

A D D E N D U M
to
PUERTO RICO'S FISCAL PROBLEMS:
EXAMINING THE SOURCE AND
EXPLORING THE SOLUTION

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Submitted by Senator Grassley:

| | |
|---|----|
| Pantojas-Garcia, Emilio, statement | 2 |
| Puerto Rico-USA Foundation, statement | 12 |
| Ramos, Hon. Luis Vega | 17 |
| Rossello, Ricardo, statement | 21 |
| Velez, Gustavo | 28 |

Puerto Rico: A Crisis of Governance Emilio Pantojas-García*

On June 29, 2015, after much fiscal maneuvering and requests for assistance to the U.S. Congress and the Federal Government, Governor Alejandro García Padilla announced what everyone knew: that the government of Puerto Rico's debt was unpayable. The key measures for fiscal stabilization taken by the García Padilla Administration were: (1) An austerity program, established by Law 66 of 2014, "The Special Law for Fiscal and Operational Sustainability of the Government of the Commonwealth of Puerto Rico". (2) New taxes were levied or special (regressive) taxes were increased, including the sales and value tax from 7% to 11.5% and taxes on oil and its by products (gasoline, lubricants, and other fuels) increased by 68%. (3) The government borrowed \$2.5 billion dollars in 2014 to ensure cash flow until 2015. Yet, at no point did the government announce or articulate a strategic plan for economic reactivation or repositioning the Puerto Rican economy in global value chains.

What Happened to the Puerto Rican Economy?

Until 1996, the "Commonwealth" of Puerto Rico enjoyed a number of fiscal, trade and economic preferences that gave the Island distinct competitive advantages in the international economy. As a possession of the United States (an unincorporated territory), businesses and citizens operating and residing on the Island are exempt from paying federal taxes. Federal tax exemption, complemented by local "tax holidays" and unrestricted access to the Mainland market fostered export-led industrialization between 1948 and 1996. These advantages were significantly increased in 1976 with the passage of Section 936 of the U.S. Internal Revenue Code, that allowed U.S. transnational corporations to operate as "possession corporations" (also known as "936 corporations"). "Section 936" allowed these companies to repatriate all profits reported from operations in Puerto Rico free of federal taxes, after remaining a minimum of five years in earmarked bank deposits on the Island and paying a 2% tollgate tax to the Commonwealth's government.

This tax status stimulated the proliferation of pharmaceutical industries in Puerto Rico. The Island was used as a unique "tax haven" where international profits were transferred to avoid paying federal taxes on global profits. American pharmaceutical companies, such as G.D. Searle, Merk Sharp and Dohme and others would "sell" to

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their Puerto Rican subsidiaries the patents and components of miracle drugs, manufacture the final product on the Island, and sell its top products in the U.S. market to final users, thus “transferring” global profits to the Island for later repatriation free of federal taxes. In 1996, the year in which Section 936 was repealed by the U.S. Congress, the profits of U.S. direct investment in Puerto Rico were the highest in the world amounting \$15.4 billion dollars. The second and third ranking economies in generating profits to U.S. direct investment abroad were the United Kingdom, \$13.8 billion dollars, and Canada, \$8.6 billion dollars. Yet, measured by GDP, the UK economy was 26 times bigger than that of Puerto Rico, and Canada’s was 13 times bigger.¹ Thus, Puerto Rico became by far the most highly industrialized non-independent territory in the Caribbean, and perhaps, with the exception of oil-producing Trinidad and Tobago, the most industrialized in the insular Caribbean. The Island also enjoyed a high living standard and, as U.S. citizens, Puerto Ricans enjoy free access to the U.S. labor market, where the Island’s poor and unemployed can move freely to search for jobs and secure higher public welfare benefits.

The repeal of “Section 936” in 1996 came after the creation of the World Trade Organization in 1995. Trade liberalization through free trade agreements, and the implementation of WTO rules and regulations, eroded Puerto Rico’s “free trade” advantage. Before the creation of the WTO, for example, American Pharmaceutical companies produced on the Island most miracle drugs for sale in the U.S. market, as phytosanitary rules required that all medicines consumed in the United States be produced in its territory under supervision of the Food and Drug Administration (FDA). Hence, the privileges of section 936, combined with the restricted market, gave the Island a unique competitive advantage for the pharmaceutical industries. After the creation of the WTO, as all corporations had to be afforded “national treatment” production of drugs and other products could take place outside of the U.S. phytosanitary territory as long as the FDA certified the manufacturing plant for production and export to the United States. After China’s accession to the WTO in 2001, most pharmaceutical companies relocated operations to that country and other parts of Asia, where production costs were lower and the tax advantages were equal to Puerto Rico’s now covered only by Section 901 of the IRC.

Trade liberalization and the repeal of section 936 had the effect of displacing Puerto Rico from its position in global value chains. Between 2000 and 2005 employment in manufacturing went from 153 to 117 thousands, a loss of 36 thousands

¹ In foreign countries, American TNCs operated under section 901 of the IRC that regulates Controlled Foreign Corporations or CFCs. Under this profits were exempt from federal taxes until repatriation. Hence, these companies deposited their profits in offshore financial centres (tax havens) or used transfer pricing mechanisms to “pass” profits through Puerto Rican subsidiaries, which explains the high profits “repatriated” from the Island. Cf. E. Pantojas-García. Federal Funds and the Puerto Rican Economy: Myths and Realities. *Centro Journal*, (Fall 2007), 19, 2: 206-223. <https://www.academia.edu/2306430/Federal_funds_and_the_Puerto_Rican_economy_MYTHS_AND_REALITIES>

jobs. By 2014, the manufacturing sector had lost over 50% of its jobs from 2000, amounting only 75 thousands. Real gross investment decreased by an average of 2.3% annually, between 2000 and 2014. The Puerto Rico recession began in 2006, when the GNP grew only 0.5 percent. Between 2006 and 2014, GNP decreased at a rate of 1.5 percent per year; 2012 was the only year when the economy grew again by 0.5 percent.² During the crisis, Puerto Rico has experienced a chronic \$2.5 billion per year budget deficits (3.5 percent of GNP) and now confronts a \$33 billion unfunded pension liability problem.

While in 1990 the firm Political Risk Services ranked Puerto Rico the number one competitive jurisdiction in the world, by 1997 it ranked the Island number 22. The government opted out of the rankings but in 2008 the World Economic Forum Competitive Survey ranked Puerto Rico number 36 in the World. It was the highest ranked jurisdiction in the Caribbean and Latin America, but a far cry from what it had been.

The end of metropolitan preferences and protectionism meant the collapse of what had been called the Puerto Rican model of industrialization. Accustomed to preferences and “corporate welfare”, the ruling political elite, could not adjust to the new international politico-economic environment. Once the showcase of democracy, and the cradle of export-led industrialization, now the Island found itself as a marginal platform in the global economy. Proposals to reposition the Puerto Rico’s economy as an international service center and a transshipment complex for goods from Europe and the Americas, were not seriously considered. Miami became the American capital of the Caribbean and Panama the service center for the Americas.

The Path to the Brink of Default

In order to cover the structural deficit and sustain economic expansion, the government borrowed money to finance public works, issue substantial service contracts and pay for operational expenses. Puerto Rican government bonds were highly popular among U.S. pension funds and other corporate investors given the fact that they are exempt from federal, local and capital gains taxes. Taking advantage of this “triple tax exemption” the Puerto Rican political elite developed three schemes to artificially stimulate economic expansion and sustain party patronage, not just for the average voter but for the large party contributors.

