## Puerto Rico's Debt Lessons

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**Abstract:**
[...]the board says Promesa's Title III bankruptcy process to reduce the debt was all but inevitable, and mutual funds could face losses as high as $5.4 billion in what are likely to be court-directed haircuts.



**Full text:**
The legal brawl over Puerto Rico's bankruptcy begins this week, and it will be long and ugly. The pain might be worth something if the island can use this rare chance to reform its government, and creditors learn a hard lesson about lending to spendthrift politicians.

After San Juan said last year that it couldn't repay its debts, Congress passed a law known as Promesa that created a seven-member federal oversight board modelled on the one that turned around Washington, D.C. in the 1990s. The board rejected the first two fiscal plans proposed by former governor Alejandro Garcia Padilla and his successor Governor Ricky Rossello before accepting a third.

But even that plan couldn't prevent a debt restructuring after Mr. Rossello and creditors failed to agree on a voluntary plan. The creditors are now crying foul, claiming that the control board intervened to scuttle the talks. But the board says Promesa's Title III bankruptcy process to reduce the debt was all but inevitable, and mutual funds could face losses as high as $5.4 billion in what are likely to be court-directed haircuts.

Their pain is understandable, but then they knew what they were getting into. Lenders piled into Puerto Rican bonds that paid high yields that are "triple tax-exempt" -- they can't be taxed by federal, state or local governments in the U.S. Yet lenders also knew that the Puerto Rican government was heading toward a debt crisis. The economy has been contracting for a decade, and the commonwealth has $48 billion in unfunded pensions on top of $72 billion in bond debt.

Creditors bet that the high yield was worth the political risk, but the music was bound to stop. One lesson of the last decade that creditors don't want to learn, even after Detroit and Greece, is that sovereign debt to lousy governments is high risk. The abrogation of debt contracts that will now take place is regrettable, but there is a price for betting on politicians.

The pain will be at least as bad for Puerto Rico. Over the next decade the fiscal plan reduces spending by 28%, higher education spending by half and health-care costs by 30%. All public employees will move to 401(k)-style retirement plans, and retiree pensions (which average a mere $14,000) would be cut by 10%.

The plan also includes an annual $585 billion cushion -- a kind of rainy day fund -- in case growth isn't as robust as estimated or spending isn't cut. The plan allocates the remaining $7.87 billion to service $51.2 billion of debt. Creditors are pressing the control board to adopt rosier fiscal projections, but that's in part how the commonwealth got into its hole.

General obligation bondholders also say their debts are senior to all others and that bonds securitized by sales tax revenues (Cofina) may be invalid. But Cofina bondholders argue the reverse. This is why Congress established Promesa's bankruptcy-like process -- so a federal judge can sort conflicting claims.

Both the government and creditors have a stake in the commonwealth's recovery, and the board could require larger debt payment if revenues exceed forecasts. But for that to happen, the territory will have to grow faster. This is where bankruptcy alone is inadequate. Puerto Rico will have to cut taxes on investment, rationalize welfare programs that deter working, and pare back labor protections that make France look like Hong Kong. If Mr. Rossello won't do it, then the control board will have to.

Puerto Rico will continue to flounder even with reduced debt if labor participation remains stuck at 40% and unemployment is in the double digits. That's something for bankruptcy Judge Laura Taylor Swain to keep in mind as she allocates the pain that always attends a failure of governance and prudence as large as Puerto Rico's.

(See related letters: "Letters to the Editor: Puerto Rico's Bankruptcy Wasn't Inevitable" -- WSJ May 23, 2017)

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