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Puerto Rico's Current Fiscal Challenges

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Summary

The government of Puerto Rico faces severe fiscal challenges. A federal district court judge in late March 2016 held that the island's government was insolvent and unable to pay its obligations on time. Emergency legislation (Act 21 of 2016) enacted on April 6, 2016, stated that the Puerto Rican government's fiscal condition "is more dire than at any other point in its history" and that "depleted resources and strained liquidity threaten to bind the Commonwealth to a choice between honoring its commitments to bondholders or continuing to provide the residents of Puerto Rico with essential services." On April 8, 2016, the Puerto Rican governor invoked emergency authorities to maintain essential public services.

The Puerto Rican government has been facing serious liquidity challenges and has lost normal access to credit markets despite measures taken by the island's government to reduce spending, increase revenues, and restructure its obligations. Much of the island's liquidity challenges stem from substantial debt service costs facing the central government and its public corporations. In August 2015, debt service on Public Finance Corporation bonds was not paid in full. The Puerto Rico Infrastructure Financing Authority (PRIFA) did pay interest in full on certain bonds due on January 1, 2016. On May 1, 2016, Governor Alejandro García Padilla declared a moratorium on certain debt payments by the Government Development Bank (GDB), the government's fiscal agent, due on that date. The Commonwealth government doubts that it can make a larger debt service payment on July 1, 2016. On June 29, 2015, Governor García Padilla stated during a televised address that "the debt is not payable." On the same day, a report commissioned from three former International Monetary Fund economists was released, which described severe short-term funding challenges as well as long-standing issues with key parts of the Puerto Rican economy and public sector. On September 9, 2015, a working group appointed by the governor released a plan that outlined its strategy. Puerto Rico's financing gap over the coming five years, according to the plan, is nearly $28 billion. The plan's proposals, along with hoped-for improvement in economic growth, were said to halve that gap.

The precarious state of Puerto Rico's public finances stems in part from prolonged economic weakness. Economic growth was sluggish even before the 2007-2009 recession, and projections suggest that the economy is contracting. Past analyses noted low employment and labor participation rates, high rates of outmigration leading to a decline in population, an economic structure shaped more by tax advantages than comparative advantages, and intensified global competition, among other factors. Others point to weaknesses in fiscal and operational controls.

In October 2015, the U.S. Department of the Treasury set out a reform framework and called on Congress to pass legislation to aid Puerto Rico. Resident Commissioner Pierluisi introduced H.R. 870 on March 16, 2015; the bill would restore the island's access to chapter 9 of the Bankruptcy Code. Senator Blumenthal introduced a similar measure (S. 1774) on July 15, 2015. On December 9, 2015, Representative Sean Duffy introduced H.R. 4199, a measure to provide fiscal oversight and a debt restructuring process. Senator Hatch introduced a similar measure (S. 2381) on the same day. On December 18, 2015, Representative Pelosi introduced H.R. 4290 and Senator Warren introduced S. 2436, both measures to stay debt-related litigation. On March 14, 2016, Senator Menendez introduced two bills (S. 2675, S. 2676) that would allow adjustments of Puerto Rico's debt. The House Natural Resources Committee issued a discussion draft on March 29, 2016. Representative Duffy introduced the Puerto Rico Oversight, Management, and Economic Stability Act (H.R. 4900) on April 12, 2016, and a revised version (H.R. 5278) on May 18, 2016, which would set up an Oversight Board for Puerto Rico and create a process to restructure the island's debts, among other provisions.

Contents

Puerto Rico's Fiscal Emergency 1
Emergency Moratorium and Financial Rehabilitation Act 1
Restructuring the Government Development Bank 2
Puerto Rico's Fiscal Strategy 3
Puerto Rican Restructuring Act 3
Credit Ratings Downgrades and Loss of Market Access 4
FY2016 Budget 6
Puerto Rican Governor: Debt Unpayable 6
Economic and Fiscal Recovery Working Group Plan 7
Extraordinary Liquidity Measures Used in Late 2015 and Early 2016 8
First Default in August 2015 8
Loss of Credit Market Access Prevented Debt Roll-Overs 9
Constitutional Limits on Borrowing are Close to Binding 9
Puerto Rico Faces Severe Challenges in FY2017 9
Structural Initiatives to Address Fiscal Challenges 10
Fiscal Challenges Have Been Building for Years 12
Debt Accumulation over Time 12
Public Corporations Incurred Much of Puerto Rico's Public Debt 13
Puerto Rico Electric Power Authority 15
Government Development Bank for Puerto Rico 16
Other Public Corporations 17
Fiscal Strategy and Outmigration 19
Potential Issues for Congress 20
Administration Proposals 21
Credit Support 21
Federal Health and Income Support Programs 21
Restructuring and Bankruptcy 22
Federalism, Flexibility, and Fiscal Responsibility 23
Control Board Proposals 24
District of Columbia Control Board and State-Established Control Boards 24
Congressional and Administration Proposals for Fiscal Oversight 25
Structural Reforms in the Medium and Long Term 26

Figures

Figure 1. Selected Puerto Rico Bonds; Dollar Prices Since January 2011 5
Figure 2. Government Employment in Puerto Rico, 1990-2016 12
Figure 3. Per Capita General Fund Outlays & Revenues 13
Figure 4. Gross Public Debt of Puerto Rico in Billions of Constant Dollars, 1960-2014 14
Figure 5. Puerto Rico Resident Population Trends 20

Contacts

Author Information..... 27

Puerto Rico's Fiscal Emergency

The government of Puerto Rico currently faces a serious fiscal emergency that is the culmination of long-standing budgetary, economic, and financial challenges. While Puerto Rico has made a number of structural reforms and has increased tax rates in the past few years, it had been unable to head off increasingly urgent fiscal challenges. Recent projections estimate the island's economy will shrink by about 1.2% in FY2016 (which ends June 30, 2016) and by about 2% in FY2017.[1]

Defaults on bonds issued by some components of the Puerto Rican government have already occurred, and credit rating agencies expect others to follow. In August 2015, debt service on bonds issued by the Public Finance Corporation, an arm of the Government Development Bank (GDB), was not paid in full. The Puerto Rico Infrastructure Financing Authority (PRIFA) did pay interest in full on certain bonds due on January 1, 2016.[2] The GDB itself did not pay principal due on May 1, 2016, as described in the next section.

The Puerto Rican government's fiscal situation, according to emergency legislation (Act 21 of 2016) enacted on April 6, 2016, "is more dire than at any other point in its history" and "depleted resources and strained liquidity threaten to bind the Commonwealth to a choice between honoring its commitments to bondholders or continuing to provide the residents of Puerto Rico with essential services."[3] A federal district judge in late March 2016 held in a case involving the tax treatment of Walmart that the government of Puerto Rico "is insolvent and no longer able to pay its debts as they become due."[4] The Governor of Puerto Rico, Alejandro García Padilla, while signing the emergency act, was quoted as stating that "Puerto Rico is insolvent."[5] The Puerto Rican government has slowed some tax refunds and supplier payments to bolster its liquidity.[6]

Emergency Moratorium and Financial Rehabilitation Act

The Puerto Rico Emergency Moratorium and Financial Rehabilitation Act (PREMFRA; Act 21 of 2016) empowers the governor of Puerto Rico to declare a fiscal state of emergency and a moratorium on certain debt service payments that would extend to January 2017. That emergency legislation, according to its preamble, was prompted by impending debt service payments. On May 1, 2016, Governor García Padilla issued an order to declare a moratorium on certain debt payments by the Government Development Bank (GDB), the government's fiscal agent, which

[1] Puerto Rico Planning Board, "Puerto Rico Planning Board Issues Economic Projections for FYs 2016 and 2017," May 6, 2016, http://www.bgfpr.com/documents/CP-JPpresentaproyeccioneseconomicas2016-2017-InformeEconomicoalGobernador-Engtrs.pdf.

[2] Commonwealth of Puerto Rico Basic Financial Statements and Required Supplementary Information (Unaudited), February 16, 2016, pp.92, 95, http://www.hacienda.gobierno.pr/sites/default/files/draft_unaudited_financial_statements_dated_2_16_2016_0.pdf.

[3] Act 21 of 2016, http://www.oslpr.org/2013-2016/leyes/doc/ley-21-06-Abr-2016.doc at p. 49.

[4] Walmart Puerto Rico Inc. v. Juan C. Zaragoza-Gomez, Secretary of the Puerto Rican Treasury, Opinion and Order, March 28, 2016, case No. 3:15-CV-03018 (JAF), http://www.noticel.com/uploads/gallery/documents/d7b90a9e684c342bffb267efc4dfadca.pdf.

[5] "Puerto Rico está insolvente y la situación requiere un esfuerzo serio para encontrar una solución" (Puerto Rico is insolvent and the situation requires serious efforts/sacrifices to reach a solution). Nydia Bauzá, "García Padilla proclama que el gobierno está insolvente," *El Nuevo Dia*, April 6, 2016, http://www.elnuevodia.com/noticias/locales/nota/garciapadillaproclamaqueelgobiernoestainsolvente-2183623/. Translations in parentheses by the author.

[6] Commonwealth of Puerto Rico Basic Financial Statements and Required Supplementary Information (Unaudited), February 16, 2016, p. 104.

was due to make a debt service payment of $423 million on that date.[7] GDB did pay interest and was able to refinance $33 million of that debt, leaving a payment shortfall of about $367 million.[8]

The Commonwealth government has stated that even after recapturing or "clawing back" revenues from other parts of the public sector that it "will not have sufficient resources to meet the entire debt service obligation on the Commonwealth's general obligations bonds due on July 1, 2016."[9] On that date, the Commonwealth government is due to pay about $1.9 billion, of which, about $800 million are for general obligation debts.

Restructuring the Government Development Bank

The GDB has faced serious liquidity issues in recent years. According to documents released in the Walmart case, a local banking regulator, the Puerto Rico Commissioner of Financial Institutions, found that the GDB was insolvent in 2015. Senior GDB officials, however, contested some claims of the Commissioner.[10] Many, however, had considered it likely that a receiver could take control of the GDB, which could complicate financial operations of the Commonwealth.[11] The Puerto Rican government has reportedly moved accounts from the GDB to commercial banks in order to avoid disruptions in public finances.[12] On April 8, Governor García Padilla invoked authorities provided by the act to declare an emergency period for the GDB in order to allow it to continue its operations.[13]

PREMFRA also allows the governor, once emergency powers are invoked, to "take any and all actions reasonable and necessary to allow the Bank [GDB or successor bank] to continue performing its operations."[14] The act also modifies legal provisions regarding the receivership of the GDB, and allows for the establishment of a bridge bank that would assume many of the responsibilities and assets of the GDB. A new public corporation, Puerto Rico Fiscal Agency and Financial Advisory Authority, would assume the role of the island's fiscal agent and financial

[7] Executive Order OE-2016-014, "Executive Order of the Governor of Puerto Rico, Hon. Alejandro J. García Padilla under Terms of Articles 201, 202, and 203 of Act 21 of 2016, Known as the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act," May 1, 2016; http://www.fortaleza.pr.gov/content/orden-ejecutiva-moratoria-temporera-en-el-pago-de-la-deuda.

[8] "Government Development Bank for Puerto Rico Announces Framework of Indicative Terms for Restructuring with GDB Ad Hoc Group of Creditors," May 1, 2016, http://www.bgfpr.com/documents/GDBPressReleaseAnnouncementofAdHocGroupDeal_001.pdf.

[9] Commonwealth of Puerto Rico Basic Financial Statements and Required Supplementary Information (Unaudited), February 16, 2016, p. 94, http://www.hacienda.gobierno.pr/sites/default/files/draft_unaudited_financial_statements_dated_2_16_2016_0.pdf. Also see last page of Sergio Marxuach, "The Endgame: An Analysis of Puerto Rico's Debt Structure and the Arguments in Favor of Chapter 9," Center for a New Economy working paper, November 30, 2015.

[10] Walmart Puerto Rico Inc. v. Juan C. Zaragoza-Gomez, Secretary of the Puerto Rican Treasury, Opinion and Order, March 28, 2016, p. 1. The regulator is the Puerto Rico Commissioner of Financial Institutions. Senior managers of the GDB have contested some claims of the Commissioner, although the precarious state of the Bank is acknowledged.

[11] Ibid. Also see Carlos Antonio Otero, "Pulseo con la Posible Sindicatura del BGF (Wrestling with the Possible GDB Receivership)," *El Vocero*, March 30, 2016, http://elvocero.com/pulseo-con-la-posible-sindicatura-del-bgf/.