All governments, starting with the Rosselló Administration (1993-2000) of the New Progressive Party (which favors annexation as the 51st state of the Union) developed mega public works projects financed with debt. Public corporations, such as the Puerto Rico Electric Power Authority (PREPA) and the Puerto Rico Sewers and Water Authority, issued bonds to finance major expansion projects. The “Super

² All calculations are based on official figures published in the statistical appendix of the Puerto Rico Planning Board, *Report to the Governor*. <http://www.jp.gobierno.pr/Portal_JP/Default.aspx?tabid=184> (12/XI/2015).

Aqueduct” and two natural gas pipelines to deliver fuel from the port where it would be delivered to various power plants are examples of major projects undertaken with bond issues guaranteed with future income from the fees of these utilities. Other projects included the “Urban Train” (a subway), a multi purpose Coliseum and various municipal projects. Of these, the “Super Aqueduct” was the only functional project, the urban train operates with a large deficit and the two pipelines were never completed although the materials were bought and contracts to develop it were issued, as a rule to party donors and affiliates. Thirty-three members of the Rosselló Administration were indicted and convicted of corruption by the U.S. Federal Prosecutor in Puerto Rico. A “pay for play” scheme was established requiring contractors had to kick back 10% of the contracts to the ruling party, a practice that became known as “tithing”.

In 2006, a “sales and use” tax was imposed to in order to allow refinancing of part of the existing central government debt and guarantee the payment of the new debt. But instead of reducing expenditures and debt, the new taxes were used, for example to purchase privately owned lands for conservation. In three known cases these purchases were paid the triple over the assessed value of the properties. The sellers were developers linked to the governing Acevedo Vilá Administration (2005-06) of the Popular Democratic Party, which favors Commonwealth, the current status of the Island.

The third spending scheme is the more traditional issuance of service and consulting contracts by government agencies and municipalities. During the Fortuño Administration (2009-12), in spite of drastic cuts, that included the layoff of 17,000 public employees, 25% of the budget was spent in service and consulting contracts. A total of \$12 billion dollars were spent in service contracts during that administration, including \$2.9 billion in “technical services”, \$2.6 billion in “trainings and orientations”, and \$1 billion in public relations.³

But in order to get to the brink of default, the Puerto Rican political elite was assisted by major banks and financial brokers. According to an article on “Bloomberg”, “Banks including UBS, Citigroup and Goldman Sachs reaped more than \$900 million in fees to manage Puerto Rico’s \$126.6 billion of bond sales since 2000.” A Washington Post editorial adds: “The island’s government frittered away funds on unproductive investments and bloated payrolls; Wall Street bankers enabled more borrowing, collecting \$880 million in fees since 2000; the U.S. government’s policy of tax-free status for Puerto Rico bonds, meant to boost its economic development, subsidized the island’s habit of living beyond its means.”⁴

Puerto Rico Competitiveness and “Good Governance”

³ Tsunami de Contratos en Administración de Luis Fortuño, *Metro* May 13, 2013. <<http://www.metro.pr/locales/tsunami-de-contratos-privados-en-administracion-de-luis-fortuno/pGXmeg!hX9jixYJTT1E/>> (11/XI/2015).

⁴ Puerto Rico’s Sinking Economy Needs Help, *Washington Post*, editorial, November 6, 2013. <https://www.washingtonpost.com/opinions/puerto-ricos-sinking-economy-needs-help/2013/11/06/35b93dac-4327-11e3-8b74-d89d714ca4dd_story.html> (31/VIII/2015). See also, Michelle Kaske and Martin Z. Braun. Puerto Rico’s Slide, *Bloomberg Quick Take*, October 29, 2015. <<http://www.bloombergview.com/quicktake/puerto-ricos-slide>> (31/VIII/2015).

The following tables based on *The Global Competitiveness Report 2014-15*, show Puerto Rico's overall competitive ranking (Table 1) and the Island's ranking on governance issues (Table 2).

At 32, Puerto Rico was the highest ranked jurisdiction in the Caribbean and Latin America in 2014-15. In fact, it had moved up four positions since 2011-12, when it ranked 36. Chile ranked 33, Panama 48, and Costa Rica 51. One possible explanation for this is that as businesses in Puerto Rico are part of U.S. transnational value chains, hence efficiency enhancers and innovation and sophistication measures are skewed favoring the Island's performance (Table 1). However, this comparison was before the governor of Puerto Rico's announcement that the debt could not be paid, which is a "game changer". In fact, the World Economic Forum will not rank Puerto Rico after 2015 because the IMF does not collect macroeconomic data on the Island and some argue that the data provided by the government is not reliable.⁵ In spite of the improvement in its competitive ranking, gross investment contracted in the past two years (2013-14) by 8.2% and 6.6% respectively. This would indicate that investors are losing confidence.

Upon closer examination, table 2 shows that Puerto Rico has a critical problem of governance. Wastefulness, transparency, tax burden, favoritism, and distrust of politicians are key problems. It can be argued that bad governance is clearly at the root of the debt problem. Puerto Rico is ruled by a kakistocracy, where cronyism, nepotism and pay for play practices are common practice, as reflected in the table.

⁵ There has been debate about this and some sources cited reliability issues with the data. However, the official reason is that the WEF is now relying solely on data from the IMF, which does not collect economic data on Puerto Rico. Puerto Rico queda fuera del informe del Foro Económico Mundial. Sin Comillas, September 29, 2015. <<http://sincomillas.com/puerto-rico-se-queda-fuera-del-informe-del-foro-economico-mundial/>>

Table 1
Global Competitiveness: Puerto Rico

| | |
|-------------------------------------|-----|
| Global Ranking (2014-15) | 32 |
| | |
| Basic requirements (20%) | 68 |
| Institutions | 34 |
| Infrastructure | 58 |
| Macroeconomic environment | 99 |
| Health and primary education | 103 |
| | |
| Efficiency enhancers (50%) | 28 |
| Higher education and training | 27 |
| Goods market efficiency | 20 |
| Labor market efficiency | 46 |
| Financial Market Development | 21 |
| Technological readiness | 37 |
| Market size | 60 |
| | |
| Innovation and sophistication (30%) | 27 |
| Business sophistication | 18 |
| Innovation | 29 |

SOURCE: KLAUS SCHWAB, WORLD ECONOMIC FORUM, *THE GLOBAL COMPETITIVE REPORT 2014-2015*, PP. 194-95, 314-15

Table 2
Puerto Rico: Governance & Institutions

| 2014-15 | |
|--|-----|
| Diversion of public funds | 44 |
| Irregular payments and bribes | 44 |
| Public trust in politicians | 57 |
| Transparency of government policymaking | 66 |
| Country capacity to attract talent | 81 |
| Favoritism in decision of government officials | 83 |
| General government debt % PIB | 104 |
| Country capacity to retain talent | 106 |
| Government budget balance %PIB | 109 |
| Wastefulness of government spending | 112 |
| Total tax rate, % of profits | 116 |
| Business cost of crime and violence | 122 |
| Burden of government regulation | 138 |
| Country credit rating | n/a |

SOURCE: KLAUS SCHWAB, WORLD ECONOMIC FORUM, *THE GLOBAL COMPETITIVE REPORT 2014-2015*, PP. 194-95, 314-15.

