



SHOULD PUERTO RICO BE ALLOWED TO RESTRUCTURE ITS DEBT? A MERCATUS DEBATE

After 10 years of recession and poor fiscal management, Puerto Rico is facing a major fiscal crisis. With \$72 billion in debt (the equivalent of the commonwealth's entire economy), deeply distressed pensions, high unemployment, and outmigration, Puerto Rico is insolvent. Congress is deliberating on legislation to provide a framework for Puerto Rico to restructure its finances under the guidance of a federal control board. The most contested point in the current proposal is whether to allow the board broad authority to restructure debt. One view is that debt restructuring violates creditors' contracts and provides an indirect bailout of a fiscally profligate lender. Another view is that the triple tax exemption given to Puerto Rico debt subsidized the increase in debt loads that pushed Puerto Rico into its current crisis and, as a result, bondholders should anticipate a reduction in interest rate payments or delayed principal payments. J. W. Verret and Marc Joffe debate whether Puerto Rico should be allowed to restructure its debt.

J. W. VERRET: NO.

Puerto Rico's dim prospects for resolution have prompted federal intervention. While this may be necessary, there are far more productive and responsible ideas that can be implemented at the federal level to help Puerto Rico than the quasi-bankruptcy approach embodied in the most recent draft of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA).

The "collective action" clause in PROMESA is a disaster for property rights, bondholders, and the people of Puerto Rico. This clause is rightfully regarded by many as both counterproductive to a successful resolution of Puerto Rico's looming debt default and a violation of the traditional American belief in property rights.

The first draft of the bill contained a "cram down" on creditors as is found in a typical bankruptcy proceeding. The new version of the bill then inserted a collective-action restructuring

provision to demonstrate the appearance of adherence to freedom-of-contract and rule-of-law principles. But the bait and switch is transparent.

Collective action clauses can be a useful device in bankruptcy, when they are anticipated in advance. However, PROMESA is not supposed to be a bankruptcy process. Additionally, Puerto Rico government bonds were not sold with the prospect of bankruptcy as part of the deal.

These bonds were sold with the expectation that any creditor would have a chance to be the “holdout” creditor, and the holdout option was priced into the initial purchase. It is a clear violation of the creditors’ contractual rights to now take away that contract right. If Puerto Rico wanted to deny creditors a holdout right, it should have specified that in its debt contracts.

The cram-down provision is being defended on the grounds that the property rights of a group of creditors are less legitimate, solely because they have purchased the bonds at a discount. Further, American taxpayers have long supported Puerto Rico with generous subsidies and grants, while Puerto Ricans do not pay federal income taxes. American taxpayers have been incentivized to purchase Puerto Rico debt. It does not follow that it is legitimate to repudiate—partially or in full—debts that are purchased in the market and defined according to contract.

A principle that flows from the property-rights centered design of the US Constitution is that the market price paid to obtain a contractual right in the securities or debt markets should not impact the legal protection afforded to that right. Hedge funds may exercise their free speech to prevent diminution of those contractual rights. The protection of investors’ contract rights is not to be confused with rent-seeking.¹

A far better approach than cram-down legislation would be to carefully consider the federal policies that could create sustainable growth for Puerto Rico. PROMESA takes a promising first step toward such an approach by reconsidering Puerto Rico’s minimum wage. The union-backed Jones Act, which heavily subsidizes union labor in ports and also inadvertently increased lawsuit abuse for the shipping industry, should also be eliminated on this struggling port island.

A truly groundbreaking initiative might consider making Puerto Rico the gateway to a repatriation of corporate profits maintained overseas to avoid the United States’s abusive corporate tax system. Many conservatives and moderate democrats have long favored a more territorial tax system, in which US corporations pay taxes on money earned abroad only in the country they are earned. Such an approach could make Puerto Rico the next Cayman Islands. The Caymans have long been a haven for corporate entities, and as a result the Caymans have a per capita GDP that is 26 percent higher than Puerto Rico’s, despite an otherwise similar economy and natural resources.

Permitting quasi-bankruptcy for Puerto Rico would violate bondholders’ property rights, and it would reduce all US municipalities’ access to credit. Rather than restructuring its debt, Puerto Rico should seek to reform its tax and regulatory climates to foster economic growth.

