



Statement before the United States Senate, Committee on the Judiciary on “Puerto Rico’s Fiscal Problems”

An Emergency Financial Control Board for Puerto Rico

Alex J. Pollock

Resident Fellow

American Enterprise Institute

December 1, 2015

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Committee on the Judiciary
United States Senate

Hearing on Puerto Rico's Fiscal Problems

December 1, 2015

An Emergency Financial Control Board for Puerto Rico

Mr. Chairman, Ranking Member Leahy, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Immediately before joining AEI, I was President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. I have published numerous articles on financial systems and credit crises, including municipal debt crises.

The government of Puerto Rico, having run a long series of constant budget deficits, has accumulated a very large debt which according to its own statements, it cannot pay. It is cut off from all normal municipal bond market financing and is running out of cash. The credit ratings of its many debt issuing entities are at the bottom of the scale, with a preponderance of CC ratings from S&P and Fitch and Ca ratings from Moody's, with additional defaults on or restructurings of government debt expected. With its current budget operations, financial control systems and government structure, it cannot produce clear, audited financial statements. The study performed by former IMF officers earlier this year concluded that "the overall deficit is larger than recognized, its true size obscured by incomplete accounting" and cited "weak budget execution and opaque data." In addition, public pension obligations, which in insolvency pit pensioners against creditors, are virtually unfunded and an estimated \$44 billion pension liability must be added to the \$71 billion in debt.

It is my recommendation that the Congress should promptly create an Emergency Financial Control Board to assume oversight and control of the financial operations of the government of Puerto Rico, as Congress successfully did in 1995 with Washington, DC; as New York State, with federal encouragement, successfully did with the insolvent and defaulting New York City in 1975; and as the State of Michigan did with the appointment of an Emergency Manager for the insolvent City of Detroit in 2013. Such Boards have also been used in Cleveland (1980), Philadelphia (1991), and Springfield, Massachusetts (2004). There is plenty of precedent.

Under the United States Constitution, Congress has sovereignty over territories and the clear authority to create such a Control Board. In my opinion, with Puerto Rico's severe and longstanding financial problems, Congress also has the responsibility to do so.

This should be the first step, prior to other possible legislative actions. I believe that the initial requirement is to establish independent, credible authority over all books, records and other relevant information; to analyze what the true overall financial deficit is; to determine which Puerto Rican government bodies are insolvent, in particular understanding the financial condition of the Government Development Bank which lends to the others; to consider fiscal, accounting and structural reforms which will lead to future balanced budgets and control of debt levels; and to consider in the light of all of these, how the current excessive levels of debt should be addressed. The Control Board should analyze and report to Congress on whether creating a bankruptcy regime for Puerto Rico is warranted as a subsequent legislative action.

The Administration's statement on "Puerto Rico's Economic and Fiscal Crisis" includes this proposal: "Enact strong fiscal oversight and help strengthen Puerto Rico's fiscal governance...Congress should provide independent fiscal oversight." This goes in the right direction, but is vague. I believe it needs to be something more specific, thus more likely to work: a Control Board. The Administration says financial oversight should "respect Puerto Rico's autonomy," but in fact Congress has unquestioned jurisdiction here. As one harsh, but accurate, assessment has it: if you are a subsidiary government and "you screw up your finances bad enough," you are going to get control and direction from somebody else.

The details of the Puerto Rican government's financial situation are complex, but the fundamentals are simple and make a familiar pattern. The government of Puerto Rico is broke. In the current century, it has run a budget deficit every single year-- 15 years in a row. Operating deficits have been financed by borrowing. As debts multiplied, debt service was met by additional borrowing. As one municipal bond expert wrote, "The Commonwealth [was] utilizing debt issuance to pay interest on existing indebtedness." This is the definition of a Ponzi scheme.

Such debt escalations always ends painfully when the lenders stop lending, as has now occurred. What must inevitably follow is reform of fiscal operations, default on or restructuring of debt, bailout funding, or permutations and combinations of these. What in particular must be done, and what the complete financial condition is, the proposed Emergency Financial Control Board must take up.

As the government of Puerto Rico recently disclosed:

- "On October 30, 2015 the Commonwealth filed a notice that the Commonwealth would not file its audited financial statements for fiscal year 2014 by October 31, 2015."

