

# Puerto Rico: Is the Sovereign in or out of the Dollar Zone?

Claude D. Montgomery and Mark S. Kaufman<sup>1</sup> take us through a simplified review of Puerto Rico's Debt Crisis



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**O**n 1 July 2015, the Commonwealth of Puerto Rico published a report authored by former World Bank chief economist Anne O. Krueger analysing its bond and other public debt (“Krueger Report”).

The Krueger Report concludes Puerto Rico and its governmental enterprises owe \$73 billion to their bond creditors. Not surprisingly, the Krueger Report also concludes that the Caribbean island sovereign with a declining population of 3.5 million residents, a declining GNP of \$72 billion and trading activity closely linked to the US mainland cannot sustain its debt burden.<sup>2</sup> According to the Federal Reserve Bank of New York (“NY Fed”), Puerto Rico’s public debt burden is more than 100% of its GNP, even excluding any federal debt. As the NY Fed observed, “*Puerto Rico is a high debt jurisdiction relative to most of the United States...[and]...looks more like a nation than do any of the mainland states....*”<sup>4</sup>

## Sovereign debt

There are some striking similarities between the Greek debt crisis and the sovereign debt crisis of Puerto Rico. Both economies are tied by a common currency and through a voluntary political union to a much larger and stronger economy borders. Both also had long histories under the non consensual rule of foreign empires. Both have had ballooning debt obligations tied to strong currencies and no ability to cut prices or reduce relative costs through currency devaluations.

Fourteen years after joining the Eurozone, the Greek public debt burden has ballooned to €320 billion,<sup>5</sup> spread over 11 million citizens with a 2014 GDP estimated by the World Bank at \$237.6 billion.<sup>6</sup> As observed by the NY Fed, “*it is unlikely to be a coincidence that the other countries (excluding Japan and the United States) with debt levels as large as Puerto Rico’s are also members of a currency union that has run large structural deficits.*”

There are, however, significant differences between the two situations relating to sovereign status which limit the analytical usefulness of any direct analogy. Greece has been a recognised sovereign nation since 1830,<sup>8</sup> a member of the European Union since 1981,<sup>9</sup> and within the Eurozone since 2001.<sup>10</sup> By contrast, Puerto Rico has never been an independent sovereign nation. Its participation in the dollar zone arises from its status as a territory of the United States, initially acquired through a treaty with Spain ending the 1897 Spanish America War. The US Congress has declared all residents born in Puerto Rico after 1898 and all individuals born in Puerto Rico after 1941 to be US Citizens.<sup>11</sup> It was not until 1952, that the citizen residents of Puerto Rico voted to adopt a constitution accepting Puerto Rico’s role as part of the United States.<sup>12</sup>

Sixty three years later, Puerto Rico’s citizens have garnered a public debt burden that, according to the NY Fed is on the surface far higher than that of the residents of any other single state or territory.<sup>13</sup> The disconnect between public revenues and

public expenditures has been building rapidly since 2002. According to the NY Fed, sluggish revenue growth began in 2002 while government expenditures did not slow. Public expenditures doubled during the ten year period ending 2012, while government revenue only grew 45%.<sup>14</sup> On top of this, government pension liabilities have grown beyond mere crisis proportions, resulting in an average actuarial funding ratio of merely 8.5%.<sup>15</sup> Unfortunately, the private economy has not fared much better. The GNP has been on a downward trend since 2005,<sup>16</sup> overall investment has been falling steadily since 2005 and housing prices have not recovered since the bubble burst in 2007.<sup>17</sup> With classic paternalistic foresight, Congress phased out mainland manufacturing investment tax breaks by 2006 and eliminated the Commonwealth’s unique growth stimulant. That stimulus phase out coincided with the 2005-2013 oil price surge rendering the petroleum dependent Islands<sup>18</sup> trapped energy import losers and unable to pass on the variable cost increases.<sup>19</sup>

## Common ground

Like most sovereigns, including Greece, there is no recognised procedure for the Commonwealth or any state within the US to adjust its direct bond or other indebtedness. However, Puerto Rico’s citizens peculiarly lack the ability to authorise their insolvent municipalities and public enterprises to participate in federal bankruptcy court supervised municipal debt

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adjustment proceedings. In 1984, the US Congress expressly excluded the Commonwealth from such rights,<sup>20</sup> which exclusion was not regarded as political news.<sup>21</sup> Given the NY Fed's 2014 estimate that the Island's municipal and enterprise debt was \$39.4 billion or 55% of its total public debt,<sup>22</sup> the absence of that legislative ability is both economically and culturally significant.