[12] Eric Platt and Mary Childs, "Puerto Rico Opens Accounts at Commercial Bank to Sustain Services: Move Seen as Quick Fix for Commonwealth's Treasury and Public Agencies to Protect Themselves," *Financial Times*, April 4, 2016.

[13] Executive Order OE-2015-010, April 8, 2016. Executive orders issued by the Puerto Rican governor are available at http://estado.pr.gov/en/executive-orders/.

[14] Act 21 of 2016, http://www.oslpr.org/2013-2016/leyes/doc/ley-21-06-Abr-2016.doc at pp. 55-56.

advisor. The act also includes a stay on legal actions against the Puerto Rican government while emergency powers are invoked.[15]

A group of GDB bondholders filed a suit on April 4, 2016, in federal district court in Puerto Rico to halt transfers or other actions that would weaken further the financial condition of the GDB.[16] A federal judge declined to issue a temporary restraining order, but required that the GDB respond by April 15.[17] Plaintiffs withdrew the suit on April 13, 2016, after concluding that the April 8 executive order placed sufficiently stringent conditions on withdrawals from GDB accounts.[18]

Puerto Rico's Fiscal Strategy

The Puerto Rican government has taken several measures over the past three years to address its deteriorating fiscal situation. Those measures, however, appear to have delayed the current fiscal emergency, but have been insufficient to put public finances on a sustainable path. The Puerto Rican government, in formulating its fiscal strategy, has employed several high-profile restructuring experts.[19]

Puerto Rican Restructuring Act

High costs of debt service and the precarious financial situation of some public corporations prompted Governor García Padilla and the island's legislature to enact a debt restructuring legislation (Act 71) in June 2014 that would have allowed public corporations to file for debt restructuring through legal structures set up within Puerto Rico.[20] A U.S. district court, however, struck down Act 71 in February 2015, holding that a provision in chapter 9 of the U.S. Bankruptcy Code[21] preempts action by Puerto Rico, even though Puerto Rico is currently barred from authorizing its subunits to file under chapter 9.[22] The U.S. Court of Appeals for the First

[15] Act 21 of 2016, http://www.oslpr.org/2013-2016/leyes/doc/ley-21-06-Abr-2016.doc at p. 56.

[16] Brigade Leveraged Capital Structures Fund, et al. v. GDB, Complaint 16-CV-1610, case 3:16-cv-01610, April 4, 2016, http://www.notiuno.com/wp-content/uploads/2016/04/Brigade-vs-GDB.pdf.

[17] Luis J. Valentín, "Wait Continues on García Padilla to Restrict GDB's Cash Outflows," *Caribbean Business*, April 7, 2016.

[18] Plantiffs' Motion to Withdraw Plantiffs' Motion, Brigade Leveraged Capital Structures Fund, et al. v. GDB, case 3:16-cv-01610, April 13, 2016.

[19] Mark Tannenbaum and Martin Z. Braun, "Puerto Rico GDB Hires Millstein Unit as Financial Adviser," *Bloomberg*, March 6, 2014, http://www.bloomberg.com/news/articles/2014-03-05/puerto-rico-gdb-hires-millstein-affiliate-as-financial-adviser. Also see Emily Glazer and Mike Cherney, "Puerto Rico Finance Arm Hires Restructuring Lawyers: Government Development Bank for Puerto Rico Hires Cleary Gottlieb Steen & Hamilton," *Wall Street Journal*, April 7, 2014.

[20] See CRS Legal Sidebar WSLG1289, *Fiscal Distress in Puerto Rico: Two Legislative Approaches*, by Carol A. Pettit.

[21] 11 U.S.C. §903.

[22] See CRS Legal Sidebar WSLG1370, *UPDATED: First Circuit: Preemption Precludes Puerto Rico's Recovery Act*, by Carol A. Pettit. The consolidated cases are Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico and BlueMountain Capital Management, LLC v. García-Padilla, (case 3:14-cv-01569). The February 6, 2015 opinion and order is available at http://www.noticel.com/uploads/gallery/documents/ed648d7e7839c5b66e556b14d3c639b3.pdf.

Circuit upheld that decision on July 6, 2015.[23] The U.S. Supreme Court accepted an appeal and heard oral arguments on March 22, 2016.[24]

Credit Ratings Downgrades and Loss of Market Access

In February 2014, the three major credit ratings agencies downgraded Puerto Rico's public debt to below investment grade.[25] A second round of downgrades followed in late June 2014 after the Puerto Rican government enacted Act 71, which sought to establish a restructuring process for debt issued by the island's public corporations.[26] A further round of downgrades was triggered in late June 2015 when Governor García Padilla said that the island's debts were unpayable.[27] By the spring of 2016, nearly all of the island's public sector debt not covered by bond insurance was rated at levels that indicated a judgement that default is "a virtual certainty."[28] The loss of investor confidence in Puerto Rico's ability to repay its debts cut off access to credit markets, which has intensified financial pressures on the government.[29]

Market traded prices for existing Puerto Rican bonds trade well below levels recorded before the current fiscal crisis emerged. **Figure 1** shows trading prices for selected Puerto Rican bonds since January 2011.

[23] Franklin California Tax-Free v. Commonwealth of Puerto Rico, No. 15-1218 (1st Cir. 2015), July 6, 2015, http://caselaw.findlaw.com/us-1st-circuit/1707047.html.

[24] Lyle Denniston, "Court to Rule on Puerto Rico Debt-relief Options," SCOTUSblog, Dec. 4, 2015, http://www.scotusblog.com/2015/12/court-to-rule-on-puerto-rico-debt-relief-options/. See also http://www.supremecourt.gov/Search.aspx?FileName=/docketfiles/15-233.htm.

[25] Commonwealth of Puerto Rico, *Consolidated Annual Financial Report for FY2013*, June 30, 2013, note 22, pp. 230-231, http://www.hacienda.gobierno.pr/downloads/pdf/cafr/FINANCIAL_REPORT_2013.pdf.

[26] Ley para el Cumplimiento con las Deudas y para la Recuperación de las Corporaciones Públicas de Puerto Rico (Ley 71 de 2014; Act 71; Law Pursuant to the Debts and for the Recovery of the Public Corporations of Puerto Rico). See also Moody's Investor's Service, "Puerto Rico's Debt Restructuring Law Raises Default Risk for Public Corporations and the Commonwealth," July 3, 2013.

[27] Reuters, "S&P Cuts Puerto Rico Rating, Says Default Seems Inevitable," June 30, 2015, http://www.reuters.com/article/2015/06/30/sp-puertorico-idUSL3N0ZG1UQ20150630. Moody's Investors Service, "Moody's Downgrades Puerto Rico GOs and COFINA Sr Bonds to Caa3 from Caa2; Outlook Negative," July 1, 2015.

[28] "The 'CC' rating is used when a default has not yet occurred, but S&P Global Ratings expects default to be a virtual certainty, regardless of the anticipated time to default." For information on Standard & Poors ratings levels, see *S&P Global Ratings Definitions*, May 3, 2016, https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352. For a history of ratings of Puerto Rican general obligation debt, see http://www.bgfpr.com/investors_resources/documents/Sep2015-SPsHistoricalRatings-Eng.pdf.

[29] Krueger, Teja, and Wolfe, op. cit., p. 1.

Figure 1. Selected Puerto Rico Bonds; Dollar Prices Since January 2011

Source: CRS graph based on data from Electronic Municipal Market Access, Municipal Securities Rulemaking Board.

Notes: Legacy General Obligation bond is CUSIP 74514LYW1 (5.75%; 2041); NY law GO bond issued March 2014 is 74514LE86 (8.0%; 2035). COFINA Senior Note is CUSIP 74529JNX9 (5.25%; 2040); COFINA Subordinated Note is CUSIP 74529JHN8 (6.0%; 2042). Puerto Rico Electric Power Authority (PREPA) Revenue Bond is CUSIP 74526QVX7 (5.25%; 2040) and Puerto Rico Aqueduct and Sewer Authority (PRASA) is CUSIP 745160QF1. First vertical line indicates appearance of Barron's article (August 20, 2013); second vertical line at enactment of Act 71 (July 28, 2014). Third vertical line is at June 29, 2015, when Governor García Padilla stated that "the debt is not payable." COFINA issued revenue anticipation securities to provide liquidity to the Puerto Rican government.

An August 2013 *Barron's* article highlighted the island's weak fiscal position and high public debt.[30] The first vertical line indicates when the *Barron's* article appeared, and the second vertical line indicates when Act 71 was enacted. The third vertical line is set at June 29, 2015, when Governor García Padilla stated that "the debt is not payable" (see discussion below).

FY2016 Budget

The Puerto Rican legislature approved an FY2016 budget, which was then sent to the governor; it reportedly set aside $1.5 billion for debt service costs. The governor signed the measure into law on July 1, 2015.[31] The budget calls for total outlays of $9.8 billion, with $4.2 billion in funding for government operations.

Governor García Padilla had submitted a FY2016 budget that called for major decreases in public spending, and aimed at achieving a balanced budget.[32] The island's lower chamber passed a budget on June 22, 2015, and the Senate passed its version on June 25, 2015.[33] A measure reported by a conference committee was approved by both chambers on June 29, 2015.[34] Senate President Eduardo Bhatia was quoted as stating that "it is one of the most difficult budgets in the history of Puerto Rico."[35]

Whether the FY2016 budget for Puerto Rico would actually achieve a balanced budget is unclear. The report of the ex-IMF economists stresses that the structural budget deficit, according to their estimates, is larger than other measures of budget balance used by the Puerto Rican government.[36] A structural budget deficit excludes effects of one-time budget adjustments or cyclical economic effects. That report estimates annual interest and principal costs at $2.8 billion.

Puerto Rican Governor: Debt Unpayable

Puerto Rican policymakers then sought other ways to restructure or renegotiate the island's public debt. On June 29, 2015—a day before the end of Puerto Rico's fiscal year 2015—Governor García Padilla stated during a televised address that "the debt is not payable." The governor said that his administration would seek concessions from the island's creditors as part of a new fiscal

[30] Andrew Bary, "Troubling Winds: Puerto Rico's Huge Debt Could Overwhelm Attempts to Revive its Economy," *Barron's*, August 26, 2013.

[31] Office of the Governor, "Gobernador Firma Presupuesto para el Año Fiscal 2015-2016 (Governor Signs Budget for FY2016)", press release, July 1, 2015, http://www.fortaleza.pr.gov/content/gobernador-firma-presupuesto-para-el-o-fiscal-2015-2016.

[32] "Puerto Rico Gov Files $9.8B Budget That Calls for Deep Cuts," *Associated Press*, May 20, 2015, http://www.nytimes.com/aponline/2015/05/20/world/americas/ap-cb-puerto-rico-economy.html. See also the Puerto Rican Governor's *Recommended Budget* (Presupuesto Recomendado 2015-2016), http://www2.pr.gov/presupuestos/Presupuesto2015-2016/Pages/default.aspx.

[33] Michelle Kaske and Ezra Fieser, "Puerto Rico's Senate Passes 2016 Budget in Preliminary Vote," *Bloomberg Business*, June 25, 2015, http://www.bloomberg.com/news/articles/2015-06-25/puerto-rico-s-senate-approves-2016-budget-in-preliminary-vote.

[34] La Resoluciónes Conjuntas de la Cámara 747 and 748. See *El Nuevo Dia*, "Ajustan Presupuesto Ante Escenario de Renegociación de la Deuda," June 30, 2015, http://www.elnuevodia.com/noticias/politica/nota/ajustanpresupuestoanteescenarioderenegociaciondeladeuda-2066681/.

[35] Luis J. Valentín, "Puerto Rico House, Senate Seek Consensus on Final Budget Plan," *Caribbean Business*, June 28, 2015, http://www.caribbeanbusiness.pr/news/puerto-rico-house-senate-seek-consensus-on-final-budget-plan-112726.html.

[36] Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, *Puerto Rico: A Way Forward*, June 29, 2015, pp. 11-12.

strategy.[37] Governor García Padilla described the present fiscal crisis, enumerated structural changes implemented or proposed by his administration, declared his intention to start a negotiating process with creditors, and called on federal policymakers to change laws that treated Puerto Rico differently than state governments.

In particular, Governor García Padilla called for a comprehensive restructuring of Puerto Rico's fiscal obligations, arguing that the public debt had grown so large that it was impeding economic growth as well as the island's access to credit markets.[38] The governor outlined a fiscal strategy that included

- reestablishment of economic growth through legislation to improve competitiveness, a reform of social insurance programs, and investments in infrastructure;
- a call for a moratorium on debt payments;
- creation of a working group for economic recovery composed of financial experts and senior island policymakers; and
- a long-term fiscal adjustment plan, to be developed by the working group by August 30, 2015.

