

Written Testimony of Richard L. Carrión
United States Senate Committee on the Judiciary
Puerto Rico's Fiscal Problems: Examining the Source and Exploring the Solution
December 1st, 2015

Introduction

At the outset, let me begin by saying that as a banker, but even more so as a proud Puerto Rican, I deeply regret that Puerto Rico's dire fiscal and economic situation is the topic which brings us to the attention of this Committee.

Leaders from several administrations, and different political parties, have opted to ignore structural problems and postponed difficult decisions because it was easier to keep borrowing to fund operational deficits and kick problems down the road, maybe to be handled after the next election or by another administration. But no amount of regret or even indignation will solve our problems. Severe measures taken throughout the last several years have clearly not been enough. Some of these recent measures include higher taxes, with an 11.5% sales tax, the highest by far of any U.S. state, reform of the largest pension system from a defined benefit to a defined contribution plan, a reduction of close to 25,000 government employees, or 14%, since 2012, and the closure of approximately 100 public schools in the same period.

The decade-long recession has taken a great toll. It is easy to get mired in figures such as debt levels, debt service, deficits and liquidity shortfalls. But let us not ignore other numbers that are equally important because they tell the human story of Puerto Rico's crisis. Approximately 250,000 jobs have been lost since 2006. Over 25,000 families have lost their homes. More than 300,000 Puerto Ricans, roughly 8% of the population, have left the Island in the past decade,

often leaving some of their family behind; this trend continues to worsen. While the entire population has suffered, the most vulnerable have suffered the most. Approximately 600,000 Puerto Ricans could lose their health care coverage when Medicaid funds run out. About 175,000 retirees and other beneficiaries depend on severely underfunded government pension funds that are expected to run out of money in the near term. Puerto Rico's elderly population represents 20% of the total, one of the highest in the U.S., is increasing rapidly as a result of some of the trends I have mentioned, and it is highly vulnerable to reductions in pension and health benefits. And perhaps most telling is the number of children living below federal poverty levels which currently stands at around 58%, up from 48% a decade ago, compared to 21% in the U.S.

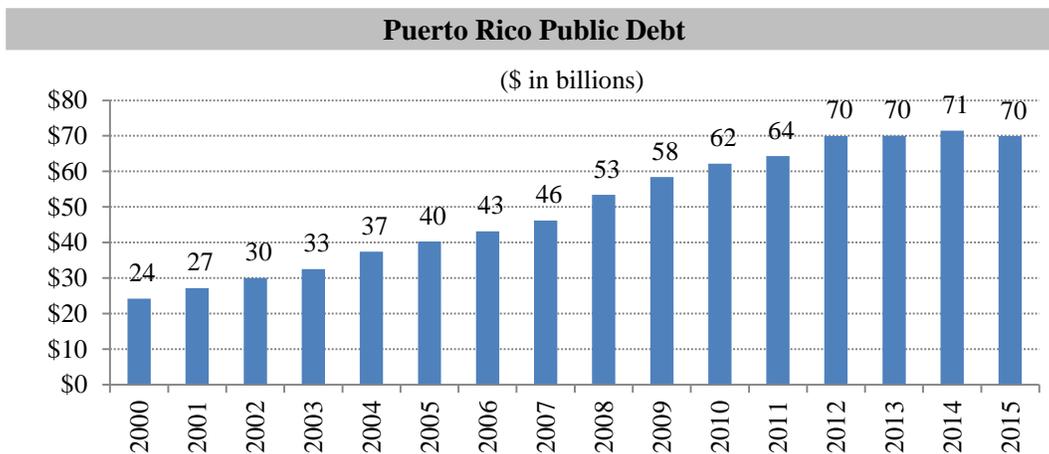
After a decade of economic contraction, lack of fiscal discipline and increasing public debt, Puerto Rico now stands at a critical junction. It is time to take decisive action to address both short-term and long-term challenges and to ensure that the errors of the past are never repeated. The decisions made by federal and local entities in the next few weeks and months will determine the Island's course for years, if not decades, to come. It is critical that they, working together, address the unsustainable debt load, a long history of fiscal indiscipline and a shrinking economy. From that standpoint, a successful solution will necessarily include three elements:

- (1) a legal framework to restructure all of Puerto Rico's public debt,
- (2) an effective fiscal oversight and control mechanism, and
- (3) economic stimulus measures to incentivize new investment and promote employment.

