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Subcommittee on the Western Hemisphere

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A Hearing on
"Building Prosperity in Latin America: Investor Confidence in the Rule of Law"

Mr. Chairman, Members of the Committee:

The surge of undocumented children into the United States in recent months from Honduras, Guatemala, and El Salvador is only the latest reminder of the importance of a stable and prosperous Latin America -- not just to Latin Americans themselves but to all of us here in the United States.

Overall, Latin America has made significant progress over the past three decades toward the kind of free-market economic policies that insure both growth and opportunity at home and robust markets for U.S. businesses. For example, iShares Latin America 40, a popular exchange-traded fund that owns large-capitalization stocks from the region, has produced average annual returns of 16.1 percent over the past 10 years, compared with 8.3 percent for a fund that mimics the U.S. large-cap benchmark.[1] There are, however, major differences among nations, and several have been moving in the precisely the wrong direction.

[1] http://etfs.morningstar.com/quote?t=ILF®ion=usa&culture=en-US

For example, the Index of Economic Freedom, published annually by the Wall Street Journal and the Heritage Foundation, ranks Chile seventh among 178 countries on a scale that includes 10 metrics, from property rights to entrepreneurship.[2] (The U.S. itself ranks 12th.) In South America, Colombia, Uruguay, Peru, and Mexico are all in the top one-third of countries in the index – rankings that reflect major strides toward growth-enhancing policies. Many Caribbean and Central American nations also score well, including Barbados, St. Lucia, and Costa Rica.

It is hardly a surprise that Cuba ranks 177th, just above last-place North Korea, and that Venezuela is number 175, edging out Zimbabwe. But, more alarming has been the decline of Bolivia (158th), Ecuador (159th), and Brazil (114th). While in the recent past, Brazil has been favorably compared to India and China as a fast-growing developing market, Brazilian GDP growth this year is expected to be just 1 percent, compared with 3.2 percent for Chile and 5 percent for Colombia – and 6 percent or more for both India and China.[3] A reflection of the lack of investor confidence in Brazil is that the country's 10-year sovereign bonds are yielding 11.7 percent, compared with 6.5 percent for a similar bond issued by Colombia, 7.8 percent for a Mexican government bond, and just 2.7 percent for an Italian bond.[4]

Backsliding Latin American nations suffer from poor governance, especially the lack of adherence to the rule of law. And governance is linked to economic performance. In its 2013 Investment Climate Statement, the U.S. State Department lays out the problem well with respect to Ecuador, whose "investment climate"

> **remains uncertain as its economic, commercial and investment policies continue to change. While some laws and regulations have been enacted to spur increased domestic and foreign private investment, other legal changes**

[2] http://www.heritage.org/index/ranking
[3] http://www.economist.com/news/economic-and-financial-indicators/21608783-output-prices-and-jobs
[4] http://www.economist.com/news/economic-and-financial-indicators/21608780-trade-exchange-rates-budget-balances-and-interest-rates

> **have reduced private sector participation in so-called strategic sectors, most notably extractive industries, and negatively affected banking and media sectors. Frequent changes in Ecuador's tax code make business planning difficult…. In general, the legal complexity resulting from the inconsistent application and interpretation of existing laws complicates enforcement of contracts and increases the risks and costs of doing business in Ecuador. According to the National Development Plan ("Plan Nacional el Buen Vivir"), economic growth is not an end in itself and economic development is led by the state. Private investment, therefore, does not constitute a policy priority.**[5]

Even more alarming, however, is Argentina, which ranks 166th on the Index of Economic Freedom, behind such exemplars as the Central African Republic and Uzbekistan. Argentina has abundant natural resources, European-style sophistication, and a workforce that has proven itself in the past. Between 1871 and 1914, Argentina's average annual growth rate was the fastest in the world, at 6 percent.[6] In 1908, it was the seventh-wealthiest country in the world; today, it is 55th.[7] Argentina is a sad case – and a shining example of why good public policies, including strong rule of law, matter.

With a population of 41 million, Argentina is the fourth-largest Latin American country, behind Brazil, Mexico, and Colombia. The danger is that its influence outweighs its size. This hearing addresses "investor confidence in the rule of law." Argentina's actions in defiance of the rule of law since its $100 billion debt default in 2001 – the largest, at the time, in history – have not merely shaken investor confidence in Argentina, but also have served as a model for other governments to emulate.