What Lies Ahead

Any attempt to solve the Puerto Rican fiscal crisis will need the intervention of the U.S. Congress, the Department of the Treasury and the Federal Reserve Bank. The government of Puerto Rico has not defaulted on its debt yet, but it has established that it cannot make the payments due without major disruption of essential public services, thus it has withheld some payments.

The Puerto Rican debt is not a single large obligation. It is fragmented and held by public corporations, the central government and agencies of the insular government. There are different contracts and risk levels. For example, the Constitution of the Commonwealth of Puerto Rico establishes a borrowing limit for the central government of 15% of the average revenues of the previous two fiscal years. These are known as government obligations (GOs) and must be paid before any other disbursement is made. But a substantial part of the debt is held by public corporations and state government agencies. This part of the debt is not constitutionally protected and this is the part of the debt to which payments have been withheld.

The governor's announcement that the debt could not be paid, was preceded by intense consultations with experts on municipal bankruptcy processes and legal counsel. As part of these consultations a group of economists led by Ann Krueger, former managing director of the IMF and main proponent of the 2010 Greek economic adjustment plan, prepared the report entitled "Puerto Rico – A Way Forward." The key recommendations of the report were typical of structural adjustment packages, lower labor costs through reductions in minimum wages and benefits, lower energy and transportation costs, government reform and fiscal restraint.⁶

Following his June 29 announcement the governor created the Working Group for the Fiscal and Economic Recovery of Puerto Rico. Two months later, the Working Group submitted its report entitled, Puerto Rico Fiscal and Economic Growth Plan. The report projects a cumulative fiscal deficit of \$27.8 billion dollars between 2016 and 2020 and the exhaustion of government liquidity by the end of 2015. To bridge this financial gap it recommended: (1) gradual budget cuts amounting to \$11.9 billion over the next five years; (2) a labor reform reducing marginal benefits and thus the real wages of workers; (3) that the Federal Government and Congress help in providing a framework for debt restructuring and restoring the competitiveness of the Island; (4) that bond holders accept a reduction in the value of their bonds using a "voluntary exchange" mechanism redefining the value and terms of the debt. The Report argues further that in spite of all this measures there will be a projected deficit of \$14 billion and that economic growth, if it happens, could reduce the cumulative financial gap by a further \$1.9 billion.⁷

⁶ Anne O. Krueger, Ranjit Teja, and Andrew Wolfer, *Puerto Rico- A Way Forward*, <http://www.bgfpr.com/documents/puertoricowayforward.pdf>. The government of Puerto Rico even hired Steven Rhodes, the bankruptcy judge that oversaw Detroit's restructuring as a consultant.

⁷ *Puerto Rico Fiscal and Economic Growth Plan*, September 9, 2015. Prepared by the Working Group for the Fiscal and Economic Recovery of Puerto Rico Pursuant to Executive Order 2015-022, <<http://www.bgfpr.com/documents/PuertoRicoFiscalandEconomicGrowthPlan9.9.15.pdf>> (12/IX/2015).

To implement government and labor reform and to ensure that the difficult decisions needed are taken, the governor submitted to the Puerto Rican legislature the Fiscal Responsibility and Revitalization Act. If it becomes law, the act will undertake a series of reforms to be monitored by a Puerto Rican financial control board appointed by the governor. The board would have extraordinary powers to implement the law, as the governor relinquishes some of its executive powers to be bestowed on “the Board”. The proposal has created unanimous opposition from political parties and labor unions which see it as a way to extend the current administration policies beyond its term in office.

But another way to interpret the governor’s Working Group’s proposals and the Fiscal Responsibility and Revitalization Act is as mechanisms of lobbying and negotiation with Congressmen, Federal Officials, and bond holders in Washington. The government of Puerto Rico is maneuvering to elicit support in Congress for the enactment of the Puerto Rico Chapter 9 Uniformity Act (HR 5305 in 2014 and HR 870 in 2015) allowing the Island to restructure its debts using the federal bankruptcy laws, which do not currently apply to Puerto Rico. The possibility of Congress appointing a Financial Control Board following the experience of Washington D.C. in 1995 has also been floated in Washington.

Bond holders are divided at the moment. Hedge funds are willing to negotiate, and in the case of the Energy Authority (PREPA) have agreed to discount the debt by 15% and “soften” debt service requirements over the next five years. This agreement is now under the consideration of the Puerto Rican legislature, as it requires changes in the law. The original lenders such as Oppenheimer Funds (\$20 billion), Goldman Sachs (\$3.4 billion), and Franklin (\$3.3 billion) are opposed to any reductions.

The White House, the Department of Treasury and Congress are on record stating that they will not set any precedents with a Puerto Rican bailout plan. Yet, as a government default appears to become a reality the President and the Secretary of the Treasury presented a plan to help Puerto Rico restructure its finances. The President’s plan supports the approval of a “super,” version of Chapter 9 bankruptcy for Puerto Rico that would cover all of the island’s debts, not just the debts of its public corporations, and would allow the island’s residents to receive the earned-income tax credit and would substantially boost Medicaid spending in Puerto Rico. The proposal has been rejected by the Republican-dominated Congress but lobbying and maneuvering continue.⁸

A long-term solution to the Puerto Rican crisis must deal with the issues that brought the Island to this point: the collapse of a colonial protectionist politico-economic system in a post-colonial world. Rafael Cox Alomar (former candidate to Resident Commissioner in Washington and now professor at the David A. Clarke School of Law at the University of the District of Columbia), recently proposed a path to a long-term solution to the crisis. He favors establishing a fiscal control board and solving the political status question:

Federal legislation establishing a fiscal control board for Puerto Rico must also contain explicit provisions detailing a fixed timetable for Puerto Rico’s

⁸ Cf. Ike Brannon, A politically viable Puerto Rico reform plan. *The Hill*, November 09, 2015. <<http://thehill.com/blogs/pundits-blog/finance/259510-a-politically-viable-puerto-rico-reform-plan>>

decolonization. As soon as Puerto Rico hits the applicable fiscal and economic growth benchmarks, the people of Puerto Rico should face a stark choice between sovereignty and annexation. The status quo must be discarded from the outset because it is both the source of the structural crisis besieging the island and a colonial anachronism at odds with the US's geopolitical interests in the Americas. The sovereignty formula presents, in of itself, a dual choice between separate sovereignty and associated sovereignty. The annexation alternative, for its part, would amount to Puerto Rico becoming a "part" of the United States as an "incorporated" territory --- bearing in mind that it befalls on Congress to spell out the conditions the island would then have to meet in order to enter the Union as a state on an equal footing with the 50 states.⁹

There are ways out of the crisis. Federal assistance and debt restructuring are not the solution, they are a point of departure for a long-term solution. Government reform should include a redefinition of the status of Puerto Rico and a cleansing from the corrupt kakistocracy that has ruled the Island over the past two and a half decades.

⁹ Rafael Cox Alomar, In search of a Puerto Rico strategy. *The Hill*, November 5, 2015. <<http://thehill.com/blogs/congress-blog/economy-budget/259165-in-search-of-a-puerto-rico-strategy>>

WRITTEN TESTIMONY SUBMITTED TO THE UNITED STATES SENATE
COMMITTEE ON THE JUDICIARY
DECEMBER 1ST, 2015
PUBLIC HEARING ON PUERTO RICO'S FISCAL PROBLEMS: EXAMINING THE
SOURCE AND EXPLORING THE SOLUTIONS

John A. Regis, Jr, President
Puerto Rico-USA Foundation
December 1, 2015

Our most sincere appreciation to Chairman Sen. Chuck Grassley, Ranking Member Senator Patrick Leahy, and all the Members of the United States Senate Committee on the Judiciary for the opportunity to express our comments on Puerto Rico's present financial and economic situation and some comments on its future.

