

**HOUSE OF REPRESENTATIVES
FINAL BILL ANALYSIS**

BILL #:	CS/HM 601	FINAL HOUSE FLOOR ACTION:	
SPONSOR(S):	Local & Federal Affairs Committee; Cortes, B.	N/A Y's	N/A N's
COMPANION BILLS:	SM 798	GOVERNOR'S ACTION:	N/A

SUMMARY ANALYSIS

CS/HM 601 passed the House on March 4, 2016, and subsequently passed the Senate on March 10, 2016.

Puerto Rico is currently suffering from a severe recession and debt crisis. The Governor of Puerto Rico has warned certain municipalities and public utilities on the island may not be able to pay currently existing bond obligations as those payments become due. A resolution of this crisis is of particular interest to Florida, not only because of the significant economic activity between the state and Puerto Rico but also because over a million Florida residents are of Puerto Rican heritage, the second largest such population in the nation.

The memorial urges the Congress of the United States to enact legislation to promote economic recovery in the Commonwealth of Puerto Rico consistent with sound fiscal principles necessary to reduce the national debt.

This memorial does not have a fiscal impact on state or local governments.

The memorial is not subject to the Governor's veto powers.

I. SUBSTANTIVE INFORMATION

A. EFFECT OF CHANGES:

Background

A History of Puerto Rico under American Administration

Since the conclusion of the Spanish-American War in 1898, the island of Puerto Rico has been part of the United States.¹ While the island was initially placed under military jurisdiction, Congress quickly passed the Foraker Act, providing a civilian government for the territory, a non-voting Resident Commissioner in Congress, and applying all federal laws to the island.²

The Jones-Shafroth Act of 1917 (Jones-Shafroth Act) made significant changes in both the organization of the Puerto Rico government and the relationship of the island with the United States. The act established a bill of rights for the territory,³ created a bicameral legislature,⁴ and made the Resident Commissioner an elected position.⁵

The Jones-Shafroth Act granted United States citizenship to all residents of the island.⁶ The Jones-Shafroth Act also provided that bonds issued by the government of Puerto Rico or under its authority are exempt from federal, state, and local taxation, regardless of the location of the bondholder.⁷ This provision makes Puerto Rican municipal debts particularly attractive to bondholders, since municipal bonds generally are only exempt from taxation when held by residents of the issuing state.⁸

The passage of the Puerto Rico Federal Relations Act of 1950 paved the way for modern self-government.⁹ The act authorized the Legislature of Puerto Rico to call for a referendum to establish a constitutional convention.¹⁰ The new constitution drafted by the convention was approved by voters on March 3, 1952,¹¹ approved by Congress on July 3, 1952,¹² and was officially proclaimed on July 25, 1952.¹³

Present Situation

¹ Treaty of Peace between the United States and Spain (Treaty of Paris), Dec. 10, 1898, available at http://avalon.law.yale.edu/19th_century/sp1898.asp.

² Liberty of Congress, *Foraker Act (Organic Act of 1900)*, <https://www.loc.gov/rr/hispanic/1898/foraker.html> (last visited Mar. 10, 2015).

³ Jones-Shafroth Act, Pub. L. No. 64-368, s. 2, 39 Stat. 951 (Mar. 2, 1917).

⁴ Jones-Shafroth Act s. 25.

⁵ Jones-Shafroth Act s. 29. The Resident Commissioner had previously been appointed by the President of the United States.

⁶ Jones-Shafroth Act s. 5.

⁷ Jones-Shafroth Act s. 3.

⁸ See *The Bonds that Broke Puerto Rico*, N.Y. Times (June 30, 2015), <http://www.nytimes.com/2015/07/01/business/dealbook/the-bonds-that-broke-puerto-rico.html> (last visited Mar. 10, 2015).

⁹ Puerto Rico Federal Relations Act of 1950, Pub. L. No. 81-600 (July 3, 1950).

¹⁰ Puerto Rico Federal Relations Act of 1950, s. 2.

¹¹ Dieter Nohlen, *Elections in the Americas A Data Handbook Volume 1: North America, Central America, and the Caribbean* 556 (Oxford University Press 2005).