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[5] http://www.state.gov/e/eb/rls/othr/ics/2013/204634.htm

[6] http://www.economist.com/news/briefing/21596582-one-hundred-years-ago-argentina-was-future-what-went-wrong-century-decline

[7] http://www.bloomberg.com/news/2014-02-03/argentina-bust-lures-bass-led-investors-in-200-years-of-defaults.html

That Argentine model can be described very simply: flout international financial standards, refuse to follow court rulings, and vilify creditors. In late 2008, Ecuador defaulted after Rafael Correa was elected president on a platform of debt repudiation.[8] In 2012, Belize, also following the Argentine script, threatened a default on a "restructuring offer that was worse than what Argentina gave creditors following its 2001 default."[9] In the end, Belize came to its senses.

Now, we are seeing the Argentine disease infect Puerto Rico, a government intimately tied to the United States. My testimony elaborates on the lessons of the Argentina default and explores the dangers of the situation in Puerto Rico. I conclude with some recommendations to policy makers on how to deal with growing attacks on investor confidence in our hemisphere.

The Argentine Model

On the very day of this hearing, July 30, 2014, the grace period for Argentina to comply with U.S. courts and make payments to creditors will run out. Barring an unexpected turn of events, Argentina will either make good on what it owes or suffer its eighth default since becoming an independent nation in 1816.[10]

Argentina finds itself in this predicament through its own poor decisions and a rogue approach to its obligations. Rather than cooperating with international financial institutions and the courts to restructure its debt, its leadership, under President Cristina Fernandez de Kirchner, chose a route of defiance – which played well temporarily at home but led to a end to private credit from abroad and, now, economic stagnation. Argentina's GDP is forecast to decline 1.2 percent this year,

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[8] http://blogs.reuters.com/felix-salmon/2009/05/29/lessons-from-ecuadors-bond-default/

[9] http://www.bloomberg.com/news/2013-01-14/belize-rejecting-argentine-default-model-spurs-region-best-rally.html

[10] http://www.bloomberg.com/news/2014-02-03/argentina-bust-lures-bass-led-investors-in-200-years-of-defaults.html

and its inflation rate, according to the State Street PriceStats Inflation Index, is 42 percent.[11] Argentina managed, over much of the last decade, to keep its economy going through the sale of agricultural commodities, like soybeans and corn, and through import and export restrictions, but those makeshift remedies have clearly failed.

After the 2001 default, Argentina gave its creditors – including foreign governments, institutional investors, and individuals – a take-it-or-leave-it 25 cents on the dollar, far below a conventional settlement offer. Many of those owed money, including 60,000 Italian pensioners, refused the deal. About three-quarters of creditors accepted, but there were far more holdouts than in a typical restructuring. The holdout creditors had some strong protections on their side.[12]

Because of its history of defaults, Argentina was only able to raise debt in the 1990s by agreeing to a waiver of sovereign immunity, a pledge to adjudicate matters in New York courts, and a *pari passu* clause that required the borrower to place creditors on an equal footing. Partly as a result, the holdout creditors won more than 100 court judgments, but Argentina refused to honor the rulings. On Oct. 26, 2012, a federal appeals court panel upheld a district court ruling that Argentina could not repudiate its obligations to holdouts and had to treat holders of all its debt equally. U.S. District Court Judge Thomas Griesa stated: "There cannot be a payment to the exchange bondholders [settled creditors] without court-ordered payments to the plaintiffs [holdout creditors]."

Argentina tried but failed to get the U.S. Supreme Court to overturn the lower court rulings, all the while mocking and criticizing the U.S. legal system. In February 2013, for example, Jonathan Blackman, a lawyer for Argentina, said to U.S. Circuit Judge

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[11] The inflation rate that the Argentine government reports has "not yet proven to be reliable," according to the Economist magazine: http://www.economist.com/news/economic-and-financial-indicators/21608783-output-prices-and-jobs

[12] http://online.wsj.com/news/articles/SB10001424127887324660404578197912267848812

Reena Raggi: “We are representing a government, and governments will not be told to do things that fundamentally violate their principles.”