Puerto Rico recovery from its catastrophic financial and economic situation must be viewed as both short term as well as long term periods and solutions.

How did Puerto Rico get into this catastrophic financial and economic situation?

There are many reasons why Puerto Rico reached the poor financial condition the island is experiencing. There are numerous testimonies and I am sure the Committee has considerable data to quantify the existing situation. The important issue now is where do we go from here? What items must be put in place so that we can correct the present economic catastrophe as quickly as possible, and what must be put in place so that the present economic situation does not reappear.

There are however two factors not frequently considered and probably contested by some past administrations that severely affect Puerto Rico's ability for economic growth and sound financial decisions. We want to concentrate our participation to these two factors which we consider of great importance. The first item is that the present economic model is obsolete and it has proven it does not any longer work; and the second item is the highly political atmosphere that creates incompetence, dishonesty and highly unsound financial decisions.

AN OBSOLETE ECONOMIC MODEL- On the one hand Puerto Rico is operating under an obsolete economic model that does not any longer work. Puerto Rico high debt and poor financial conditions is partly, if not largely based on the island's poor economic development. Puerto Rico's economy once thrived based on economic incentives once offered to manufacturing plants doing business in the island. The world economy has significantly changed due mainly to globalization, liberalized trade treaties in past years, increased communications and transportation, the automatization of manufacturing plants reducing the job creating effect and the expiration of patents, all reducing significantly the competitive advantage that Puerto Rico once enjoyed within the United States common market.

Through the years the United States Government tried to help the Puerto Rico's economy with tax incentives that benefited more the manufacturing companies than the Puerto Rico's wage earner or the island's economy. Between 1970 and 2000, when 936 was in effect and 936 corporations saved nearly 4.5 Billion dollars a year in tax payments. During this period the Puerto Rican economy expanded by 2.7% annually, while the U.S. economy grew by 3.3% annually. That is, over this 30 year

period, the U.S. economy grew 17% more than the Puerto Rican economy. In the 936 era, then, Puerto Rico was falling further and further behind the states.

An even more dramatic comparison: In 1970, per capita gross national product (GNP) in South Korea was 65% *less* than in Puerto Rico. By 2000, per capita GNP in South Korea was 9% *larger* than in Puerto Rico. (By 2010, with the Puerto Rican economy in deep recession, Korean per capita GNP was 62% above that in Puerto Rico.)

From the era when Rexford Tugwell governed Puerto Rico in the early 1940s, Puerto Rico has sought provisions in the U.S. tax code that provide special incentives for U.S.-based firms to operate on the island. These provisions, according to Tugwell and later Puerto Rican governments, would create a basis for Puerto Rico to catch up economically with the states. Special tax incentives have thus long been a central element in governments' economic development programs, and they are touted as promoting economic growth and increased employment.ⁱ

In the 1950s and 1960s, the era of Operation Bootstrap, federal (as well as local) tax incentives may have played a role in the rapid growth of the Puerto Rican economy. While 936 did not exist in those years, similar provisions were put in place, implementing Governor Tugwell's concept that Puerto Rico needed special tax treatment to attract investment to the island. In this early period, however, the major factors pushing the expansion of output and employment were low-wage labor and privileged access to the U.S. market. As wages rose and privileged access largely disappeared (as many lower-wage parts of the world obtained virtually equal access), the tax incentives remained but economic growth faltered. Since 1980, economic growth in Puerto Rico has lagged substantially behind that in the states.

Puerto Rico's economic model as a Commonwealth (a territory) based on tax incentives, freebees and give a ways helped to a degree in years past, but it does not work any longer. Economic development has been strapped helping in a big way to the present economic situation causing over seventy thousand (70,000) residents moving to the mainland last year alone in search of jobs and better opportunities. At the same time the tax base is further reduced. Our labor participation rate is 41.2ⁱⁱ while that in the mainland is 62.4ⁱⁱⁱ. A new economic model is urgently needed.

Perhaps one of the best examples of why manufacturing incentives like 936 do not work in Puerto Rico is the existence of the present Controlled Foreign Corporations (IRS-957). Many of the former 936 corporations converted to CFC's enjoying many of the benefits under the former 936 program, but still economic growth is stagnant.

It is our opinion that the economic model is directly related to the islands political status. It is time to face reality and commence a process to culminate the present Commonwealth into full participation as a State of the Union. Divergent theory studies project the island could be revenue neutral to the US Treasury within 10 to 15 years.

On a long term basis the evolution into a different economic model, that possible as a State of the Union is the long term solution to achieve sufficient economic development and growth.

A HIGHLY POLITIZED ENVIRONMENT HAS HANDICAPPED FINANCIAL AND ECONOMIC DECISIONS. On the second hand, this little spoken about non-quantitative factor

has severely affected our ability to make sound economic decisions. This highly polarized environment is greatly magnified by the highly divisive status question, a controversy that could go as far as one's own citizenship. This controversy has our two main political parties and administrations in an eternal conflict and tug of war. When one political party is in power they act more like a state, while when the other party is in power they try to act or behave more like an independent sovereign nation and legislate more conforming to the territory's fiscal autonomy. This is a highly polarized environment with the purpose to firm up or solidify each party's political status positions.

Frequent past changes of administrations went as far as eliminating the English language as an official language, while English was restored as an official language within days of another administration coming into power.

One party promotes the restoring of the former 936 tax incentive program (erroneously believing it is a hedge against statehood), while the other party tried to promote the use of 30-A and other domestic incentive programs.

Throughout the years different administrations have developed 10 and 20 year economic development plans, while the next administration will discard it completely and develop new plans.

This highly polarized and combative environment produces uncertainty, poor stability, poor investment confidence and a very poor base for economic development.

For this reason local political issues must be separated from the financial and economic decision making process. For this reason an oversight board must be one under the control and direction of Congress not subject to the whims and desires of the local political parties. While we recommend the inclusion of several local economists, financial experts or business persons to this oversight board, these must be non-political persons which will allow the decision making process based on sound economic and financial principles not marred by local politics.

On a short term basis we recommend the creation of an oversight board named and under the control and direction of the federal government to supervise and control the fiscal aspects of the Puerto Rico Government, work on manageable future operational budgets, put in place cost reduction strategies, and work on a solution of the unsustainable high government debt of the central government as well as all its agencies.

SUPPORT OF THE RECOMMENDATIONS OF THE WHITE HOUSE AND TREASURY DEPARTMENT. On a short term basis we also support the recommendations made by the White House and the Treasury Department, mainly the equal treatment or parity of the Medicare, Medicaid and other health programs, the implementation of the Earned Income Tax Credit, and the Child Credit Program as tools to combat poverty and improve economic development, and the

approval for Puerto Rico of Chapter 9 of the U.S. Bankruptcy Code so that Puerto Rico has the ability to renegotiate part the existing debt and work out of the present and unsolvable terrible financial situation.

In summary, it is our unequivocal opinion that Puerto Rico must become a state of the Union for the economy to sustain itself and grow. Neither local nor other investment will come to Puerto Rico with the drawbacks and uncertainty of its current “colonial” status. In the meantime the playing field must be leveled. The choice is clear: statehood or a worsening more of the same...