¹² Pub. L. No. 82-447 (July 3, 1952).

¹³ PBS, Puerto Rico: A Timeline, <http://www.pbs.org/wgbh/masterpiece/americancollection/woman/timeline.html> (last visited Mar. 10, 2015).

Puerto Rico is in the midst of a severe economic downturn and its government is unable to meet certain debt obligations as they become due. The island has been in continuous recession since 2006.¹⁴ The beginning of the recession is often linked to the expiration of Section 936,¹⁵ a federal tax credit for manufacturing.¹⁶ Section 936 provided a federal tax credit for income earned in Puerto Rico for firms making at least 80 percent of their income from sources within the territory with at least 75 percent of their total income being derived from an active trade or business within the Commonwealth.¹⁷

Section 936 was credited with encouraging major pharmaceutical firms like Pfizer to establish operations on the island.¹⁸ The phase out of the provision, however, slowed the growth of new firms in Puerto Rico, harming the island's economy.¹⁹ Some studies suggest the benefits of Section 936 to the Puerto Rican economy were overstated, with benefits largely flowing to firms who employed few workers on the island.²⁰

The recession has had a significant impact on the island's population. The number of residents leaving the island has been steadily increasing for the last decade, from approximately 10,000 per year in 2005 and 26,000 per year in 2010 to more than 64,000 in 2014.²¹ Much of this migration has been to Florida, with the state's population of people of Puerto Rican heritage increasing from 816,002 in 2009 to 1,006,542 in 2014.²²

Puerto Rico's economy has also been harmed by the liberalization of global trade, removing tariff barriers that shielded firms from competitors in nations such as Mexico, Canada, Chile, Peru, and Columbia.²³ Two additional factors that combine to make Puerto Rican firms less competitive are labor and transport costs. The impact of the federal minimum wage on Puerto Rico is significant, with full-time workers receiving the equivalent of 77 percent of per capita income, compared to 28 percent of per capita income on the mainland.²⁴ The island suffers from significantly higher transportation costs due to the Merchant Marine Act of 1920. This act, requiring all shipping between two United States ports to occur on ships built and flagged in the United States and owned and crewed by American citizens, results in firms facing shipping costs that are more than double those of neighboring islands.²⁵

¹⁴ *Puerto Pobre*, The Economist (Oct. 26, 2013), <http://www.economist.com/news/finance-and-economics/21588364-heavily-indebted-island-weighs-americas-municipal-bond-market-puerto-pobre> (last visited Mar. 10, 2015).

¹⁵ 28 U.S.C. s. 936; see Internal Revenue Manual, Part 4: Examining Process, Ch. 61: International Program Audit Guidelines, S. 9: Possession Corporations, available at https://www.irs.gov/irm/part4/irm_04-061-009.html (last visited Mar. 10, 2015) (phase out rules for Section 936 credit).

¹⁶ *Puerto Pobre*, *supra* note 14.

¹⁷ General Accounting Office, *Puerto Rico and the Section 936 Tax Credit* (June 1993) at 2, <http://www.gao.gov/assets/220/218131.pdf> (last visited Mar. 10, 2015).

¹⁸ *Can Puerto Rico Reinvent Itself as a Global Competitor?*, Knowledge@Wharton (Aug. 22, 2012), <http://knowledge.wharton.upenn.edu/article/can-puerto-rico-reinvent-itself-as-a-global-competitor/> (last visited Mar. 10, 2015).

¹⁹ *Id.*

²⁰ See generally J. Tomas Hexner and Glenn P. Jenkins, *Puerto Rico and Section 936: A Costly Dependence*, 10 Tax Notes Int'l 235 (Jan. 16, 1995). In 1989, pharmaceutical companies received 50 percent of Section 936 credits, but employed 17 percent of workers in firms receiving credits.

²¹ Jens Manuel Krogstad, *Puerto Ricans leave in record numbers for mainland U.S.*, Pew Research Center (Oct. 14, 2015), <http://www.pewresearch.org/fact-tank/2015/10/14/puerto-ricans-leave-in-record-numbers-for-mainland-u-s/> (last visited Mar. 10, 2015).