“So,” said Judge Raggi, “the answer is you will not obey any order but the one you propose?”

“We would not voluntarily obey such an order,” Blackman said.[13]

President Fernandez echoed these sentiments last months: “What I cannot do as president is submit the country to such extortion,” she said last month.”[14]

But Argentina’s defiance would not have been nearly so effective in delaying the day of reckoning if the official international financial community had not displayed so much tolerance, even encouragement, of its antics. The International Monetary Fund, for example, censured Argentina for doctoring its economic statistics but took no more significant action. Argentina refused to abide by the rulings of the World Bank’s International Centre for the Settlement of Investment Disputes, with no consequences.[15] In 2011, to its credit, the U.S. adopted a policy of declining to vote yes on multilateral development bank loans to Argentina, but few countries followed its lead. And earlier this year, the Club of Paris, some 13 years after Argentina’s default, agreed to a settlement of $10 billion in debt to such governments as Japan, Germany, and the United States, but acceded to Argentina’s demand that, contrary to past practice, there would be no oversight by the IMF. The Club of Paris meekly went along.[16] On top of this defiance, Argentina nearly three years ago expropriated the majority interest that Repsol, a large Spanish company,

[13] http://www.businessweek.com/news/2013-02-26/argentina-seeks-relief-from-u-dot-s-dot-court-in-debt-fight and http://www.finalternatives.com/node/22998
[14] http://www.foxnews.com/politics/2014/06/17/argentina-president-defies-us-court-orders-on-repayment-debts/
[15] http://www.reuters.com/article/2012/03/26/us-usa-argentina-trade-idUSBRE82P0QX20120326
[16] http://online.wsj.com/articles/james-k-glassman-dont-welch-on-me-argentina-1401826159

held in the Argentine energy firm YPF.[17] In February, Argentina agreed to pay Repsol $5 billion for the seized stock – about half what it was worth

Perhaps worst of all, Argentina remains a member of the most exclusive economic club in the world, the Group of 20. Founded 15 years ago in response to the Asian financial crisis, the G20 was meant to consist of 20 large, systemically important economies. It was only in 2008, after President George W. Bush called its heads of government together in the wake of a far more serious crisis that the G20 rose to prominence, and it adopted the role of relieving that crisis and establishing standards to promote growth and prevent another catastrophe.

The G20 never had criteria for members. It was merely the G7 (U.S., U.K., Germany, France, Italy, Canada, and Japan) plus the European Union as a separate member, China, and 11 others, chosen by the original group. For reasons that defy logic, Argentina was one of those selected. In June 2012, Alex Brill of the American Enterprise Institute and I published a study that looked at this question: If the G20 members *were* chosen by objective criteria, what would those metrics be, and which countries would be chosen? Our study examined such data as GDP, extent of exports, systemic financial connections, and rule of law.[18] For the last set of measurements, we relied on three of the World Bank's Governance Indicators: "control of corruption," "regulatory quality," and "rule of law."[19]

We concluded that four of the 20 countries did not qualify, but of those four, Argentina was by far the most glaring case. Among the 20, Argentina ranked last in size, last in financial interconnectedness with the rest of the world, and fourth from the bottom in rule of law. Recent rule of law data from the World Bank are worse. Argentina now ranks below the 20th percentile,[20] that is, among the bottom one-fifth

[17] http://www.reuters.com/article/2014/02/25/us-repsol-argentina-idUSBREA1O1LJ20140225
[18] http://www.aei.org/files/2012/06/14/-brill-g20-ntu-paper_095940274931.pdf
[19] http://info.worldbank.org/governance/wgi/index.aspx#home
[20] Ibid.

of all countries. In addition, Argentina ranked last among the 20 in compliance with the priority commitments that members made at the 2010 Seoul Summit.[21]

Argentina never should have been a member of the G20 in the first place, but the United States and other G20 have had a golden opportunity to use the threat of expulsion as a incentive for Argentina to comply with its international commitments. Sen. Richard Lugar, who has since retired, introduced a resolution in Congress in 2012 to suspend Argentina's G20 membership because of its activities involving default, but no action was taken.[22]

Now there are signs that the Argentine model of rogue behavior has attracted the attention of a U.S. territory, Puerto Rico. It is hard to overstate the danger if Puerto Rico decides to become another Argentina. Not only will the territory's economy suffer, but, in the end, not only U.S. investors but also U.S. taxpayers would be left holding the bag.