We sincerely appreciate the opportunity to express our opinion in the subject of Puerto Rico’s present financial position and some of the strategies necessary to bring Puerto Rico back to a sound economic and financial condition. We are at your service and available if you have any questions.

The exception was the government of Pedro Rosselló, who held the governorship from 1993 to 2001. Rosselló was in favor of statehood for Puerto Rico and opposed 936 because it treated Puerto Rico differently, and outside of, the states, while the preferred IRS code 30-A was believed to be more beneficial.

ii Puerto Rico Labor Department

iii Bureau of Labor Statistics



Hon. Luis Vega Ramos
REPRESENTANTE POR ACUMULACIÓN

November 30, 2015

Hon. Chuck Grassley
Chairman
Committee on the Judiciary
U.S. Senate
Washington, D.C 20510

Esteemed Mr. Chairman:

My name is Luis Vega-Ramos and I am an At-Large Member of the House of Representatives of Puerto Rico. I am also a former chairman of our Judiciary Committee. I ask that this letter be made part of the record of the Committee's hearing on Puerto Rico's fiscal situation to be held on the 1st of December, 2015.

First, let me acknowledge your Committee's interest in Puerto Rico's delicate fiscal situation. For the last two years, a growing number of persons and institutions, including a group of Puerto Rican legislators of which I am part, have been stating the obvious: our public debt as it was contracted cannot be serviced in the manner it was structured. It is simply impossible to pay as originally agreed.

Were Puerto Rico to continue trying to pay as structured, our government functions would have to be seriously reduced or stopped, there would have to be numerous layoffs in the public sector and even certain rights as pension payments could have to be postponed. Aside from the "humanitarian crisis," as described recently by the U.S. Treasury Department, that this would create, those measures would have a devastating effect on our economy. If there is no economic growth, then there is no revenue from tax collection. Absent that revenue, there will be no funds to pay our creditors and bondholders. At that critical juncture, many will demand --more aggressively-- some sort of intervention by the Federal Government.

So it would seem that bondholders, the Federal Government and Puerto Rico are all in this together. We all need to chip in so that Puerto Rico's economy jumpstarts, so that the engine starts running and the revenue needed to meet our obligations is generated.

The Government, the Legislature and the People of Puerto Rico have done more to deal with our fiscal crisis than we are given credit for. With great pain, we reformed our pension system, have raised revenues through higher taxes and more efficiency collecting them. Recently, we enacted legislation to establish an independent fiscal board that would monitor and report on the handling of our government operation and

the compliance with any deal we reach with creditors. We are also dealing with a complex process to see if PREPA's debt and operations can be restructured.

And above all, Governor Alejandro García-Padilla's administration has reduced expenditures in government operations by 1.8 billion dollars, according to our local Office of Management and Budget. This has been done without massive layoffs or significant reductions of essential services.

There is, however, one additional thing we have not done. There needs to be an independent citizen's commission to audit the validity and legality of our public debt. Last summer our Legislature enacted a law that created said commission but all its members have yet to be appointed. That should be done immediately by Puerto Rican authorities in compliance with our law.

As stated, we are spending close to 2 billion dollars less in running our government, yet our actual budget remains the same. The reason is that the only slice of our budgetary pie that continues to consistently grow is our debt service. We simply cannot keep pace with that debt structure and remain a viable society in which our young, most talented and prepared kin can stay and build a better future.

The time to take action is now. I want to express my gratitude to those on the U.S. Senate that already have expressed their support to Puerto Rico and demanded reasonable negotiations from creditors and more action from the Federal Executive Branch. We hope to continue gaining support within your ranks so that we may structure a process and a solution that is fair for all parties involved.



What can you do? There are several things in the short term that you should do, one that you should not do and one issue that must finally be addressed.

- First, you need to legislate to make Chapter 9 bankruptcy procedures available once again to Puerto Rico's public corporations. The lack of structured process is a great obstacle that needs to be taken out. As a law scholar stated it on a similar hearing in the House, we should avoid a "law of the Wild West" scenario where there is no certainty for anybody.
- Second, you should explore the possibility of fashioning a special judicial bankruptcy mechanism that may permit the restructuring of Puerto Rico's and other territorial jurisdictions' non-public corporation debt. I know this is somewhat more controversial but should not be discarded for a reason I will state further on.
- Third, you must legislate both to recognize equitable treatment in Medicaid and Medicare funding for Puerto Rico residents and to exempt our main ports from the shipping provisions of the Jones Act, as it currently happens on the U.S.

Virgin Islands. Under the current relationship, Congress can pick and choose which laws and programs should apply uniformly to Puerto Rico and which ones should not. We request that while you still have that excessively broad authority over Puerto Rico, you exercise it in a reasonable manner.

- Fourth, you must join your colleagues that have already demanded that creditors, including so called hedge funds, sit down and negotiate with Puerto Rico in good faith. As previously stated, if they help us move our economy forward, their chances of getting back a reasonable return on their investment grow. Help us show them the simple logic in that.
- Fifth, demand from the Federal Executive Branch a more active approach. Kind words, gentle counsel and a plan that solely rests in Congressional action are not enough. They know they can do a lot more. You should raise your voices, along with the colleagues on both sides of the aisle that have already done it, so that the Executive -- particularly the Treasury Department-- do more.

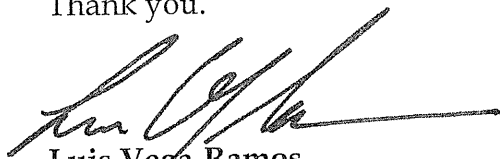
There is --however-- one thing you should not do. Some are suggesting that you legislate a Federal Fiscal Control Board with broad powers over Puerto Rico. That would be a mistake for two reasons. The first reason is that taking that step would show creditors, the world and Puerto Ricans that the Federal Government is not looking for a partnership with us so that we can solve this, but that you rather unilaterally impose a solution on us. From a democratic standpoint that would mean the clear and unvarnished restatement of the worst policies of the Federal Government towards PR..

There is another issue that you raise by enacting a Federal Control Board. Such action would clearly invite both creditors and Puerto Ricans to ask Federal Courts to expand on what the Supreme Court decided on *Limtiaco v. Camacho*, 549 U.S. 483 (2007). That case suggests that the public debt of U.S. Territories is of federal concern and could possibly be considered federal debt. By enacting a Federal Control Board, Congress practically would be inviting the Supreme Court to conclude that Puerto Rico's public debt is also part of the United States of America's public debt. Therefore, all possible outcomes should be considered before giving in to those who ask from you for a Federal Control Board.

This brings me to one last point. We need to address the urgent fiscal and economic situation. Puerto Rico's debt and public finances must be restructured and the U.S. needs to play an important role in that. However, the bottom line cannot be ignored any longer. The political status of Puerto Rico must be addressed. By the powers of the Territorial Clause of the U.S. Constitution, Puerto Rico is subject to a regime of laws, rules, practices and decisions over which we have no control and little influence. As we deal with urgent matters, let us not forget important ones. Congress must afford Puerto Rico the right to choose from status alternatives that place us outside the Territorial

Clause. Alongside hundreds of thousands in Puerto Rico, I am ready to engage you and that process on behalf of the option of a non- territorial and sovereign "Estado Libre Asociado" as a future vehicle for our relations.

Thank you.

A handwritten signature in black ink, appearing to read 'Luis Vega-Ramos', with a long horizontal stroke extending to the right.

