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# **Puerto Rico's Current Fiscal Challenges: In Brief**

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## Summary

The government of Puerto Rico faces multiple fiscal challenges in coming weeks and months. Concerns regarding the sustainability of Puerto Rico's public finances have intensified over the past year, despite several measures taken by the island's government to reduce spending, increase revenues, and restructure its obligations.

Puerto Rico faces several fiscal hurdles in 2015. Puerto Rico's publicly owned electric utility faces a \$416 million debt service payment due on July 1. The island's central government also faces substantial debt service costs. The Puerto Rican government, which has faced major liquidity challenges in recent years, recently warned that it may "lack sufficient resources to fund all necessary governmental programs and services as well as meet debt service obligations for fiscal year 2016," although it had contended that it has sufficient funds available.

The Puerto Rican government, either directly or through financing arms, has been able to issue bonds, but on relatively expensive terms. The island's ability to meet debt service payments depends in part on the willingness of investors to roll-over existing debt. A \$2.9 billion bond sale, which the Puerto Rican government had contemplated, appears to be on hold. The island's ability to access credit markets appears highly uncertain.

A June 29, 2015, *New York Times* article quoted Puerto Rico's Governor Alejandro García Padilla as stating that "the debt is not payable" and that his Administration would seek concessions from the island's creditors. Governor García Padilla delivered a televised address on the same day, in which he outlined a new fiscal strategy.

The precarious state of Puerto Rico's public finances stems in part from prolonged economic weakness. Economic growth has been sluggish even before the 2007-2009 recession and official forecasts project a continuation of slow growth. Previous analyses have pointed to low employment and labor participation rates, high rates of outmigration leading to a decline in population, an economic structure shaped more by tax advantages than comparative advantages, and the effects of intensified global competition, among other factors.

This report will be updated as events warrant.

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## Puerto Rico's Weak Fiscal Situation

Since mid-2013, serious concerns emerged in municipal bond markets and among other observers regarding financial challenges facing Puerto Rico. An August 2013 *Barron's* article highlighted the island's weak fiscal position and high public debt.<sup>1</sup> In February 2014, the three major credit ratings agencies downgraded Puerto Rico's public debt to below investment grade.<sup>2</sup> A second round of downgrades followed after the Puerto Rican government enacted Act 71 on June 28, 2014, which sought to establish a process for restructuring of debt issued by the island's public corporations.<sup>3</sup> **Figure 1** shows trading prices for selected Puerto Rican bonds since January 2011. The first vertical line indicates when the *Barron's* article appeared, and the second vertical line indicates when Act 71 was enacted.

Puerto Rico's public debt has grown steadily since the mid-1980s, and is now slightly larger than the island's gross national product (GNP).<sup>4</sup> **Figure 2** shows the accumulation of Puerto Rico's gross public debt since 1962. The governor of Puerto Rico, Alejandro García Padilla, according to a *New York Times* article, stated that "the debt is not payable" and that his Administration would seek concessions from the island's creditors.<sup>5</sup> The appearance of that article coincided with the release of a report written by three former International Monetary Fund (IMF) economists, which described serious problems with Puerto Rico's fiscal situation, budget execution, public administration, and tax structure.<sup>6</sup> The Puerto Rican government now appears to face serious liquidity challenges over the summer, which are described in more detail below.

<sup>1</sup> Andrew Bary, "Troubling Winds: Puerto Rico's Huge Debt Could Overwhelm Attempts to Revive its Economy," *Barron's*, August 26, 2013.

<sup>2</sup> Commonwealth of Puerto Rico, *Consolidated Annual Financial Report for FY2013*, June 30, 2013, note 22, pp. 230-231; [http://www.hacienda.gobierno.pr/downloads/pdf/cafr/FINANCIAL\\_REPORT\\_2013.pdf](http://www.hacienda.gobierno.pr/downloads/pdf/cafr/FINANCIAL_REPORT_2013.pdf).

<sup>3</sup> Ley para el Cumplimiento con las Deudas y para la Recuperación de las Corporaciones Públicas de Puerto Rico (Ley 71 de 2014; Act 71; Law Pursuant to the Debts and for the Recovery of the Public Corporations of Puerto Rico). The law has also been referred to as the "Recovery Act" or the "Local Bankruptcy Law" (Ley de Quiebra Criolla), even though its text states that it is not a bankruptcy act. See also Moody's Investor's Service, "Puerto Rico's Debt Restructuring Law Raises Default Risk for Public Corporations and the Commonwealth," July 3, 2013.

<sup>4</sup> Puerto Rico's gross public debt was reported at \$72.2 billion at the end of March 2015. GNP estimates for FY2015 are not yet available, but FY2014 GNP was projected to be \$69.2 billion. See GDB, *Commonwealth Quarterly Financial Report*, May 7, 2015, p.56; <http://www.gdb-pur.com/documents/CommonwealthQR-5-7-15.pdf>. Also see *Statistical Appendix (Apéndice Estadístico) of the Economic Report to the Governor and the Legislature for FY2014*; [http://www.jp.gobierno.pr/Portal\\_JP/Default.aspx?tabid=184](http://www.jp.gobierno.pr/Portal_JP/Default.aspx?tabid=184).