The fiscal adjustment plan, according to the governor, would propose reductions in public outlays, improve tax administration, privatize some publicly provided services, improve budgetary execution and controls, and create a nonpartisan fiscal commission, while guaranteeing the provision of essential services. He also stated that new taxes or additional layoffs of public employees were not being contemplated.[39] The plan does include projected revenues from implementation of tax measures already scheduled to go into effect.

On the same day, a report by three former International Monetary Fund (IMF) economists was released that described serious problems with Puerto Rico's fiscal situation, budget execution, public administration, and tax structure.[40]

Economic and Fiscal Recovery Working Group Plan

Governor García Padilla also appointed an Economic and Fiscal Recovery Working Group[41] comprised of senior executive and legislative policymakers. The Working Group issued a framework plan on September 9, 2015, that outlined a strategy for putting the island's finances on a stable basis. The plan also outlined reforms to bolster long-term economic growth.[42] The

[37] *El Nuevo Dia*, "Mensaje del Gobernador Alejandro García Padilla Sobre Situación Fiscal de Puerto Rico," June 29, 2015, http://www.elnuevodia.com/noticias/politica/nota/mensajedelgobernadoralejandrogarciapadillasobresituacionfiscaldepuertorico-2066574/.

[38] *El Nuevo Dia*, "Mensaje del Gobernador Alejandro García Padilla Sobre Situación Fiscal de Puerto Rico," June 29, 2015, http://www.elnuevodia.com/noticias/politica/nota/mensajedelgobernadoralejandrogarciapadillasobresituacionfiscaldepuertorico-2066574/.

[39] Office of the Governor (La Fortaleza), "Gobernador Ofrece Mensaje Sobre el Plan de Ajuste Fiscal (Governor Issues Statement on the Plan of Fiscal Adjustment)," September 9, 2015, http://www.fortaleza.pr.gov/content/gobernador-ofrece-mensaje-sobre-el-plan-de-ajuste-fiscal.

[40] Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, *Puerto Rico: A Way Forward*, June 29, 2015, http://recend.apextech.netdna-cdn.com/docs/editor/Informe%20Krueger.pdf.

[41] El Grupo de Trabajo para la Recuperación Fiscal y Económica de Puerto Rico.

[42] Office of the Governor (La Fortaleza), "Grupo de trabajo divulga Plan Fiscal (Working Group Releases Fiscal Plan)," September 9, 2015; http://www.fortaleza.pr.gov/content/grupo-de-trabajo-divulga-plan-fiscal. Full plan is

working group's plan includes various budgetary and structural economic reforms, as well as the establishment of a control board. The proposed control board would be composed of experts from Puerto Rico and elsewhere.

Puerto Rico, according to the working group, faces a $27.8 billion financing gap over the next five years that could be reduced to $14 billion through fiscal measures and stronger economic growth. Those gaps, according to the working group, "could severely impair the Commonwealth's ability to provide essential services to its residents."[43] The Working Group issued an updated plan on January 18, 2016, which estimated a five-year (FY2016-FY2020) fiscal gap of $16 billion and a 10-year (FY2016-FY2025) fiscal gap of $23 billion.[44]

Implementing recommendations of the working group may present serious challenges. The plan calls on the U.S. Congress to make changes in several policy areas, such as the structure of income support programs, reimbursement policies for federal health programs, federal labor and public housing policies, and tax policy. Proposed reforms that would require approval by the Puerto Rican legislature, such as labor code modifications, may prove controversial. Moreover, austerity measures that may improve medium- or long-term fiscal stability may have adverse short-term macroeconomic consequences.

Extraordinary Liquidity Measures Used in Late 2015 and Early 2016

An August 2015 financial liquidity analysis had projected that the government would likely run out of money by November 2015.[45] A number of extraordinary financial measures, however, including delays in tax refunds, contractor payments, changes in pension funding, and "clawbacks" of public corporation funds to the general fund, among others, allowed the government to continue its funding operations.[46] Delayed tax refunds and contractor payments, however, have strained the liquidity of many households and businesses. The Puerto Rican government also sought to delay some bond payments in order to maintain liquidity and ensure continuity of government operations. As of early April 2016, as noted above, the Governor of Puerto Rico and a federal judge both had declared that the island's government was insolvent.

First Default in August 2015

The Puerto Rican government at the beginning of August 2015 paid $0.63 million of $58 million in interest and principal due on bonds issued by the Public Finance Corporation, a subsidiary of the island's Government Development Bank. Puerto Rico's failure to make full payment on those bonds, which carried a relatively weak "moral obligation" guarantee, has raised concerns about future payments on bonds backed by general obligation guarantees.[47]

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available at http://bgfpr.com/documents/PuertoRicoFiscalandEconomicGrowthPlan9.9.15.pdf.

[43] Working Group for the Fiscal and Economic Recovery of Puerto Rico, *Puerto Rico Fiscal and Economic Growth Plan*, September 9, 2015, http://www.fortaleza.pr.gov/content/gobernador-ofrece-mensaje-sobre-el-plan-de-ajuste-fiscal.

[44] Working Group for the Fiscal and Economic Recovery of Puerto Rico, *Puerto Rico Fiscal and Economic Growth Plan: Update Presentation*, January 18, 2016, http://www.gdb-pur.com/documents/PRFEGPUpdatePresentation1.18.16-2.pdf.

[45] Conway MacKenzie, *Commonwealth of Puerto Rico: Liquidity Update*, August 25, 2015, http://www.bgfpr.com/documents/150825ConwayMacKenzieLiquidityUpdateReport.pdf.

[46] Act 21 of 2016, http://www.oslpr.org/2013-2016/leyes/doc/ley-21-06-Abr-2016.doc at p. 52.

[47] Standard & Poors, "Rating on Three Puerto Rico PFC Series Lowered to 'D' On Non-Payment," *RatingsDirect*, August 3, 2015, http://www.gdb-pur.com/investors_resources/documents/SP-RatingsDirectNews-Aug-03-2015.pdf.

Loss of Credit Market Access Prevented Debt Roll-Overs

The island's ability to meet debt service payments in recent years had depended in part on the willingness of investors to roll over existing debt. Puerto Rico had planned to issue about $2.9 billion in bonds in 2015, but those plans were put on hold. The García Padilla Administration reportedly wanted to prepare the way for that bond issue with a fiscal package consisting of a tax reform to bolster revenues, a balanced budget for FY2016, and a five-year plan to achieve fiscal sustainability.[48]

Once Puerto Rico's government was "virtually shut off from normal [credit] market access" according to ex-IMF economists,[49] funding government operations became increasingly difficult. The Puerto Rican legislature passed a measure to allow certain public corporations to issue revenue bonds, which may provide some measure of liquidity.[50] The governor signed the measure into law on July 3, 2015, clearing the way for the issuance of about $400 million in tax and revenue anticipation notes (TRANs) by three publicly owned insurance corporations.[51] While those notes helped the Puerto Rican government maintain access to liquidity during the first part of the fiscal year, some policymakers expressed concerns that adding exposure of those insurance companies to governmental credit risks could harm their soundness.

Constitutional Limits on Borrowing are Close to Binding

Constitutional limits on Puerto Rico's borrowing could also present financial hurdles. Puerto Rico's government debt servicing costs—apart from debt servicing costs of public corporations—totaled 13.6% of average annual internal revenues for FY2014 and FY2015, not far below the 15% limit imposed by the Commonwealth's Constitution.[52] If that limit became binding, maintaining operations of the government could then require either further fiscal adjustments or a constitutional amendment, which would require supermajorities in both legislative chambers and a plebiscite.

Puerto Rico Faces Severe Challenges in FY2017

Puerto Rico faces severe fiscal challenges in FY2017, which begins on July 1, 2016. As noted above, Puerto Rico is due to pay $1.9 billion in debt service. Both the Puerto Rico government and credit ratings agencies expressed doubts as to whether those payments would be made. In

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[48] The bonds would have been issued through the Puerto Rico Infrastructure Financing Authority (PRIFA). See Thomas McLoughlin and Kristin Stephens, "Puerto Rico Credit & Market Update," *UBS Municipal Brief*, December 15, 2014; Robert Slavin, "Puerto Rico Gov. Lacks Budget for Annual Speech," *Bond Buyer*, April 28, 2015, GDB, "Government Development Bank for Puerto Rico Comments on Enactment of Act 29 of 2015," March 17, 2015, http://www.gdbpr.com/documents/GDBCommentonAmendment.pdf.

[49] Krueger, Teja, and Wolfe, op. cit., p. 1.

[50] Petición de la Camera 2542 was passed by both chambers on June 29, 2015.

[51] Luis J. Valentín, "García Padilla Signs Bill to Raise $400M from Public Corporations, Suspend Monthly GO Set-Asides," *Caribbean Business*, July 3, 2015, http://www.caribbeanbusiness.pr/news/garcia-padilla-signs-bill-to-raise-$400m-from-public-corporations-suspend-monthly-go-set-asides-113053.html. Also see Robert Slavin, "Puerto Rico Governor Signs Cash and Spending Measure," *Bond Buyer*, July 7, 2015, and Rebecca Banuchi, "Ajustan Presupuesto Ante Escenario de Renegociación de la Deuda (Budget Altered Ahead of Proposed Renegotiation of the Debt)," *El Nuevo Dia*, June 29, 2015, http://www.elnuevodia.com/noticias/politica/nota/ajustanpresupuestoanteescenarioderenegociaciondeladeuda-2066681/.

[52] GDB, *Commonwealth of Puerto Rico, Financial Information and Operating Data Report*, November 6, 2015, pp. 47-48.

addition, the island government lacks a line of credit that would allow it to manage financing gaps caused by the timing of revenue and outlay cash flows.

On May 23, 2016, Governor García Padilla submitted a FY2017 budget, which called for outlays totaling $9.1 billion, approximately $700 million less than recommended the previous year. The budget submission was delayed due to the enactment of an emergency fiscal act in early April 2016 and the possibility of a federal control board, among other uncertainties.[53] The proposed FY2017 budget, submitted on May 23, 2016, comes "at the hour of choice between paying money to the creditors and providing services to our people," according to Governor García Padilla.[54] Proposed payments for debt service in FY2017 are well below amounts due.[55]

Structural Initiatives to Address Fiscal Challenges

Puerto Rico's government has taken numerous steps over the past few years to realign revenues and outlays, although those efforts have not closed the structural budget deficit. Those measures include cutbacks to public pension systems, tax increases and tax administration reforms, and a reduction in public sector employment.[56] **Figure 2** shows trends in public sector employment in Puerto Rico since 1990. Since 2009, public sector employment has dropped by nearly a fifth. Some public employees retired early in 2013 and 2014 in order to mitigate effects of benefit decreases resulting from pension reforms.[57]

Other fiscal austerity measures include reorganization of public school teaching staffs and school closings, cancellation or postponement of salary and benefit increases, and reductions in transfers to municipalities.[58] The government has also taken steps to bolster the financial condition of its public corporations.

Puerto Rico has modified its pension systems to increase future employee and employer contributions, moved participants from defined benefit to defined contribution plans, and begun a transition to higher retirement ages.[59] The Supreme Court of Puerto Rico held that the government's rationale for the changes was insufficient to justify abrogation of certain contractual rights of existing or retired teachers under the Teachers Retirement System. The court, however, reaffirmed the government's powers to modify certain aspects of pension programs in

[53] Carlos Antonio Otero, "Anticipan recortes al presupuesto 2017/18 (Cuts Anticipated in the 2017-2018 Budget)," *El Vocero*, April 20, 2016, http://elvocero.com/anticipan-recortes-al-presupuesto-201718/.

[54] Puerto Rico Office of Management and Budget, "Gobernador presenta presupuesto para el próximo año fiscal (Governor Presents Budget for the Next Fiscal Year)," press release, May 23, 2016. Original quoted sentence is "En momentos en que ya no es posible recurrir a aumentar la deuda pública y que dependemos exclusivamente del dinero que recauda Hacienda, este presupuesto es la mejor evidencia a la hora de escoger entre pagarle a los acreedores y dar servicio a nuestra gente, escogemos por nuestra gente."

[55] See Puerto Rico Office of Management and Budget, "Presupuesto Consolidado Por Concepto de Gasto y Origen de Recurso (Consolidated Budget by Outlays and Object Class)," May 23, 2016, http://www2.pr.gov/presupuestos/presupuesto2016-2017/Tablas%20Estadsticas/03.pdf.

