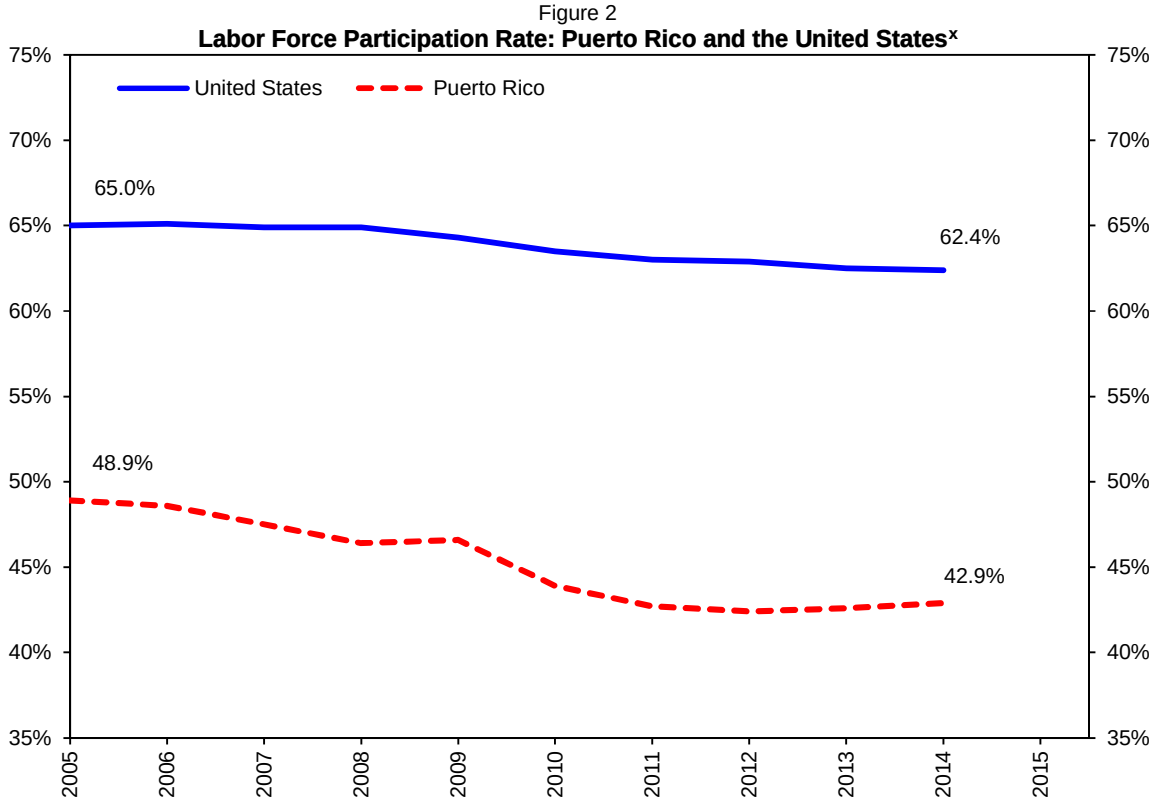
- **Joblessness:** The headline unemployment rate on the island is currently 12%, though the rate has been as high as 18%. Figure 1 compares this rate with the average for all states and the rate for high unemployment states.

Figure 1
Highest Unemployment: Puerto Rico, Select States and U.S. Average[ix]



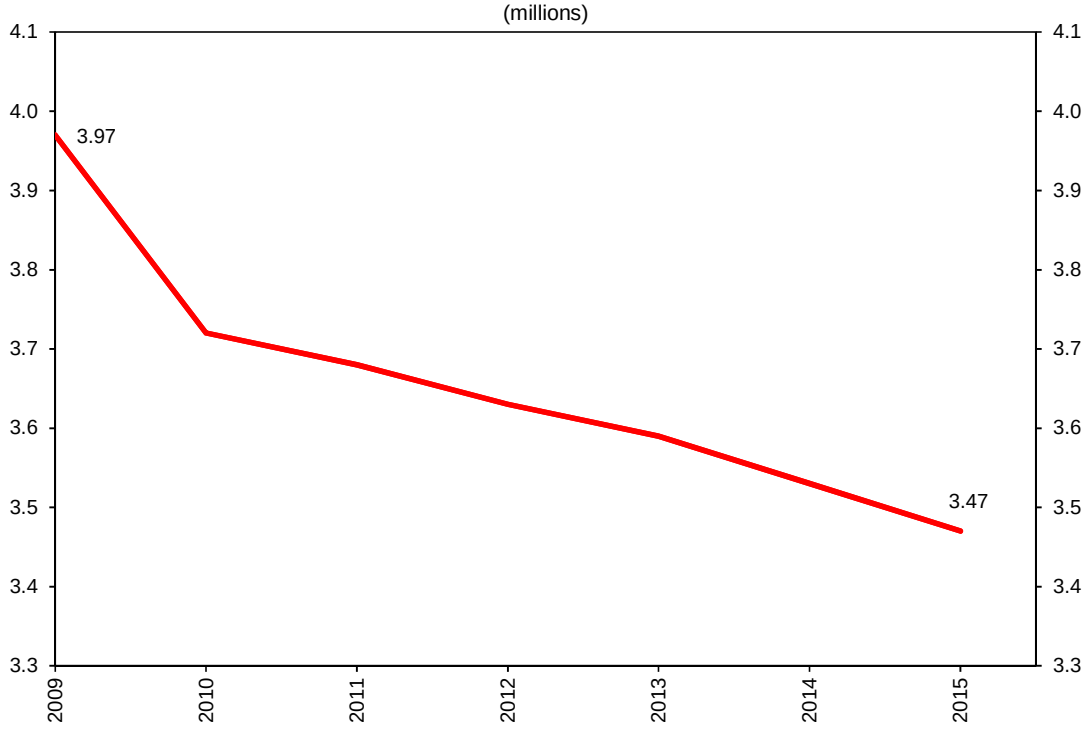
- **Labor Force Participation:** What makes the jobless situation much worse than even the official statistics is the stunningly low labor force participation rate. The labor force participation rate for the U.S. today for those between ages 15-64 is about 70%. That is very low in historical terms and the lowest since the late 1970s. But for Puerto Rico, the labor force participation rate is closer to 41%. With a normal labor force participation rate, Puerto Rico would have a half million more people working, earning a paycheck, less reliant on welfare, and paying taxes. See Figure 2.