<sup>5</sup> Michael Corkery and Mary Williams Walsh, "Puerto Rico's Governor Says Island's Debt Are 'Not Payable,'" *New York Times*, June 28, 2015, p. A1; <http://www.nytimes.com/2015/06/29/business/dealbook/puerto-ricos-governor-says-islands-debts-are-not-payable.html>.

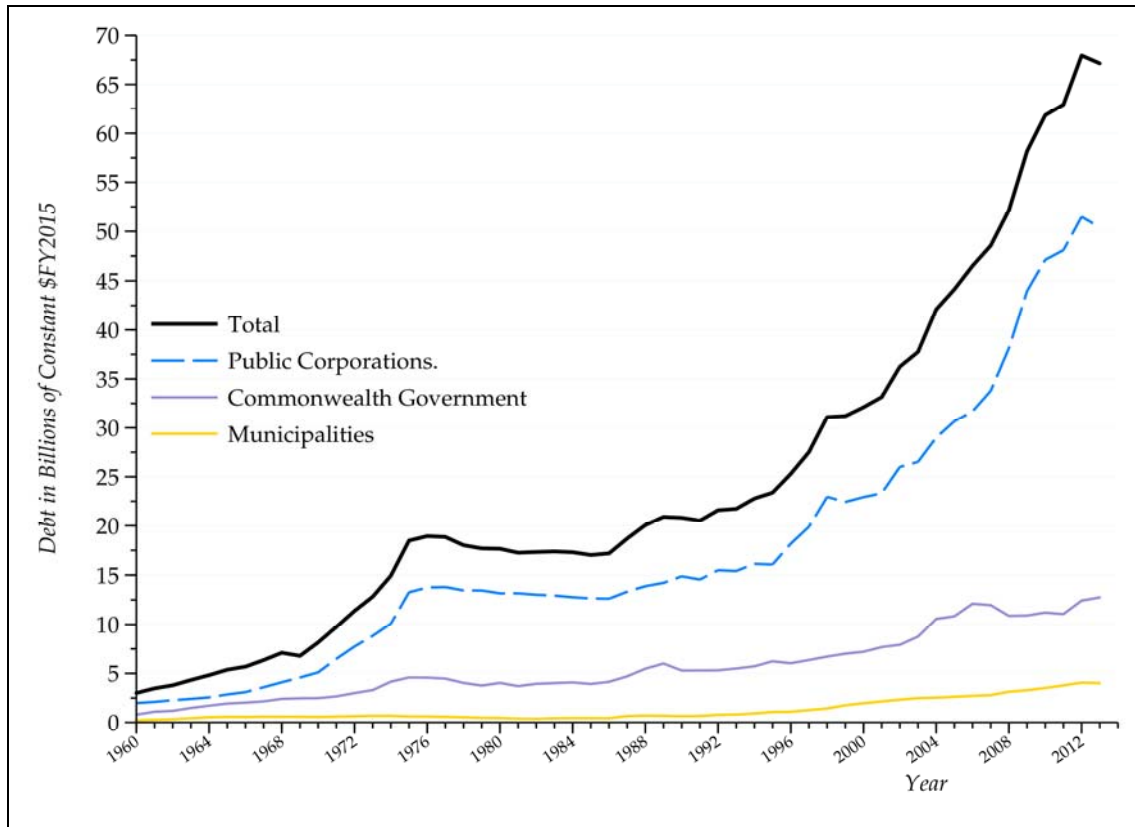
<sup>6</sup> Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, *Puerto Rico: A Way Forward*, June 29, 2015; <http://recend.apextech.netdna-cdn.com/docs/editor/Informe%20Krueger.pdf>.

**Figure I. Selected Puerto Rico Bonds; Dollar Prices Since January 2011**



**Source:** Electronic Municipal Market Access, Municipal Securities Rulemaking Board.

**Notes:** Legacy General Obligation bond is CUSIP 74514LYW1 (5.75%; 2041); NY law GO bond issued March 2014 is 74514LE86 (8.0%; 2035). COFINA Senior Note is CUSIP 74529JNX9 (5.25%; 2040); COFINA Subordinated Note is CUSIP 74529JHN8 (6.0%; 2042). Puerto Rico Electric Power Authority Revenue Bond is CUSIP 74526QVX7 (5.25%; 2040). First vertical line indicates appearance of Barron's article (August 20, 2013); second vertical line at enactment of Act 71 (July 28, 2014). COFINA issues revenue anticipation securities to provide liquidity to the Puerto Rican government.

**Figure 2. Gross Public Debt of Puerto Rico in Billions of Constant Dollars, 1960-2014**

**Source:** Statistical Appendix (*Apéndice Estadístico*), various years; available at [http://www.jp.gobierno.pr/Portal\\_JP/Default.aspx?tabid=184](http://www.jp.gobierno.pr/Portal_JP/Default.aspx?tabid=184).

**Notes:** Data represent gross public debt of Puerto Rico as of June 30 of each year, provided by the Government Development Bank of Puerto Rico. Figures for 1989 and 2014 are preliminary estimates. The Highway and Transportation Authority and the University of Puerto Rico are included in the Commonwealth Government subtotal. The U.S. GDP price index is used to adjust levels for inflation. These debt data differ from those available from other sources.