[56] For a summary of previous initiatives, see Working Group for the Fiscal and Economic Recovery of Puerto Rico, *Puerto Rico Fiscal and Economic Growth Plan*, September 9, 2015, p. 10.

[57] See Commonwealth of Puerto Rico, Quarterly Report, February 18, 2014, p. 16, http://www.gdbpr.com/documents/QuarterlyReport2-18-2014.pdf.

[58] Center for a New Economy, *Fiscal Situation Update: Analysis of the Governor's Budget Request for FY2015*, pp. 9-10.

[59] Ellie Ismailidou and Maryellen Tighe, "Puerto Rico's Pension Problem Treated on a Cash-flow Basis," *Debtwire*, July 25, 2014. See also Robert Slavin, "Puerto Rico Falters on Pensions," *Bond Buyer*, September 26, 2014.

order to meet pressing fiscal demands.[60] Independent analysts note that funding ratios for the Puerto Rican retirement systems remain low.[61]

On May 26, 2015, the Legislative Assembly passed and sent to the governor a measure to raise the sales and use tax rate from 7% to 11.5%, which the governor signed into law on May 29, 2015.[62] Of that rate, 1% is earmarked for local governments.[63] In addition, the measure would establish a Consumption Tax Transformation Alternatives Commission,[64] which would be charged with evaluating further changes in Puerto Rico's tax system, including a possible transition to a value-added tax (VAT). Previously, a proposal to replace certain sales taxes with a value-added tax was voted down on April 30, 2015.[65] Puerto Rico, as noted above, enacted Act 1 on January 15, 2015, which raised petroleum taxes, contingent on implementation of broader tax changes, and took other measures to strengthen the financial condition of the Authority for Highways and Transportation.[66]

[60] See John Mudd, "My Short Take on the Teachers Retirement Fund Opinion," Muddlaw website, April 12, 2014, http://johnmuddlaw.com/2014/04/12/my-short-take-on-the-teachers-retirement-fund-opinion/. The decision for the case (Asociación de Maestros de PR, et al., v. Sistema de Retiro de Maestros de PR) is available at http://www.scribd.com/doc/217729948/Sentencia-Retiro-Maestros.

[61] Ismailidou and Tighe, ibid.

[62] Act 72 of 2015.

[63] Luis J. Valentín, "Tax Bill Approved by Legislature, Awaits Governor's Signature," *Caribbean Business*, May 27, 2015, http://www.caribbeanbusinesspr.com/news/tax-bill-approved-by-legislature-awaits-governors-signature-110958.html. The sales and use tax is also known as IVU, an acronym of Impuesto de Ventas y Uso. Also see Ernst & Young, "Puerto Rico Enacts Income Tax and Other Changes as Part of FY2016 Budget," *Global Tax Alert*, June 8, 2015, http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert—Puerto-Rico-enacts-income-tax-and-other-changes-as-part-of-FY2016-budget.

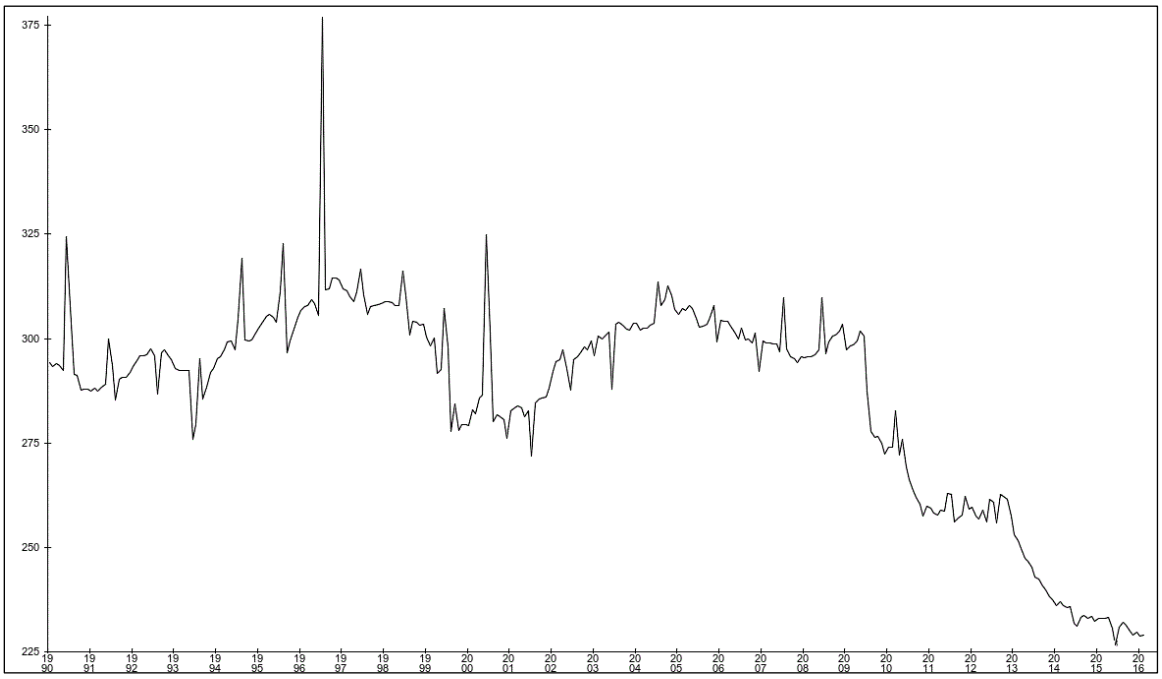
[64] Comisión de Alternativas para Transformar el Impuesto al Consumo (CATIC).

[65] Ibid. and Gustavo Vélez, "La Nueva Ruta Sin el IVA (The New Path Without the VAT)," blog post, May 5, 2015, http://www.economiapr.com/la-nueva-ruta-sin-el-iva/. Also see Ernst and Young, "Puerto Rico House of Representatives Votes Down Proposed VAT Bill by Narrow Margin," May 7, 2015; also see http://www.ey.com/Publication/vwLUAssets/Puerto_Rico_House_of_Representatives_votes_down_proposed_VAT_bill_by_narrow_margin/$FILE/2015G_CM5431_Indirect_PR%20House%20of%20Representatives%20votes%20down%20proposed%20VAT%20bill%20by%20narrow%20margin.pdf. The measure was House Bill 2329 (Para crear la "Ley de Transformación al Sistema Contributivo del Estado Libre Asociado de Puerto Rico" (For the creation of a Law for the Transformation of the Contributive System of the Commonwealth of Puerto Rico).

[66] Eduardo San Miguel Tió, "Puerto Rico Governor Signs Petroleum-tax Increase into Law," *Caribbean Business*, January 15, 2015, http://www.caribbeanbusiness.pr/news/puerto-rico-governor-signs-petroleum-tax-increase-into-law-103300.html. The act also authorizes certain bond issues. Text of the law is available at http://www.oslpr.org/legislatura/tl2013/tl_medida_print2.asp?r=P%20C2212&ult=1.

Figure 2. Government Employment in Puerto Rico, 1990-2016

Thousands of Persons, Seasonally Adjusted



Source: Department of Labor, Bureau of Labor Statistics, series SMS72000009000000001.

Notes: Vertical axis scaled to show variation as clearly as possible. Y-axis begins at 225,000 persons.

Fiscal Challenges Have Been Building for Years

Puerto Rico has faced fiscal challenges ever since the mid-1970s. The economic effects of the 1973-1974 energy crisis, which caused serious dislocation to the mainland economy, had even more severe consequences for Puerto Rico.[67]

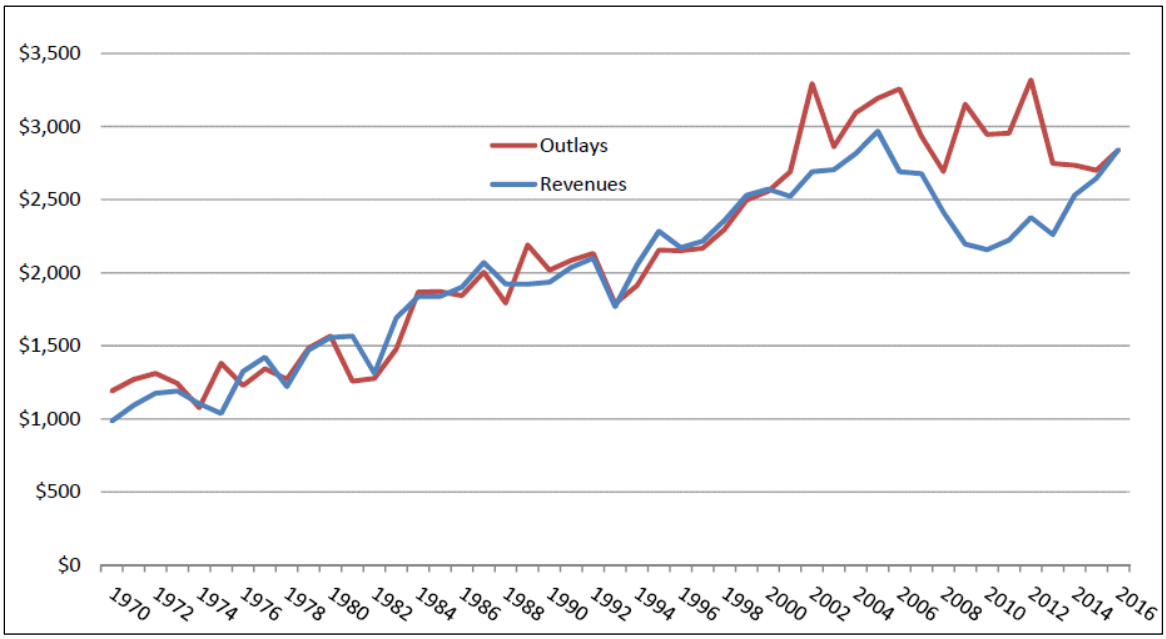
Debt Accumulation over Time

Once Puerto Rico was able to recommence borrowing in the 1980s, its public debt grew steadily and is now slightly larger than the island's gross national product (GNP).[68] Debt accumulation accelerated in the early 2000s, as expenditure growth outstripped revenues. **Figure 3** shows outlays and revenues for Puerto Rico since 1970.

[67] U.S. Department of State, Office of the Historian, *Oil Embargo, 1973-1974*, October 31, 2013; https://history.state.gov/milestones/1969-1976/oil-embargo. Even before the oil embargo started in October 1973, Puerto Rico's power utility was affected by a strike that began on January 4, 1973, signaling the start of a more contentious labor relationship. See Unión de Trabajadores de la Industria Eléctrica y Riego (UTIER), *Breve Reseña Histórica de la UTIER;* http://www.utier.org/estructuras/historia.php.

[68] Puerto Rico's gross public debt was reported at $72.2 billion at the end of March 2015. See GDB, *Commonwealth Quarterly Financial Report*, May 7, 2015, p.56; http://www.gdb-pur.com/documents/CommonwealthQR-5-7-15.pdf. Also see *Statistical Appendix (Apéndice Estadístico) of the Economic Report to the Governor and the Legislature for FY2014*, http://www.jp.gobierno.pr/Portal_JP/Default.aspx?tabid=184.

Figure 3. Per Capita General Fund Outlays & Revenues
1970-2016, inflation-adjusted (base-2014)



Source: CRS calculations based on Puerto Rico financial reports (via Carlos Costas de Armas); Apéndice Estadísticos for various years; CPI deflator from Departamento del Trabajo y Recursos Humanos/Puerto Rico Dept. of Labor and Human Resources.

Notes: Levels for FY2015 and FY2016 reflect budget proposals.

Figure 4 shows the accumulation of Puerto Rico's gross public debt in inflation-adjusted terms since 1962.[69] By that measure, total debt levels rose until the mid-1970s, then declined gradually until the mid-1980s, after which they again increased until 2013. Puerto Rico's public sector debt stood at $69.9 billion at the end of September 2015.[70] **Figure 4** also indicates that public corporations have accounted for the largest portion of public sector debt in recent decades.