### Good faith

For creditors, the distinction between the Commonwealth and its agencies and enterprises is quite important. Indebtedness authorised by the Commonwealth as general obligation ("GO") bonds is backed by the sovereign's "good faith and credit" under the Island's Constitution. GO bonds are subject to constitutional annual debt issuance and payment limitations, and appear entitled to a first priority on

expenditures in the event of budget shortfalls.<sup>23</sup> By contrast, agency debt may only be protected by identified revenue, if any. For example, the Government Development Bank of Puerto Rico is only an agency of the Commonwealth, but it issued over \$11 billion of debt between 2006 and 2014.<sup>24</sup> Other major Puerto Rico agency and enterprise issuers during that same time frame include: Employees Retirement System (\$2.95 billion); Puerto Rico Aqueduct and Sewer Authority (\$3.7 billion); Puerto Rico Electric Power Authority (\$7.6 billion); and Puerto Rico Highway and Transportation Authority (\$2.5 billion).<sup>25</sup>

At the bottom of the financial totem pole are the so called "moral obligation" or "budgetary appropriation" bonds. Such bonds are entirely dependent upon legislative enactment of spending authorisation. The Public Finance Corporation has issued such

bonds and skipped its August 2015 debt payment, because the Governor did not ask the legislature to appropriate any funds for the debt payment.<sup>26</sup>

### Civil rights

Puerto Rico's inability to access Chapter 9 is reflective of long running tensions within the Congress and the Judiciary regarding the US's relationship with its largest remaining territory.<sup>27</sup> The Spanish Treaty gave Congress the right to "determine the civil rights and political status of native inhabitants" of Puerto Rico,<sup>28</sup> and early on the US Supreme Court ruled only Congress could make the US constitution applicable to Puerto Rico, and its determination need only be rational.<sup>29</sup>

Some recent cases appear to assume that the US Constitution applies to all territory under the extended complete and total



**THERE ARE SOME STRIKING SIMILARITIES BETWEEN THE GREEK DEBT CRISIS AND THE SOVEREIGN DEBT CRISIS OF PUERTO RICO**





**TODAY, THE QUESTION OF PUERTO RICO'S ACCESS TO FEDERAL DEBT ADJUSTMENT PROCEDURES IS ONE OF SERIOUS LEGAL AND POLITICAL DEBATE**



control of the US, unless properly excluded by Congress.<sup>30</sup> Similar tensions lead to Puerto Rico's 2014 passage of its own legislation to permit restructuring of both Commonwealth and public enterprise debt, sponsored by its current Governor Alejandro Garcia Padilla. However, the US Court of Appeals in Boston unanimously ruled the Island's legislation was preempted by the federal bankruptcy legislation, which expressly precludes Puerto Rico's access to Chapter 9.<sup>31</sup> Notwithstanding unanimity in the result, one appellate judge questioned whether Congress' 1984 refusal to include Puerto Rico within the ambit of Chapter 9 lacked rationality and therefore was itself an unconstitutional exclusion of territorial citizens from the uniform application of the Bankruptcy Clause of the US Constitution.<sup>32</sup>

**Political debate**

Today, the question of Puerto Rico's access to federal debt adjustment procedures is one of

serious legal and political debate. The Republican controlled House of Representatives, with the ardent support of many in the US bondholder and mutual fund manager communities, appears opposed to any extension of Chapter 9 to Puerto Rico's public enterprises.<sup>33</sup> The current Democratic Administration through the Treasury Secretary Jacob Lew has decided to support the extension of Chapter 9 to Island municipalities.<sup>34</sup> Also, there appears to be growing support for the imposition of a federal review and financial oversight board with the power to make operating, tax and contract changes for both enterprises and perhaps the Commonwealth itself.<sup>35</sup>

These debates also reflect deep disagreements over whether tax increases and major public expenditure reductions (austerity in Greek debt debate terms) or the return of targeted tax incentives and economic growth combined with enhanced infrastructure investment are necessary preconditions to sustainability of

debt repayment.

In response to the Krueger Report, a former IMF Deputy Director published a report putting forward a classic austerity plan.<sup>36</sup> Citing IMF statistics showing significant GDP growth in the years following fiscal deficit reductions equating to 2% or more of a country's GDP<sup>37</sup>, the Centennial Report argues for (a) fiscal reform by increasing property taxes, increasing personal income taxes, increasing sales and use taxes (b) reduced government expenditures by reducing the number of teachers to reflect declining enrollments, reducing subsidies to University of Puerto Rico and reducing government health care benefits for the poor.<sup>38</sup> The Centennial Report argues, that its projected \$5 to 6.5 billion of annual benefits from such changes could lead to fiscal surpluses. If combined with structural business registration and labor law reforms the plan would stimulate growth and avoid debt relief with continued access to the credit markets.<sup>39</sup>

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### Greek drama?

