

**PUERTO RICO'S FISCAL PROBLEMS:
EXAMINING THE SOURCE AND
EXPLORING THE SOLUTION**

HEARING
BEFORE THE
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE
ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

DECEMBER 1, 2015

Serial No. J-114-41

Printed for the use of the Committee on the Judiciary



www.judiciary.senate.gov
www.govinfo.gov

U.S. GOVERNMENT PUBLISHING OFFICE

WASHINGTON : 2025

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**PUERTO RICO'S FISCAL PROBLEMS:
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TUESDAY, DECEMBER 1, 2015

UNITED STATES SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Committee met, pursuant to notice, at 10 a.m., in Room 226, Dirksen Senate Office Building, Hon. Charles E. Grassley, Chairman of the Committee, presiding.

Present: Senators Grassley [presiding], Hatch, Lee, Perdue, Tillis, Schumer, Durbin, Klobuchar and Blumenthal.

**OPENING STATEMENT OF HON. CHARLES E. GRASSLEY,
A U.S. SENATOR FROM THE STATE OF IOWA**

Chairman GRASSLEY. This is how we planned the hearing, that I am going to give an opening statement, Senator Blumenthal is going to give an opening statement, and if Senator Schumer comes, he will give an opening statement because he can't stay around for Q&A. And then we're going to call on the Governor and the Congressman, and it's my understanding we have agreed that we will listen to the Congressman and the Governor and not have questions of them. And then we will go to our second panel.

The purpose of today's hearing is to learn more about the origins of Puerto Rico's fiscal problems and what's needed to help restore fiscal balance and economic growth. It's my hope that we will have a valuable discussion based on facts and informed by our witnesses' expertise.

Puerto Rico's debt crisis didn't happen overnight. It has been years in the making. Fundamentally, the starting point for any solution is to first identify the problem and understand its size and scope. Unfortunately, confusion reigns as Puerto Rico has failed to provide audited financial statements for the past 2 years.

What we do know is that for many years as Puerto Rico's economy suffered, debt and spending increased to the point where the island lost investor confidence. Puerto Rico has defaulted on certain debt obligations, lost access to the normal markets, and now faces a liquidity crisis. The Governor and others have stated that the island's current debt "is not payable."

Puerto Rico's economy has suffered for decades, in part, because of barriers to job creation and labor force participation. The Federal minimum wage mandate, generous entitlement programs, red tape and the bureaucracy, and a bloated public sector have stifled business activity. This has a direct impact on Puerto Rico's residents.

They are, of course, our fellow U.S. citizens. High unemployment rates have resulted in a declining population as Puerto Ricans have left the island to search for better jobs. A diminished population means lower tax revenues to fund government.

Despite these long-term economic challenges, for many years Puerto Rico maintained a balanced budget and high credit ratings on its debt. So, what then led to the fiscal crisis that the island faces today? While the economic challenges may be debatable, it's clear that since 2000, Puerto Rico's public debt has risen from 60 percent of GDP to now more than 100 percent. This is an indication of serious fiscal mismanagement.

Thanks to the highly attractive triple-tax exempt status of its bonds, it was easier for the island to borrow and paper over deficits rather than address financial shortcomings and economic realities in order to balance the budget. The consequence of this decision is an accumulation of approximately \$72 billion of debt, arising from roughly 17 different debt issuers. This includes more than \$18 billion in constitutionally protected general obligation debt and also around \$24 billion in debt issued by public corporations, like the Puerto Rico Electric Power Authority.

Moreover, because of its triple-tax exempt status, a wide array of investors own Puerto Rican bonds. According to Bloomberg, Puerto Ricans alone hold \$20 billion of the debt. And nearly 60 percent of Puerto Rico's debt is held largely in the individual retirement accounts and 401(k)'s of regular folks throughout the United States. I am told that approximately 16,000 Iowans are invested in funds that hold PREPA bonds. And, of course, these folks aren't vultures. They are middle-class Americans who probably knew little about Puerto Rico's finances. They simply invested in one of the many tax-exempt municipal bond funds containing Puerto Rico's bonds.

Notwithstanding all of this, we are told that Puerto Rico's debt needs to be restructured in order to address its fiscal challenges. Puerto Rico, though, lacks access to an orderly debt restructuring mechanism, like Chapter 9 of the Bankruptcy Code. Thus, Congress has been called upon to extend Chapter 9 to Puerto Rico's public corporations, or to create a broad new bankruptcy regime that people have dubbed as "Super Chapter 9" to restructure all debt, including the island's constitutionally guaranteed general obligation bonds. According to a recent New York Times article, quote, "advisers to the island's government have been urging the Governor to default on the debt, saying that the only a catastrophe would move Congress—especially Republicans—to help," end of quote. I hope the Governor will tell us whether this is accurate. If so, it would trouble to me greatly if true.

This is not the first time Congress has been asked to help address a situation like Puerto Rico now faces. In the past, we have provided help in a bipartisan way. During the 1990s, the District of Columbia faced a fiscal crisis, as it was insolvent and unable to pay. Congress worked with the District and the Clinton administration officials to pass the District of Columbia Financial Responsibility and Management Assistance Act in 1995. We'll hear more about the response to that crisis and others from our witnesses today. I'll note that Congress considered extending Chapter 9 to the

District of Columbia, but decided that there was, quote, “little practical significance or advantage to such a legislative gesture,” end quote. The Committee report to that bill stated, quote, “the issues facing the District of Columbia...require political and structural, as well as financial remediation,” end of quote.

One of the reasons extending Chapter 9 to the District was rejected is because it is designed primarily to restructure and decrease municipal debt, the idea being that relief from creditors is what is needed in order to gain a fresh start. But Chapter 9 cannot bring about financial rehabilitation. It does not increase economic growth or alter the fundamental fiscal trajectory. In short, Chapter 9 cannot address the root causes of fiscal problems, but instead pushes them off to future generations.

As for Super Chapter 9, this is something that no State can do and has been described as, quote, “unprecedented in the American context,” end of quote. It would be a bad idea, with negative consequences, for Congress to permit Puerto Rico to walk away from its constitutional debt obligations. Unlike other bonds, constitutional debt, whether issued by Puerto Rico or any of our States, has that government’s full faith and credit commitment to repay the debt.

And let us not forget that Puerto Rico issued its bonds with the knowledge that Chapter 9 bankruptcy wasn’t an option for—in the event of a default. Is it fair to retroactively change the rules at the expense of these investors if other options exist for addressing Puerto Rico’s debt problems? At least—at the very least, this is an idea that should be at the end of the line, not at the front of the line.

The challenges Puerto Rico face are great and require more than just short-term solutions that don’t provide long-term relief. The debt is a symptom of a bigger problem. Merely extending debt restructuring authority, absent tools to address the fundamental causes of the fiscal problem, is not a long-term solution that will help Puerto Rico.

Puerto Rico has struggled to make the difficult decisions to cut spending and balance its budget. If Congress is to act, then we must ensure that Puerto Rico has the tools to help itself out of this situation. Today’s hearing can help us identify what may, or may not, need to be considered for Puerto Rico to get its balance sheet back in order. Senator Blumenthal.

**OPENING STATEMENT OF HON. RICHARD BLUMENTHAL,
A U.S. SENATOR FROM THE STATE OF CONNECTICUT**

Senator BLUMENTHAL. Thank you, Mr. Chairman. I particularly want to thank you for having this hearing and other colleagues on the Committee for your contributions this morning and over the past months. Most especially Senator Hatch as Chairman of the Finance Committee, I know has been working diligently, and I want to welcome our two first witnesses who have really dedicated themselves to addressing and solving these problems, which are so intractable and difficult, so that our fellow Americans—and they are our fellow Americans in Puerto Rico, 3.5 million United States citizens—can be saved from the financial and humanitarian catastrophe and calamity that threatens them and really our entire

country, because we will all be affected by the catastrophe that threatens here.

What Congress does or fails to do with respect to Puerto Rico will have indeed a massive impact not only on those 3.5 million fellow Americans but throughout the financial—financial market in the United States and possibly even around the world. And it will send a profoundly significant message about the Federal Government's moral responsibility well beyond our financial obligation, our moral responsibility to look out for fellow Americans regardless of where they live.

There has been a lot of discussion about how we got here. We should always learn from history so we don't repeat it. But right now this crisis demands action. Many of us remember the headline that appeared in the newspapers not so long ago in American history that was, in effect, Congress to New York, "Drop dead." Congress cannot tell Puerto Rico to drop dead financially anymore than it could New York or any other State represented by my colleagues here today. What Puerto Rico needs is very simply the authority to address and deal with its financial problems and authority is lacks simply by a quirk of history. And reasonable people may disagree about the details of the current situation, but one thing should be absolutely clear. This situation is unsustainable. The status quo is unacceptable. And we need to come together, regardless of party and geography, to fashion and craft a solution that enables Puerto Rico to restructure its debts under the auspices of a court.

Working with my colleagues like Senator Schumer—and I want to thank him for his leadership as well—Senator Menendez, Senator Gillibrand, and Nelson, I have put forward a plan for moving forward. The plan begins by recognizing, as one of the Republican witnesses at this hearing has said, that debts cannot be—debts that cannot be repaid will not be repaid. Debts that can't be paid back will not be paid back. Puerto Rico can and must reform itself, but no amount of long-term reform will address the short-term reality that Puerto Rico cannot pay its current debts when due. That is the definition of insolvency, both in law and practical reality.

The only question is whether this reality results in a messy and chaotic default with nobody winning except the legions of predators' attorneys who will spend years, countless billable hours, fighting each other. As we have seen for more than a decade in the case of Argentina, the alternative is an orderly restructuring which served the public interest as well as the interests of our fellow Americans in Puerto Rico. If we prefer an orderly, rational, deliberative, productive process, Congress must act.

Puerto Rican—Puerto Rico also needs and deserves equal treatment under the Earned Income Tax Credit, the Child Tax Credit, and Federal health care programs. Not only will equal treatment alleviate suffering among Puerto Rico's people, it will reduce pressure on the Puerto Rican government and free up resources to resolve the island's fiscal crisis.

Others have different ideas about how to help Puerto Rico, and I appreciate those ideas and my colleagues who have offered them on both sides of the aisle. I am open to any proposal that will actually solve the problem. What is essential is that we act, and we must act before it is too late.

I want to close by making one thing really completely clear here. Congress, generally, and this Committee, in particular, are at a crossroads. Puerto Rico is at a crossroads, but America is at a crossroads in addressing the needs of 3.5 million Americans but our financial markets and our moral obligation. Eight percent of Puerto Ricans have fled the island since 2006 as a result of diminished economic opportunity. Eighty-four thousand Puerto Ricans came to the mainland last year alone. Those are numbers you see after an armed conflict or a disaster. They are a mark of tragedy on an island that deserves better. And if Congress fails to act, the situation could become much worse.

Just today, Puerto Rico has narrowly averted a complete default that could have hobbled its government, including its ability to provide education, law enforcement, health care, and other essential services. It avoided this default only by resorting to unsustainable financial gymnastics. Let's be very blunt and real. Those financial gymnastics cannot be sustained or continued indefinitely. The financial somersaults and headstands must end.

The prospect of a humanitarian catastrophe within the United States territory is very real, and it is very immediate. Congress can act to prevent this catastrophe, or it can choose not to do so. If we fail that, the responsibility is ours. I know that Members of this Committee will address rather than shirk that responsibility, and I look forward to working with all of my colleagues in the coming days. Thank you, Mr. Chairman.

Chairman GRASSLEY. Thank you. It is my understanding that Senator Schumer has to go.

Senator SCHUMER. I do.

Chairman GRASSLEY. You asked if he could speak. Go ahead.

**OPENING STATEMENT OF HON. CHARLES E. SCHUMER,
A U.S. SENATOR FROM THE STATE OF NEW YORK**

Senator SCHUMER. Thank you, Mr. Chairman, and I very much appreciate your letting me speak and, more importantly, having this hearing. It is such an important issue. There are different views in this Congress. But just ignoring them and sweeping them under the rug will accomplish nothing. So, thank you so much for holding the hearing.

And let me just say I am committed to finding a solution to help not just the 3.5 million Americans living in Puerto Rico but the additional 5.2 million living in the United States, including over 1 million in New York. These are brothers and sisters, sons and daughters, uncles and aunts, worried about the quality of life of their relatives and friends living on the island, and they deserve the peace of mind to know that Americans, no matter where they live—on the mainland or on the island—are Americans and are entitled to the same rights and quality of life we all expect. We have a basic American responsibility to answer that call, to aid all American citizens in times of crisis, regardless of where they live.

So, Mr. Chairman, here is the bottom line. The Puerto Rican people can no longer wait. They can no longer wait for Congress to give them the tools they need to address a disastrous financial crisis. The situation in Puerto Rico grows more dire each month, and

my good colleague and Co-Sponsor—lead sponsor on our bill has laid that out.

The bill we have put forward, Senator Blumenthal and I, the Puerto Rican Chapter 9 Uniformity Act, that many of my colleagues on this Committee also support, provides Puerto Rico with the authority to access Chapter 9 protections and would be a significant step in the right direction, allow them to begin to climb out of this financial hole.

I recognize, of course, that there's more that can be done and more that should be done. I have never said that our Chapter 9 bill would be a silver bullet that solves all of the issues. There's no question in my mind Puerto Rico needs some restructuring authority. But there's much more we can do.

I have introduced legislation to address several aspects of the health care crisis, including issues like Medicaid funding and fairness, appropriate Medicare reimbursement, equitable physician payments. The disparities in how the Medicare and Medicaid programs treat Puerto Rico versus the rest of the United States are significant and also need to be addressed.

But today's hearing is focused on the legal authority that is appropriate to provide Puerto Rico to be able to sufficiently resolve the significant debt burden it faces, and, more importantly, Puerto Rico needs sufficient authority to compel all the creditors to come to the table. There are different creditors with different agendas. If they would all come to the table, we could get something done here. The legislation requires that, forces that to happen.

I'm deeply concerned, if we are unable to address these issues and provide Puerto Rico with sufficient restructuring authority in the near term, we're going to see a humanitarian crisis develop on the island. The Puerto Rican people have already lost access to the capital markets, and should they default on more and more debt payments, it is a real worry we could see public services—health care, education, utilities—become scarce.

Residents of the island have already begun to flee their homeland, as Senator Blumenthal mentioned. If the economic situation worsens, the population shift from the island to the mainland will continue until the only ones left are those who have no resources to move.

So, the Puerto Rican people can no longer wait. This country can no longer wait. Congress must act now, and I thank my colleagues on both sides of the aisle not just for having the hearing, but for rolling up their sleeves and exploring what solutions can be agreed upon to address this important issue.

I ask unanimous consent that the rest of my statement be added to the record, and I very much appreciate the courtesy of you, Mr. Chairman, Ranking Member Blumenthal today, and all the other Members to make my statement.

Chairman GRASSLEY. Thank you, Senator Schumer.

Our first panel is Puerto Rican Governor Garcia Padilla and Resident Commissioner Pierluisi. I welcome both of you. Thank you for joining the Committee. We have asked each of you to provide us with a statement as we consider this very important issue. You have 5 minutes, and your complete statements will be put in the record. So, proceed, Governor.

**STATEMENT OF THE HONORABLE ALEJANDRO
JAVIER GARCIA PADILLA, GOVERNOR,
COMMONWEALTH OF PUERTO RICO**

Governor GARCIA PADILLA. Thank you, Chairman Grassley, Ranking Member Blumenthal, and Members of this Committee. Puerto Rico is facing a crisis with severe consequences for the lives of 3.5 million American citizens on the island. More than 300,000 have moved away in the last decade. Inaction by Washington at this time will only aggravate the state of affairs. A comprehensive solution is imperative. Give us the tool to make it happen.

This hearing is proof enough—and I really appreciate it—that you are aware of the gravity of Puerto Rico’s current state. On the other hand, one thing that I still hear frequently in the halls of this Congress is that we in Puerto Rico have not done enough to solve our problems. That’s not true. My constituents have made significant sacrifices over the past 10 years, and the administration from both governing parties in Puerto Rico have implemented measures to shore up public finances. And while we may disagree on the effectiveness of the strategies, one thing is clear: We, the people of Puerto Rico, have done our part.

Over the last decade, Puerto Rico has endured significant austerity measures. My administration has cut expenditures by over 20 percent of the budget. We have reformed our largest pension fund from defined benefits to defined contribution, including current employees. A new tax on pricing was put in place, and, most importantly, Puerto Rico is currently transitioning from a sales tax to a value-added tax with an 11.5-percent rate. My administration has approved new revenue measures that impacted gasoline and water rates that are mentally—dramatically reducing government expenditures and froze collective bargainings. Public transportation routes have been cut, and we have been consolidating schools to improve education outcomes and force cost savings.

The reduction in the government payroll has also been dramatic, 27 percent over the last 7 years, which is affecting already essential services. And massive outmigration is shrinking our tax base and is also in a death spiral. These austerity measures are in addition to the sales tax implemented in 2007 along with increasing tolls on water rates under the previous administration. Property tax rates were doubled. A new 4-percent excise tax on the exports from foreign and U.S. corporations with manufacturing operations in Puerto Rico was legislated, and more than 30,000 public employees were laid off.

We have taken significant austerity measures, and we will take additional ones if it is necessary. But the magnitude of the fiscal and economic problem bearing down on Puerto Rico is simply too large. We cannot solve this crisis alone, and Congress has a very important role to play.

The loss of Section 936 benefits significantly contributed to the crippling of our economy and led directly to the recession that began in 2006. The 1984 amendments to exclude Puerto Rico from the Bankruptcy Code further aggravate the present crisis and lack, as First Circuit Judge Torruella noted, any rational base or clear policy reasons for their enactment. The imminence of a default when presented with the alternative between paying our creditors

and providing essential government services looms large. Absent an orderly process, its effects will be catastrophic.

That is why starting today the Commonwealth of Puerto Rico will have to claw back revenues pledged to certain bond issues in order to maintain essential public services. We have taken this difficult step in the hope that Congress will act soon. But let us be clear: We have no cash left. The emergency measures we have taken to avoid a default and maintain essential services are unsustainable.

Members of the Committee, as you know, my request for immediate action, we have never asked Congress for a bailout, and we are not seeking one today. We ask for access to a legal framework to restructure our liabilities; fair treatment in Medicaid and Medicare funding; reforms that stimulate labor force participation; and tax measures that attract investment to Puerto Rico and create jobs; an exemption from the Jones Act, just like the one of our close neighbors, the United States Virgin Islands.

Mr. Chairman, Members of the Committee, this is a distress call from a ship of 3.5 million American citizens that have been lost at sea since 199–1996. This is a distress call requesting tools to sail, not a bailout. We are asking for the tools to finish the job. It's your choice whether to answer or to disregard—disregard this call from the people of Puerto Rico. The cost of delay will be significant. The cost of inaction will be catastrophic.

Again, please, give us the tools, and we will finish the job. Thank you so very much for your attention.

[The prepared statement of Governor Garcia Padilla appears as a submission for the record.]

Chairman GRASSLEY. Thank you, Governor. Now, Congressman.

**STATEMENT OF THE HONORABLE PEDRO R.
PIERLUISI, RESIDENT COMMISSIONER FOR
PUERTO RICO, U.S. HOUSE OF REPRESENTATIVES**

Representative PIERLUISI. Chairman Grassley, Ranking Member Blumenthal, and Members of the Committee, thank you for inviting me to speak on behalf of the island's 3.5 million American citizens I represent in Congress.

When Puerto Rico becomes a State, as I know it will, my constituents will vote for the President and Members of Congress who make our laws, and they will be treated equally under those laws. Until then, Puerto Rico must depend on the goodwill of Senators and Representatives from the States. We must make the case for congressional action and hope you find it compelling. We are reduced to the role of a supplicant, pleading for equal treatment, or at least more equitable treatment.

What a shameful arrangement—for us, but also for you.

I believe in American exceptionalism—the concept that this country is unique in terms of its character and its conduct. But I also believe that the manner in which the Federal Government has treated Puerto Rico could cause one to question whether our Nation's devotion to democratic self-government is rhetorical rather than real.

This is the fifth congressional hearing on Puerto Rico this year. At each hearing I have emphasized that Puerto Rico confronts a crisis for two reasons.

First, over the years, the Puerto Rico government—with certain notable exceptions—has demonstrated a lack of discipline, transparency, and common sense when it comes to managing its finances and creating a business climate that attracts private investment, generates jobs, and grows the economy. Any individual that aspires to a leadership position in Puerto Rico should acknowledge that too many island officials have a record of overpromising and underdelivering and should have a credible plan to break this cycle.

Second, the Federal Government's policies toward Puerto Rico are inequitable and incoherent. They essentially make it impossible for the island to prosper, even if our local leaders were beyond reproach.

Just as Puerto Rico's leaders must concede their failures, this Congress must acknowledge its own responsibility. Introspection is a two—two-way street.

For example, it is inexcusable that over 500 days have elapsed since the end of FY 2014 and the Puerto Rico government has not yet released an audited financial statement. Members of Congress are right to criticize Puerto Rico for such ineptitude. Just ask Senator Hatch yesterday.

But let's place things in proper perspective. Puerto Rico has been treated 20/20 unequally under Medicaid and Medicare for 50 years, under the SSI and EITC programs for over 40 years, and under the CTC program for nearly 20 years. The argument that Congress needs audited financial statements from Puerto Rico before it can act to rectify these devastating, decades—decades-long disparities defies logic.

Faced with this lack of Federal economic support, and seeking to provide a decent quality of life for its people, the Puerto Rico government—unwisely but understandably—has overspent its own funds and overborrowed in the bond market. This has led to recurring deficits, a large debt, and the loss of over 60,000 residents a year through migration to the States.

For both moral and practical reasons, Congress should swiftly enact a legislative package that gives Puerto Rico more equitable treatment under Federal programs. Of course, these provisions will cost money, just as it costs the Federal Government money every year when it spends \$2.5 billion to support the Medicaid program in Iowa, or sends over \$400 million in checks to working families in Utah, or spends over—or provides \$100 million to vulnerable individuals in Vermont under the SSI program. If Congress refuses to provide fair treatment to my constituents, they will continue to move in massive numbers to the States in order to obtain it. That is the logical consequence of an illogical system.

This package should also authorize Puerto Rico to restructure a meaningful portion of its debt. We can have a reasonable debate about the scope and nature of this authority, which falls within the jurisdiction of this Committee, but at the very least, Puerto Rico should have the same ability to adjust its debts as the States. Providing this authority will cost the Federal Government nothing;

whereas, failing to provide it will have an enormous humanitarian cost.

If, but only if, Congress acts on these items that I have laid out, I will not oppose the creation of an independent board that respects the Puerto Rico government's primary role in crafting its budget and making fiscal policy, but that is authorized to ensure that the Puerto Rico government complies with appropriate budgeting standards and fiscal metrics. As I see it, this board should be redundant, because the Governor and Legislative Assembly of Puerto Rico ought to be conforming to such standards and metrics anyway, and so, I would not object to Federal oversight to make certain that they do.

Five congressional hearings are enough. It is time for Congress to legislate and, in so doing, to be part of the solution to a problem it had a significant role in creating. Thank you.

[The prepared statement of Representative Pierluisi appears as a submission for the record.]

Chairman GRASSLEY. Thank you, Congressman. Thank you, Governor. You are free to go, and now we will call the second panel. [Pause.]

I am going to introduce the panel while you are coming up. Turning to our second panel of witnesses, Dr. Carlos Colón de Armas is a professor of finance, Graduate School of Business, University of Puerto Rico. Prior to that he served as executive vice president for Government Development Bank for Puerto Rico. He has an undergraduate degree from the University of Puerto Rico and a Ph.D. from Purdue.

Stephen Spencer is a managing director, Financial Restructuring Group of Houlihan Lokey, where he focuses on advising companies in executive distress recapitalizations. He has represented creditors in several municipal restruct—restructurings resulting in significant experience on municipal finance issues. He received an undergraduate degree from the University of Wisconsin, Madison.

Alex Pollock is a resident fellow at the American Enterprise Institute, Washington, DC, where he works on several policy issues, including the role of uncertainty and risk of financial systems. From '91 to 2004, Mr. Pollock served as the President and CEO of the Federal Home loan Bank board—Federal Loan Home Bank of Chicago. He has an M.P.A. from Princeton University, an M.A. from Chicago U and a B.A. from Williams College.

Richard Carrión is chief executive officer of Popular Inc., which is the largest banking institution by both assets and deposits in Puerto Rico. He spent more than 35 years working in banking at Popular. He has a master's degree from MIT and a bachelor's degree from the University of Virginia—University of Pennsylvania.

Richard Ravitch is former Lieutenant Governor of the State of New York, which is one of many jobs he has held throughout his career. From '75 to '76, he assisted New York City and State officials in resolving New York City's crisis. He has an undergraduate degree from Columbia and a law degree from Yale.

Welcome, and I thank all of you for being with us today, because we know it takes a lot of preparation. Your opening statements will be the same as other witnesses', 5 minutes. Longer statements will

be put in the record, and we'll have a lot of questions, so I hope you'll stay to the time. We will start with Dr. Colón de Armas.

I want to make an announcement. At 11:10, I have to be gone for a short period of time, and Senator Perdue will chair the hearing at that particular time. Would you proceed with your testimony.

**STATEMENT OF CARLOS A. COLÓN DE ARMAS, PH.D.,
PROFESSOR OF FINANCE, GRADUATE SCHOOL OF
BUSINESS, UNIVERSITY OF PUERTO RICO,
SAN JUAN, PUERTO RICO**

Mr. COLÓN DE ARMAS. Good morning, Chairman Grassley, Ranking Member Blumenthal, and Members of the Committee. Thank you for the opportunity to appear here today to discuss Puerto Rico's fiscal and economic challenges.

My name is Carlos Colón de Armas. I am a professor of finance at the Graduate School of Business at the University of Puerto Rico. This document starts with an executive summary, that highlights the key points of my written testimony. Given the time constraints, I will limit my initial remarks to the executive summary, and I will leave the rest for the record and to discuss with you in the Q&A portion of the hearing.

Puerto Rico faces two distinct challenges. A fiscal crisis and an economic crisis. Contrary to what most people are saying, the available evidence indicates that the fiscal crisis was not caused by a weakening economy. For one, the downward trend in the economy began almost three decades before the fiscal problems started. More importantly, public expenses started to get out of line at the same time that general fund revenues were increasing at a healthy pace.

To finance its profligate ways, the government of Puerto Rico sacrificed its limited borrowing capacity that was supposed to be utilized only to finance public investments and used it instead to finance spending. As a result, an already fragile economy experienced a significant loss of investments and deteriorated even more.

Fixing the economy of Puerto Rico, while necessary, will not repair the island's fiscal crisis. To fix the fiscal crisis, the government of Puerto Rico needs to cut spending. To fix the economic crisis, public and private investments on the island must be increased, and the business climate in Puerto Rico should be improved.

The starting point to fix the fiscal crisis should be to cut expenses in the general fund by \$1 to \$1.5 billion. To be most effective, this reduction should be achieved through a participatory process that must include all relevant interest groups, including labor leaders. The evidence shows that this level of reduction in expenses is feasible, without the need to fire government employees, and without affecting the quality of the public services required by the citizens.

The available evidence also demonstrates that the government of Puerto Rico has the necessary resources to honor its debt commitments as originally contracted. In other words, the public debt of Puerto Rico can be paid. Therefore, from the standpoint of what is best for Puerto Rico, default, bankruptcy, debt restructuring, or

any kind of negotiation that involves not complying with debt commitments as originally contracted should be avoided at all costs.

In this regard, the key consideration should be how to restore access to financial markets to enhance investments on the island. It would be incorrect to frame this issue as a short-term budgetary matter. To improve the quality of life on the island, more investments are needed. For those investments to take place, financing is necessary for which access to financial markets is essential.

As an example, look at the recent drought in the San Juan metro area which left many residents without water for up to 5 days a week, while water was going to waste on the western side of the island. This situation illustrates vividly the human costs of the government's inability to access financial markets to finance projects that are critical for everyday life in Puerto Rico.

It also is important to mention that the government of Puerto Rico intends to force bond holders to suffer losses for problems caused not by the bonds but by unfunded loans issues by its own government development bank. Such an outcome, if implemented, would be unreasonable.

To address many of these issues, appointing a control board has been proposed. I have mixed feelings toward that proposal. On the one hand, I recognize that a control board may be very effective to put the financial house in order and restore credibility in Puerto Rico. On the other hand, we do not need people to make hard decisions. We need people to make smart decisions. Yet these control boards have the tendency to enter troubled spots to cut indiscriminately. In Puerto Rico, this would not be the correct approach to follow.

Perhaps instead of creating such a board, it could make more sense to establish specific targets of what needs to be done and to counter with an independent certified public accountant to certify whether it has been done. This approach would have the added benefit of keeping responsibility in the hands of the public officials whose job it is to fix these problems.

The reality is that all the time that government officials are dedicating to measures like bankruptcy, debt restructuring, debt negotiations, and control boards diverts their attention from the important actions that they should be undertaking.

Chairman GRASSLEY. Can I ask you to summarize your statement?

Mr. COLÓN DE ARMAS. I am finishing.

Chairman GRASSLEY. Okay.

Mr. COLÓN DE ARMAS. It would be more productive if all that time and effort were dedicated instead to reducing public expenses. The rest is basically for the record.

[The prepared statement of Mr. Colón de Armas appears as a submission for the record.]

Chairman GRASSLEY. Thank you. Mr. Spencer.

**STATEMENT OF STEPHEN J. SPENCER,
MANAGING DIRECTOR, FINANCIAL RESTRUCTURING
GROUP, HOULIHAN LOKEY, MINNEAPOLIS, MINNESOTA**

Mr. SPENCER. Chairman Grassley, Ranking Member Blumenthal, and Members of the Committee, my name is Stephen Spencer. I ap-

pear today for Franklin Advisers and OppenheimerFunds, who together own about \$10 billion in Puerto Rican debt on behalf of more than a half million retail investors throughout the country.

For 18 months, I have led negotiations between my clients—Franklin, Oppenheimer, and six other fund managers and the Puerto Rico Electric Power Authority, or PREPA. We got to a deal on significant debt relief to support PREPA's recovery, and I earned a deep understanding of Puerto Rico's problems in the process.

Puerto Rico and its allies say access to Chapter 9 is an issue of fairness and a simple, effective fix. Nothing could be further from the truth. Giving Chapter 9 to Puerto Rico would impose a bailout on the backs of millions of retail investors, violate the sanctity of contract, undermine the rule of law and harm the Commonwealth and municipal debt markets throughout the country. More specifically, extending Chapter 9 would be poor public policy for three primary reasons.

One, Chapter 9 would not allow Puerto Rico to fix its problems. Take Detroit. Presented as a success, but in reality a series of failures—a failure to address pensions, a failure to cut costs, a failure to streamline government. The court's own expert witness testified that the bankruptcy was largely focused on deleveraging the city, often to the exclusion of fixing the city's broken operations.

This is the problem with Chapter 9. From Detroit and other recent Chapter 9 cases, like Vallejo, Stockton, and San Bernardino, the message to municipal officials is clear, pay bond holders as little as possible to avoid necessary reform as long as possible. Pensions that Vallejo and Detroit refused to address are already forcing Vallejo to contemplate a second Chapter 9 and threatening Detroit's recovery. Post bankruptcy, Detroit still needs help from the State of Michigan to issue debt. If Puerto Rico gets Chapter 9 today, it will be back to the Federal Government for help tomorrow, because like Detroit, no one will loan it money.

The maturity of Puerto Rico's debt is held directly or indirectly—and this is the second point. Extending it Chapter 9 will hurt individual retail investors in the broader muni market. The majority of Puerto Rico's debt is held directly or indirectly by individual retail investors, a largely mom-and-pop investor base, who buy municipal debt because it is safe. Congress told these retail investors they didn't have to worry about a Puerto Rican Chapter 9, so they bought Puerto Rico's bonds at lower interest rates. Over 30-plus years, the Commonwealth enjoyed billions in interest savings that these retail investors will never recover. That's the consequence of retroactively changing the rules and shows why so many individual investors would feel betrayed by Congress giving Puerto Rico access to Chapter 9.

For the broader muni market, the Detroit experience suggests that extending Chapter 9 to Puerto Rico will be seriously disruptive. Post Detroit, yields on Chicago's debt increased 100 basis points, and they haven't returned to pre-Detroit levels. That cost Chicago \$180 million in increased interest expense annually. And that is just Chicago. For the city of Scranton, the cost of borrowing doubled. Because Puerto Rico is nine times the size of Detroit, the impact of Chapter 9 could be even more disruptive.

Last, to support a long-term recovery, Puerto Rico needs to regain access to the municipal credit markets for long-term, low-cost financing. Chapter 9 will prevent this from happening.

Third, Puerto Rico doesn't need Chapter 9 to recover. The Commonwealth says it can't pay its debts. That is a failure of political will more than statement of economic necessity. Puerto Rico has a comparatively low debt burden. Two years ago, the Commonwealth itself told investors that its debt load per capita is approximately 70 percent lower than any U.S. State. Puerto Rico can reduce costs. Puerto Rico's consolidated government expenditures have increased 47 percent over the past 10 years, hardly austerity. And Puerto Rico, an island of 3.6 million people, has 120 government agencies.

Puerto Rico can reform its Tax Code. Puerto Ricans do not pay Federal income tax. They pay substantially less than U.S. taxpayers. Yet the Commonwealth still fails to collect over 40 percent of its sales taxes and any income tax at all from many of its wealthiest residents. KPMG, the Commonwealth's own outside tax consultant, found that better tax collection and a simpler Tax Code would generate more than \$3.6 billion a year. That's enough to close Puerto Rico's 5-year projected budget gap and leave a surplus of billions.

I want to leave you with a few simple thoughts. Fix the Puerto Rico Tax Code, and you fix Puerto Rico. Fix Puerto Rico's government spending, and you fix Puerto Rico. Finally, give Puerto Rico Chapter 9, you fix nothing. You undermine the deal that we have cut with PREPA and the current negotiations toward a broader deal.

Again, I thank you for your time, and I look forward to answering any questions from the Committee.

[The prepared statement of Mr. Spencer appears as a submission for the record.]

Chairman GRASSLEY. Thank you, Mr. Spencer. Now, Mr. Pollock.

**STATEMENT OF ALEX J. POLLOCK,
RESIDENT FELLOW, AMERICAN ENTERPRISE
INSTITUTE, WASHINGTON, DC**

Mr. POLLOCK. Thank you, Mr. Chairman and Senator Blumenthal and Members of the Committee. The government of Puerto Rico has run many years of constant budget deficits so that, as we all know, it now has a very large debt, which, according to its own statements, it cannot pay. It's cutoff from all normal bond market financing. The credit ratings of its many debt-issuing entities are at the bottom of the credit scale. It cannot produce timely, audited financial statements. Its public pension obligations are virtually unfunded, and an estimated \$44 billion pension liability must be added to the \$71 billion in government debt, giving us a total of \$115 billion.

It is my recommendation that the Congress should promptly create an Emergency Financial Control Board to assume oversight and control of the financial operations of the government of Puerto Rico, as Congress successfully did in 1995 with Washington, DC; as New York State, with Federal encouragement, successfully did with the insolvent and defaulting New York City in 1975; and as the State of Michigan did with the appointment of an Emergency Man-

ager for the insolvent city of Detroit in 2013. Such control boards have also been used in Cleveland, Philadelphia, and Springfield, Massachusetts, and there is plenty of precedent.

Of course, Congress has sovereignty over territories of the United States and the clear authority to create a control board. In my opinion, given the severe financial and management—or as the Chairman has said, mismanagement—problems, it also has the responsibility to create a control board in Puerto Rico, and in my view, this is the tool that's really needed.

A control board is the first step to take. The initial requirement is to establish independent, credible authority over all books, records, and other information; to analyze what the true overall financial deficit is; to determine which Puerto Rican government bodies are insolvent, in particular to understand the financial condition of the Government Development Bank which lends to all the others; to consider fiscal, accounting, and structural reforms which will lead to future balanced budgets and control of debt levels; and to consider in the light of all of these how the current excessive levels of debt should be addressed. The control board, in my view, should be instructed to analyze and report to the Congress on whether creating a bankruptcy regime for Puerto Rico is warranted as a subsequent legislative action.

The details of the Puerto Rican government's financial situation are complex, but the fundamentals are simple. The government of Puerto Rico is broke. In the current century, it has run a budget deficit every single year—that is 15 years in a row. Operating deficits have been financed by borrowing. And as debts multiplied, debt service was met by additional borrowing, utilizing debt issuance to pay interest on existing indebtedness. That is the definition of a Ponzi scheme, which must end painfully, as this one is now ending.

Among the robust precedents for Emergency Financial Control Boards, the closest legal parallel is Washington, DC, which, like Puerto Rico, is not a State. The city had become a financial quagmire by the mid-1990s, and Congress, in a notable bipartisan effort, responded with the District of Columbia Financial Responsibility and Management Assistance Act of 1995, which the Chairman previously cited.

Although there were disputes and difficulties along the way, the Washington D.C. Control Board achieved clear success in financial management and controls, efficiency, and reaching balanced budgets. It adjourned in 2001, but is authorized to return should Washington, DC's budget discipline ever again slide into aggregate deficits.

Now, the cases of New York City and the city of Detroit are discussed in my written testimony, and I think all evidence indicates the time for a control board has come.

Mr. Chairman, Puerto Rico's financial and managerial problems are severe, and as the Governor has already said, its cash is running out. In my judgment, Congress should establish the Emergency Finance—Financial Control Board for Puerto Rico as a high priority. Thank you for the chance to share these thoughts.

[The prepared statement of Mr. Pollock appears as a submission for the record.]

Chairman GRASSLEY. Thank you, Mr. Pollock. Now, Mr. Carrión, proceed please.

**STATEMENT OF RICHARD CARRIÓN,
EXECUTIVE CHAIRMAN, BANCO POPULAR,
SAN JUAN, PUERTO RICO**

Mr. CARRIÓN. Good morning, Chairman Grassley, Senator Blumenthal, and other distinguished Members of the Committee. My name is Richard Carrión. I am chairman and CEO of Popular, the holding company of Banco Popular de Puerto Rico. Banco Popular is the largest financial institution on the island, and our 122-year history has been closely linked to that of Puerto Rico's.