Public Corporations Incurred Much of Puerto Rico's Public Debt

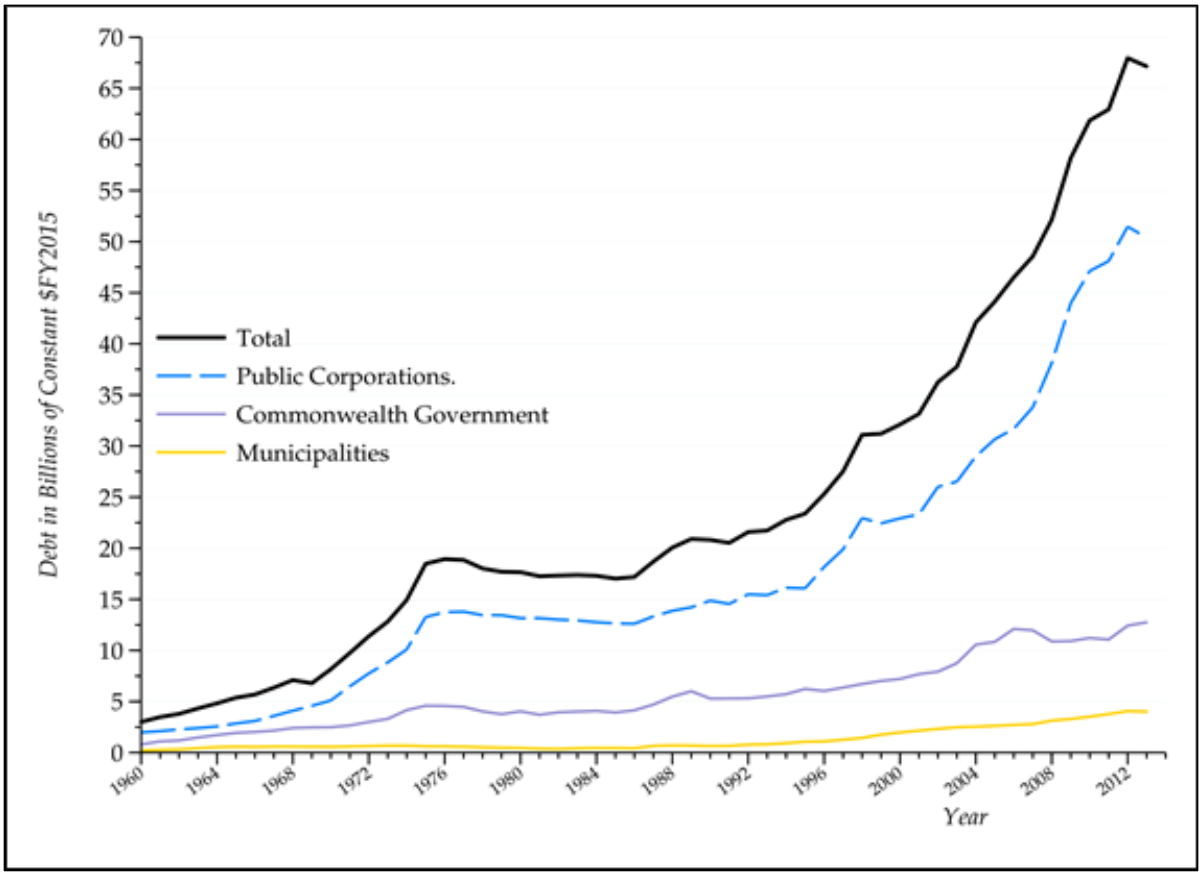
Public corporations, which have played a prominent role in the Puerto Rican economy since the 1930s, are closely linked to the island's fiscal challenges. Some 50 public corporations serve a variety of purposes, ranging from public infrastructure, banking, real estate, insurance, industrial development, health care, transportation, electric power, broadcasting, education, arts, and tourism, among others.[71] Some public corporations resemble public authorities of state governments, although in some cases, have responsibilities more akin to public agencies.

[69] A congressional distribution memorandum on the structure of Puerto Rico's debt is available to congressional clients upon request.

[70] GDB, *Commonwealth of Puerto Rico, Financial Information and Operating Data Report*, November 6, 2015, p. 119; http://www.bgfpr.com/documents/CommonwealthReport11-06-15.pdf.

[71] For one listing of public corporations, see Commonwealth of Puerto Rico, *Budget Proposal for 2013-2014*, Consolidated Budget by Agency for FY2011-FY2014 (Estado Libre Asociado de Puerto Rico, *Presupuesto Recomendado 2013-2014*, Presupuesto Consolidado por Agencia), http://www2.pr.gov/presupuestos/Presupuesto2013-2014/Tablas%20Estadsticas/04.pdf.

Figure 4. Gross Public Debt of Puerto Rico in Billions of Constant Dollars, 1960-2014



Source: *Statistical Appendix (Apéndice Estadístico),* various years; available at http://www.jp.gobierno.pr/Portal_JP/Default.aspx?tabid=184.

Notes: Data represent gross public debt of Puerto Rico as of June 30 of each year, provided by the Government Development Bank of Puerto Rico. Figures for 1989 and 2014 are preliminary estimates. The Highway and Transportation Authority and the University of Puerto Rico are included in the Commonwealth Government subtotal. The U.S. GDP price index is used to adjust levels for inflation. These debt data differ from those available from other sources.

Off-budget debt issued by public corporations, generally not included in the 15% debt servicing limit, has accounted for much of the buildup in Puerto Rico's public debt since 2000 (see **Figure 4**).[72] Moreover, the central government's financial support for public corporations has weakened its own fiscal situation. In particular, credit and liquidity support provided via the GDB to public corporations was a major factor in the insolvency of the GDB, as noted above.[73]

[72] See FY2013 *Economic Report to the Governor, Statistical Appendix,* Table 29, http://www.gdbpr.com/economy/documents/AE2013_T29.pdf.

[73] Act 21 of 2016; http://www.oslpr.org/2013-2016/leyes/doc/ley-21-06-Abr-2016.doc at p. 50. Also see Arturo C. Porzecanski, "The Government Development Bank: At the Heart of Puerto Rico's Financial Crisis," American University working paper, September 18, 2014, http://nw08.american.edu/~aporzeca/The%20GDB%20at%20the%20Heart%20of%20Puerto%20Ricos%20Financial%20Crisis.pdf.

Puerto Rico Electric Power Authority

The Puerto Rico Electric Power Authority (PREPA), one of Puerto Rico's oldest public corporations, owes over $9 billion—or about one-eighth of Puerto Rico's total public sector debt.[74] PREPA entered into a restructuring and forbearance agreement in August 2014 with major creditors[75] prompted by the need to maintain sufficient financing for fuel purchases.[76] Lisa Donahue, a partner in energy management consultancy, was appointed Chief Restructuring Officer (CRO) in September 2015 as part of that agreement.

Forbearance and Revitalization

The August 2014 forbearance agreement has been extended numerous times, as negotiations between PREPA and major creditor groups—including mutual funds, bond insurers, hedge funds, and others—have proceeded. PREPA issued a summary of a restructuring plan on June 1, 2015, which calls for $2.3 billion to modernize its operations and stabilize its finances.[77] On September 1, 2015, PREPA announced a preliminary agreement with certain creditors to restructure part of the utility's debt, including bond exchange that would include a 15% writedown of non-insured debt.[78] A tentative agreement was reached in mid-December 2015 between PREPA and holders of about 70% of PREPA's debt. Fulfillment of the agreement was contingent on passage of a PREPA Revitalization Act by the Puerto Rico legislature and participation of additional debtholders. How measures to restructure PREPA's debt and revitalize its operations would affect energy reforms adopted in 2014 (Act 57 of 2014), and the powers of the Energy Commission established as part of those reforms, have raised concerns. Puerto Rico enacted a PREPA Revitalization Act (Act 4 of 2016) on February 16, 2016.[79] The act creates a "transition" surcharge that will be added to consumer bills to help PREPA meet its financial obligations.

Financial and Operational Challenges

PREPA faces major financial and operational challenges. Chief Restructuring Officer Lisa Donahue testified that PREPA could run out of cash in the summer of 2016, which could lead to operational disruptions.[80] The utility's existing oil- and diesel-fired plants are old, inefficient, and unreliable.[81] PREPA also buys some power from one private generation firm that uses coal and

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[74] In Spanish, the Autoridad de Energía Eléctrica or AEE.

[75] Government Development Bank, Forbearance Agreement: Executive Version, August 14, 2014, http://www.gdbpr.com/documents/BondholderForbearanceAgreementEXECUTED.pdf.

[76] Mary Williams Walsh, "Puerto Rico Power Supplier Saved From Cash Squeeze," *New York Times*, August 14, 2014. Reuters, "Puerto Rico Power Authority Weighs Financing Options as Bank Deadline Nears," July 30, 2014, http://www.reuters.com/article/2014/07/30/usa-puertorico-prepa-idUSL2N0Q52GQ20140730.

[77] PREPA, "PREPA's Transformation" A Path to Sustainability," June 1, 2015, http://www.aeepr.com/Docs/RecoveryPlan.pdf. Also see Michelle Kaske, "PREPA Submits Recovery Plan as Creditors Say Talks Continue," Bloomberg Business, June 1, 2015 (updated June 2, 2015). Financial details of the restructuring plan were withheld pending negotiations with creditors.

[78] Robert Slavin, "PREPA, Forbearing Bondholders Reach Agreement on Restructuring," *Bond Buyer*, September 2, 2015. Also see Janney Fixed Income, "PREPA Restructuring," September 3, 2015.

[79] Official text (in Spanish) is at http://www2.pr.gov/ogp/Bvirtual/leyesreferencia/PDF/Energ%C3%ADa/4-2016/4-2016.pdf.

[80] Testimony of Lisa Donahue, Chief Restructuring Officer of PREPA, in U.S. Congress, House Committee on Natural Resources, Subcommittee On Energy And Mineral Resources, "Exploring Energy Challenges and Opportunities Facing Puerto Rico," January 12, 2016, http://naturalresources.house.gov/uploadedfiles/testimony_donahue.pdf.

[81] PREPA, "PREPA's Transformation" A Path to Sustainability," June 1, 2015. Also see U.S. Department of Energy,

from another that uses natural gas. While Caribbean electrical systems typically depend on oil-based power generation, the lack of sufficient modern gas-fired power generation capacity to handle fluctuations in base loads limits the potential of renewable energy on the island.[82] While falling oil prices led to some reductions in PREPA's prices, recent residential electricity prices have been about 50% above average mainland rates, and commercial rates nearly twice as high, which may have hindered economic growth.[83]

PREPA's revenues have been reduced by unbilled power generation.[84] In recent years, 14% of power generated by PREPA was classified as lost or unaccounted for. In addition, PREPA had not been billing many municipalities and government offices, in part to offset payments to those entities in lieu of taxation.[85] PREPA has also been mandated to subsidize certain non-profit organization and business sectors.[86] In total, PREPA provided $69 million worth of subsidized power in FY2014, according to press accounts.[87] PREPA has, however, become more aggressive in collecting its accounts receivable.[88]

Government Development Bank for Puerto Rico

The Government Development Bank for Puerto Rico, one of the oldest public corporations, serves as bank, fiscal agent, and financial advisor to the Commonwealth and other public corporations.[89] The GDB and its subsidiaries are the main source of short-term financing for the Puerto Rican government and its public corporations and municipalities. The GDB also issues loans and guarantees to private entities and has historically played a leading role in strategic economic investments for Puerto Rico.

During the 1990s and 2000s, the GDB was used to finance investments and even operating costs of other parts of the Puerto Rican government. By June 2013—the date of the last audited financial statement—the public sector accounted for nearly all of the GDB's loan portfolio, which

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Energy Information Administration, Puerto Rico Territory Energy Profile, updated April 16, 2015, http://www.caribbeanbusiness.pr/prnt_ed/u.s.-supreme-court-suspends-the-epas-mats-regulations-11402.html.

[82] National Renewable Energy Laboratory, *Energy Policy and Sector Analysis in the Caribbean (2010–2011)*, Organization of American States, http://www.ecpamericas.org/data/files/Initiatives/lccc_caribbean/LCCC_Report_Final_May2012.pdf.

[83] U.S. Department of Energy, "Puerto Rico Territory Energy Profile," updated January 16, 2016, http://www.eia.gov/state/print.cfm?sid=RQ.

[84] For a description of subsidies and discounts, see "Estructura Tarifaria Autoridad de Energía Eléctrica (PREPA's Rate Structure)," May 19, 2015, pp. 3-4, http://aeepr.com/Docs/Ley57/Presentacion%20Tarifas%20para%20Pagina%20AEE%20Internet%20-%2005-19-2015.pdf. One Puerto Rican municipality, according to news reports, operates a skating rink using electricity provided without charge by PREPA. See Mary Williams Walsh, "How Free Electricity Helped Dig $9 Billion Hole in Puerto Rico," *New York Times*, February 1, 2016.

[85] Mesirow Financial, ibid.

[86] Carmelo Ruiz-Marrero, "Debt and Dirty Energy Weigh Heavy on Puerto Rico's Utility," *Inter Press Service*, April 28, 2014, http://www.ipsnews.net/2014/04/debt-dirty-energy-weigh-heavy-puerto-ricos-utility/.