The Travails of Puerto Rico

The United States acquired the island of Puerto Rico as a result of the Spanish-American War of 1898. Its inhabitants, who now number 3.7 million, enjoy many of the benefits of being full-fledged U.S. citizens, including Social Security and Medicare. Interest on Puerto Rico's municipal bonds is exempt from U.S. taxes on a federal, state, and local basis, and, until lately, there has been a ready market for buying Puerto Rican debt.

Puerto Rico's economy is a shambles. It is now in the eighth year of recession. Its closely watched Economic Activity Index has plunged from 155 in January 2007 to

[21] www.g20.utoronto.ca/compliance/2010seoul-final/index.html

[22] "A Resolution Expressing the Sense of Congress That the Republic of Argentina's Membership in the G20 Should Be Conditioned on Its Adherence to International Norms of Economic Relations and Commitment to the Rule of Law," Senate Resolution 457, 112th Congress, 2d Session, May 10, 2012.

128 in May 2014,[23] unemployment is 13.1 percent,[24] and the labor-force participation rate is a mere 41 percent.[25] In 2007, nearly 1.3 Puerto Ricans had jobs; today, fewer than 1 million do. Residents are abandoning the island at a rate of 100 a day.

What makes matters worse is that Puerto Rico has total public sector debt of $73 billion.[26] The Wall Street Journal called that figure "gigantic compared with the roughly $18 billion owed by Detroit when it filed in July [2013] for the largest municipal bankruptcy in U.S. history."[27] If Puerto Rico were a state, it would rank behind only California and New York as the third most indebted, "despite a smaller and poorer population."[28] A study by Nuveen, the bond house, points out that net tax-supported debt as a percentage of personal income is 88 percent in Puerto Rico, compared with less than 11 percent in Hawaii, which is the highest among all 50 states.[29]

Puerto Rico not only has a large debt, it also has payments coming due. For example, "within the next 30 days," writes Reid Wilson of the Washington Post, "the Puerto Rico Electric Power Authority (PREPA) will have to pay back more than $650 million to two big banks."[30] PREPA is one of Puerto Rico's "public corporations," government-run companies created seven decades ago. PREPA's debt load is $9.3 billion,[31] and it is only one of many government entities on the island whose debt service is in jeopardy.

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[23] http://www.gdbpr.com/documents/2014-04MayGDBEconomicActivityIndex.pdf
[24] http://www.bls.gov/eag/eag.pr.htm
[25] http://www.economist.com/news/finance-and-economics/21588364-heavily-indebted-island-weighs-americas-municipal-bond-market-puerto-pobre
[26] http://www.noticel.com/uploads/gallery/documents/275643203a526da79d9252aedffde414.pdf
[27] http://online.wsj.com/news/articles/SB10001424052702304441404579119251798925192
[28] http://www.economist.com/news/finance-and-economics/21588364-heavily-indebted-island-weighs-americas-municipal-bond-market-puerto-pobre
[29] http://www.nuveen.com/Home/Documents/Viewer.aspx?fileId=63250
[30] http://www.washingtonpost.com/blogs/govbeat/wp/2014/07/24/looming-puerto-rico-debt-deadlines-have-investors-nervous/
[31] http://www.noticel.com/uploads/gallery/documents/275643203a526da79d9252aedffde414.pdf

Heavy debt is a function both of the ease of borrowing and of mismanagement of the Puerto Rican economy. The best course of action for Puerto Rico would be to reduce its bloated public sector (which accounts for more than 20 percent of the workforce[32]) and enact the kind of free-market policies and strict rule of law that have helped other small nations, such as Singapore, to thrive. As Thomas Weyl of Barclays, one of the best-informed analysts of Puerto Rico, wrote last month: "Absent economic progress, which is not currently visible, it is only a matter of time before the debt load becomes unsustainable."[33]

