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Chairman Murkowski, Ranking Member Cantwell, and Members of the Committee:

Thank you for the invitation to participate in today's hearing on Puerto Rico's economy, debt, and options for Congress moving forward. On behalf of the U.S. Department of the Treasury and the Obama Administration, we welcome the opportunity to have a constructive dialogue with you and your colleagues on this important and urgent matter. The well-being of 3.5 million Americans living in the Commonwealth of Puerto Rico is at stake.

I would also like to acknowledge our collaboration with Governor Alejandro Garcia Padilla and Resident Commissioner Pedro Pierluisi, both of whom are here today.

We also appreciate the growing interest in this urgent issue by a wide range of Members of Congress on both sides of the aisle, and other Committees who have been engaged and have held hearings.

But while growing bipartisan interest is appreciated, Congress will need to take action. The Commonwealth of Puerto Rico is in the midst of an economic and fiscal crisis, and, without federal action, the situation could become a humanitarian crisis as well. Puerto Rico's government is out of cash and running out of options. Over the past year, we have met regularly with key stakeholders, including members of Puerto Rico's legislature and local business and labor leaders. We also remain in daily contact with the officials managing Puerto Rico's fiscal response. The sense of crisis is escalating and very real.

My testimony today will describe the magnitude of Puerto Rico's challenges and offer a comprehensive set of specific policies the Administration believes are needed to fix the problem. Let me be clear: there is no substitute for legislative action. No administrative authority can put an end to this crisis. A very wide gap exists between the proposals the Administration has put forth and any non-legislative alternatives.

We remain deeply committed to doing what we can to help, but Congressional action is required to avert further crisis and put Puerto Rico's economy on a path toward sustainable growth. All stakeholders, including bondholders, need to contribute to the solution. Puerto Rico must also do its part by implementing a comprehensive fiscal plan.

As the Administration has made clear, our policy proposals are not a bailout. On the contrary, they are the critical reforms we believe Puerto Rico requires to manage through this crisis. Only

Congress can provide the tools Puerto Rico needs to restructure its debt, enhance its fiscal governance, fix its healthcare system, and help jumpstart its economy.

Without action by Congress, the Commonwealth's crisis will escalate and result in further economic contraction, further outmigration, and further suffering of the American citizens in Puerto Rico. In the very near future, Puerto Rico will face impossible choices among providing essential public services, delivering promised pension benefits, and paying its debt.

This Could Become a Humanitarian Crisis, Not Just an Economic and Fiscal Crisis

Puerto Rico was once referred to, and emulated, as a beacon for economic growth and democracy around the world. The Commonwealth has substantial strengths with a stable rule of law and currency as well as a highly-skilled workforce. For more than a century, Puerto Ricans have fought courageously to defend our nation. In 2014, the 65th Infantry Regiment, known as the Borinqueneers, was awarded the Congressional Gold Medal, and tens of thousands of Puerto Ricans proudly serve in our armed forces.

Today, however, the Island is suffocating from a decade of economic decline and expanding deficits. Important efforts to increase revenues and reduce outlays have been insufficient to reverse the trend. As a result, Puerto Rico is experiencing a prolonged, downward spiral in economic performance, investment, employment and income flows, intensified by a sharp cutback in business and consumer lending.

Puerto Rico's decline started before the U.S. financial crisis, but unlike the rest of our country, the Commonwealth never recovered and remains in recession today. Since 2006, Puerto Rico's economy has shrunk by more than 10 percent and has shed more than 250,000 jobs. More than 45 percent of the Commonwealth's residents live in poverty – the highest poverty rate of any state or territory – and its 11.6 percent unemployment rate is more than twice the national average. Median household income in Puerto Rico is less than \$19,000, approximately one-third of the U.S. median.

These economic challenges have sparked the largest wave of outmigration from Puerto Rico since the 1950's, and that pace continues to accelerate. More than 300,000 people have left Puerto Rico in the past decade; a record 84,000 people left in 2014. Citizens are leaving from across the socioeconomic spectrum. More than 40 percent leave for job-related reasons. They range from highly educated doctors, who are leaving at a rate of more than one a day, to young adults unable to find work in the local economy. As they depart, the population ages and the revenue base shrinks. Seniors already represent more than 23 percent of Puerto Rico's population, one of the highest in the United States, and the number of children under five years of age has decreased 37 percent to 187,000 since 2000. Only a return to growth can end this vicious cycle.