[87] "PREPA Doesn't Rule Out Rate Hikes," *Caribbean Business*, August 11, 2014, http://www.caribbeanbusinesspr.com/news/prepa-doesnt-rule-out-rate-hikes-99473.html.Article cites testimony of PREPA Executive Director Juan Alicea to the Puerto Rican Senate Committee on Energy Affairs.

[88] Testimony of Lisa Donahue, Chief Restructuring Officer of PREPA, in U.S. Congress, House Committee on Natural Resources, Subcommittee On Energy And Mineral Resources, "Exploring Energy Challenges and Opportunities Facing Puerto Rico," January 12, 2016; http://naturalresources.house.gov/uploadedfiles/testimony_donahue.pdf.

[89] Government Development Bank for Puerto Rico, *The GDB: Seven Decades of Service to Puerto Rico (1942-2012)*, http://www.gdb-pur.com/about-gdb/history_01.html.

amounted to 48% of its government-wide assets.[90] Credit rating agencies and government financial reports have warned that the restructuring of Puerto Rico's public debt presents serious financial risks to the GDB.[91]

At the beginning of August 2015, Puerto Rico did not make a full interest and principal payment due on bonds issued by the Public Finance Corporation, a subsidiary of the island's GDB.[92] In late March 2016, as noted above, a federal district court judge unveiled a 2015 finding of the Puerto Rico Commissioner of Financial Institutions that the GDB was insolvent in 2015. While GDB officials have disputed some claims of the Commissioner, they have acknowledged the precarious financial situation of the bank.

On May 1, 2016, as noted above, Governor García Padilla issued an order to declare a moratorium on certain debt payments by the Government Development Bank (GDB), which is due to pay $423 million in debt service on May 2, 2016.[93] Governor García Padilla was quoted previously as stating that the GDB will be unable to make a full payment on that date.[94] The Puerto Rico government has taken steps, noted in the introduction to this report, to shift responsibilities and assets of the GDB to other institutions in order to avoid the consequences of having the island government's fiscal agent come under the control of a receiver.

Other Public Corporations

Independent analysts argue that a few other large public corporations are insolvent.[95] Island officials, however, have emphasized that the financial condition of various government entities differs in important ways.[96]

Highways and Transportation Authority (HTA)

The Highways and Transportation Authority (HTA; or in Spanish, Autoridad de Carreteras y Transportación) has faced serious financial challenges. For instance, cost overruns on the Tren Urbano project in San Juan, constructed between 1996 and 2005, nearly doubled costs (from an initial estimate $1.25 billion to a final $2.4 billion).[97] In addition, HTA has been running

[90] GDB, Comprehensive Annual Financial Report 2013, June 30, 2013, note 7; http://www.bgfpr.com/documents/GDB-CAFR-June-30-2013.pdf. Also see Arturo C. Porzecanski, "The Government Development Bank: At the Heart of Puerto Rico's Financial Crisis," American University working paper, September 18, 2014, http://nw08.american.edu/~aporzeca/The%20GDB%20at%20the%20Heart%20of%20Puerto%20Ricos%20Financial%20Crisis.pdf.

[91] Moody's Investor's Service, "Puerto Rico's Debt Restructuring Law Raises Default Risk for Public Corporations and the Commonwealth," July 3, 2013. See also GDB, *Commonwealth Quarterly Financial Report*, July 17, 2014, pp. 4-5, http://www.gdb-pur.com/documents/CommonwealthQuarterlyReport71714.pdf.

[92] Standard & Poors, "Rating on Three Puerto Rico PFC Series Lowered to 'D' On Non-Payment," *RatingsDirect*, August 3, 2015, http://www.gdb-pur.com/investors_resources/documents/SP-RatingsDirectNews-Aug-03-2015.pdf.

[93] Executive Order OE-2016-014, "Executive Order of the Governor of Puerto Rico, Hon. Alejandro J. García Padilla under Terms of Articles 201, 202, and 203 of Act 21 of 2016, Known as the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act," May 1, 2016; http://www.fortaleza.pr.gov/content/orden-ejecutiva-moratoria-temporera-en-el-pago-de-la-deuda.

[94] Joanisabel González, "`El próximo lunes hay impago` (Next Monday Will Be a Default)," *El Nuevo Día*, April 28, 2016.

[95] Center for a New Economy, *Fiscal Situation Update, FY2014-2015 Budget*, June 2014.

[96] Government Development Bank, "Statement from Government Development Bank for Puerto Rico on Announcement of Upcoming Offering by Puerto Rico Aqueduct and Sewer Authority," August 11, 2015, http://www.gdbpr.com/documents/StatementfromGDBonPRASAoffering.pdf.

[97] U.S. Department of Transportation Inspector General, Audit of the Tren Urbano Rail Transit Project, Federal Transit Administration Report Number: MH-2004-098, September 29, 2004; https://www.oig.dot.gov/sites/default/files/

operating deficits of about a half a billion dollars in recent years, which has required substantial support from other parts of the Puerto Rico government such as the GDB.[98] At the end of December 2012, HTA owed the GDB $2.2 billion, which it lacked the means to pay.[99] On January 15, 2015, Puerto Rico enacted a tax on petroleum products (Act 1 of 2015) intended to provide HTA with funds to repay its debts, among other aims.[100]

Puerto Rico Aqueduct and Sewer Authority (PRASA)

The island government has contended that the financial situation of the Puerto Rico Aqueduct & Sewer Authority (PRASA; in Spanish, Autoridad de Acueductos y Alcantarillados or AAA) has improved due to increases in water rates, although investors have remained skeptical.[101] PRASA had planned to issue $750 million in new revenue bonds by the end of August 2015, but those plans were postponed indefinitely once the Puerto Rican governor declared the island's public debts to be unpayable.[102] Issuing those bonds would have helped PRASA pay arrears due contractors and make bond payments to the GDB, along with providing funding for infrastructure improvements, including some mandated by a consent decree with the U.S. Environmental Protection Agency.[103] A revitalization bill (P.C. 2786) for PRASA along the lines of PREPA's revitalization act passed both the Puerto Rican House of Representatives and Senate, which have agreed to conference to resolve differences.[104] The measure would create a customer surcharge to support debt service for three years.[105] A severe drought affecting much of the island in 2015 also affected PRASA operations.[106]

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mh2004098.pdf. Also see GDB, *Commonwealth of Puerto Rico, Financial Information and Operating Data Report*, November 6, 2015, pp. 201-203.

[98] Ibid.

[99] Preamble, Act 1 of 2015, http://www.lexjuris.com/lexlex/Leyes2015/lexl2015001.htm.

[100] The Puerto Rican government had intended to use the petroleum products tax, known in Spanish as "la crudita," to support an issue of $2.95 billion in bonds by the Puerto Rico Infrastructure Financing Authority (PRIFA), which would then assume certain debts of the HTA. That bond sale was suspended, however, due to adverse market conditions.

[101] Michelle Kaske, "Puerto Rico Optimistic About Bond Sale as Buyer Doubts Increase," *Bloomberg Business*, August 26, 2015.

[102] Luis J. Valentín, "PRASA files for $750M in New Bonds," *Caribbean Business*, August 11, 2015, http://www.caribbeanbusinesspr.com/news/prasa-files-for-$750m-in-new-bonds-115012.html. Also see Government Development Bank, "Statement from Government Development Bank for Puerto Rico on Announcement of Upcoming Offering by Puerto Rico Aqueduct and Sewer Authority," August 11, 2015, http://www.gdbpr.com/documents/StatementfromGDBonPRASAoffering.pdf.

[103] NotiUno News, "CIAPR Reclama Pago de Deuda de la AAA a Sus Colegiados (College of Engineers and Surveyors Calls for Payment of Debts of PRASA)," September 18, 2015; http://www.notiuno.com/ciapr-reclama-pago-de-deuda-de-la-aaa-a-sus-colegiados/. See also Consent Decree, U.S.A v. PRASA, in re 01-1709(JAF), March 13, 2003; http://www2.epa.gov/sites/production/files/2013-09/documents/prasacd.pdf. For information on other compliance issues, see GDB, *Commonwealth of Puerto Rico, Financial Information and Operating Data Report*, November 6, 2015, pp. 198-201.

[104] Rebecca Banuchi, "Senado condiciona aprobación de proyecto de revitalización de la AAA (Senate Conditions its Approval of PRASA's Revitalization Project)," *El Nuevo Dia*, March 31, 2016, http://www.elnuevodia.com/noticias/locales/nota/senadocondicionaaprobaciondeproyectoderevitalizaciondelaaaa-2181120/. The measure is Proyecto de la Cámara 2786, "Ley para la Revitalización de la Autoridad de Acueductos y Alcantarillados de Puerto Rico (Act for the Revitalization of the Puerto Rico Aqueduct and Sewer Authority)."

[105] Luis J. Valentín, "PRASA Maneuvers Through Revitalization Maze," *Caribbean Business*, February 25, 2016; http://cb.pr/prasas-labyrinth/. Legislative text of the measure is at http://www.oslpr.org/2013-2016/%7B4FCEE3DB-161D-4669-9636-0150D96C758E%7D.doc.

[106] National Oceanic and Atmospheric Administration, National Centers for Environmental Information, *Drought Annual 2015*, January 13, 2016, https://www.ncdc.noaa.gov/sotc/drought/201513#pr-sect.

Fiscal Strategy and Outmigration

The precarious state of Puerto Rico's public finances stems in part from prolonged economic weakness. Economic growth was sluggish even before the 2007-2009 recession, and official forecasts project continued slow growth. Previous economic analyses of Puerto Rico's economy have pointed to low employment and labor participation rates, an economic structure shaped more by tax advantages than comparative advantages, and intensified global competition.[107]

Those trends and associated economic challenges have prompted many Puerto Ricans to move to the U.S. mainland, leading to population decline of about 1% per year over the past decade. **Figure 5** shows estimated trends for Puerto Rico's resident population since 1950.

One study estimated that a third of those born on Puerto Rico now reside on the mainland and found that migrants tended to be younger and less well educated compared to island population averages.[108] Economic growth depends on productivity and the availability of resources such as capital and labor. By reducing the amount of labor available to the island economy, outmigration poses risks to future economic growth. Moreover, outmigration serves as a signal that some island residents perceive that the mainland presents more attractive economic opportunities. Some Puerto Ricans who migrate to the mainland later return to the island. Since the mid-1990s, the number of those moving to the mainland has trended upwards, whereas the number of those returning to Puerto Rico has not shown a distinct trend.[109]

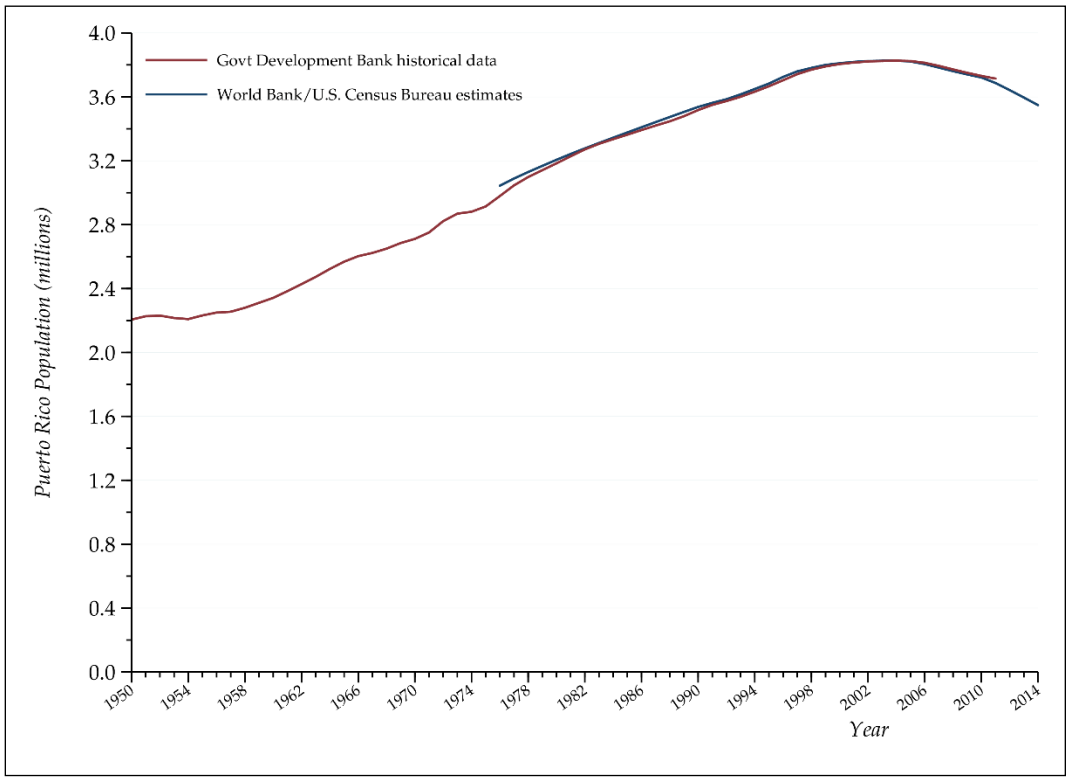
[107] Barry Bosworth and Susan M. Collins, "Economic Growth," in Susan M. Collins, Barry P. Bosworth, and Miguel A. Soto-Class, eds., *The Economy of Puerto Rico: Restoring Growth* (Brookings: Washington, DC, 2006), pp. 17-81; Federal Reserve Bank of New York, *Report on the Competitiveness of Puerto Rico's Economy*, 2012. Available in English at http://www.newyorkfed.org/regional/puertorico/index.html.