While it is an honor to appear before you today, as a banker, or even more so as a proud Puerto Rican, I deeply regret that Puerto Rico's dire fiscal and economic situation is the topic which brings us to the attention of this Committee.

After a decade of economic contraction, lack of fiscal discipline, and increasing public debt to unsustainable levels, Puerto Rico now stands at a critical junction. Leaders from several administrations and different political parties have opted to ignore structural problems and postpone difficult decisions because it was easier to keep borrowing to fund operational deficits and kick problems down the road.

No amount of regret or even indignation will solve our problems. I am here today because I am convinced that without prompt, decisive, and coordinated action by local and Federal Government authorities, Puerto Rico's future is in jeopardy. Since time is limited and I previously submitted my written testimony to the Committee, I will stress two points that I feel are critical and will hopefully help you gain a deeper understanding of the Puerto Rico fiscal and economic situation and then answer any questions you may have.

First, the Puerto Rico government will run out of money, and soon. In fact, the only reason why it hasn't done so already is because the government has employed several emergency liquidity measures such as delaying payment of income tax refunds owed to taxpayers, using part of the liquidity of the two largest retirement systems, and deferring payment of accounts payable to vendors and other third parties. These measures are clearly unsustainable, and they are harming the economy.

The funds required to service the existing debt are substantial and increasing. In this fiscal year, the Puerto Rico government is scheduled to make \$4.1 billion in debt payments, which represents approximately 40 percent of projected revenues. Given the lack of access to the capital markets, absent some type of restructuring, the government would have to pay the full principal and interest coming due, something it will be unable to do while it seeks to provide basic services to the population.

Furthermore, the government's severely underfunded pension plan will place additional pressure on public finances. Once the funds are depleted, which is expected to happen soon, the central government will have to divert resources normally used to provide essential services to pay pension benefits.

Finally, if no measures are taken to address the impending depletion of Medicaid funds, the government could be forced to incur

additional expenses related to health care. While I am a very strong advocate of free thinking and restructuring the entire central government, there is simply no amount of cost cutting or belt tightening that will generate the funds to bridge this enormous financing gap.

The second point, I am convinced that an effective, long-term solution for Puerto Rico's fiscal and economic troubles must include three components.

First, we need a legal framework to restructure all of Puerto Rico's public debt in an orderly fashion. A successful debt restructuring requires a legal regime where the interests of all parties can be balanced fairly while allowing financing alternatives that would provide much needed liquidity during restructuring. The absence of such a regime will result in a slew of legal battles that will take years to resolve and create disruption and uncertainty while consuming inordinate resources and, inevitably, debt defaults.

The second element is an effective fiscal oversight and control mechanism. Puerto Rico's current economic problems are closely tied to a decade of sluggish economic growth, but also are a direct result of longstanding fiscal undiscipline. The oversight body should consist of members with the appropriate expertise, must be truly independent, and it needs to have the necessary authority to effectively carry out its oversight and control responsibilities.

Finally, an effective plan must include economic stimulus measures to incentivize new investment and promote employment.

These three components are all necessary, and not one of them is sufficient by itself. The failure to include any one of those components would render the other two ineffective. Problems that took decades to create cannot be solved in months or through small or isolated efforts of one group or another. A real solution will require local and Federal action, support from the executive and legislative branches, backing from all political parties, and the active participation of all sectors of Puerto Rican society. Failure to take decisive action now will only make these problems worse and their solutions more costly and less effective. Thank you.

[The prepared statement of Mr. Carrión appears as a submission for the record.]

Chairman GRASSLEY. Thank you very much. Now, Mr. Ravitch.

**STATEMENT OF RICHARD RAVITCH, FORMER
LIEUTENANT GOVERNOR, STATE OF NEW YORK,
NEW YORK, NEW YORK**

Mr. RAVITCH. Thank you, Mr. Chairman, Senator Blumenthal, Members of the Committee. It is a privilege to be here. I represent no one in this matter. I am not compensated for the time I have spent in the last year examining the fiscal situation in Puerto Rico. I was, as the Chairman referred to it, very much involved in New York City's fiscal crisis in 1975 as an adviser to Governor Carey. I sat in the halls of this Congress and the Treasury Department 40 years ago this past November addressing some of the same very basic issues. And I've been an adviser to the bankruptcy judge in Detroit, and I continue my involvement there at Governor Rick Snyder's request as an adviser to the control board in Detroit. And for the last 5 years, my dear friend and colleague, former Fed

Chairman Paul Volcker, and I have spent a great deal of our time and effort studying the fiscal stress that many cities and States are—are addressing within increasing alarm, with reduced expenditures in education and infrastructure, untenable pension obligations, and increasingly difficult burdens to open up credit markets for themselves.

It is my conclusion that restructuring all of the debt—the general obligation debt, the Cofina debt, as well as the corporate and municipal debt—is the sine qua non of assuring social stability in Puerto Rico and giving Puerto Rico a chance to recover economically.

I believe such restructuring authority is not constitutionally questionable since Article IV of the Constitution gives the Congress the power to make any rule whatsoever with respect to a territory.

I know the concern that many people share, and legitimately, and I share it myself, as to whether or not this is an inappropriate precedent to the suggestion that States should be authorized to file bankruptcy. And I have to say though that position was very well advocated by Jeb Bush and Newt Gingrich in an article in the Los Angeles Times, I do not agree with it because of the simple fact that it is the 11th Amendment to the Constitution which says that a Federal court can't have jurisdiction over a dispute between one State and a citizen of another State. And that's the reason why States cannot file bankruptcy. So, I agree with—disagree with Mr. Bush and Mr. Gingrich on that matter.

I think that the issue that many jurisdictions are struggling with around this country as to how do you deal with the fact that they have debt service obligations and pension obligations that they can't meet, and whether it's political decisions or court decisions, I think basically the principle that is emerging that is governing these decisions is that a promise to pay interest to somebody is morally—lends you money is morally indistinguishable from a promise to pay a benefit to somebody who worked for you for 20 years. And Puerto Rico faces a particularly severe problem because, inappropriately and improperly, they have spent down their pension fund, and in another 12 to 18 months, they are obligated, in the absence of any authorization to renegotiate these benefits, they are obligated to pay a billion two hundred dollars a year in pension benefits to close to 100,000 retirees. That is potentially a very, very serious problem.

Richard Carrión mentioned that the debt service obligations are equal to 40 percent of the revenues of the Commonwealth. Well, the average percent of revenues that are utilized to pay debt service in every other jurisdiction in this country is somewhere in the neighborhood of 5 to 6 percent.

If the debt—total debt service obligation of the Commonwealth and its corporations is not significantly reduced in the short term, there will be insufficient cash to provide for the basic essential services of running the government.

If I may, Mr. Chairman, quote from a Wall Street Journal editorial, quote, "Bankruptcy would be painful and carries risks, but an orderly restructuring under a legal framework in Federal court is preferable to a creditor brawl that would likely follow-up in default. Hedge funds, mutual funds, and bond insurers would have to

take haircuts for mispricing the risk in enabling Puerto Rico's political mismanagement."

Incredibly, yields on the island's general obligation bonds were as low as 6 percent 2 years ago. As of last July, they were yielding 12 percent.

Let me say, Mr. Chairman, that the issue of—of restructuring debt is a serious center issue to the future of this island and its population. I have to add that I think a concomitant of such an authorization has to be a federally mandated oversight board. And with all respect to Mr. Pollock, the New York Board, which I helped design back in 1975, did not have the powers that were legislated for the District of Columbia. And nor does the Detroit Control Board have those powers. Such an oversight board should merely have the power to approve budgets, to approve any future incurrence of debt, and to approve any colleague bargaining agreement. And it should have the right to approve any restructuring plan that the elected government of Puerto Rico comes up with.

Let me say, last of all, that I think to permit a filing of only the corporations would produce several unintended consequences that are not in the public interest. One, if that were to be enacted, it would increase by billions of dollars the—

Senator PERDUE [presiding]. I am sorry to interrupt. Can you move to a close for us?

Mr. RAVITCH. Sure.

Senator PERDUE. Thank you.

Mr. RAVITCH. It would increase the value of the general obligation debt automatically by billions of dollars. It would prevent the Commonwealth from being able to do debtor in possession financing. And, last of all, Mr. Chairman, if I may, the suggestion that we need a Federal control board now, the Federal Reserve Bank of New York has had a very talented group of people studying the economy. I don't know to what extent their research is made public. And the U.S. Treasury Department has been studying it, a large group of very talented people. I'm not sure that anybody else could come to a different conclusion than the Treasury Department and the Federal Reserve Bank came to in concluding that debt restructuring was essential for the future of Puerto Rico.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Ravitch appears as a submission for the record.]

Senator PERDUE. Thank you, and thank you to the panel today. We will start questioning, in the absence of Chairman Grassley, with Senator Hatch.

Senator HATCH. Well, thank you, Mr. Chairman. I have been very interested in each one of you and your testimony here.

Senator PERDUE. Your microphone.

Senator HATCH. I do have it on. I just better move up a little bit maybe.

Senator PERDUE. A little closer.

Senator HATCH. Okay. I will try. Let me ask this question of Mr. Colón de Armas and Mr. Pollock. I would like to begin by asking some questions about Chapter 9, and my first question is this. How much would extending Chapter 9 to Puerto Rico actually improve the situation on the island? Would it reach enough debt to make

a significant difference? And what about the approximately 70 percent of island debt that Chapter 9 would not reach? If you could take a crack at that, Mr. Colón de Armas and Mr. Pollock.

Mr. POLLOCK. Thank you, Senator. The—Chapter 9 for municipal entities would not reach a lot of the Commonwealth debt. There's another proposal to have the Commonwealth of Puerto Rico itself be able to enter into Chapter 9, a more radical or fundamental idea. In my opinion, as I said, the first step is the control board to clarify the situation.

Mr. Ravitch, maybe we could put a couple members from the Treasury and the Federal Reserve Board on that control board as they get around to approving the plans of the government of Puerto Rico and potentially being able to give instructions to it.

In a banking situation, you don't first put the bank in receivership. You first send in an examination team to find out what the situation really is, give such instructions as you think can save the situation with the least cost to all concerned. And it seems to me that's a fair model for the situation we have with the very troubled and messed up finances of Puerto Rico.

Mr. RAVITCH. If I could add, Mr. Chairman, very quickly, the firm of Conway MacKenzie was retained some time ago to do an independent liquidity study of the financial situation. They have issued 2 such reports. And about a year ago, the Commonwealth, at the urging of some of its counselors, retained a very reputable economist, Anne Krueger, from the IMF, to do a study, and she produced a very exhaustive, thorough study which concluded that the Commonwealth was incapable of meeting its obligations at anywhere close to its current level of revenues. That report is fully available publicly and I think was released last June.

Senator HATCH. We will look at that. Mr. Colón de Armas.

Mr. COLÓN DE ARMAS. Senator, my main concern regarding bankruptcy is what sustains that proposal, and to sustain that proposal, people use the figure of 40 percent debt burden. Well, let me share—share with you some facts.

The general fund budget for this year in Puerto Rico, as approved by the legislature and signed by the Governor, has the proper debt service payments, and those debt service payments represent 15.8 percent of the budget. On a consolidated basis, for the entire government, the debt service burden represents 16.8 percent of the budget. Those are the official numbers. Those are the correct numbers.

Now, the 40-percent figure appears on page 17 of the Working Group report that itself is based on the Krueger report. Now, to reach 40 percent, they selected by their own free will—there is no basis that I know of—they selected particular agencies to include. They did not include revenues from the new increased sales tax. They did not include revenue from the VAT tax that was approved. And from the selected agencies that they chose to put together in the calculation, from that group and the revenues they selected to use, they proved allegedly that the debt burden is 40 percent.

I want to point out for the Committee that the Krueger report, as stated in the disclaimers, was not prepared at the request of the government. It was prepared at the request of counsel. It may be a good document to support a particular legal strategy. I have big

reservations as to whether that report really serves as the basis for sound public policy.

Senator HATCH. Well, Mr. Chairman, if I could just ask one more question, I am very concerned about these issues. We know we have got to solve these problems, and I want to do it in the best possible way. But let me just ask this question. Let's talk about retroactivity. We have heard arguments that extending Chapter 9 to Puerto Rico would be unfair to bond holders because it would reduce their return on their investments. Now, some have argued that any Chapter 9 extension should apply only to future debts.

As an initial matter, it would be helpful to know whether past Bankruptcy Code reforms have applied to existing debts or whether bankruptcy reforms have typically applied only to future debts. Can any of you offer any insight on this matter? And if past reforms have applied to existing debts, have any of those reforms been analogous to what we are considering here, namely, extension of bankruptcy access to entities which previously had no such access? Anybody care to take that?

Mr. SPENCER. Senator Hatch, I will take it. This is a fundamental investor protection issue. Puerto Rican investors, retail investors, bought this debt with the explicit—with the knowledge that Puerto Rico was explicitly precluded from filing for Chapter 9 protection. There is a lot of question about the intentions behind precluding Puerto Rico from Chapter 9. To me it is very clear. There was a—an investor protection issue that went along with a unique benefit that was given to Puerto Rico. Puerto Rico Congress gave Puerto Rico the unique benefit of being able to issue debt tax-free in every State in the Union. But they gave an important protection to these investors, the retail investors, in that debt in the form of preventing Chapter 9 from—preventing Puerto Rico, rather, from using Chapter 9. You can't separate the protection from the benefit. Those two go hand in hand, and that would be pulling the rug out from underneath retail investors throughout the country.

Senator HATCH. I understand. Now, look, there has been a lot of discussion in Congress both about Chapter 9 and about the possibility of creating a financial control board for the island, which has been mentioned here. Are there any other ideas or proposals that Congress should be looking at to address Puerto Rico's financial crisis? Because I am happy to look at anything to help this.

Mr. RAVITCH. Might I, Mr. Chairman, just comment further on Senator Hatch's first question, and that is, there are—have been many instances since—bankruptcy by a municipality is not permitted unless a State specifically statutorily authorizes it. So, there have been the instances in which municipalities have filed have come after States have—in some cases subsequent to States having authorized it.

When Governor Snyder appointed an emergency manager, not to be the equivalent of a bankruptcy judge but merely to assume the fiscal powers of the city incident to submitting to a bankruptcy court a plan of adjustment, that is very different from what had been otherwise described here. And, second of all, that the buyers of over \$3 billion of general obligation debt in the spring of 2014 at a stated return of in excess of 9 percent a year interest rate, which is over 3 times higher than what any government that is run

prudently has to pay in interest costs to run its operation—look, if I may, at the prudent way that the State of Utah budgets, they do not pay 9 percent; they pay less than 3 percent for their money.

And, furthermore, the simple fact is that the amount of money that was lent in 2014, Senator Hatch, was lent without the benefit of having received an audited financial statement from the year 2000, FY 2013. So, the creditors who now assert that they should not run the risk of a restructuring authorized by the Federal Government, nonetheless, without any audited financial statements, lent, as I said, \$3 billion at over 9 percent.

Mr. COLÓN DE ARMAS. Senator, if I may—

Senator HATCH. Thank you. I am sorry I took so long.

Mr. COLÓN DE ARMAS. If I may?

Senator PERDUE. Yes, briefly. Go ahead.

Mr. COLÓN DE ARMAS. Senator Hatch asked for what Congress could do to solve this situation. I think the most important issue is to abandon the myth about Puerto Rico and look at the facts. Take, for instance, the tax-related proposals. Puerto Rico is not part of the U.S. Tax Federal system, so you need to be careful. Many of the proposals being toyed around with are not going to help Puerto Rico, EITC and all those. But the benefit to Puerto Rico from those proposals is limited because we are not integrated into the tax system.

What Puerto Rico needs in terms of economics is more investments. We need to improve our water storage and distribution system. We need to improve our energy generation capacity. We need to improve our transportation infrastructure. We need to improve the business climate on the island. If I wanted to work on what is best for the economy of Puerto Rico, those are the areas that I would target. Health-related funds are important, and it is a fairness issue. Many of the issues that are discussed are issues that are not really economic in nature. They are issues that are camouflaged as economic arguments but are really political in the end. So, solving the status could also be helpful in eliminating those discussions.

Senator HATCH. Well, thank you.

Mr. POLLOCK. Senator Hatch, may I answer your question about are there other possibilities? There is one other possibility, of course, and that's a bailout. You just give troubled debtors more money, and in these situations, you can either restructure debt under some form of governance. You can restructure the government, the budgets, the control, the financial management. And you can provide money. And I think the comment that it is a political discussion is quite true. It is what is the governance under which these decisions are being made, and in my view, as you know, of course, the control board is the superior governance mechanism.

Senator PERDUE. Thank you. Senator Blumenthal.

Senator BLUMENTHAL. Thank you. Let me pursue the thought that you just raised, Mr. Pollock. I think all of the witnesses here agree that the current story ends well for no one. The status quo is unacceptable. The current situation is unsustainable. You are very direct in saying that Puerto Rico is broke. That is the classic definition of insolvency. So, I take it you would disagree with Mr. Spencer that—that the Commonwealth can continue paying its

debts—I know that I am summarizing his testimony—continue paying its debts by taking the measures that he suggests.

Mr. POLLOCK. Thanks, Senator, and may I start by saying thank you for quoting Pollock's Law of Finance in your opening statement, that loans which can't be paid won't be paid. The question is, which loans are those of the many debtors? To what extent can't they be paid or can they be paid? I don't think we know the answers to those yet, and I think we ought to put ourselves in the—in the position to know it.

The government—my precise statement was the government of Puerto Rico is broke, and I think it's true that under its current operations, with its current management, it can't pay its debts. It is an open question yet whether with serious reforms and improvements in discipline and management that couldn't be much improved.

Senator BLUMENTHAL. And, in fact, Mr. Spencer, as you know from your experience with bankruptcy court, the first judgment that a bankruptcy court has to make is, in fact, whether the petitioner is insolvent. In fact, I tried a bankruptcy case in which the city of Bridgeport sought Chapter 9 protection and was denied it. The State, which I represented, in fact, opposed the bankruptcy filing, and the bankruptcy court denied it after a trial in which it concluded that the city of Bridgeport, in fact, was not insolvent.

So, if your concern is legitimate factually, why can't the bankruptcy court simply make that determination?

Mr. SPENCER. You are correct that the bankruptcy court makes a fundamental determination—

Senator BLUMENTHAL. And so, why not give Puerto Rico the opportunity to have access to the bankruptcy court that could make that determination and, in fact, consider the interests of the investors whom you represent as well as the obligor, the Commonwealth of Puerto Rico?

Mr. SPENCER. Senator, because I have a fundamental problem with Chapter 9. There is a perception that Chapter 9 is very similar to Chapter 11, that is a fair and equitable forum for dispute resolution. It's not. Chapter 9 fundamentally gutted protections, important creditor protections. Everything that Chapter 11 does so well, balancing the interests of debts and creditors, Chapter 9 got horribly wrong. And that is the reason—

Senator BLUMENTHAL. Well, you may have—

Mr. SPENCER [continuing]. It is not a fix for Puerto Rico.

Senator BLUMENTHAL. And I apologize for interrupting you, but under our rules my time is limited, so I am trying to elicit as much testimony as I can. And I understand your criticism is of Chapter 9 generally. But if we're going to extend Chapter 9 for public policy reasons to municipalities generally, isn't there an argument based on consistency that we also give municipalities and governmental entities in Puerto Rico the same kind of access that other municipalities have?

Mr. SPENCER. Well, again, Senator, Puerto Rico was explicitly precluded, and it's not a State, and more fundamentally to bankruptcy, Chapter 9 solves nothing. It hurts retail investors throughout the country, and, importantly, it keeps Puerto Rico on a path to an eventual Federal bailout.

Senator BLUMENTHAL. Let me turn, in the time that I have left, to Mr. Ravitch. You made the point, and I think it's a valid one, that under our Constitution, States are precluded from, in effect, access to bankruptcy protections such as Chapter 9. I take it that argument would not apply to a territory. Is that correct?

Mr. RAVITCH. As I testified, because of Article IV of the Constitution, yes, sir.

Senator BLUMENTHAL. And so, a territory like Puerto Rico would not be precluded by the Constitution from—

Mr. RAVITCH. That is correct. And I don't think there is any disagreement. I know the scholarship that is published on this subject. I don't think there is any disagreement with that.

Let me say, if I may, Senator, in response to what Mr. Spencer said, number one, the people who worked for the Puerto Rican government and expected that their promise to receive a benefit on their retirement in their old age also perhaps relied on the fact that there would not be a bankruptcy authorization. It's not just—there's not only one kind of obligee, the people who want cash. And, second of all, with all respect again, the interest rate in Chicago did not go up because of Detroit. It went up because the State in its wisdom decided to reduce its income tax revenues by 40 percent in an effort by the mayor to get—a modification of pension benefits failed in the highest court of Illinois. And, therefore, with \$100 billion underfunding of its pension system, its credit rating went way down. That's why Chicago's interest rate went way up.

Senator BLUMENTHAL. Mr. Chairman, I would just like to ask that the testimony of Mark Zandi be entered in the record. It is written testimony. And he points out, by the way, that in the last 13 years—in other words, since 2003—the public—number of public employees, State and local, has been cut by 25 percent. I think that kind of cut over a little more than a decade is unprecedented. Mr. Carrión has pointed out that hundreds of thousands, I believe, have been cut just in the last 2 or 3 years. So, these cuts are ongoing. They have been made. Thank you.

Senator PERDUE. It will be added, without objection.

[The prepared statement of Mark Zandi appears as a submission for the record.]

Senator PERDUE. Senator Lee.

Mr. COLÓN DE ARMAS. Mr. Chairman, may I address the issues that Mr. Blumenthal raised?

Senator PERDUE. Certainly.

Mr. COLÓN DE ARMAS. Mr. Blumenthal asked a question about couldn't bankruptcy court make the determination of insolvency, but that is a statement made from the perspective of a budgetary problem and the point of view of bond holders.

From the point of view of Puerto Rico and what is best for Puerto Rico, just petitioning to bankruptcy court, we lose. And the important thing from Puerto Rico's standpoint is restore access to financial markets. If we get to bankruptcy, even if we simply file, we are not helping Puerto Rico at all.

Senator BLUMENTHAL. The only point I would make, sir, if I may, with all due respect, Puerto Rico has already, in effect, petitioned for bankruptcy by seeking officially and publicly that it be given the opportunity to do so, leaving no doubt that it would if it had

that legal authority. So, I understand your point, but I think that that horse is out of the barn.

Mr. COLÓN DE ARMAS. Well, but if I may, we have an economic crisis and a fiscal crisis. The liquidity crisis that is also mentioned has nothing to do with the fiscal and economic crisis. The liquidity crisis is a self-inflicted problem because of exactly what you mentioned. Because Puerto Rico is petitioning for the right to go to bankruptcy court, because Puerto Rico is finding ways of not complying with its debt commitments, we have been closed from the financial markets, and that is the liquidity issue that is self-inflicted.

Senator PERDUE. Thank you. Senator Lee.

Senator LEE. Thank you, Mr. Chairman. Thanks to all of you for being here.

Mr. Spencer, I would like to start with you, if I could. Talk to me about what you think about the possible constitutional impediments to Congress extending the availability of Chapter 9 background to States. What constitutional impediments would there be to that type of action?

Mr. SPENCER. First of all, let me preface my remarks by acknowledging I'm not a constitutional scholar or even a lawyer. I—I approach this from the perspective of a practitioner, so my—my issue with Congress extending Chapter 9 to Puerto Rico is not rooted really in constitutional law issues.

My issue with extending Chapter 9 is two-fold. One, it's not a fix for Puerto Rico; and, two, as you have heard, I have fundamental issues with Chapter 9 as a statute. What—in my practical experience in municipal restructuring, Congress erred when it gutted—when it passed Chapter 9, a law that gutted fundamental investor protections. That introduces a tremendous moral hazard for municipalities that want to use it.

So, I don't know if I answered your question, but those are my principal concerns.

Senator LEE. I appreciate that. That's helpful insight. Mr. Ravitch, why don't you chime in and answer the same question? What constitutional impediments do you see that would exist?

Mr. RAVITCH. The 11th Amendment to the Constitution, which says a Federal court can't have jurisdiction over a dispute between a citizen of one State and another State, and that, by definition, would be if a State were able to file, some of the creditors would be from other States. And that's why legal opinion has always said States can't file, despite, as I said, the arguments that have been made by Jeb Bush and—and if you would care to have a copy of it, I happen to have it with me and would be glad to share it with you.

Senator LEE. It is the 11th Amendment. It is all the 11th Amendment. There is not—

Mr. RAVITCH. Yes, sir.

Senator LEE. Okay. Thank you. Mr. Colón de Armas, you referred to 2 things that you state are necessary steps to take to revitalize Puerto Rico's economy. One involves government cutting spending, and another involves increasing investments, public and private, in Puerto Rico. In your opinion, how would extending Chapter 9, either little Chapter 9 or Super Chapter 9, to Puerto

Rico affect those essential elements of economic recovery in Puerto Rico?

Mr. COLÓN DE ARMAS. Well, I alluded to in my testimony to the situation in the water crisis. That was the best example that I can think of. We have excess water in Puerto Rico, but it is not well distributed.

Senator LEE. On the west side of the island.

Mr. COLÓN DE ARMAS. Right. In the middle of this fiscal crisis, we had a drought situation in the metro area. Some areas had limited service of water for 5 days a week. And in the middle of all this, the Puerto Rico Aqueduct and Sewer Authority, which has the finances to go to bonds, to the bonds market, was working on a bond issue, because the government filed a brief to the Supreme Court defending the bankruptcy local law. They had to cancel the projects. They had to cancel the bond issue. And the solution to the water crisis was solved with rain in this day and age. We couldn't make the investment in infrastructure. We couldn't solve one of the most essential services for people—water—because the strategy selected by the government of Puerto Rico closed access to financial markets.

Bankruptcy, to answer your question directly, would deter Puerto Rico from financing, and if you deter Puerto Rico from financing, you are not able to make investments.

Senator LEE. I would imagine, by the way, that those most affected by that 5-day water crisis were not the wealthy. Those most affected were likely—

Mr. COLÓN DE ARMAS. I feel it was the whole metro area. It was widespread.

Senator LEE. Well, thank you. That is helpful. Would—I will extend this question both to you, sir, and also to Mr. Spencer, whoever wants to answer it. Would extending any iteration of Chapter 9 to Puerto Rico, if you were to do that, what impact would it likely have on the negotiations between bond holders and major public corporations such as PREPA?

Mr. SPENCER. I'll start. I think the agreement, the—the restructuring support agreement that we were able to reach in PREPA, happened precisely because Puerto Rico did not have access to Chapter 9. Had it had access to Chapter 9, we would not have reached that accord. I believe that if it is extended now, not only will it jeopardize the—there are many execution steps left that the deal will not close until sometime Q2 this next year. I believe it will jeopardize concluding and closing that deal. And I believe it will jeopardize the negotiations that are already ongoing between a substantial component of the island's major investors and the island itself.

If the island is negotiating in good faith with us, right now we will continue to negotiate in good faith with it, and I have every confidence that that will yield a constructive result for the island.

Mr. RAVITCH. Senator, may I respond briefly to that? The filing of bankruptcy would produce an orderly negotiation and discussion as to how to settle the fact that the Commonwealth doesn't have the ability to pay all its debts. The absence of a bankruptcy authorization wouldn't mean that the debts would be paid. It would mean that there would be endless acrimonious litigation in the courts in

New York and in Puerto Rico with a resolution that during which the liquidity problem of the Commonwealth would face would be overwhelming. And in New York's case, a matter, hopefully, of interest to you, it was the power to file bankruptcy that gave us the ability to leverage our negotiations with both the unions and the banks. But we, nonetheless, had a liquidity crisis, which is why a month after President Ford had announced that the Federal Government was not going to help New York, the choice was if we filed bankruptcy, we could get debtor in possession financing. And it was the view of the financial world that even the mere filing, regardless of what the consequence, would injure New York as the financial center of the world. It was at that point that Secretary Simon decided that the Federal Government would provide that liquidity with a fully secured program under which the Federal Government was guaranteed of repayment. So, that was because the only way you could get the other financing was by filing.

Mr. SPENCER. Senator, I would like to respond to that just briefly. With respect to Mr. Ravitch, I advised the single largest creditor in the city of Detroit's bankruptcy. Detroit wasn't a bankruptcy. It was a stick-up. And—because there were, again, fundamental creditor protections that are absent in Chapter 9. And, again, with respect to Mr. Ravitch, New York, DC, other cities have all done this outside of Chapter 9. I understand that threat. The markets understand that threat. But it is a threat that is counterproductive from the standpoint of long-term sustainable fiscal recovery for the island.

Mr. COLÓN DE ARMAS. If I may—

Senator PERDUE. Mr. Carrión.

Mr. CARRIÓN. I just want to interrupt, and I am sorry. I am a banker. I like people to pay their debts. What I say I don't say lightly. But let us bear in mind that the money will run out. And I think that is the key point I wanted to make. The money will run out. I am all for trying to do voluntary restructurings. There is just not enough time. The money will run out. The debt will start not getting paid, and there needs to be the three things that I mentioned. There needs to be some regime, some forum to balance the interests of all the affected stakeholders. There needs to be some kind of fiscal oversight board. And there needs to be—above all, there needs to be stimulus to the economy.

Senator PERDUE. Professor, I will come back to you. I still have reserved my time, so I will give you a chance during my time. But I want to honor Senator Durbin. You have been very patient here, Senator Durbin.

Senator DURBIN. Thank you very much, and thanks for your testimony today. I want to acknowledge that I'm receiving counsel on this from Luis Gutierrez of Chicago, as well as Nydia Velasquez I see in the audience here, my former colleague from the House, and Jose Serrano, who I also notice is here. And I apologize if I've met others, but we are in constant communication about this situation.

I'm trying to put this in a broader perspective, and we start with the premise that our relationship with the island of Puerto Rico is unique. We do not have anything quite like that anywhere else in the world, and we have a special relationship with Puerto Rico and the people who live there and many who come to the United States

and become citizens and full participants in our political process. And I am trying to find some way to balance that political reality, that unique political reality, with the challenges that we face today.

People have talked about what are the options. One option that someone mentioned is bailout. What if we just came in there and rescued Puerto Rico? I don't think that is going to happen. I have to tell you, as I listened to the budgetary debate here in Congress, I don't think there is an appetite for that. And versions of it, including reimbursement for Medicaid, Medicare, EITC, are a form of helping Puerto Rico get on its feet, but it will be, in fact, a painful process here on Capitol Hill.

There are others who argue that we should—I think the Governor said the reality, and reflected by Mr. Carrión, is that if we go to default, we go into depression, and things will get progressively worse. We do not want that to occur.

When I look at Mr. Colón de Armas' argument, the Wall Street Journal argument, that it really isn't as bad as it appears, that it is only 17 or 18 percent, and a little belt tightening and we can see our way through this, Moody's does not agree with you on that, and I do not know that they have any particular special personal interest. They do have a reputation for a lot of people who follow their ratings as to whether they are being honest, and they have said flat out it is 40 percent in a publication which we have here. So, they kind of dispute your premise about 18 percent as they get into it.

As I see it, that austerity, which is being preached by those who say it's not as bad as you think, is going to create, we know, further exodus from the island. People are going to leave if they can't, in fact, survive, if there are not jobs, if there are not basics in terms of essential services.

Then there's this issue of the control board, and I have heard Mr. Pollock and Mr. Ravitch and others talk about this control board and our experiences with it in the past. And I think what you've said, Mr. Pollock, is control boards sometimes lead to bankruptcy—Detroit—sometimes don't lead to bankruptcy—Washington, New York City. So, it could happen; it might not happen.

I would go to Mr. Carrión because I have listened to you carefully, and I understand, as you said earlier, as a banker it is painful for you to stand here—sit here and give us advice about not paying debts. But do you see this combination of control board and recommendation, yes-no, on a bankruptcy regime as a potential avenue?

Mr. CARRIÓN. Again, Senator, it is truly painful to sit here because I am ashamed that we have let it go this far. This is the product of many, many decades of mismanagement. I will tell you that a control board is necessary but not sufficient to solve the problem. I think we need to have some kind of regime to balance all these different interests. The pension issue has not come to the fore yet, but it will. The funds will run out in the next 18 to 24 months. And ultimately there needs to be some stimulus.

So, it is a three-legged stool, if you will, that all three things are needed—not two, not one of them by itself.

Senator DURBIN. By three, you mean control board—

Mr. CARRIÓN. Control board, some kind of bankruptcy regime—

Senator DURBIN. Chapter 9.

Mr. CARRIÓN [continuing]. And economic stimulus.

Senator DURBIN. Economic stimulus.

Mr. CARRIÓN. Yes.

Senator DURBIN. There are some who have expressed concern that if there is not a bar or prohibition on subsequent filings under Chapter 9, the island, the nation, Puerto Rico—

Mr. CARRIÓN. I would hope we would never be in this position again. I would have no problem with a bar on subsequent filings.

Senator DURBIN. Mr. Spencer, you represent the bond holders who have a lot at stake here, and if you knew that there was a prospect of this outcome, control board and potential Chapter 9 filing, do you feel there would be an effort underway by the bond holders to negotiate a better ending?

Mr. SPENCER. Again, I am somewhat ambivalent or maybe even a little conflicted on the issue of control board. There're two central issues in any control board. One is the composition of the board, and the second is the scope of powers. I don't know what is being proposed here, so I guess I would have to reserve judgment until I know exactly what is being proposed.

But further to your prior question, Senator Durbin, I wanted to address in case there is a perception that we don't think the economic situation is serious. That's not true. We do understand. That's one of the reasons that motivated the constituents I represent to provide meaningful debt service relief to PREPA.

The question, I think, though, is, does making Puerto Rico a financial pariah, which will most assuredly happen if they get Chapter 9 and they use it, does that help in terms of the long-term recovery interests of the island? I would point you again to Detroit. The premise there was if they purged significant debt obligations, the city on a post-reorganized basis would return to the capital markets and be able to borrow on a regular basis. I agree with Mr. Colón de Armas that one of the things that is needed—and really other members of the panel here—is investment capital to stimulate a recovery on the island.

Senator DURBIN. Mr. Spencer, let me ask, you use the word “pariah.”

Mr. SPENCER. Yes.

Senator DURBIN. And you use “bankruptcy pariah.” Wouldn't you also be able to say “default pariah?”

Mr. SPENCER. Exhibit A, Argentina. We do not want Puerto Rico to be the Argentina of the Caribbean. I don't think it needs to happen, and I don't think it is productive from a long-term recovery standpoint.

Senator DURBIN. Well, I think the situations are different, substantially different.

Mr. SPENCER. Admittedly.

Senator DURBIN. And I think Puerto Rico is in a weakened state—economic state and has been for a number of years, and I am trying to figure out a way to move, as Mr. Carrión and others are, to move us to a point where there is at least stability so people want to stay and invest their lives in the future of Puerto Rico.

That to me has to be an ultimate goal for the good of that nation and our relationship.

Mr. SPENCER. One of the overlooked ironies of municipal bankruptcy is that the long-term recovery interests of the bond holders are very closely linked to the residents of any municipality, including the island of Puerto Rico. We need to see that happen as well, and we are looking for ways to make it happen.

Senator DURBIN. Thank you.

Mr. RAVITCH. Senator, may I, a fast observation on this?

Senator DURBIN. If the Chairman allows it.

Senator PERDUE. Absolutely. Go ahead.

Mr. RAVITCH. First of all, the control board did not come into effect until after the plan of adjustment had been approved by the bankruptcy court in Detroit. So, the control board didn't exist beforehand. What was created under Michigan law was a special provision to entitle the Governor to appoint an emergency manager because the government of Detroit was not deemed to be capable on its own hook of coming up with a plan to adjust.

Second of all, it wasn't just the bond holders whose debt was cut back. The health care liabilities to the employees of the city of Detroit were cut by billions of dollars in the bankruptcy, and the pension was saved only because of an extraordinary exercise by the business community in Michigan, which contributed \$400 million, and at the Governor's request, the legislature appropriated another \$400 million. And that was the basis on which the pension—the retirees got money, and there were 23,000 of them, and they weren't even eligible for Social Security because the State of Michigan had waived Social Security. So, I think an examination of the Detroit bankruptcy would—would certainly—and Governor Snyder I think would have a very different view of it than Mr. Spencer.

But I would only say that I think with all respect that the choice that Congress has here is a default with years of litigation—as I said, just because you can't file bankruptcy doesn't mean you are going to pay your debts. And the Governor made it very clear in June when he made public the assertion that they did not have the capacity to pay their debts.

So, the question is whether it is done in an orderly fashion under the jurisdiction of a Federal judge and a bankruptcy process with all the requirements that that entails, constitutionally and statutorily, or whether it is done, as I said earlier, chaotically without any structure at all.

Mr. COLÓN DE ARMAS. Mr. Chairman, if I may, there was a comment made about something I said earlier, and I wanted to clarify.

Senator PERDUE. Please, go ahead.

Mr. COLÓN DE ARMAS. Senator, you pointed to the Moody's report, which I have right here with me. As I mentioned earlier in my testimony, Footnote 3 of that document, the reference that they used is a Working Group report. And I explained to you how that Working Group report is based on selective information at best.

Now, I am a professor of finance. I prefer to live in academia, not in politics. And the reason I do that is because, in academia, I show that with the evidence. In politics, it is not as such.

I was talking to a friend last night, and I was saying, you know, my challenge tomorrow at the hearing, I have the facts, they are

not my facts; I have official documents, audited statements, the ones available, official numbers from the planning board, and I know what the facts say. But you don't know me. Anne Krueger is a respected person in economics. Moody's is a respected person in economics. I assure you in my Corporate Finance Ph.D. class, we examined the scientific evidence, and part of that evidence talks about how analysts in financial markets don't stand a chance in terms of how they perform the analysis.

