Puerto Rico: The audit now in progress has already revealed that the debt is largely illegal

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by Pierre Gottiniaux

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The island of Puerto Rico, which is part of the Commonwealth of the United States, is staggering under the weight of an unsustainable debt of nearly $73 billion. Its neo-colonial legal structure prevents it from restructuring its debt and protecting itself from the rapacious creditors who have already begun to secure their positions, working in the shadows to get Washington to make the "right decisions"– meaning those that will bring the island's population to their knees. And yet, a debt audit commission is now revealing that a large part of Puerto Rico's public debt was issued unconstitutionally and could be considered illegal under US law.

Causes of the indebtedness

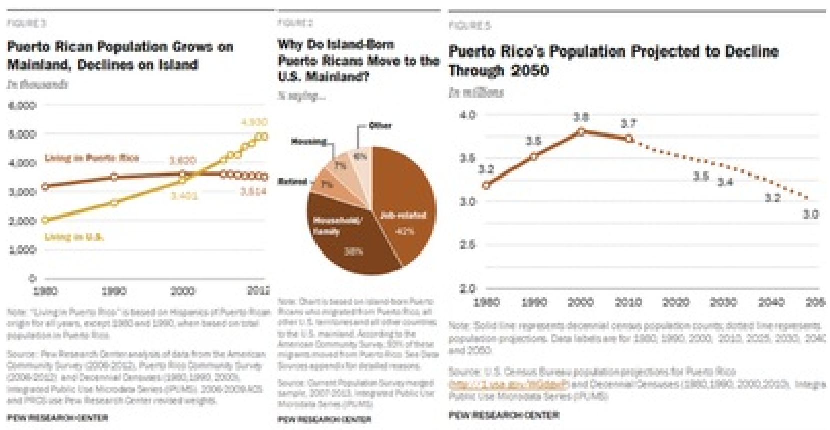
The USA has made Puerto Rico into a tax haven for its companies, who also use the island as a pool of cheap labour. Puerto Rico provides a full tax exemption for US companies that are based there, and also the possibility of returning revenue to their parent companies without paying taxes. But that tax advantage, which a large number of companies were profiting from, ended in 2006 by decision of the federal government. That led to a large number of companies and investors – and therefore employers – leaving the island.

Puerto Rico provides another advantage to investors, and it is still in force: a tax exemption on revenues from public debt securities. That exemption is in force for all American public entities, but in the case of Puerto Rico it provides a unique, threefold advantage: exemption from federal taxes, state taxes, and local taxes, even for non-residents of Puerto Rico (whereas for US states – Puerto Rico being a territory and not a state – the exemption from state and local taxes is only applicable to residents of the state and/or municipality where the investment is made). That's what we mean by a threefold exemption. And it amounts to threefold losses for the government of Puerto Rico. US investment funds have taken full advantage of this system.

Another major cause of the growth of Puerto Rico's debt is the difference in treatment between the social-security systems: The Puerto Rican government receives significantly less from the federal government, proportionally, than the 50 states, for a population who are much poorer on average and therefore much more in need of such support. And this is despite the fact that the island's population pays the same taxes as "continentals." The compensatory outlay the government has been forced to make in recent decades accounts for over a third of Puerto Rico's current debt ($25 billion out of $73 billion) |1|. Many cuts have already been made to public and private social-security programmes (cuts in wages, increased payroll taxes, lower coverage rates, etc.), with devastating consequences, because behind those programmes there are women and men who can no longer afford to receive care (see the "People are literally dying because of Wall Street greed" video campaign) |2|.

Another factor is the crisis in 2007, which made investors wary of anything that might involve risk; Puerto Rico's situation, a year after the end of the tax advantage mentioned above, was not an encouraging one. The sudden recession in 2009, which followed the crisis of 2007, also heavily impacted Puerto Rico's tourist industry, further shrinking an already strangling economy. Lastly, the failure of Detroit in 2013 prompted many investors to shun public debt securities, because they were suddenly no longer considered “untouchable” – that is, exempt from restructuring and payment default.