[108] Jaison R. Abel and Richard Deitz, "Population Lost: Puerto Rico's Troubling Out-Migration," Liberty Street Economics, New York Federal Reserve Bank, April 13, 2015, http://libertystreeteconomics.newyorkfed.org/2015/04/population-lost-puerto-ricos-troubling-out-migration.html.

[109] Samuel M. Otterstrom and Benjamin F. Tillman, "Income Change and Circular Migration: The Curious Case of Mobile Puerto Ricans, 1995-2010," *Journal of Latin American Geography*, vol. 12, no. 3 (2013), pp. 33-57.

Figure 5. Puerto Rico Resident Population Trends

Estimates from 1950 through 2014



Source: U.S. Census Bureau, World Bank, and Government Development Bank.

Note: U.S. Census Bureau population estimates are for July 1 of each year.

Potential Issues for Congress

Possible options for Congress to address the fiscal distress faced by the government of Puerto Rico and its constituent public corporations are framed by the island's status as a territory—something different than a state and different from an independent sovereign country.[110] The federal government has generally been reluctant to offer direct financial assistance to individual states in fiscal distress, although Congress at times has adjusted technical parameters of federal programs to provide direct or indirect support for states.[111] The independence of state governments to set their own fiscal paths has been linked to an expectation that those governments take responsibility for the consequences of their fiscal decisions. In some other fiscal systems, a central government's willingness to cover shortfalls by state governments has been seen as having led to less prudent fiscal behavior. Central governments in some federal systems provide subnational governments with more support, but impose more intrusive fiscal controls.

[110] See CRS In Focus IF10241, *Puerto Rico: Political Status and Background*, by R. Sam Garrett; or CRS Report R42765, *Puerto Rico's Political Status and the 2012 Plebiscite: Background and Key Questions*, by R. Sam Garrett.

[111] Jonathan A. Rodden, *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism* (New York: Cambridge, 2006). The American Recovery and Reinvestment Act (ARRA; P.L. 111-5) included support for state governments and territories.

The report of the former IMF economists was framed in terms familiar to typical IMF interventions, in which short-term bridge financing is provided conditional on agreements with governments to address structural economic issues over a longer term.[112] Congressional options might thus be divided between strategies to address imminent liquidity challenges, such as providing credit support or altering bankruptcy laws, and strategies intended to promote economic growth over the longer term.

Administration Proposals

The U.S. Department of the Treasury proposed a framework in October 2015 that called on Congress to pass legislation to "provide the critical tools Puerto Rico needs to restructure its debt, enhance its fiscal governance, fix its healthcare system, and help jumpstart its economy."[113] The Obama Administration had earlier indicated that it is not contemplating a federal bailout of Puerto Rico, but provided technical support and has sought to make existing federal resources available.[114] President Obama's FY2017 budget plan called for a "broad legal framework" that would allow Puerto Rico's public debt to be restructured and would provide for fiscal oversight for the island.[115]

Credit Support

Central governments and international organizations have at times stepped in to backstop debts of other governments to lower those governments' borrowing costs. Such support typically has been linked to budgetary or structural reform requirements. For example, the European Central Bank in 2011 acted to support debt offered by Eurozone countries, which dramatically lowered borrowing costs of countries that could have faced severe liquidity challenges.[116] The U.S. government provided credit guarantees for the Mexican government in 1994-1995.[117] The U.S. government also provided indirect credit support for many state government agencies through the Depression-era Reconstruction Finance Corporation (RFC). For instance, in 1941 the RFC acted as an intermediary to roll over $136 million in debt for the state of Arkansas.[118] In the early decades of the 20th century, the U.S. government took an expansive role in addressing debts of Caribbean and Central American countries.[119]

Federal Health and Income Support Programs

Reimbursement and eligibility rules for federal entitlement programs in Puerto Rico often differ from those in effect on the mainland.[120] For example, funding for the federal portion of Medicaid

[112] Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, *Puerto Rico: A Way Forward*, June 29, 2015, pp. 25-26.

[113] U.S. Department of the Treasury, "Addressing Puerto Rico's Economic and Fiscal Crisis and Creating a Path to Recovery: Roadmap for Congressional Action," October 21, 2015.

[114] White House Press Briefing, June 29, 2015, http://www.c-span.org/video/?326821-1/white-house-briefing.

[115] *Reuters*, "Puerto Rico Could Restructure Debts, Boost Healthcare Under Obama Budget," February 9, 2016, http://www.reuters.com/article/us-obama-budget-puertorico-idUSKCN0VI29H.

[116] CRS Report R42377, *The Eurozone Crisis: Overview and Issues for Congress*, coordinated by Rebecca M. Nelson.

[117] Joseph A. Whitt Jr., "The Mexican Peso Crisis," *Federal Reserve Bank of Atlanta Economic Review*, January/February 1996, https://www.frbatlanta.org/filelegacydocs/J_whi811.pdf.

[118] Jesse H. Jones, *Fifty Billion Dollars: My Thirteen Years with the RFC* (New York: Macmillan, 1951), p. 179.

[119] For a summary, see Faisal Z. Ahmed, Laura Alfaro, and Noel Maurer, "Lawsuits and Empire: On the Enforcement of Sovereign Debt in Latin America," *Law and Contemporary Problems*, vol. 79, no. 4 (2010), pp. 39-46.

[120] See CRS Report R44275, *Puerto Rico and Health Care Finance: Frequently Asked Questions*, coordinated by

is capped for U.S. territories, but is open-ended for states.[121] The federal matching rate for Medicaid ranges from 50% for states with the highest per capita income to 74% for the state with the lowest per capita income, while the matching rate for Puerto Rico is set at 55%.[122] Congress could revise Medicaid matching fund formulas or eligibility standards. It could also modify reimbursement rules or enrollment standards under Medicare, or adjust rules governing other federal programs, such as the income support programs. Resident Commissioner Pierluisi introduced several bills (H.R. 1225, H.R. 1417, H.R. 1418, H.R. 1822, H.R. 2635) in the 114th Congress to modify federal health and income support programs to provide additional resources to Puerto Rico.

Restructuring and Bankruptcy

Under current law, Puerto Rico is generally considered a state for most provisions of the Bankruptcy Code; but it is explicitly excluded from that definition for purposes of determining those eligible to file under chapter 9, which sets out a process for consideration of debt relief requests of instrumentalities of state governments.[123] Thus, subunits of Puerto Rico, such as public corporations, are barred from filing under chapter 9.

The restructuring law that Puerto Rico enacted in June 2014, which was in part motivated by the financial situation of PREPA and other public corporations, was established with the aim of providing an alternative to processes provided by the Bankruptcy Code. That law, however, was struck down by a U.S. district court.[124] On July 6, 2015, the U.S. Court of Appeals for the First Circuit affirmed the lower court's ruling that federal bankruptcy provisions[125] preempted Puerto Rico's ability to employ its own restructuring law.[126]

Congress could amend the Bankruptcy Code to permit Puerto Rico to allow its municipalities (which include instrumentalities and subdivisions of the territory) to enter into chapter 9 and proceed with a well-established process for restructuring public debts. To that end, Resident Commissioner Pierluisi introduced H.R. 870 on March 16, 2015.[127] Senator Blumenthal introduced a similar measure (S. 1774) on July 15, 2015. Representative Pelosi introduced the Puerto Rico Emergency Financial Stability Act of 2015 (H.R. 4290) on December 18, 2015, a measure to stay litigation related to the island's public debts, which could provide further time for negotiations between Puerto Rico and its creditors. Senator Warren introduced a companion measure, the Puerto Rico Emergency Financial Stability Act of 2015 (S. 2436), in the Senate on

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[121] Medicaid is a joint federal-state program that provides access to health care for low-income persons and includes some long-term health care benefits.

[122] CRS Report R43847, *Medicaid's Federal Medical Assistance Percentage (FMAP)*, by Alison Mitchell. The maximum statutory matching rate is 83%. Mississippi has the highest matching rate (74.17%).

[123] 11 U.S.C. §101(52). Also see CRS Legal Sidebar WSLG1289, *Fiscal Distress in Puerto Rico: Two Legislative Approaches*, by Carol A. Pettit.

[124] The consolidated cases are *Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico* and *BlueMountain Capital Management, LLC v. García-Padilla* (case 3:14-cv-01569). The February 6, 2015, opinion and order is available at http://www.noticel.com/uploads/gallery/documents/ed648d7e7839c5b66e556b14d3c639b3.pdf.

[125] 11 U.S.C. §903(1).

[126] *Franklin California Tax-Free Trust et al. v. Commonwealth of Puerto Rico* and Puerto Rico Electric Power Authority et al.; opinion, docket items 15-1218, 15-1221, 15-1271, 15-1272 (consolidated), July 6, 2015, http://media.ca1.uscourts.gov/pdf.opinions/15-1218P-01A.pdf.

[127] Resident Commissioner Pierluisi introduced H.R. 5305, a similar bill, in the 113th Congress.

the same day. On March 14, 2016, Senator Menendez introduced two bills (S. 2675, S. 2676) that would allow adjustments of Puerto Rico's debt.

Governor García Padilla has also called for giving Puerto Rico access to chapter 9.[128] Treasury Secretary Lew has also expressed support for allowing Puerto Rico to access chapter 9.[129] Some hedge funds and other holders of Puerto Rican bonds, however, have opposed including the island in chapter 9.[130] Interests of hedge funds with major holdings of general obligation (GO) bonds, however, may differ from those of funds holding bonds of the island's public corporations that are not secured by a general obligation of the Puerto Rican government.[131]

Access to chapter 9 might provide limited relief from debt burdens, as the central government of Puerto Rico—like state governments—would presumably be unable to file for bankruptcy relief itself. As **Figure 4** indicates, a substantial portion of the island's debt was issued by the central government. Public corporations issued the bulk of their debt as special revenue bonds, which have been generally considered as protected from adjustment.[132]

Federalism, Flexibility, and Fiscal Responsibility

Federal systems allow lower level governments to adapt policies to reflect local preferences, while letting the central government focus on programs of national interest and concern. A federal system of government also provides a degree of fiscal insurance to lower-level governments. For example, a central government can respond to mitigate the consequences of disasters or localized economic downturns affecting specific states or regions.

The level of support for lower-level governments provided by a central government is typically linked to the stringency of fiscal controls. Federal systems, by and large, can be divided into two types. Some federal governments—such as the United States—allow local governments more autonomy, but maintain an expectation that those governments will manage any budgetary shortfalls largely on their own. Other federal systems provide more extensive support for lower-level governments, but impose more restrictive central control on local decisions.[133] The independence of U.S. state governments to set their own fiscal paths has thus been linked to an expectation that those governments take responsibility for their finances. In some other fiscal

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[128] Governor García Padilla, Mensaje del Gobernador (Message of the Governor), June 29, 2015.

[129] *Bloomberg*, "Treasury's Lew Says Puerto Rico Crisis Must be Resolved Locally," July 29, 2015, http://www.bloomberg.com/news/articles/2015-07-29/treasury-s-lew-says-puerto-rico-crisis-must-be-resolved-locally.

[130] Testimony of Thomas Mayer, Partner of Kramer Levin Naftalis and Frankel LLP, in U.S. Congress, House Committee on the Judiciary, H.R. 870*, the "Puerto Rico Chapter 9 Uniformity Act of 2015,"* 114th Cong., 1st sess., February 26, 2015, http://judiciary.house.gov/?a=Files.Serve&File_id=B7832791-B261-4FD8-ADC4-5A4117A52339.

