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Norbert Michel Contributor

I follow the evolution and devolution of monetary and financial policy

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Changing U.S. Bankruptcy Law Will Not Help Puerto Rico

Imagine a small U.S. city that owns and operates its own electric power company. The business has been poorly run for decades. But it's backed by the government, so it's been able to borrow huge sums of money.

Much of the borrowing was done via a set of special tax-exempt bonds, with contracts that spell out exactly what the power company can and can't do in the event it gets into financial trouble.

While the company can use a local-court receivership process, it cannot use the U.S. bankruptcy code.

After years of mounting difficulties, the power company finds itself in severe financial distress. So instead of sticking to its bond agreement, the company petitions the government to change the local law.

The government complies, enacting a new law that allows the company to break its agreement. The bondholders respond by taking the company to court. Eventually, a federal court rules the new law was unconstitutional.

Undaunted, the power company seeks help from the U.S. Congress, asking it to amend the U.S. bankruptcy code so that they can, in fact, file bankruptcy.

This scenario is not hypothetical. It summarizes real-life events, although not in the U.S. proper. They've occurred in Puerto Rico, a U.S. territory since the Spanish American War ended in 1898.

Here's a rundown of the parties and the basic facts.

- The power company is the Puerto Rico Electric Power Authority (PREPA), and the unconstitutional (according to a U.S. district court) law is the *Puerto Rico Public Corporation Debt Enforcement and Recovery Act*.
- The bonds are municipal bonds that are tax exempt in every state of the U.S. This tax exemption makes Puerto Rico's municipal bonds unique because those issued on the mainland provide tax exemptions only in their home state.
- Puerto Rico (along with Washington, D.C.) is explicitly excluded from using the U.S. bankruptcy code. Specifically, the code prohibits Puerto Rico from using Chapter 9 of the U.S. bankruptcy code, the option available to U.S. cities provided that their home state allows it.
- The House Judiciary Committee has introduced H.R. 870, a bill that would remove the Chapter 9 exclusion for Puerto Rico.

PREPA's supporters argue it's only fair that Puerto Rico has the same access to the U.S. bankruptcy code as all other U.S. states, even though Puerto Rico is not a state.

Still, maybe they have a point. Perhaps it would be better to allow Puerto Rico's municipalities to file Chapter 9. Maybe Puerto Rico should be the 51st state of the Republic.

These theoretical possibilities are interesting, but they have nothing to do with the fact that PREPA is trying to disadvantage a particular class of its bondholders.

Rather than pass a bill that bears directly on ongoing negotiations between PREPA and its bondholders, Congress should use this opportunity to reconsider *every* aspect of the U.S. relationship with Puerto Rico.

Maybe Puerto Rico should be a state, or maybe it should be completely independent of the U.S. They've sort of been in limbo for quite some time now, so let's figure it out once and for all.

In a 2012 referendum, a majority of Puerto Rican citizens signaled they no longer wish to remain a U.S. territory.

Exactly what that vote meant for statehood was unclear, so the island's status remained unchanged. Puerto Rico's fiscal situation also remained unchanged: It's been a complete mess for decades, and no tweaking of the bankruptcy code can fix it.

According to Carlos Colón de Armas, acting dean of the School of Business Administration at the University of Puerto Rico:

> A Puerto Rican default should not surprise anyone. For eight years, from 2005 through 2012, government expenses exceeded revenues on average by approximately $1 billion annually.

These cash flow difficulties are symptoms of much deeper problems. In general, Puerto Rico is a shining example of what statist, Keynesian economic policies can do to an economy.

For more than half a century Puerto Rico has depended on what many on the Left would now call an infrastructure bank. In 1942 the island created the Government Development Bank (GDB), a "fiscal agent…financial advisor, and primary lender to the Commonwealth, its political subdivisions, and its public corporations."

In the early years, things seemed to go well. But by the 1970s the GDB typified exactly why we should keep governments out of the economic development business. The GDB set up a plethora of subsidiaries, such as "the Puerto Rico (PR) Municipal Finance Agency, PR Development Fund, PR Housing Finance Authority, and PR Tourism Development Fund."

Over the same period, successive Puerto Rican government's set up other state enterprises, such as PREPA and the Puerto Rican Highways and Transportation Authority (PRHTA).

As of 2014, virtually all of the GDB's $9 billion in loans were to government enterprises. The PRHTA alone accounts for nearly 25 percent of the GDB's total loans.

And nearly all of the GDB's roughly $6 billion in deposits were government funds. It may not have started out this way, but the GDB has clearly become the government's piggy bank.

And this toxic public-private mix is pervasive on the island. For instance, almost half of PREPA's 2014 accounts receivables are from government clients, and some of PREPA's largest public customers are not even making payments on current invoices.

Interestingly, PREPA is in financial trouble even though it takes in more revenue and sells less electricity than comparable power companies inside of the U.S.

Regardless, the Puerto Rican economy is floundering despite excessive government deficit spending.

If, for example, we rank Puerto Rico against the 50 U.S. states, we find that from 2003 to 2013 the commonwealth's GSP ranks dead last.

Using BLS and Census data, the island's GSP growth (adjusted for inflation) was negative 13.2 percent. Puerto Rico was also dead last for growth in nonfarm payroll employment over roughly the same period.

The island was, however, in the top 10 for the number of government employees per 10,000 residents, and in the top three for the highest percentage of total revenue spent on debt service.

As of 2010, the Puerto Rican government had issued bonds totaling 90 percent of its gross state product (GSP). The financially troubled state of Illinois, by comparison, had issued bonds amounting to only 4 percent of GSP.

(It's not entirely surprising they've issued so much debt, given that interest on Puerto Rican municipal bonds is tax exempt in every U.S. state.)

There's also the tricky little issue that Puerto Rican citizens don't pay federal income taxes, even though they receive all the benefits of the U.S. welfare state. (They are not exempt from all federal taxes.)

The U.S. government also returns all of the excise taxes on Puerto Rican rum to the island, only to have the Commonwealth government subsidize rum companies.

This process started in 1917 as an economic development tool, but the island's economy has continued to deteriorate while the Puerto Rican government has become highly dependent on the revenue stream.

One way to help fix the island's finances would be to repeal the Merchant Marine Jones Act, a change that would lower the island's energy costs.

Overall, it's clear that heavy government involvement in the private sector has left the Puerto Rican economy in shambles. If Congress wants to help Puerto Rico, it should start by fixing that problem.

Giving PREPA an easy way out of its financial obligations would do nothing to help the economy, and doing so would likely worsen Puerto Rico's long-term ability to borrow in the bond market.