The Commonwealth is already taking significant revenue and expense actions that, while necessary, are creating further economic headwinds. Nearly \$2.0 billion in tax increases are reducing household income spending, and reductions in pay and benefits are having a

contractionary effect. The wholesale petroleum tax quintupled to \$15.50 per barrel, and the sales tax recently increased to 11.5 percent, the highest in our nation. A strict fiscal sustainability law was enacted to reduce government expenses and cap public wages. Government spending, net of debt service, is now at its lowest level since 2005, both in nominal terms and as a share of Gross National Product.

However, austerity alone is not a path to recovery. After ten years of recession, there are limits to the scale and pace of additional fiscal adjustment that can be achieved.

Puerto Rico's Current Liquidity Situation

Puerto Rico lost access to the traditional municipal bond market in February 2013 after ratings agencies downgraded its bond rating to below investment grade status. In March 2014, the Commonwealth raised \$3.5 billion at an 8.5 percent yield entirely from hedge funds, but they too are no longer available as a sustainable funding source. Even short-term financing, such as tax revenue anticipation notes, has proved impossible to obtain on an affordable basis.

Given the lack of market access, the Commonwealth ran out of the cash needed for normal operations earlier this year. Government services and debt payments have only continued because Puerto Rico is deploying onerous and unsustainable emergency liquidity actions. These measures include delaying payment of tax refunds to residents, borrowing from Puerto Rico's workers compensation funds, liquidating pension assets early to provide working capital, failing to pay certain appropriation debts, withholding monthly set aside funds for debt service, and stretching payment of accounts payables to vendors and other third parties. Despite these actions, the Commonwealth projects it will completely run out of emergency liquidity before year-end.

The strain created from these actions is already evident. For example, delays in healthcare reimbursements have forced many medical centers to close floors and eliminate specialized services, and at least one hospital shut down temporarily because of a failure to pay its bills. Puerto Rico's Federation of Mayors estimates that forty-five of Puerto Rico's seventy-eight municipalities will not have enough cash for payroll expenses as early as this November. Fuel services at six municipalities could be cutoff within weeks as well. Against this backdrop, any additional fiscal adjustment must be measured against its potentially adverse effects on the Puerto Rican economy and people.

The central government's ongoing structural deficits also put Puerto Rico's pension systems at risk. Monthly pension payments are the only source of steady income for many of the pension system's 163,000 retirees. An additional 167,000 workers, who represent nearly 20 percent of Puerto Rico's workforce, are also counting on the pension systems for future retirement income.

For much of the past decade, while workers paid into the system, Puerto Rico failed to pay its annual required contributions. As a result, system administrators are currently being forced to sell pension assets to pay current benefits. Once those assets are depleted – likely by 2019 – all

future pension benefits will need to be paid directly from the Commonwealth's General Fund. This will require an additional \$700 million to \$1 billion of outlays per year.

Longer-term, absent policy changes, Puerto Rico projects it will confront a \$28 billion budget shortfall over the next five years. The Commonwealth has identified additional tough revenue and expense measures to narrow that gap. However, full implementation of Puerto Rico's proposed actions, including the generation of economic growth, only reduces the estimated five-year fiscal deficit to \$14 billion. The remaining \$14 billion shortfall must be closed, in part, through the restructuring of Puerto Rico's large and complex debt burden.

The Administration's Proposed Plan

The Administration believes federal actions, executed alongside measures taken in the Commonwealth, are now required to allow Puerto Rico to address its fiscal crisis and restore economic growth. The Administration is presenting these concepts as principles and stands ready to work with Congress to advance comprehensive legislation that achieves our collective objective.

There are four interrelated elements to the Administration's proposal:

First, Congress should provide tools for Puerto Rico to comprehensively restructure its financial liabilities. Puerto Rico's debt load is unsustainable. Tax-supported debt service is projected to consume over 35 percent of government receipts in coming years. In contrast, debt service for the fifty states is, on average, only 5 percent of revenues. Additionally, total liabilities exceed 160 percent of GNP – a greater burden than can likely be supported by Puerto Rico even if economic growth resumes. The bond market also knows this, which is, in part, why Puerto Rico's uninsured debt trades between 30 and 70 cents on the dollar, and rating agencies have determined there is a high probability of default.