Figure 2
Labor Force Participation Rate: Puerto Rico and the United States[x]



- **Outmigration**: Puerto Ricans are leaving the island and coming to the continental states in search of better economic opportunity. The island's population has declined by 500,000 from 2009 to 2015, which is a 12.6% decline. The overall U.S. population has risen by 4% over this time period. See Figure 3.

Figure 3
Population: Puerto Rico
(millions)

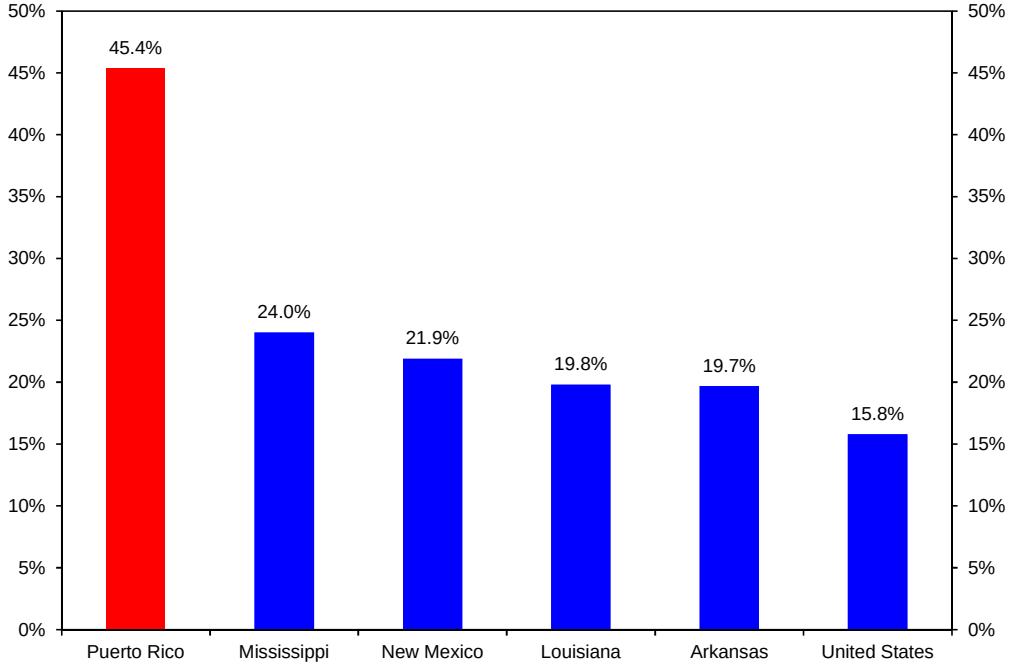


- **Business Climate:** The World Bank's annual survey of best places to do business uncovers big deficiencies in Puerto Rico's business climate.[xi] The island ranks 57th in the world, way behind the continental United States, which ranks 7th. One big setback is the tax code, which is too complicated. Low tax compliance rates are also a problem. Regulations, permitting requirements, and property rights are also holding back growth.

- **Welfare dependency:** Puerto Rico is a welfare state with half of the island's residents on Medicaid. Almost all analysts agree that the generosity and widespread availability of government benefits deters growth. One prominent study finds that food stamps, cash benefits, and Medicaid pay almost 50% more than a minimum wage job. Economist Anne Kruger et al. recently found in their comprehensive review of the Puerto Rican financial crisis that: "a household of three eligible for food stamps, AFDC, Medicaid, and utilities subsidies could receive $1,743 per month—as compared to a minimum wage earner's take-home earnings of $1,159."[xii] In Puerto Rico, work does not pay.

- **Poverty:** Nearly half the children in Puerto Rico live below the poverty line. The poverty rate is nearly twice as high as in a high-poverty state, such as Mississippi. See Figure 4.

Figure 4
Highest Poverty Rates: Puerto Rico, Select States and U.S. Average
(% population)

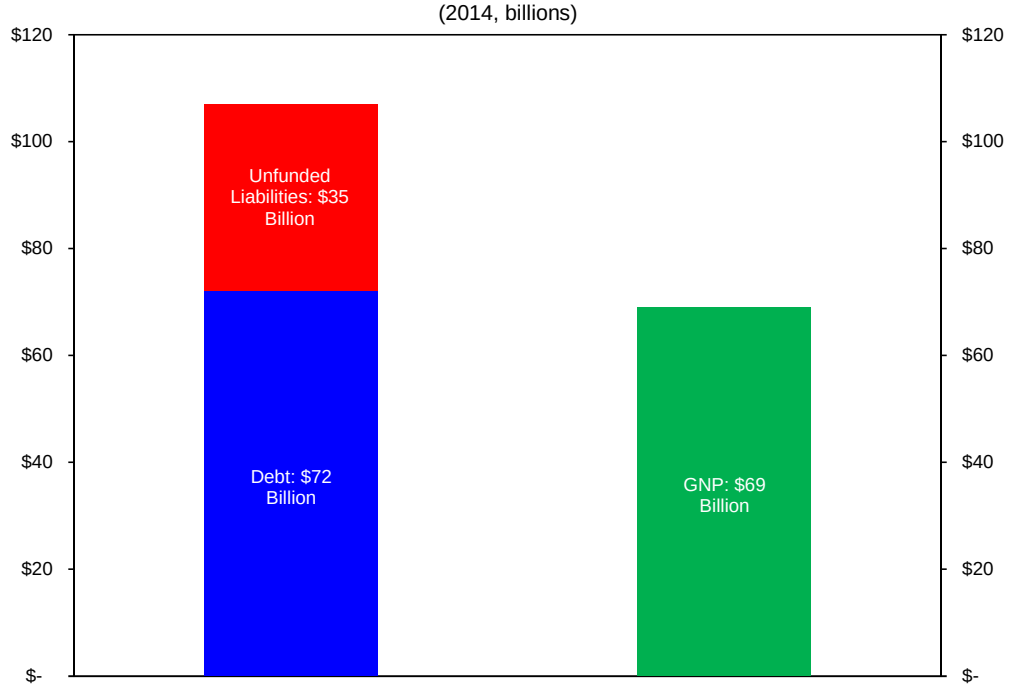


Financial Conditions

Puerto Rico has seldom been fully transparent in its financial dealings and so some believe the island is exaggerating the severity of its financial plight. That doesn't appear to be the case. The financial condition and outlook on the island have deteriorated concomitantly with the economic recession. Fewer people working, an outmigration of people and capital, higher welfare dependency and no growth in output has made debt repayment an unachievable burden. Without a resumption of growth, all of the financial reforms discussed here are merely delaying tactics until the next financial time bomb detonates.