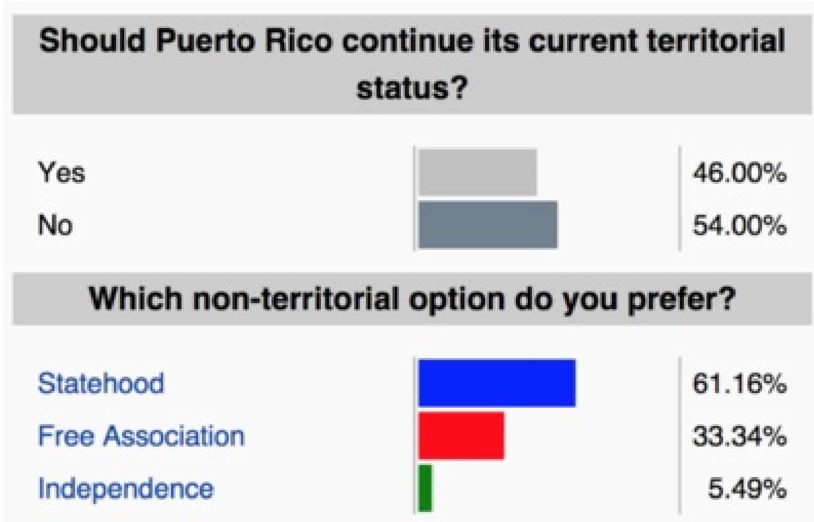
For all these reasons – and the list is not exhaustive – Puerto Rico’s budget has been in deficit for 16 consecutive years and the government has been borrowing to compensate. In exchange for the loans, it has imposed austerity measures aimed at reducing the deficit, with the sole result of plunging the population into ever-increasing poverty, forcing an ever-increasing number of people to emigrate. Puerto Ricans have US citizenship and can therefore travel and take up residence freely throughout the country. The result is that the island’s population is inexorably dwindling, year after year, aggravating the situation further; Puerto Rico’s demographic balance is now negative. And needless to say, the first ones to leave are university graduates, since there are no longer any employment opportunities for them on the island. That only accelerates the deterioration of the situation and is dragging the government – and the population who suffer the consequences – into a deepening spiral of indebtedness and austerity.



The sovereignty problem

Puerto Rico is a semi-colony of the United States, and its sovereignty is extremely limited. Those limitations are particularly flagrant regarding management of her debt. The federal government has excluded Puerto Rico from filing under Chapter 9, the law that applies to insolvent local governments, which Detroit made use of in 2013. The island’s government tried to pass a law in 2014 called the Recovery Act which would have allowed it to restructure its debt, but the US Supreme Court struck down the law on 13 June 2016. |3|

The question of Puerto Rico’s sovereignty is debated regularly, but there are many obstacles to implementing it. In a referendum held in 2012, a majority of the population voted in favour of statehood – full incorporation into the USA – as opposed to the current status of unincorporated territory or Commonwealth. Most Puerto Ricans have family in the USA and are attached to the country, and therefore massively reject the option of becoming an independent nation. But the federal government, and the American population in general, reject the idea on the grounds that statehood for the island would cost them too much – refusing to deal with the issue of who is responsible for Puerto Rico’s economic situation. And indeed, just days before it struck down the Recovery Act, in early June 2016 the Supreme Court of the US’s rejection of a petition |4| by Puerto Rico’s government reaffirmed the island’s subordinate status.



(results of the 2012 referendum – source Wikipedia)

The threat of default

Concretely, the government of Puerto Rico has already been in default of payment since 2015, but on bonds that are not senior debt since they are not guaranteed by the constitution. On 1 July, if nothing changes, Puerto Rico will default on a senior debt of $2 billion – a default which could set off a wave of judicial reprisals on the part of the creditors, who will inevitably go to court to force repayment of their debts. And, even if Puerto Rico manages to scrape up the money to repay that debt by 1 July, which is highly unlikely, it would automatically result in non-payment of wages and pensions and the shutdown of hospitals and public services, because the government doesn't have the cash necessary to cover that amount, and could only do it by robbing other budget items.

Who holds Puerto Rico's debt?

The system of threefold tax exemptions on Puerto Rico's debt securities made them extremely attractive for US investors, beginning with the numerous investment funds that operate almost exclusively by purchasing municipal bonds and have a large impact on the local economy. There are also a large number of pension funds throughout the USA.

But since the Puerto Rico debt crisis deepened, in 2014, and the ratings assigned by the bond rating agencies began to slip, new participants have gotten into the game – the "vulture funds," who purchase Puerto Rican debt securities on the secondary market at a fraction of their value (on average 30 cents on the dollar, or 30% of face value), demanding exorbitant interest rates (up to 34%). These funds have a very specific goal: They wait until Puerto Rico defaults on its debt, and then file suit to demand payment of the face value of the securities (the "dollar" they acquired for 30 cents). It's what they specialise in. They've done it with Argentina, with Greece... with all countries who experience over-indebtedness, and it's made them billions.

The main solution currently being proposed

Currently, the "solution" that has the most chance of actually being adopted is a bill passed by the House of the Representatives of the USA on 9 June 2016, known under the name PROMESA (for Puerto Rico Oversight, Management and Economic Stability Act), which means "promise" in Spanish. The bill has had wide bipartisan support — as much from Republicans as from Democrats —, and in particular from presumed presidential candidate Hillary Clinton. And for good reason, since the bill, which still needs approval from the Senate, is aimed at restructuring only a part of the Puerto Rican bonds in circulation, and the vulture funds are obviously concentrating on another part, which will not be restructured but has the same guarantees under Puerto Rico's constitution. That is one of the criticisms raised by its detractors, who include Bernie Sanders |5|, the Democrat Senator from Vermont and candidate for the Democratic presidential nomination in 2016, numerous trade unions, and small investors in Puerto Rico, who rightly feel that there is a prejudice towards big investors. But that's not the only reason.