But, again, you are bound to trust Moody's. I understand. The scientific evidence questions their judgment. But the facts are not what they are saying there.

Senator DURBIN. Thank you.

Senator PERDUE. I just have—we are trying to finish by around noon, to be respectful of your time as well. We really appreciate your time today. I know Senator Blumenthal has a question or two left, but I wanted to ask just a couple myself.

I've been interested in Puerto Rico since I recognized the potential there, the economic potential of that part of the world. I've been involved in Puerto Rico since the 1970s, and I was involved in major economic development work in Aguadilla, Mayaguez. I actually learned to surf in Rincon, but we will talk about that another day.

I am very concerned that today we are talking about—and, Mr. Carrión, I agree with you. The potential there is unlimited, but we're—this is not a crisis that just came up in the last year or two. It has been coming for decades. I remember in the 1970s, we talked about economic development around water and power and labor and infrastructure. Here today we had those same four quoted today, talking about how to get the economy going there.

I am really concerned that whatever we do here, we end up with Puerto Rico's ability to access capital, because without that, as we have all said, there is no future economic development. With that, you have to maintain confidence in the markets where it comes from. So, that is my driving motivation as just one member up here.

Mr. Pollock, I would like to have you just talk a little bit more about your experience with this control board, authority, whatever—however we are going to characterize that. I know it has been done several times—the District of Columbia, you guys mentioned New York Municipal Assistance Corporation back in the '70s. Talk to us about the applicability of that here. What were the deficits that were mentioned earlier? I think, Mr. Ravitch, you mentioned some of the problems that we had with those earlier. Can you talk to us about how that would potentially be an alternative here?

Mr. POLLOCK. Thanks, Mr. Chairman, and I think you are absolutely right that the economic problems have been long developing and have basically, in my judgment, come from a government-centric as opposed to a market-centric approach to the development of Puerto Rico, which was a huge long-term mistake which we should not repeat.

The other cases I think are very interesting. I discussed three. Of course, they are all different in different ways, but they are all the same in that you have a public entity which has overbor-

rowed—overborrowed. In the case of New York City, it actually did default on its debt, on its short-term notes. In all cases, you had a series of deficits leading to financing of financing of deficits by debt and just borrowing to spend current money, as I said in my testimony. And in all cases, you had to come in with a different governance structure to get control, first of all, of what the facts are and, second, what the decisions are.

As Secretary Simon, who was earlier cited, said after the New York experience, by forcing the issue in New York they made the city of New York and the State of New York make decisions which they otherwise never would have made. I think that is also likely to be true of what would happen in Puerto Rico under—under such a structure.

In Detroit, as was correctly said, the first step was an emergency manager. An emergency manager under the law of the State of Michigan has extremely wide fiscal and political powers that have been quite controversial. That was the first step which then indeed did lead to bankruptcy but was very important, the emergency manager, in getting control of what the situation was.

And in Washington, which is relevant because it is, as I said, not a State and, therefore, directly subject to the jurisdiction of Congress, without the intervention of the sovereign Federal State, you had what I think of as a very interesting bipartisan process which structured the control board. They had two outstanding chairmen of this board, Andrew Brimmer and Alice Rivlin. I think the point is right about who is on the board is essential. You would want an outstanding chairman, as Washington did. You have to think a lot about the representation, and that's extremely important, and the various powers. But it has to be, in my view, a fairly powerful board, and I will just mention one particular power that Washington had, which I think might be repeated for Puerto Rico, and that is, the require—the requirement that the board approve an independent chief financial officer for the jurisdiction, which could be appointed and by the government but approved by the board and not removable by the government so that you get this really independent financial discipline, which in all these cases, in my judgment, is essential.

Senator PERDUE. Thank you. Mr. Ravitch.

Mr. RAVITCH. A correction. New York never defaulted. The Municipal Assistance Corporation was created in early June 1975 to deal with the fact that the city of New York has, as the Commonwealth of Puerto Rico has, improvidently borrowed to cover its operating deficits. New York had \$8 billion of short-term debt maturing, and there was no way whatsoever New York could pay it.

So, the first step, which was not imposed by anyone in Washington but was suggested by the Governor and the legislature, was to create the Municipal Assistance Corporation. And the sales tax and stock transfer tax that was collected by the city of New York was taken away from the city of New York and pledged to the holders of the long-term MAC bonds. So, the general obligation debt of the city of New York was impaired by removing from the city a great deal of the city's revenues, and the financial community did not object to that at all.

The control board was not created until September of that year, and that's because there continued to be a great deal of reluctance on the part of both the financial community and the union pension funds to invest in the MAC bonds without a tougher set of discipline over future budgets and future expenditures and future collective bargaining agreements. But there was never a default.

Senator PERDUE. Thank you. Senator Blumenthal I think has a few questions.

Senator BLUMENTHAL. Thanks. Just a—just a few final questions, and I really want to thank all of you for your patience and your contribution. It has been very valuable.

Mr. Carrión, you referred to the fact that the money will run out. The simple stark fact is the money has run out. That's the reason that the Commonwealth has resorted to the extraordinary financial gymnastics—some would say “gimmick”—of clawing back money to pay its ongoing obligation to avoid default. Am I correct in that judgment?

Mr. CARRIÓN. That is correct, and I think “gimmick” is probably a more appropriate word than “gymnastics,” yes.

Senator BLUMENTHAL. And you live on the island.

Mr. CARRIÓN. I do.

Senator BLUMENTHAL. You have skin in this game.

Mr. CARRIÓN. I do.

Senator BLUMENTHAL. And I think you would agree with me that Puerto Rico is an extraordinarily beautiful and bountiful, well-resourced island with hardworking people who, through no fault of their own, face a potential human calamity.

Mr. CARRIÓN. That is correct, Senator, and that is why I am here.

Senator BLUMENTHAL. And, in fact, Puerto Rico has immense future potential for development.

Mr. CARRIÓN. I do believe that profoundly. I think we have great potential. We need to address this issue and make sure it doesn't happen again.

Senator BLUMENTHAL. So, like New York City, which now is prospering in one of its most financially prosperous eras, at least in recent history, Puerto Rico has that same potential to regain its financial health and, in fact, prosper.

Mr. CARRIÓN. I believe that, yes.

Senator BLUMENTHAL. But to do so, it really needs to avoid the chaos, financial chaos and human chaos, that would ensue from the inability, in effect, to function. It's not just to pay its debts. It's to function as a society and a civilized entity. Am I correct in that?

Mr. CARRIÓN. Yes, and as has been said here, that ability must go hand in hand with some guarantees that this will not happen again, and that's the reason for some type of oversight or control board, together with—with some efforts to start increasing private investment into the island.

Senator BLUMENTHAL. So, it is a kind of quid pro quo.

Mr. CARRIÓN. Absolutely.

Senator BLUMENTHAL. A control board is a necessity or a condition for the extension of bankruptcy protection.

Mr. CARRIÓN. Yes. This should not be a freebie. It needs to have some pain associated with it, yes.

Senator BLUMENTHAL. And you were not initially a—a supporter of Chapter 9 protection. Am I right in that view?

Mr. CARRIÓN. That's correct. As I mentioned earlier, I am a banker. I am usually not in the position of lobbying for bankruptcy laws. But I have very reluctantly examined this issue over the past few months and have looked at the cash situation and have, again, reluctantly and with a profound sense of shame, come to the conclusion that this is necessary. And, you know, I am sorry about it, but it has to be done. We have to start again. Some regime to sort out all these competing claims needs to be put in place. Some type of board to oversee the spending and the revenue projections has to be put in place, and hopefully some economic stimulus has to be added to the process.

Senator BLUMENTHAL. Because the alternative, as Mr. Ravitch has said so well, is endless acrimony, litigation that only enriches the lawyers. It doesn't create wealth for anyone else.

Mr. CARRIÓN. Unfortunately, we can't go long on law firms, but I think that's correct, and it's very difficult to project what dynamic that would unleash.

Senator BLUMENTHAL. And I am a lawyer. I don't begrudge my profession financial—

Mr. CARRIÓN. Well, nobody is perfect.

[Laughter.]

Senator BLUMENTHAL. Just so, I do not offend anyone here, you are all honest, all you lawyers here. But if we can save money for the people of Puerto Rico—

Mr. CARRIÓN. Absolutely.

Senator BLUMENTHAL [continuing]. The 3.5 million Americans who live there, all the better, and assure that Puerto Rico does not become the Argentina of America, in effect. It's not of the Caribbean. The threat is that it becomes the Argentina of America.

Mr. CARRIÓN. Yes.

Senator BLUMENTHAL. Thank you.

Mr. CARRIÓN. Thank you. Thank you, Senator.

Senator PERDUE. Professor, I cut you off earlier, and I reserved a few minutes for you. We have run over just a minute or two, but I would like to give you the opportunity, if you would like to respond to that earlier question.

Mr. COLÓN DE ARMAS. Yes. First of all—

Senator PERDUE. Could you turn your mic on? Thank you.

Mr. COLÓN DE ARMAS. First of all, thank you. On these last comments, Senator Blumenthal, you gave us a nice, heartwarming narrative. If it only were backed by the evidence, it would be excellent.

But my earlier point was regarding negotiations, and people have made a big deal about the fact that many bond holders have shown willingness to negotiate. We have to be careful about that because, remember, in my stand—from my standpoint, I look at what is best for Puerto Rico, not necessarily the bond holders. A hedge fund will find great advantages to negotiations, because for a hedge fund, a negotiation is a way to make a profit, realize a profit on bonds purchased at a steep discount.

A regular bond holder, a regular investment fund, widows and orphans, a negotiation is a way to cut their losses and run away

from Puerto Rico. The key question is, will they ever buy a bond again from Puerto Rico?

For a politician, a negotiation is excellent because it is a way to save cash in the short term to see if you can get to the next elections.

Puerto Rico is a long-term project. What is important to me is that we protect the viability of Puerto Rico for the long haul. For the standpoint of Puerto Rico, we need to make decisions based on the correct data. We need to change strategy, turn around that strategy 180 degrees, and correct course. That is what Puerto Rico needs.

Senator PERDUE. Thank you. On behalf of the Committee, I want to thank you for your patience and forbearance today and for your testimony. It has been very helpful.

As always, we will keep the record open for 1 week for the submission of written questions and other materials. If you are approached, please respond accordingly. And, again, thank you so much.

The Committee stands adjourned.

[Whereupon, at 12:07 p.m., the hearing was adjourned.]

[Additional material submitted for the record follows.]

**Prepared Statement by Senator Chuck Grassley of Iowa
Chairman, Senate Judiciary Committee
Hearing on "Puerto Rico's Fiscal Problems:
Examining the Source and Exploring the Solution"
December 1, 2015**

Good morning. The purpose of today's hearing is to learn more about the origin of Puerto Rico's fiscal problems, and what's needed to help restore fiscal balance and economic growth. It's my hope that we'll have a valuable discussion based on facts, and informed by our witnesses' expertise.

Puerto Rico's debt crisis didn't happen overnight. It's been years in the making. Fundamentally, the starting point for any solution is to first identify the problem and understand its size and scope. Unfortunately, confusion reigns as Puerto Rico has failed to provide audited financial statements for the past two years.

What we do know is that for many years as Puerto Rico's economy suffered, debt and spending increased to the point where the Island lost investor confidence. Puerto Rico has defaulted on certain debt obligations, lost access to the normal markets, and now faces a liquidity crisis. The Governor and others have stated that the Island's current debt "is not payable."

Puerto Rico's economy has suffered for decades in part because of barriers to job creation and labor force participation. The federal minimum wage mandate, generous entitlement programs, bureaucratic red tape, and a bloated public sector have stifled business activity. This has a direct impact on Puerto Rico's residents, who are our fellow U.S. citizens. High unemployment rates have resulted in a declining population as Puerto Ricans have left the Island in search of jobs. A diminished population means lower tax revenues to fund government spending.

Despite these long-term economic challenges, for many years Puerto Rico maintained a balanced budget and high credit ratings on its debt. What, then, led to the fiscal crisis the Island faces today? While the economic challenges may be debatable, it's clear that since 2000, Puerto Rico's public debt has risen from 60 percent of GDP to now more than 100 percent. This is an indication of serious fiscal mismanagement.

Thanks to the highly attractive triple-tax exempt status of its bonds, it was easier for Puerto Rico to borrow and paper over deficits, rather than address financial shortcomings and economic realities in order to balance its budget. The consequence of this decision is an accumulation of approximately \$72 billion of debt, arising from roughly 17 different debt issuers. This includes more than \$18 billion in constitutionally protected general obligation debt. And, also around \$24 billion in debt issued by public corporations, like the Puerto Rico Electric Power Authority (PREPA).

Moreover, because of its triple-tax exempt status, a wide array of investors own Puerto Rican bonds. According to Bloomberg, Puerto Ricans alone hold \$20 billion of the debt. And nearly 60 percent of Puerto Rico's debt is held largely in the individual retirement accounts and 401(k)'s of regular folks throughout the U.S. I'm told that approximately 16,000 Iowans are

invested in funds that hold PREPA bonds. These folks aren't vultures. They're middle-class Americans who probably knew little about Puerto Rico's finances. They simply invested in one of many tax-exempt municipal bond funds containing Puerto Rico's bonds.

Notwithstanding all of this, we're told that Puerto Rico's debt needs to be restructured in order to address its fiscal challenges. Puerto Rico, though, lacks access to an orderly debt restructuring mechanism, like Chapter 9 of the bankruptcy code. Thus, Congress has been called upon to extend Chapter 9 to Puerto Rico's public corporations. Or to create a broad new bankruptcy regime, dubbed "Super Chapter 9," to restructure all debt, including the Island's constitutionally guaranteed general obligation bonds. According to a recent New York Times article, "advisers to the island's government have been urging the governor to default on the debt, saying that only a catastrophe would move Congress – especially Republicans – to help." I hope the Governor will tell us whether this is accurate. It would trouble me greatly if true.

This isn't the first time Congress has been asked to help address a situation like Puerto Rico now faces. In the past, we've provided help in a bipartisan way. During the 1990s, the District of Columbia faced its own fiscal crisis, as it was insolvent and unable to pay its bills. Congress worked with District and Clinton Administration officials to pass the District of Columbia Financial Responsibility and Management Assistance Act in 1995. We'll hear more about the response to that crisis and others from our witnesses today. I'll note that Congress considered extending Chapter 9 to the District of Columbia, but decided that there was "little practical significance or advantage to such a legislative gesture." As the committee report to the bill stated, "the issues facing the District of Columbia . . . require political and structural, as well as financial remediation."

One of the reasons extending Chapter 9 to the District was rejected is because it's designed primarily to restructure and decrease municipal debt. The idea being that relief from creditors is what's needed in order to gain a fresh start. But Chapter 9 cannot bring about financial rehabilitation. It does not increase economic growth or alter the fundamental fiscal trajectory. In short, Chapter 9 cannot address the root causes of fiscal problems, but instead pushes them off to future generations.

As for "Super Chapter 9," this is something that no State can do, and has been described as "unprecedented in the American context." It would be a bad idea, with negative consequences, for Congress to permit Puerto Rico to walk away from its constitutional debt obligations. Unlike other bonds, constitutional debt, whether issued by Puerto Rico or a State, has that government's full faith and credit commitment to repay the debt.

Let's not forget that Puerto Rico issued its bonds with the knowledge that Chapter 9 bankruptcy wasn't an option in the event of a default. Is it fair to retroactively change the rules at the expense of these investors, if other options exist for addressing Puerto Rico's debt problems? At the very least, this is an idea that should be at the end of the line, not the front.

The challenges Puerto Rico faces are great and require more than just short-term solutions that don't provide long-term relief. The debt is a symptom of a bigger problem. Merely extending

debt restructuring authority, absent tools to address the fundamental causes of the fiscal problem, is not a long-term solution that will help Puerto Rico.

Puerto Rico has struggled to make the difficult decisions to cut spending and balance its budget. If Congress is to act, then we must ensure that Puerto Rico has the tools to help itself out of this situation. Today's hearing can help us identify what may, or may not, need to be looked at for Puerto Rico to get its balance sheet back in order.

Schumer Remarks for Judiciary Committee Hearing:

“Puerto Rico’s Fiscal Problems: Examining the Source and Exploring the Solution”
December 1, 2015

- Mr. Chairman and Ranking Member, I want to thank you for holding this hearing and the opportunity to speak on this incredibly important issue.
- I am committed to finding a solution to help not just the 3.5 million Puerto Ricans living on the Island today, but the additional 5.2 million living across the United States, including the over 1 million in my state of New York. These are brothers and sisters, sons and daughters, aunts and uncles... worried about the quality of life of their relatives and friends living on the Island. They deserve the peace of mind to know that Americans, no matter where they live -- on the mainland or on the Island -- are Americans and are entitled to the same rights and quality of life *we all expect*.
- We have a basic, American responsibility to answer that call – to aid all American citizens in times of crisis, regardless of where they live.
- Mr. Chairman, here’s the bottom line: the Puerto Rican people can no longer wait. They can no longer wait for Congress to give them the tools they need to address a disastrous financial crisis.
- The situation in Puerto Rico grows more dire each month. I’m sure the witnesses can confirm that. Today, next month, the months after...if we do nothing, it will get worse, not better. They have \$73 billion in debt and they have bond payments coming due without sufficient funds to cover them. This is not a situation where we can stand by and hope that the problem resolves itself.

- Senator Blumenthal and I have put forward a bill, the *Puerto Rico Chapter 9 Uniformity Act*, that many of my colleagues on this committee also support. We believe that providing Puerto Rico the authority to access Chapter 9 protections would be a significant step in the right direction and allow them to begin to climb out of this financial hole.
- But I recognize that there is more that *can* be done and more that probably *should* be done. I have never said that our Chap. 9 bill would be the silver bullet that solves all of Puerto Rico's issues. There is no question in my mind that Puerto Rico does need some restructuring authority, but there is much more that we can do.
- For example, I have introduced legislation to address several aspects of the health care crisis, including issues like Medicaid funding and fairness, appropriate Medicare reimbursement rates and equitable physician payments. The disparities in how the Medicare and Medicaid program treat Puerto Rico are significant and also need to be addressed.
- But today's hearing is focused on what legal authority is appropriate to provide Puerto Rico in order for those on the island to be able to sufficiently resolve the significant debt burden that they face. And importantly, Puerto Rico needs sufficient authority to compel all of the creditors to come to the table and collectively work to resolve this debt crisis.
- I am deeply concerned that if we are unable to address these issues and provide Puerto Rico with sufficient restructuring authority in the very near term, we are more and more likely to see a real humanitarian crisis develop on the Island.

- The Puerto Rican people have already lost access to the capital markets and, should they default on more and more debt payments, it is a real worry that we could see access to public services across the Island – like healthcare, education, and public utilities – become more and more scarce.
- Residents of the Island have already begun to flee their homeland, and if the economic situation worsens, this population shift from the Island to the mainland United States will continue until the only ones left are those that do not have the resources or ability to move.
- The Puerto Rican people can no longer wait. Congress must act now. And I thank my colleagues on both sides of the aisle, not just for holding this hearing but for rolling up their sleeves and seeing what solutions can be agreed upon to address this important issue.

Alejandro J. García Padilla
Governor of the Commonwealth of Puerto Rico
Written Statement
Senate Committee on Energy and Natural Resources
Hearing on Puerto Rico: economy, debt, and options for Congress
October 22, 2015

Chairman Murkowski, Ranking Member Cantwell, and Members of the Committee:

I want to thank the Committee for giving the Commonwealth of Puerto Rico (“Commonwealth” or “Puerto Rico”) the opportunity to participate in this hearing.

Introduction

The plain and simple truth is that, notwithstanding the unprecedented emergency liquidity measures that Puerto Rico has implemented over the last year, the Government of Puerto Rico may run out of sufficient money to meet all of its obligations in the ordinary course before the end of the year and will inevitably have to choose between paying its creditors on time and providing essential government services to the island’s 3.5 million American citizens.

As many of you know, in early 2015 we commissioned a team of world-renowned economists led by Dr. Anne Krueger, the former Chief Economist at the World Bank and First Deputy Managing Director of the International Monetary Fund (IMF), to undertake a comprehensive analysis of Puerto Rico’s fiscal and economic challenges as well as a debt sustainability analysis, the first ever by any administration.

Dr. Krueger’s findings – detailed in a report often referred to as the “Krueger Report” – described that a number of economic shocks have contributed to Puerto Rico’s economic stagnation and that, even with significant and painful reforms to reverse Puerto Rico’s economic trends, large residual financing gaps would persist well into the next decade, implying a critical need for debt relief from a significant proportion of the principal and interest falling due in Puerto Rico in the next several years.

After the release of the Krueger Report I constituted the Working Group for the Fiscal and Economic Recovery of Puerto Rico (often referred to as the “Working Group”) and tasked it with developing the Fiscal and Economic Growth Plan for Puerto Rico. The Fiscal and Economic Growth Plan, which was

released on September 9, 2015, reviews the historical measures taken to increase taxes and reduce expenses; analyzes the current liquidity and fiscal position of Puerto Rico; recommends certain fiscal and economic reform and growth measures, including critical measures that require action by the U.S. Government; proposes to create a financial control board appointed by the governor upon the recommendation of a nationally recognized executive search firm or other independent third party; and identifies significant projected financing gaps (even assuming the implementation of the recommended fiscal reform and economic growth measures) that requires widespread debt relief.

The bottom-line is that Puerto Rico faces a \$28 billion funding gap over the next five (5) years, and serious action must be taken both by the Government of Puerto Rico and the U.S. Government to close that gap. But even if serious action is taken (notwithstanding all the implementation risks of doing so), Puerto Rico will still face a funding gap of approximately \$14 billion over the next five (5) years, which will require substantial debt relief.

Today, however, I would like to focus on three topics. *First*, and most critically, I will discuss the debt crisis that Puerto Rico faces right now, which, if not addressed, threatens 3.5 million Americans with the disruption of essential government services. *Second*, I will address a misconception raised in the Finance Committee hearing on the Financial and Economic Challenges in Puerto Rico related to the availability of current and reliable financial information, which availability should not be used as a justification for failing to take action to solve this imminent crisis. *Finally*, I will provide an update regarding PREPA's ongoing restructuring efforts and the progress it has made and challenges it continues to face.

Debt Crisis

Based on current information, the Commonwealth will have a negative cash balance of \$29.8 million in November 2015. The Commonwealth's illiquidity will only grow worse when a \$355 million debt service payment on bonds of the Government Development Bank for Puerto Rico ("GDB") comes due on December 1, 2015. These GDB bonds are supported by a guarantee from the Commonwealth, and the GDB, which faces its own liquidity crisis, is not expected to be able to make the payment on its own based on current information. Accordingly, Puerto Rico's negative cash balance will swell to \$205 million by year end. And by the end of Puerto Rico's current fiscal year (June 2016), Puerto Rico's cash balance will be further deteriorate to *negative* \$512 million. These numbers are optimistic in that they assume the Commonwealth will be successful in implementing a number of "one-time" liquidity measures (such as continuing

to defer payments to suppliers (the past due amount of which already exceeds \$1.6 billion) and \$291 million of refunds due to taxpayers), measures that simply cannot be sustained without having a material adverse effect on the local economy. As we cannot pay debt service out of a negative cash balance, a default on some of our debt obligations is inevitable.

I stress that, while these sums may seem small in comparison to Puerto Rico's overall indebtedness of \$73 billion plus approximately \$45 billion in unfunded pension liabilities (notwithstanding that we reformed our largest pension system from a defined benefit to a defined contribution plan), a negative cash balance poses an immediate and grave danger to the American citizens living in Puerto Rico. If Puerto Rico is unable to provide adequate assurance of future payment to its suppliers, service providers, and employees, the Commonwealth's ability to provide essential government services to its citizens will be put in severe jeopardy. Police and fire protection, medical services, social services and every other government service on which Puerto Rico's 3.5 million American citizens rely will be at risk. A disruption of essential government services will only exacerbate the massive outmigration of Puerto Ricans to the mainland, which last year reached almost 100,000 persons. The Government's cash crunch has already affected taxpayers, which will see their tax refunds delayed for almost a year, and individuals and businesses who provide essential services to the government, which have not been paid in months. This is and should be unacceptable.

Additionally, while Puerto Rico has done everything in its power to avoid defaulting on its obligations (including reducing its public employee headcount to the 66 public employees per 1,000 persons, which is lower than the U.S. average), when faced with the prospect of either making payments on debt obligations or paying for essential public services, Puerto Rico will have no choice but to default. Nobody wants this, but it is a reality, and the consequences will be grave. With no insolvency regime in place, Puerto Rico's creditors will engage in a classic "race to the courthouse." The Government will be embroiled in countless complex and crippling legal battles that will further drain Puerto Rico of critical resources and prevent it from implementing many of the measures designed to achieve fiscal and economic sustainability. Much of this litigation is likely to be "intercreditor," that is, litigation between and among different groups of creditors seeking to establish the relative priority of their claims, which will have potentially devastating effects on Puerto Rico's access to its tax revenues and therefore on its ability to continue to provide essential services to its citizens.

Notwithstanding this crisis, we have never asked Congress for a bailout, and we are not seeking one today. We ask for (i) access to a legal regime that would allow to restructure Puerto Rico's liabilities in an orderly manner; (ii)

equitable treatment in Medicaid and Medicare funding, incentives to grow Puerto Rico's economy; (iii) reforms that stimulate employment and labor force participation; and (iv) an exemption from the Jones Act (like that of the U.S. Virgin Islands).¹

By taking action on these measures now, you can help prevent the situation from spiraling further out of control.² Waiting will only allow the situation to grow worse and more expensive and difficult for Congress to address down the road. The window to take action to avert an imminent crisis is rapidly closing. The time is now.

Financial Information

It became apparent after the Finance Committee hearing that a misconception about the availability of reliable and up-to-date financial information regarding Puerto Rico's finances and its financial crisis is being used by some commentators as "justification" for not taking action to prevent this humanitarian crisis. The unavailability of reliable and up to date financial information is a "red herring" resulting from disinformation being propagated by

¹ Congress should not allow short-term distress investors who have amassed significant financial stakes speculating that Puerto Rico will be forced to default in the absence of a restructuring regime to drive national policy, particularly at the cost of the futures of 3.5 million Americans. While some of these investors have argued that extending bankruptcy protections would represent a bailout, it in fact does not require the expenditure of a single Federal tax dollar. Nor can distress investors suggest that providing a legal framework would be unfair because they purchased debt with the expectation that Chapter 9 would be unavailable. Instead, Congress already effectively dealt with this argument when it adopted Chapter 9's predecessor provision and made it applicable to both future and existing obligations. Indeed, every purchaser of Puerto Rico bonds was well aware that Congress has the right and authority to make Chapter 9 available to Puerto Rico.

² The costs of not having access to a restructuring regime are already weighing on the island. Specifically, despite reaching a consensual restructuring agreement with holders of nearly \$4 billion of PREPA's debt, PREPA has been prevented from consummating the restructuring transaction by 3 institutions that are holding out. With no debt-adjustment regime in place, PREPA has no mechanism by which to bind these hold-outs to the will of the majority. Failure to consummate this transaction will not only mean that PREPA is unable to restructure its overwhelming debt burden, but will also prevent PREPA from going forward with plans to modernize its antiquated and unreliable infrastructure, forcing millions of Americans to wonder whether they will have power each day – a fear to which I can personally attest. While the availability of a legal mechanism to adjust Puerto Rico's debts may seem theoretical, the consequences of not having such a framework in place are very real for PREPA, for PREPA's employees and for the 3.5 million Americans who depend on PREPA for electricity. There are 18 other entities on the island facing this same issue.

those with vested interests in seeing Congress defer taking action so as to force Puerto Rico into a disorderly default. As you are no doubt aware, a number of institutions, many of whom have made a short-term bet on the outcome of Puerto Rico's dire financial situation, have literally spent millions of dollars on a coordinated lobbying campaign to propagate disinformation of this type. To be perfectly clear, in the last six months, Puerto Rico has been more transparent about its financial situation than at any point in its history, and it has engaged some of the best professionals in the world to provide up-to-date financial information to key stakeholders, all of which has been made publicly available.

For example, over the last four months, Puerto Rico has commissioned – and made publicly available – the Krueger Report, which includes a comprehensive and up-to-date debt sustainability analysis, the first ever commissioned by the Government, prepared by independent and internationally recognized experts. The Krueger Report is also unprecedented in presenting, for the first time, a consolidated long-term revenue and expense projection for the Commonwealth. In addition, at the request of our creditors, we commissioned a comprehensive liquidity analysis prepared by Conway MacKenzie (the “Conway Report”), the same financial management and consulting firm that the City of Detroit hired to assist it during its bankruptcy proceedings.³ As discussed above, the Conway Report concluded that Puerto Rico's liquidity is running extremely low and the Commonwealth will face a major cash crunch during the months of November and December of 2015. We also published on our website the Puerto Rico Fiscal and Economic Growth Plan (“FEGP”), which contains our plan to stabilize our finances by increasing revenues and reducing expenses, and to grow our economy. Furthermore, note that the Puerto Rico Treasury Department publishes revenue results on a monthly basis.

Both of the Krueger Report and the Conway Report were commissioned to provide independent third-party expert reports on the sustainability of the Commonwealth's debt, long-term revenue and expense projections and the current liquidity position of the Commonwealth. In addition, creditors and their advisors that are willing to sign confidentiality agreements may access additional material non-public information, including certain data supporting the reports that were released publicly. The fact that the Commonwealth has shared more detailed background information on the Krueger and Conway reports with creditors and advisors is standard practice in debt restructuring negotiations and should not be used to suggest the Commonwealth has not been forthcoming and

³ All of the reports commissioned by Puerto Rico and the GDB have been made public on GDB's website at <http://www.bgfpr.com/>.

transparent with respect to its current financial crisis. Finally, in the coming days, we will be issuing the Commonwealth Report, a quarterly document that provides updated information on all the various aspects of the Government finances, including up-to-date revenue, expense, debt, pension and litigation information, along with relevant risk factors and descriptions of recent material events. This too will be publicly available on the GDB website. In fact, during the past two years, the Commonwealth has sought to publish this report on a quarterly basis, which had previously been published only once a year or in connection with a public bond offering.

The Government has kept the market updated with recent and relevant information, such as the Krueger Report, the FEGP, the Conway Report, monthly revenue and economic data, as well as May and June updates to the Commonwealth Report, among others. The issuance of our financial statements has taken longer than expected in large part due to the Government's fiscal condition, and the additional tests that our auditors are conducting regarding liquidity and other variables. Delays in the release of audited information is common in corporate and municipal distressed situations such as the one faced by Puerto Rico, as auditor demands become more searching and time-consuming. However, all the information necessary to make a proper evaluation of the Commonwealth's finances and liquidity position is public and has been vetted by third parties.

In addition, as part of the FEGP, the Commonwealth is conducting an overhaul of its financial, accounting and payroll system in order to unify the patchwork of existing Governmental platforms, improve the Government's ability to monitor its fiscal situation on a real time basis and eliminate unnecessary delays in the preparation of financial information. Furthermore, the FEGP also requires the implementation of an ambitious 5-year plan to strengthen the Commonwealth's economic statistical systems and analysis by modernizing national accounts with an estimated investment of \$3 million per year. Federal assistance in modernizing our financial systems would help improve the fiscal and economic decision making.

Finally, as I mentioned earlier, the Puerto Rico legislature is considering legislation that provides for a control board (the "Board") to oversee the financial affairs of Puerto Rico's Government and each of its public corporations. The Board will be responsible for generating 5-year Commonwealth-wide budgets and certifying that the budgets of each public corporation conform to the Commonwealth budget. The Board will have broad information gathering powers and the ability to sanction public corporations and the Commonwealth itself for

non-compliance. Sanctions will include, automatic budget cuts, hiring freezes, approval requirements for large contracts and publication of a notice of non-compliance. To facilitate this process and ensure transparency across the Government, all Government entities will be required to conform their accounting systems to that of the Department of Treasury by no later than July 1, 2018, among other steps to simplify and coordinate financial practices and reporting. These steps necessarily take time, but the foundation for their implementation is being laid and the results will be greater transparency, accountability and controls across the Government.

In short, any suggestion that Puerto Rico is not doing everything it can to provide up-to-date and accurate information to creditors, this Congress or the general public is simply not true. The breadth and depth of the fiscal and financial information published by the Commonwealth during the past six months is simply unprecedented. The situation is too dire to allow this fabricated misconception to delay immediate and necessary legislative action.

PREPA

As discussed above, while PREPA continues to face significant hurdles to implementing a consensual debt restructuring, namely, its inability to bind minority holdout creditors to the will of the majority without a restructuring regime in place, it has made significant progress in its efforts to do so, including reaching agreement on the terms of such a restructuring with the holders of nearly \$4 billion of its debt. Like many other entities in Puerto Rico, however, a restructuring of its debt is only one piece, albeit a significant piece, of PREPA's turnaround efforts. In addition to its debt burden, PREPA suffers from an outdated rate structure, aging and technologically obsolete generating facilities and infrastructure, and significant operational inefficiencies.

We have worked tirelessly to turnaround PREPA. In May 2014, I signed Act 57-2014 into law, pursuant to which an energy commission was established to exercise oversight over PREPA. The commission required PREPA to improve its services to the people and businesses of the Commonwealth, including by pursuing public-private partnerships to assist in the construction and operation of new generation facilities. Following the passage of Act 57-2014, PREPA initiated discussions with its key creditors and negotiated forbearance agreements in connection with which it retained a chief restructuring officer to implement operational reforms and lead its restructuring efforts. In addition to the more than \$600 million in sinking fund payments that these agreements relieved PREPA from making, and the access they provided to various trust accounts during the forbearance period, PREPA's chief restructuring officer identified and

implemented steps to achieve between \$245 and \$390 million in annual operational savings and up to \$260 million in one-time liquidity measures. The sources of these savings have ranged from day-to-day operational changes such as inventory tracking, purchasing controls, limiting cash payments and other industry-standard practices, to prevention of theft, enhanced collection efforts and a consolidation of PREPA's vendor relationships. PREPA is also actively examining its business to reduce and eliminate its operating deficit. Significantly, notwithstanding the cost cutting associated with these efficiencies, PREPA has managed to instill a culture of safety and accountability in its workforce during this time.

These measures have enabled PREPA to continue to operate over the last 18 months in spite of its severe liquidity crisis. Unfortunately, with no restructuring regime in place, PREPA's breathing room may soon be exhausted. In the first half of 2016 nearly \$1.5 billion of debt will come due, an amount that PREPA will be likely unable repay. The consequences of a disorderly default of the island's only electricity provider could be catastrophic for the people of Puerto Rico. I urge you in the strongest of terms not to let that happen.

Conclusion

In conclusion, I thank the Committee for recognizing the urgency of these matters by holding this hearing, and for giving Puerto Rico the opportunity to participate. I look forward to working with all of the members of the Committee to ensure the health, safety and well-being of the 3.5 million Americans that call Puerto Rico home. And I urge you to maintain your focus on Puerto Rico's fiscal emergency; the future of 3.5 million Americans depends on what you do next.

Written Testimony of Richard L. Carrión
United States Senate Committee on the Judiciary
Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution
December 1st, 2015

Introduction

At the outset, let me begin by saying that as a banker, but even more so as a proud Puerto Rican, I deeply regret that Puerto Rico's dire fiscal and economic situation is the topic which brings us to the attention of this Committee.

Leaders from several administrations, and different political parties, have opted to ignore structural problems and postponed difficult decisions because it was easier to keep borrowing to fund operational deficits and kick problems down the road, maybe to be handled after the next election or by another administration. But no amount of regret or even indignation will solve our problems. Severe measures taken throughout the last several years have clearly not been enough. Some of these recent measures include higher taxes, with an 11.5% sales tax, the highest by far of any U.S. state, reform of the largest pension system from a defined benefit to a defined contribution plan, a reduction of close to 25,000 government employees, or 14%, since 2012, and the closure of approximately 100 public schools in the same period.

The decade-long recession has taken a great toll. It is easy to get mired in figures such as debt levels, debt service, deficits and liquidity shortfalls. But let us not ignore other numbers that are equally important because they tell the human story of Puerto Rico's crisis. Approximately 250,000 jobs have been lost since 2006. Over 25,000 families have lost their homes. More than 300,000 Puerto Ricans, roughly 8% of the population, have left the Island in the past decade,

often leaving some of their family behind; this trend continues to worsen. While the entire population has suffered, the most vulnerable have suffered the most. Approximately 600,000 Puerto Ricans could lose their health care coverage when Medicaid funds run out. About 175,000 retirees and other beneficiaries depend on severely underfunded government pension funds that are expected to run out of money in the near term. Puerto Rico's elderly population represents 20% of the total, one of the highest in the U.S., is increasing rapidly as a result of some of the trends I have mentioned, and it is highly vulnerable to reductions in pension and health benefits. And perhaps most telling is the number of children living below federal poverty levels which currently stands at around 58%, up from 48% a decade ago, compared to 21% in the U.S.

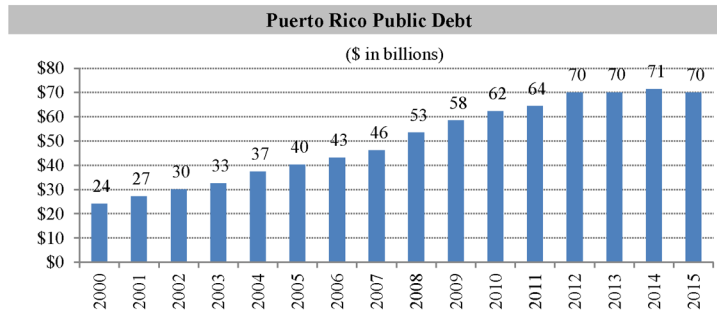
After a decade of economic contraction, lack of fiscal discipline and increasing public debt, Puerto Rico now stands at a critical junction. It is time to take decisive action to address both short-term and long-term challenges and to ensure that the errors of the past are never repeated. The decisions made by federal and local entities in the next few weeks and months will determine the Island's course for years, if not decades, to come. It is critical that they, working together, address the unsustainable debt load, a long history of fiscal indiscipline and a shrinking economy. From that standpoint, a successful solution will necessarily include three elements:

- (1) a legal framework to restructure all of Puerto Rico's public debt,
- (2) an effective fiscal oversight and control mechanism, and
- (3) economic stimulus measures to incentivize new investment and promote employment.