There are many sophisticated and well funded players in the Puerto Rico drama on all sides of every issue. The drama sounds Greek in nature: austerity versus democracy, capital vs. people and above all what is the meaning of shared sacrifice? With the Administration firmly in the “no bailout” camp, but favouring Island access to Chapter 9 for enterprises, creditor oversight of Puerto Rico’s independently minded and pro debt relief Governor is possible. But only a Delphic Oracle would know which bonds will be exchanged for less than par and where all of this tragedy will end. ■

#### Footnotes:

- 1 Claude D. Montgomery and Mark S. Kaufman are partners in Dentons US LLP respectively residents in the firm’s New York and San Francisco offices. The authors’ views expressed in this article are strictly their own and are not those of Dentons or any of its clients.
- 2 *Krueger Report* at 3.
- 3 *An Update on the Competitiveness of Puerto Rico’s Economy*, Federal Reserve Bank of New York (July 31, 2014) (*Update* at 16).
- 4 *Update* at 17.
- 5 <http://www.bbc.com/news/world-europe-33407742>
- 6 <http://data.worldbank.org/country/greece>
- 7 *Update* at 19.
- 8 London Protocol of 3 February 1830, <http://www.kingscollections.org/exhibitions/specialcollections/greece/british-involvement-in-the-war/london-protocol>
- 9 [http://europa.eu/about-eu/countries/member-countries/greece/index\\_en.htm](http://europa.eu/about-eu/countries/member-countries/greece/index_en.htm)
- 10 *Id.*
- 11 8 U.S.C. §1402
- 12 Act of July 3, 1952, 66 Stat. 327. See also, *Torres v. Puerto Rico*, 431 U.S. 465 (1979)
- 13 *Update* at 16.
- 14 *Update* at 18.
- 15 *Update* at 18.
- 16 *Krueger* at 3.
- 17 *Krueger* at 5.
- 18 <http://www.eia.gov/state/analysis.cfm?sid=RQ>
- 19 *Krueger* at 6
- 20 The Bankruptcy Amendment and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333
- 21 “The term municipality... does not include the District of Columbia or any territories of the United States.” S. Rep. 95-989, 95th Cong 2d Sess. 25 (1978).
- 22 *Update* at 16.
- 23 See, Puerto Rico Constitution, Article VI, section 7.
- 24 Quarterly Report, Government Development Bank of Puerto Rico, [http://www.gdbpr.com/investors\\_resources/government\\_development\\_bank.html](http://www.gdbpr.com/investors_resources/government_development_bank.html)
- 25 *Id.*
- 26 <http://www.gdbpr.com/documents/GDBStatePaymentofPFCBonds080315.pdf>
- 27 Except for the original thirteen colonies which formed the United States in 1784[?], all other US states were once US territories. The Philippines is the only former US Territory to become an independent republic.
- 28 Art II, *Treaty of Paris*, 30 Stat. 1754 (1899).
- 29 *E.g., Downes v. Bidwell*, 182 U.S. 244 (1901).
- 30 *Bonmedianne v. Bush*, 553 U.S. 723 (2008).
- 31 *Franklin California Tax Free Trust v. Commonwealth of Puerto Rico*, --F.3rd.-- (Slip Op. July 6, 2015).
- 32 *Franklin v. Puerto Rico*, --F.3rd.-- (Slip Op. at 51-52)
- 33 [http://judiciary.house.gov/index.cfm/press-releases?ContentRecord\\_id=73F4990C-4D3D-4BD8-B360-D642875054AC](http://judiciary.house.gov/index.cfm/press-releases?ContentRecord_id=73F4990C-4D3D-4BD8-B360-D642875054AC)
- 34 Letter dated July 28, 2015 to Senator Orin Hatch from Treasury Secretary Jacob Lew. 1
- 35 *Puerto Rico in Perspective*, National Public Finance Guarantee (August 10, 2015) (“NGFP” at 12)
- 36 Centennial Group International Report dated July 2015 by Joel Faigenbaum (“Centennial Report”).
- 37 *Centennial Report* at 13.
- 38 *Centennial Report* at 5-6
- 39 *Centennial Report* at 5-6



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