Rather than economic progress. Puerto Rico has chosen a course pioneered by Argentina. On June 25, the administration of Governor Alejandro Garcia Padilla introduced the Puerto Rico Public Corporations Debt Enforcement and Recovery Act (Recovery Act), and within just three days it was passed by the Senate and House and signed into law. The Recovery Act sets a legal framework for restructuring much of Puerto Rico's debt. Specifically, it calls for creditors to reach a consensual agreement among themselves without the courts. "After 50 percent of creditors vote and 75 percent of those voting (by amount outstanding) agree to a plan, it will then go before a judge for approval."[34] This alternative effectively strips creditors of their rights. A group of them representing just three-eighths of the total debt can determine the grounds for a settlement. If creditors are unable to reach an agreement themselves, then a court-ordered bankruptcy process kicks in. In short, the Recovery Act is an after-the-fact measure that gives Puerto Rico's government inordinate power to decide who gets paid, how much, and when.

The Recovery Act applies only to bonds issued by PREPA as well as Puerto Rico's public corporations concerned with highways, sewer and water, and public buildings. The four bond-issuing authorities have about $25 billion in debt

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[32] http://www.economist.com/news/finance-and-economics/21588364-heavily-indebted-island-weighs-americas-municipal-bond-market-puerto-pobre

[33] Thomas Weyl, Sarah Xue, and Ming Zhang, Barclays Municipal Research, "Implications of Puerto Rico's Recovery Act," June 27, 2014.

[34] Ibid.

outstanding, according to the latest official quarterly report of Puerto Rico's finances[35] -- or more than one-third of the total for the territory. These corporations have consistently run deficits, which have been funded by other Puerto Rican government entities, such as the Government Development Bank. They are poorly run, and there is no reason to believe they will suddenly become profitable or solvent. (A majority of the electric power on the island, for instance, is generated by PREPA from expensive oil.)

A recent Nuveen report on the Recovery Act was headlined, "Puerto Rico Reaches the Limit of Its Ability to Pay,"[36] and there is little doubt that the Act was meant to set the stage for restructuring a large chunk of the territory's debt in ways that will cause pain to creditors. The fact that the majority of debt -- including that of the Puerto Rico Sales Taxes Financing Corp. (COFINA) and the general obligation bonds of the Commonwealth of Puerto Rico itself -- were listed as exempt from the Recovery Act is hardly a reassurance to these other creditors. While this debt appears to be "roped off," the level of trust is not high for a government that would swiftly pass an Argentina-style Recovery Act without consultation with creditors. The group of exempt bond may simply be the next target of legislation. It is worth quoting the Nuveen report at length:

> **While introducing the legislation, Governor Alejandro Garcia Padilla repeatedly stressed that the Commonwealth of Puerto Rico intends to honor the obligations of the central government, namely general obligation, sales tax backed and appropriation debt. We note that Gov. Padilla and his predecessors previously made similar assertions about all of Puerto Rico's obligations, and therefore we take little comfort in such claims today.**
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> **By instituting legislation to restructure the debt of the public corporations – all of which are instrumentalities of the Commonwealth – Puerto Rico is clearly demonstrating that there is a limit to its willingness to pay its**

[35] http://www.noticel.com/uploads/gallery/documents/275643203a526da79d9252aedffde414.pdf
[36] http://www.nuveen.com/Home/Documents/Viewer.aspx?fileId=63194

obligations. The government is effectively saying it is no longer willing to pay back loans used to build Puerto Rico's essential transportation, power, and water and sewer infrastructure, in full or on time. Barring a significant and lasting reversal in Puerto Rico's economic trajectory, we believe the Commonwealth will continue to struggle with budget deficits and may ultimately enact similar restructuring measures for its general obligation debt.[37]

If the Recovery Act was meant to condemn some bonds while assuring the protection of others, it failed. Within days, the U.S. bond ratings agencies cut the ratings of PREPA and the other public corporations. Moody's, for example, demoted PREPA from Baa2 to Caa3, to "speculative of poor standing and…subject to very high credit risk."[38] That was no surprise. But the credit agencies also downgraded the bonds that the Recovery Act was supposed to protect. Puerto Rico's general obligation bonds, for instance, were slashed by Moody's from B2 to Ba2,[39] defined as "speculative and…subject to substantial credit risk."