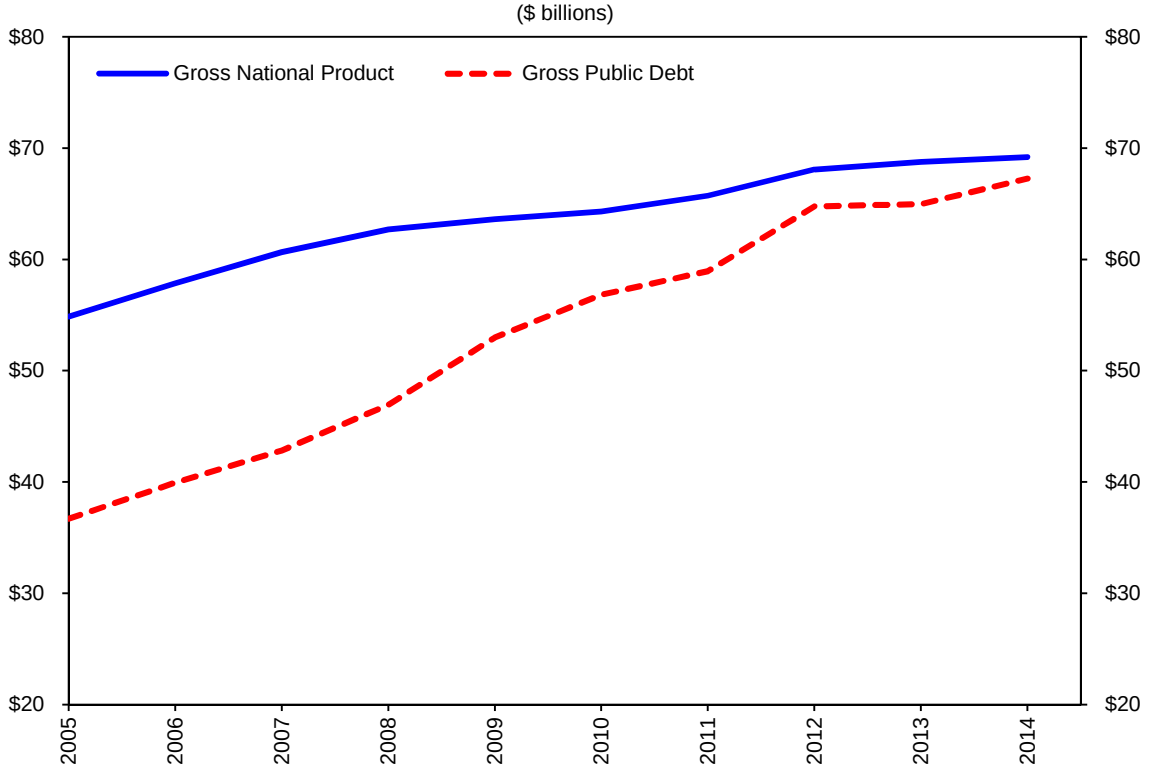
- **Debt Burden:** Puerto Rico's debt burden can be measured many ways. The outstanding bonds that have been issued total $72 billion. On top of that debt, the government also faces $35 billion in unfunded pension and health care liabilities. See Figure 5.

Figure 5
Debt and Unfunded Liabilities: Puerto Rico and Puerto Rican GNP[xiii]
(2014, billions)



As a share of output, Puerto Rico's debts exceed the annual GNP. The debt has risen as output, population, and the workforce have fallen. See Figure 6.

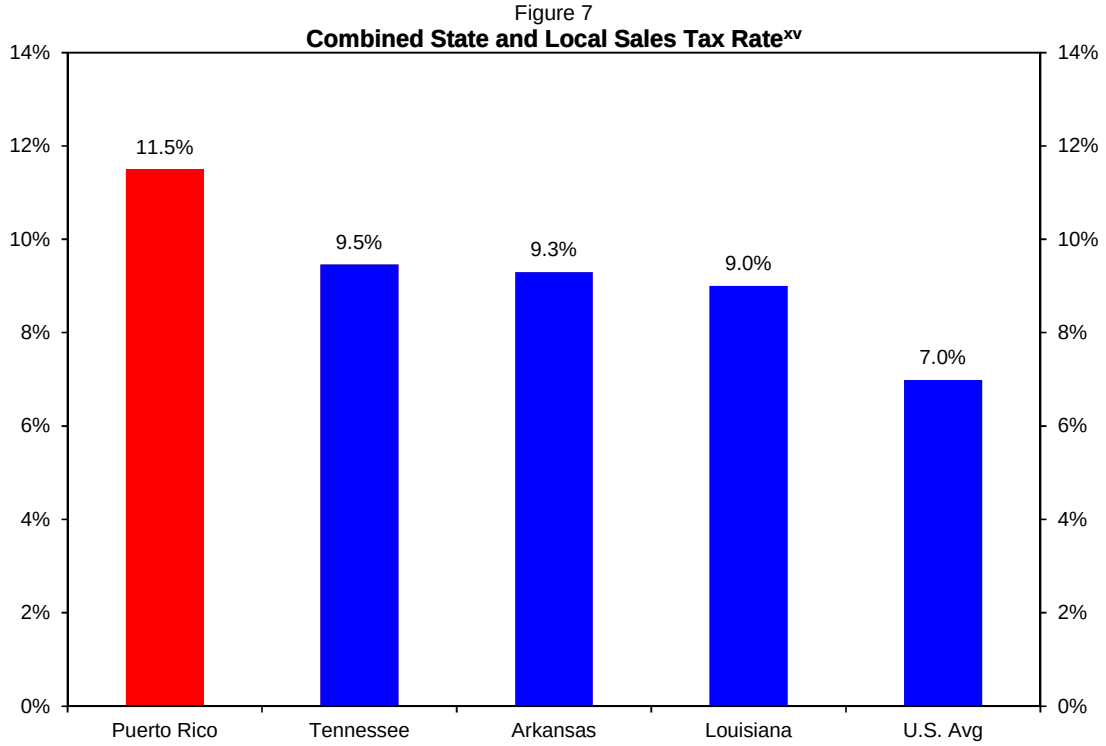
Figure 6
Debt and Output: Puerto Rico[xiv]
($ billions)



- **Debt Burden per capita:** The debt per person has risen from $14,000 to more than $20,000 in constant 2014 dollars over the past decade.

