Econ Americas

# WHAT BANKRUPTCY MEANS FOR PUERTO RICO

Source: Financial Oversight & Management Board for Puerto Rico

Three years have passed since a legal experiment allowed Puerto Rico to declare bankruptcy. Financial recovery remains elusive, despite the claim of exiting bankruptcy in 2020. After Hurricane Maria devastated the island in 2017, the commonwealth required federal funding to jump-start the economy and rebuild its infrastructure. Moreover, several lawsuits have stalled Puerto Rico's debt-restructuring plan.

**Background**

Puerto Rico entered a recession in 2006 after years of mismanagement and flawed economic policies.

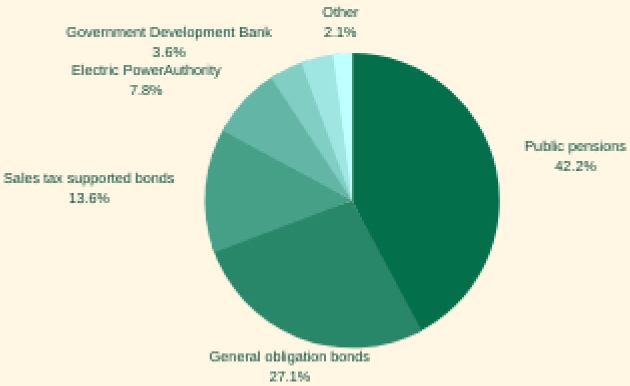
- Until 2005, the commonwealth was a business-friendly jurisdiction with a series of benefits such as a federal tax exemption on corporate income originating from the island. However, after accusations of tax evasion, the US Congress phased out that loophole over a 10-year period starting in 1996.
- The US federal government encouraged Puerto Rico to fill funding gaps with debt and removed the commonwealth's borrowing limits. The public sector accrued an unsustainable level of bonded debt and pension liabilities, whereas residents voted in officials who promised ever more benefits. This gave political leaders no incentive to balance the books.
- The Jones Act, a century-old regulation prohibiting foreign-flagged ships from transporting goods between the mainland and Puerto Rico, has kept trade inefficient and has driven up the cost of living.

Due to rising unemployment and capital flight, by 2014 Puerto Rico was trying to figure out how to file for bankruptcy. However, like US states, the commonwealth was ineligible for such legal protection. Congress and President Barack Obama had to pass *sui generis* legislation to create a bankruptcy-like scheme in 2016: the Oversight, Management, and Economic Stability Act (PROMESA). A seven-member board took control of Puerto Rico's finances in 2017.

**What are Puerto Rico's debt and pension liabilities?**

Puerto Rico has a total bonded debt of $52.6 billion and $54.5 billion in unfunded pension liabilities. The government also owes around $15 billion to the water and electricity authorities.

**Puerto Rico's Public Debt Obligations**




| | |
|---|---|
| Public pensions | $54.5 |
| General obligation bonds | $35.0 |
| Sales tax supported bonds | $17.6 |
| Electric Power Authority | $10.1 |
| Government Development Bank | $4.7 |
| Water Authority | $4.6 |
| Other | $2.7 |
| | **$129.2** |

**In billion of US dollars*

Source: Financial Oversight and Management Board for Puerto Rico.

**What changed after the US Congress allowed Puerto Rico to declare bankruptcy?**

1. The Financial Oversight and Management Board established under PROMESA started to manage Puerto Rico's finances in May 2017.
2. PROMESA temporarily relieved Puerto Rico from its liabilities and suspended payments to bondholders. All debt-restructuring plans had to go through the appointed judge, Laura Taylor Swain of the Southern District of New York.
3. The oversight board began negotiations with creditors and proceedings in court to counter lawsuits.

**Who has challenged Puerto Rico in court and why?**

- **Walmart**, Puerto Rico's largest employer, won a $100 million lawsuit against the territorial government in 2016. A federal court ruled that a new tax on tangible property was unconstitutional.
- **University of Puerto Rico bondholders** filed a lawsuit against the commonwealth in 2016 to stop it diverting $89 million in tuition and fees for the university's own bond payments.
- The Puerto Rico Sales Tax Financing Corporation (**COFINA**), a government agency that issued bonds to refinance Puerto Rico's debt, began a dispute on whether the sales and use taxes pledged by COFINA to secure its bonds belonged to the government or to the corporation. One year of mediation and litigation later, the parties reached an agreement whereby COFINA received 53 percent of the funds.

- The Center for Investigative Journalism (**CPI**) sued the oversight board for disclosure of emails and messages about Puerto Rico's debt restructuring between the federal government, the commonwealth, and the board. In May 2018, the US District Court for the District of Puerto Rico ruled in favor of the CPI.
- **Hedge funds** Aurelius Capital Investment, which owns more than $400 million in defaulted Puerto Rican bonds, and Monarch Alternative Capital have filed suit, arguing the oversight board is unconstitutional. The case is pending before the US Supreme Court.
- **The Puerto Rican Electrical Workers Union** is also challenging the board's constitutionality. Along with the State Insurance Fund Corporation, they argue PROMESA violates Puerto Ricans' political liberties.
- **Insurance companies** Assured Guaranty Corp and Ambac Assurance Corp filed petitions to limit PROMESA's authority to halt municipal-bond payments. The Supreme Court denied their request on January 13, 2020.

**What has been the impact on the territory's economy?**

- For years, Puerto Rico's government failed to adequately fund the Employment Retirement System (ERS), the main reason behind the unfunded pension liabilities. In July 2017, the system collapsed and turned into a pay-as-you-go system.
- Around 50,000 people left the island every year between 2013 and 2016, a trend that continues to this day. According to estimates, the Puerto Rican population will drop below 3 million by 2025, straining the local economy and the government's finances.
- Economic growth has stalled: GDP growth was 1 percent in 2018 and 0.2 percent in 2019.
- The Puerto Rican Medicaid system, which serves half of the resident population, depends on $12 billion of pending federal aid.

**Who are the main winners and losers?**

In September 2019, the board filed its major plan to restructure around half of the island's bonded debt ($35 billion) and most pension liabilities ($50 billion). The plan is currently pending before the US Supreme Court, but it faces an uphill battle. Parties seeking better deals have filed several adversarial proceedings.

Retired Government Employees

- The most generous pension plans would be reduced by, at most, 8.5 percent. Monthly plans below $1,200, which account for 74 percent of all pensions, would not be cut at all.
- The restructuring would establish a trust fund to ensure benefit payments regardless of the island's political or economic swings.

Current Government Employees

- No further cuts to employee benefits.
- A $170 monthly increase to employers' contribution to the medical system.

Bondholders

- The plan would cut Puerto Rico's annual debt service from $2.4 billion to $1.5 billion.

- General obligation (GO) bonds issued before 2012 would get a 36 percent haircut. The board argues GO bonds issued in 2012 and 2014 were unconstitutional, so it is offering 55 and 65 percent reductions, respectively.
- Employment Retirement System (ERS) bonds would get an 87 percent haircut.
- Public Buildings Authority (AEP) bonds issued before 2012 would see a 28 percent haircut. Later bonds, deemed unconstitutional, would get a 42 percent reduction.
- The plan also contemplates the creation of an escrow to finance the repayment of bonds the board deems unconstitutional, in case the courts rule disfavorably.

**Previous Econ Americas Coverage**

"Puerto Rico Is Canary in Coalmine for States," *Epoch Times,* by Fergus Hodgson.

"Puerto Rico: Tax Haven or Economic Disaster?" *Gold Newsletter*, podcast by Fergus Hodgson.

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