For that reason, a central element of any Congressional response must include a fair and orderly restructuring mechanism built on the tested principles of the federal bankruptcy code. Puerto Rico does not have access to the federal bankruptcy courts to restructure its financial obligations. Puerto Rico's officials tried to address this shortfall on their own by passing a law to provide a bankruptcy-like process, but the United States Court of Appeals for the First Circuit held that federal law preempts the local legislation. Further, the Court held that only Congress may grant Puerto Rico access to bankruptcy protection.

Puerto Rico's debt stock is highly complex. More than 20 creditor committees have already formed around Puerto Rico's 18 different debt issuers, each with its own competing interests. This will make it very difficult for Puerto Rico to negotiate a voluntary restructuring on a timely basis. A court-supervised process would help ensure fair treatment to all parties. Absent an orderly process, all stakeholders stand to lose in the face of continued deterioration of Puerto Rico's economic and financial conditions.

Bankruptcy is not a bailout. Allowing Puerto Rico to resolve its liabilities under the supervision of a bankruptcy court involves no federal financial assistance whatsoever. Instead, bankruptcy requires shared sacrifice from both Puerto Rico and its creditors. The alternative – an untested and potentially disorderly process with numerous creditor lawsuits and years of litigation – would depress the local economy, increase costs, and make long-term recovery harder to achieve.

Congress should move swiftly to pass pending legislation that provides Chapter 9 protection to Puerto Rico’s municipalities in the same manner it already provides bankruptcy protection to municipalities in the fifty states. This legislation would cover approximately one-third of Puerto Rico’s bonded debt.

Congress should also authorize a broader legal framework that goes beyond the scope of Chapter 9 to allow for a comprehensive restructuring of all of Puerto Rico’s outstanding debt. The restructuring regime should be reserved exclusively for U.S. territories. As under current law, states would remain ineligible to file for bankruptcy under this or any other bankruptcy regime.

The restructuring regime should provide the basic protections of bankruptcy: a stay on creditor collection actions, priority for new private short-term cash flow financing, and voting by creditor classes on any proposed restructuring.

The restructuring regime should fairly balance the interests of Puerto Rico and all its creditors. It should safeguard Puerto Rico’s capacity to fund its public pensions and pay retiree benefits. Such an approach would, among other things, provide breathing space for consensual negotiations and ensure the uninterrupted provision of essential public services.

Second, Congress should require that Puerto Rico implement strong fiscal governance and oversight as part of a comprehensive legislative package. Puerto Rico’s efforts have been hampered by a lack of fiscal oversight and transparency. Historically, Puerto Rico’s budgets relied on unrealistic revenue estimates, and, as a result, annual budgets masked recurring structural deficits. Moreover, proposed revenue and expense measures have fallen short because Puerto Rico lacks important fiscal controls to ensure discipline.

Consequently, independent and credible fiscal oversight is needed. Congress should enact that oversight as part of a comprehensive approach to the crisis. Care must be taken to structure the fiscal oversight in a way that respects Puerto Rico’s autonomy. At the same time, the oversight should provide sufficient safeguards to ensure Puerto Rico adheres to its recovery plan and fully implements proposed reforms. This would help restore confidence among all stakeholders. Access to the broader restructuring regime should be conditioned on this oversight. The Administration is ready to work with Congress to identify the powers of this oversight body and its proposed membership.

Any fiscal oversight should also work to improve Puerto Rico’s fiscal accounting and reporting systems. While the historical inadequacies of Puerto Rico’s financial systems are undeniable, there is little doubt about the realities of the current fiscal crisis. The Commonwealth recently

commissioned an independent and exhaustive forensic accounting of their financial books that for the first time revealed the true extent of Puerto Rico's fiscal crisis. This rigorous and thorough accounting is available on the website of the Government Development Bank.

Congress should provide funding and authorization for technical assistance to help Puerto Rico make the critical investments needed to bring its accounting and disclosure practices into the 21st century. This includes taking action to fund information technology upgrades, improve economic forecasting capabilities and provide Federal technical assistance around budgeting, cash management and spending controls. Agencies in Puerto Rico use different financial systems that are incompatible with one another, making it difficult to provide consistent, timely financial reporting and visibility into expenses. The funding amounts involved would be small, but the benefits would be great.