- **Taxes keep going up**: Anyone who thinks Puerto Rico can relieve its debt crisis by raising taxes is not facing reality. The sales tax in Puerto Rico was just recently raised from 7% to 11.5%. Figure 7 shows how Puerto Rico's sales tax compares to the U.S. average and other high sales tax states. Sales taxes are higher in Puerto Rico than in any of the 50 states. Puerto Rico also raised its energy import taxes.

Figure 7
Combined State and Local Sales Tax Rate[xv]



- **Government employment:** Puerto Rico has roughly one million workers but almost one-quarter of them work for Puerto Rico's government.

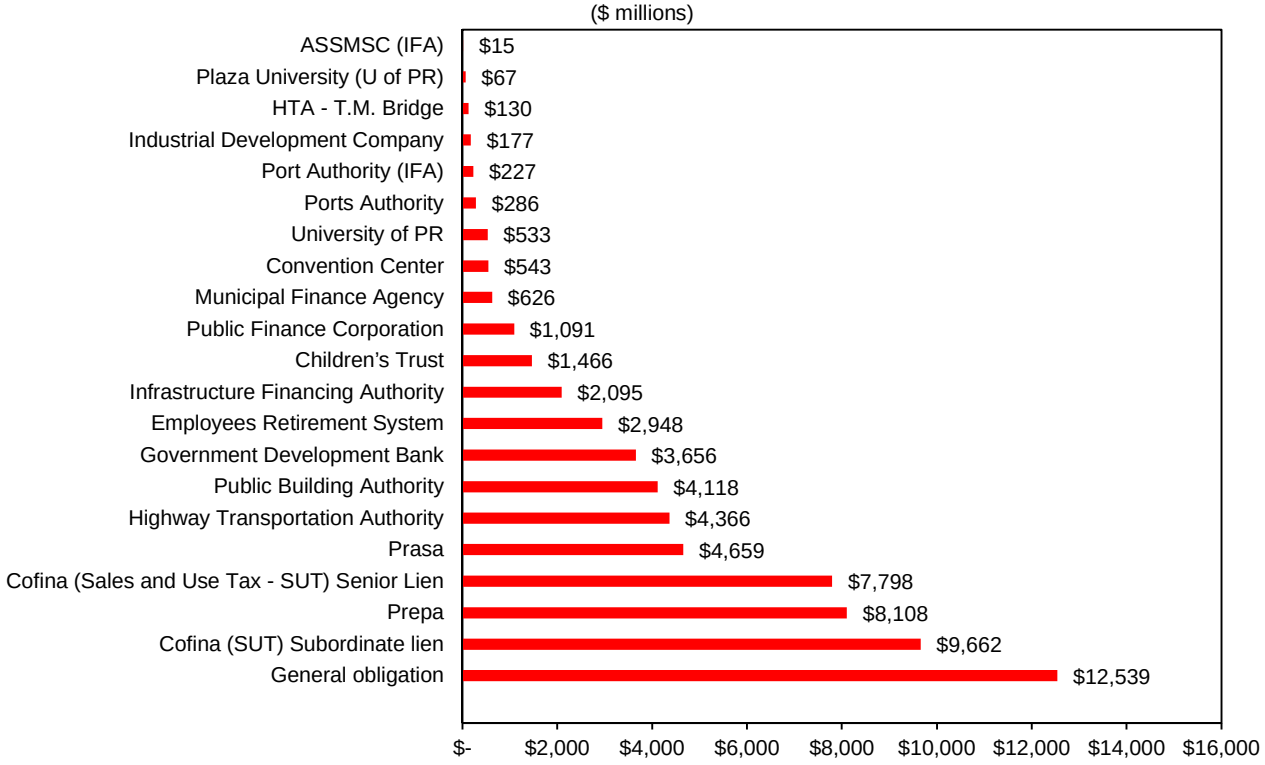
- **Government spending:** The Puerto Rico government budget has risen every year even with declines in population and workforce and even while facing a debt crisis. At the end of last year the government gave out bonuses to its public employees even as the government could not pay its bills. *The Wall Street Journal* reports that "Over the next five years general fund spending is on a path to grow by 20%, resulting in a cumulative $28 billion deficit."[xvi]

- **Tax Collection:** The Puerto Rican government loses billions of dollars a year in non-collection of taxes owed. For example, KPMG estimated sales tax compliance at a rate of only 56%, with unpaid sales tax liabilities of $1.4 billion.[xvii, xviii]

The Status of Debt Repayment

One of the complications of solving the Puerto Rico financial crisis in an equitable way is that the government has issued 21 different types of bonds–each with a unique status in terms and conditions of repayment and with the hierarchy of claims on Puerto Rico assets and revenues. Figure 8 shows the various classifications of outstanding bonds and how much is owed under each classification. Believe it or not, Puerto Rico has a constitutional balanced budget requirement, which the government has openly ignored over the past decade.

Figure 8
Outstanding Bond Obligations: Puerto Rico[xix]
($ millions)



Of critical importance in the Puerto Rico debate is that, of the $72 billion owed, roughly $13 billion of these bonds are general obligation, or "GO bonds." This special class of bonds carries the full faith and credit guarantee of the Puerto Rico government. If Puerto Rico were a company, and not a government, there would be no legal issue of who gets paid first out of PR revenues in any bankruptcy proceedings. It would be the GO bondholders that would be first in line.

Other classifications of debt include the so-called COFINA debt. COFINA is a government corporation created by the Puerto Rican government in 2006 in order to bypass the Commonwealth's Constitutional debt limit by issuing bonds, to be paid back by the revenue stream from the sales tax. Because the COFINA debt is backed by sales tax revenue, and not the full faith and credit of the Commonwealth, it is eligible for restructuring.