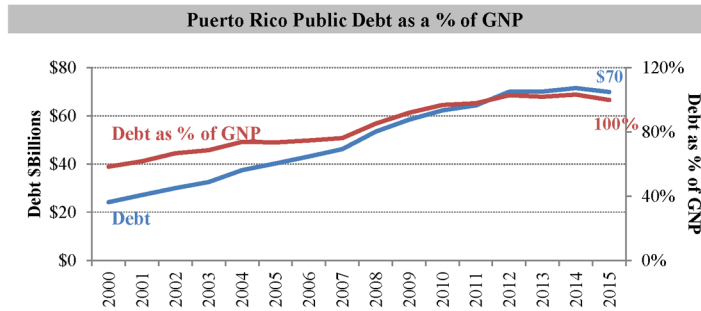
All three components are vital and must work in conjunction to ensure the maximum possible debt repayment and the long-term viability of Puerto Rico's economy.

Debt Restructuring

Puerto Rico’s total public debt currently stands at \$69.9 billion and has increased at a compounded annual growth rate of 7% since the year 2000. The Island’s GNP grew at a nominal rate of only 3.6% during the same period. As a result, public debt as a percent of GNP increased from 58% in 2000 to 100% in 2015, and, unfortunately, a significant portion of the increase in debt was used to finance budget deficits.



Source: Center for the New Economy and Commonwealth of Puerto Rico, Quarterly Report Dated November 6, 2015



I must confess that I initially resisted the idea that Puerto Rico's public debt would have to be restructured. However, it is now clear to me that the size of the fiscal shortfall is so large, even including the impact of revenue and expense measures proposed by the current administration, that some form of debt restructuring is inevitable.

The funds required to service the existing debt are substantial and increasing. In fiscal year 2016, the Puerto Rico government, excluding the two principal utilities, municipalities and other agencies, is scheduled to make \$4.1 billion in debt payments, which represents approximately 40% of projected revenues. Last year, the government was able to borrow to help make its payments, albeit at very high interest rates. This is no longer an option, given the lack of access to capital markets on sustainable terms. This means that, absent some type of restructuring, the government would have to pay the full principal and interest coming due, something it will be unable to do while it seeks to provide basic services to the population. If yet more resources are devoted to debt service, the pace of emigration will continue to increase, further decreasing the amount of resources available to pay debt service.

Furthermore, the government's severely underfunded pension funds will place additional pressure on public finances. Once the funds are depleted, which is expected to happen soon, the central government will have to divert resources normally used to provide essential services to pay pension benefits. For most retired government employees, including teachers, their government pension is their sole source of income and failure to receive that income would result in a true humanitarian crisis.

Finally, if no measures are taken to address the impending depletion of one-time Medicaid funds, the government could be forced to incur additional expenses related to health care.

Put simply, the government will run out of money...and soon.

Puerto Rico currently lacks a legal framework to allow it to restructure its debt in an orderly fashion. A successful debt restructuring requires a legal regime where the interests of all parties can be balanced fairly while allowing financing alternatives that would provide much needed liquidity during restructuring. A proper legal regime is not inconsistent with negotiations between the parties. In fact, it will encourage all parties to negotiate in good faith. The only alternative at this point is another combination of events that will be to the detriment of all involved: an inability to make the payments that our public sector retirees were promised on which they are dependent; a slash in funding for our children and those in need of health care; accelerated deterioration of the Puerto Rico economy and tax base; a slew of legal battles that will take years to resolve and create disruption and uncertainty while consuming inordinate resources; and, inevitably, debt defaults.

If we want to avoid this outcome, time is of the essence. Over the last few months, government services and debt payments have continued only because of emergency liquidity actions such as: (1) delaying payment of income tax refunds owed to taxpayers, (2) requiring advance payment to the Puerto Rico Treasury Department from the two largest retirement systems of funds needed to pay benefits, rather than the usual eventual reimbursement by these systems to Treasury for actual payments made on their behalf, (3) borrowing from state-owned insurance funds, (4)

failing to pay certain appropriation debt, (5) suspending monthly set-aside payments for debt service on general obligation bonds, and (6) deferring payment of accounts payable to vendors and other third parties. These measures are unsustainable and they are aggravating the underlying problems.

Even with these emergency measures, liquidity is likely to run out before the fiscal year ending on June 30, 2016, and there are several considerable debt service payments due in the coming months.

Fiscal Oversight and Control Mechanism

Any long-term solution to Puerto Rico's fiscal situation must also include a fiscal oversight and control body. Puerto Rico's current economic problems are closely tied to a decade of sluggish economic growth but also are a direct result of longstanding fiscal indiscipline. I have served on various advisory boards for several governors, of different parties, and have witnessed the inability or unwillingness of many administrations to manage our public finances in a fiscally responsible manner. Fiscal control boards have proven effective in similar situations, such as New York forty years ago. In the case of Puerto Rico, such a body would guarantee the long-term adherence to a recovery plan and should be considered in conjunction with any debt restructuring regime.

The oversight body should consist of members with the appropriate expertise and must be truly independent from the Puerto Rican government. It needs to have the necessary authority to effectively carry out its oversight and control responsibilities. It must have the power to examine

and veto annual budgets that are not truly balanced and to continuously monitor performance against those budgets. It also needs to have the ability to approve capital expenditures that exceed a certain amount. Finally, all labor contracts for government employees should be subject to review by the fiscal control board.

Economic Stimulus Measures

The Puerto Rico economy has been contracting for almost a decade. Since the repeal in 2006 by the U.S. Congress of the incentives contained in Section 936 of the Internal Revenue Code, the economy has contracted by more than 10% and lost close to 40,000 quality jobs in the manufacturing sector alone. This prolonged recession has led to a vicious circle involving, among other negative trends, outmigration and a marked decline in labor participation.

Some have suggested that Puerto Rico can tackle its problems through more rigorous belt-tightening measures. I believe we simply cannot cost-cut our way out of this situation. There is clearly a need for fiscal discipline – we have more government agencies than we can afford or effectively manage. An overhaul of the central government and its agencies is necessary, and will surely result in lower spending, but this alone will not be sufficient to bridge the large financing gap. Indeed, less government spending in the short run will necessarily have a negative impact on economic activity. Thus, a meaningful stimulus plan must be put in place to steer the economy on the path of sustainable growth. Economic growth is the only element that will promote the long-term interest of all parties, including bondholders.

Some proposals that have been discussed include measures such as providing Puerto Ricans the same access to Medicaid as citizens on the mainland and the use of the Earned Income Tax Credit (EITC) to promote formal participation in the economy. These two areas – health and labor participation – are clearly important, and there may be other efforts that also make sense to spur economic growth. But the key point is that some combination of economic stimulus measures is an essential component of any recovery plan.

Conclusion

Throughout its recent history, Puerto Rico has experienced many testing events such as a change in sovereignty from Spain to the United States, two world wars, the Great Depression and devastating hurricanes. During this time we have seen Puerto Rico transform itself again and again, a testament to the Island's resilience and resourcefulness. Puerto Rico has a modern infrastructure, tested human capital, high enrollment in local universities, a modern communication and transportation network and a solid legal, financial and institutional framework – all important pillars we can build on to jumpstart the economy once again.

To do so, Puerto Rico needs a comprehensive recovery plan that includes all three components I have discussed: a debt restructuring regime, a fiscal control board and economic stimulus measures.

Problems that took decades to create cannot be solved in months, or through small or isolated efforts of one group or another. A real solution will require local and Federal action, support

from the executive and legislative branches, backing from all political parties and the active participation of all sectors of Puerto Rican society.

Failure to take decisive action now will only make these problems worse and their solutions more costly and less effective for all parties involved.

Written Testimony of

**Carlos A. Colón-De-Armas, Ph.D.
Professor of Finance
Graduate School of Business
University of Puerto Rico**

to the

United States Senate Committee on the Judiciary Hearing on

Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution

**December 1, 2015
Washington, D.C.**

“I think as economists we should at least always suspect ourselves if we find that we are on the popular side.”

Friedrich A. Hayek, *On Being an Economist*, (1944)

Good morning, Chairman Grassley, Ranking Member Leahy, and members of the Committee. Thank you for the opportunity to appear here today to discuss Puerto Rico's fiscal and economic challenges. My name is Carlos A. Colón-De-Armas and I am a professor of finance at the Graduate School of Business at the University of Puerto Rico.

This document starts with an Executive Summary that highlights the key points of my written testimony. Given the time constraints, I will limit my initial remarks to the Executive Summary and I will leave the rest for the record, and to discuss with you during the Q&A portion of the hearing.

Executive Summary

- Puerto Rico faces two distinct challenges: a fiscal crisis and an economic crisis.
- Contrary to what most people are saying, the available evidence indicates that the fiscal crisis was not caused by a weakening economy. For one, the downward trend in the economy began almost three decades before the fiscal problems started. More importantly, public expenses started to get out of line at the same time that General Fund revenues were increasing at a healthy pace.

- To finance its profligate ways, the Government of Puerto Rico sacrificed its limited borrowing capacity, that was supposed to be utilized only to finance public investments, and used it instead to finance spending. As a result, an already fragile economy experienced a significant loss of investments and deteriorated even more.
- Fixing the economy of Puerto Rico, while necessary, will not repair the Island's fiscal crisis. To fix the fiscal crisis, the Government of Puerto Rico needs to cut spending. To fix the economic crisis, public and private investments on the Island must be increased and the business climate in Puerto Rico should be improved.
- The starting point to fix the fiscal crisis should be to cut expenses in the General Fund by \$1.0 - \$1.5 billion annually.
 - To be most effective, this reduction should be achieved through a participatory process that must include all relevant interest groups including labor leaders.
 - The evidence shows that this level of reduction in expenses is feasible without the need to fire government employees and without affecting the quality of the public services required by the citizens.
- The available evidence also demonstrates that the Government of Puerto Rico has the necessary resources to honor its debt commitments as originally contracted. In other words, the public debt of Puerto Rico can be paid.
- Therefore, from the standpoint of what is best for Puerto Rico, default, bankruptcy, debt restructuring, or any kind of negotiation that involves not complying with debt commitments as originally contracted should be avoided at all costs.
 - In this regard, the key consideration should be how to restore access to financial markets to enhance investments on the Island.
 - It would be incorrect to frame this issue as a short-term budgetary matter.
 - To improve the quality of life on the Island, more investments are needed. For these investments to take place, financing is necessary. For which access to financial markets is essential.
 - As an example, look at the recent drought in the San Juan Metropolitan area, which left many residents without water for up to 5 days a week, while water was going to waste on the western side of the Island. This situation illustrates vividly the human costs of the government's inability to access financial markets to finance projects that are critical to everyday life in Puerto Rico.
- It also is important to mention that the Government of Puerto Rico intends to force bondholders to suffer losses for problems caused, not by the bonds, but by unfunded loans issued by its own Government Development Bank. Such an outcome, if implemented, would be unreasonable.

- To address many of these issues, appointing a control board has been proposed. I have mixed feelings toward that proposal. On the one hand, I recognize that a control board may be very effective to put the financial house in order and restore credibility in Puerto Rico. On the other hand, we do not need people to make hard decisions. We need people to make smart decisions. Yet, these control boards have the tendency to enter troubled spots to cut indiscriminately. In Puerto Rico, this would not be the correct approach to follow. Perhaps, instead of creating such a board, it could make more sense to establish specific targets of what needs to be done and to contract with an independent CPA to certify whether it has been done. This approach would have the added benefit of keeping responsibility in the hands of the public officials whose job it is to fix these problems.
- The reality is that all the time that government officials are dedicating to measures like bankruptcy, debt restructuring, debt negotiations, and control boards diverts their attention from the important actions that they should be undertaking. It would be more productive if all that time and effort were dedicated instead to reducing public expenses and finding ways to pay the public debt.
- Finally, although most of the actions required to fix these problems are local in nature, there are some actions that Congress may take to help Puerto Rico face its current challenges. These include the following:
 - Provide Puerto Rico with parity in funds for all health-related programs.
 - Channel any additional resources available toward infrastructure investments.
 - Solve Puerto Rico's political status once and for all.

Once again, thank you Chairman Grassley, Ranking Member Leahy, and members of the Committee for holding a hearing on this important matter and for giving me the opportunity to participate in it. I now look forward to answering any questions that you may deem appropriate.

Puerto Rico: How Did We Get Here and How Do We Get Out?

The Government of Puerto Rico is suffering from chronic deficit spending, an excessive public debt burden, and retirement systems for public employees with acute actuarial and cash deficits that dangerously threaten their very existence (i.e., the fiscal crisis). At the same time, the economy of Puerto Rico has been experiencing, for various decades now, a long-term debilitating trend that one usually associates with a region that lost its productive capacity (i.e., the economic crisis). As we face these two crises, and as we look for ways to solve these problems and turn this situation around, a wide gap has become apparent between what many people are saying, and proposing, and what the data, and the available evidence, actually indicate.

In fact, I pose to you that, regarding the challenges that we face in Puerto Rico, much of what is being said is unsubstantiated. Even worse, most of what has been proposed is largely irrelevant and with far more adverse consequences than the problems that the proposals themselves aim to solve.

For the most part, government officials, analysts, and so called experts, assume a cause and effect relationship that moves from the economy to the government. As that narrative goes, Puerto Rico's economy weakened around the year 2006, allegedly as a result of the termination of Section 936 of the U.S. Internal Revenue Code. This debilitated economy, supposedly, brought about a reduction in government revenues which, in turn, triggered its fiscal crisis. Nothing could be further from the truth.¹ Let's look at the evidence.

According to the official statistics available from the Puerto Rico Planning Board, the deterioration of Puerto Rico's economy started in the 1970s, around when Section 936 started, and not when it ended. In fact, the economic strategy followed by Puerto Rico, centered on giving tax incentives to Multinational Corporations, created an ever increasing gap between the economic activity that took place on the Island (as measured by the Gross Domestic Product or GDP), and the economic activity generated by the local factors of production (as measured by the Gross National Product or GNP), without significantly benefitting the local economy.²

Puerto Rico's fiscal crisis started much later. The evidence from the annual audited financial statements of the Government of Puerto Rico between fiscal year 1970 and fiscal year 2013³ demonstrates that the budget of the General Fund of the Government of Puerto Rico was mostly balanced through fiscal year 2000. During those same years, even with the economy in its long-term downward trend, not only was the budget balanced, but Puerto Rico's public debt was well-rated⁴ and well-regarded in financial markets. The total public debt as a percent of GNP actually declined during that time indicating a proper usage of debt to finance investments that spearheaded economic development.⁵

General Fund expenses began to increase disproportionately with revenues, and chronic deficit spending by the Government of Puerto Rico started, in fiscal year 2001. In that year, the Island

¹ It is certainly true that in situations like Puerto Rico now faces causality usually goes from the economy to the government. Usually, a weak economy is what creates fiscal problems for the government. In this particular case, however, causality goes in the other direction. It was the government, and its profligate ways, that caused additional havoc on Puerto Rico's economy.

² For instance, between 1948 and 1979, Puerto Rico's Gross National Product (GNP) grew at an average annual real rate of +5.56% (surpassing the corresponding U.S. rate of +3.89%). From 1980 to 2014, however, that growth dwindled to +1.28% (below the corresponding U.S. rate of +2.65%). One way to ascertain that this downward trend is of a long-term nature and not due to recent events is to break down the growth of the GNP by decades. When you do so, you get the same relative result of higher growth in Puerto Rico in every decade before 1980, but higher growth in the states in every decade afterwards. (See pages 4-10 of the enclosed presentation.)

³ The audited financial statements for years 2014 and 2015 are not yet available.

⁴ For example, GOs were rated A/A- by Standard & Poor's and Baa1 by Moody's Investors Service.

⁵ See pages 12-13 of the enclosed presentation.

experienced a short recession and General Fund revenues were down by -1% (-\$79 million) compared to the year before, but the General Fund deficit was -\$464 million. In other words, the deficit for fiscal year 2001 was almost six times the revenue shortfall. The following years, while revenues steadily increased, deficit spending skyrocketed. In 2002, revenues increased by +7% (+\$492 million), but the deficit was -\$1,674 million. In 2003, revenues were up by +2% (+\$151 million), but the deficit reached -\$438 million. In 2004, revenues went up by +7% (+\$515 million), but the deficit ended up being -\$803 million. In 2005, revenues jumped by +11% (+\$916 million), but the deficit was -\$681 million. In other words, deficit spending by the Government of Puerto Rico started while revenues were increasing at a healthy pace. That is hardly the case of a fiscal crisis caused by a weakening economy. On the contrary, these data suggest that the fiscal problems of the Government of Puerto Rico resulted from deliberate over-spending by local politicians. Then recession hit again in 2006 and revenues decreased by -5%, but the damage was already done since the cost structure of the government was already out of control. As a result, the increasing trend in expenses continued unaltered.⁶ Instead of fixing this deficit spending, starting with the budget for fiscal year 2004, the government formalized the usage of debt to balance the budget at the time it was approved, and not just to cover the excess spending that accumulated during the year.

In light of this evidence, it does not make sense, as many are proposing nowadays, to prescribe economic growth to cure the fiscal crisis that ails the Government of Puerto Rico.⁷ As much as I am in favor of strengthening economic growth in Puerto Rico, the truth of the matter is that no economic growth in the world is able to mitigate the effects of a political class bent on excess spending.

To finance this excess spending, the Government of Puerto Rico sacrificed its limited borrowing capacity, which was supposed to be utilized to finance public investments, and used it instead to finance spending. As a result, investments on the Island suffered, decreasing in real terms at an average annual rate of -2.80% over the last 11 years, while consumption spending and disposable income increased, albeit weakly.⁸ Thus, it becomes evident that, in the case of the fiscal and economic crises that ail Puerto Rico, causality goes in the opposite direction. It was not a weak economy that caused the fiscal crisis, but rather a government bent on overspending took resources away from investments, used them instead to finance its profligate ways, thereby

⁶ See page 14 of the enclosed presentation.

⁷ Two of the proposals geared toward economic development revolve around exempting Puerto Rico, totally or partially, from the maritime Jones Act and the federal minimum wage. Neither of these two proposals is likely to have any impact towards addressing the many challenges facing Puerto Rico.

- The maritime Jones Act was enacted in 1920. That enactment occurred more than 50 years before the economy of Puerto Rico started its deterioration process in the 1970s, and 81 years before the fiscal crisis began in 2001. Thus, any discussion regarding cabotage laws in relation to the solution to the crises in Puerto Rico, while entertaining, is utterly irrelevant.
- The federal minimum wage was implemented in Puerto Rico in 1983, almost a decade after the economic deterioration started and 18 years before the fiscal crisis began. Therefore, it is unlikely that it had anything to do with either of these two problems. More importantly, the scientific evidence regarding the impact of the minimum wage on the economy of Puerto Rico is not clear. (See pages 20-22 of the enclosed presentation.)

⁸ See page 16 of the enclosed presentation.

causing an already weakening economy to accelerate its deterioration process.

Surprisingly, in light of the above evidence, the Government of Puerto Rico has concentrated its efforts on renegeing on its commitments to bondholders and to reduce the debt burden through a process of restructuring, negotiation, or bankruptcy.⁹ The Governor even went as far as to say that Puerto Rico is unable to pay its public debt as contracted. This approach is not only wrong, but it is extremely dangerous for the well-being of the Island. Specifically, this approach is not justified by the budget numbers, it fails to distinguish between bonds and loans issued by the Government Development Bank for Puerto Rico (GDB), which are the culprit of the overwhelming debt burden facing the government, and it would close access to financial markets for an indeterminate number of years to the detriment of all Puerto Ricans. Besides, this approach is what created the liquidity crisis that has become one of the most urgent matters that the government now faces.

- According to the official budget approved by the Legislature of Puerto Rico and signed by the Governor, the total debt service on the entire public debt, for the current fiscal year 2016, represents 16.8% of the consolidated budget of the Government of Puerto Rico. If we limit the analysis to the General Fund, the corresponding debt service burden represents only 15.8% of the budget.¹⁰ Contrary to what the Governor said, these numbers indicate that the Government of Puerto Rico is able to pay its debt service.¹¹

⁹ For the most part, the Government of Puerto Rico is basing its strategy on the report by Krueger, Anne O., Ranjit Teja, and Andrew Wolfe, *Puerto Rico - A Way Forward*, June 29, 2015 (updated on July 13, 2015), the so called “Krueger Report”. That report is too limited in scope, concentrating on the period since the year 2000. This limitation biases the analysis and produces recommendations that are equally distorted. Although there is no fixed rule regarding the number of years that a study of this kind should analyze, it is not sound practice to cover only “bad” years, like this report did, and neglecting to consider “good” years. In the case of Puerto Rico, it also is important to analyze the situation before, during, and after Section 936 was enacted, and later eliminated. Of course, the report was “prepared at the request of legal counsel”. As such, it may serve well to support a legal theory or strategy. It does not have, however, the depth necessary to serve as the basis upon which to establish sound public policy. The *Puerto Rico Fiscal and Economic Growth Plan* prepared by the Working Group for the Fiscal and Economic Recovery of Puerto Rico pursuant to Puerto Rico Executive Order 2015-022, dated September 9, 2015, follows closely along the same lines of the “Krueger Report” and, accordingly, is equally defective in that regard.

¹⁰ See pages 17-18 of the enclosed presentation.

¹¹ These figures are part of the official budget for the Government of Puerto Rico as approved by the Legislature and signed by the Governor. In that regard, it is important to consider the following chronology:

- May 20, 2015: The Governor of Puerto Rico proposed to the Legislature a General Fund budget for fiscal year 2016 for a total of \$9,800 million.
- June 28, 2015: The Governor declared, through *The New York Times*, that Puerto Rico’s public debt is “not payable”.
- June 29, 2015: The “Krueger Report” is published.
- June 29, 2015: The Legislature approved, and the Governor signed, a General Fund budget for the same total as originally proposed, \$9,800 million. That budget is part of a consolidated budget for the entire government that adds approximately \$28,800 million.

If the Government of Puerto Rico were to pay the debt service included as part of its approved budget, it would have honored all its commitments to bondholders and we would not be discussing the possibility of default. If new information would have emerged between the time that the budget was proposed and when it was finally approved,

- Bond contracts in Puerto Rico contain appropriate “additional bonds tests.” When those tests prevented the issuance of more bonds, the GDB simply loaned money to government agencies knowing full well that they had no reliable sources of payment, thereby making the overspending possible. Those GDB loans, and not the bonds, caused the problems. In its approach, however, the Government of Puerto Rico fails to distinguish between bonds and GDB loans. Thus, it intends to penalize bondholders by forcing them to absorb a reduction in the value of their bonds for problems caused, not by the bonds, but by these unfunded loans issued by the very same government entity that was supposed to control government finances and to make sure that these problems would never happen. Such an outcome, if implemented, would not be reasonable. In the case of Puerto Rico, the only debt holder who should suffer a “hair loss” is the GDB.
- Any kind of default, bankruptcy proceedings, restructuring, or negotiation that results in the Government of Puerto Rico not honoring its debt commitments as originally contracted would disrupt access to financial markets for an uncertain number of years. As a result, investments on the Island would be severely curtailed. Thus, the economic development of Puerto Rico, and the quality of life of the residents of the Island, would be adversely affected.
- The liquidity crisis that the Government of Puerto Rico is currently facing, and that government officials are using as the latest excuse to renege on its commitments, is not part of the fiscal and economic crises discussed above. This liquidity shortfall is nothing more than the normal annual situation faced by the government due to the fact that its “tax revenues are received during the second half of the fiscal year (January through June) while operational expenditures are spent evenly throughout the fiscal year.”¹² The government normally handled this situation by issuing “tax and revenue anticipation notes (TRANs).”¹³ The government, however, “has been unable to obtain TRANs financing this fiscal year from commercial banks or capital market sources.”¹⁴ This inability to issue TRANs is due to the fact that the Government of Puerto Rico has been denied access to financial markets because of the way in which it has improperly managed its fiscal crisis.

In summary, Puerto Rico is facing two severe, and distinct, crises, each with its own origin and causes. Next, I will outline some of the actions that I deem necessary to address each of these two crises.

either through the “Krueger Report” or by any other source, that the debt was actually not payable, the budget should have been amended to reflect a lower figure for debt service. The fact that the budget was finally approved for the same amount as originally proposed demonstrates that the debt is payable. Alternatively, one would have to conclude that the budget was not correctly approved.

¹² See Commonwealth of Puerto Rico, “Financial Information and Operating Data Report,” November 6, 2015, p. 34.

¹³ *Ibid*

¹⁴ *Ibid*

To solve the fiscal crisis, since the problem resulted from excess spending and not from a reduction in revenues, the solutions have to revolve around spending reductions and a wiser usage of public resources. Some ideas along those lines are presented below.

- Reduce expenses in the General Fund by \$1.0 - \$1.5 billion annually.¹⁵
 - To do so, labor leaders should be actively involved in the process. After all, government employees know better than anybody else how public resources are wasted.¹⁶
 - As part of that process, there should be an evaluation of the possibility of eliminating some government agencies.
 - The possible elimination of subsidies to cities, towns, and related agencies should also be considered.
 - Because it is not necessary, and to show good faith and to elicit the right collaboration by labor leaders, there should be a firm commitment to not fire government employees. Besides, firing government employees would exacerbate the financial problems facing the retirement system, which is another reason why this option should be avoided.
 - But, there should be no recruiting of new government employees either.
- The resources liberated from cutting expenses should be redirected toward investments.
- The possibility of liquidating the GDB should be carefully studied. This liquidation may help to strengthen government controls, by eliminating the entity that made possible the deficit spending. Also, it may help to reduce a portion of the public debt.
- Do not use public-private partnerships (PPPs) as financing tools. PPPs increase the cost of financing and, therefore, reduce the feasibility of many projects that otherwise would be worthwhile to undertake.
- Reduce income taxes and replace them with consumption-based taxes, **ON A REVENUE NEUTRAL BASIS!**

¹⁵ According to the audited financial statements of the Government of Puerto Rico, between fiscal year 2001 and fiscal year 2013, General Fund revenues averaged approximately \$8,100 million, expenses averaged \$9,700 million, and the deficit averaged -\$1,600 million. Since then, new revenue sources have been added and, according to the Puerto Rico Department of Treasury, revenues in fiscal year 2014 and 2015 averaged approximately \$9,000 million. Therefore, reducing expenses in the General Fund by \$1,000 - \$1,500 million annually should be enough to eliminate the deficit, pay debt service, and free resources for investment purposes.

¹⁶ In addition to examining the audited financial statements, I also examined the General Fund and the Consolidated budget of the Government of Puerto Rico. From that examination, I can reasonably conclude that the above suggested budget reduction is not only feasible, but it can be accomplished without affecting the quality of the services that the government needs to provide to its citizens. Also, I obtained a good sense of the line items that I would cut, if it were up to me, to accomplish the task. In the end, however, as the saying goes, "there is more than one way to skin a cat". In other words, there are multiple ways to accomplish the objective of reducing expenses by \$1,000 - \$1,500 million annually. More importantly, it is better to let a consensus process dictate the way instead of trying to force my ideas upon others. That is why I did not to include in my written testimony the detailed list of line items that I would prefer to cut.

- Create a trust fund to preserve the funds to be received from government asset sales, to avoid spending the value of capital assets in the short term.
- In the different retirement systems, benefits should be linked to contributions while preserving, as much as possible, the defined-benefits structure.
- Discuss with private sector entities like, for example, the Puerto Rico Chamber of Commerce and the Puerto Rico Manufacturers Association, the possibility for them to provide services that in Puerto Rico, contrary to other jurisdictions, are carried out by government agencies (e.g., Tourism Company, Puerto Rico Industrial Development Corporation).

Even though the economic crisis is not the main culprit in terms of the fiscal crisis, the economy needs strengthening. Below are some brief ideas to address that as well.

- Establish, as the top priority, the discussion and implementation of initiatives that would promote economic growth and wealth creation, as opposed to wealth distribution, which tends to dominate policy discussions.
- Advance public policies that encourage exporting by local firms.
- Reduce the cost of doing business in Puerto Rico (e.g., eliminate bureaucratic permitting requirements, and improve water, energy, and transportation infrastructure).
- To be really effective, all of these recommended initiatives should be advanced by consensus, and with the principal political parties sitting at the table.

As you see, most of the above actions are local initiatives, to be undertaken by officials in Puerto Rico.¹⁷ In addition to these actions, there is a lot that Congress can do to help Puerto Rico face its current challenges. A few of those actions are outlined next.

- Make it clear that Congress will not approve any initiative that can be considered a substitute for the local actions necessary to lower expenses, stop deficit spending, and put the fiscal side of the Government of Puerto Rico in order. In fact, these local actions

¹⁷ Shortly after he took office, the Governor of Puerto Rico proposed a budget for fiscal year 2014 that increased expenses by \$750 million. In his address to the Legislature defending that budget (available at <http://www2.pr.gov/presupuestos/Presupuesto2013-2014/Mensaje%20del%20Gobernador/Mensaje%20de%20Estado%20del%20Gobernador.pdf>), delivered on April 23, 2013, the Governor itemized how that increase would be allocated. A complete itemized description of that proposed increase can be found on page 2.63 of the *Síntesis General de Presupuesto Consolidado* (available at <http://www2.pr.gov/presupuestos/Presupuesto2013-2014/Informacion%20de%20Referencia/S%C3%A9ntesis%20Presupuesto%20Consolidado.pdf>). Before fiscal year 2014 was over, in February 2014, Moody's Investors Service, Standard & Poor's, and Fitch Ratings downgraded the General Obligation bonds and other credits of the Government of Puerto Rico below investment grade ("junk") and the ratings of the public debt of Puerto Rico have been going down the rating charts ever since. In subsequent budgets, the Governor reduced expenses but, for the most part, those reductions have been too timid and have largely come from the initial increase he himself brought about. Naturally, we will only be able to corroborate this information when the audited financial statements for fiscal years 2014 and 2015 are published.

should be considered to be the first line of attack in solving the fiscal crisis of the Island's government.

- To address many of these issues, appointing a control board has been proposed. I have mixed feelings toward that proposal. On the one hand, I recognize that a control board may be very effective to put the financial house in order and restore credibility in Puerto Rico. On the other hand, we do not need people to make hard decisions. We need people to make smart decisions. Yet, these control boards tend to be dominated by IMF types who usually enter troubled spots to cut indiscriminately. In Puerto Rico, this would not be the correct approach to follow. Perhaps, instead of creating such a board, it could make more sense to establish specific targets of what needs to be done and to contract with an independent CPA, under the basis of "agreed-upon procedures", to certify whether it has been done. This approach would have the added benefit of keeping responsibility in the hands of the public officials whose job it is to fix these problems.
- Provide Puerto Rico with parity in funds for health-related programs such as medicare, medicaid, and the tricare plus program for military personnel. After all, if Puerto Rico pays the same social security and medicare-related federal taxes, it is only fair that we receive the same benefits as well.
- Since Puerto Rico's most urgent economic needs revolve around increasing investments and improving the business climate on the Island, any additional resources available from the Federal Government should be channeled toward infrastructure investments. In that regard, the primary objectives should be to (1) improve the water storage and distribution infrastructure in Puerto Rico; (2) modernize the technology for energy generation; and (3) complete the strategic highway network around the Island.
- Solve Puerto Rico's political status once and for all. Following in the best human rights traditions of our country, it is the right thing to do and it is Congress's responsibility to do so. In addition, solving the political status of Puerto Rico would put a stop to the confusion brought about by political arguments, camouflaged as economic arguments, that contaminate the process and distract us from properly concentrating on meeting the fiscal and economic challenges ahead.

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Enclosure: Presentation - "How Do We Get Out of This?"

Puerto Rico: How Do We Get Out of This?

By

Carlos A. Colón De Armas, Ph.D.
December 1, 2015

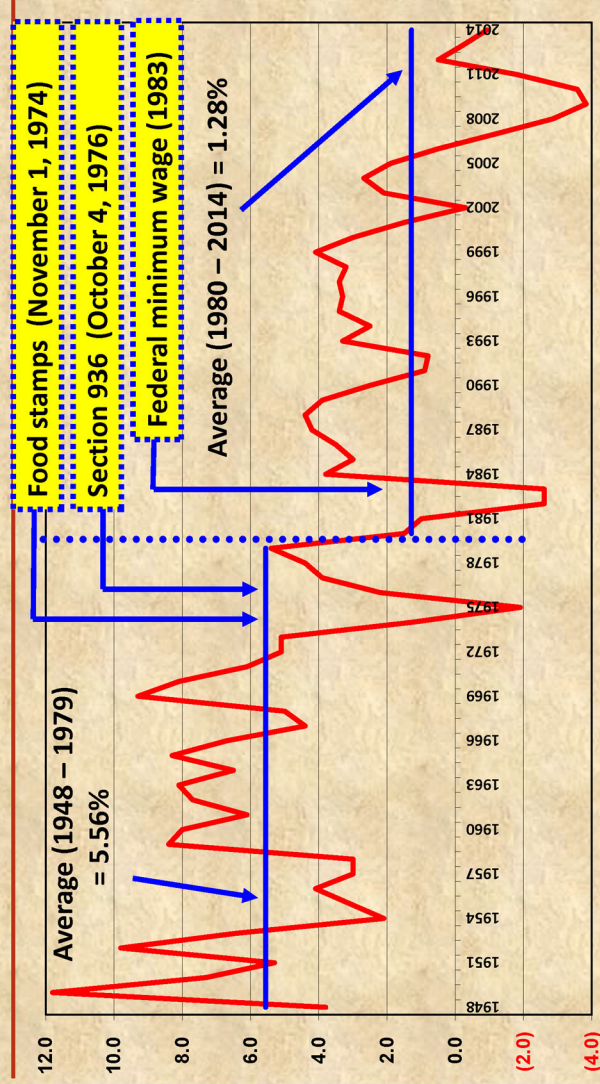
Presentation Outline

- ➔ Economic Crisis
- ➔ Fiscal Crisis
- ➔ Additional Facts
- ➔ The Impact of the Federal Minimum Wage on Employment in Puerto Rico
- ➔ Conclusions and Recommendations

Economic Crisis

Puerto Rico: GNP Annual Growth

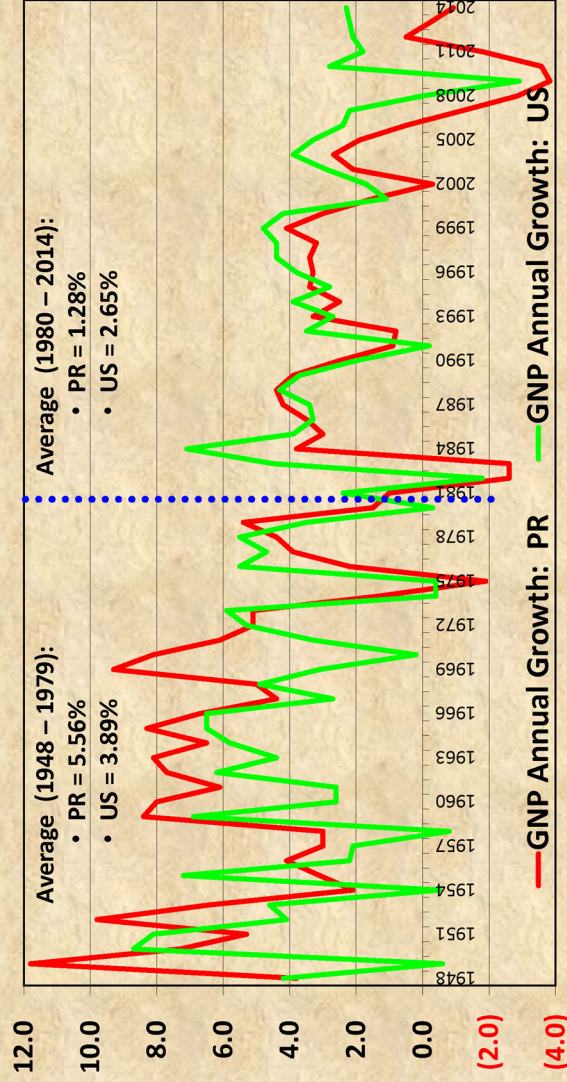
(In real terms and in %.)



Source: Puerto Rico Planning Board and author's computations.

GNP annual Growth: PR vs. US

(In real terms and in %.)



Source: Puerto Rico Planning Board, U.S. Bureau of Economic Analysis, and author's computations.

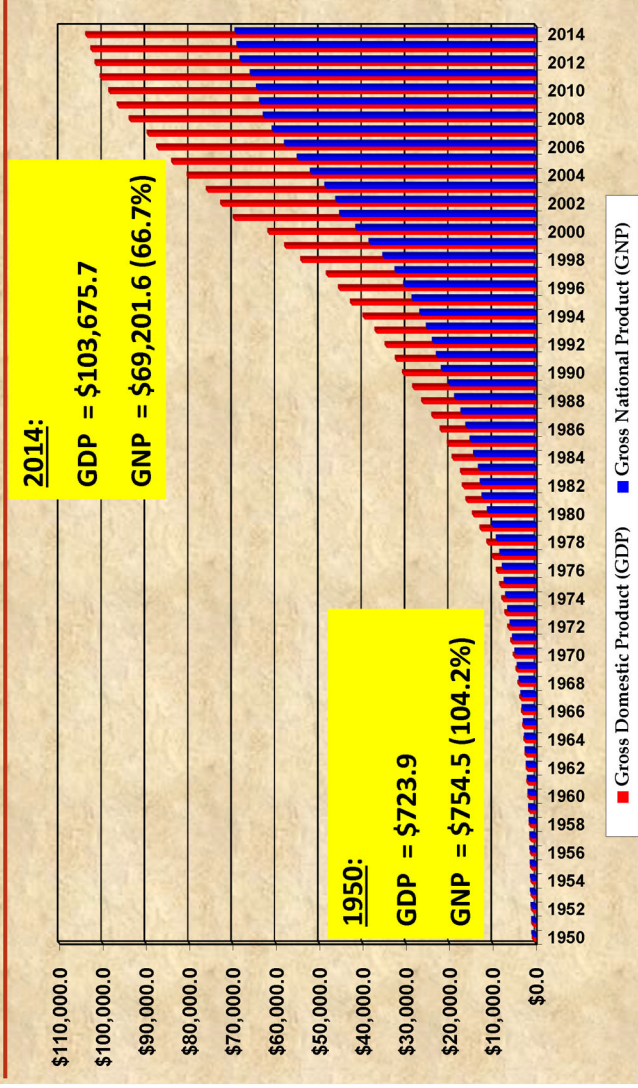
GNP Average Annual Growth: PR vs. US (In real terms and in %.)