## Public Corporations Incurred Much of Puerto Rico's Public Debt

Public corporations, which have played a prominent role in the Puerto Rican economy since the 1930s, are closely linked to the island's fiscal challenges. Some 50 public corporations serve a broad variety of purposes and activities, ranging from public infrastructure, banking, real estate, insurance, industrial development, health care, transportation, electric power, broadcasting, education, arts, and tourism, among others.<sup>7</sup> Off-budget debt issued by public corporations,

<sup>7</sup> For one listing of public corporations, see Commonwealth of Puerto Rico, *Budget Proposal for 2013-2014*, Consolidated Budget by Agency for FY2011-FY2014 (Estado Libre Asociado de Puerto Rico, *Presupuesto Recomendado 2013-2014*, Presupuesto Consolidado por Agencia); <http://www2.pr.gov/presupuestos/Presupuesto2013-2014/Tablas%20Estadsticas/04.pdf>.

generally not included in the 15% debt servicing limit, has accounted for much of the buildup in Puerto Rico's public debt since 2000 (see **Figure 2**).<sup>8</sup> Moreover, the central government's financial support for public corporations has weakened its own fiscal situation.

The largest public corporation in Puerto Rico, the Puerto Rico Electric Power Authority (PREPA), entered into a restructuring agreement in August 2014 with major creditors.<sup>9</sup> PREPA faces a bond interest payment of \$416 million on July 1, 2015, which may present serious liquidity challenges.<sup>10</sup> PREPA issued a summary of a restructuring plan on June 1, 2015, which calls for \$2.3 billion to modernize its operations and stabilize its finances.<sup>11</sup> Independent analysts argue that a few other large public corporations are insolvent.<sup>12</sup>

## Short-Term Challenges

The government of Puerto Rico faces multiple immediate fiscal challenges. Several large debt payments are due from the island's central government and from public corporations that present serious liquidity challenges. The Puerto Rican legislature approved a FY2016 budget, which was then sent to the governor, which reportedly sets aside \$1.5 billion for debt service costs. How the restructuring initiative announced by Governor García Padilla on June 29, 2015, will affect the island's debt servicing is unclear at present.

Governor García Padilla had submitted a FY2016 budget that called for major decreases in public spending, and aimed at achieving a balanced budget.<sup>13</sup> The island's lower chamber passed a budget on June 22, 2015, and the Senate passed its version on June 25, 2015.<sup>14</sup> A measure reported by a conference committee was approved by both chambers on June 29, 2015.<sup>15</sup> Senate President Eduardo Bhatia was quoted as stating that "it is one of the most difficult budgets in the history of Puerto Rico."<sup>16</sup>

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<sup>8</sup> See FY2013 *Economic Report to the Governor, Statistical Appendix*, Table 29; [http://www.gdbpr.com/economy/documents/AE2013\\_T29.pdf](http://www.gdbpr.com/economy/documents/AE2013_T29.pdf).

<sup>9</sup> Government Development Bank, *Forbearance Agreement: Executive Version*, August 14, 2014; <http://www.gdbpr.com/documents/BondholderForbearanceAgreementEXECUTED.pdf>.

<sup>10</sup> Edward Krudy, "Puerto Rico's PREPA Upset with Creditors After Disclosure of Finance Plan," Reuters, April 1, 2015; <http://www.reuters.com/article/2015/04/02/usa-puertorico-prepa-idUSL2N0WZ05520150402>.

<sup>11</sup> PREPA, "PREPA's Transformation" A Path to Sustainability," June 1, 2015; <http://www.aeepr.com/Docs/RecoveryPlan.pdf>. Also see Michelle Kaske, "PREPA Submits Recovery Plan as Creditors Say Talks Continue," Bloomberg Business, June 1, 2015 (updated June 2, 2015). Financial details of the restructuring plan were withheld pending negotiations with creditors.

<sup>12</sup> Center for a New Economy, *Fiscal Situation Update, FY2014-2015 Budget*, June 2014.

<sup>13</sup> "Puerto Rico Gov Files \$9.8B Budget That Calls for Deep Cuts," Associated Press, May 20, 2015; <http://www.nytimes.com/aponline/2015/05/20/world/americas/ap-cb-puerto-rico-economy.html>. See also the Puerto Rican Governor's *Recommended Budget* (Presupuesto Recomendado 2015-2016); <http://www2.pr.gov/presupuestos/Presupuesto2015-2016/Pages/default.aspx>.

<sup>14</sup> Michelle Kaske and Ezra Fieser, "Puerto Rico's Senate Passes 2016 Budget in Preliminary Vote," *Bloomberg Business*, June 25, 2015; <http://www.bloomberg.com/news/articles/2015-06-25/puerto-rico-s-senate-approves-2016-budget-in-preliminary-vote>.