- "The Commonwealth cannot provide an estimate at this time of when it will be able to complete and file its audited financial accounts."

A municipal bond analyst from UBS opined that the "inability to produce an audited financial statement for a fiscal year that ended almost sixteen months ago is inexplicable." On the contrary, it is all too explicable, given a financially stressed, insolvent borrower.

Among the "Risk Factors" for investors in its debt, the government currently cites the following:

- "The Commonwealth faces an immediate liquidity crisis."

- "The Commonwealth does not have sufficient resources to pay its debt obligations in accordance with their terms."

-“The budget deficit of the Commonwealth’s central government during recent years may be larger than the historical deficits of the General Fund because they do not include the deficits of various governmental funds, enterprise funds, and Commonwealth instrumentalities.”

-“The Puerto Rico Planning Board recently acknowledged the existence of certain significant deficiencies in the calculation of its macroeconomic data.”

-“The assets of the Commonwealth’s retirement system will be completely depleted within the next few years unless the Commonwealth makes significant additional contributions...the Retirement Systems will continue to have large unfunded actuarial accrued liability and a low funding ratio for several decades.”

-“Each fiscal year, the Commonwealth receives a significant amount of grant funding from the U.S. government. A significant portion of these funds is utilized to cover operating costs.”

-“The Commonwealth’s accounting, payroll and fiscal oversight systems have deficiencies due to obsolescence and compatibility issues...this has affected the Commonwealth’s ability to control and forecast expenses.”

-“The Commonwealth has frequently failed to meet its revenue projections.”

-“The Government Development Bank’s financial condition has materially deteriorated and it could become unable to honor all its obligations.”

-The Government Development Bank has historically served as the principal source of short-term liquidity for the Commonwealth and its instrumentalities,” but faces “the inability of the Commonwealth and its instrumentalities to repay their loans.”

-“The Commonwealth has failed to file its financial statements before the 305-day deadline in ten of the past thirteen years, including the most recent fiscal years (2012, 2013 and 2014).”

They themselves have said it. All indications are of a government much in need of emergency, authoritative management help which is not dependent on short-term local politics.

In addition, one Puerto Rican expert testified to the Senate Finance Committee that “Puerto Rico has an excessively bureaucratic and inefficient central government...when it comes to fiscal policy, budgeting, financial recordkeeping, tax collection, business permitting, professional contracting, use of modern technology and overall performance....Anyone who has dealt with the Puerto Rican government knows how opaque and difficult to navigate it can be.” Another expert has described “significant government corruption and predatory rent-seeking behavior,” along with “substantial tax evasion.” Are these assertions true? A Control Board will need to make judgments and then decisions accordingly.

I previously mentioned the robust precedents for Emergency Financial Control Boards. As one analyst correctly observed, “The fundamentals of Puerto Rico resemble those of New York City in the mid-1970s and of other municipalities on which a Financial Control Board has been imposed.”

The closest legal parallel is Washington DC, which had become a financial quagmire by the mid-1990s. Like Puerto Rico, Washington DC, not being a state, is Constitutionally subject to the direct jurisdiction of Congress. Congress responded with the District of Columbia Financial Responsibility and Management Assistance Act of 1995, which created the District of Columbia Financial Responsibility and Management Assistance Authority. (A good political title, which might be adapted for use in Puerto Rico.)

The Act was developed, approved and implemented as a successful bipartisan effort and the Board was given broad powers and authority. These included approving or disapproving financial plans and budgets, implementing recommendations on financial stability and management, approving the appointment of the Inspector General of the District government, having total access to official reports and data, holding hearings, issuing subpoenas, and requiring District officers and employees to carry out its orders.

A very important power, worthy of note, was to approve the appointment of an independent District Chief Financial Officer—an office which continues today.

Two years later, Congress followed up with the National Capital Revitalization and Self-Government Improvement Act of 1997, which set tighter controls. The purposes included: “to improve the ability of the District of Columbia government to match its resources with its responsibilities”—in other words, to run a balanced budget. Another explicit goal of this act is very relevant to Puerto Rico: improvement in tax collection.