Source: Puerto Rico Planning Board, U.S. Bureau of Economic Analysis, and author's computations.

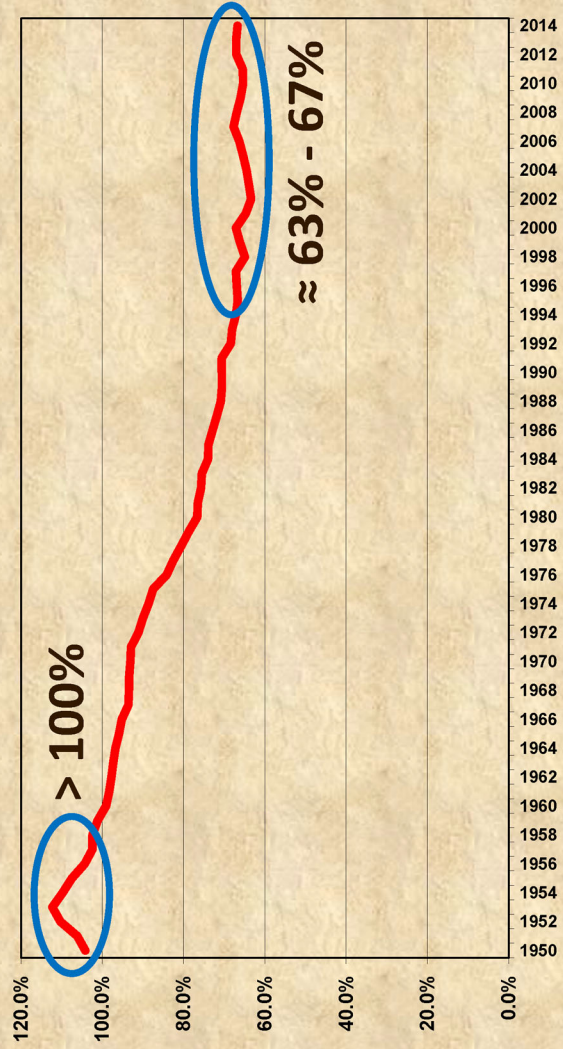
Puerto Rico: GDP vs. GNP

(Current prices. In millions.)

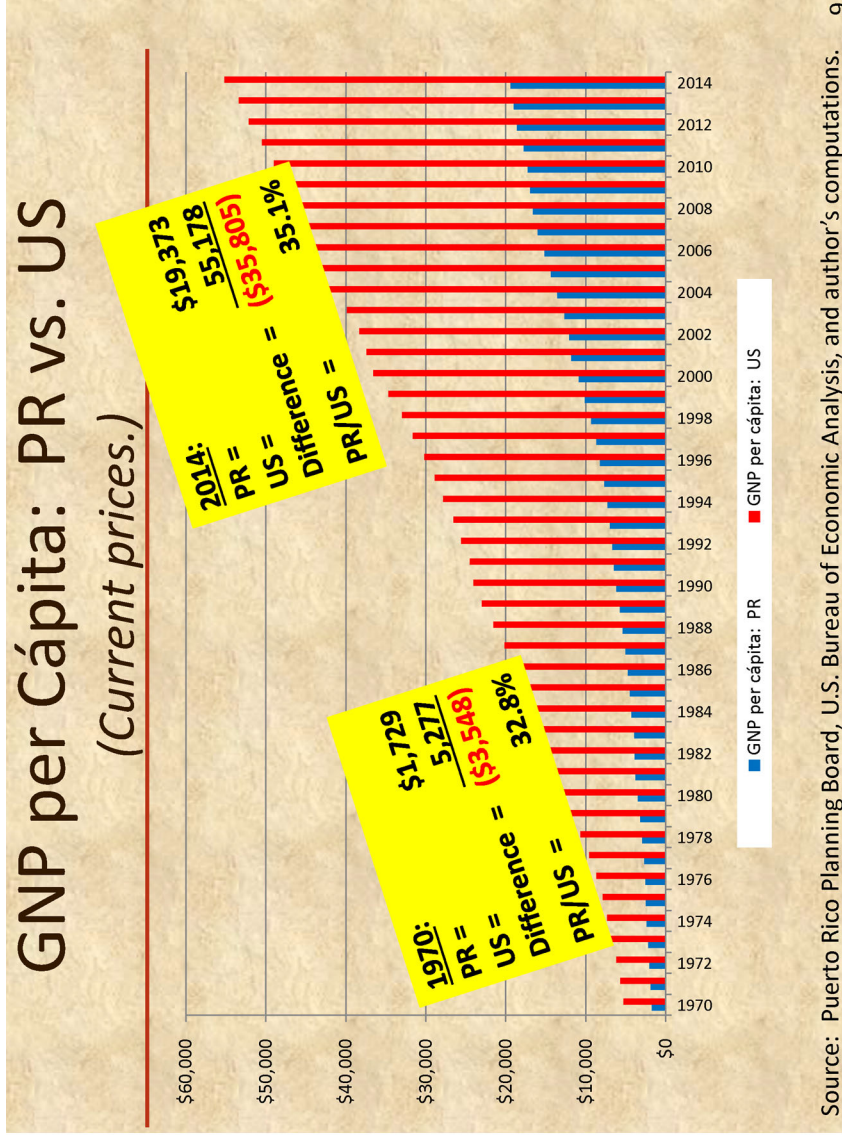


Source: Puerto Rico Planning Board and author's computations.

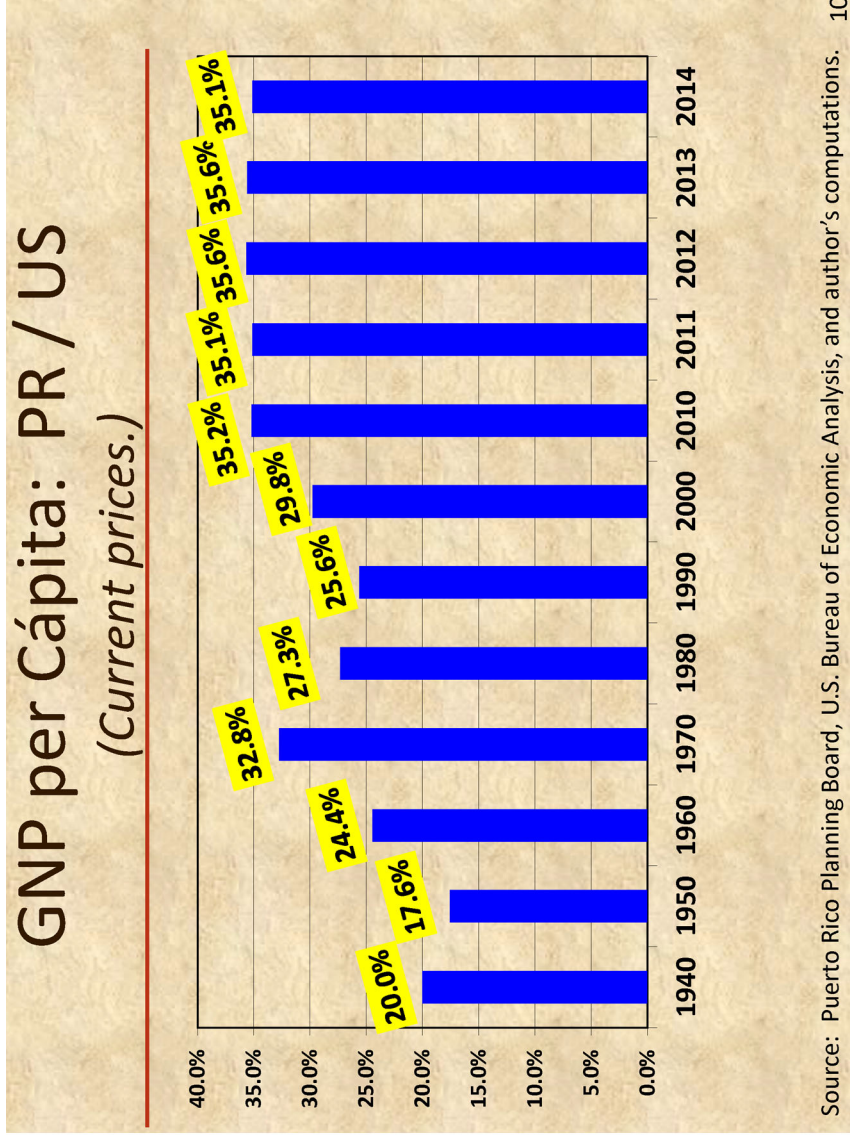
Puerto Rico: GNP / GDP



Source: Puerto Rico Planning Board and author's computations.



Source: Puerto Rico Planning Board, U.S. Bureau of Economic Analysis, and author's computations.



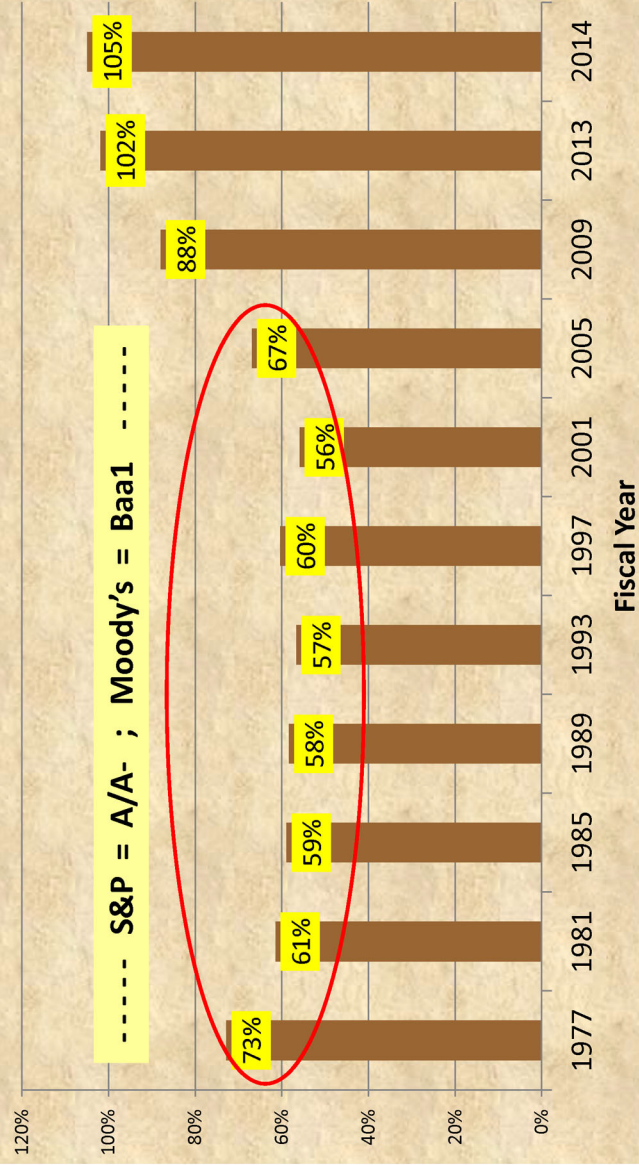
Fiscal Crisis

Puerto Rico's Public Debt (In millions.)



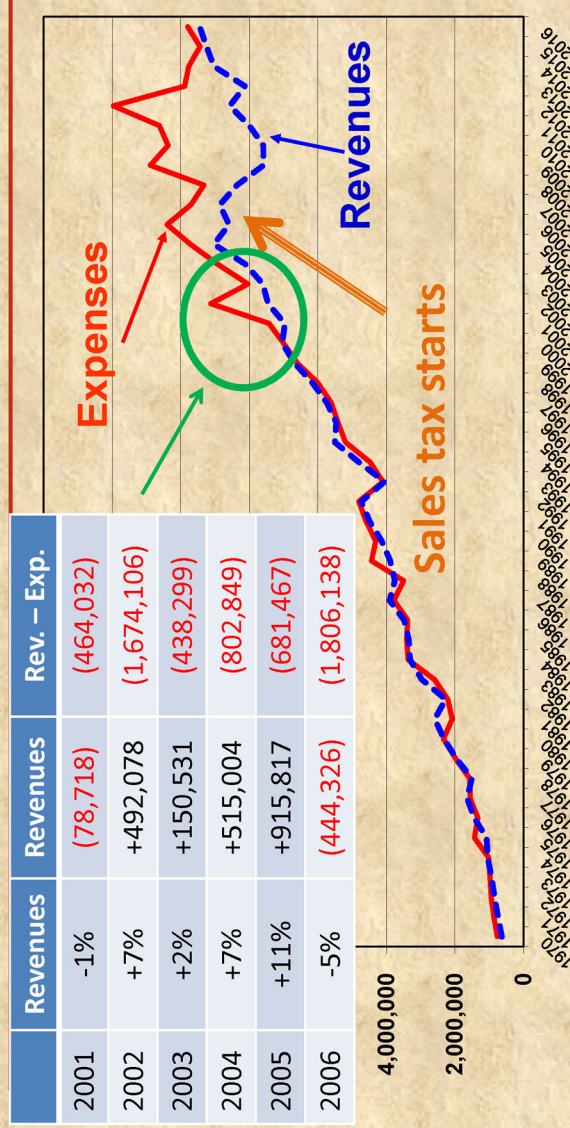
Source: Government Development Bank for Puerto Rico.

Public Debt as a % of GNP



Source: Government Development Bank for Puerto Rico.

General Fund: Revenues vs. Expenses (In \$ thousands.)



Sources:

1970-2013: *Comprehensive Annual Financial Report (CAFR)* of the Government of Puerto Rico.

2014-2016: Puerto Rico Office of Management and Budget.

Additional Facts

Income, Expenses, and Investment in PR (In millions.)

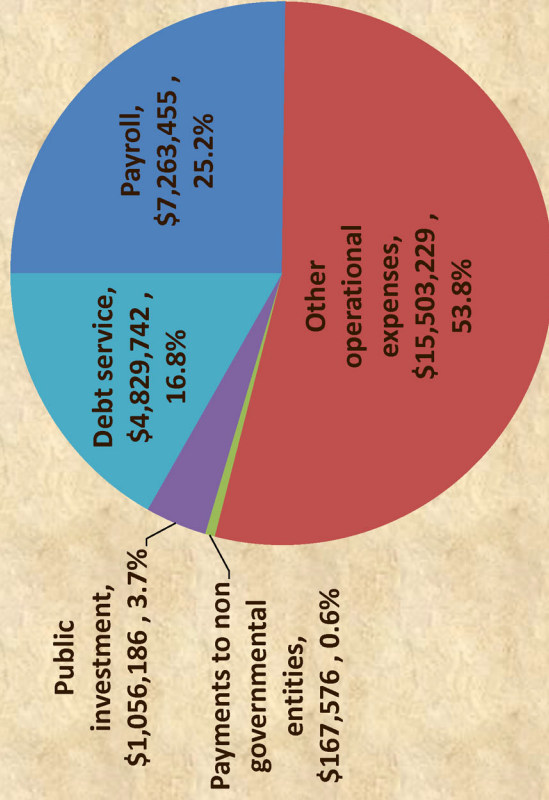
	2003	2014	Average annual change
Disposable personal income			
At current dollars	\$42,132.6	\$61,444.2	+3.49%
At constant dollars	\$8,723.3	\$9,659.3	+0.93%
Personal consumption expenditures			
At current dollars	\$41,970.4	\$62,324.4	+3.66%
At constant dollars	\$8,832.2	\$9,797.7	+0.95%
Gross domestic investment			
At current dollars	\$11,619.1	\$9,065.7	-2.23%
At constant dollars	\$1,871.9	\$1,369.4	-2.80%

Source: Puerto Rico Planning Board, Statistical Appendix.

Government Budget: 2015-2016

(In thousands.)

Consolidated Budget = \$28,820,188

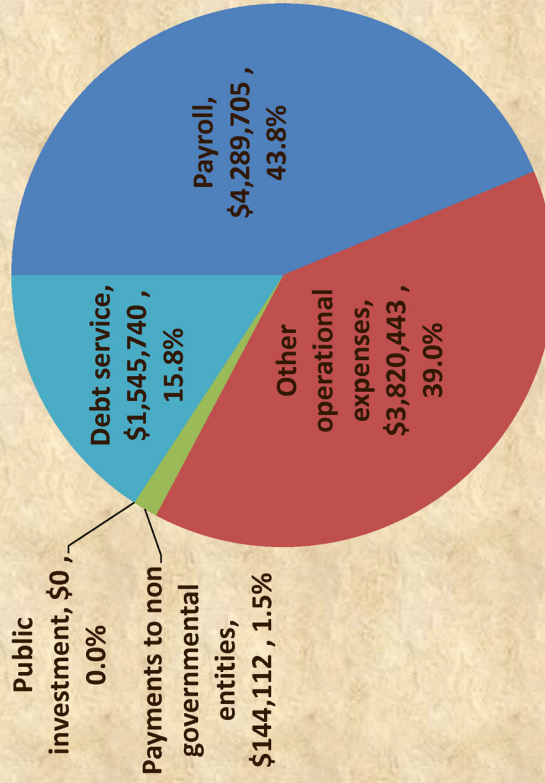


Source: Puerto Rico Office of Management and Budget

Government Budget: 2015-2016

(In thousands.)

General Fund Budget = \$9,800,000



Source: Puerto Rico Office of Management and Budget

The Impact of the Federal Minimum Wage on Employment in Puerto Rico

Negative? ...

➔ “Imposing the U.S.-level minimum reduced total island employment by 8-10 percent compared to the level that would have prevailed had the minimum been the same proportion of average wages as in the United States.”

Castillo-Freeman, Alida J. and Richard B. Freeman. (January 1992, p. 178). “When the Minimum Wage Really Bites: The Effect of the U.S.-Level Minimum on Puerto Rico.” Chapter 6, pp. 177-212, in Borjas, George J. and Richard B. Freeman, editors, *Immigration and the Workforce: Economic Consequences for the United States and Source Areas*, University of Chicago Press.

... or maybe not?

➡ “... the cross-industry panel analysis of Castillo-Freeman and Freeman is found to be extremely sensitive to plausible, minor changes in specification. Indeed, just estimating Castillo-Freeman and Freeman's specification by weighted least squares (WLS), instead of ordinary least squares (OLS), changes the sign of the minimum wage variable. The basic conclusion of this paper is that **the evidence on minimum wage effects stemming from Puerto Rico is quite fragile.**”

Krueger, Alan B. (June 1994, p. 4). “The Effect of the Minimum Wage When It Really Bites: A Reexamination of the Evidence from Puerto Rico.” NBER Working Paper No. 4757.

Impact on Current Crises?

➤ **“The timing of their problems does not have to do with the minimum wage,”** Richard Freeman, the Herbert Ascherman Chair in Economics at Harvard University, told ThinkProgress. “I don’t believe it’s done much positive but it certainly didn’t cause any of the current problems.” ... “I thought that was going to be the great cause of massive job loss,” he said. Instead, they found that it reduced total employment on the island by 8 to 10 percent, mainly in low-wage jobs. **That wasn’t as much as he had expected, and the losses were also concentrated in some industries that were already on the decline.** “It’s dubious it would cause the problems today,” he said ... “If I were looking for solutions for getting the economy out of its trouble, **I wouldn’t be pushing the minimum wage,**” he said.

Covert, Bryce. (July 8, 2015). “What Really Caused the Puerto Rican crisis.” *ThinkProgress*.
(<http://thinkprogress.org/economy/2015/07/08/3677565/puerto-rico-crisis-minimum-wage/>)

Conclusions and Recommendations

Fiscal Crisis and Economic Crisis

- The fiscal crisis and the economic crisis that afflict Puerto Rico are two separate problems, with very distinct causes and origins.
- Fiscal crisis:
 - Origin:
 - Spending in excess of revenues: 2001 budget
 - Balancing the budget with debt: 2005 budget
 - Cause: Excess public spending
- Economic crisis:
 - Origin: Mid 1970s
 - Cause: Economic policies divorced from globalization trends.

Fiscal Crisis: What needs to be done?

- Reduce expenses in the General Fund by \$1,000 - \$1,500 million annually
 - Actively involve labor leaders.
 - Evaluate the possibility of eliminating some government agencies.
 - Eliminate subsidies to cities, towns, and related agencies.
 - No firings of government employees.
 - No recruiting of new government employees.
- Redirect resources toward investing the GDB.
- Study the possibility of liquidating the GDB.
- Do not use PPPs as financing tools.
- Reduce income taxes and replace them with consumption-based taxes, **ON A REVENUE NEUTRAL BASIS!**
- Create the General Fund Trust to preserve the funds to be received from asset sales.
- In the different retirement systems, link benefits to contributions while preserving, as much as possible, the defined-benefits structure.
- Private sector entities like, for example, the Chamber of Commerce and the Manufacturers Association, should explore the possibility of providing services that in Puerto Rico, contrary to other jurisdictions, are carried out by government agencies (e.g., Tourism Company, PRIDCO).

“Competitiveness is a meaningless word when applied to national economies. And the obsession with competitiveness is both wrong and dangerous”.

Krugman, Paul. (March/April 1994).
“Competitiveness: A Dangerous
Obsession.” *Foreign Affairs*, 73(2), p. 44.

Economic Crisis:

What needs to be done?

- ➔ Top priority: Growth and wealth creation.
- ➔ Public policy that encourages exporting by local firms.
- ➔ Reduce the cost of doing business in Puerto Rico.
- ➔ To be really effective, all of this should be done by consensus, and with the principal political parties sitting at the table.

End

Alejandro J. García Padilla
Governor of the Commonwealth of Puerto Rico
Written Testimony
U.S. Senate Committee on the Judiciary
Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution
Tuesday, December 1, 2015

Chairman Grassley, Ranking Member Leahy and members of the Committee:

The consequences of a default without any legal framework to restructure our liabilities are so disastrous that for the past 6 months we have been executing emergency measures to continue meeting our obligations with our creditors and avoid a disruption of essential services to our citizens. These emergency measures are unsustainable.

The Commonwealth of Puerto Rico has so far avoided a major default with bondholders by executing emergency measures such as: not paying tax refunds; funding working capital needs by selling assets of the worker's compensation fund; advancing the liquidation of assets of our pension systems; stretching third-party payables to over \$1.6 billion; suspending set-asides for the payment of general obligation bonds; and not paying the bonds of a subsidiary of the Government Development Bank for Puerto Rico ("GDB").

The emergency measures we are deploying are in addition to the austerity measures that Puerto Rico has been implementing over the last decade. Measures that have caused further economic contraction, limiting our ability to meet our obligations and causing massive outmigration. In the three years of my Administration alone we have, inter alia, reformed our largest pension fund from a defined benefit plan to a defined contribution plan, including for current employees; froze collective bargaining agreements, revenues measures that impacted the sales tax, the petroleum products tax and water rates; reduced government employment as a share of the population to an average lower than in the states though attrition and hiring freezes; and reduced expenses by twenty percent, the lowest spending level in a decade. The people of Puerto Rico have been the sole bearers of these burdens.

The depth of our debt crisis has been extensively documented. In June 29, 2015 we released a debt sustainability analysis commissioned from Dr. Anne Krueger, the former Chief Economist at the World Bank and First Deputy Director of the International Monetary Fund ("IMF") and other former IMF economists. That report was followed by the forensic accounting analysis by Conway MacKenzie dated August 25, 2015; the Puerto Rico Fiscal and Economic Growth Plan dated September 9, 2015; my written testimony for the U.S. Senate Committee on Energy and Natural Resources hearing titled "Puerto Rico: Economy, Debt and Options for Congress" held in October 22, 2015; and the Commonwealth of Puerto Rico Financial Information and Operating Data Report dated November 6, 2015. The five documents are enclosed. Various stakeholders have called for greater transparency with respect to the financial information of the Commonwealth. We can improve the availability of our financial data; however, equally true, is the fact that in no point in time has the Commonwealth provided as much financial information as we have currently disclosed. The reality and immediacy of the

crisis has been validated by the U.S. Department of the Treasury and illustrated by the massive outmigration of our citizens.

The emergency measures and fiscal adjustments outlined above have so far stayed off a default. The actions, however, are having a devastating effect on our economy and on the Commonwealth's revenues: further diminishing our capacity to repay. The island is being suffocated by a vicious cycle of fiscal adjustments that decrease economic activity and revenues, which then require further fiscal adjustments. As the Puerto Rico Fiscal and Economic Growth Plan illustrates, over the next five years we project a financing gap of \$28 billion. More austerity measures will not bridge that gap. Putting Puerto Rico on a sustainable path in the long-term necessitates a legal framework to restructure all our liabilities.

Given the absence of a restructuring mechanism we are trying to negotiate a resolution with a countless number of creditors. So far this type of voluntary process has not been encouraging. After more than a year of negotiation the Puerto Rico Electric Power Authority has not been able to reach an agreement with its creditors because of a single holdout. A holdout, I should add, that has extracted preferential treatment. This out of court restructuring process is yielding inequitable results for the debtor and a majority of the creditors. We need a restructuring process that is fair to all stakeholders, lowers electricity rates and promotes economic growth.

The Commonwealth has no legal authority to restructure its debts or any legal recourse to defend its citizens from a default. Congress and the U.S. Courts have left the people of Puerto Rico bereft of any legal remedy. And the downward spiral of economic contraction and revenue declines is intensifying. In early November we revised our revenue forecast downward from \$9.8 billion to \$9.4 billion. Last month our revenues plummeted and, yesterday, we did a further downward revision to \$9.2 billion.

In light of the rapidly deteriorating revenue situation, in accordance with Article 6, Section 8 of the Constitution of the Commonwealth of Puerto Rico, I ordered the "clawback" of revenues assigned to certain instrumentalities of the Commonwealth for the repayment of their debts. Together these instrumentalities have approximately \$7 billion in bonds outstanding. In simple terms, we have begun to default on our debt in an effort to attempt to repay bonds issued with the full faith and credit of the Commonwealth and secure sufficient resources to protect the life, health, safety and welfare of the people of Puerto Rico.

Without a federally authorized legal framework, this will be the beginning of a very long and chaotic process. The choices ahead will become ever more difficult and potentially harmful to our economy, our stakeholders and our people. Let me be clear, if Congress does not provide Puerto Rico the authority to restructure all its liabilities a humanitarian crisis will envelop the 3.5 American citizens on the island. We are simply requesting rule of law. This costs nothing to the federal government. Give Puerto Rico the tools it needs to manage its crisis.

Thank you for your time and attention.



The Hon. Pedro R. Pierluisi
Oral Testimony
“Puerto Rico’s Fiscal Problems: Examining the Source and Exploring the Solution”
Senate Committee on the Judiciary
December 1, 2015

Chairman Grassley, Ranking Member Leahy, and Members of the Committee:

Thank you for inviting me to speak on behalf of the island’s 3.5 million American citizens.

When Puerto Rico becomes a state, as I know it will, my constituents will vote for the president and members of Congress who make our laws, and they will be treated equally under those laws.

Until then, Puerto Rico must depend on the goodwill of senators and representatives from the states. We must make the case for congressional action, and hope you find it compelling. We are reduced to the role of a supplicant, pleading for equal treatment, or at least more equitable treatment.

What a shameful arrangement—for us, but also for you.

I believe in American exceptionalism—the concept that this country is unique in terms of its character and its conduct. But I also believe that the manner in which the federal government has treated Puerto Rico could cause one to question whether our nation’s devotion to democratic self-government is rhetorical rather than real.

This is the fifth congressional hearing on Puerto Rico this year. At each hearing I have emphasized that Puerto Rico confronts a crisis for two reasons.

First, the Puerto Rico government has demonstrated a lack of discipline, transparency and common sense when it comes to managing its finances and creating a business climate that attracts private investment, generates jobs and grows the economy. Any individual that aspires to a leadership position in Puerto Rico should acknowledge that island officials have a record of over-promising and under-delivering, and should have a credible plan to break this cycle.

Second, the federal government’s policies towards Puerto Rico are inequitable and incoherent. They essentially make it impossible for the island to prosper, even if our local leaders were beyond reproach.

Just as Puerto Rico’s leaders must concede their failures, this Congress must acknowledge its own responsibility. Introspection is a two-way street.

For example, it is inexcusable that over 500 days have elapsed since the end of Fiscal Year 2014 and the Puerto Rico government has not yet released an audited financial statement. Members of Congress are right to criticize Puerto Rico for such ineptitude.

But let's place things in proper perspective. Puerto Rico has been treated unequally under Medicaid and Medicare for 50 *years*; under the SSI and EITC programs for over 40 years; and under the CTC program for nearly 20 years. The argument that Congress needs audited financial statements from Puerto Rico before it can act to rectify these devastating, decades-old disparities defies logic.

Faced with this lack of federal economic support, and seeking to provide a decent quality of life for its people, the Puerto Rico government—unwisely but understandably—has over-spent its own funds and over-borrowed in the bond market. This has led to recurring deficits, a large debt, and the loss of over 60,000 residents a year through migration to the states.

For both moral and practical reasons, Congress should swiftly enact a legislative package that gives Puerto Rico more equitable treatment under federal programs. Of course these provisions will cost money, just as it costs the federal government money every year when it spends \$2.5 billion to support the Medicaid program in Iowa, or sends over \$400 million in checks to working families in Utah under the EITC program, or provides \$100 million to vulnerable individuals in Vermont under the SSI program. If Congress refuses to provide fair treatment to my constituents, they will continue to move in massive numbers to the states in order to obtain it. That is the logical consequence of an illogical system.

This package should also authorize Puerto Rico to restructure a meaningful portion of its debt. We can have a reasonable debate about the scope and nature of this authority, but—at the very least—Puerto Rico should have the same ability to adjust its debts as the states. Providing this authority will cost the federal government nothing, whereas failing to provide it will have an enormous humanitarian cost.

If—but only if—Congress acts on these items, I will not oppose the creation of an independent board that respects the Puerto Rico government's primary role in crafting its budget and making fiscal policy, but that is authorized to ensure that the Puerto Rico government complies with appropriate budgeting standards and fiscal metrics. As I see it, this board should be redundant, because the governor and legislative assembly of Puerto Rico ought to be conforming to such standards and metrics anyway, and so I would not object to federal oversight to make certain that they do.

Five congressional hearings are enough. It is time for Congress to legislate and, in so doing, to be part of the solution to a problem it had a significant role in creating.

Thank you.



Statement before the United States Senate, Committee on the Judiciary on “Puerto Rico’s Fiscal Problems”

An Emergency Financial Control Board for Puerto Rico

Alex J. Pollock

Resident Fellow

American Enterprise Institute

December 1, 2015

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Committee on the Judiciary
United States Senate

Hearing on Puerto Rico's Fiscal Problems

December 1, 2015

An Emergency Financial Control Board for Puerto Rico

Mr. Chairman, Ranking Member Leahy, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Immediately before joining AEI, I was President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. I have published numerous articles on financial systems and credit crises, including municipal debt crises.

The government of Puerto Rico, having run a long series of constant budget deficits, has accumulated a very large debt which according to its own statements, it cannot pay. It is cut off from all normal municipal bond market financing and is running out of cash. The credit ratings of its many debt issuing entities are at the bottom of the scale, with a preponderance of CC ratings from S&P and Fitch and Ca ratings from Moody's, with additional defaults on or restructurings of government debt expected. With its current budget operations, financial control systems and government structure, it cannot produce clear, audited financial statements. The study performed by former IMF officers earlier this year concluded that "the overall deficit is larger than recognized, its true size obscured by incomplete accounting" and cited "weak budget execution and opaque data." In addition, public pension obligations, which in insolvency pit pensioners against creditors, are virtually unfunded and an estimated \$44 billion pension liability must be added to the \$71 billion in debt.

It is my recommendation that the Congress should promptly create an Emergency Financial Control Board to assume oversight and control of the financial operations of the government of Puerto Rico, as Congress successfully did in 1995 with Washington, DC; as New York State, with federal encouragement, successfully did with the insolvent and defaulting New York City in 1975; and as the State of Michigan did with the appointment of an Emergency Manager for the insolvent City of Detroit in 2013. Such Boards have also been used in Cleveland (1980), Philadelphia (1991), and Springfield, Massachusetts (2004). There is plenty of precedent.

Under the United States Constitution, Congress has sovereignty over territories and the clear authority to create such a Control Board. In my opinion, with Puerto Rico's severe and longstanding financial problems, Congress also has the responsibility to do so.

This should be the first step, prior to other possible legislative actions. I believe that the initial requirement is to establish independent, credible authority over all books, records and other relevant information; to analyze what the true overall financial deficit is; to determine which Puerto Rican government bodies are insolvent, in particular understanding the financial condition of the Government Development Bank which lends to the others; to consider fiscal, accounting and structural reforms which will lead to future balanced budgets and control of debt levels; and to consider in the light of all of these, how the current excessive levels of debt should be addressed. The Control Board should analyze and report to Congress on whether creating a bankruptcy regime for Puerto Rico is warranted as a subsequent legislative action.

The Administration's statement on "Puerto Rico's Economic and Fiscal Crisis" includes this proposal: "Enact strong fiscal oversight and help strengthen Puerto Rico's fiscal governance...Congress should provide independent fiscal oversight." This goes in the right direction, but is vague. I believe it needs to be something more specific, thus more likely to work: a Control Board. The Administration says financial oversight should "respect Puerto Rico's autonomy," but in fact Congress has unquestioned jurisdiction here. As one harsh, but accurate, assessment has it: if you are a subsidiary government and "you screw up your finances bad enough," you are going to get control and direction from somebody else.

The details of the Puerto Rican government's financial situation are complex, but the fundamentals are simple and make a familiar pattern. The government of Puerto Rico is broke. In the current century, it has run a budget deficit every single year-- 15 years in a row. Operating deficits have been financed by borrowing. As debts multiplied, debt service was met by additional borrowing. As one municipal bond expert wrote, "The Commonwealth [was] utilizing debt issuance to pay interest on existing indebtedness." This is the definition of a Ponzi scheme.

Such debt escalations always ends painfully when the lenders stop lending, as has now occurred. What must inevitably follow is reform of fiscal operations, default on or restructuring of debt, bailout funding, or permutations and combinations of these. What in particular must be done, and what the complete financial condition is, the proposed Emergency Financial Control Board must take up.

As the government of Puerto Rico recently disclosed:

-“On October 30, 2015 the Commonwealth filed a notice that the Commonwealth would not file its audited financial statements for fiscal year 2014 by October 31, 2015.”

-“The Commonwealth cannot provide an estimate at this time of when it will be able to complete and file its audited financial accounts.”

A municipal bond analyst from UBS opined that the “inability to produce an audited financial statement for a fiscal year that ended almost sixteen months ago is inexplicable.” On the contrary, it is all too explicable, given a financially stressed, insolvent borrower.

Among the “Risk Factors” for investors in its debt, the government currently cites the following:

-“The Commonwealth faces an immediate liquidity crisis.”

-“The Commonwealth does not have sufficient resources to pay its debt obligations in accordance with their terms.”

-“The budget deficit of the Commonwealth’s central government during recent years may be larger than the historical deficits of the General Fund because they do not include the deficits of various governmental funds, enterprise funds, and Commonwealth instrumentalities.”

-“The Puerto Rico Planning Board recently acknowledged the existence of certain significant deficiencies in the calculation of its macroeconomic data.”

-“The assets of the Commonwealth’s retirement system will be completely depleted within the next few years unless the Commonwealth makes significant additional contributions...the Retirement Systems will continue to have large unfunded actuarial accrued liability and a low funding ratio for several decades.”

-“Each fiscal year, the Commonwealth receives a significant amount of grant funding from the U.S. government. A significant portion of these funds is utilized to cover operating costs.”

-“The Commonwealth’s accounting, payroll and fiscal oversight systems have deficiencies due to obsolescence and compatibility issues...this has affected the Commonwealth’s ability to control and forecast expenses.”

-“The Commonwealth has frequently failed to meet its revenue projections.”

-“The Government Development Bank’s financial condition has materially deteriorated and it could become unable to honor all its obligations.”

-The Government Development Bank has historically served as the principal source of short-term liquidity for the Commonwealth and its instrumentalities,” but faces “the inability of the Commonwealth and its instrumentalities to repay their loans.”

-“The Commonwealth has failed to file its financial statements before the 305-day deadline in ten of the past thirteen years, including the most recent fiscal years (2012, 2013 and 2014).”

They themselves have said it. All indications are of a government much in need of emergency, authoritative management help which is not dependent on short-term local politics.

In addition, one Puerto Rican expert testified to the Senate Finance Committee that “Puerto Rico has an excessively bureaucratic and inefficient central government...when it comes to fiscal policy, budgeting, financial recordkeeping, tax collection, business permitting, professional contracting, use of modern technology and overall performance....Anyone who has dealt with the Puerto Rican government knows how opaque and difficult to navigate it can be.” Another expert has described “significant government corruption and predatory rent-seeking behavior,” along with “substantial tax evasion.” Are these assertions true? A Control Board will need to make judgments and then decisions accordingly.

I previously mentioned the robust precedents for Emergency Financial Control Boards. As one analyst correctly observed, “The fundamentals of Puerto Rico resemble those of New York City in the mid-1970s and of other municipalities on which a Financial Control Board has been imposed.”