These are considered high-priority bonds by the courts, because of the claim on the dedicated revenue stream. There is some legal dispute as to whether the revenues dedicated to repaying COFINA bonds can be diverted to other purposes—such as repaying the GO full faith and credit bonds.

What is beyond dispute is that Puerto Rico is technically insolvent today. It is already late on existing bond repayments and there are two bond payments that come due in the weeks ahead, a $400 million payment due May 1st and a $2 billion bond payment due in mid-Summer. It is believed that Puerto Rico does not have the money to repay these loans in a timely manner. We say "believed" because no one in recent years has done an independent audit of Puerto Rico's financial status. Such an open audit should be a first priority of any financial control board.

If Puerto Rico can't meet its bond repayment obligations in the months ahead, the credit holders have several options.

1. Sue in court for full repayment. One issue is whether courts would rule that given the enormity of the debt, repaying the bonds would jeopardize the health and safety of the citizens.

2. Renegotiate debt restructuring with the government of Puerto Rico. Many bondholders are already voluntarily sitting across the table from Puerto Rican officials and working out mutually acceptable bond restructuring arrangements that tend to spread payments out over a longer period of time and the bondholders agree to a lower return.

3. Accept a financial control board established by Congress and the restructuring of the debt as determined by the board.

It is important to note that the bond market is already pricing in a deep discount on Puerto Rico bonds given the enormity of the island's economic and financial problems. The Municipal Securities Rulemaking Board reports that Puerto Rico's GO bonds are selling at between 70 and 75 cents on the dollar.[xx] This discount reflects the risk of non-full payment, a potential de facto bankruptcy arrangement, and delays in repayment—all of which would make the bonds less valuable.

While the Republican plans to provide an economic and financial life raft for Puerto Rico are well-intentioned and necessary, there are indications that the prospect of a federal government intervention along with the chance of a "cram down" on the bondholders is impeding independent negotiations between Puerto Rico and its creditors. For example, some of the negotiations between COFINA creditors and the island's municipalities have been stalled because the government now believes it can get a better deal under a Washington legislative solution. This was pointed out by *Breitbart* in April, when the story noted:

> *"The Republican draft legislation to rescue Puerto Rico would shield the island from lawsuits filed by creditors for missed debt repayments. The prospect of civil immunity being granted by Congress no doubt spurred Puerto Rico to take the extraordinary step [of missing debt payments]. The suspended payments would jeopardize many U.S. institutional investors, including pension funds."*[xxi]

It is worth emphasizing that nonpayment of the Puerto Rico debt will not just or even primarily hurt wealth bond traders and hedge fund managers. An analysis by Morningstar, an investment research firm, has found that "over 180 municipal bond mutual funds hold more than 5% of their portfolios in Puerto Rican bonds."[xxii] So pensioners own these bonds–and nonpayment or default will hurt middle class seniors. Moreover, CNN Money reports that 30% of Puerto Rico bonds are owned by "middle class Puerto Ricans."[xxiii]

The Puerto Rican government has been offering take-it-or-leave-it settlements with bondholders promising to pay between 33 and 75 cents on the dollar depending on the class of the bonds. Under these terms, bondholders would trade in their existing bonds for a new issue of bonds that would be longer term in payment and would offer a lower return.

The Rule of Law and Sanctity of Contract

Under federal law, the Commonwealth territory of Puerto Rico is not permitted to enter Chapter 9 bankruptcy as many local municipalities are permitted to do.

One long term legal and property rights issue that the Puerto Rico government, the Obama Administration, and some in Congress want to suspend in these negotiations is safeguarding the contractual rights of the bondholders. In any normal bankruptcy-type proceeding, creditors and other stakeholders are prioritized for claims on the borrowers' income stream and assets. Bondholders come first. There are exceptions, of course, as when a government is involved and its ability to provide for the health and safety of citizens may be impaired, paying for the continuation of public services may be deemed the highest priority.

What complicates matters in the Puerto Rico case is that the government has issued 21 different classifications of bonds. Each tier of debt has a prioritization in terms of repayment. Right now the GO "full faith and credit" debt sells for 70 cents on the dollar, while lesser priority debt is selling at as little as half that amount.

We find it highly objectionable and injurious to the rule of law for this legal prioritization to be overridden by a third party without the buy-in consent of the impacted creditors. Article VI of the Puerto Rico constitution guarantees that repayment of the debt is subject to a first priority payment before other bills or claimants are paid.

Especially improper is a scheme favored by many Democrats and the Puerto Rico government to allow pensions to be paid before creditors. This happened in the situation of Detroit and GM bankruptcies. This was an unconstitutional taking of property of the class A bondholders and was done for political expediency, not out of fairness or any regard for the rule of law.

The political temptation is to let the Wall Street hedge funds take the hit for Puerto Rico's financial malfeasance. Under one plan that is circulating, the bonds held by Puerto Rican citizens would be paid a higher return than the bonds held by hedge funds and other institutional investors. This is highly objectionable as well. Since when do people with equal claims get unequal treatment based on who they are? It's easy to demonize Wall Street and "rich investors," but often these investors are pension funds and most of the bonds are held by working class Americans. There is no equitable or constitutional case for paying some bondholders more than others on the basis of their incomes.

Bonds are not social programs—and to turn them into such would do irreparable damage to the integrity of American financial markets.

How to Deal with the GO Bonds

It appears to us that the most contentious issue to resolve and an impediment to getting legislation passed is finding an equitable solution with regard to the bondholders. In particular, the constitutionally-protected GO bonds, which carry full faith and credit guarantees from Puerto Rico's government must be restructured with the consent of these bondholders.

Clearly the bondholders will and should take a financial hit in whatever restructuring plan is settled on. The bondholders took a risk—an excessive one in our view—in buying these bonds into the winds of a clearly imminent financial collapse in Puerto Rico. They will realize a loss for taking on extreme risk and failing to conduct proper due diligence in scoping out the financial waterfall that awaited the island in the years to come.