Third, Congress must provide a long-term solution to Puerto Rico's inadequate Medicaid treatment. Given the current treatment of Puerto Rico and the other territories under federal law, the 3.5 million Americans in Puerto Rico do not have access to healthcare services considered standard in the rest of the nation. There are currently more than 1.6 million Medicaid enrollees in Puerto Rico's healthcare system, representing nearly half of the Commonwealth's population. Insufficient and unstable funding for Medicaid has contributed to Puerto Rico's fiscal challenges and endangered access to coverage. When one-time funds from the Affordable Care Act for Puerto Rico's Medicaid system are exhausted, as many as 600,000 Americans living in Puerto Rico could lose coverage.

Puerto Rico's Medicaid program is fundamentally different from the Medicaid program that serves Americans in the 50 states and the District of Columbia. Medicaid funding in Puerto Rico is capped; U.S. citizens in Puerto Rico are offered fewer benefits; and the federal government contributes less on a per capita basis in Puerto Rico than in the states.

As a result, Congress should reform Puerto Rico's Medicaid program to raise the standard of care and prevent Medicaid's unstable financing from exacerbating Puerto Rico's fiscal crisis. Americans in Puerto Rico should be provided with access to Medicaid and key healthcare services that better align with what people receive on the mainland.

Congress should also remove the cap on Puerto Rico's Medicaid program and increase the Federal support Puerto Rico receives through the Federal Medicaid match, after a sufficient transition period. A transition period is required so Puerto Rico can develop the more robust infrastructure required to offer new benefits and strengthen its internal accountability, financial management, and program integrity controls to prevent fraud, waste, and abuse. Because the transition may take years, Congress should avoid a drop in coverage when one-time funds from the Affordable Care Act expire.

Finally, Puerto Rico desperately needs measures to boost economic growth. The decade-long recession has taken its toll on Puerto Rico's finances, its economy, and its people. To break this vicious cycle and help those hardest hit, Congress should extend some of the most proven, bipartisan tools for stimulating growth and rewarding work to the citizens of Puerto Rico.

At forty percent, Puerto Rico has the lowest labor market participation in the United States and the territories – participation rates are about two-thirds the U.S. average. Low participation in the formal economy stunts economic growth and undermines Puerto Rico’s economic reform.

Puerto Rico does not currently have an Earned Income Tax Credit (EITC). A large body of economic research has found that the EITC is one of the strongest, most powerful policy tools for rewarding work and supporting economic growth. The existence of an EITC should also increase employment in the official sector relative to the informal economy by providing higher wages to workers who file taxes. As a result, Congress should grant Puerto Rico access to an EITC.

The EITC is a proven job creation policy that has long garnered broad bipartisan support in Washington. President Reagan proposed a major EITC expansion in his 1986 Tax Reform Act, which he argued was “the best antipoverty, the best pro-family, the best job creation measure to come out of Congress.” Several studies demonstrate that the large expansions to the EITC enacted in the 1980s and 1990s induced more than half a million people to enter the labor force.

Congress should also consider other proven measures, in addition to an EITC, that reward work and support growth, such as the Child Tax Credit.

The Administration’s Ongoing Engagement

Although there is no substitute for legislative action, the Administration has been actively working for many months, within existing authorities, to help the residents of Puerto Rico.

Treasury started monitoring Puerto Rico’s fiscal situation several years ago. As the Commonwealth’s financial challenges worsened, Secretary Lew intensified the Department’s effort. He created a dedicated team within Treasury to evaluate Puerto Rico’s fiscal outlook more closely and begin sharing our expertise with the officials that oversee the Commonwealth’s economic policies.

Since its formation, the team has visited Puerto Rico regularly to review Puerto Rico’s financial data, offer our perspectives on how other entities have managed through similar crises, and recommend steps Puerto Rico could take to restore economic growth. We meet frequently with the Governor, members of Puerto Rico’s legislature, and local business and labor leaders. We also remain in daily communication with the officials managing Puerto Rico’s fiscal response.

The National Economic Council and Treasury are also leading a broad, Administration-wide effort on Puerto Rico. This broader, Administration-wide effort includes the support of the White House Task Force on Puerto Rico, the Office of Management and Budget, the Department of Health and Human Services, the Department of Justice, and all other agencies needed to construct the legislative priorities proposed in this testimony.

The effort has three primary objectives. First, to ensure the Administration brings our full capabilities to bear, within the limit of our authorities, to guarantee Puerto Rico has access to all available federal programs. Second, to encourage federal agencies to pursue all possible administrative options for assistance. And, finally, it established the legislative priorities proposed today.