Luis Vega-Ramos
At-Large Member
Puerto Rico House of Representatives

**Senate Judiciary Committee
Full Committee**

**Hearing on “Puerto Rico’s Fiscal Problems: Examining the Source and Exploring the
Solution”**

December 1, 2015

Prepared for the Record

“Diagnosis and Treatment of Puerto Rico’s Fiscal Crisis”

by

Ricardo Rosselló

Candidate for Governor of Puerto Rico

and

Professor at the Metropolitan University of Puerto Rico

Diagnosis and Treatment of Puerto Rico's Fiscal Crisis

Puerto Rico's fiscal crisis is primarily a liquidity crisis, brought about by rising debt levels, low nominal GDP growth, and a loss of investor confidence in the government's policies and actions. The correct response was and is to:

1. Restore investor confidence to regain market access;
2. Address budget imbalance between revenues and expenses;
3. Limit future debt growth and reduce debt, if possible; and
4. Implement a coherent economic development strategy.

The current Administration is doing the opposite of this. In addition to destroying investor confidence, its debt renegotiation is focused on *deferring* debt payments, which will *increase* the future debt burden. Commonwealth debt service is about 13% of total government expenditures, and PREPA's debt service is less than 15% of its cost structure. It is not possible to achieve fiscal balance for either entity solely through the renegotiation of debt.

The Administration's focus on debt restructuring is a distraction from the urgent need to reduce government expenditures, which exceeded revenues by \$6 billion in FY2013 (the last year of audited financials of the consolidated budget). Commonwealth debt service of about \$3 billion is slightly more than 13% of total expenditures and eliminating the debt entirely would only reduce the deficit by around 50%.

Looking Beyond the Current Fiscal Year

It is time for Puerto Rico's leaders to stop improvising and managing finances on a year-to-year basis and to start addressing the long-term imbalance between spending and revenues. Eliminating all of the debt service on all of the Commonwealth's bonds would still leave a significant budget deficit, and the challenge of unfunded pension liabilities will swamp any other debt service obligations. We need to look ahead and anticipate these challenges instead of simply careening from one crisis to the next.

The resolutions of municipal fiscal crises in the US and emerging market sovereign debt crises have followed very different paths. The Garcia Padilla Administration's decision to retain experts in sovereign restructurings with little experience in US municipal finance seems to be going down a path that is more appropriate for Argentina, Ecuador or Venezuela than for an issuer which has historically borrowed at very low interest rates.

The "Road Map" that the Garcia Padilla Administration claims it needs to address the fiscal crisis already exists. The Administration is seeking to change this Road Map to find an easier, more politically expedient way out of the chaos it has created through its last three years of improvisations and incoherent policies. Every attempt by this administration to avoid responsible fiscal management drives Puerto Rico further from away from fiscal stability and sustainability.

The Administration's policies that have led to its current lack of credibility and access to liquidity have included:

- passing local bankruptcy legislation (the "Recovery Act") and then litigating unsuccessfully over the constitutionality of this Act;
- lobbying Congress to retroactively apply Chapter 9 to Commonwealth subdivisions and more recently to the Commonwealth itself;
- undergoing a protracted restructuring of PREPA's debt service (representing only 15% of PREPA's total rates and charges);
- defaulting on the Public Finance Corporation bonds;
- threatening to default indiscriminately on all Commonwealth obligations without regard to the priorities established by the Commonwealth's Constitution, statutes and contracts;
- delaying the publication of audited financial statements and attempting to replace them with made-to-order cash-flow projections and analysis.

In addition, the Administration's restructuring efforts are focused primarily on deferring debt service, which is extremely dangerous as it increases the future debt service burden. It is time to start reducing Puerto Rico's debt, not increasing the burden on future administrations and generations.

Restoring Credibility and Market Access

As an important step toward restoring investor confidence in Puerto Rico, the Administration should start by following the rule of law, including the US Constitution, the Commonwealth's Constitution, Federal statutes, Commonwealth statutes and contracts between the Commonwealth and its lenders.

It will be critically important for a new administration to establish credibility with this small universe of institutional municipal bond buyers and eventually the broader universe of retail investors. These steps will also restore credibility with Federal policymakers, Puerto Rico's government employees, and residents of Commonwealth. Following are some general guidelines that will be followed:

- *Complete truthfulness.* Investors hate surprises, so getting all of the facts out as quickly as possible is vital to success. The new Administration will be as open as possible, avoid "spin", expose difficult facts as quickly as possible – even mistakes the new administration makes – and every member of government will be focused on transparency and informational integrity.

- *Accurate, independent and timely financial reports, budgetary forecasts, and economic statistics.* The Commonwealth’s accounting, statistical and revenue forecasting infrastructure is completely inadequate, and the new administration will take immediate steps to improve it. The market is highly attuned and suspect of any attempt to delay or manipulate information for political or negotiating purposes and there is a need for independent oversight as well as technical support by the Federal government in this area.
- *Active Communication.* In a crisis, people fill any informational void with worst-case scenarios. It is critical to actively and repeatedly engage with the press, residents, the local Legislature, government employees, Washington, investors, and rating agencies. The goal is to provide every constituency with the same understanding of the reality of the circumstances rather than to “fine tune” the message for each audience.
- *Sense of Urgency.* The new administration will need to make bold decisions and few if any will be perfect, but delaying decisions will be much worse than making imperfect ones. The government must prioritize the important actions that can make meaningful differences and avoid getting distracted by actions that do not have a large impact. It must also not let bureaucracy, study committees, and reliance on consultants impede progress.
- *Measuring Progress.* Restoring confidence requires keeping and communicating a scorecard report every month. At this point, there are no investors left who will believe any promises a representative of the Commonwealth makes. A new administration must prove itself with steady, concrete, verifiable progress.
- *Debt Management.* Debt should not be allowed to monopolize the Administration’s agenda. Debt is a symptom, not a cause of the problem. The accumulation of debt threatens to magnify the problem, but the persistent structural imbalance between revenues and expenses is the central issue. If fiscal balance is achieved, the debt issue will take care of itself.
- *Relentless focus on government expenses and revenue and on improving the business environment.* Government cannot improve economic conditions by direct intervention, especially if it cannot print its own currency. Puerto Rico’s leaders need to focus on balancing expenses and revenues, reducing the level of government intervention in the Commonwealth’s economy, and providing a competitive business environment for external and local investors and entrepreneurs to lead the path towards economic recovery.

Paying the Commonwealth’s Most Senior Obligations

The incoherence of the Garcia Padilla’s Fiscal Adjustment Plan has increased investor confusion and alarm in part because it does not follow any established priority for

Commonwealth obligations. If investors cannot rely on the legal framework established when they invested in Commonwealth debt, literally nothing is safe.

Puerto Rico's Constitution provides the strongest possible protection for:

- \$12.7 billion in outstanding General Obligation Bonds (GOs) and
- \$5.6 billion of Public Building Authority Bonds and other bonds that carry a Commonwealth guarantee (Commonwealth Guaranteed Bonds or CGBs).

The Constitution provides that all Commonwealth Revenues (CRs) must be used first to pay these bonds before any other appropriation or contractual obligation, including certain bonds to which CRs have been pledged such as Highways and Transportation Authority Bonds (HTAs), Convention Center Development Authority Bonds (CCDAs) and Infrastructure Authority Bonds backed by the Rum Tax or the Petroleum Products Tax (PRIFAs). HTAs, CCDAs and PRIFAs were sold to investors with explicit provisions that the revenues pledged to these bonds included CRs which are subject to a "Claw Back" in favor of GOs and CGBs.