²² United States Census Bureau, Geographies: State - ACS Demographic and Housing Estimates 2014 American Community Survey 1-Year Estimates, <http://factfinder.census.gov/faces/nav/jsf/pages/searchresults.xhtml?refresh=t#none> (last visited Mar. 10, 2015); United States Census Bureau, Geographies: State - ACS Demographic and Housing Estimates 2009 American Community Survey 1-Year Estimates, <http://factfinder.census.gov/faces/nav/jsf/pages/searchresults.xhtml?refresh=t#none> (last visited Mar. 10, 2015).

²³ Knowledge@Wharton, *supra* note 18.

²⁴ Anne O. Kreuger, Ranjit Teja, and Andrew Wolfe, *Puerto Rico – A Way Forward* at 6, Government Development Bank of Puerto Rico, June 29, 2015, available at www.bgfpr.com/documents/puertoricawayforward.pdf.

²⁵ *Id.* at 8.

Puerto Rico's government, including municipalities and government utilities, currently has \$72 billion of outstanding debt.²⁶ Approximately one-third of the payment due is for general obligation bonds, while the remainder is mostly due from public corporations operating vital services such as water, electricity, and the highway system.²⁷ Concerns about repayment led some creditors of the Electric Power Authority to agree to limited debt restructuring in late December 2015.²⁸ Puerto Rico's government has previously defaulted on a \$58 million "moral obligation bond" in August 2015.²⁹ The crisis was accelerated when much of Puerto Rico's general debt was downgraded to junk status in early 2014.³⁰ This downgrade required the government to post cash as collateral to cover interest-rate swaps and sparked selling by mutual funds and other financial institutions which are prohibited from holding assets that are not investment-grade.³¹

Bonds issued by the Puerto Rico Urgent Interest Fund Corporation (COFINA) represent roughly \$16 billion of Puerto Rico's outstanding debt.³² These bonds were sold to investors as a safe asset, since the government pledged a portion of the island's sales tax revenues to bond repayment.³³ The rights of these bondholders, however, may be threatened if the government of Puerto Rico redirects funds pledged for the repayment of COFINA bonds to avoid default on general obligation debt.³⁴ Some analysts feared this outcome is likely since general obligation debt is protected by Puerto Rico's constitution.³⁵ This concern was partially realized on January 4, 2016, when Puerto Rico's government defaulted on \$174 million of non-general obligation bonds.³⁶

Beyond its effect on Puerto Rico, the threat of default poses significant risks for investors in Florida. Puerto Rico's debt burden is the third highest in the nation, behind only California and New York.³⁷ Since the interest from Puerto Rican bonds is exempt from federal, state, and local taxes, the bonds are a popular choice for mutual funds.³⁸ Nearly 70 percent of domestic municipal bonds funds have exposure to Puerto Rico.³⁹

Potential Policies

Chapter 9 of the Bankruptcy Code or Other Forms of Debt Relief

Municipal bankruptcy is governed by Chapter 9 of the Bankruptcy Code. The interactions between various provisions of the U.S. Constitution require municipal bankruptcy to be a cooperative enterprise

²⁶ Michael Corkery and Mary Williams Walsh, *Governor of Puerto Rico Warns of Looming Default Without Bankruptcy Plan*, N.Y. Times (Dec. 16, 2015), <http://www.nytimes.com/2015/12/17/business/dealbook/governor-of-puerto-rico-warns-of-looming-default-without-bankruptcy-plan.html> (last visited Mar. 10, 2015).

²⁷ *Id.*

²⁸ Michelle Kaske and Erik Schatzker, *Puerto Rico Electric Reaches Tentative Pact With Creditors*, Bloomberg Business (Dec. 18, 2015), <http://www.bloomberg.com/news/articles/2015-12-18/puerto-rico-electric-said-to-reach-tentative-pact-with-creditors> (last visited Mar. 10, 2015).

²⁹ Corkery and Walsh, *supra* note 26.

³⁰ *Fitch becomes third agency to cut Puerto Rico to junk*, Reuters (Feb. 11, 2014), <http://www.reuters.com/article/munis-puertorico-ratings-idUSWNAB046DO20140211> (last visited Mar. 10, 2015).

