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Puerto Rico's Recovery Depends on Getting Back Its Government.

The island's exit from bankruptcy won't deliver it from hard economic decisions — the kind that are best made by elected officials whom voters can hold to account.

Last week, Judge Laura Taylor Swain of the Southern District Court of New York certified the plan that will sharply reduce Puerto Rico's tax-supported debt and allow the island to emerge from bankruptcy.

Thus ends a five-year chapter in the largest and most complex municipal restructuring in U.S. history, a saga that unfolded as the commonwealth coped with devastating hurricanes and earthquakes, a U.S. president who held up $20 billion in aid, popular protests that toppled the island's government and, finally, the onslaught of Covid-19.

The plan that Judge Swain approved is technically sound. But strategic investment and hardheaded realism will be needed to avoid long-term deficits and avert a second default. More fundamentally, to make the difficult decisions that lie ahead, Congress should amend the Puerto Rico Oversight, Management and Economic Stability Act ("Promesa"), the law passed to save the island, and return power to the people of Puerto Rico and their elected officials.

From 2015 to 2017, I led a team at the U.S. Treasury that worked with Congress to design and pass Promesa. As Puerto Rico veered toward default in 2016, it had depleted its $55 billion pension plan and amassed $70 billion in debt, owed to everyone from on-island retirees to hedge funds that had bought claims for pennies on the dollar. If Congress had not stepped in, a cascading series of defaults threatened to turn a fiscal crisis into a humanitarian one.

What makes the restructuring plan approved by Judge Swain, which covers $55 billion in public pension plan claims and $34 billion in debt, technically sound?

First and foremost, by petitioning the courts five years ago, the island was able to suspend debt payments, deferring nearly $20 billion that would otherwise have been disgorged to creditors. Promesa staved off those claims, allowing the government to function and invest in the face of natural disasters.

Second, the debt will be simplified and significantly reduced. Prior to the restructuring, the commonwealth would have had to pay between $2.5 billion and $3.9 billion in annual debt service. This will be reduced to between $1.15 and $1.7 billion, with the higher amount paid only if the island's sales and rum tax collections exceed current expectations. Debt payments will consume 7% of the budget, versus roughly a quarter before. Including interest savings, the amount of debt forgiveness, or haircut, will total over 50%, ranging from a third for the most senior creditors to over 90% for the most junior — and if taxes overperform, senior creditors could eventually recover close to their entire claim.

Third, public pensions, which prior governments depleted to an unheard-of zero level of funding against $55 billion of liabilities, will remain intact. Because pensions support nearly 320,000 residents in Puerto Rico, Promesa included language that they “must be adequately funded,” a provision not found in the municipal bankruptcy code, which treats these important stakeholders as relatively junior, unsecured claims. Although teachers and judges will have their pensions frozen at today’s rates, they will have access to Social Security benefits for the first time.

These achievements are real, but they do not ensure that the island’s debt is truly sustainable over time. The Oversight Board created by Promesa to renegotiate the island’s debts and oversee its finances will soon publish the 2022 Fiscal Plan. Past plans have shown deficits starting in 2036, while relying unrealistically on structural reforms, including changes to labor law beyond the board’s authority, as a way to spur economic growth. Even though the debt has been cut, it is the only fixed component of the budget, so the people of Puerto Rico bear the risk of underperformance. The critical investments that Puerto Rico can now make must be guided by a long-term strategic vision for the economy.

The U.S. Congress must also address the uncertainty over future Medicaid contributions to Puerto Rico, a provision that was included in the stalled Build Back Better bill. An interpretation by the Biden administration’s Center for Medicare and Medicaid Services (CMS) increases the statutory federal share of Medicaid for the island to nearly $2.9 billion from $400 million under the Trump administration. But without legislation, re-interpretation by a future CMS could blow a hole in Puerto Rico’s budget larger than the pension payments.

As important, the federal funds already allocated to rebuild the island’s infrastructure, electricity grid and housing need to flow more quickly. These investments will underpin longer-run growth. As of this writing, over $40 billion have been obligated but not outlaid in Puerto Rico, including more than $18 billion in Community Development Block Grants for housing construction.

More fundamentally, it is time to reassess the governance of Puerto Rico’s fiscal planning.

In the spring of 2016, the late Governor Rafael Hernandez Colon visited me at the U.S. Treasury, accompanied by former Governor Anibal Acevedo Vila, to voice his opposition to Promesa. To me, the technical merits of the law were clear: Without it, there was no path to avert the cascading series of defaults and draconian cuts to essential government services that would ensue.

Yet as Hernandez Colon emphasized, Promesa’s technical merits weren’t what really mattered to the people of Puerto Rico. He spoke primarily of its “oversight” provisions creating a federally appointed board to negotiate the restructuring of the debt and oversee the island’s finances. He saw this as an affront to his life’s work of preserving the commonwealth, whereby Puerto Rico, by its own constitution, is “a state that is free of superior authority in the management of its own local affairs but which is linked to the United States.”

Promesa essentially overrode this clause. In order to withstand inevitable challenges from creditors in federal courts, the law relies on Article 4 of the U.S. Constitution, which defines the island as a territory or “possession” and, while the full scope of its jurisdiction remains an unsettled matter, confers plenary authority over its affairs to the U.S. Congress. Hernandez Colon had come to Washington to state his opposition as a matter of principle. “It is the kind of thing over which wars are fought,” he said starkly. The meeting left a lasting impression and still requires an adequate response.

Promesa became law in a divided government, with a Democratic administration that sought debt restructuring for Puerto Rico and a Republican-controlled Congress more focused on controlling the island’s finances. A bipartisan compromise paired a powerful restructuring authority with an oversight board modeled on those created for New York and Detroit, giving it the ability to approve or, if necessary, revise the Puerto Rico legislature's budgets.

As predicted, creditors sought to have Promesa overturned. But in 2020, the Supreme Court held unanimously that the oversight board was legally constituted. In a concurring opinion, Justice Sonia Sotomayor nonetheless echoed Hernandez Colon's private remarks, lamenting the "freewheeling exercise of [federal] control" over the government of Puerto Rico.

To be free of the Oversight Board, Puerto Rico must have four consecutive years of balanced budgets according to GASB accounting rules and access to traditional municipal markets. Given its chronic delay in producing audited financial statements, that will take years to achieve.

Some may argue that the board is necessary to encourage much-awaited fiscal reform and transparency. But there has been little progress. And for all its good work on the commonwealth plan, the board's limited political legitimacy on the island has inhibited its ability to play the constructive, ongoing role for which it was designed.

The Oversight Board of New York, the Municipal Assistance Corporation, was founded in 1975 (when the city nearly went bankrupt) and didn't vote itself out of existence until 2008. Puerto Rico cannot afford to wait that long for its financial governance to be returned to duly elected officials.

True, Puerto Rico can now attract investment without the cloud of an ongoing bankruptcy proceeding, and the federal government can appropriate funds without fear that the money will flow to creditors, rather than the people of Puerto Rico. But current Governor Pedro Pierluisi is also right that "we still have a lot of work ahead of us."

The right response to Governor Hernandez Colon will be to allow the government of Puerto Rico to carry out that work, fully embracing the fiscal reforms, transparency initiatives and balanced budgets that will be necessary to avoid a second crisis. Congress should amend Promesa to sunset the board as soon as practical following confirmation of the final plan of adjustment.

No meaningful, lasting recovery is possible without the restoration of self-governance to the people of Puerto Rico.

Bloomberg Politics

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January 26, 2022

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