Although there were disputes and difficulties along the way, the Washington DC Control Board achieved clear success in financial management and controls, efficiency, and indeed reaching balanced budgets. It adjourned in 2001, after Washington DC achieved its fourth consecutive balanced budget. The city’s bond ratings greatly improved; they have now reached AA/Aa. However, the Board remains in the wings, authorized for a possible return, should Washington DC’s budget discipline ever again slide into aggregate deficits.

Another strong precedent is New York City. Like Puerto Rico, it had run a long series of budget deficits, financed them with ever more debt, and finally needed new loans to service the old ones. In the spring of 1975, the market for the city’s debt closed. By that fall, the city government was out of money and was, with the support of many of its prominent citizens, lobbying desperately for a federal bailout. President Ford wisely turned this down.

Instead a deal was worked out among the federal, state and city governments, resulting in the establishment by New York State of the New York City Emergency Financial Control Board. Other elements of the deal were the default, called a “moratorium,” on the city’s short-term notes; later Congressionally-approved provision of seasonal emergency financing for three years by the U.S. Treasury; and restructuring of debt through bonds issued by the Municipal Assistance Corporation, also established by New York State. The necessity of the Control Board was primary.

Intensely needed reforms of New York City’s spending, management, budget discipline, financial reporting and financial controls were achieved. New York City by now has also improved its bond ratings to AA/Aa. Here is another success story for Control Boards and their ability to bring outside authority and resulting action. As then-Treasury Secretary William Simon later wrote, “The city and state were required to make decisions of a type they had heretofore refused to make.”

The State of Michigan, facing several municipalities in serious financial difficulty, adopted the Local Government and School District Accountability Act in 2011, authorizing the appointment of Emergency Managers, individuals rather than a board, with very broad financial and operating powers. The best known was Kevyn Orr in the City of Detroit, appointed in 2013, but four other Michigan cities have had similar appointments. (It seems to me that the more common practice of appointing a board, with the balance of multiple perspectives and expertise, is a preferred structure.)

In Detroit, the first step was the Emergency Manager. Having analyzed the massive problems and the debt, he concluded that the city's deep insolvency required a municipal bankruptcy. This largest municipal bankruptcy ever was concluded in 2014, with major losses to creditors, including smaller but significant losses to pension claims. Following the settlement of the bankruptcy, the Emergency Manager has been succeeded by the Detroit Financial Review Commission, which will continue to oversee the city's budgets and financial management.

Should Puerto follow Washington DC and New York City, working its way through its management and debt problems without a bankruptcy proceeding? --or should it follow Detroit, with a bankruptcy included along with reforms? I believe Congress should first appoint the Control Board for Puerto Rico, and charge it with getting on top of the financial situation, pursuing management reforms, considering the debt servicing issues, and then recommending to Congress whether or not a bankruptcy, which would involve new bankruptcy legislation, is required.

Let's compare the debt burdens of three of the cases. The government of Puerto Rico's \$71 billion in total debt is 15% greater than the \$62 billion, when re-stated to 2015 dollars, of New York City during its 1975 debt crisis. Detroit's debt, in 2015 dollars, was \$19 billion. Since the populations of the three are very different--Puerto Rico, 3.6 million; New York City 7.9 million; City of Detroit, 700 thousand-- we need to view the per capita local government debt. These were, at the time of each crisis, expressed in 2015 dollars:

Puerto Rico	\$20 thousand
New York City	\$ 8 thousand
City of Detroit	\$27 thousand

Puerto Rico is much more heavily indebted per capita than New York City was, but less so than Detroit.

One of the most distressing economic statistics of Puerto Rico is its labor participation rate of less than 40%. There is additional work in the "informal" sector, but that does not generate taxes to pay the government's debt. So let's look at local government debt per officially employed person in 2015 dollars:

Puerto Rico	\$71 thousand
New York City	\$19 thousand
City of Detroit	\$90 thousand

Again, the Puerto Rican debt level per employee is much worse than New York City, but 20% less bad than Detroit. Maybe in Puerto Rico the Emergency Financial Control Board will be sufficient to work through the reforms while debts are restructured outside of bankruptcy. I do not think it is possible to say at this point.

In any case, the financial and managerial problems are severe, cash is running out, and time is wasting. In my judgment, Congress should establish the Emergency Financial Control Board for Puerto Rico as a high priority.

Thank you again for the opportunity to share these thoughts.