<sup>15</sup> La Resoluciones Conjunta de la Cámara 747 and 748. See *El Nuevo Día*, "Ajustan Presupuesto Ante Escenario de Renegociación de la Deuda," June 30, 2015; <http://www.elnuevodia.com/noticias/politica/nota/ajustanpresupuestoanteescenarioderenegociaciondeladeuda-2066681/>.

<sup>16</sup> Luis J. Valentín, "Puerto Rico House, Senate Seek Consensus on Final Budget Plan," *Caribbean Business*, June 28, (continued...)



Whether the FY2016 budget for Puerto Rico would actually achieve a balanced budget is unclear. The report of the ex-IMF economists stresses that the structural budget deficit, according to their estimates, is larger than other measures of budget balance used by the Puerto Rican government.<sup>17</sup> A structural budget deficit excludes effects of one-time budget adjustments or cyclical economic effects. That report estimates annual interest and principal costs at \$2.8 billion.

The finances of Puerto Rico's public corporations present another major challenge. The island's publicly owned electric power utility has been negotiating with creditors since August 2014, while certain debt payments have been stayed by a series of forbearance agreements. The current agreement runs through June 30, 2015.<sup>18</sup> The power utility, like the island's central government, faces large debt payments in the summer of 2015 that may be difficult to make and create strong liquidity pressures on public finances.

The island's ability to meet debt service payments depends in part on the willingness of investors to roll over existing debt. The report of the ex-IMF economists asserted that the island was "now virtually shut off from normal [credit] market access."<sup>19</sup> Puerto Rico had planned to issue about \$2.9 billion in bonds in 2015, but those plans were put on hold. The García Padilla Administration reportedly wanted to prepare the way for that bond issue with a fiscal package consisting of a tax reform to bolster revenues, a balanced budget for FY2016, and a five-year plan to achieve fiscal sustainability.<sup>20</sup> The Puerto Rican legislature passed a measure to allow certain public corporations to issue revenue bonds, which may provide some measure of liquidity.<sup>21</sup>

According to recent estimates, Puerto Rico's government debt servicing costs—apart from debt servicing costs of public corporations—are 13.8% of average annual internal revenues for the past two years, not far below the 15% limit imposed by the Commonwealth's Constitution.<sup>22</sup> If that limit became binding, maintaining operations of the government could then require either further fiscal adjustments or a constitutional amendment, which would require supermajorities in both legislative chambers and a plebiscite.

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2015; <http://www.caribbeanbusiness.pr/news/puerto-rico-house-senate-seek-consensus-on-final-budget-plan-112726.html>.

<sup>17</sup> Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, *Puerto Rico: A Way Forward*, June 29, 2015, pp. 11-12.

<sup>18</sup> Joanisabel González, "Acreedores Darian Otra Oportunidad a la AEE (Creditors Will Give PREPA Another Chance)," *El Nuevo Día*, June 18, 2015; <http://www.elnuevodia.com/negocios/finanzas/nota/acreedoresdarianotraoportunidadalaaee-2062171/>.

<sup>19</sup> Krueger, Teja, and Wolfe, op. cit., p. 1.

<sup>20</sup> The bonds would have been issued through the Puerto Rico Infrastructure Financing Authority (PRIFA). See Thomas McLoughlin and Kristin Stephens, "Puerto Rico Credit & Market Update," *UBS Municipal Brief*, December 15, 2014; Robert Slavin, "Puerto Rico Gov. Lacks Budget for Annual Speech," *Bond Buyer*, April 28, 2015; GDB, "Government Development Bank for Puerto Rico Comments on Enactment of Act 29 of 2015," March 17, 2015; <http://www.gdbpr.com/documents/GDBCommentonAmendment.pdf>.

<sup>21</sup> Petición de la Cámara 2542 was passed by both chambers on June 29, 2015.

<sup>22</sup> Commonwealth of Puerto Rico, *Financial Information and Operating Data Report*, October 30, 2014. Estimates of debt servicing costs are for July 31, 2014.

