Testimony submitted to the Committee on Natural Resources, legislative hearing on a discussion draft of the *"Puerto Rico Oversight, Management, and Economic Stability Act*," Wednesday, April 13, 10am.

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A. Overview

1) Puerto Rico is in the midst of a serious crisis. The economy is in decline, public health is threatened, and residents are moving to the 50 states. Unless there is a significant improvement in living conditions and job prospects, out-migration will likely pick up speed in the months and years ahead.
2) Making promised debt payments has – as a result of much broader stress on public finances – become difficult and, by some measures, Puerto Rico is already in default.
3) As a territory of the United States, Puerto Rico does not have access to the standard debt restructuring mechanisms available to the 50 states.
4) Compared with the situation for states and municipal borrowers within states, the U.S. Congress has much broader ultimate authority over all aspects of public finance in Puerto Rico. Some powers can be, have been, and should be delegated to Puerto Rico. But Congress must now decide on what broad strategy is adopted for dealing with the crisis in Puerto Rico.
5) Insisting on full repayment of all debts would be counterproductive. Most residents of Puerto Rico are also U.S. citizens. By moving to the 50 states, these people automatically can participate fully in more vibrant economies, while also changing their relationship to public finances – specifically, becoming eligible for the earned income tax credit.
6) It is no surprise that current net outmigration is around 60,000 per year and the population has declined by nearly 500,000 over 15 years.
7) Attempting to repay all of Puerto Rico's debts would involve either large further tax increases or significant cuts in public services or both. Either way, the incentive to leave the island will be stronger – and the tax base (people who earn income) will literally fly away. The odds of full repayment in that scenario are almost zero. And the social costs – in terms of lower living standards for those who remain – would be dramatic.
8) The best way forward includes agreeing on a mechanism for restructuring Puerto Rico's debts, with the goal of making a voluntary negotiation easier and more effective. The restructured debt should include some standard debt commitments, but with lower principal as well as reduced cash flow commitment in the near term. At the same time, it would be very helpful if creditors could be persuaded to accept bonds with a contingent payoff – so that lenders get paid more if the economy does better.

[1] Also a member of the Federal Deposit Insurance Corporation's Systemic Resolution Advisory Committee, the Office of Financial Research's Financial Research Advisory Committee, and the independent Systemic Risk Council (created by Sheila Bair). All the views expressed here are mine alone. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com. For important disclosures, see http://baselinescenario.com/about/.

9) At the same time, it is necessary to change the organization of public finance in Puerto Rico. The ability of the governor and the legislature to do this by themselves has proven to be limited. Establishing an oversight board would help build credibility.
10) At the same time, long experience – including with International Monetary Fund program lending – suggests that imposing institutional arrangements or even specific polices on countries does not usually lead to good outcomes.
11) The proposed legislation has some strong points in terms of creating an oversight board that would bring meaningful changes to governance, without being overly intrusive. However, I am concerned that the way in which board members are picked may slow the debt restructuring process. More on this is in Section B below.
12) In terms of the debt restructuring mechanism, the current draft of the bill is a great improvement over previous versions. However, there are a number of significant dimensions that require further clarification – including the extent to which debt principal can be reduced, whether all debt issued by Puerto Rico government entities can be readily included in any restructuring, and the mechanism through which a debt restructuring agreement is concluded. I expand on these points in Section C.
13) In addition, I am concerned about opening the door to reducing the minimum wage in Puerto Rico. Again, it is not in the interest of creditors to encourage taxpayers to leave the island.

B. Oversight Board

The proposed legislation does a good job of balancing the need for greater oversight for public finance in Puerto Rico along with the important priority of maintaining sovereignty.

We should keep in mind one very important lesson from economic and political history – an oversight board that is too strong would be counterproductive. Unless there is sufficient local ownership of any reform program, that program fails to deliver sustained growth (and better outcomes for creditors).

There are seven main elements in the proposed structure under discussion today:

- The proposed law specifies what must be in the five year fiscal plan.
- This plan is approved by the oversight board (or not).
- The governor draws up this plan and can adjust it in the process of discussion with the board.
- The governor is also responsible for the annual budget.
- This budget can be revised by the legislature, as long as it remains consistent with the five year fiscal plan.
- The board watches out for variances from the fiscal plan and makes recommendations for course corrections.
- If the government fails to correct these variances, after repeated opportunities have been missed, then the board can do more.

It is important to note that in the current draft, the board cannot issue regulations or other rules over the objection of the government of Puerto Rico.

The board will terminate after four years of balanced budgets. This seems entirely appropriate – and consistent with what was required for the District of Columbia.

There are also strong ethics and conflict of interest rules for the oversight board. These are important both in terms of perceived legitimacy and to ensure the board remains effective throughout its duration.

However, I am concerned with how members of the oversight board would be selected. In the case of DC, board members were picked by the president, in consultation with the leadership of the relevant congressional committees. In the current draft for Puerto Rico, the structure is more cumbersome and perhaps would lead to unintended outcomes.

For example, if the Speaker of the House proposed a list with only two names on it, would the president have to accept those names – or could he (or she) request a new list? How long would this process take?

C. Debt Restructuring

With regard to the ability of the government of Puerto Rico to restructure its debts, I understand these provisions were controversial and the subject of much discussion. I also recognize that key details in this draft may shift as the legislation moves through Congress, so let me emphasize that the points made here apply to this particular wording – and even minor shifts in language could be sufficient reason to change my opinion.

Title III represents a great improvement over previous attempts to address the restructuring issue. However, the current language (also in Title VI) suggests that the process could be streamlined further in ways that would be helpful.

In particular, I would flag four issues which, at the very least, would benefit from greater clarity.

First, any and all forms of Puerto Rico official sector debt should be eligible for a reduction in principal as a result of the debt restructuring process. The bill's language could usefully be clarified in this regard.

Second, it should not be possible for creditors to prevent or delay a particular class of debt from being restructured. The current draft seems to create the possibility of a very slow process, for example for COFINA bonds.

Third, there needs to be a clear and workable mechanism through which a debt restructuring is concluded. At present there may be potential for relatively few creditors to delay or even prevent a final agreement. It is important not to allow any kind of hold out in this situation.

Fourth, while the goal is a voluntary comprehensive renegotiation of Puerto Rico's debt, the legislation could also recognize more explicitly that – under some circumstances – it may be necessary for a judge to impose a deal.