MARC JOFFE: YES.

Owing to inadequate constitutional debt limits, fiscal mismanagement, and the unintended consequences of previous federal actions, Puerto Rico has accumulated \$70 billion of bonded debt and over \$40 billion in unfunded public employee pension liabilities. In total, these obligations exceed Puerto Rico's GDP, which has been shrinking because of overregulation and out-migration. With Puerto Rico locked out of the capital markets and unable to balance its books, the situation has become unsustainable and is now the subject of federal action.

The Territorial Clause of the Constitution gives Congress the power to create a regime under which Puerto Rico's bonded debts can be restructured. By limiting this mechanism to territories, Congress can avoid any possibility that it will be later applied to US states. To prevent a disorderly default on all classes of Puerto Rico debt, years of costly litigation, and repercussions for the municipal bond market on the US mainland, Congress should use its power to create a territorial debt adjustment regime for Puerto Rico as part of a larger reform package that includes strong federal oversight.

One argument made by opponents of this approach is that it thwarts the rights of individual bondholders to obtain relief in court. Since a debt adjustment mechanism did not previously exist, the allegation is that Congress is effectively abrogating contracts between bondholders and Puerto Rico government entities. This is seen as an insult to bondholders' contractual rights, because it changes the rules in the middle of the game.

However, this type of federal intervention has a clear precedent: the addition of Chapter 9 to the bankruptcy code in 1934 provided a mechanism for defaulting cities across the United States to restructure bonds issued before they were eligible for a bankruptcy process. The belief that government bonds should enjoy the same protection as other contracts has been challenged by free-market thinkers on numerous occasions, because the fulfillment of these agreements require coercive taxation. A number of these scholars have even advocated the outright repudiation of government bonds.²

I would not go so far as to advocate a full repudiation of Puerto Rico government debt (or any other public debt). In a modern mixed economy, we require well-functioning government debt markets, with some level of investor protection to fund civil infrastructure. But delayed principal repayment and interest rate reduction both have 20th-century precedents in entities roughly comparable to Puerto Rico. These cases, in such diverse places as Arkansas, Alberta, and Australia (prior to full independence), did not disrupt the overall functioning of government bond markets.

Municipal market disruption is legitimate cause for worry in the case of Puerto Rico, because its securities are so widely held on the US mainland. Since interest on Puerto Rico bonds is exempt from all state and local taxes, they appear in many municipal bond fund portfolios. A full repudiation could cause substantial losses in these funds, souring investors on the municipal bond asset category, and thus driving up state and local borrowing costs. However, if the

present value of payments on Puerto Rico bonds is adjusted down to something approximating their current depressed market value (recently in the range of 50–70 cents on the dollar), fund investors will not experience further mark-to-market losses. This suggests that beyond reduced coupons and delayed maturities, the market could tolerate some degree of principal reduction.

Much of Puerto Rico’s debt has already been purchased by hedge funds at distressed levels. Managers of these funds are wagering that they can use the legal process to extract a substantial premium over purchase price from Puerto Rico, undoubtedly inspired by hedge funds obtaining favorable terms from Argentina after most other bondholders had settled for a substantial loss. The hedge funds are thus opposed to congressional actions that would restrict their ability to litigate.

We should be concerned about powerful interests using the political process to extract economic rents. Gains for hedge funds will be financed not only by Puerto Rico taxpayers, but also by US mainland taxpayers who provide one-third of Puerto Rico’s revenue through a variety of federal grants. Free-market thinkers have historically advocated equal rights under the law. Lobbying by well-funded special interests in the pursuit of taxpayer-funded rents does not seem consistent with the free-market tradition.

NOTES

1. See Gordon Tullock, Gordon Brady, and Arthur Seldon, *Government Failure* (Washington, DC: Cato Institute, 2002), 43. Rent seeking is “the use of resources for the purpose of obtaining rents for people where the rents themselves come from some activity that has negative social value.”

2. See, for example, Murray Rothbard, “Repudiating the National Debt,” *Chronicles* (June 1992): 49–52; Jeffrey Rogers, “Some Possible Consequences of a U.S. Government Default,” *Econ Journal Watch* 9, no. 1 (January 2012): 24–40.

ABOUT THE AUTHORS

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