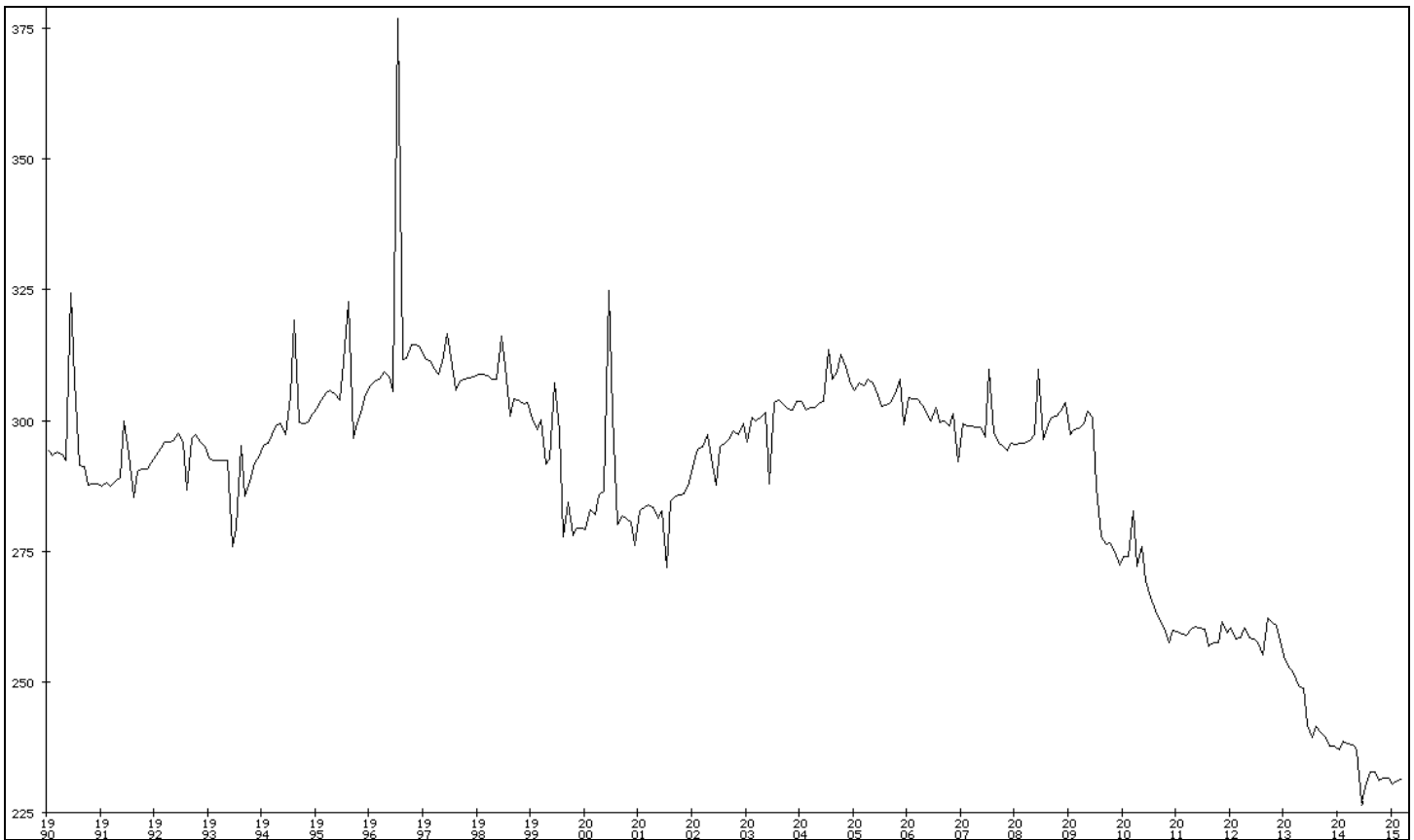


## Initiatives to Address Fiscal Challenges

Puerto Rico's government has taken numerous steps over the past few years to realign revenues and outlays, although those efforts have not closed the structural budget deficit. Those measures include cutbacks to public pension systems, tax increases and tax administration reforms, and a reduction in public sector employment. **Figure 3** shows trends in public sector employment in Puerto Rico since 1990. Since 2009, public sector employment has dropped by nearly a fifth.

**Figure 3. Government Employment in Puerto Rico, 1990-2015**

Thousands of Persons, Seasonally Adjusted



**Source:** Department of Labor, Bureau of Labor Statistics, series SMS72000009000000001.

**Notes:** Vertical axis scaled to show variation as clearly as possible. Y-axis begins at 225,000 persons.

Other fiscal austerity measures include reorganization of public school teaching staffs and school closings, cancellation or postponement of salary and benefit increases, and reductions in transfers to municipalities.<sup>23</sup> The government has also taken steps to bolster the financial condition of its public corporations.

<sup>23</sup> Center for a New Economy, *Fiscal Situation Update: Analysis of the Governor's Budget Request for FY2015*, pp. 9- (continued...)

On May 26, 2015, the Legislative Assembly passed and sent to the governor a measure to raise the sales and use tax rate from 7% to 11.5%. Of that rate, 1% is earmarked for local governments.<sup>24</sup> In addition, the measure would establish a Consumption Tax Transformation Alternatives Commission,<sup>25</sup> which would be charged with evaluating further changes in Puerto Rico's tax system, including a possible transition to a value-added tax (VAT). Previously, a proposal to replace certain sales taxes with a value-added tax was voted down on April 30, 2015.<sup>26</sup> Puerto Rico had enacted Act 1 on January 15, 2015, which raised petroleum taxes, contingent on implementation of broader tax changes, and took other measures to strengthen the financial condition of the Authority for Highways and Transportation.<sup>27</sup>

## Fiscal Strategy and Outmigration

The precarious state of Puerto Rico's public finances stems in part from prolonged economic weakness. Economic growth was sluggish even before the 2007-2009 recession, and official forecasts project continued slow growth. Previous analyses of the growth of Puerto Rico's economy have pointed to low employment and labor participation rates, an economic structure shaped more by tax advantages than comparative advantages, and the effects of intensified global competition.<sup>28</sup>

Those trends and associated economic challenges have prompted many Puerto Ricans to move to the U.S. mainland, leading to population decline of about 1% per year over the past decade.