³¹ Mary Williams Walsh, *Worsening Debt Crisis Threatens Puerto Rico*, N.Y. Times (Oct. 7, 2013), http://dealbook.nytimes.com/2013/10/07/worsening-debt-crisis-threatens-puerto-rico/?_r=0 (last visited Mar. 10, 2015).

³² Aaron Kuriloff, *'Safe' Puerto Rican Debt Stirs Worries*, The Wall Street Journal (Dec. 27, 2015), <http://www.wsj.com/articles/safe-puerto-rican-debt-stirs-worries-1451266037> (last visited Mar. 10, 2015).

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ Mary Williams Walsh, *Puerto Rico Defaults on Debt Payments*, N.Y. Times (Jan. 4, 2016), http://www.nytimes.com/2016/01/05/business/dealbook/puerto-rico-defaults-on-debt-payments.html?_r=0 (last visited Mar. 10, 2015).

³⁷ Michelle Caruso-Cabrera, *Why Puerto Rico needs to borrow money—and soon*, CNBC (Jan. 24, 2014), <http://www.cnbc.com/2014/01/24/puerto-rico-debt-crisis-island-must-borrow-by-end-of-january.html> (last visited Mar. 10, 2015).

³⁸ *Id.*

³⁹ *Id.*

between states and the federal government.⁴⁰ States would be unable to provide an effective resolution for debtors without violating the Contracts Clause,⁴¹ while an entirely federal scheme would infringe on state sovereignty to control their municipalities under the Tenth Amendment.⁴² The Bankruptcy Code does not prevent a state from creating its own insolvency procedures, as long as the state statute does not bind any creditors who do not consent to the procedures.⁴³

To file for relief as a debtor under ch. 9, an entity must meet five criteria⁴⁴:

- The entity must be a municipality;⁴⁵
- The entity must be specifically authorized to be a debtor under ch. 9 by state⁴⁶ law or by a governmental official or organization empowered by state law to make such authorization;
- The entity must be insolvent;
- The entity must desire to effect a plan to adjust such debts; and
- The entity must meet one of the following four criteria:
 - The entity has obtained the agreement of the creditors holding a majority of the claims in each class of claims that would be impaired by the plan;
 - The entity has negotiated in good faith with creditors and has failed to obtain agreement of creditors holding a majority in each class of claims that would be impaired by the plan;
 - The entity is unable to negotiate with creditors because such negotiations are impracticable; or
 - The entity reasonably believes a creditor may attempt to obtain a transfer that is avoidable under s. 547 of the Bankruptcy Code.⁴⁷

After a petition has been filed, the case is administered and directed similar to reorganizations under Chapter 11 of the Bankruptcy Code. The United States Trustee may appoint committees of creditors and of equity security holders⁴⁸ authorized to investigate issues and participate in formulating a restructuring plan.⁴⁹

Puerto Rican municipalities are currently precluded from filing for bankruptcy under Chapter 9.⁵⁰ From 1938 (the first municipal bankruptcy statute) until 1978, Puerto Rico was defined as a state for all bankruptcy purposes, expressly able to afford bankruptcy protection to its municipalities.⁵¹ The Bankruptcy Reform Act of 1978 removed the definition of “state” from the statute, placing the status of Puerto Rican municipalities under Chapter 9 into limbo.⁵² When the definition of “state” was reintroduced to the Bankruptcy Code in 1984, the current language was added excluding Puerto Rico for the purpose of determining who qualified as a debtor under ch. 9.⁵³

⁴⁰ *Franklin California Tax-Free Trust v. Puerto Rico*, 805 F.3d 322, 328 (1st Cir. 2015), *cert. granted*, 84 USLW 3100 (Dec. 4, 2015).

⁴¹ U.S. Const. art. I, s. 10, cl. 1.

⁴² *Id.* at 327-28.

⁴³ 11 U.S.C. s. 903.

⁴⁴ 11 U.S.C. s. 109(c).

⁴⁵ 11 U.S.C. s. 101(40) defines “municipality” to mean any political subdivision, public agency, or public instrumentality of the state. This definition encompasses counties, cities, special districts, school districts, and publicly-owned corporations.