The closest legal parallel is Washington DC, which had become a financial quagmire by the mid-1990s. Like Puerto Rico, Washington DC, not being a state, is Constitutionally subject to the direct jurisdiction of Congress. Congress responded with the District of Columbia Financial Responsibility and Management Assistance Act of 1995, which created the District of Columbia Financial Responsibility and Management Assistance Authority. (A good political title, which might be adapted for use in Puerto Rico.)

The Act was developed, approved and implemented as a successful bipartisan effort and the Board was given broad powers and authority. These included approving or disapproving financial plans and budgets, implementing recommendations on financial stability and management, approving the appointment of the Inspector General of the District government, having total access to official reports and data, holding hearings, issuing subpoenas, and requiring District officers and employees to carry out its orders.

A very important power, worthy of note, was to approve the appointment of an independent District Chief Financial Officer—an office which continues today.

Two years later, Congress followed up with the National Capital Revitalization and Self-Government Improvement Act of 1997, which set tighter controls. The purposes included: “to improve the ability of the District of Columbia government to match its resources with its responsibilities”—in other words, to run a balanced budget. Another explicit goal of this act is very relevant to Puerto Rico: improvement in tax collection.

Although there were disputes and difficulties along the way, the Washington DC Control Board achieved clear success in financial management and controls, efficiency, and indeed reaching balanced budgets. It adjourned in 2001, after Washington DC achieved its fourth consecutive balanced budget. The city’s bond ratings greatly improved; they have now reached AA/Aa. However, the Board remains in the wings, authorized for a possible return, should Washington DC’s budget discipline ever again slide into aggregate deficits.

Another strong precedent is New York City. Like Puerto Rico, it had run a long series of budget deficits, financed them with ever more debt, and finally needed new loans to service the old ones. In the spring of 1975, the market for the city’s debt closed. By that fall, the city government was out of money and was, with the support of many of its prominent citizens, lobbying desperately for a federal bailout. President Ford wisely turned this down.

Instead a deal was worked out among the federal, state and city governments, resulting in the establishment by New York State of the New York City Emergency Financial Control Board. Other elements of the deal were the default, called a “moratorium,” on the city’s short-term notes; later Congressionally-approved provision of seasonal emergency financing for three years by the U.S. Treasury; and restructuring of debt through bonds issued by the Municipal Assistance Corporation, also established by New York State. The necessity of the Control Board was primary.

Intensely needed reforms of New York City’s spending, management, budget discipline, financial reporting and financial controls were achieved. New York City by now has also improved its bond ratings to AA/Aa. Here is another success story for Control Boards and their ability to bring outside authority and resulting action. As then-Treasury Secretary William Simon later wrote, “The city and state were required to make decisions of a type they had heretofore refused to make.”

The State of Michigan, facing several municipalities in serious financial difficulty, adopted the Local Government and School District Accountability Act in 2011, authorizing the appointment of Emergency Managers, individuals rather than a board, with very broad financial and operating powers. The best known was Kevyn Orr in the City of Detroit, appointed in 2013, but four other Michigan cities have had similar appointments. (It seems to me that the more common practice of appointing a board, with the balance of multiple perspectives and expertise, is a preferred structure.)

In Detroit, the first step was the Emergency Manager. Having analyzed the massive problems and the debt, he concluded that the city's deep insolvency required a municipal bankruptcy. This largest municipal bankruptcy ever was concluded in 2014, with major losses to creditors, including smaller but significant losses to pension claims. Following the settlement of the bankruptcy, the Emergency Manager has been succeeded by the Detroit Financial Review Commission, which will continue to oversee the city's budgets and financial management.

Should Puerto follow Washington DC and New York City, working its way through its management and debt problems without a bankruptcy proceeding? --or should it follow Detroit, with a bankruptcy included along with reforms? I believe Congress should first appoint the Control Board for Puerto Rico, and charge it with getting on top of the financial situation, pursuing management reforms, considering the debt servicing issues, and then recommending to Congress whether or not a bankruptcy, which would involve new bankruptcy legislation, is required.

Let's compare the debt burdens of three of the cases. The government of Puerto Rico's \$71 billion in total debt is 15% greater than the \$62 billion, when re-stated to 2015 dollars, of New York City during its 1975 debt crisis. Detroit's debt, in 2015 dollars, was \$19 billion. Since the populations of the three are very different--Puerto Rico, 3.6 million; New York City 7.9 million; City of Detroit, 700 thousand-- we need to view the per capita local government debt. These were, at the time of each crisis, expressed in 2015 dollars:

Puerto Rico	\$20 thousand
New York City	\$ 8 thousand
City of Detroit	\$27 thousand

Puerto Rico is much more heavily indebted per capita than New York City was, but less so than Detroit.

One of the most distressing economic statistics of Puerto Rico is its labor participation rate of less than 40%. There is additional work in the "informal" sector, but that does not generate taxes to pay the government's debt. So let's look at local government debt per officially employed person in 2015 dollars:

Puerto Rico	\$71 thousand
New York City	\$19 thousand
City of Detroit	\$90 thousand

Again, the Puerto Rican debt level per employee is much worse than New York City, but 20% less bad than Detroit. Maybe in Puerto Rico the Emergency Financial Control Board will be sufficient to work through the reforms while debts are restructured outside of bankruptcy. I do not think it is possible to say at this point.

In any case, the financial and managerial problems are severe, cash is running out, and time is wasting. In my judgment, Congress should establish the Emergency Financial Control Board for Puerto Rico as a high priority.

Thank you again for the opportunity to share these thoughts.

Outline of the testimony of Richard Ravitch before the Senate Judiciary Committee
December 1, 2015

1. Restructuring **all** of the debt obligations of the Commonwealth of Puerto Rico and its municipalities and in conjunction with the establishment of a federal control Board is essential to ensure social stability and economic growth in the territory of Puerto Rico.
2. My experience with the New York City fiscal crisis in 1975, my role as advisor to the bankruptcy judge in Detroit, and my work with Paul Volcker as co-chair of the state and city fiscal crisis task force constitutes the basis of the recommendations I'm offering to this Committee.
3. The gross product of Puerto Rico has declined by 9% in the latest decade and employment has fallen by almost 14 percent.
4. The total debt service represents almost 40% of the revenues available to the government whereas debt service in our states and cities is rarely greater than 6% of their revenues.
5. The pension system will run out of money in another 12 to 18 months and the obligation to pay benefits, without modification, will cost the Commonwealth \$1.2 billion annually.
6. If the total debt service isn't dramatically reduced there will be insufficient funds to provide essential public services and the risk of social unrest and accelerated emigration from the island could impose a significant cost to the federal government given the fact that the 3 1/2 million people who live in Puerto Rico are United States citizens. To quote from a Wall Street Journal editorial in July "Bankruptcy would be painful and carries risks, but an orderly restructuring under a legal framework in federal court is preferable to a creditor brawl that would likely follow up a default. Hedge funds, mutual funds and bond insurers would have to take haircuts for mis-pricing the risk and enabling Puerto Rico's political mismanagement. Incredibly, yields on the island's general obligation bonds were as low as 6% two years ago----- they are now 12%
7. A bankruptcy filing would enable the Commonwealth to undertake debtor in possession financing thus providing a cash flow during the period of debt restructuring and budget Reformation.
8. Any argument that enabling Puerto Rico to file sets a precedent for states is incorrect because it is a constitutional inhibition which prevents states from filing that is not applicable to the Commonwealth... a point overlooked in an article by Jeb Bush and Newt Gingrich advocating the right of states to use the bankruptcy code.
9. The risk of legislative changes to the law has already been priced into the current market value.
10. Voluntary restructuring would never produce an annual debt service cost that would afford the Commonwealth sufficient funds to regrow its economy.

Inevitably there would be holdouts whereas under bankruptcy the collective action clause would bind everyone.

11. To limit the bankruptcy authorization to just the corporations and municipalities would produce an iniquitous result. Citibank has estimated that such an authorization would instantly raise the value of the GO and Cofina debt by approximately \$4 billion. This would provide a reward to those who receive the highest interest rate for taking the highest risk. Such a limitation would also prevent enough cash flow saving to address the problem of economic growth-- the most significant objective of this entire effort.
12. The contemporaneous creation of a control board that would have the power to approve the Commonwealth budgets, its future indebtedness, and its collective-bargaining agreements would constitute the assurance that the revised debt obligations would be paid and that the Commonwealth would no longer use the proceeds of borrowing to cover operating deficits.

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TESTIMONY

OF

STEPHEN J. SPENCER

December 1, 2015

U.S. Senate Committee on the Judiciary

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

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Introduction

Chairman Grassley, Ranking Member Leahy, and members of the Committee, thank you for allowing me to testify today and to share the benefit of my experience and insight on the source of, and possible solutions to, Puerto Rico's fiscal problems.

My name is Stephen J. Spencer.¹ I represent certain funds managed by Franklin Advisers ("Franklin") and by OppenheimerFunds, Inc. ("Oppenheimer") in connection with their investment in approximately \$10 billion of bonds issued by the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico") and its government agencies.² Franklin and Oppenheimer have been for many years two of the largest investors in bonds issued by Puerto Rico and its governmental corporations. Hundreds of thousands of individual retail investors in the U.S. States and Puerto Rico invest in Commonwealth debt through funds managed by Franklin and Oppenheimer alone.³

Throughout the past year and a half, I have been on the frontlines in the negotiations between my clients and the government of Puerto Rico, particularly the Puerto Rico Electric Power Authority ("PREPA"), that recently resulted in a consensual restructuring agreement wherein my clients are providing debt relief to support PREPA's revitalization. For the PREPA negotiations, I advise both Franklin and Oppenheimer, along with the investment interests of six separate asset investors. Through this lens, I have developed a deep understanding of the Commonwealth's finances, economy, tax structure, government inefficiencies, and political challenges. In addition, I have represented creditors in other municipal restructurings, including San Bernardino, Detroit, and the Indiana Toll Road, so I have significant related experience on municipal finance.

Mr. Chairman, I agree with the sentiment you expressed in the press release announcing this hearing, stating that "restructuring debt and throwing taxpayer money at the Commonwealth, without ensuring the creation and implementation of structural and fiscal reform, fails to resolve the underlying problems in Puerto Rico required to creating economic growth." I would further submit that enactment of legislation, such as S.1774, that retroactively amends the Bankruptcy Code to authorize Puerto Rico to declare its government corporations eligible for Chapter 9, would be a bailout of Puerto Rican municipal corporations on the backs of hundreds of thousands of individual retail investors throughout the United States, including Puerto Rico: a bailout that would undermine reform efforts needed to foster growth in Puerto Rico by violating the sanctity of contract; undermining the rule of law; and harming the Commonwealth and municipal debt markets throughout the country.

Moreover, Chapter 9 is not needed to solve Puerto Rico's problems. As demonstrated by the recently announced agreement between PREPA and its largest bondholders, whom I represent, debt service issues can be worked-out in a mutually acceptable manner under current law and contracts. While the PREPA

¹ I am a Managing Director at Houlihan Lokey with over 20 years of relevant experience advising both debtors and creditors in large, complex corporate and municipal restructurings. In municipal finance, in addition to advising the largest investors in Puerto Rico, I have advised creditors in the Detroit, San Bernardino, and Indiana Toll Road restructurings. I am a Financial Industry Regulatory Authority ("FINRA") series 7 and series 63 registered financial representative.

² Franklin and Oppenheimer are the largest investors in the Commonwealth's General Obligation, Puerto Rico Sales Tax Financing Corporation ("COFINA"), PREPA and a variety of other government agency debt issues.

³ Franklin and Oppenheimer estimates.

agreement required hard work and shared sacrifice – my clients have agreed to support a significant haircut, and a reduction in interest rate, for all bondholders – the PREPA agreement illustrates that debtor / creditor divisions are not insurmountable and that the current process can work without Congress retroactively changing Chapter 9.

I appreciate the opportunity to provide some additional perspectives on Chapter 9 and on the source of Puerto Rico’s fiscal problems.

Chapter 9 – Commonwealth Spin vs. Fiscal Reality

Extending Chapter 9 to Puerto Rico has been presented as an issue of fairness and as a simple, non-controversial fix. The argument is that Puerto Rico, like U.S. States, should have access to bankruptcy as an effective tool to manage the Commonwealth’s financial challenges, and that opponents are financial opportunists engaging in a form of market predation. These arguments are dangerously misguided. Chapter 9, whether applied to municipalities and governmental corporations in its current form, or in a “Super Chapter 9” format for the Commonwealth itself, is ineffective as a tool for use in addressing the root causes of municipal financial distress, and its use in Puerto Rico would have broad adverse consequences on municipal borrowers and individual retail investors throughout the United States. Contrary to the public spin being put on the issue by the Commonwealth, there is nothing simple, straight forward, or even fair about extending Chapter 9 to Puerto Rico. It is a complex issue with potentially profound negative financial and public policy ramifications and I urge you not to pass S.1774.

Chapter 9 Impedes Fiscal Reform

Proponents of Chapter 9 for Puerto Rico assume it would provide an effective and “orderly” tool for the Commonwealth to use in addressing its financial constraints. In reality, Chapter 9 has a proven track record of frustrating the fiscal and structural reforms that are needed for the Commonwealth to achieve a sustainable recovery (notably, 22 U.S. States have not authorized their municipalities to file under Chapter 9 for good reason). This poor track record is rooted in Congress’ decision to omit from Chapter 9 many of the creditor protections that are a key part of Chapter 11. Crucially, Congress omitted these protections from Chapter 9 out of concern that federal intervention might interfere with the Tenth Amendment rights of States to control their own municipalities – a concern that does not apply to Puerto Rico, due to its territory status.⁴ As a result, Chapter 9 is fundamentally different from Chapter 11.

⁴ See *Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico*, 2015 WL 4079422, at *9 (1st Cir. July 6, 2015) (because Puerto Rico is a Territory, “the limitations on Congress’s ability to address municipal insolvency in the states . . . are not directly applicable to Puerto Rico. Accordingly, Congress may wish to adopt other – and possibly better – options to address the insolvency of Puerto Rico municipalities that are not available to it when addressing similar problems in the states.”) (citations omitted); *id.* at *14 (“The limits of the Tenth Amendment do not apply to Puerto Rico, which is ‘constitutionally a territory’”) (citations omitted); see generally M. W. McConnell & R. C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. Chi. L. Rev. 425, 427-28 (1993) (describing Tenth Amendment bases of Chapter 9’s limitations).

A few examples make clear the enormous practical consequences of Congress' omission from Chapter 9 of creditor protections that are included in Chapter 11:

- Court Powers. In Chapter 11, if a debtor hides assets or cannot (or will not) provide critical financial information, then creditors can petition the judge to install a Chapter 11 trustee to provide a fair and impartial accounting. Not so in Chapter 9. No *federal* judge can usurp the right of a *municipality* to self-govern. Consequently, if a municipality bungles, stalls, or if it cannot even provide basic audited financial information (as is the case with Puerto Rico),⁵ there is little a creditor can do.
- Plan Exclusivity. In Chapter 11, the debtor cannot simply remain in bankruptcy indefinitely. Creditors can file their own plans for the corporate debtor after, at most, 18 months – even sooner if the Court allows. Not so in Chapter 9. Only the municipal debtor can file a plan. A municipal debtor can wage a war of attrition against creditors indefinitely if it chooses. The strategy can dramatically escalate creditor costs, as well as administrative costs of debtors,⁶ and the mere threat of it conveys incredible leverage to a municipal debtor.
- Sheltering Assets. In Chapter 11, the debtor must sell extraneous assets. Not so in Chapter 9. A municipality can accumulate substantial non-core assets and actually use Chapter 9 bankruptcy protection to shield them.

Detroit's bankruptcy is often erroneously cited as an example of a "successful" Chapter 9. As the advisor to Detroit's single largest unsecured creditor, I can address this misperception from personal experience. The end result was that investors took disproportionately large losses so Detroit could avoid needed reforms. Specifically, the Detroit Plan of Adjustment ("Plan") had a number of major deficiencies including:

Failure to address pensions – Although pension costs were the single largest expenditure in Detroit's budget,⁷ the city's pension obligations were effectively reinstated in full while bondholders received less

⁵ Most recent audited Commonwealth financial statements provided for FY 2013. FY 2014 audited financials originally due on October 30, 2015 have not yet been provided. <http://www.bgfpr.com/documents/2013CommonwealthFIS-SecuredVersion.pdf>

⁶ The restructuring advisory expenditures for the City of Detroit's bankruptcy totaled more than \$180 million for the 18 months the city spent on bankruptcy equating to approximately 12% of the \$1.5 billion in repudiated bond debt.

- (i) Karen Pierog, Lisa Lambert, and Matthew Lewis. "Fees, expenses for Detroit bankruptcy hit nearly \$178 million." *Reuters* 30 December 2014. <http://www.reuters.com/article/2014/12/30/usa-detroit-bankruptcy-fees-idUSL1N0UE1LJ20141230#HxQhBXyMb8moj5r.97>
- (ii) "City of Detroit Plan of Adjustment - 40 year projections." http://www.michigan.gov/documents/treasury/Detroit_FRC_Plan_of_Adjust_40_Year_Proj_10-21-14_490442_7.pdf

⁷ Fourth Amended Disclosure Statement for the Adjustment of Debts of the City of Detroit, 5 May 2014. Pages 99 and 145 (of 197) and page 12 (of 212). <https://www.kccllc.net/detroit/document/135384614050500000000005>

than 10 cent recoveries.⁸ Post-bankruptcy, the city recently concluded that the size of the remaining pension obligation may stress cash flow to the point of derailing a recovery.⁹

Failure to cut costs – In just one of many examples, Detroit was unable to staunch the bleeding in the Detroit Department of Transportation (“DDOT”). Although millions were spent on outside consulting reports recommending a range of operational efficiency improvements, not a single major strategic suggestion was adopted. Consequently, the city’s Plan projected that DDOT would continue to lose hundreds of millions of dollars over the next decade, despite tens of millions in federal and state support annually.¹⁰ Today, DDOT remains inefficient and poorly managed.¹¹

Failure to streamline government infrastructure – Despite abysmal government service delivery metrics and overlapping operational objectives among multiple government agencies, no structural changes to Detroit’s government were made. The city exited bankruptcy with the same 28 government agencies it had when it entered into bankruptcy.¹² I note that Puerto Rico has 120 government agencies, suggesting even greater structural realignment opportunities may exist within the Commonwealth.

Failure to adopt a strategic plan – By ignoring calls from urban planners and civic engineers,¹³ Detroit failed to rationalize its geographic footprint to serve a much smaller population. Consequently, the city’s \$1.7 billion pot of revitalization capital is being spent on a far less efficient, largely ad hoc basis to revive a civic infrastructure originally designed to support a population nearly three times as large.¹⁴

In these and many other ways, the Detroit bankruptcy failed to accomplish critical reforms to help the city achieve a quicker, more efficient, and more secure long-term recovery. According to the bankruptcy court’s own expert witness, “[t]he bankruptcy ha[d] been largely focused on deleveraging [Detroit] ...often to the exclusion of fixing [Detroit’s] broken operations.” As a result, “the operational restructuring that often occurs with commercial reorganizations will be left largely to Mayor Duggan and his managers for the post confirmation period.”¹⁵

The problem isn’t unique to Detroit. In the handful of other cities that have attempted to use Chapter 9 as a tool to adjust their debts, little has been done to address legacy entitlement expenditures or achieve a more efficient and effective government. While bankruptcy judges have recognized a municipality’s

⁸ City of Detroit – Expert Witness Report of Stephen J. Spencer. July 2014.

⁹ Matthew Dolan, Matt Helms and Joe Guillen. “\$195M pension payment might derail Detroit’s recovery.”

Detroit Free Press 15 November 2015. <http://www.freep.com/story/news/local/detroit-bankruptcy/2015/11/14/detroit-pension-balloon-payment-estimated-195m/75657200/>

¹⁰ See source cited in footnote 7.

¹¹ Stephen Henderson and Kristi Tanner. “Region’s transit system can’t get many to job centers.” *Detroit Free*

Press 22 February 2015. <http://www.freep.com/story/opinion/columnists/stephen-henderson/2015/02/22/detroit-bus-transit/23775245/>

¹² See source cited in footnote 8.

¹³ “Detroit Future City – 2012 Detroit Strategic Framework Plan.” May 2013. Page 10.

http://detroitfuturecity.com/wp-content/uploads/2014/02/DFC_ExecutiveSummary_2ndEd.pdf

¹⁴ See source cited in footnote 7.

¹⁵ Expert Report of Martha E.M. Kopacz Regarding the Feasibility of the City of Detroit Plan of Adjustment.

Page 26.

<http://www.detroitmi.gov/portals/0/docs/em/bankruptcy%20information/m.%20kopacz%20expert%20report%20to%20judge%20rhodes%20071814.pdf>

power to abrogate pensions, the municipalities have strongly resisted cuts impacting government workers and none, so far, have meaningfully diminished pension obligations. The difficulty in reducing pension costs has been equally evident in the Vallejo, Stockton, and San Bernardino bankruptcies. In these cases, the same pattern elevating the financial interests of pensions and labor above financial creditors, and even municipal residents, is clear.¹⁶ Because active and retiree labor costs are rapidly growing municipal financial obligations,¹⁷ more widespread use of Chapter 9, including in Puerto Rico, risks relegating municipalities to a serial Chapter 9 filing, which confiscates savings from a diminishing pool of lenders but solves no problems. Indeed, the City of Vallejo, having cut virtually everything but its pension costs, may soon find itself back in bankruptcy to address its biggest problem, and one it used the first Chapter 9 to ignore.¹⁸

One of the primary reasons this kind of failure to cut costs and achieve greater operational efficiency is uncommon in corporate bankruptcies is that creditors with a vested stake in the corporate entity's long-term survival are given the standing and opportunity to force management to make difficult decisions in the interests of long-term recovery, which is something that has not occurred in Chapter 9 municipal restructurings. Simply put, because creditor rights are lacking in Chapter 9, there is a gaping moral hazard available for municipal debtors to exploit. It is one of the overlooked ironies of Chapter 9 that creditors, who are often misrepresented as working against the interests of citizens, are often aligned with municipal *residents* in achieving long term recovery.

To municipal officials, the message from Detroit and other recent Chapter 9 plans is clear: payment of financial obligations is optional and the hard work of reform can be delayed indefinitely. For these reasons, anybody seriously interested in helping Puerto Rico address the root causes of its financial distress should understand that, in practice, Chapter 9 actually frustrates the fiscal and operational changes that form the base of a longer-term fiscal and economic recovery.

Chapter 9 Would Hurt Individual Investors and The Broader Municipal Market:

For individual investors, and there are hundreds of thousands of them throughout the United States and within Puerto Rico itself, there is a basic investor protection issue at stake. They bought Puerto Rican bonds and thus financed critical government infrastructure at a time when the market knew and understood that the Commonwealth and its municipalities were prohibited from filing for Chapter 9 bankruptcy. The language precluding Puerto Rico from access to Chapter 9 is clear and unambiguous.¹⁹ If the Bankruptcy Code had listed all 50 U.S. States as authorized to use Chapter 9, and simply excluded Puerto Rico, there might have been some justifiable confusion. But it did not, and the fact that it did not, is economically significant. Because Puerto Rico was explicitly precluded from using Chapter 9, a significant risk factor relating to the repayment of the Commonwealth's municipal debt was removed and the market priced Puerto Rico municipal bonds at lower interest rates than if that risk had remained.

¹⁶ Houlihan Lokey Chapter 9 Considerations Analysis. (*See Appendix pages 1 & 2*)

¹⁷ Alicia Munnell. "The Funding of State and Local Pensions: 2013-2017." Center for Pension Research June 2014. Page 3. http://crr.bc.edu/wp-content/uploads/2014/06/slp_39.pdf

¹⁸ Hicken, Melanie. "Once bankrupt, Vallejo still can't afford its pricey pensions." *CNNMoney* 10 March

2014. <http://unionwatch.org/why-pacific-grove-matters-to-pension-reformers/>

¹⁹ Administrative Office of the U.S. Courts: Chapter 9 – Bankruptcy Basics.

<http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics>

Securities laws are premised on the markets factoring in available public information. Puerto Rico's lack of access to Chapter 9 was clearly public information and this information was factored into the pricing of Puerto Rico debt. Consequently, for more than 30 years, the markets assumed Puerto Rico was a safer credit risk and the Commonwealth enjoyed lower interest rates on its municipal debt resulting in billions of dollars of interest reductions that investors will never recover.²⁰ The magnitude of this value transfer underscores the problem with retroactively changing the rules in the middle of the game and it illustrates why so many individual investors would feel justifiably cheated if the legislation is passed.

In addition to the impact on individual investors, extending Chapter 9 to Puerto Rico municipal corporations would hit the broader municipal market at a point of uncertainty. The municipal market is still struggling to understand if Detroit and the handful of other recent municipal bankruptcies are part of a broader trend or are anomalies in a market that has otherwise historically experienced exceedingly low default rates and remarkable stability.²¹ That market stability was challenged by Detroit, whose cadre of corporate restructuring advisors advocated for an aggressive corporate restructuring approach to resolving the city's financial distress on the thesis that the causes of and solutions to the distress were singular, and that the overall municipal market would be unaffected.

The thesis has so far proven to be incorrect and Detroit's bankruptcy has had negative consequences for both the city and the broader market. Contrary to the public's perception that Detroit's bankruptcy was an unmitigated success, the city remains a junk-rated municipal credit and has been unable to access the municipal credit markets without support from the State of Michigan.²² Given Detroit's poor credit profile, the yield on Detroit's B-notes (bonds issued to Detroit's creditors in exchange for their pre-petition claims) currently tops 16% – they trade at less than 30 cents on the dollar. Worse, Detroit's Chapter 9 filing clearly inflicted collateral damage on the broader municipal market. For larger, more liquid municipal credits, such as Chicago, the negative impact of Detroit's bankruptcy was observed almost immediately.²³ During the week of June 10th, the week Detroit presented its first restructuring proposal requiring significant bondholder impairment,²⁴ yields on the general obligation ("GO") bonds for the City of Chicago widened out 100 basis points and have not returned to pre-Detroit levels.²⁵ This represents a quantum upward shift in the cost of borrowing for Chicago, amounting to more than \$180

²⁰ Average annual gross public debt over the past 30 years of \$30 billion multiplied by 100 basis points (widened yields on GO Bonds for the City of Chicago²³) equals an illustrative annual potential interest savings of \$300 million.

Statistical Appendix (Apéndice Estadístico), Multiple reports.
http://www.jp.gobierno.pr/portal_jp/ActividadEcon%C3%B3micaEconomicActivity/Ap%C3%A9ndice/tabid/184/Default.aspx

²¹ Further, general government defaults comprise a minority of total municipal defaults – the majority of municipal defaults have been in the healthcare and local housing project finance sectors. Altogether, the low number of municipal defaults (average of 5 per year from 2008-2013) stands in stark contrast to the thousands of Chapter 11 filings that occur annually.

"US Municipal Bond Defaults and Recoveries, 1970-2013." *Moody's Investor Service* 7 May 2014.

²² Houlihan Lokey Detroit Ex Post Facto Analysis. (See Appendix pages 3 & 4)

²³ Houlihan Lokey Supplemental Analysis. (See Appendix pages 5-9)

²⁴ City Of Detroit Proposal For Creditors – Restructuring Proposal. 14 June 2013.

<http://archive.freep.com/assets/freep/pdf/C4206913614.PDF>

²⁵ See source cited in footnote 23.

million annually²⁶ on the city's GO debt alone. In this way, the treatment of creditors under Chapter 9 in Detroit not only increased borrowing costs in other financially challenged U.S. cities, but it also further stressed cash flows and increased the chances of similar defaults within those same cities.

Because of the comparatively low trading volumes in the municipal market,²⁷ the collateral damage of Detroit has taken longer to filter down to smaller municipal credits – but its pricing impact was in some cases even more severe. The City of Scranton, Pennsylvania is a good example. With significant unfunded pension and OPEB obligations, deferred capital expenditures, and a lack of financial reporting sophistication, the city bears all the hallmarks of a small to mid-sized distressed municipality.²⁸ Despite its financial challenges, Scranton had maintained access to the municipal tax revenue anticipation note (“TRAN”) market, which it used to fund working capital needs at low, single digit interest rates. In the wake of Detroit, Scranton was forced to issue a private placement note to a local bank with a net interest cost of 9% – nearly twice as high as the 5% net interest cost Scranton paid on its TRANs in the preceding year, in which it faced a similar liquidity crunch.²⁹

At bottom, the problem with the Detroit approach to municipal restructuring is that it made inappropriate assumptions about the structure and composition of the municipal market. In contrast to the corporate debt market, the average municipal issuer is much smaller and provides less extensive financial disclosure than the average corporate issuer.³⁰ On the municipal buy-side, there is far greater “retail” investor participation, with 9.5 million individual participants who invest, directly or indirectly, in municipal bonds primarily for safety and income.³¹ Given the risk averse nature of municipal market participants, the market composition skews toward older, often retired investors who are willing to accept lower interest rate debt for perceived safety.³² For the most part, these investors are not financial experts who pore over municipal comprehensive annual financial reports for signs of distress. They are patient, buy and hold investors who have put their confidence in an implicit pact that state and local governments would honor their full faith and credit commitments and do everything in their power to honor the debt service obligations, no matter how politically challenging the obligations become.

Before Detroit, this faith was rewarded by a market that experienced a very low default rate and almost no bankruptcy activity. Over many decades, the prioritization of willingness to pay above quantitative risk factors was a distinguishing feature of risk assessment within the municipal market, as evidenced by

²⁶ Average annual total General Obligation and Revenue Bonds over the past 10 years of \$18 billion multiplied by 100 basis points equals an illustrative annual potential interest savings of \$180 million. “Comprehensive Annual Financial Reports.” *City of Chicago, Illinois*. Multiple reports. https://www.cityofchicago.org/city/en/depts/fin/supp_info/comprehensive_annualfinancialstatements.html

²⁷ See source cited in footnote 23.

²⁸ City of Scranton, Pennsylvania 2012 Independent Auditors' Report. Page 15 and Note 10. http://www.scrantonpa.gov/business_admin_docs/2012%20Audit%20Report.pdf

²⁹ HJA Strategies, LLC. – Report on the Budget and Finances of the City of Scranton, page 32. http://www.scrantonpa.gov/business_admin_docs/2014/HJA%20Report%207-2-2014.pdf

³⁰ See source cited in footnote 23.

³¹ In 2012, 5,954,819 tax returns reported tax exempt income, comprised of 3,532,100 tax returns from married couples filing jointly, or 7,064,200 individuals, and 2,422,719 other individual tax returns, for a total of 9,486,919 individuals. Statistics of Income, 2012 Individual Income Tax Returns, Publ. 1304, U.S. Dep't of the Treasury, Internal Revenue Service, Table 1.3 at 36 (2012), http://www.irs.gov/file_source/pub/irs-soi/12inalcr.pdf [hereinafter “IRS Publ. 1304”]

³² See source cited in footnote 23.

major ratings agencies' primary reliance on legal and contractual assurances in assigning municipal credit ratings.³³ In the post-Detroit world, the municipal market's reaction to cities like Chicago and Scranton shows a certain segment of municipal buyers have lost faith in the market and may have left the market for good. The recent municipal bankruptcies show that for the first time a municipality's willingness to pay back the debts it owes is being questioned. Moreover, the discriminatory outcomes favoring legacy municipal entitlement claims over bond debt obligations has broadcasted to the market that the Chapter 9 playing field is tilted decidedly against municipal bondholders.³⁴ It simply doesn't make sense for a retiree to buy bonds to help a city build roads and schools when the investor now knows that if the city mismanages its finances, the investor would be left holding the bag.

The central point is that the historical risk paradigm for the municipal bond market is currently at a precarious place. Puerto Rico's debt obligations are approximately 9 times as large as Detroit's.³⁵ If Chapter 9 is extended to Puerto Rico, the potential collateral damage of a negative market reaction could be far more significant. In such a scenario, because the municipal market provides the vast majority of financing for state and local governments and government infrastructure,³⁶ the federal government could be called upon, in one manner or another, to fill a potentially major void once filled very efficiently by the municipal finance market.

With respect to Puerto Rico, a final observation is critical: Puerto Rico will need access to the capital markets in the future for vital capital expenditures. PREPA must – by EPA consent decree – spend billions to convert dirty diesel generators to clean natural gas. Puerto Rico Aqueduct and Sewer Authority must raise hundreds of millions to improve the Commonwealth's sewer and water system. Puerto Rico Highways and Transportation Authority needs access to the capital markets to fix the Commonwealth's roads. Giving Puerto Rico access to Chapter 9 would do nothing to persuade investors to risk their capital – again – on an island with the ability to serially default like Argentina.

³³ Rating agencies' presentations.

- (i) "US Local Government General Obligation Debt." *Moody's Investor Service* 15 January 2014. <http://www.rigfoa.org/media/presentations/wintertraining2014/go-us-local-govts-methodology-1-2014-moodys.pdf>
- (ii) "U.S. Local Governments General Obligation Ratings: Methodology and Assumptions." *Standard & Poor's Ratings Services, McGRAW HILL FINANCIAL* 12 September 2013. http://www.standardandpoors.com/spf/upload/Events_US/US_PF_logo102014.pdf

³⁴ See source cited in footnote 19.

³⁵ As of June 30, 2015, Puerto Rico had \$71 billion of debt outstanding compared to \$8 billion for Detroit.

- (i) "Puerto Rico Fiscal and Economic Growth Plan." *Working Group for the Fiscal and Economic Recovery of Puerto Rico Pursuant to Executive Order 2015-022* 9 September 2015. Pages 12 and 59. <http://www.bgfpr.com/documents/PuertoRicoFiscalandEconomicGrowthPlan9.9.15.pdf>
- (ii) "Comprehensive Annual Financial Report." *City of Detroit, Michigan* 30 June 2014. Page 31. <http://www.detroitmi.gov/Portals/0/docs/finance/cafr/Final%20CAFR.pdf>
- (iii) Diane Bukowski. "LEAVING BANKRUPTCY, DETROIT TAKES ON \$1.28 BILLION OF NEW DEBT." *Voice of Detroit* 14 December 2014. <http://voiceofdetroit.net/2014/12/14/leaving-bankruptcy-detroit-takes-on-1-28-billion-of-new-debt/>

³⁶ Roughly 75% of the infrastructure in this country was funded with municipal bonds. Comments of the Honorable Stephen K. Benjamin Mayor of Columbia, South Carolina, 15 April 2013. Page 11. (See Appendix for referenced page) <http://www.munibondsforamerica.org/cms/wp-content/uploads/2013/04/FINAL-MBFA-Tax-Reform-Working-Group-Testimony-April-2013.pdf>

Puerto Rico Doesn't Need Chapter 9 to Recover

The Commonwealth says it cannot pay its debts. That is failure of political will more than a statement of economic necessity. In fact, there are some very effective tools the Commonwealth has at its disposal to address its fiscal and economic challenges, and a number of objective indicators suggest its debt obligations are payable in full over time.

Puerto Rico is a comparatively low tax jurisdiction – In a comprehensive analysis of the Commonwealth's tax structure, KPMG, the Commonwealth's own outside tax consultant, found that Puerto Rico's tax as a percent of GDP burden was far lower than comparable sovereign states.³⁷ Further analysis also reveals the Commonwealth's tax burden as a percent of GDP is far lower than all U.S. States.³⁸ Puerto Rico's status as a low tax jurisdiction makes it unique when comparing to distressed municipalities that are often already heavily taxed jurisdictions.³⁹

Puerto Rico has a comparatively low debt burden – In October 2013, the Commonwealth *itself* produced an analysis distributed to its investor base suggesting its debt service obligations are vastly lower than any U.S. State government. According to the Commonwealth's *own* calculations, its debt burden is approximately 70% lower than any U.S. State.⁴⁰ These assertions run counter to more recent pronouncements that the Commonwealth's debts are no longer payable. Further analysis suggests the Commonwealth continues to have a comparatively light consolidated debt burden and may now be seeking to expunge debt opportunistically.⁴¹

It should also be noted that the Commonwealth, its professional advisors, and even the U.S. Treasury continue to reference a highly misleading debt service statistic as a prominent rationale for seeking Chapter 9. More specifically, they have argued that debt service consumes nearly 40% of government revenues.⁴² The figure is misleading because it compares apples to oranges; it aggregates debt services across general fund and non-general fund debt obligations and divides the number by a denominator that excludes certain related revenues that would either service such debt obligations or reduce the overall

³⁷ KPMG's Commonwealth of Puerto Rico Tax Reform Assessment Project. (*See Appendix for select pages*)

- (i) "Unified Tax Code of Puerto Rico: Tax Policy Implementation Options Executive Summary." 31 October 2014. Pages 6, 9, and 14.
http://www.hacienda.gobierno.pr/sites/default/files/unified_tax_code_of_pr_executive_summary_0.pdf
- (ii) "Unified Tax Code of Puerto Rico: Tax Policy Implementation Options & General Explanation of Principal Options." 31 October 2014. Pages 19, 21, 26, 34, and 61.
http://www.hacienda.pr.gov/sites/default/files/unified_tax_code_of_pr_general_explanation.pdf
- (iii) "Unified Tax Code of Puerto Rico: Tax Policy Implementation Options Appendix." 31 October 2014.
http://www.hacienda.gobierno.pr/sites/default/files/unified_tax_code_of_pr_appendix.pdf

³⁸ See source cited in footnote 23.

³⁹ "50-State Property Tax Comparison Study." *Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence* May 2013. Pages 1, 15, 18, 19 and 21. http://www.lincolnst.edu/subcenters/significant-features-property-tax/upload/sources/ContentPages/documents/Pay_2012_PT_%20Report_National.pdf

⁴⁰ "Update on Fiscal and Economic Progress." *The Commonwealth of Puerto Rico* 15 October 2013. Page 57. (*See Appendix for referenced page*)
<http://www.bgfpr.com/documents/UpdateonFiscalandEconomicProgressWebcast-Final.pdf>

⁴¹ See source cited in footnote 23.