**Figure 4** shows estimated trends for Puerto Rico's resident population since 1950. One study estimated that a third of those born on Puerto Rico now reside on the mainland and found that migrants tended to be younger and less well educated compared to island population averages.<sup>29</sup>

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<sup>24</sup> Luis J. Valentín, "Tax Bill Approved by Legislature, Awaits Governor's Signature," *Caribbean Business*, May 27, 2015; <http://www.caribbeanbusinesspr.com/news/tax-bill-approved-by-legislature-awaits-governors-signature-110958.html>. The sales and use tax is also known as IVU, an acronym of Impuesto de Ventas y Uso.

<sup>25</sup> Comisión de Alternativas para Transformar el Impuesto al Consumo (CATIC).

<sup>26</sup> Ibid. and Gustavo Vélez, "La Nueva Ruta Sin el IVA (The New Path Without the VAT)," blog post, May 5, 2015; <http://www.economiapr.com/la-nueva-ruta-sin-el-iva/>. Also see Ernst and Young, "Puerto Rico House of Representatives Votes Down Proposed VAT Bill by Narrow Margin," May 7, 2015; also see [http://www.ey.com/Publication/vwLUAssets/Puerto\\_Rico\\_House\\_of\\_Representatives\\_votes\\_down\\_proposed\\_VAT\\_bill\\_by\\_narrow\\_margin/\\$FILE/2015G\\_CM5431\\_Indirect\\_PR%20House%20of%20Representatives%20votes%20down%20proposed%20VAT%20bill%20by%20narrow%20margin.pdf](http://www.ey.com/Publication/vwLUAssets/Puerto_Rico_House_of_Representatives_votes_down_proposed_VAT_bill_by_narrow_margin/$FILE/2015G_CM5431_Indirect_PR%20House%20of%20Representatives%20votes%20down%20proposed%20VAT%20bill%20by%20narrow%20margin.pdf). The measure was House Bill 2329 (Para crear la "Ley de Transformación al Sistema Contributivo del Estado Libre Asociado de Puerto Rico" (For the creation of a Law for the Transformation of the Contributive System of the Commonwealth of Puerto Rico).

<sup>27</sup> Eduardo San Miguel Tió, "Puerto Rico Governor Signs Petroleum-tax Increase into Law," *Caribbean Business*, January 15, 2015; <http://www.caribbeanbusiness.pr/news/puerto-rico-governor-signs-petroleum-tax-increase-into-law-103300.html>. The act also authorizes certain bond issues. Text of the law is available at [http://www.oslpr.org/legislatura/tl2013/tl\\_medida\\_print2.asp?r=P%20C2212&ult=1](http://www.oslpr.org/legislatura/tl2013/tl_medida_print2.asp?r=P%20C2212&ult=1).

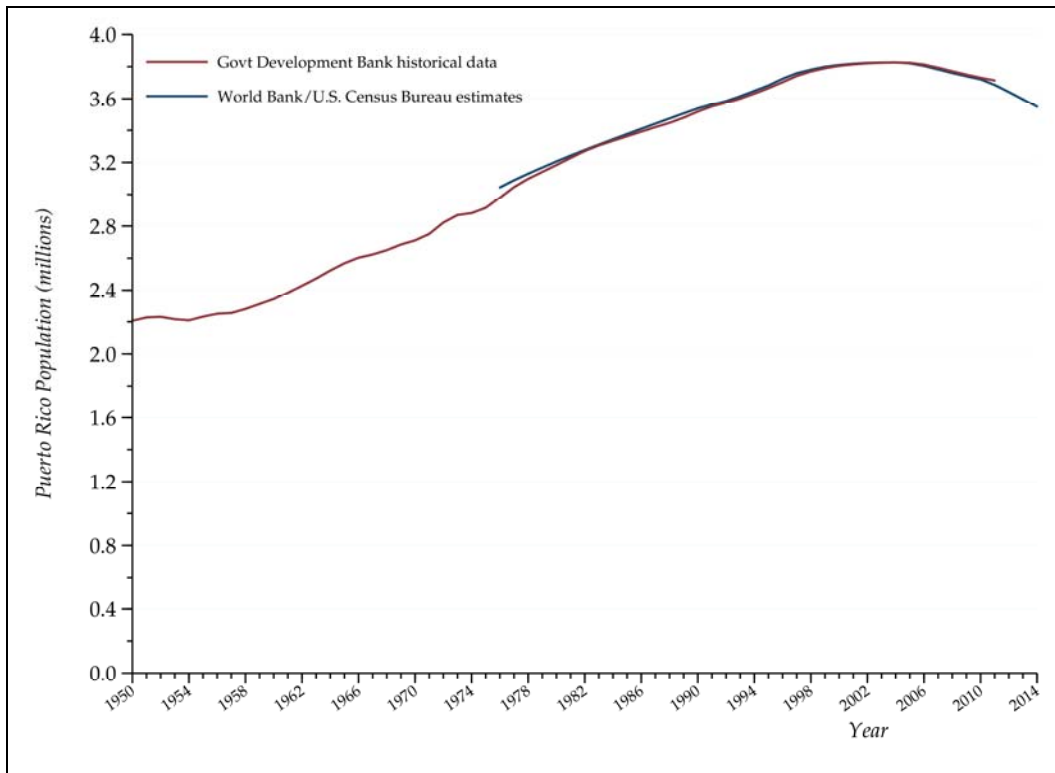
<sup>28</sup> Barry Bosworth and Susan M. Collins, "Economic Growth," in Susan M. Collins, Barry P. Bosworth, and Miguel A. Soto-Class, eds., *The Economy of Puerto Rico: Restoring Growth* (Brookings: Washington, DC, 2006), pp. 17-81; Federal Reserve Bank of New York, *Report on the Competitiveness of Puerto Rico's Economy*, 2012. Available in English at <http://www.newyorkfed.org/regional/puertorico/index.html>.