Puerto Rico is, pure and simple, out of money. The bondholders were complicit in the crisis by buying the bonds although they were lured into these debt instruments because of high interest rates, tax free designation on the bonds, and the false notion that these government bonds were risk free. They took a gamble—and they lost. Federal taxpayers certainly shouldn't have to reimburse them for their bad bet.

As we see it, the GO bondholders now have three courses of action: 1) quickly renegotiate a new repayment schedule with Puerto Rico; 2) accede to the authority of a financial control board to resolve the issue of bond repayment; or 3) take their chances by suing in court. Congress wants to "cram down" the financial control board option without the consent of the creditors. We believe free marketers like Orrin Hatch and the Republican Study Committee are correct in objecting to this involuntary surrendering of legal rights.

We believe that bondholders should not be forced into a settlement imposed upon them by a control board—unless they agree to participate in advance. One version of the House legislation calls for a stay on legal action, which appears to be an unfair taking away of the legal rights of these bondholders. This is a fundamental flaw of the House Republican bill.

Critics say that the control board will become toothless without the unilateral authority to renegotiate the terms and conditions of debt repayment. The argument is also made that without the stay against lawsuits there will be a "rush to the courthouse" and litigation could go on for years. But that is all the more reason why creditors may rationally prefer to take their chances with the control board. Few bondholders want to pay exorbitant legal fees and be stuck in court with settlement delayed for perhaps years as they seek a litigation solution. And there is no assurance that the bondholders will win in court.

So why is the right to sue in court so important to a just solution? The right to sue protects the stake holders from an egregiously unjust ruling by the control board. The GO bondholders have good reason to be suspicious. The Democratic/White House rescue plan would allow for a so-called "superbankruptcy" which would allow the board to ignore the full faith and credit protections on GO bonds.

Similarly, a cram down by the control board without the buy-in consent of the GO bondholders violates their rights of repayment under the Puerto Rican constitution.

Both of these provisions of the House restructuring bill would need to be revised for the bill to be constitutional and fairly arbitrated.

A Cram Down Hurts Puerto Rico

While many liberal advocates believe that a cram down or an illegal bankruptcy will only hurt the "rich Wall Street bondholders," while preserving government programs and services for the Puerto Rican residents, this is myopic thinking. If Puerto Rico technically defaults on its GO bonds, or any bonds for that matter, the short term gain will be a steep discount in paying back the lenders, in exchange for a long term premium payment on future borrowing. Investors—whether institutional or self-directed—won't get burned twice, and the credit rating of the island will be permanently impaired. A real or de facto default, meaning only partial repayment, could shut out Puerto Rico from credit markets for many years to come.

Puerto Rico must decide whether the short term financial gain from bankruptcy or other forms of non-payment is worth losing access to credit markets for even legitimate borrowing projects. At the very least, future interest rate charges on Puerto Rico bonds will skyrocket.

Representative Rafael 'Tatito' Hernandez recently said that a priority for Puerto Rico is to maintain "one of the main pillars of our Constitution, which is the good faith and credibility of the Commonwealth of Puerto Rico." A cram down doesn't do that.

Puerto Rico may be better off reaching an equitable settlement with its creditors than destroying its credit rating for years and decades to come.

We believe that Bill Isaac, formerly of the FDIC, put this point perfectly:

> *"The cost of defaulting on constitutional bonds will in the long term cost the commonwealth far more than any temporary respite from debt. I believe that the credibility of the commonwealth and its future access to private sector capital markets will suffer drastically should they default on restructured GO bonds given priority in the PR constitution."*[xxiv]

A Workable Solution

The current House bill may be voted on in the days ahead. It would create a financial control board to take charge of Puerto Rico's finances and budget affairs.

This is the right model. It helped Washington, DC recover economically when it was in a similar stage of financial crisis. Its bonds now sell at AA rating because of its vastly improved financial outlook. Of crucial importance, the financial control board is NOT a cash taxpayer bailout of Puerto Rico—which is what the Puerto Rico government wants as do many Democrats in Congress.

Under the control board, Puerto Rico would enter de facto bankruptcy. This step is necessary because formal Chapter 9 bankruptcy is not constitutionally-permitted for states and territories. This will enable necessary and proper debt restructuring. Every class of bondholder will take a haircut under this solution. Even the Puerto Rico GO bonds that carry "full faith and credit" guarantees are now selling on the market at a discount of about 70 cents on the dollar. The market knows Puerto Rico cannot fully repay its obligations and is pricing bonds accordingly.

If anything good comes of this debacle it is that hopefully bond traders will finally start to realize that government bonds are NOT risk free.

The Obama Administration wants Congress to pass legislation revising bankruptcy law for territories. Under Article IV of the Constitution, Congress has "Power to dispose of and make all needful Rules and Regulations" for territories.

One virtue of bankruptcy for territories is that it would provide predictability and order to the process of untangling claim priorities and creating specified voting classes. While bondholders would take haircuts, pensioners and workers would likely also have to get snipped for a readjustment plan to obtain creditor approval.

This new law could preclude territories from issuing full faith and credit debt. But this should apply to FUTURE Puerto Rico debt, not retroactively to existing debt already issued—as some in Congress and in the Puerto Rico government would like to see happen. This would stave off future debt crises but it won't solve the crisis at hand.

Specific Recommendations

The House Natural Resources Committee Puerto Rico bill is a big step in the right direction, but there are some remaining flaws that need to be fixed. Even the Committee itself has to its credit acknowledged that there are problems that need to be ironed out. In releasing the bill, the Committee noted that the draft legislation includes "highly complex with sensitive constitutional implications and will likely demand additional refinements."

The Republican Study Committee (RSC) with more than 150 House members says that bill needs to be fixed before its members can vote for it. The RSC's main complaint is that the bill "includes provisions that essentially provide for a federally-forced restructuring of the island's debt." This appears to be a nonstarter.

We recommend that to optimize economic growth potential for Puerto Rico in the future and in order to adhere to the rule of law, the Puerto Rico rescue legislation should be amended in the following ways:

1. The legal rights of bondholders, who have first claim on revenues and assets, should not be subordinated, for example, to the political power of the government unions, as happened with the Obama Administration bailout of auto companies. This would be an unconstitutional taking of property from the bondholders.

2. We also believe that any rule that gives some bondholders, such as Puerto Rico residents, a higher return than others in the same bond class is unlawful discrimination and should be impermissible. These safeguards should be explicit in the legislation with a mandate that the control board honor the legal and constitutional prioritization of the bonds.