⁴² "Testimony Of Counselor Antonio Weiss Before The Senate Committee On Energy And Natural Resources" 22 October 2015. <https://www.treasury.gov/press-center/press-releases/Pages/j10230.aspx>

expenditure burden on the general fund. In other words, the representation uses either an inflated numerator or a deflated denominator to produce an inflated debt service burden ratio. Making the appropriate adjustments, the debt service ratio is actually much lower – about 20%.⁴³

Puerto Rico can significantly improve revenue collections – Crucially, the analysis undertaken by the Commonwealth’s tax consultant, KPMG, concluded that by improving tax collections and simplifying the Commonwealth’s tax structure, net revenue collections could be improved by more than \$3.6 billion annually. The size of the incremental revenue collections opportunity stems from a system of taxation that KPMG found is plagued by “...structural complexity, instability, internal inconsistency, inefficient administration and inadequate enforcement.” KPMG also noted that revenue collections were hindered by a “culture of tax evasion.” Further highlighting the extent of the incremental revenue opportunity, the Commonwealth was found to collect less than 60% of sales taxes owed, to have a large number of high income filers who pay no income tax at all, and to be collecting property taxes off a base that was in some cases last assessed in the 1950s.⁴⁴ Implementing KPMG’s recommended tax code changes would close the \$14.0 billion 5-year budget gap estimated in the Fiscal and Economic Growth Plan (“FEGP”),⁴⁵ leaving the Commonwealth with a surplus of several billion dollars at the end of the period.

Puerto Rico can reduce costs –Although Puerto Rico has recently attempted to limit the growth in government spending, consolidated government expenditures have still increased 47% over the past 10 years.⁴⁶ The governor’s recent FEPG identifies a number of sensible cost reduction opportunities, but fails to identify a detailed execution plan explaining how the measures will be implemented. Given the government’s historical inability to reduce costs, the lack of implementation detail is concerning. Moreover, while there have been calls by some to focus on a more significant realignment of government structure to achieve greater operational efficiencies, these calls do not yet appear to be widely embraced.⁴⁷

One advantage Puerto Rico has that will help it achieve greater governmental efficiency is progressive public private partnership (“P3”) legislation. Puerto Rico has a record of leveraging its P3 model successfully to facilitate significant private investment in key infrastructure assets, such as its airport and highways. There appears to be many more transactional opportunities available to enhance the operating efficiency of Puerto Rico’s infrastructure assets, and potentially achieve significant monetization proceeds.

Can These Remedies Be Implemented Absent Chapter 9?

Real world experience suggests the answer is “yes”. The case of the City of Harrisburg, Pennsylvania is instructive. After having its Chapter 9 petition denied, the city executed real reforms that were previously

⁴³ Illustrative example for 2016: Total projected Debt Service of \$4.1 billion divided by total projected Revenue of \$17.4 billion equals 24%. Total Revenue (for 2016) includes General Fund and Other Select Revenues (\$8,503 million), GDB Net Operating Revenues ((\$96) million), COFINA Revenue (\$696 million), Federal Transfers (\$6,477 million), and Revenue Measures (\$1,121 million). Data obtained from the FEGP.³⁵

⁴⁴ See source cited in footnote 37.

⁴⁵ See source cited in footnote 35.

⁴⁶ See source cited in footnote 23.

⁴⁷ Ricardo Rosselló. “A New Path For Puerto Rico--Which Doesn't Include A Washington Bailout.” *Forbes* 22 October 2015. <http://www.forbes.com/sites/realspin/2015/10/22/a-new-path-for-puerto-rico-which-doesnt-include-a-washington-bailout/>

assumed to be impossible. The city rationalized its infrastructure and improved fiscal control to cut city government expenditures. Beyond Harrisburg, larger and more complicated municipal restructurings such as New York City and Washington, D.C. were effectuated outside Chapter 9. Indeed, the comparatively few number of Chapter 9 cases overall shows the overwhelming majority of municipalities manage their fiscal challenges and constraints effectively outside of bankruptcy.

Finally, the PREPA restructuring agreement also illustrates that out-of-court consensual negotiations can produce a positive outcome. The PREPA negotiations worked because both PREPA creditors and the Commonwealth were able to embrace a dialogue focused on solutions that involved give and take from all parties – which is the essence of financial restructuring. Under the terms of the deal, PREPA creditors were able to minimize impairment by providing debt service relief that PREPA will use to improve operational efficiency and lower electricity costs in the Commonwealth. Beyond PREPA, there are other opportunities within the Commonwealth’s government agencies, and for the Commonwealth as a whole, where these types of “win-win-win” solutions can be structured and implemented. The Commonwealth’s key creditors are organized and a critical mass of them are already involved in a restructuring dialogue with the Commonwealth.

Conclusions and Recommendations

While there are no easy solutions to restoring Puerto Rico’s fiscal and economic health, I can nonetheless offer the Committee the following conclusions and recommendations:

1. Chapter 9 Should Be Avoided – The remedy of Chapter 9 is an illusion. In reality, Chapter 9 merely relieves municipalities of the pressure to effect operational and governance reforms necessary for long-term fiscal and economic recovery. It would also unfairly harm hundreds of thousands of retail investors throughout the country and have adverse consequences for the U.S. municipal markets.
2. Puerto Rico Needs to Maintain the Confidence of its Traditional Investor Base – Puerto Rico’s financial creditors are not the source of its fiscal problems. Puerto Rico’s investor base is still overwhelmingly comprised of individual municipal investors (many through mutual funds), hundreds of thousands of them in both the Commonwealth and United States. Puerto Rico must ultimately win back this core creditor constituency as an important source of long-term, low cost capital.
3. Puerto Rico Can Effect Essential Remedies – Puerto Rico has recently started to make progress in key areas such as revenue collections, but much more needs to be done. Additionally, very little significant effort has been made to reduce government costs and much more attention should be given to implementation of sensible cost reduction initiatives. There is reason to expect both revenue increases and cost reductions can be achieved without damage to the economy.
4. The Commonwealth Must Work With Congress – Puerto Rico’s recovery is dependent on a complex interrelationship between federal and Commonwealth officials, as well as its major capital providers. Flexibility will be required from all parties, but real world examples suggest such flexibility will be critical to a positive outcome.
5. The Ultimate Solution Lies With Puerto Rico – Chapter 9 is rarely used by the U.S. States (even those who have authorized it) because they know *it can poison their financial reputation while allowing* municipalities to avoid undertaking the real reforms needed for long-term success. As a

beautiful island with an educated populace and a comparatively diverse economy supported by the rule of law, Puerto Rico has tremendous competitive advantages that will allow its economy to recover over time, provided it executes critical fiscal and economic reforms (like many U.S. States and municipalities), rather than seeking a quick fix through Chapter 9. Puerto Rico can work through its current problems and establish a foundation for economic growth and job creation for decades to come.

Appendix

Discriminatory Aspects of Chapter 9

- The comparative lack of creditor protections in Chapter 9 has proven to be uniquely disadvantageous to financial creditors (specifically municipal bond investors) in recent Chapter 9 proceedings
- Pensions in all recent Chapter 9 proceedings have generated significantly higher recoveries on their claims than financial creditors, even in jurisdictions like Detroit, where pension and financial claims were deemed by the bankruptcy court to be pari passu, or of equal standing

City	Recovery	
	Pension	Financial Creditors
Central Falls, RI	■ 75-100% ⁽¹⁾	■ GO: NA ⁽²⁾
Detroit, MI ⁽³⁾	■ 59% - 60%	■ LTGO: 41% ■ COP: 3% ⁽⁶⁾
Jefferson County, AL	■ N/A	■ Secured Sewer Bonds: 56%
Stockton, CA	■ 100%	■ Lease Revente: 1%+ ⁽⁴⁾
Vallejo, CA	■ 100%	■ COP: 33% ⁽⁵⁾

(1) Reflects approximate cut in actual retiree pension distributions
 (2) State passed legislation specifically elevating the priority of municipal debt obligations before the city filed for chapter 9 bankruptcy protection
 (3) Excludes 74% UTGO recovery due to the bonds' secured status relative to LTGO and COP debt
 (4) COP recovery of 12% (includes 10% secured recovery plus unsecured claim)
 (5) Reflects estimated NPV reduction of Vallejo's costs with respect to approximately \$50 million of COP claims held by Union Bank
 (6) Reflects market value of New B Notes consideration as of October 2015

Discriminatory Aspects of Chapter 9 (cont.)

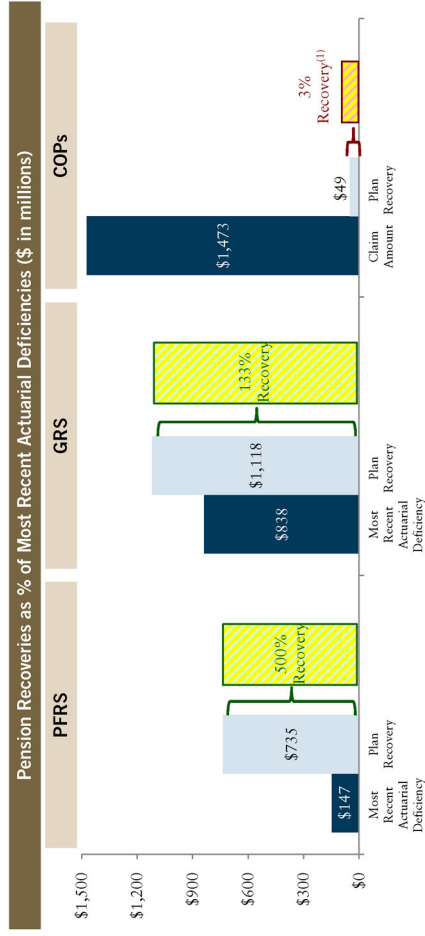
- Beyond the objective metrics highlighting vastly divergent pensioner and financial creditor Chapter 9 recovery outcomes, the lack of creditor protections in Chapter 9 has had a negative impact on municipal restructurings in a number of key respects

Restructuring Objective	Outcome
Operational Restructuring Initiatives	<ul style="list-style-type: none"> ■ Despite profound city government dysfunction, no recent Chapter 9 municipal debtors have effected significant operational improvements under Chapter 9 bankruptcy protection ■ According to the court-appointed expert in Detroit's bankruptcy, "the majority of the operational restructuring initiatives have been laid in the lap of the mayor and are expected to be executed after the City emerges from bankruptcy." ■ This outcome stands in stark contrast to corporate restructurings, where exigent circumstances are customarily used to effect otherwise challenging institutional changes for the benefit of all stakeholders
Municipal Asset Monetization Strategies	<ul style="list-style-type: none"> ■ Recent Chapter 9 debtors have largely ignored transactional opportunities for City assets as a means of generating capital to catalyze municipal recovery and increase creditor recoveries ■ In unique circumstances such as the partial monetization of Detroit's city-owned art collection, the monetization process was flawed and generated sub-optimal outcomes ■ In the case of Detroit's art collection, the transaction executed in bankruptcy realized a mere \$455 million in value for a city asset appraised at \$8.1 billion⁽¹⁾
City / Creditor Recovery Alignment	<ul style="list-style-type: none"> ■ In nearly all recent Chapter 9 bankruptcies, financial creditor losses have been set or crystallized with creditors receiving no contingent value recovery mechanisms to allow for incremental creditor recoveries as the city's financial condition improves ■ The "heads I win, tails you lose" outcome stands in stark contrast to the corporate restructuring model which seeks to align creditor and corporate recovery interests ■ The asymmetric risk dynamic acts as a substantial deterrent to new municipal investment capital from either existing or outside creditors as is the norm in the corporate context

(1) City of Detroit – Expert Witness Report of Victor Wiener, July 2014.

COP Recoveries vs. Pension Recoveries

- If the City's prior actuarial pension deficiency assumptions had been used to calculate pension recoveries, the recovery differential between pension and COPs would have been even more skewed
- Under the City's pre-petition actuarial calculations, the pensions would be receiving well in excess of 100% recoveries on their calculated deficiency amounts
- In comparison to COP recoveries, this produces more than a 100% recovery differential



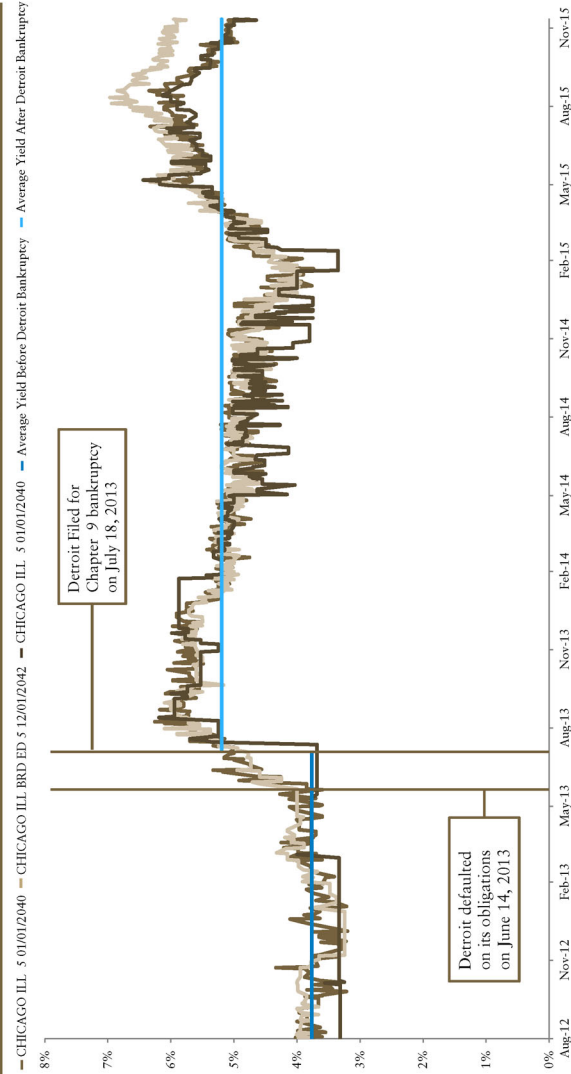
Note: PFRS – Police and Fire Retirement System; GRS – General Retirement System; COP – Certificate of Participation
 (1) COP recoveries reflect (i) a 16% discount rate to value the New B Notes Consideration and (ii) COP claims asserted at 100% of principal value

- On July 29, 2015, defenders of Detroit's Plan, including prominent City bankruptcy advisors promoting the outcome as a model for other distressed municipalities, seized on the investment grade rating the City received for the refinancing of its Barclays exit financing facility as evidence that the approach taken by the City in Chapter 9 had worked
- A further examination of the terms of the new financing reveal these assertions to be disingenuous at best
- While the \$245 million refinancing did indeed receive an "A" rating with a current yield of approximately 4% on the 9 year maturity bonds, the new issue required Michigan to pass legislation giving the Michigan Finance Authority permission to issue the bonds on behalf of Detroit with a first-lien pledge of the City's income tax revenues coupled with a limited-tax general obligation pledge
- In response to assertions that the refinancing had signaled the City's return to investment grade status, Standard & Poor's issued a clarifying statement stressing it was maintaining a "B" rating for the City's overall credit — five grades below the lowest investment grade rating
- According to Jane Ridley, an S&P analyst:
 - "The 'A' rating isn't based on the credit of the City itself. It's based on the strength of the revenue pledge and the income stream. It doesn't really stay in the City's hands at all. It's designed to be immediately taken by the trustee for the benefit of bondholders"
- For advisors to City financial creditors during the Chapter 9, the refinancing media campaign was a painful reminder of disinformation tactics used by the City during the bankruptcy

Chicago General Obligation Debt Yields

From August 15, 2012 to July 18, 2013, or when Detroit filed for Chapter 9, Chicago's average GO yield was 3.8%, representing a 140 basis point increase compared to the average yield after the filing.

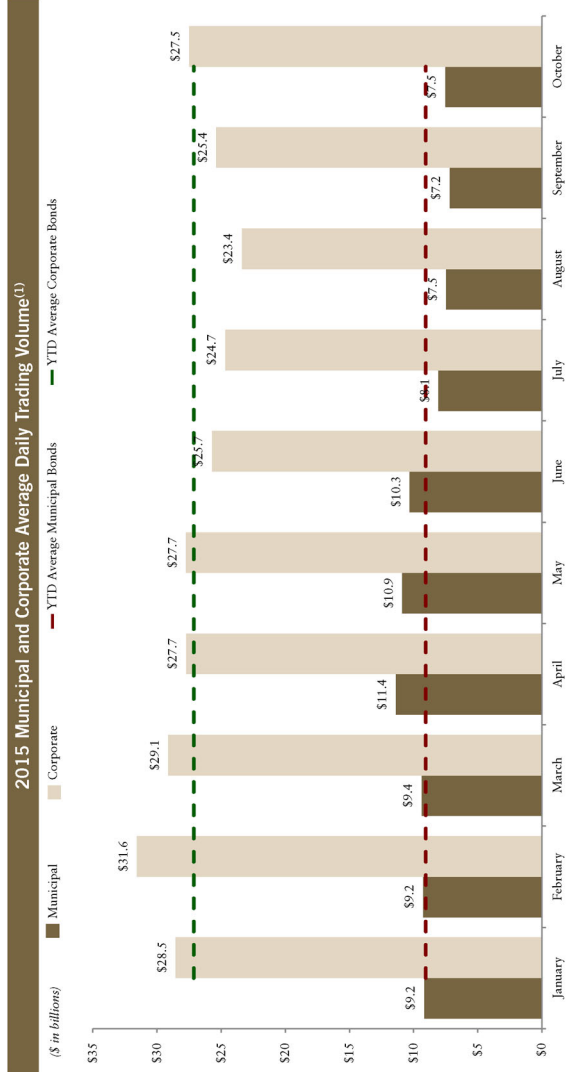
Historical Yields for Chicago's General Obligation Bonds



Sources: Public Filings, Bloomberg.
Referenced on page 6 on testimony of Stephen J. Spencer

Trading Volume Comparison

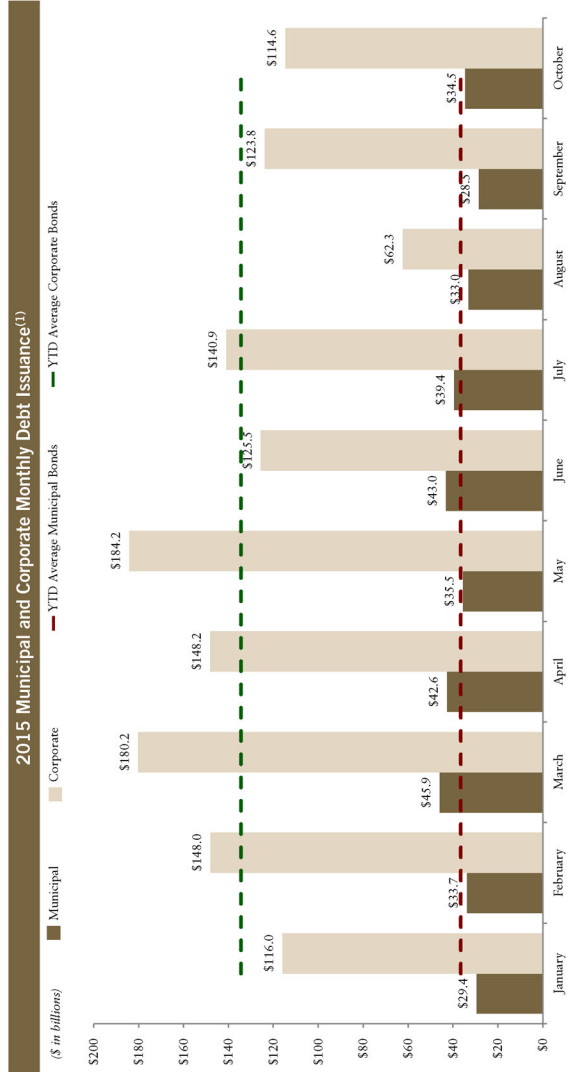
Year-to-date average daily trading volumes for corporate bonds is \$18.1 billion higher than municipal bonds



Source: Securities Industry and Financial Markets Association
 Note: Referenced on page 7 on Testimony of Stephen J. Spencer
 (1) Year-to-date as of October 31, 2015

Debt Issuance Comparison

Year-to-date average monthly debt issuance for corporate bonds is \$97.8 billion higher than municipal bonds

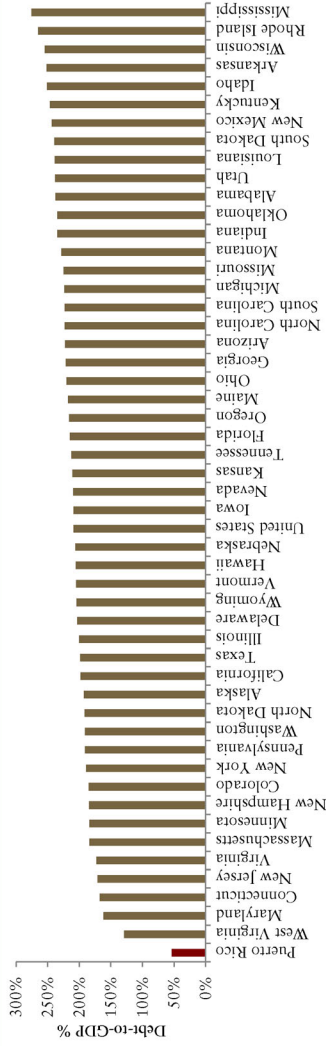


Source: Electronic Municipal Market Access; Securities Industry and Financial Markets Association
 Note: Referenced on page 7 on Testimony of Stephen J. Spencer
 (1) Year-to-date as of October 31, 2015

Comprehensive Debt to GDP is More Appropriate

- Appropriately comparing Puerto Rican debt levels to that of U.S. states requires consolidating local and state government debt
- As most Puerto Rican residents do not pay federal income tax, the average federal income tax burden should also be added to states on a per capita basis
- After reflecting these adjustments, Puerto Rico's actual tax burden is comparatively lower than all U.S. states

Debt Per Capita / Income Per Capita for U.S. States and Puerto Rico⁽¹⁾

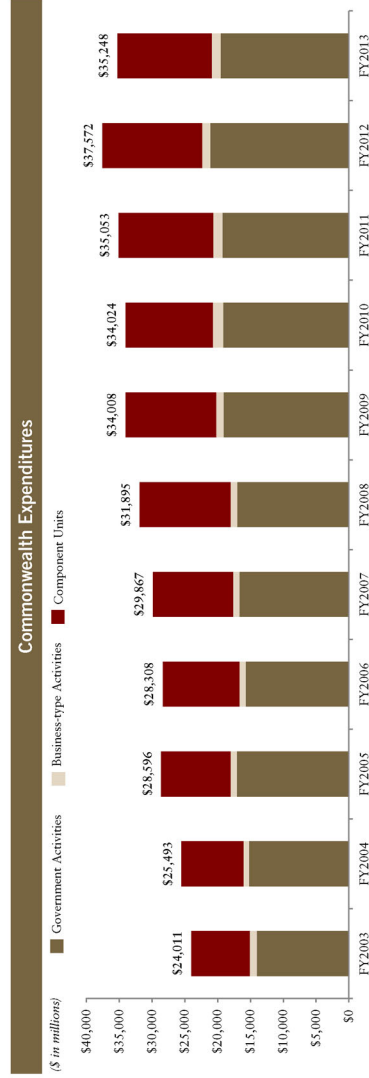


Source: Treasury Direct, US Census Bureau, Bureau of Economic Analysis, Federal Bank of New York, Center for a New Economy
 Note: Figures are based on the testimony of Stephen J. Spencer
 (1) PREPA, PRASA, PRHTA and Tobacco bonds have been stripped from this calculation

Commonwealth Expenditures

Despite the government's claims that it has implemented austerity measures, total government expenditures have increased by 47% over the past 10 years

- **Government Activities:** Majority of services associated with the Commonwealth, including general government, education, public housing and welfare, health, public safety, and economic development
- **Business-type Activities:** Activities are normally intended to recover all of a significant portion of their costs through user fees and charges to external users of goods and services
- **Component Units:** Comprises of Government Development Bank for Puerto Rico ("GDB"), Puerto Rico Highways and Transportation Authority ("PRHTA"), Puerto Rico Electric Power Authority ("PREPA"), Puerto Rico Aqueduct and Sewer Authority ("PRASA"), University of Puerto Rico ("UPR"), Puerto Rico Health Insurance Administration ("PRHIA") and non-major component units



Source: Commonwealth of Puerto Rico Audited Annual Financial Reports
Note: Referenced on page 11 on Testimony of Stephen J. Spencer

**Commonwealth of Puerto Rico
Tax Reform Assessment Project**

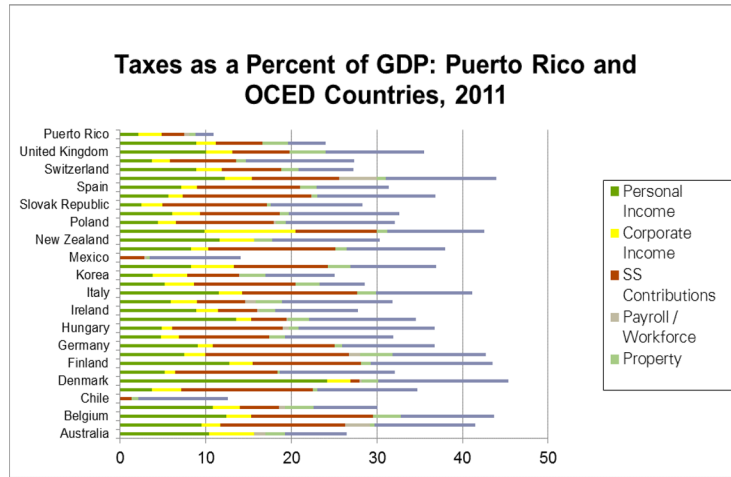
*Unified Tax Code of Puerto Rico:
Tax Policy Implementation Options
Executive Summary
October 31, 2014*

1.3 Summary of Principal Findings

1.3.1 High Level Observations

The current income and consumption tax structures are inordinately complex, due principally to a plethora of special provisions that for the most part were adopted in a haphazard manner over time generally to provide incentives for particular forms of economic activity. These special provisions have never been subjected to a cost benefit analysis. As shown in Tables 1 and 2, revenue from consumption and income taxes are below peer jurisdictions.

Table 1: Taxes as a Percentage of GDP in Puerto Rico Compared to Selected Jurisdictions⁴



⁴ (*) While Table 1 uses GDP as the measure of comparison across countries, the results are similar when using GNP as the measure of comparison. Puerto Rico taxes as a percentage of GNP is closer to 15% but still substantially lower than the tax liability of the peer countries shown.

- Could be reduced if specified economic and revenue goals are attained.

1.5 Summary of Projections

The following tables illustrate the revenue, distributional and macroeconomic consequences of the options outlined above, individually and in combination. The parameters of any of the options may be altered and these results will change. The results of other options are set out in the Attached General Explanation.

Table 7 compares the current General Fund receipts with receipts under the above parameters.

Table 7

	Current Law		Proposed Law (1)		Difference (\$)	Difference (%)
	2014 General Fund Tax Receipts (in \$ millions)	General Fund Tax Receipts as a % of Total GF Receipts	General Fund Tax Receipts (in \$ millions)	General Fund Tax Receipts as a % of Total GF Receipts		
Individual Income Tax	\$1,979	21.91%	\$1,409	12.21%	(\$570)	-28.80%
Corporate Income Tax - Regular Companies	\$1,435	15.88%	\$996	8.63%	(\$439)	-30.59%
Corporate Income Tax - Exempt Companies	\$479	5.30%	\$479	4.15%	\$0	0
Withholding Tax Receipts	\$900	9.96%	\$900	7.80%	\$0	0
Law 154 Receipts	\$1,902	21.05%	\$1,902	16.48%	\$0	0
Sales and Use Tax	\$595	6.59%	\$0	0.00%	(\$595)	-100%
Excise Tax	\$919	10.17%	\$482	4.18%	(\$437)	-47.55%
Property Tax Receipts	\$20	0.22%	\$20	0.17%	\$0	0
Licenses	\$20	0.22%	\$20	0.17%	\$0	0
GST	\$0	0.00%	\$4,545	39.39%	\$4,545	-
Other Taxes	\$52	0.58%	\$52	0.45%	\$0	0
Non-tax and external	\$733	8.11%	\$733	6.35%	\$0	0
Total	\$9,034	100.00%	\$11,538	100.00%	\$2,504	27.72%

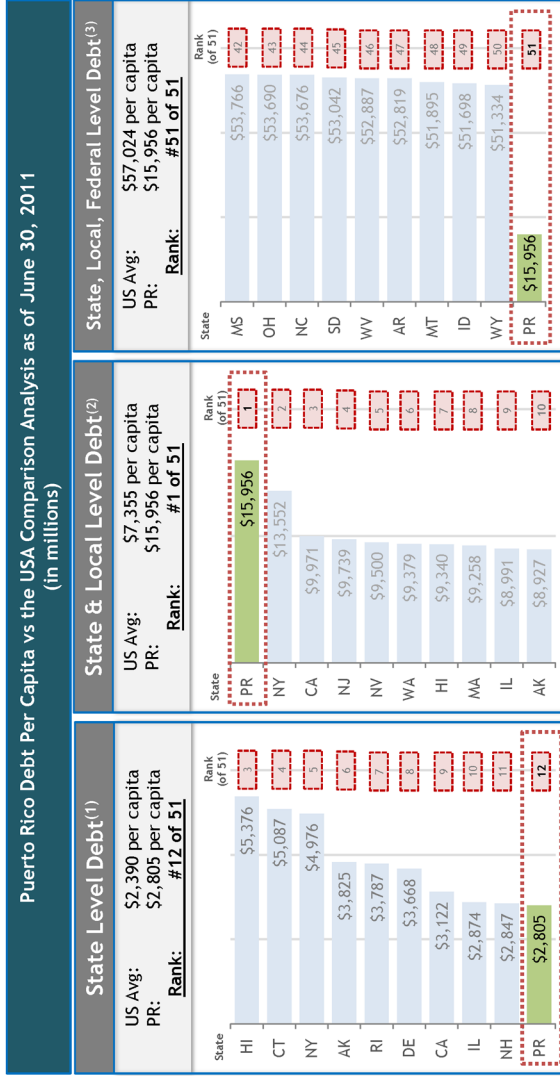


The Commonwealth of Puerto Rico
Update on Fiscal and Economic Progress

FY 2014 Q1 Investor Webcast - October 15, 2013

GDB believes that any comparison of the public debt levels of Puerto Rico with the states should include state, local and federal debt

If one factors in the federal debt load, PR would rank last in outstanding debt per capita amongst all US jurisdictions*



*Source: US Bureau of the Census and the Government Development Bank for Puerto Rico
 (1) For Puerto Rico State Debt includes GO debt.
 (2) For Puerto Rico local debt includes debt of Municipalities and Public Corporations.
 (3) US Federal Debt per capita is \$49,069

Questions for the Record
Senator Orrin G. Hatch
Senate Judiciary Committee
Hearing: "Puerto Rico's Fiscal Problems:
Examining the Source and Exploring the Solution"
Tuesday, December 1, 2015

Questions for all Panel II Witnesses

1. Would extending Chapter 9 to Puerto Rico carry any negative consequences for the island? I'm not talking just about bondholders. I'm talking about the commonwealth as an entity. If Congress extended Chapter 9 to Puerto Rico and island municipalities began taking advantage of Chapter 9, how would that impact the island's bond rating, its creditworthiness, its attractiveness as an investment location, etc.? Is there a scenario under which extending Chapter 9 to Puerto Rico would actually make the island's fiscal situation worse?

Answer: I do not believe extending Chapter 9 to Puerto Rico would worsen the current state of affairs. It is difficult to see how the Commonwealth's bond ratings or creditworthiness would fall to lower levels than what they currently stand at. On the contrary, Chapter 9 would provide order and certainty to a currently uncertain process. It would allow eligible entities to reorganize themselves and their operations in a manner that would allow them to better provide services to citizens while servicing their corresponding debt and meeting obligations within existing limitations. The extension of Chapter 9 should also not affect the Commonwealth as an investment destination. On the contrary, the application of federal laws and the operation of federal courts in Puerto Rico has always been touted as one of the advantages of doing business in Puerto Rico. This extension will further serve to provide certainty in an area that is currently devoid of the benefits that many investors perceive federal laws add to the investment environment in Puerto Rico.

2. We've heard arguments that extending Chapter 9 to Puerto Rico would be unfair to bondholders because it would reduce their return on their investments. Some have argued that any Chapter 9 extension should apply only to future debts. As an initial matter, it would be helpful to know whether past bankruptcy code reforms have applied to existing debts, or whether bankruptcy reforms have typically applied only to future debts. Can you offer any insight on this matter? And if past reforms have applied to existing debts, have any of those reforms been analogous to what we're considering here—namely, extension of bankruptcy access to entities who previously had no such access? I asked this question at the hearing, but I didn't get a complete answer and I believe it's extremely important.

Answer: There is ample precedent showing that U.S. Bankruptcy Code amendments have typically been applied to existing debts, thereby modifying or impairing existing contractual obligations. Please see attached articles on the subject of applying new bankruptcy provisions to existing debts. In the case of “Municipal Bankruptcy: A Guide for Public Finance Attorneys,” please see chapter 2.

3. Another question on Chapter 9 and retroactivity: If Congress steps in and changes the rules of the game after the fact to allow municipalities to discharge existing debts, do we need to worry about the message that sends to other debtors and other creditors across the country? Parties negotiate contracts according to existing laws. If we step in and suddenly change the rules, does that tell parties in other situations that the rules are actually more up for grabs than they might think? Does that tell other states or other municipalities outside Puerto Rico that if things get bad enough, Congress will simply change the rules to help ease the pressure?

Answer: The enactment of federal laws that change the rules of the game is commonplace and municipal finance should not be the exception. For example, changes in law applicable to healthcare and other highly regulated industries consistently affect entities that entered into contracts with such companies under a set of rules. When Congress sees fit to change those rules (either through direct legislation or executive delegation), such entities must adapt to a new set of rules that may not be consistent with what they originally bargained for.

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Answers by

**Carlos A. Colón-De-Armas, Ph.D.
Professor of Finance
Graduate School of Business
University of Puerto Rico**

to the

Questions for the Record Submitted by

Senator Orrin G. Hatch

United States Senate Committee on the Judiciary Hearing on

Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution

**December 1, 2015
Washington, D.C.**

The three questions submitted revolve around the issue of extending to the Government of Puerto Rico access to bankruptcy proceedings. Therefore, it seems important to preface my answers by expressing my two main objections to the use of bankruptcy as the way to solve the fiscal problems faced by the Government of the Island: (1) it would worsen the economic situation in Puerto Rico, and (2) it is not supported by the available evidence.

In my written testimony, and in the Q&A portion of the hearing, I addressed the impact of bankruptcy to the economy. In essence, I explained that the fiscal crisis was not caused by a weakening economy, but rather, that it was the government, in the way it handled its finances, that damaged the economy. It did so by using its limited borrowing capacity, that was supposed to be utilized only to finance public investments, and used it instead to finance spending. As a result, an already fragile economy experienced a significant loss of investments and deteriorated even more. To revert this trend, and to fix the economic crisis, public and private investments on the Island must be increased and the business climate in Puerto Rico should be improved. For these investments to take place, financing is necessary, for which access to financial markets is essential. Bankruptcy, however, would close access to financial markets for Puerto Rico for an indeterminate number of years, to the detriment of the quality of life of the residents of the Island.

Regarding the reason to seek bankruptcy, it is important to understand the debt burden calculation that serves as the basis for that option. To start, consider the consolidated budget for the entire Government of Puerto Rico, for fiscal year 2016, which totals \$28,808 million. Within that budget, the aggregate debt service for the entire public debt of Puerto Rico, including General Obligations, COFINA, all public corporations, and all other debts, amounts to \$4,491 million. That debt service payment represents 16% of the entire consolidated budget. Nevertheless, on page 17 of The Puerto Rico Fiscal and Economic Growth Plan, prepared by

the Working Group for the Fiscal and Economic Recovery of Puerto Rico pursuant to Puerto Rico Executive Order 2015-022, dated September 9, 2015, the debt service as a percent of revenues for fiscal year 2016 is calculated to be 42%. On that same page, they make the same calculations for the projected figures for fiscal years 2017 through 2020 and the result amounts to approximately 40% for the five years presented. That 40% figure is cited by many people as the public debt burden of the Government of Puerto Rico, and it is used as the justification for seeking the right to declare bankruptcy. On closer examination, it is easy to see that the calculation of a 40% debt burden is wrong. To see why, let's examine the detailed calculations for fiscal year 2016 presented in the following table.

**Puerto Rico Public Debt Burden for Fiscal Year 2016:
Working Group vs. Consolidated Budget**

	Working Group	Consolidated Budget
Revenues		
General Fund and other select revenues (1)	\$8,503	\$8,503
GDB net operating revenues (1)	(96)	(96)
COFINA (1)	696	696
HTA revenues (1)	677	677
Increased sales tax and VAT (2)		1,121
Other revenues (plug)		10,535
Federal transfers (1)		6,477
Loans and bond issues (2)		895
Total revenues	\$9,780	\$28,808
Debt service		
GOs and selected agencies (1)	\$4,130	\$4,130
Other debt service (plug)		361
Total debt service	\$4,130	\$4,491
Debt service as a % of total revenues	42%	16%

Notes to table:

- (1) From page 17 of The Puerto Rico Fiscal and Economic Growth Plan ("FEGP") prepared by the Working Group for the Fiscal and Economic Recovery of Puerto Rico pursuant to Puerto Rico Executive Order 2015-022, dated September 9, 2015.
- (2) Available at: <http://www2.pr.gov/presupuestos/presupuestoaprobado2015-2016/Pages/default.aspx>.

As can be seen from the table, to make its calculations, the Working Group uses only \$9,780 of revenues, which represent only 34% of the consolidated budget, but includes \$4,130 for debt service, which represents 92% of the entire aggregate debt service required for the year. When you include the rest of the resources available in the budget, even when you add the rest of the debt service, the proper debt service as a percent of the total budget is significantly lower, at 16%.