Moody's clearly did not buy the distinction that the Padilla administration was trying to make. In the report that accompanied the downgrades, the agency stated:

By providing for defaults by certain issuers that the central government has long supported, Puerto Rico's new law marks the end of the commonwealth's long history of taking actions needed to support its debt. It signals a depleted capacity for revenue increases and austerity measures and a new preference for shifting fiscal pressures to creditors, which, in our view, has implications for all of Puerto Rico's debt, including that of the central government.[40]

Padilla's response to the Moody's downgrades was to threaten the credit agencies with lawsuits. "I have instructed the Attorney General to assert the truth and clear

[37] Ibid.
[38] http://online.barrons.com/news/articles/SB50001424053111904248904580003610191234810
https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004
[39]
[40] http://online.barrons.com/news/articles/SB50001424053111904248904580003610191234810

the good name of Puerto Rico," he said, in a statement similar to those of President Fernandez of Argentina. "That credit agency, and any other entity acting alike, will have to answer for this offense."[41]

On June 28, the day the Recovery Act was signed, Oppenheimer and Franklin Templeton, two asset management firms that own a total of $1.7 billion worth of Puerto Rican bonds of many varieties, filed a lawsuit in the U.S. District Court of Puerto Rico, alleging that the Act violates provisions of the U.S. Constitution. The argues that the Act deals with bankruptcy matters but, according to the U.S. Constitution, only the U.S. Congress can determine such issues under the "bankruptcy clause."[42] BlueMountain Capital Management, a hedge fund that owns $400 million in debt and is represented by Ted Olson, the former U.S. solicitor general, has also challenged the Recovery Act in court.[43]

Meanwhile, according to a July 17 statement, a group of 18 hedge funds said that it "stands behind the efforts of the governor and the commonwealth to enact legislation to substantially eliminate budget deficits and address the financial and operational difficulties facing certain non-guaranteed public corporations."[44] The hedge funds that back the Recovery Act bought up most of the island's most recent general obligation issue, $3.5 billion of debt sold in March. The price of that debt dropped sharply after the Recovery Act was announced, down 3 points to 85.5, compared with 93 when the bonds were released.[45]

In many ways, the Puerto Rican situation is developing along Argentine lines, including the high-handed way the government has laid the groundwork for a debt restructuring, the possibility of a long and bloody legal challenge, and the presence

[41] http://mobile.bloomberg.com/news/2014-07-02/puerto-rico-s-downgrade-shows-debt-law-can-t-contain-rot.html
[42] http://www.noticel.com/uploads/gallery/documents/275643203a526da79d9252aedffde414.pdf
[43] http://www.reuters.com/article/2014/07/23/usa-puertorico-bluemountain-idUSL2N0PY28Z20140723
[44] http://mobile.bloomberg.com/news/2014-07-25/hedge-fund-pool-supporting-puerto-rico-legislation-adds-14-firms.html#disqus-tab
[45] http://online.barrons.com/news/articles/SB50001424053111904248904580003610191234810

of so many U.S. hedge funds in the battle. Also reminiscent of Argentina is the Puerto Rican government's disregard for the rule of law in dealing with local businesses, with the effect of discouraging investment on the island.

The most visible case involves Doral Financial Corporation.[46] Founded in 1972, it grew from a small mortgage company to the island's largest residential lender with about $8 billion in assets, with 22 branches in Puerto Rico and eight in New York and Florida. A decade ago, Doral made a substantial overpayment of its taxes. Over seven years, Puerto Rico's Treasury Department and Doral entered into a series of agreements about the size of a refund and the timing. Doral still is owed $230 million, but on May 16, the government suddenly declared its longstanding refund agreement null and void.