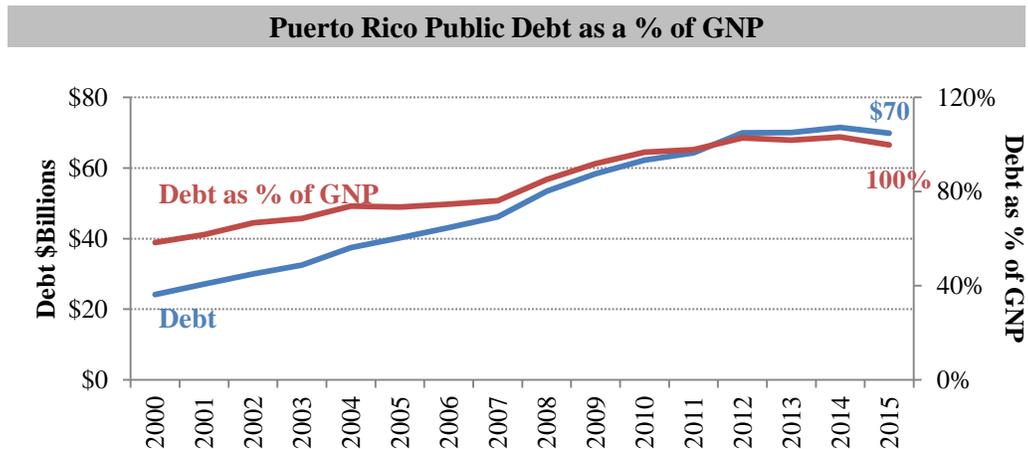
All three components are vital and must work in conjunction to ensure the maximum possible debt repayment and the long-term viability of Puerto Rico's economy.

Debt Restructuring

Puerto Rico's total public debt currently stands at \$69.9 billion and has increased at a compounded annual growth rate of 7% since the year 2000. The Island's GNP grew at a nominal rate of only 3.6% during the same period. As a result, public debt as a percent of GNP increased from 58% in 2000 to 100% in 2015, and, unfortunately, a significant portion of the increase in debt was used to finance budget deficits.



Source: Center for the New Economy and Commonwealth of Puerto Rico, Quarterly Report Dated November 6, 2015



I must confess that I initially resisted the idea that Puerto Rico's public debt would have to be restructured. However, it is now clear to me that the size of the fiscal shortfall is so large, even including the impact of revenue and expense measures proposed by the current administration, that some form of debt restructuring is inevitable.

The funds required to service the existing debt are substantial and increasing. In fiscal year 2016, the Puerto Rico government, excluding the two principal utilities, municipalities and other agencies, is scheduled to make \$4.1 billion in debt payments, which represents approximately 40% of projected revenues. Last year, the government was able to borrow to help make its payments, albeit at very high interest rates. This is no longer an option, given the lack of access to capital markets on sustainable terms. This means that, absent some type of restructuring, the government would have to pay the full principal and interest coming due, something it will be unable to do while it seeks to provide basic services to the population. If yet more resources are devoted to debt service, the pace of emigration will continue to increase, further decreasing the amount of resources available to pay debt service.

Furthermore, the government's severely underfunded pension funds will place additional pressure on public finances. Once the funds are depleted, which is expected to happen soon, the central government will have to divert resources normally used to provide essential services to pay pension benefits. For most retired government employees, including teachers, their government pension is their sole source of income and failure to receive that income would result in a true humanitarian crisis.

Finally, if no measures are taken to address the impending depletion of one-time Medicaid funds, the government could be forced to incur additional expenses related to health care.

Put simply, the government will run out of money...and soon.

Puerto Rico currently lacks a legal framework to allow it to restructure its debt in an orderly fashion. A successful debt restructuring requires a legal regime where the interests of all parties can be balanced fairly while allowing financing alternatives that would provide much needed liquidity during restructuring. A proper legal regime is not inconsistent with negotiations between the parties. In fact, it will encourage all parties to negotiate in good faith. The only alternative at this point is another combination of events that will be to the detriment of all involved: an inability to make the payments that our public sector retirees were promised and on which they are dependent; a slash in funding for our children and those in need of health care; accelerated deterioration of the Puerto Rico economy and tax base; a slew of legal battles that will take years to resolve and create disruption and uncertainty while consuming inordinate resources; and, inevitably, debt defaults.