⁴⁶ 11 U.S.C. s. 101(52) defines “state” for the purposes of the bankruptcy code as including the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor in 11U.S.C. s. 109(c).

⁴⁷ 11 U.S.C. s. 547.

⁴⁸ 11 U.S.C. ss. 901, 1102. Since 1986, Florida and Puerto Rico have been represented by the same United States Trustee office. *See* Bankruptcy Judges, U.S. Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554 s. 111(a) (1986), codified at 28 U.S.C. s. 581.

⁴⁹ 11 U.S.C. ss. 901, 1103.

⁵⁰ *See* 11 U.S.C. s. 101(52) (excluding Puerto Rico from the definition of “state” for the purposes of defining Ch. 9 debtors).

⁵¹ *Franklin California Tax-Free Trust* at 329.

⁵² *Id.* at 330.

⁵³ *Id.*

Since its municipalities are ineligible for Chapter 9, Puerto Rico attempted to create an alternative bankruptcy-like process with the passage of the Puerto Rico Public Corporation Debt Enforcement and Recovery Act.⁵⁴ The act created two paths for the restructuring of public corporations, a consensual out-of-court process and a judicially managed in-court process, that closely parallel the Bankruptcy Code.⁵⁵ The act, however, was permanently enjoined by the United States District Court for the District of Puerto Rico on the grounds it is preempted by 11 U.S.C. s. 903.⁵⁶ This decision was upheld by the United States Court of Appeals for the First Circuit and is currently awaiting hearing at the Supreme Court of the United States.⁵⁷

Economic Development

Structural reforms may provide another potential avenue for economic development in Puerto Rico. The labor force participation rate in Puerto Rico is approximately 40 percent, compared to 63 percent on the mainland.⁵⁸ This disparity is the result of federal policies that create disincentives for employers to hire workers and for potential employees to seek employment. A full-time employee working for minimum wage receives a salary equivalent to 77 percent of per capita income, compared to 28 percent on the mainland.⁵⁹ This disparity creates a strong constraint on employment for low-wage workers, with 28 percent of hourly workers in Puerto Rico earning less than \$8.50 per hour, compared to 3 percent on the mainland.⁶⁰ Some scholars have suggested additional labor market opportunities could be created by suspending the minimum wage in Puerto Rico until its per capita income is closer to that of the poorest state, or by setting a special minimum wage for Puerto Rico.⁶¹ The federal government could create additional work incentives by restructuring welfare programs in Puerto Rico to be more responsive to local labor market conditions, instead of using a one-size-fits-all approach.⁶²

Puerto Rico's economy could be invigorated by measures to reduce transportation and energy costs. The Merchant Marine Act of 1920 (Jones Act) places a unique burden on Puerto Rico, as the island is almost completely dependent on ships for the delivery of goods. Import costs to the island are nearly double those of neighboring islands.⁶³ Exemptions for territories have proven successful at reducing shipping costs in the past. Congress exempted the U.S. Virgin Islands from the Jones Act in 1992 and today shipping costs are nearly half of those of shipping to Puerto Rico.⁶⁴ The Jones Act is a contributing factor in the island's high electricity costs, raising the cost of gasoline by 15 cents per gallon.⁶⁵ Over half of Puerto Rico's electricity generation utilizes petroleum.⁶⁶ Energy costs are also increased due to inefficiencies in the public-owned company responsible for producing and distributing energy.⁶⁷

Pending Legislation

⁵⁴ 2014 P.R. Laws Act No. 71.

⁵⁵ *Puerto Rico Public Corporation Debt Enforcement and Recovery Act*, 128 Harv. L. Rev. 1320, 1322 (2015).

⁵⁶ *Franklin California Tax-Free Trust* at 332.

⁵⁷ *Melba Acosta-Febo v. Franklin California Tax-Free Trust*, 2015 WL 5096465 (Dec. 4, 2015).

