
How Puerto Rico's Default Lowered States' Borrowing Costs.

The legal framework for state (as opposed to municipal) default is uncertain; no state has defaulted on its debt since Arkansas did so in 1933. In a paper, "Legal Uncertainty and Municipal Bond Yields: Market Spillovers from Puerto Rico," prepared for the 2019 Municipal Finance Conference at Brookings, Chuck Boyer of the University of Chicago Booth School of Business argues that markets view Puerto Rico's recent default as setting precedents for the legal framework should any U.S. state default. (In the U.S., municipal and county governments can declare bankruptcy; states cannot.) Using an event study methodology, Boyer finds that state bond prices had statistically significant reactions to legislation and legal decisions regarding Puerto Rico. By reducing the legal uncertainty surrounding a possible state default, the Puerto Rico decisions reduced the cost of state borrowing, he finds.

Boyer studies highlights four events in the Puerto Rico saga. First, in 2014, Puerto Rico enacted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (Recovery Act), which allows state-owned corporations to restructure their debts. Two years later, in 2016, they passed the Debt Moratorium and Financial Recovery Act (Debt Act) that allowed Puerto Rico to stop making debt payments. Third, in the same year, U.S. Congress passed PROMESA, allowing Puerto Rico to restructure debts with more favorable terms toward creditors than Chapter 9, the means through which local governments declare bankruptcy. Finally, in 2018, a judge ruled that Puerto Rico's special revenue bond payments are optional during bankruptcy proceedings. These events "decrease market uncertainty as they have begun to create some precedent for a framework for state government default," Boyer writes.

Using data on individual bonds issued by state governments, the author estimates changes in the average bond spreads between state-issued bonds and U.S. Treasury debt of similar maturities, 15 days and 30 days following the announcement of each event. Bond spreads are a measure of the market's judgment on the riskiness of a security. Boyer reasons that "if an event leads to an increase in the expected recovery rate, one would expect to see a decrease in spread as the expected payout to debtholders is now higher." Controlling for factors related to the characteristics of each bond, Boyer finds that the three Acts lowered the bond spread between 0.03 and 0.08 percentage points. In addition, consistent with his hypothesis, the ruling that Puerto Rico does not need to pay its revenue bonds in bankruptcy, which decreases recovery rate, increased bond spreads by 0.08 percentage points. These results suggest that state bond prices reacted to the legal events in Puerto Rico.

The author also examines whether states in worse fiscal health are worse affected by the legal decisions in Puerto Rico as they are more likely to default. He finds mixed results for this hypothesis. Although bonds from states with credit ratings below the highest investment grade reacted negatively to the Recovery Act, increasing spreads between 0.95 and 1.25 percentage points, neither the Debt Act nor PROMESA had a sizeable or significant effect. He concludes that there is no broad evidence that weaker state government are particularly affected, but suggests that a model of legal uncertainty may better illuminate reactions.

In short, Boyer finds that the legal decisions on Puerto Rico decrease bond spreads between state bonds and Treasury debt. This suggests that one channel affecting municipal debt is legal uncertainty. The author concedes that more research needs to be done on the legal uncertainty channel, but says that his results imply that establishing a legal framework for state government default could lead to lower borrowing costs for state governments.

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