The Working Group performed its calculation using as its basis the report by Krueger, Anne O., Ranjit Teja, and Andrew Wolfe, *Puerto Rico - A Way Forward*, June 29, 2015 (updated on July 13, 2015), the so called "Krueger Report". Accordingly, the argument is that "the General Fund alone ... does not adequately capture the total financing needs of the Commonwealth." (See the FEGP, p. 15.)

Although it may be true that the General Fund represents only a portion of the Government of Puerto Rico, and although certain items in the consolidated budget (e.g., federal funds, loans and bond issues) are not available to pay debt service, the entire consolidated budget represents the total amount of resources available to the Government of Puerto Rico to pay debt service and to provide services to the people. Therefore, if we accept the premise of the Governor of Puerto Rico, that in this fiscal crisis the debt payments must be balanced against the need to provide services to the people of the Island, the entire consolidated budget should be the basis of the analysis. After all, the funds that are not available to pay debt service may be used to provide services to the citizens. The usage of these funds for these purposes, therefore, would liberate resources that then could be used to pay debt service. Accordingly, the needs of the people and the commitments to honor debt obligations, would be effectively balanced.

It must be noted that the Krueger Report "was prepared at the request of legal counsel." (See the Krueger Report, p. 2.) As such, it may well serve as the basis for a particular legal strategy like, for example, bankruptcy. It is doubtful, however, that it should serve as the basis upon which to base a sound public policy.

Based on the above, the proper debt service burden of the Government of Puerto Rico, when correctly calculated, is 16%¹, and not 40%. In that regard, it is worth mentioning that in a report by Moody's Analytics (Zandi, Mark, Dan White, and Bernard Yaros, *Puerto Rico Looks Into the Abyss*, November 2015), that unquestioningly accepts the 40% debt service figure calculated by the Working Group, the authors argue that a debt service burden of 20% of government revenues is "sustainable" (p. 1). By the same logic, if 20% is sustainable, a 16% debt burden does not justify the use of bankruptcy.

In summary, the use of bankruptcy is not justified by the available evidence.

¹ In my written testimony at the hearing I indicated that the debt service represents 16.8% of the consolidated budget of the Government of Puerto Rico. That calculation was based on the proposed budget. Based on the budget that was finally approved, the debt service is 16%, like it was indicated above.

I now proceed to answer each of the questions specifically.

Question #1: Would extending Chapter 9 to Puerto Rico carry any negative consequences for the island? I'm not talking just about bondholders. I'm talking about the commonwealth as an entity. If Congress extended Chapter 9 to Puerto Rico and island municipalities began taking advantage of Chapter 9, how would that impact the island's bond rating, its creditworthiness, its attractiveness as an investment location, etc.? Is there a scenario under which extending Chapter 9 to Puerto Rico would actually make the island's fiscal situation worse?

Answer to Question #1: First, it is important to make the distinction between having access to bankruptcy proceedings and actually using it. That distinction is relevant because every state of the Union has access to bankruptcy protection for their public corporations and that access does not seem to have affected their credit quality.

As I indicated in the introduction, if the Government of Puerto Rico were to use bankruptcy as the way to solve its fiscal crisis that would worsen the economic situation of the Island because it would close access to financial markets for an indefinite number of years which would make it impossible to undertake necessary investments on the Island. That outcome would come about, at least, for three reasons:

1. The use of bankruptcy is not justified and to argue otherwise the government and its consultants had to resort to data manipulation, as I demonstrated in the introduction.
2. Reneging on its debt commitments would constitute a drastic change in the financial tradition of the Government of Puerto Rico that, until now, had an unblemished record of meeting its debt commitments.
3. Using bankruptcy protection would constitute a change of the rules under which bonds were issued. This change of rules not only could constitute a violation of constitutional provisions that protect contractual relations, but it also would erode the confidence on the Island of potential investors.

That situation would be even worse under the proposal by the Department of Treasury that would allow the Government of Puerto Rico to seek bankruptcy protection even for debt guaranteed by the Island's Constitution.

Naturally, any situation that weakens the economy of Puerto Rico would make the fiscal situation even worse.

Question #2: We've heard arguments that extending Chapter 9 to Puerto Rico would be unfair to bondholders because it would reduce their return on their investments. Some have argued that any Chapter 9 extension should apply only to future debts. As an initial matter, it would be helpful to know whether past bankruptcy code reforms have applied to existing debts, or whether bankruptcy reforms have typically applied only to future debts. Can you offer any insight on this matter? And if past reforms have applied to existing debts, have any of those reforms been analogous to what we're considering here—namely, extension of bankruptcy access to entities who previously had no such access? I asked this question at the hearing, but I didn't get a complete answer and I believe it's extremely important.

Answer to Question #2: I am aware of the constitutional impediments, both locally and at the federal level, to enact laws that may affect contractual relationships. At the same time, I am also cognizant of the fact that those very same Constitutions protect the power of Congress, at the federal level, and of state legislatures, at the local level, to approve laws. Balancing those two constitutional provisions is not an easy task and may require court intervention. Given that my area of expertise is not the law, on this question, I defer to those who do have that expertise.

From an economic standpoint, however, even if it were legally permissible, granting Puerto Rico access to bankruptcy protection for its existing debts is both troublesome and extremely dangerous. Utilizing bankruptcy when the debt service burden is 16% is equivalent to saying that "we can pay our debts, but we rather not pay them." Any jurisdiction acting that way, and one that does it with the express approval of Congress (via the contemporaneous extension of Chapter 9), will find it incredibly difficult to access the markets thereafter, since they are, plain and simply, refusing to pay their debts. In fact, it seems fair to say that an act of Congress that would allow a jurisdiction to avoid paying debts that it can otherwise pay would not only be unique, but it also would have disastrous consequences.

Question #3: Another question on Chapter 9 and retroactivity: If Congress steps in and changes the rules of the game after the fact to allow municipalities to discharge existing debts, do we need to worry about the message that sends to other debtors and other creditors across the country? Parties negotiate contracts according to existing laws. If we step in and suddenly change the rules, does that tell parties in other situations that the rules are actually more up for grabs than they might think? Does that tell other states or other municipalities outside Puerto Rico that if things get bad enough, Congress will simply change the rules to help ease the pressure?

Answer to Question #3: To ascertain whether granting Puerto Rico access to bankruptcy proceedings would constitute a change in the rules under which bonds were sold, I examined the official statements issued by the government of the Island as part of prior bond offerings. I did not find a direct reference to the issue of bankruptcy until the official statement issued in March 11, 2014, in which case the following disclosure was included:

The Commonwealth is not currently eligible to seek relief under Chapter 9 of the United States Bankruptcy Code. In the future, however, new legislation could be enacted by the United States Congress or by the Legislative Assembly that would entitle the Commonwealth to seek the protection of a statute providing for restructuring, moratorium and similar laws affecting creditors' rights. This could affect the rights and remedies of the holders of general obligation bonds and notes of the Commonwealth, including the Bonds, and the enforceability of the Commonwealth's obligation to make payments on such general obligation bonds and notes. (Commonwealth of Puerto Rico, Official Statement issued in relation with the issuance of the \$3,500,000,000 General Obligation Bonds of 2014, Series A, March 11, 2014, page 9.)

This disclosure constitutes an admission by the Government of Puerto Rico that if it were granted bankruptcy protection the rules under which bonds were issued would change. Otherwise, they would not have felt obligated to make the aforementioned disclosure.

Since it would constitute a change of rules, that would be another reason not to advocate bankruptcy as the tool to use to solve Puerto Rico's fiscal crisis. Thus, the only way in which Puerto Rico should be given access to bankruptcy protection is through a process in which that protection, instead of the primary objective, would be incidental to another decision as would be, for example, as a result of a change in the political status of Puerto Rico. Even under those conditions, however, for the reasons indicated before, I would not advocate for the Island to use that mechanism.

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Answers to Follow-Up Questions from Senator Hatch
Hearing on Puerto Rico's Fiscal Problems, December 1, 2015

Alex J. Pollock
Resident Fellow, American Enterprise Institute

It is a pleasure to reply to Senator Hatch's questions for the record. By way of preface, let me say that I remain convinced that the first step and indeed the sine qua non of addressing Puerto Rico's severe debt and financial management, or mismanagement, problems is the appointment by Congress of an Emergency Financial Control Board. Of course, this control board can be given another name, as long as the substance of its undoubted authority is provided for. It appears to me in reading the proposed statutory provisions for the "Puerto Rico Financial Responsibility and Management Assistance Authority" contained in "The Puerto Rico Assistance Act of 2015," S. 2381, that this is the case. The case is strengthened by the bill's provisions for a Chief Financial Officer for the government of Puerto Rico.

Once the control board is in place and in possession of the requisite financial information and analysis, it continues to be my recommendation that it should be required to report to Congress on the alternatives for addressing Puerto Rico's massive debt, specifically whether a bankruptcy regime, other debt restructuring or refinancing, or other actions would be the most appropriate and efficient, considering all the factors.

My answers to the three questions are as follows:

1. Puerto Rico already has debt ratings at the bottom of the scale, is shut out of the municipal debt market, and now has a well-deserved terrible financial reputation, as a fiscally and economically failing government-centric, welfare state. It is not clear whether a bankruptcy filing, whether under a revised Chapter 9 or a new territorial chapter of the bankruptcy code, would make any of that worse. Entities can go through bankruptcy and then later re-emerge as good credits, as for example in the municipal sector, Orange County, California, which was the largest municipal bankruptcy in history at the time of its insolvency. States of the U.S. often resist bankruptcy filings by their municipalities because they do not want the reputational damage to spread to their other cities and public bodies or the state itself. This concern would not apply in the case of the current Puerto Rico, which already appears insolvent on an overall basis. As stated above, I believe the first step should in any case be a control board, which should then recommend what the next steps should be.
2. The historical question about past bankruptcy code changes is very interesting and worthy of research, but not being a historian of bankruptcy laws, I unfortunately do not know the answer and have not seen it in my summary review of the history. The underlying intuition of the question seems reflected in the history of U.S. state laws because of the Constitutional provision

that "No State shall... pass any... Law impairing the Obligation of Contracts." But this obviously does not apply to federal bankruptcy laws. As to the extension of bankruptcy procedures to entities who previously had no such access, the addition of bankruptcy for municipalities, in 1934 and 1937, is itself one notable example, as was the 19th century innovation of allowing debtors voluntarily to petition into bankruptcy, instead of being forced into it by their creditors.

3. It seems to me that this question depends in part on whether one thinks a territory is easily analogized to a U.S. state, or conversely, whether a territory is so obviously distinct and different from a state that the ideas do not transfer. The complete jurisdiction of Congress over a territory, which has always been the case, as entirely distinct from its relation to a state, inclines me to the latter view. However, I would never even consider a bankruptcy regime for Puerto Rico without first installing an emergency financial control board (by whatever name one prefers). To allow bankruptcy without first exercising reformed control over Puerto Rico's finances, would, in my opinion, be a fundamental mistake and a very bad precedent.

Thank you for the opportunity to share these views.

Questions for the Record

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

Question for Mr. Ravitch:

Working with then-Governor Hugh Carey, you were one the leading architects of the major restructuring of New York City’s finances and debt – helping avoid the bankruptcy of that city in 1975. You also have extensive experience in public finance, having served as the chairman of the Metropolitan Transportation Authority and as chairman of the New York State Urban Development Corporation U-D-C.

- From your experience in public finance, what policies best assist state, city and local governments that are facing the type of debt crisis currently being experienced by Puerto Rico?

There is a limited amount of precedent for Chapter 9 of the Bankruptcy Code.

- How did the lack of case law interpreting Chapter 9 impact the 1975 restructuring of New York City’s finances and the recent Detroit bankruptcy?
- What thoughts do you have on how the Chapter 9 process can be improved?

TO: The Senate Judiciary Committee

FROM: Richard Ravitch

SUBJECT: My response to the questions you requested.

1. There are no circumstances under which the Commonwealth or its citizens could possibly be better off if the Congress does not extend restructuring authority through some form of bankruptcy process. Puerto Rico cannot pay its debts; it will default. The only question is whether or not it will do so in an orderly supervised process or in chaos with massive litigation in both Puerto Rico and New York. Every level of government faces disorderly defaults, liquidity crises and a growing inability to provide essential government services.

2. Clearly the Congress has the power under article 4 of the Constitution to give the Commonwealth the power to file in a bankruptcy court of the United States. Whether the result is unfair to bondholders or to pension beneficiaries or recipients of essential public services depends on the wisdom of the restructuring plan and the bankruptcy court that **will** ultimately approve it. Retroactivity is not an issue; the bankruptcy laws were enacted by the Congress to assist the municipalities of this country during the Great Depression. Obviously, they were intended to apply retroactively to help cities that couldn't pay all of their debts. Retroactivity was not ever raised as an issue while many amendments to the original bankruptcy statute were debated and enacted. The Supreme Court of the United States as held that the Congress has the power to retroactively impair existing contractual obligations under its Bankruptcy Clause power.

3. I respectfully suggest that the message that needs to be sent to other creditors around the country has more to do with the adequacy of the disclosure of the financial condition of the debtor than it does with the process by which a judgment is made as to how the needs of a society are to be balanced against an inability to pay all the money creditors. The failure of the debtor to disclose all of the material facts can be remedied under the securities and exchange laws of the United States. Enacting restructuring authority for the Commonwealth of Puerto Rico sets no precedent for States because constitutional limitations do not apply to territories.

It is impossible to fail to note that the \$3 billion of general obligation bonds that were purchased in 2014 with full knowledge of the deteriorating fiscal condition of the Commonwealth. That is why the interest rate was more than three times greater than the rate paid by creditworthy municipal borrowers.

4. I wish to offer the following recommendations; the authority being sought should sunset within a short period of time after the restructuring is accomplished. This would ensure that no future government would borrow as promiscuously and then be able to take advantage of the bankruptcy laws. A federally appointed control

Board should be created to ensure compliance with the restructuring plan and future prudent fiscal practices.

As to the question of what policies best assist local governments facing similar crises I offer the following thoughts:

States and local governments should be required to balance their budgets in accordance with generally accepted accounting principles; that is, current revenues must match current expenditures. Such a statutory rule is the explanation why the city of New York has never had another fiscal crisis.

New York didn't file in 1975. But had it not had the statutory power to do so the debt wouldn't have been restructured, the wage freezes and layoffs wouldn't have happened, the State wouldn't have raised taxes; don't know what the chaos would have produced. But the uncertainty of that very question is why the President and Congress provided over 2 billion dollars of loans after swearing a month earlier they would never do so.

I don't believe the absence of real case law affected the result in Detroit. The facts were sui generis; the actions of the governor, the business community, the creditors and unions were motivated by the uniform conviction that without a Court approved Plan of Adjustment everyone would be in much worse shape. The most important change to Chapter 9 should be a better definition of the word "feasibility" particularly with respect to its duration.

The best cure is avoidance by using responsible fiscal practices.

I would be pleased to discuss any of these questions should there be any interest.

QUESTIONS FOR THE RECORD – WRITTEN RESPONSES

OF

STEPHEN J. SPENCER

January 7, 2016

U.S. Senate Committee on the Judiciary

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

Stephen J. Spencer
Managing Director
Financial Restructuring Group
Houlihan Lokey
225 South 6th St #4950
Minneapolis, MN 55402

Question 1:

Would extending Chapter 9 to Puerto Rico carry any negative consequences for the island? I'm not talking just about bondholders. I'm talking about the commonwealth as an entity. If Congress extended Chapter 9 to Puerto Rico and island municipalities began taking advantage of Chapter 9, how would that impact the island's bond rating, its creditworthiness, its attractiveness as an investment location, etc.? Is there a scenario under which extending Chapter 9 to Puerto Rico would actually make the island's fiscal situation worse?

Response:

Extending Chapter 9 to Puerto Rico will have a wide range of negative consequences for the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico") and its government agencies.

Short Term Liquidity Threat:

In the short term, approval of Chapter 9 will erode the remaining trade credit being extended to the Commonwealth, further exacerbating current liquidity constraints. The impact is likely to be most acute at the Commonwealth's government agencies, whose financial creditors are assumed to bear the brunt of any potential Chapter 9 related impairment. Beyond the Commonwealth's government agencies, potentially significant and prolonged trade credit disruption will also negatively impact general fund liquidity, as all government vendors will perceive heightened risk of repayment on their current and future government receivable positions, regardless of the particular government agency that owes them money.

The financial impact on Puerto Rico Electric Power Authority ("PREPA"), after the Puerto Rico Corporations Debt Enforcement & Recovery Act, Act 71-2014 ("DERA"), illustrates how passage of Chapter 9 legislation could trigger a broader near-term liquidity crisis. More specifically, after DERA was enacted, PREPA lost support from many of its vendors, including Petrobras, its major fuel supplier.¹ As a sophisticated vendor of a critical trade item (i.e. fuel for electricity generation), Petrobras demanded payment on millions of dollars in outstanding receivables before agreeing to continue providing PREPA with additional fuel.² The actions of Petrobras and other PREPA vendors plunged PREPA into a liquidity crisis virtually overnight, one for which it was ill-prepared and had no immediate plan to address. In a relatively short period after the crisis, the situation deteriorated to the point that the Commonwealth entered hurricane season with an inadequate fuel inventory, a dangerous situation created by poor governance at multiple levels.

Could passage of Chapter 9 generate a similar PREPA style liquidity crisis threatening to disrupt the provision of essential government services on a broader scale? There is certainly a legitimate concern of this. Unfortunately, the answer at this point is not clear. While in theory, Chapter 9 would provide

¹ The island enacted DERA legislation on June 28, 2014, with the stated intent of using it to address effect a financial restructuring at PREPA and potentially two other government agencies: the Puerto Rico Sewer Water Authority ("PRASA") and the Puerto Rico Highway Authority ("PRHTA"). The extent of attendant vendor related liquidity contraction at PRASA and PRHTA has not been publicly disclosed.

² Cate Long. "Puerto Rico's electricity monopoly is in a downward spiral." *Reuters* 19 June 2014. <http://blogs.reuters.com/muniland/2014/06/19/puerto-ricos-electricity-monopoly-is-in-a-downward-spiral/>

certain tools, such as an automatic stay and the ability to raise emergency Debtor-in-Possession (“DIP”) financing that might help the Commonwealth manage escalating liquidity pressures, there is no indication that these tools will work or that the Commonwealth has properly analyzed or quantified the potential for a sudden deterioration in trade credit support across a broad range of government entities.³ To the contrary, the Commonwealth’s continued inability to produce critical data and analysis on a timely basis, and the nearly calamitous post DERA experience at PREPA, raises substantial doubt that the Commonwealth is adequately prepared for the potential negative liquidity impact resulting from passage of Chapter 9 legislation.

Additional Short Term Issues & Considerations:

Extending Chapter 9 to Puerto Rico provides no guarantee that its immediate liquidity needs will be met. Embedded in Puerto Rico’s aggressive Chapter 9 push is the presumption that it will give the Commonwealth the ability to raise DIP financing on a comparatively low-cost and efficient basis. However, the perspective of the capital markets is that the Commonwealth has engineered the current liquidity crisis to support a pro-Chapter 9 agenda. Any new prospective lender will be forced to evaluate the Commonwealth’s use of misleading data directly contradicting prior market representations,⁴ its anti-investor rhetoric,⁵ and its rejection of new money financing offers from current creditors that would have allowed it to avoid default.⁶ The fact pattern is consistent with a high level of political risk for which any prospective DIP lender will charge an interest rate premium.

Furthermore, it is not clear how the Commonwealth will be able to raise any DIP financing at all. For the Commonwealth to raise a DIP in an uncontested manner, it would need unencumbered collateral, which it does not have. Additionally, even if it did have unencumbered collateral, the Commonwealth’s unusually aggressive pro-Chapter 9 tactics have raised concerns about its willingness to honor contractual debt repayment obligations at any level, causing many market participants to question the value of even super-priority DIP repayment commitments.

³ The government has 125 different government agencies. The government has never disclosed how many of these agencies secure goods or services through independent trade relationships making it impossible to independently assess the potential magnitude of a Chapter 9 driven liquidity disruption.

⁴ (i) “Update on Fiscal and Economic Progress.” The Commonwealth of Puerto Rico 15 October 2013. Page 57. <http://www.bgfpr.com/documents/UpdateonFiscalandEconomicProgressWebcast-Final.pdf>

(ii) Written Testimony of Carlos A. Colón-De-Armas, Ph.D. Page 6. [http://www.judiciary.senate.gov/imo/media/doc/12-01-15%20Colon%20De%20Armas%20Testimony%20\(with%20attachment\).pdf](http://www.judiciary.senate.gov/imo/media/doc/12-01-15%20Colon%20De%20Armas%20Testimony%20(with%20attachment).pdf)

⁵ “With the current level of economic growth, the debt is not payable... When [investors] lent, they knew there was a deficit... That’s why they’re being called to the table for sacrifices.” – Puerto Rican Gov. Alejandro García Padilla

“Puerto Rico could turn into the next Greece, Gov. García Padilla warns.” *Fox News* 06 July, 2015. <http://latino.foxnews.com/latino/money/2015/07/06/puerto-rico-could-turn-into-next-greece-governor-garcia-padilla-warns/>

⁶ Mary Williams Walsh. “Puerto Rico Defaults on Debt Payments.” *The New York Times* 4 January 2016. <http://www.nytimes.com/2016/01/05/business/dealbook/puerto-rico-defaults-on-debt-payments.html>

Finally, Chapter 9 DIP lending is a largely untested area of finance. There has been only one other Chapter 9 DIP, which was for the City of Detroit, and the DIP experience did not go well. Detroit is not a precedent for Puerto Rico because unlike Puerto Rico, it had unencumbered collateral. Still, Detroit's DIP experience merits discussion because it speaks to the questionable utility of Chapter 9 on a whole. The City of Detroit was able to attract a new money DIP lender, Barclays Capital Inc., by granting super-priority repayment protection with the promise that the City of Detroit, upon emergence from its financial restructuring, would be able to re-finance the DIP facility with a more traditional municipal borrowing facility.⁷ Unfortunately, given widespread investor sentiment that the restructuring accomplished little but impairment of the City of Detroit's financial creditor claims, it was unable to refinance the DIP facility and Barclays was forced to roll their DIP facility into an exit facility to allow the City of Detroit to emerge from bankruptcy. Post-emergence, investor sentiment towards the City of Detroit has continued to be negative and the Barclays facility was only paid off through financial assistance from the State of Michigan, which was forced to support the City of Detroit by issuing the refinancing debt through the Michigan Finance Authority. The State was also forced to enact special legislation giving the lenders a statutory lien on the City's income taxes.⁸ For Puerto Rico, the only entity that could provide similar types of incremental assistance would be the U.S. Federal Government, which has so far declined to do.

In summary, Congressional action granting Chapter 9 powers to Puerto Rico in the context of rampant investor mistrust over the Commonwealth's present conduct and motivations would be perceived as the federal government sanctioning fiscal irresponsibility – an indication that political expediency trumps investor protection. Conversely, denying Chapter 9 would re-focus the Commonwealth on the need to work with existing lenders to secure any needed debt service and liquidity relief. From an immediate liquidity perspective, with DIP an impossibility, this would appear to be the only viable approach. Moreover, the practice of creditors in financial restructurings providing additional liquidity to prevent further financial deterioration (thereby improving recovery prospects) is commonplace. Notably, the liquidity crisis at PREPA was resolved by PREPA bondholders granting the entity access to debt service reserve accounts to bolster the Company's cash reserves. PREPA's bondholders did so because it made the most economic sense. For the same reason, multiple other creditors have advanced preliminary financing proposals to the Commonwealth to support its general fund liquidity, which the Commonwealth has so far rejected, presumably because they would have imposed certain conditions, like the imposition of operational or fiscal reforms, that would be easier for the Commonwealth to avoid. The reality of the Commonwealth's current liquidity situation is that it has a variety of options to raise financing, all of which it will continue to reject as long as it remains fixated on the siren's song of Chapter 9 DIP financing.

Longer Term Issues and Considerations:

To the extent the Commonwealth's Chapter 9 quest is successful, perhaps the greatest damage it will inflict will be to investor perception regarding Puerto Rico's credit worthiness and its attractiveness as a

⁷ In April 2014, the Court approved a \$120 million DIP facility from Barclays to the City of Detroit. <http://www.investmentbank.barclays.com/our-insights/barclays-helps-finance-detroits-economic-recovery.html>

⁸ Testimony of Stephen J. Spencer. U.S. Senate Committee on the Judiciary – "Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution". 01 December 2015. <http://www.judiciary.senate.gov/imo/media/doc/12-01-15%20Spencer%20Testimony.pdf>

place to invest. Over the intermediate term, it is a certainty that no matter how much the Commonwealth is able to optically improve its balance sheet by purging debt through Chapter 9 related financial restructurings, it will still be forced by the ratings agencies to pay penalty interest rates on all new debt issues. As discussed further in both my oral and written testimonies, risk assessment in the municipal capital markets is weighted toward measuring a municipal debt issuer's willingness to pay and adhere to established contractual creditor protections, which is of paramount importance. For example, 60% of the Standard & Poor's ("S&P") municipal credit ratings rubric is directed toward measuring a debtor's political and legal commitment (i.e., institutional framework, economy, and management) to honoring debt obligations.⁹ Within the S&P municipal credit ratings paradigm, any debtor actions that weaken these commitments necessitate a 5 notch ratings downgrade, effectively capping the debtor's credit rating at the high-end of non-investment grade or "junk" ratings status – even if the debtor is rated highly in every other rating category. At a minimum, the ratings agency guidelines ensure that the Commonwealth will be cut-off from the low-cost municipal financing markets for a period of 5 years, the precise period during which the Commonwealth has indicated it requires substantial incremental investment capital to facilitate economic revitalization initiatives.

Beyond the next 5 years, there is a higher likelihood the Commonwealth will continue to be charged penalty interest rates. While in theory it is conceivable that the Commonwealth might use the benefit of Chapter 9 related debt relief to address fiscal mismanagement, the reality of government debt impairment, whether in a municipal or sovereign government context, is that few governments have used debt relief successfully to address the politically challenging problem of systemic government misadministration or to catalyze sustainable economic development.

For example, none of the municipalities that have recently filed for Chapter 9 were able to implement significant operational improvements or overcome political opposition to meaningfully reduce entitlement costs such as unfunded pension or healthcare costs.¹⁰ Among sovereign debtors, the experience of Mozambique, Ghana, and Zambia offer recent case studies on how purging legacy debt to access new development capital does not guarantee economic recovery. All three countries were rather famously granted debt relief under IMF supervision in the 2001-2002 timeframe, and then subsequently borrowed extensively to finance what proved to be ill-conceived economic development schemes. In approximately a decade, all three countries have completed the cycle of financial distress by failing to realize economic expansion expectations and are again exhibiting significant levels of economic distress.¹¹

As a commonwealth, Puerto Rico is in a different category of government debtor, being neither a sovereign country nor a traditional municipal borrower, and it exhibits patterns of economic and fiscal failure, which are found in both. Annually, Puerto Rico and its citizens enjoy approximately \$23.5 billion

⁹ "U.S. Local Governments General Obligation Ratings: Methodology and Assumptions." *Standard & Poor's Ratings Services, McGRAW HILL FINANCIAL* 12 September 2013. http://www.standardandpoors.com/spf/upload/Events_US/US_PF_logo102014.pdf

¹⁰ See page A1 and A2 in Testimony of Stephen J. Spencer (See source cited in footnote 8).

¹¹ Matina Stevis. "Big African Debt Burdens, Written Off, Are Back Again." *The Wall Street Journal* 17 November 2015. <http://www.wsj.com/articles/big-african-debt-burdens-written-off-are-back-again-1447705258>

of U.S. Federal Government financial support.¹² Historically, the Commonwealth has been unable to capitalize on various Federal Government support mechanisms to stimulate sustainable economic development schemes in a range of industries – similar to the way the highlighted African countries failed to capitalize on international financial assistance. Additionally, Puerto Rico’s own government advisor, Anne Krueger, points out that the Commonwealth exhibits certain economic performance metrics that are worse than the most distressed U.S. States. She goes on to suggest that the cause of some of these poor performance metrics, such as poor labor utilization, may actually be rooted in well-intentioned but economically and fiscally misguided forms of U.S. financial assistance.¹³

Because Chapter 9 is really just a blanket form of economic assistance at the expense of creditors, and because Puerto Rico has historically failed to capitalize on external financial aid, the greatest likelihood is that the passage of Chapter 9 will do little more than perpetuate a cycle of economic financial distress. To the extent it does, the negative long-term implications of Chapter 9 for Puerto Rico will be a cycle of economic dependency, continued episodic financial “crises”, and an attendant long-term elevation in the cost of borrowing.

¹² Merrill Oliver. “Federal Funds Management Office.” *Commonwealth of Puerto Rico*. Page 3. <http://www2.pr.gov/agencias/FederalFunds/Documents/Fondos%20Fderales%20vFINAL.pdf>

¹³ Anne O. Krueger, Ranjit Teja, and Andrew Wolfe. “Puerto Rico – A Way Forward.” 29 June 2015. Page 17. <http://www.bgfpr.com/documents/puertoricowayforward.pdf>

Question 2:

We've heard arguments that extending Chapter 9 to Puerto Rico would be unfair to bondholders because it would reduce their return on their investments. Some have argued that any Chapter 9 extension should apply only to future debts. As an initial matter, it would be helpful to know whether past bankruptcy code reforms have applied to existing debts, or whether bankruptcy reforms have typically applied only to future debts. Can you offer any insight on this matter? And if past reforms have applied to existing debts, have any of those reforms been analogous to what we're considering here—namely, extension of bankruptcy access to entities who previously had no such access? I asked this question at the hearing, but I didn't get a complete answer and I believe it's extremely important.

Response:

Bankruptcy reforms have traditionally applied to all debts, not just future debts. There is no issue where those debts are unsecured.

However, almost all bonds issued by Puerto Rico's governmental corporations, including bonds issued by the Puerto Rico Electric Power Authority ("PREPA"), are secured debts – secured by statutory pledges of revenues of those governmental corporations. Applying chapter 9 retroactively to outstanding secured debts would raise constitutional issues.

In United States v. Security Industrial Bank, 459 U.S. 70 (1982), a secured creditor argued that the Bankruptcy Code's voiding of its lien under Section 522(f) was a taking of property under the Fifth Amendment. The Court avoided the constitutional issue by holding that Section 522(f) did not apply retroactively to liens that had been perfected before the Bankruptcy Code was enacted.¹⁴

Chapter 9 has been interpreted in ways that damage, if not eliminate, the rights of secured bondholders. Puerto Rican bonds secured by revenues have the right to have Puerto Rico increase those revenues to pay off the bonds – this "rate covenant" is absolutely critical to the value of the bonds, and indeed, PREPA refusal to raise its rates in 27 years is a major reason for the financial difficulties that beset PREPA starting in 2014.

However, municipalities in Chapter 9 have argued that the filing of the Chapter 9 eliminates the rate covenant and the municipalities' obligation to raise revenues to pay their creditors. Professor Ken Klee made that argument in the Jefferson County, Alabama bankruptcy with respect to \$3 billion in secured sewer bonds en route to a settlement where the County finally agreed to raise its sewer rates. The City of Detroit made that argument in its Chapter 9 case.

Puerto Rico itself has taken the position that a rate covenant is irrelevant by neutering rate covenants in DERA declaring that the act was "modeled" on Chapter 9. DERA says it is "a model similar to that of Chapter 9" and is subject to jurisprudence interpreting Chapter 9, Preamble at 85. DERA § Section 315(o) says there is no requirement to raise rates if "they cause individuals or businesses to leave the Commonwealth, to reduce spending in the Commonwealth or to reduce consumption of services provided

¹⁴ Owen v. Owen, 500 U.S. 305, 317 (1991).

by the petitioner.” Since this argument can be made about any rate increase, Section 315(o) effectively neuters rate covenants.

The issue of Chapter 9’s effect on rate covenants makes the retroactive imposition of Chapter 9 on secured debts uniquely unfair to municipal bondholders, because only those debts benefit from rate covenants.

It is particularly unfair to the hundreds of thousands of investors who hold, directly or indirectly, secured bonds issued by Puerto Rico’s government corporations who agreed to raise rates to cover their debts, under Puerto Rican laws that authorized and (in PREPA’s case) required that rates cover their debts. See Puerto Rico’s Act 57 of 2014, establishing an Energy Commission to set electrical rates and providing in Section 6.3(m) that the Commission has a duty to:

“(m) Ensure that the powers and authorities exercised by the Commission over PREPA, including those related to rate review or approval, guarantee that PREPA meets its obligations to bondholders.”

Arguments in favor of retroactivity are all drawn from the bankruptcies of individuals or private corporations and are thus inapplicable to the issue of whether Chapter 9 can or should be retroactively imposed on existing secured debts.

With respect to the question:

“[I]f past reforms have applied to existing debts, have any of those reforms been analogous to what we’re considering here—namely, extension of bankruptcy access to entities who previously had no such access?”

None of the previous reforms are analogous to the extension of Chapter 9 to Puerto Rico’s municipalities and governmental corporations.

With respect to private sector corporations, the first bankruptcy law that retroactively provided for the restructuring of secured debt was the 1934 insertion of Section 77B into the Bankruptcy Act of 1898. Retroactivity was not an issue because state receivership laws had generally provided for similar restructuring with requisite creditor consents, through a state receivership or sale of assets.¹⁵

With respect to secured debt of municipal corporations, retroactivity was not an issue when Congress extended bankruptcy access to municipalities because the first three municipal bankruptcy acts required agreement from a majority of bondholders before the municipality could even start a bankruptcy case.

¹⁵ A 1916 article by Paul D. Cravath shows that secured debts of private sector corporations have been subject to restructuring for more than 130 years. Cravath, *The Reorganization of Corporations: Bondholders’ and Stockholders’ Protective Committees; Reorganization Committees; and the Voluntary Recapitalization of Corporations*, SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION (F.L. Stetson, ed.).

I understand that the Committee is not considering amending Chapter 9 to allow the Commonwealth of Puerto Rico itself to file for bankruptcy. As you know, there is absolutely no precedent for the retroactive application of the bankruptcy laws to any debt, secured or unsecured, of a state, commonwealth or territory.

Finally, there is no precedent for retroactive application of the bankruptcy laws to outstanding debt of a class of obligors where the obligors had been previously and explicitly excluded from bankruptcy.

Question 3:

Another question on Chapter 9 and retroactivity: If Congress steps in and changes the rules of the game after the fact to allow municipalities to discharge existing debts, do we need to worry about the message that sends to other debtors and other creditors across the country? Parties negotiate contracts according to existing laws. If we step in and suddenly change the rules, does that tell parties in other situations that the rules are actually more up for grabs than they might think? Does that tell other states or other municipalities outside Puerto Rico that if things get bad enough, Congress will simply change the rules to help ease the pressure?

Response:

Yes, Congress should worry about the message that would be sent if Chapter 9 was retroactively changed for Puerto Rico. Although the U.S. States are precluded from using Chapter 9 to address state level financial distress, extending Chapter 9 to Puerto Rico would send an implicit message that Chapter 9 is a flexible framework and state level fiscal profligacy will ultimately be backstopped by the federal government, either through further modifications of the bankruptcy code or in some other manner. Additionally, as a more immediate worry, Congress should be concerned that extending Chapter 9 to Puerto Rico may erode investor confidence in the sanctity of contract that supports the proper functioning of the municipal capital markets across the country. To the extent individual investors develop a view that contractual investor protections can be modified by Congress to respond to whatever circumstances are deemed to be “challenging” or “exigent” at any particular moment, the market will place a higher risk premium on municipal debt, negatively impacting borrowing costs for every city, county, and state in the country, without exception. Further to the point, the following excerpt from my written testimony highlights the fundamental investor protection issues that would be at risk if Congress were to grant access to Chapter 9 to Puerto Rico:

Chapter 9 Would Hurt Individual Investors and The Broader Municipal Market:

For individual investors, and there are hundreds of thousands of them throughout the United States and within Puerto Rico itself, there is a basic investor protection issue at stake. They bought Puerto Rican bonds and thus financed critical government infrastructure at a time when the market knew and understood that the Commonwealth and its municipalities were prohibited from filing for Chapter 9 bankruptcy. The language precluding Puerto Rico from access to Chapter 9 is clear and unambiguous.¹⁶ If the Bankruptcy Code had listed all 50 U.S. States as authorized to use Chapter 9, and simply excluded Puerto Rico, there might have been some justifiable confusion. But it did not, and the fact that it did not, is economically significant. Because Puerto Rico was explicitly precluded from using Chapter 9, a significant risk factor relating to the repayment of the Commonwealth’s municipal debt was removed and the market priced Puerto Rico municipal bonds at lower interest rates than if that risk had remained.

Securities laws are premised on the markets factoring in available public information. Puerto Rico’s lack of access to Chapter 9 was clearly public information and this information was factored into the pricing of Puerto Rico debt. Consequently, for more than 30 years, the markets assumed Puerto Rico was a safer

¹⁶ Administrative Office of the U.S. Courts: Chapter 9 – Bankruptcy Basics.
<http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics>

credit risk and the Commonwealth enjoyed lower interest rates on its municipal debt resulting in billions of dollars of interest reductions that investors will never recover.¹⁷ The magnitude of this value transfer underscores the problem with retroactively changing the rules in the middle of the game and it illustrates why so many individual investors would feel justifiably cheated if the legislation is passed.

¹⁷ Average annual gross public debt over the past 30 years of \$30 billion multiplied by 100 basis points (widened yields on GO Bonds for the City of Chicago – See source cited in footnote 8) equals an illustrative annual potential interest savings of \$300 million. Statistical Appendix (Apéndice Estadístico), Multiple reports. http://www.jp.gobierno.pr/portal_jp/ActividadEcon%C3%B3micaEconomicActivity/Ap%C3%A9ndice/t/abid/184/Default.aspx

A P P E N D I X
to
PUERTO RICO'S FISCAL PROBLEMS:
EXAMINING THE SOURCE AND
EXPLORING THE SOLUTION

The following submissions are available at:

<https://www.govinfo.gov/content/pkg/CHRG-114shrg52553/pdf/CHRG-114shrg52553-add1.pdf>

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