[131] See Michael Corkery, "Let Us Help You, Hedge Funds Tell Puerto Rico," *New York Times*, September 12, 2014, http://dealbook.nytimes.com/2014/09/12/puerto-rico-finds-it-has-new-friends-in-hedge-funds/.

[132] One summary of chapter 9 provisions concludes that "Congress made clear that revenue bondholders are entitled to receive the revenues pledged to them without any interference and on a timely basis." James E. Spiotto, *Primer on Municipal Debt Adjustment: Chapter 9*, 2012, p. 28, http://www.afgi.org/resources/Bankruptcy_Primer.pdf. The Senate's explanation of the relevant provision stated that "[t]o eliminate the confusion and to confirm various state laws and constitutional provisions regarding the rights of bondholders to receive revenues pledged to them in payment of their debt obligations of a municipality, a new section is provided in the Amendment to ensure that revenue bondholders receive the benefit of their bargain with the municipal issuer and that they will have unimpaired rights to the project revenues pledged to them." U.S. Congress, Senate Committee on the Judiciary, *Report to Accompany* S. 1863, 100th Cong., 2nd sess., S.Rept. 100-506, 1988, p. 12.

[133] Jonathan A. Rodden, *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism* (New York: Cambridge, 2006).

systems, the willingness of a central federal government to cover shortfalls by lower-level governments has been seen as having led to fiscal behavior that was less prudent.[134]

The U.S. federal system provides substantial implicit fiscal insurance to state and local governments through the automatic stabilization characteristics of income support programs, federal disaster assistance, and by a progressive federal individual income tax.[135] The federal government, however, has been generally reluctant to offer direct financial assistance to states in difficult fiscal situations.

Control Board Proposals

Some Members have called for some form of control board to oversee Puerto Rico's finances and other aspects of public administration. As noted above, Governor García Padilla has called for establishment of a local control board to oversee fiscal recovery. Representative Jeff Duncan, chairman of the Subcommittee on the Western Hemisphere of the House Foreign Affairs Committee, called for a control board to oversee Puerto Rico's finances along the lines of the financial control board that Congress set up in 1995 to oversee the District of Columbia's government.[136] One federal appeals court judge, however, contended that "instituting direct Congressional control of Puerto Rico's finances through a financial control board would require fundamentally redefining Puerto Rico's relationship to the United States."[137]

District of Columbia Control Board and State-Established Control Boards

Congress established the District of Columbia Financial Responsibility and Management Assistance Authority, commonly known as the Control Board, by passing the District of Columbia Financial Responsibility and Management Assistance Act of 1995 (P.L. 104-8).[138] That act also created a chief financial officer (CFO) position with authority to administer the District's financial operations. The federal government also assumed certain pension and judicial obligations of the District and reduced the District's share of Medicaid costs.[139] After the District government was able to balance its budget for four years, the Control Board became dormant after September 2001.[140]

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[134] Ibid.

[135] One 1991 study estimated that a $1 drop in a U.S. region's income would result in a decrease in tax collections of 34 cents and a 6-cent increase in federal transfers. See Xavier Sala-i-Martin and Jeffrey Sachs, "Fiscal Federalism and Optimum Currency Areas: Evidence for Europe From the United States," NBER Working Paper no. 3855, October 1991.

[136] Representative Jeff Duncan, "Puerto Rico Financial Board," Dear Colleague letter, June 19, 2015. Also see Micheal Corkery, "Financial Control Board Should Take Over Debt-Laden Puerto Rico, Lawmaker Says," *New York Times*, June 19, 2015, http://www.nytimes.com/2015/06/20/business/dealbook/financial-control-board-should-take-over-debt-laden-puerto-rico-lawmaker-says.html.

[137] Franklin California Tax-Free v. Commonwealth of Puerto Rico, No. 15-1218 (1st Cir. 2015), Concurrence by Torruella at p. 68, July 6, 2015, http://caselaw.findlaw.com/us-1st-circuit/1707047.html.

[138] See CRS Report R43847, *Medicaid's Federal Medical Assistance Percentage (FMAP)*, by Alison Mitchell, and CRS Report RL30897, *The Evolution of District of Columbia Governance*, by Michael K. Fauntroy (out of print; available to congressional clients upon request).

[139] Those changes were made through the National Capital Revitalization and Self-Government Improvement Act of 1997 (P.L. 105-33). For details, see Jon Bouker, "The D.C. Revitalization Act: History, Provisions, and Promises," in *Building the Best Capital City in the World* (Washington, DC: Brookings, 2008).

[140] District of Columbia Government, Office of the Chief Financial Officer, "History of the OCFO," http://cfo.dc.gov/page/history-ocfo.

State governments have also established financial control boards for other municipal governments, such as the cities of Philadelphia, Cleveland, and Detroit.[141] The federal government also extended fiscal assistance directly and indirectly to New York City in 1975.[142]

Congressional and Administration Proposals for Fiscal Oversight

In October 2015, the U.S. Department of the Treasury set out a reform framework that included a call for fiscal oversight as well as a broad debt restructuring of Puerto Rico's debts.

Several congressional proposals have put forth that include some form of control or oversight board. Representative Sean Duffy introduced H.R. 4199, the Puerto Rico Financial Stability and Debt Restructuring Choice Act on December 9, 2015. Senator Hatch introduced S. 2381, the Puerto Rico Assistance Act of 2015, on the same day. The House Natural Resources Committee issued a discussion draft on March 29, 2016, of the Puerto Rico Oversight, Management, and Economic Stability Act.

PROMESA

On April 12, 2016, Representative Duffy introduced the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA; H.R. 4900), which would set up an Oversight Board for Puerto Rico and create a process to restructure the island's debts, among other provisions.[143] The House Natural Resources Committee held hearings on H.R. 4900 on April 13, 2016.[144] A markup session was started on the same day to hear opening statements, but a continuation of the markup for the next day was postponed.

Representative Duffy introduced H.R. 5278, a revised version of H.R. 4900, on May 18, 2016.[145] The House Committee on Natural Resources marked up H.R. 5278 on May 25, 2016. Amendments agreed to include technical corrections, extensions of certain studies on the Puerto Rico government and economy, among others. The major provisions of the bill, however, were unaffected.[146] The committee approved the measure on a 29-10 vote.[147]

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[141] See CRS Report 95-328E, *Financial Control Boards for Cities in Distress*, by Nona Notto and Lillian Rymarowicz, which is available to congressional clients upon request. For a summary of other prominent municipal bankruptcies, see James E. Spiotto, Primer on Municipal Debt Adjustment: Chapter 9, 2012, pp. 8-12, http://www.afgi.org/resources/Bankruptcy_Primer.pdf.

[142] Dall Forsythe, "Debt Management in New York City, 1978-2008," working paper, Wagner School, New York University, October 2008, http://wagner.nyu.edu/files/faculty/publications/Forsythe_Debt_Management_in_NYC_ABFM_2008_Final.pdf.

[143] A congressional distribution memorandum summarizing H.R. 4900 is available to congressional clients from the author upon request.

[144] House Committee on Natural Resources, "The Puerto Rico Oversight, Management, and Economic Stability Act," hearings, 114th Cong., 2nd sess., April 13, 2016.

[145] An earlier congressional distribution memorandum that analyzed H.R. 4900 is available to congressional clients from the Coordinator upon request. For a brief summary of H.R. 5278, see CRS Insight IN10485, *PROMESA (H.R. 5278) and Puerto Rico*, by D. Andrew Austin.

[146] H.R. 5278 was immediately referred to the House Committee on Natural Resources as well as the Committees on the Judiciary, Education and the Workforce, and Small Business. The latter committees could consider provisions falling within each of their jurisdictions. If those committees, however, do not act on H.R. 5278 before a deadline set by the Speaker, or if they agree to waive their opportunity to do so, they could then be discharged from any obligation to consider the bill, which then could be taken up by the House. Alternatively, the Committee on Rules could report an "extraction rule" providing for consideration of the bill notwithstanding that certain committees had not reported it.

[147] H.R. 5278 was referred to the House Committee on Natural Resources as well as the committees on the Judiciary, Education and the Workforce, and Small Business. The latter committees could consider provisions falling within each

The Congressional Budget Office (CBO) judged that the Oversight Board that H.R. 5278 would establish should be considered part of the federal budget according to the "unified budget concept" set forth in the 1967 President's Commission on Budget Concepts.[148] CBO estimated that operating the Oversight Board for Puerto Rico would cost $370 million over the period FY2017-FY2022. Section 107 of H.R. 5278 mandates that the territory's government designate a dedicated funding source for the board, which (under the unified budget concept) would increase federal revenues by an estimated $370 million. The net effect on the federal budget, therefore, is estimated to be zero.

Structural Reforms in the Medium and Long Term

Congress could also encourage the Puerto Rican government to pursue economic development strategies more in line with the island's economic comparative advantages rather than its tax advantages.

Revenue Policies

Puerto Rico has long relied on special provisions in the U.S. tax code and in its own tax laws to stimulate investment. Many of the tax advantages available to corporations or subsidiaries located in Puerto Rico, such as Internal Revenue Code Section 936, which until it was phased out between 1996 and 2005, essentially exempted income of U.S. firms operating in U.S. possessions, have reduced the U.S. Treasury's receipts.[149] The IRS's unwillingness to challenge the creditability of Puerto Rico's Act 154 taxes against U.S. tax liability provides indirect support for the island's public finances that is nearly offset by the loss of revenues foregone by the U.S. Treasury.[150] Puerto Rico's Act 22, which provides certain tax exemptions to wealthy persons who establish residency in Puerto Rico, may also affect U.S. Treasury receipts.

Jones Act and Transportation

Congress could also consider options that might address structural issues that may have hindered Puerto Rico's economic growth. Congress could consider several regulatory policies, such as Jones Act restrictions on shipping between Puerto Rico and the mainland. Congress has already

of their jurisdictions. If those committees, however, do not act on H.R. 5278 before a deadline set by the Speaker, or if they agree to waive their opportunity to do so, they could then be discharged from the bill, and it could be taken up by the House. Alternatively, the Committee on Rules could report an "extraction rule" providing for consideration of the bill notwithstanding that certain committees had not reported it.

[148] CBO, "H.R. 5278: Puerto Rico Oversight, Management, and Economic Stability Act, As ordered reported by the House Committee on Natural Resources on May 25, 2016," June 3, 2016, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/costestimate/hr5278.pdf. Also see President's Commission on Budget Concepts, *Report*, (Washington, D.C.; October 1967), which stated (at p. 25) that "The budget should, as a general rule, be comprehensive of the full range of Federal activities. Borderline agencies and transactions should be included in the budget unless there are exceptionally persuasive reasons for exclusion."

[149] CRS Report RS20695, *The Puerto Rican Economic Activity Tax Credit: Current Proposals and Scheduled Phaseout*, by David Brumbaugh (out of print; available to congressional clients upon request).

[150] Some subsidiaries of foreign countries, such as Ireland and Netherlands, have not been able to credit section 154 taxes, although at least one German firm has reportedly been able to credit those taxes.

waived Jones Act requirements for the U.S. Virgin Islands and could extend that waiver to Puerto Rico.[151]

Labor and Income Support

Several past studies have noted that labor participation rates for Puerto Rico are well below those on the mainland. Some have suggested that social insurance may play a role in discouraging employment outside the underground economy. The Economic and Fiscal Recovery Working Group plan of September 2015 proposes establishment of an earned income tax credit, a restructuring of the Nutritional Assistance Program (NAP; the island analogue to the Food Stamps/Supplemental Nutrition Assistance Program), and changes to public housing policies—all designed to bolster incentives to work.[152]

Some economists have also pointed to the federal minimum wage as a hindrance to labor demand.[153] The Economic and Fiscal Recovery Working Group plan calls for several labor reforms, including limits on severance pay, weakened dismissal protections, and changes in overtime regulations. The plan also calls on Congress to grant a 10-year waiver of minimum wage increases for workers under the age of 25.[154]

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[151] CRS Report R43653, *Shipping U.S. Crude Oil by Water: Vessel Flag Requirements and Safety Issues*, by John Frittelli.

[152] That report was updated in January 2016. See *Puerto Rico Fiscal and Economic Growth Plan: Update Presentation*, January 18, 2016, http://www.gdb-pur.com/documents/PRFEGPUpdatePresentation1.18.16-2.pdf.

[153] Krueger, Teja, and Wolfe, op. cit.

[154] Working Group for the Fiscal and Economic Recovery of Puerto Rico, *Puerto Rico Fiscal and Economic Growth Plan*, September 9, 2015, op. cit.