If we want to avoid this outcome, time is of the essence. Over the last few months, government services and debt payments have continued only because of emergency liquidity actions such as: (1) delaying payment of income tax refunds owed to taxpayers, (2) requiring advance payment to the Puerto Rico Treasury Department from the two largest retirement systems of funds needed to pay benefits, rather than the usual eventual reimbursement by these systems to Treasury for actual payments made on their behalf, (3) borrowing from state-owned insurance funds, (4)

failing to pay certain appropriation debt, (5) suspending monthly set-aside payments for debt service on general obligation bonds, and (6) deferring payment of accounts payable to vendors and other third parties. These measures are unsustainable and they are aggravating the underlying problems.

Even with these emergency measures, liquidity is likely to run out before the fiscal year ending on June 30, 2016, and there are several considerable debt service payments due in the coming months.

Fiscal Oversight and Control Mechanism

Any long-term solution to Puerto Rico's fiscal situation must also include a fiscal oversight and control body. Puerto Rico's current economic problems are closely tied to a decade of sluggish economic growth but also are a direct result of longstanding fiscal indiscipline. I have served on various advisory boards for several governors, of different parties, and have witnessed the inability or unwillingness of many administrations to manage our public finances in a fiscally responsible manner. Fiscal control boards have proven effective in similar situations, such as New York forty years ago. In the case of Puerto Rico, such a body would guarantee the long-term adherence to a recovery plan and should be considered in conjunction with any debt restructuring regime.

The oversight body should consist of members with the appropriate expertise and must be truly independent from the Puerto Rican government. It needs to have the necessary authority to effectively carry out its oversight and control responsibilities. It must have the power to examine

and veto annual budgets that are not truly balanced and to continuously monitor performance against those budgets. It also needs to have the ability to approve capital expenditures that exceed a certain amount. Finally, all labor contracts for government employees should be subject to review by the fiscal control board.

Economic Stimulus Measures

The Puerto Rico economy has been contracting for almost a decade. Since the repeal in 2006 by the U.S. Congress of the incentives contained in Section 936 of the Internal Revenue Code, the economy has contracted by more than 10% and lost close to 40,000 quality jobs in the manufacturing sector alone. This prolonged recession has led to a vicious circle involving, among other negative trends, outmigration and a marked decline in labor participation.

Some have suggested that Puerto Rico can tackle its problems through more rigorous belt-tightening measures. I believe we simply cannot cost-cut our way out of this situation. There is clearly a need for fiscal discipline – we have more government agencies than we can afford or effectively manage. An overhaul of the central government and its agencies is necessary, and will surely result in lower spending, but this alone will not be sufficient to bridge the large financing gap. Indeed, less government spending in the short run will necessarily have a negative impact on economic activity. Thus, a meaningful stimulus plan must be put in place to steer the economy on the path of sustainable growth. Economic growth is the only element that will promote the long-term interest of all parties, including bondholders.

Some proposals that have been discussed include measures such as providing Puerto Ricans the same access to Medicaid as citizens on the mainland and the use of the Earned Income Tax Credit (EITC) to promote formal participation in the economy. These two areas – health and labor participation – are clearly important, and there may be other efforts that also make sense to spur economic growth. But the key point is that some combination of economic stimulus measures is an essential component of any recovery plan.

Conclusion

Throughout its recent history, Puerto Rico has experienced many testing events such as a change in sovereignty from Spain to the United States, two world wars, the Great Depression and devastating hurricanes. During this time we have seen Puerto Rico transform itself again and again, a testament to the Island's resilience and resourcefulness. Puerto Rico has a modern infrastructure, tested human capital, high enrollment in local universities, a modern communication and transportation network and a solid legal, financial and institutional framework – all important pillars we can build on to jumpstart the economy once again.

To do so, Puerto Rico needs a comprehensive recovery plan that includes all three components I have discussed: a debt restructuring regime, a fiscal control board and economic stimulus measures.

Problems that took decades to create cannot be solved in months, or through small or isolated efforts of one group or another. A real solution will require local and Federal action, support

from the executive and legislative branches, backing from all political parties and the active participation of all sectors of Puerto Rican society.

Failure to take decisive action now will only make these problems worse and their solutions more costly and less effective for all parties involved.