<sup>29</sup> Jaison R. Abel and Richard Deitz, "Population Lost: Puerto Rico's Troubling Out-Migration," Liberty Street Economics, New York Federal Reserve Bank, April 13, 2015; <http://libertystreeteconomics.newyorkfed.org/2015/04/population-lost-puerto-ricos-troubling-out-migration.html>.

Economic growth depends on productivity and the availability of resources such as capital and labor. By reducing the amount of labor available to the island economy, outmigration poses risks to future economic growth. Moreover, outmigration serves as a signal that some island residents perceive that the mainland presents more attractive economic opportunities.

**Figure 4. Puerto Rico Resident Population Trends**

Estimates from 1950 through 2014



**Source:** U.S. Census Bureau, World Bank, and Government Development Bank.

**Notes:** U.S. Census Bureau population estimates are for July 1 of each year.

## Potential Issues for Congress

Possible options for Congress to address the fiscal distress faced by the government of Puerto Rico and its constituent public corporations are framed by the island's status as a territory—something different than a state and different from an independent sovereign country.<sup>30</sup> The federal government has generally been reluctant to offer direct financial assistance to individual states in fiscal distress, although Congress has at times adjusted technical parameters of existing federal programs to provide direct or indirect support for states.<sup>31</sup> The independence of state

<sup>30</sup> For details, see CRS In Focus IF10241, *Puerto Rico: Political Status and Background*, by R. Sam Garrett; or CRS Report R42765, *Puerto Rico's Political Status and the 2012 Plebiscite: Background and Key Questions*, by R. Sam Garrett.

<sup>31</sup> Jonathan A. Rodden, *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism* (New York: Cambridge, 2006). Support for state governments and territories was included in the American Recovery and Reinvestment Act (continued...)

governments to determine their own fiscal paths has been linked to an expectation that those governments take responsibility for the consequences of their fiscal decisions. In some other fiscal systems, the willingness of a central government to cover shortfalls by state governments has been seen as having led to less prudent fiscal behavior. In some federal systems, the central government provides subnational governments with more support, but imposes more intrusive fiscal controls.

The Obama Administration has indicated that it is not contemplating a federal bailout of Puerto Rico, but has provided technical support and has sought to make existing federal resources available.<sup>32</sup> The report of the former IMF economists was framed in terms familiar to typical IMF interventions, in which short-term bridge financing is provided conditional on agreements with governments to address structural economic issues over a longer term.<sup>33</sup> Congressional options might thus be divided between strategies to address imminent liquidity challenges, such as providing credit support or altering bankruptcy laws, and strategies intended to promote economic growth over the longer term.

## Credit Support

Central governments and international organizations have at times stepped in to backstop debts of other governments to lower those governments' borrowing costs. Such support typically has been linked to budgetary or structural reform requirements. For example, the European Central Bank in 2011 acted to support debt offered by Eurozone countries, which dramatically lowered borrowing costs of countries that could have faced severe liquidity challenges.<sup>34</sup> The U.S. government provided credit guarantees for the Mexican government in 1994-1995.<sup>35</sup> The U.S. government also provided indirect credit support for many state government agencies through the Depression-era Reconstruction Finance Corporation (RFC). For instance, in 1941 the RFC acted as an intermediary to roll over \$136 million in debt for the State of Arkansas.<sup>36</sup>

## Federal Health and Income Support Programs

Reimbursement and eligibility rules for federal entitlement programs in Puerto Rico often differ from those in effect on the mainland. Congress could revise those reimbursement rules and eligibility standards.

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(ARRA; P.L. 111-5).

<sup>32</sup> White House Press Briefing, June 29, 2015; <http://www.c-span.org/video/?326821-1/white-house-briefing>.

<sup>33</sup> Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, *Puerto Rico: A Way Forward*, June 29, 2015, pp. 25-26.

<sup>34</sup> See CRS Report R42377, *The Eurozone Crisis: Overview and Issues for Congress*, coordinated by Rebecca M. Nelson.

<sup>35</sup> Joseph A. Whitt, Jr., "The Mexican Peso Crisis," *Federal Reserve Bank of Atlanta Economic Review*, January/February 1996, [https://www.frbatlanta.org/filelegacydocs/J\\_whi811.pdf](https://www.frbatlanta.org/filelegacydocs/J_whi811.pdf).

<sup>36</sup> Jesse H. Jones, *Fifty Billion Dollars: My Thirteen Years with the RFC* (New York: Macmillan, 1951), p. 179.