The PROMESA bill, if does not undergo modifications when it goes before the US Senate, will impose a "fiscal oversight board" made up of seven members, four of whom will be appointed by the Republican Party, two by the Democratic Party, and one by the President, and only one of whose members will be required to be a resident of Puerto Rico. This board will have greater powers than those of the island's government, in the economic sphere but also in terms of general governance - which harks back to the colonial period, when the governor of the island was an officer of the United States army appointed by the President. It is also reminiscent of the international financial commissions set up in Tunisia in 1869 |6| and in Greece in 1898. |7|

The fiscal oversight board would have the task of negotiating the restructuring of a portion of Puerto Rico's debt and taking the measures demanded by the creditors to "clean up" the island's economy, which would mean deepening and extending the austerity measures taken in recent years and which have already caused the closing of 150 schools, the loss of 20% of the jobs on the island, the emigration of nearly 50,000 persons per year, the explosion of inequalities, etc. |8| Currently, more than one out of two children in Puerto Rico already lives below the poverty threshold. The board would fire even more schoolteachers, close more schools, and reduce the minimum wage (there is talk of reducing it to $4.25 an hour for people under age 25) or even eliminate it outright, etc.

Alternatives

There is a coalition in Puerto Rico, bringing together trade unions, community organisations, and activists, which defends the idea of an audit of the debt, on the grounds that a large part of Puerto Rico's public debt may well be illegal. The coalition, called Vamos4PR ("Let's Move 4 PR"), has the ear of the government of Puerto Rico, which decided in July 2015 to set up a debt audit commission with the task of analyzing the issuance of Puerto Rican bonds over the last 45 years. Unfortunately, due to a lack of funds, the commission — made up of 17 persons (elected officials, representatives of financial institutions, trade-union representatives, and researchers) — was only able to begin its work in January 2016. It has just filed an initial "pre-audit" report which will serve as the basis for future work, but already provides serious evidence of the illegality of a portion of Puerto Rico's debt. The audit analyzes the two most recent issuances of Puerto Rican debt securities, in 2014 and 2015 (see the report below this article).

This report comprises extremely important items of information and provides strong arguments in favour of repudiation of a large part of Puerto Rico's public debt. One can only regret that it is not receiving more discussion and media attention. In any case, the report reveals that a large portion of Puerto Rico's debt was contracted in flagrant violation of the Commonwealth's constitution and can therefore be considered illegal.

- - Puerto Rico issued multimarket bonds in 2014 in order to finance its deficit, but the constitution requires that the Commonwealth maintain a balanced budget and prohibits the government's using credit to compensate for a budget deficit. Yet Puerto Rico has borrowed more than $30 billion to finance its deficit since 1979. That debt might well be considered illegal by a court.
- - The constitution requires that Puerto Rico spend no more than 15% of its revenues on debt service; the government devotes between 14% and 25% of its budget to debt repayment. If the final audit demonstrates that Puerto Rico devotes more than 15% of its budget to debt, then the debt could be declared illegal by a court. At that point a determination would have to be made as to what portion of the debt exceeds the limit.
- - The constitution prohibits the issuance of securities with a maturity greater than 30 years. However the government of Puerto Rico, like most countries, "rolls over" its debt – that is, when a debt reaches maturity,

instead of the repaying it, the government contracts another debt to finance the preceding one. The commission gives the example of a debt issued in 2014 to repay a debt issued in 2003, which had itself been issued to refinance a debt from 1987. So the commission will have to determine whether the practice in question is constitutional or not.

The commission will also examine possible illegitimate aspects of the debt, even though it doesn't identify them as such in its report. Puerto Rico holds approximately 37 billion in CABs – Capital Appreciation Bonds –, which are bonds of a particular type, for which the issuer pays the interest and repays the capital only when the security reaches maturity. For example, one of the bonds Puerto Rico must repay on 1 July is a CAB issued in 1998 with a nominal value of $14 million, for which the estimated total payout is $38 million once the interest is included. The commission will examine this practice in its final report.

A final question the commission will attempt to answer has to do with productivity and the debt's contribution to economic growth. Puerto Rico has a GDP/debt ratio of 96%. Since the recent increase in the debt has had no positive effect on the economy whatsoever, the commission will analyze the economic impact of the successive debt issues in detail.

Conclusion

It is clear that the PROMESA law will not improve the situation of Puerto Rico's people, but will worsen it. The federal government is making no attempt to determine the reasons for the island's over-indebtedness, instead arguing that poor management by a government that overspends requires that the situation be taken firmly in hand, without concessions. And yet there are many reasons why repudiation of the debt may well be justified, and they have been revealed by the audit commission which has in fact only begun a serious analysis of the debt. However the private interests hiding behind this "debt crisis" are powerful and know how to make themselves heard in Washington, which is why there appears to be no possibility of moving beyond the crisis in a positive way without strong popular mobilisation and real political determination.

Translated by Snake Arbusto