3. The control board should be granted authority to renegotiate the unfunded government pension liabilities—in the tens of billions of dollars due to government mismanagement and over-promises. Pensions must be dramatically scaled back to ensure the government has the ability to provide its vital public services such as schools, roads,

and public safety. The control board should also be able to adjust pension payments so they are in line with private sector compensation for similar work.

4. The control board must get buy-in from Puerto Rico's government. Liberals are denouncing the economic life raft House Speaker Paul Ryan is offering with preposterous charges like "colonial subjugation." Minority leader Nancy Pelosi complains that the control board is "undemocratic" because the board would be empowered to override the Puerto Rico legislature whose reckless borrowing and spending created the crisis in the first place.[xxv] These charges are utter nonsense.

   The solution here is obvious: Let the democratically-elected Puerto Rico legislature vote on whether it will accept board control. Congress should make clear that the alternative is NOT a federal bailout. If Puerto Rico votes yes to the control board, the process of solving the financial crisis begins immediately. If the legislature votes no, then Washington will have to wash its hands of the matter and allow Puerto Rico to deal with its financial insolvency on its own.

5. The stay on lawsuits should be lifted to protect the rights of bondholders—unless the bondholders agree in advance to forfeit their right to sue.

6. No more tax increases. The control board should rule out tax hikes as a solution to the fiscal crisis. As the Tax Foundation puts it: "Additional taxes without tax reform on an already weak economy are a recipe for financial collapse."[xxvi] Tax reform to broaden the tax base, lower tax rates, and improve collections is the right revenue approach.

7. Finally, Congress should instruct the control board to enact long term pro-growth fiscal, regulatory, and legal reforms. This should include exemption from extraneous federal laws, such as the Jones Act and other labor laws that inhibit growth. Without growth and enterprise, it is doubtful Puerto Rico will ever fully recover from the financial turmoil that reigns today. The goal should be to covert Puerto Rico from a dependent welfare state to the Hong Kong of the western hemisphere.

Learning from the Last Economic Crisis

As noted earlier, only a rejuvenation of the Puerto Rico economy will lead to the kind of financial stability and higher living standards that those living on the island need and deserve. The alternative is that the commonwealth becomes even more of a welfare state and a cost burden to the United States, while those on the island are left in economic isolation and despair.

We note here that the current crisis has many parallels to the mid-1970s crisis in Puerto Rico when the economy fell into severe recession. One of us, Laffer, worked 40 years ago to save the Puerto Rican economy, which was drowning under its own anti-growth policies. The solution agreed to was a supply side fiscal reform which included cutting the highest personal income tax rate down from 87% to 50%. The policies worked like a charm. Puerto Rico's economy grew every year at a record pace and tax revenues surged even with lower rates. It was a Laffer Curve miracle and the success was one of the inspirations for the Reagan tax cuts, which would help revive the U.S. Economy five years later.

We believe many of the solutions adopted in that previous era could be reengaged in this current crisis to help turn the economy around.

Here is some background of the dire situation and reforms in that period:

In 1974, Puerto Rican Gov. Hernandez Colon imposed a graduated surtax (up to 5%). This tax earned the local name of "La Vampirita," or baby vampire. With La Vampirita's inclusion, the maximum effective income tax rate was 87%. The 48.5% tax bracket was reached at the $22,000 taxable income level. In spite of the high income tax rates, only one-third of all tax revenues were collected from the income tax.

The Puerto Rican economy lost 40,000 jobs between 1973 and 1976, and on a base of about 725,000 jobs, such losses were serious. Real output declined in both 1975 and 1976. The budget officially was in deficit by more than $15 million. Constitutionally, deficits are forbidden. Statewide accounting practices being what they are, the government was not forced to bounce its checks. But as a consequence, yields on Puerto Rican tax-exempt bonds were even higher than New York City tax exempts.

In the elections of 1976, Puerto Ricans saw first what Californians witnessed only one year earlier. The one-time mayor of San Juan, Carlos Romero Barcelo, defeated the incumbent Gov. Hernández Colon with the promise of exterminating La Vampirita. In 1977, when the new governor took office, La Vampirita died. Gov. Romero has also eliminated yet another 5% tax surcharge which had been instituted during the Korean War. Quite ironically this surcharge had the name of "Victory Tax." From the standpoint of Puerto Rico, elimination of "La Vampirita" and the "Victory Tax" wasn't enough. During this past year all income tax rates were reduced by an additional 5% across the board with another 5% cut scheduled for next year. Excise taxes were lowered and a special $2 per barrel oil import surcharge was lifted.

The experts' prognoses for Puerto Rico were as far off the mark as they were in California. The Puerto Rican economy experienced a dramatic turnaround.

Employment from 1976 to 1979 increased by 107,000 jobs. Real growth averaged 6% for 1977 and 1978. Even Puerto Rican tax-exempt bond yields fell relative to those of other tax-exempt bonds.

Most surprisingly to many is that Puerto Rico's budget went full circle and ended up in a surplus. Expatriate Puerto Ricans returned to their island as opportunities there expanded.

Why not turn Puerto Rico once again into a Hong Kong in the western hemisphere through a combination of tax, regulatory, property rights, and welfare reforms? The first step is to restructure the debt and then jump start the dormant private economy so that the standard of living starts rising again. It worked 40 years ago, and it can work again in 2016.

Conclusion: Five Economic Reforms to Jumpstart Growth in Puerto Rico

Here are the specific reforms that will help revive the Puerto Rico economy:

1. A Puerto Rico flat tax of 15 to 20% down from 33% on personal income and 39% on corporations. A New York Federal Reserve Bank study notes: "Puerto Rico tends to levy high rates on a narrow tax base."[xxvii] This is the epitome of a bad tax system. The flat tax will make the island more business friendly and increase tax collections. We estimate that a more efficient tax system could increase tax payments each year by as much as $2.5 billion annually. Hong Kong operates with a 15% flat tax.

2. Make Puerto Rico exempt from the 1920 Jones Act, which requires that goods transported between U.S. ports be shipped on vessels built and manned by Americans. This is a well-documented wealth and jobs killer. This require acts of Congress, but is vital to restoring productivity in Puerto Rico.