To ignore or seek to evade this provision of Puerto Rico's Constitution undermines the rule of law and the foundation of Puerto Rico's credit in the capital markets.

In addition, bonds issued by the Sales Tax Financing Corporation (COFINAs using its Spanish acronym), which are backed by a portion of the Sales and Use Tax (SUT) were sold to investors with the promise that these bonds are *not* subject to the Claw Back.

If Puerto Rico is to regain credibility with investors, it must first honor its obligation to pay debt service on GOs, CGBs and COFINAs above all else. This responsibility is far less onerous than the Garcia Padilla Administration and its lawyers and consultants would have us believe. Indeed, the process of debt restructuring seems designed to maximize drama so as to justify the exorbitant fees being paid to this large group of debt restructuring consultants and lawyers.

In 2016, \$1.5 billion or 15% of General Fund revenues are required to pay GO and CGB debt service. This leaves \$8.4 billion or 85% of the General Fund in addition to \$6.4 billion in Federal funds and about \$8 billion in fees and revenues that do not flow through the General Fund (nearly \$20 billion after debt service) to pay for essential services. This is before accounting for the Claw Back, which would make at least \$1 billion more in revenue available to pay \$1.5 billion in combined debt service on GOs and CGBs.

Approximately \$681 million of SUT collections are devoted to pay COFINAs in 2016. Aggregate debt service on GOs, CGBs and COFINAs totals \$2.2 billion in 2016 and rises to a maximum of \$2.7 billion in 2035. This amounts to 18% and 23% respectively of the most conservative estimate of 2016 CRs, assuming no growth in revenues.

Collaboration with the Federal Government

Notwithstanding all of the above, it is possible that the damage to Puerto Rico's credibility cannot be repaired without the intervention of an independent third party, namely the Federal government. In addition to providing much needed equality and funding opportunities on federal programs such as EITC, CTC, and Medicaid, the Federal government's intervention should not be to provide a temporary bailout or to allow the Commonwealth to continue to defer debt payments or issue more debt in order to finance operational deficits, rather it should look to ensure that the aforementioned strategies are promptly implemented and effectively communicated to bondholders, investors, policy makers, and the People of Puerto Rico.

A Federally legislated Fiscal Control Board that would effectively put Puerto Rico into receivership and make the Federal Congress responsible for the resolution of the territory's current fiscal crisis is an option, but it's not necessary or sustainable and will produce unintended political consequences.

Alternatively, the creation of a novel special permanent Joint Commission with participation of the Federal and local governments would provide a robust and lasting collaboration framework to implement the aforementioned measures, by focusing specifically on the management of the debt. Such a strategy would include the establishment of an independent financial and operating Puerto Rico Debt Management Authority (PRDMA) and Trust (PRT) that, in conjunction with the Federal Internal Revenue Service (IRS), would support the collection of government revenues and ensure that they are segregated and allocated based on the established payment priorities, including the balance of debt service guarantees and the provision of essential services.

This new Debt Management Authority and Trust would act as the Commonwealth's fiscal agent and would manage all current and future debt issuances under strict guidelines, total transparency, and independence from political considerations and interests. In addition, PRDMA would provide the much-needed credibility and market access to provide immediate interim financing, to solve short-term liquidity needs, and be able to implement restructuring objectives. The Joint Commission could also collaborate by overseeing the implementation of the expense reduction and government restructuring and modernization initiatives to ensure that Puerto Rico's government achieves fiscal sustainability within a specified timetable that will not exceed five (5) years. We have previously proposed a comprehensive government restructuring strategy for the administration to achieve such modernization, increased effectiveness, and reduction in expenses (e.g. <http://www.forbes.com/sites/realspin/2015/10/22/a-new-path-for-puerto-rico-which-doesnt-include-a-washington-bailout/>). If for whatever reason, these expense reduction measures cannot be achieved within the specified timetable, the Joint Commission may recommend to Congress that additional powers be given to the Commission, akin to those of a Fiscal Control Board. This strategy would give the People of Puerto Rico the opportunity to restructure and redesign its own government structure.

By restoring credibility, reaffirming debt-service priorities, and establishing the control mechanisms to guarantee repayments, the PRDMA may be able to issue new debt that can serve as an instrument to repurchase and redeem lower-priority obligations at discounts,

having a similar principal reduction effect of what could be achieved through bankruptcy and restructuring.

The Joint Commission will also serve as a forum for the Federal and local governments to collaborate on joint economic development initiatives, including those that involve additional Federal funding and any financial and economic aspects of a transition in the status of the territory of Puerto Rico towards statehood.

December 1, 2015

Senator Chuck Grassley
Chairman
Judiciary Committee
U.S. Senate

Mr. Chairman, Senator Chuck Grassley:

Since 2006, Puerto Rico has been struggling with its worst economic crisis in recent history. Since the repeal of Section 936 of the IRS, the Commonwealth has been unable to develop a new economic model to remain competitive on the new global economy. Moreover, all the efforts made by the government have relied in short term fiscal measures, such as increasing taxes, to maintain the level of government spending. Over the last decade U.S. Congress along with the local government have ignored the fact that the local economy faces a structural problem. The end of the U.S. federal tax incentives program eroded Puerto Rico's main competitive advantages, therefore affecting the capacity to generate growth.

During the phase out period provided by Congress after the repeal of Section 936 (1996-2005), the manufacturing industry lost 76,400 direct jobs. Manufacturing total employment decreased from 152,000 in 1997 to 75,600 in 2015. In the pharmaceutical sector, where Puerto Rico generated global competitive advantages, the situation is not much different. Total employment fell from 22,556 to 13,752 (-39%).

In addition to high paying jobs, manufacturing investment plays a crucial role in Puerto Rico's economic growth. According to the Puerto Rico Development Company (PRIDCO), from 1996 to 2008, U.S. industrial investment in the island amounted to \$4.90 billion. After the repeal of Section 936, the local economy was able to retain pharmaceutical and medical devices manufacturing facilities in which Puerto Rico is still relatively competitive. However, the labor intensive operations which represented a large component of industrial activity left to other destinations with lower operational costs.

Neither major political party nor the private sector has been able to develop a new economic development strategy. Instead, policy makers from both parties implemented short term fiscal policies such as tax increases, and issuing more public debt trying to balance the budget and fix the financial problem. These policies have in turn shaped a downward spiral of the economy creating a further recession.

As of 2006 the government collected \$15 billion as result of new taxes such as the 7 percent sales and use tax (SUT) in 2006, the excise tax on foreign corporations (2010), and more than a dozens of new taxes imposed by the current administration. From 2008 to 2012, Governor Luis Fortuño implemented an austerity fiscal program combined with a tax reform that cut personal and corporate taxes. Additionally, the island received \$7 billion in ARRA funds (American Recovery and Reinvestment Act of 2009).

The policies implemented by Fortuño's administration contributed to a brief economic stabilization process between 2011 and 2012. However, when the current administration took the helm in 2013 the new policies based on additional taxes and increase government spending derailed the stabilization process.