The inter-agency effort has already produced results. These are some salient examples:

- As part of our effort to ensure Puerto Rico has access to all available federal resources, the **Department of Health and Human Services** worked with the Administración de Seguros de Salud (ASES) to implement an accelerated reimbursement timeline for eligible healthcare expenses. Rather than reimbursing ASES on a periodic basis, reimbursements now occur weekly, substantially reducing the friction between the time funds are outlaid and subsequently repaid. This helps to ease the burden on Puerto Rico as it manages through its limited liquidity. The **Department of Health and Human Services** also convened a working group between the Secretary’s office and the Puerto Rico Healthcare Coalition to exchange information and identify any administrative flexibility that might exist. This working group is considering data proxies to improve Medicare payments to hospitals in Puerto Rico and adjustments to Medicare measures that would benefit high-poverty areas across the United States, including Puerto Rico.
- The **Department of Transportation** (DOT) is working closely with Puerto Rico’s Highways & Transportation Authority to spur infrastructure investment. As a result, the Federal Highway Administration identified more than \$750 million in toll credits Puerto Rico can use to fund new and potentially existing infrastructure projects. DOT is also working with Puerto Rico to add PR-22 to the Presidential Dashboard and is accelerating the design of a congestion pricing system to improve traffic flow on PR-52. The Build America Transportation Infrastructure Center is also in conversation with Puerto Rico about lending its expertise on possible public private partnership opportunities.
- The **Department of Commerce**, led by SelectUSA and through direct engagement from the Vice President of the United States, supported efforts to attract significant new investment to develop the Lufthansa Maintenance, Repair, and Overhaul facility in Aguadilla. SelectUSA continues to partner with Puerto Rico on a pipeline of potential investment deals to help attract jobs and boost economic growth on the Island.
- The **General Services Administration** is helping create opportunities for local and small businesses by spending \$85 million to construct a new FBI headquarters in San Juan. This will create both jobs and procurement opportunities for local businesses. As part of their Big Building Projects, the GSA also recently hosted a networking event for local contractors interested in being shortlisted for the FBI

project. Separately, the Department of Commerce's **Economic Development Administration** provided \$800,000 to the Puerto Rico Trade and Export Company (PRTE) and the Puerto Rico Investment Development Corporation (PRIDCO) to host a Small and Medium Enterprises conference focused on business to business matching and procurement processes.

- The Administration continues to partner with Puerto Rico to improve the structural competitiveness of its economy. **Department of Agriculture** is working with Puerto Rico to modernize and reform the Island's Nutrition Assistance Program to help remove significant benefits cliffs that can potentially discourage individuals from seeking work in the formal economy. The **Department of Justice** recently signed a Memorandum of Understanding to help reduce violent crimes. And, the **Department of Energy** signed a Memorandum of Understanding to develop a long-term energy plan that will provide Puerto Rico with safe, reliable, and clean energy. The Department of Energy's efforts could help to lower electricity costs on the Island, which at twice the levels of the mainland, decrease the Commonwealth's competitiveness for business investment and raise costs faced by its residents.

The Administration remains committed to supporting Puerto Rico as it addresses its fiscal crisis and seeks to restore economic growth. However, while these achievements represent tangible progress, they are insufficient to meet the magnitude of Puerto Rico's fiscal challenges. That is why Congressional action is essential to provide Puerto Rico with the tools it needs to manage through this crisis and restore growth.

Conclusion

There is plenty of blame to go around for the mistakes of the past. But we must now focus on the path forward. Puerto Rico can and will emerge from the current crisis and return to growth. The fundamental question is when and at what cost to its residents and economy. By implementing the Administration's four-part plan, Congress can help put Puerto Rico on the best path to a sustained recovery.

If we do not act collectively and quickly, Puerto Rico will face a long, difficult, and uncertain process. The federal government will also pay a price if a comprehensive solution is not enacted. More residents of Puerto Rico would need to turn to federal safety nets including unemployment insurance, low-income housing grants, nutrition assistance grants, and temporary assistance for needy families, among other federal assistance programs.

We look forward to a constructive, bipartisan dialogue to identify ways to execute the Administration's proposals and provide Puerto Rico with the tools it needs to manage through this crisis and restore growth. You have kindly invited us today to discuss Puerto Rico's economy, debt, and options for Congress. We believe this discussion is timely and the issue must be addressed.