3. Slash government payrolls. The Puerto Rican government employs one in four workers on the island. Those payrolls could be cut in half and the island would still have a higher percentage of government workers than most states.

4. Implement work for welfare requirements to grow the labor force and reward work over government dependency. We have strong evidence from the 1980s and 1990s that work requirements reduce welfare caseloads, increase labor force participation, and help the poor get on the road to financial self-reliance. Federal work requirements helped reduce welfare caseloads by more than half within five years.

5. Eliminate full faith and credit debt issuance. This would apply prospectively to debt issued after January 1, 2017. This would allow Puerto Rico to default on debt in a period of crisis, and without federal government intervention. But it will also require the island to pay higher interest rates on bonds, which should inhibit excessive reliance on debt to pay the island's bills.

6. Privatize the state-run electric utility and other state-owned enterprises.

7. Allow Puerto Rican workers to put Social Security payroll funds into private investment accounts, much like IRAs, and allow families to build up real wealth and savings. Studies show that these private accounts will offer workers up to 50% higher payments at the time of retirement than Social Security promises.

[i] This paper references a past report by Dr. Laffer that is available upon request. Interested parties can contact Laffer Associates at (615) 460-0100.
[ii] The Commonwealth of Puerto Rico is the proper name for Puerto Rico, but Puerto Rico is also a U.S. territory. The titles 'Commonwealth" and "territory" have different legal meanings as they relate to the status of Puerto Rico's sovereignty. The demarcation line where Puerto Rico is a sovereign and where it is subject to U.S. authority is a matter of legal debate. "As a [U.S] constitutional matter, Puerto Rico remains a territory subject to Congress's authority under the Territory Clause." However, Puerto Rico has its own constitution and is largely self-governing. According to the U.S. State Department, "The term 'Commonwealth' does not describe or provide for any specific political status or relationship. It has, for example, been applied to both states and territories. When used in connection with areas under U.S. sovereignty that are not states, the term broadly describes an area that is self-governing under a constitution of its adoption and whose right of self-government will not be unilaterally withdrawn by Congress."
Source: "7 Fam 1120, Acquisition of U.S. Nationality in U.S. Territories and Possessions," State Department. https://fam.state.gov/FAM/07FAM/07FAM1120.html#M1121_2_1
Source: Julio Verla, "In New Supreme Court Amicus Brief, Obama Administration Questions Puerto Rico's Commonwealth Status," Latino USA Online, Dec. 28, 2015. http://latinousa.org/2015/12/28/in-new-supreme-court-amicus-brief-us-confirms-that-congress-determines-fate-of-puerto-rico/
[iii] Source: Lena H. Sun, "Zika is expected to infect 1 in 5 Puerto Ricans, raising threat to rest of U.S.," *Washington Post*, February 29, 2016. https://www.washingtonpost.com/national/health-science/zika-is-expected-to-infect-1-in-5-puerto-ricans-raising-threat-to-rest-of-us/2016/02/29/c1288e30-db62-11e5-891a-4ed04f4213e8_story.html
[iv] Writing in the San Juan Star on November 23rd, 1979, James McDonough, a member of Gov. Colon's administration, claimed:
"The Republican answer is… the new face of colonialism; it is being encouraged in the United States not by its liberals, but by its conservatives.
[v] Source: Salim Furth and Rachel Grezler, The Heritage Foundation, "An Economic Crisis is the Heart of Puerto Rico's Financial Crisis," July 27, 2015, http://www.heritage.org/research/reports/2015/07/an-economic-crisis-is-the-heart-of-puerto-ricos-financial-crisis
[vi] Source: Belen Marty, "Running on Empty: Puerto Rico Ups Gas Tax amid Falling Oil Prices," PanAm Post, January 19, 2015. https://panampost.com/belen-marty/2015/01/19/running-on-empty-puerto-rico-ups-gas-tax-amid-falling-oil-prices/
[vii] Source: William Isaac, "TESTIMONY of WILLIAM M. ISAAC SENIOR MANAGING DIRECTOR & GLOBAL HEAD OF FINANCIAL INSTITUTIONS, FTI CONSULTING FORMER CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION," February 25, 2016. http://www.williamisaac.com/published-works/testimony-of-william-m-isaac-senior-managing-director-global-head-of-financial-institutionsfti-consulting-former-chairman-federal-deposit-insurance-corporation-before-the-subcommittee-on-oversigh/
[viii] Source: Mike Cherney, "Puerto Rico's Power Authority Reaches Deal With Bondholders," *The Wall Street Journal*, September 2, 2016. **http://www.wsj.com/articles/puerto-ricos-power-authority-reaches-deal-with-bondholders-1441191429#:RBDkiV1H0Q1AnA**
[ix] Source: U.S. Census
[x] Source: World Bank
[xi] Source: "Doing Business 2016: Measuring Regulatory Quality and Efficiency," World Bank Group. http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB16-Full-Report.pdf
[xii] Source: Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, "Puerto Rico – A Way Forward," June 29, 2015. http://www.bgfpr.com/documents/puertoricoawayforward.pdf
[xiii] Source: Government Development Bank of Puerto Rico; National Public Finance Guarantee Corporation, "Puerto Rico in Perspective," August 10, 2015, http://www.nationalpfg.com/pdf/Presentations/PRinPerspective.pdf (accessed April 29, 2016).
[xiv] Source: Statistical Appendix of the Economic Report for the Governor and Legislative Assembly, Government Development Bank for Puerto Rico, http://www.gdb-pur.com/economy/statistical-appendix.html
[xv] Source: Tax Foundation.
[xvi] Source: "Saving Puerto Rico from Itself," *The Wall Street Journal*, December 25, 2015. http://www.wsj.com/articles/saving-puerto-rico-from-itself-1451066343
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[xix] Source: Municipal Securities Rulemaking Board, Puerto Rico Clearinghouse, Citi.
[xx] Source*: Ibid.*
[xxi] Source: Mike Flynn, "Congress Prepares Puerto Rico Bailout as Island Governor Suspends Debt Payments," *Breitbar*t, April 12, 2016. http://www.breitbart.com/big-government/2016/04/12/congress-prepares-puerto-rico-bailout-island-governor-suspends-debt-payments/
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