It is clear that any action from Congress, or the White House, has to recognize the structural dimension of Puerto Rico's economic crisis and the fact that local politicians have not been willing to implement the structural reforms required to reestablish sustainable growth. Furthermore, since 2001 the commonwealth had three consecutive one period administrations (of four years each), making it even harder to sustain long term fiscal and economic policies. The partisan war and the lack of ability to achieve bipartisan consensus in essential for policy issues and have created a real threat to Puerto Rico's viability. Moreover, I also believe that the commonwealth has a serious administrative problem due to the disagreeing views between both parties.

The financial crisis

The underlying factors behind the current crisis have been ignored by local politicians. This ten-year depression has had a terrible effect on the island's productive structure and on the tax base. The Commonwealth's administration has been reluctant to cut government spending and restructure its 131 agencies. Instead, more public debt has been issued to artificially balance the budget. Puerto Rico's public debt escalated from \$25.2 billion in 2001 to \$ 71.3 billion in 2014. The public corporations' debt increased from \$27.21 billion in 2006 to \$48.74 billion in 2014. The commonwealth has reached the borrowing margin of its main debt issuers not to finance new infrastructure or economic growth, but to sustain non-productive spending across the government.

The practice to finance fiscal deficits through irresponsible borrowing in the municipal market reached an end. In early February 2014, the three main U.S. credit agencies downgraded the island's credit to "junk status," and Puerto Rico became the first U.S. jurisdiction to fall under this rating.

Puerto Rico's public debt per capita ascends to \$20,384, while the debt per tax payer is of \$89,181, in an island losing its population each year.

After the downgrade the commonwealth lost access to the municipal market affecting its capacity to issue new debt. Instead, the government's fiscal strategy continues to be based on imposing new taxes and on implementing short term fiscal measures.

The impact of a fiscal collapse in Puerto Rico could lead to a debt default and the destabilization of the island's financial sector. Under a troublesome scenario, the main federal agencies will have to assume a higher costs and a higher level of complexity to find effective solutions. In fact, a potential default could damage the credit unions in the island, which are a key component of the financial sector that serves the financial needs of one third of the population. Debt held by credit unions represent 17% of their assets and the financial system will have to manage an unrealized loss of \$400 million.

In the past decade thousands of frustrated Puerto Ricans have left to the mainland searching for a superior quality of living, away from a political and economic dysfunctional island. The massive migration of professionals and the deterioration of the economy is creating a dangerous situation that could damage Puerto Rico's recovery. I am deeply concern about the social and economic impact of the current migration patterns, particularly due to the fact that human capital is one of the few competitive advantages of Puerto Rico.

A comprehensive federal policy towards the fiscal and economic crisis

There are sufficient reasons for Congress to take action on Puerto Rico's fiscal crisis, but any Congressional action has to be based on a broad approach to the Commonwealth's current fiscal and economic situation.

A complete federal policy should consider the following action:

1. Economic recovery program

In order to avoid another financial crisis in the near future, Puerto Rico needs a comprehensive economic program based on its own competitive advantages. Furthermore, Congress must revise federal regulations that affects the island's competitiveness and consider fiscally neutral incentives to support a recovery program.

a. Section 933-A

Congress should consider the approval of Section 933-A, a proposal in the federal tax code that would make viable for a U.S. corporation to be able to request the federal Internal Revenue Service (IRS) individual treatment into becoming a domestic company. This would allow corporations incorporated in Puerto Rico, who generate more than half

their income on the island, to operate as domestic entities at the time of repatriation of their dividends at a preferential rate, as allowed by Section 243 of the code.

It is estimated that U.S. companies have some \$1.5 billion invested outside the U.S. The proposed amendment to Section 933, aimed at attracting part of that money to pay taxes in the U.S. at preferential rates while at the same time bringing investments and jobs to Puerto Rico is a step in the right direction.

b. Procurement program

Temporarily increase the preference levels for the purchase of products and services of the federal government to local companies. Each year, different federal government agencies spend millions of dollars in products and services. Some local companies participate in these programs, through the Small Business Administration (SBA). Increasing the preferential access to Puerto Rican companies could expand production and create jobs, thus, contributing to the economic recovery. This increase in preference levels can be extended for a five-year period and may include specific criteria in prices, quality of key businesses within the local economy, such as the manufacturing, construction, technology, and professional services sectors.

c. External trade

Congress should provide the Commonwealth a higher degree of participation in free trade agreements. The promotion of free trade with Latin American countries has been a priority to the U.S. Government since 1990. The U.S. has signed free trade agreements with countries in Central America, the Dominican Republic (CAFTA-DR) and with other important countries such as Colombia, Chile and other regional economies.

When examining the trade balance, the local companies have not taken advantage of the gradual opening of these markets, and the exports supply of local businesses continues to weaken.

The local government should work in a coordinated manner with the federal Department of Commerce to promote the participation of local enterprises in the commercial trade agreements approved with countries in the region. Puerto Rico needs to take advantage of its geographical position and the fact of being a Latin American country, to position itself to increase its commercial presence.

2. Fiscal reform

In order to stabilize its public finances, the commonwealth needs a comprehensive government reform, and local public administrators have to restore a culture of fiscal discipline. Under the current macroeconomic trends, the current public spending level of \$10.7 billion is not sustainable, which leads to the government's obligation to reduce the 131 agencies and corporations.

Public corporations that are not financially self-sufficient have to be eliminated. Moreover, the extension of subsidies to insolvent corporations and credit lines through the Government Development Bank (GDB) need to be eliminated. As part of the new culture of fiscal responsibility, the government of Puerto Rico has to implement best practices of fiscal planning such as zero-based budget and performance metrics.

New borrowing has to be used only for public works or infrastructure, and never to finance budget deficits like in the past. Finally, the new government structure must operate under the metrics of efficiency, labor productivity and the achievement of the programmed goals. The annual allocation of fiscal resources should be based on a rigorous assessment of the accomplishment of the agencies goals.

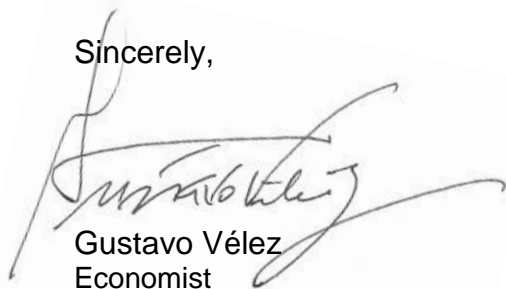
3. Debt restructuring

Congress should allow Puerto Rico to file bankruptcy under Chapter 9 (Federal Bankruptcy Act). However, the inclusion of the commonwealth under chapter 9 has to be conditioned to a Federal Fiscal Board. An external oversight entity appointed by Congress is crucial to assure that the restructuring process and the structural reforms are conducted in an orderly manner. Likewise, the debt restructuring under bankruptcy should be permitted to public corporations (excluding COFINA and General Obligations) which have a combined total debt of \$31.1 billion. The restructuring process has to evaluate every debt issuer individually considering its legal and financial structure. Finally, the process should emphasize on reestablishing the financial feasibility of the corporations and their capacity to invest in new infrastructure.

Never before has Puerto Rico come to a crossroads as complicated as the one it's currently facing. Every day that passes the options become limited and the government runs out of options to manage the crisis. There is no doubt that these are times of great challenges that will demand leadership from all sectors of Puerto Rico's society. Nevertheless, I do believe, that the crisis provides an opportunity for Congress to take action over the economic deficiencies generated by the current political relationship between Puerto Rico and the United States.

I hope that these recommendations are useful to the Committee.

Sincerely,



Gustavo Vélez
Economist