## Restructuring and Bankruptcy

Under current law, Puerto Rico is generally considered a state for most provisions of the Bankruptcy Code; but it is explicitly excluded from that definition for purposes of determining those eligible to file under chapter 9, which sets out a process for consideration of debt relief requests of instrumentalities of state governments.<sup>37</sup> Thus, subunits of Puerto Rico, such as those public corporations, are barred from filing under chapter 9.

The restructuring law that Puerto Rico enacted in June 2014, which was in part motivated by the financial situation of PREPA and other public corporations, was established with the aim of providing an alternative to processes provided by the Bankruptcy Code. That law, however, was struck down by a U.S. District Court.<sup>38</sup> That decision was appealed to U.S. Court of Appeals for the 1<sup>st</sup> Circuit.<sup>39</sup>

Congress could amend the Bankruptcy Code to remove this exclusion, thus enabling the Puerto Rican government to allow its municipalities or other instrumentalities to file applications, and thus enter a well-established process for restructuring public debts. Resident Commissioner Pierluisi introduced H.R. 870 on March 16, 2015, which would allow Puerto Rico access to chapter 9.<sup>40</sup> Governor García-Padilla has also called for giving Puerto Rico access to chapter 9.<sup>41</sup> Some hedge funds and other holders of Puerto Rican bonds, however, have opposed including the island in chapter 9.<sup>42</sup>

## Structural Reforms in the Medium and Long Term

Congress could also encourage the Puerto Rican government to pursue economic development strategies more in line with the island's economic comparative advantages rather than its tax advantages. Puerto Rico has long relied on special provisions in the U.S. tax code and in its own tax laws to stimulate investment. Many of the tax advantages available to corporations or subsidiaries located in Puerto Rico, such as Internal Revenue Code Section 936, which until it was phased out between 1996 and 2005, essentially exempted income of U.S. firms operating in U.S. possessions, have reduced the U.S. Treasury's receipts.<sup>43</sup> At present, the IRS's unwillingness to challenge the creditability of Puerto Rico's Act 154 taxes against U.S. tax liability provides

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<sup>37</sup> 11 U.S.C. §101(52). Also see CRS Legal Sidebar WSLG1289, *Fiscal Distress in Puerto Rico: Two Legislative Approaches*, by Carol A. Pettit.

<sup>38</sup> The consolidated cases are *Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico* and *BlueMountain Capital Management, LLC v. García-Padilla* (case 3:14-cv-01569). The February 6, 2015, opinion and order is here: <http://www.noticel.com/uploads/gallery/documents/ed648d7e7839c5b66e556b14d3c639b3.pdf>.

<sup>39</sup> Matthew Perlman, *Puerto Rico Asks 1<sup>st</sup> Circ. to Revive Restructuring Law*, *Law360*, April 30, 2015; <http://www.law360.com/articles/650201/puerto-rico-asks-1st-circ-to-revive-restructuring-law>.

<sup>40</sup> Resident Commissioner Pierluisi introduced H.R. 5305 in the 113<sup>th</sup> Congress to the same end.

<sup>41</sup> Governor García Padilla, *Mensaje del Gobernador (Message of the Governor)*, June 29, 2015; text in Spanish available here: <http://www.elnuevodia.com/noticias/politica/nota/mensajedelgobernadoralejandrogarciapadillasobresituacionfiscaldepuertorico-2066574/>.

<sup>42</sup> Testimony of Thomas Mayer, Partner of Kramer Levin Naftalis and Frankel LLP, in U.S. Congress, House Committee on the Judiciary, *H.R. 870, the "Puerto Rico Chapter 9 Uniformity Act of 2015"*, 114<sup>th</sup> Cong., 1<sup>st</sup> sess., February 26, 2015; [http://judiciary.house.gov/?a=Files.Serve&File\\_id=B7832791-B261-4FD8-ADC4-5A4117A52339](http://judiciary.house.gov/?a=Files.Serve&File_id=B7832791-B261-4FD8-ADC4-5A4117A52339).

<sup>43</sup> CRS Report RS20695, *The Puerto Rican Economic Activity Tax Credit: Current Proposals and Scheduled Phaseout*, by David Brumbaugh (out of print; available upon request).

indirect support for the island's public finances that is nearly offset by the loss of revenues foregone by the U.S. Treasury. Puerto Rico's Act 20 and Act 22, which provide certain tax exemptions to wealthy persons who establish residency in Puerto Rico, may also affect U.S. Treasury receipts.

Congress could also consider options that might address structural issues that may have hindered Puerto Rico's economic growth. For instance, Congress could consider several regulatory policies, such as Jones Act restrictions on shipping between Puerto Rico and the mainland. Congress has already waived Jones Act requirements for the U.S. Virgin Islands and could extend that waiver to Puerto Rico.<sup>44</sup> Several past studies have noted that labor participation rates for Puerto Rico are well below those on the mainland. Some have suggested that social insurance or minimum wage legislation may play a role in discouraging employment outside the underground economy.

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<sup>44</sup> CRS Report R43653, *Shipping U.S. Crude Oil by Water: Vessel Flag Requirements and Safety Issues*, by John Frittelli.