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Saving Puerto Rico From Itself

The price for bankruptcy: A review board that can overrule local politicians.

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After snowballing for decades, Puerto Rico's debt problems have become an avalanche. Governor Alejandro Garcia Padilla says his government has run out of cash and will soon beginto default on debt payments to junior bondholders. House Speaker Paul Ryan has promised some response by the first quarter of 2016, but any rescue-by-bankruptcy needs to be accompanied with some very tough love.

The case for helping the U.S. territory is that it needs debt relief to grow again and its problems will spill over to the mainland as Puerto Ricans (who don't need visas) flee. Like stateside spendthrifts, Puerto Rico has borrowed to finance operating deficits, employed dubious accounting and deferred payments to contractors.

Government debt has increased by two thirds since 2006, when the island fell into a decade-long recession, and exceeds 100% of gross national product. Taxpayers are close to tapped out. The sales tax increased to 11.5% this year from 7% and next year will turn into a value-added tax. Since 2013 the tax on petroleum—the island's primary fuel for generating electricity—has quintupled to $15.50 per barrel. Sewage rates have jumped 60%.

The result has been a flight of human and investment capital. Nearly 100,000 Puerto Ricans left the island last year, and Orlando has become Little San Juan. Unemployment is 12.5%, and the labor force participation rate is 40% compared to 63% on the mainland.

Employment laws, such as mandatory 15 days of paid vacation, and stringent job protections provide disincentives to hire. Generous welfare, housing, food stamp and health benefits discourage work. Nearly half of island residents are on Medicaid. A household can rake in 50% more in government assistance than the take-home monthly minimum wage. Federal strictures such as the $7.25 minimum wage, welfare eligibility rules and the 1920 Jones Act, which requires that goods transported between U.S. ports be shipped on vessels built and manned by Americans, are also growth killers.

The overriding problem is mal-governance, which creditors have enabled by financing patronage politics and bloated government payrolls. The commonwealth has 40% fewer students but 10%

more teachers than a decade ago. Territory government still constitutes a quarter of the island's workforce. Recent government reforms such as shifting workers to defined-contribution pensions and increasing the retirement age haven't stanched the red ink. Over the next five years general fund spending is on path to grow by 20%, resulting in a cumulative $28 billion deficit.

Puerto Rico can no longer keep its lights on and pay creditors, and more than 20 creditor committees have convened to press competing claims. The island's $72 billion overhang—including about $13 billion in general obligation bonds—is distributed among 18 public debt issuers, which have intermingled funds. This week the Puerto Rico Electric Power Authority agreed with creditors to restructure some $9 billion in debt, which is a step forward. But conflicting bond contracts and the overall debt burden still need a holistic and rational treatment.

The Obama Administration wants Congress to pass a new chapter of bankruptcy law for territories. Under Article IV of the Constitution, Congress has "Power to dispose of and make all needful Rules and Regulations" for territories. The fear that giving Puerto Rico access to bankruptcy would set a precedent for states is misplaced because of constitutional language that enshrines the dual sovereignty of states. As a co-equal sovereign, the federal government can't restructure state debt.

One virtue of bankruptcy is that it would provide order to a complicated debt restructuring by staying lawsuits, untangling claim priorities and creating specified voting classes. While bondholders would take haircuts, pensioners and workers would likely also have to get snipped for a readjustment plan to obtain creditor approval.

The main objection to bankruptcy, as ever, is moral hazard. But that can be mitigated with a muscular financial review board modeled on (but with more power than) New York City's of the 1970s. The board needs the power to reject budgets, contracts and new borrowing, audit government agencies and cut spending. Ideally, the board would be jointly appointed by Congress and the White House with ex officio members from the Puerto Rican government to mute protests of a federal takeover.

The Obama Administration also wants to increase federal Medicaid funding to halt a physician exodus to the states and an earned-income tax credit to boost labor participation. These palliatives have merit to reduce mainland flight if they're paired with regulatory relief.

Meantime, Senate Republicans led by Chuck Grassley, Lisa Murkowski and Orrin Hatch this month introduced legislation—which they claim isn't a bailout—that would offer the government $3 billion in repurposed ObamaCare funds, cut Puerto Rican workers' Social Security taxes by half and establish a financial oversight board that could underwrite new borrowing. This salve could postpone the current liquidity crisis but won't solve the underlying debt woes.

To restore economic growth, the island needs a wholesale debt restructuring that provides certainty to investors and tax relief to Puerto Ricans. Bankruptcy with a tough review board offers a chance to impose fiscal discipline and prevent the need for more federal assistance in the future.

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