⁵⁸ Kreuger, Teja, and Wolfe, *supra* note 24, at 6. The labor force participation rate is the ratio of the labor force (all person employed or unemployed and looking for work) as a percentage of the civilian non-institutional population (persons aged 16 or older who are not inmates of institutions and are not on active military duty). BLS Glossary, <http://www.bls.gov/bls/glossary.htm>.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.* at 17. Currently, American Samoa and the Northern Mariana Islands have special minimum wage rates. United States Dept. of Labor Wage and Hour Division, *Minimum Wages Laws in the States – January 1, 2015*, <http://www.dol.gov/whd/minwage/america.htm> (last visited Mar. 10, 2015).

⁶² *Id.* at 18.

⁶³ *Id.* at 8.

⁶⁴ Patrick Holland, *Help Puerto Rico by Repealing the Jones Act*, e21 (July 15, 2015), <http://economics21.org/commentary/jones-act-puerto-rico-debt-crisis-anne-krueger-07-15-2015> (last visited Mar. 10, 2015).

⁶⁵ *Id.*

⁶⁶ United States Energy Information Administration, *Puerto Rico Territory Energy Profile*, <https://www.eia.gov/state/print.cfm?sid=RQ> (last visited Mar. 10, 2015).

⁶⁷ Kreuger, Teja, and Wolfe, *supra* note 24, at 8.

There are currently three proposals pending in Congress to address the fiscal crisis in Puerto Rico.

The Puerto Rico Assistance Act of 2015 is currently pending in the Senate Finance Committee.⁶⁸ The bill creates the Puerto Rico Financial Responsibility and Management Assistance Authority to oversee financial planning and budgets for the Commonwealth and insolvent public corporations.⁶⁹ The bill commissions a study on public pension debt and requires the Commonwealth and local governments to conform to generally applicable reporting requirements.⁷⁰ The bill also contains a temporary employee payroll tax cut of 3.1 percent for calendar years 2016-2019 and 1.55 percent for calendar year 2020.⁷¹

The Puerto Rico Chapter 9 Uniformity Act of 2015 would amend the Bankruptcy Code to enable Puerto Rican municipalities to file for bankruptcy.⁷²

The Puerto Rico Financial Stability and Debt Restructuring Choice Act combines the above approaches.⁷³ The bill would create the Puerto Rico Financial Stability Council.⁷⁴ The Governor of Puerto Rico would be required to submit the Commonwealth's annual budget to the council for final approval.⁷⁵ Any budget approved by the council must apply "sound budgetary practices," make progress on balancing the Commonwealth's budget, and be reviewed by an independent auditor.⁷⁶ The bill would also allow Puerto Rican municipalities to file for bankruptcy under Chapter 9 of the Bankruptcy Code.⁷⁷

Effect of the Memorial

CS/HM 601 urges the Congress of the United States to enact legislation to promote economic recovery in the Commonwealth of Puerto Rico consistent with sound fiscal principles necessary to reduce the national debt.

Copies of the memorial will be sent to the President of the United States, to the President of the United States Senate, to the Speaker of the United States House of Representatives, and to each member of the Florida delegation to the United States Congress.

Legislative memorials are not subject to the Governor's veto power and are not presented to the Governor for review. Memorials have no force of law, as they are mechanisms for formally petitioning the federal government to act on a particular subject.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

None.

⁶⁸ Puerto Rico Assistance Act of 2015, S. 2381, 114th Cong. (2015).

⁶⁹ Puerto Rico Assistance Act of 2015 s. 321-328.

⁷⁰ Puerto Rico Assistance Act of 2015 s. 201-202.

⁷¹ Puerto Rico Assistance Act of 2015 s. 101.

⁷² Puerto Rico Chapter 9 Uniformity Act of 2015, H.R. 870, 114th Cong. (2015). S. 1774 contains identical language.

⁷³ See Puerto Rico Financial Stability and Debt Restructuring Choice Act, H.R. 4199, 114th Cong. (2015).

⁷⁴ Puerto Rico Financial Stability and Debt Restructuring Choice Act s. 101.

⁷⁵ Puerto Rico Financial Stability and Debt Restructuring Choice Act s. 202.

⁷⁶ Puerto Rico Financial Stability and Debt Restructuring Choice Act s. 201.

⁷⁷ Puerto Rico Financial Stability and Debt Restructuring Choice Act s. 301.

2. Expenditures:

None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

None.

D. FISCAL COMMENTS:

None.