In repudiating its debt to Doral, Puerto Rico is sending the worst possible message to other businesses. Who would want to invest in a territory whose government refuses to pay what it owes? "It is not an option for the government of Puerto Rico to issue that refund," said economist Robert Shapiro, a former top official in the Clinton administration. "They are legally, politically, and morally obliged to do so." Shapiro added, in a telephone media conference in May: "By refusing to honor its obligations, the Puerto Rican government joins such deadbeat sovereigns as Argentina, which will measurably reduce the flow of direct investments to Puerto Rico."[47]

The Doral case may also be a factor in a distressing report by Reuters: that Puerto Rico's tax collections are running 27 percent behind budget, with nearly all of the shortfall coming from corporate income taxes.[48] What company would want to

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[46] http://www.aei.org/article/economics/fiscal-policy/absent-major-changes-puerto-rico-faces-a-fiscal-calamity/

[47] http://www.aei.org/article/economics/fiscal-policy/absent-major-changes-puerto-rico-faces-a-fiscal-calamity/

[48] http://blogs.reuters.com/muniland/2014/05/12/puerto-rico-stumbles-on-tax-collections/

overpay the government in light of Doral? Better to underpay and have the government fight for the money.

Recommendations for U.S. Policy Makers

What makes Puerto Rico more ominous for the United States than Argentina is that our own taxpayers could be left with the obligation. Imagine, for example, what would happen if the island defaults, PREPA fails, and the lights begin to go out. Nor can Puerto Rico, because it is not an independent nation, avail itself of such institutions as the IMF. As a U.S. territory (called a "commonwealth" in this case), Puerto Rico's legal status is ambiguous when it comes to responsibility for debt. But it is clear that the U.S. cannot simply walk away from Puerto Rico's financial troubles.

One possibility is a federally appointed financial control board, akin to the one that ran the affairs of the District of Columbia from 1995 to 2001.[49] The board -- established by Congress, with a bill signed by President Clinton – was similar to the one set up in New York in 1975 and terminated in 1986. The DC board, chaired by Constance Berry Newman, former director of the U.S. Office of Personnel Management, and then by Alice Rivlin, former vice chair of the Federal Reserve and director of the U.S. Office of Management and Budget, had "vast authority over municipal spending, financial planning, borrowing, hiring and contracts."[50] Such a board would be well advised not only to pare the island's bureaucracy but also to rescind the Recovery Act, negotiate with borrowers, and settle differences with Doral and others with valid claims.

U.S. law does not provide for the bankruptcy of states,[51] and Puerto Rico, as a territory, is closer to a state than to any other U.S. entity. But Chapter 9 bankruptcy,

[49] http://www.washingtonpost.com/wp-dyn/content/article/2011/01/30/AR2011013003901.html
[50] http://www.nytimes.com/1995/04/08/us/congress-creates-board-to-oversee-washington-dc.html
[51] http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?pagewanted=all&_r=0

which applies to cities and municipal agencies, could be adapted by Congress to Puerto Rico and provide a far better basis for an orderly disposition of assets in the case of default than the island's home-grown, quickly passed Recovery Act remedy.

Also ominous is that Puerto Rican bonds are widely held by small U.S. investors – many of whom have no idea they own this risky debt. Because Puerto Rican bonds are triple tax-free, they leaven many bond funds marketed to residents of specific states. For example, the top holding of the Oppenheimer Rochester Maryland Municipal bond fund is a Puerto Rican COFINA (sales tax) series, which represents a whopping 8.7 percent of the fund's holdings as of the most recent reporting period, ending May 31. The fund also owns several Puerto Rican public corporation series, including bonds of PREPA, the Public Buildings Authority and the water and highways boards. Overall, roughly one-fourth of the assets of this ostensible *Maryland* muni fund consist of bonds issued by Puerto Rico.[52] Similarly, an Arizona muni fund managed by Oppenheimer has at least 10 percent of its assets, including its top holding, in Puerto Rican bonds.[53]

More careful monitoring of Puerto Rico's economy and finances may have prevented the current crisis, but the U.S. government's ambivalent, and often negligent, attitude toward Argentina exacerbated that situation and gave Governor Padilla a profitable model to emulate. The U.S. could at least have threatened to remove Argentina from the G20 and could have insisted that the Club of Rome show some backbone. The Secretary of the Treasury could have used his bully pulpit to condemn Argentina's flouting of the U.S. courts and the World Bank. With strong U.S. encouragement, the IMF could have taken serious action against Argentina – including expulsion -- for falsifying its inflation statistics. Instead, the U.S. – and, worse, nations like France, whose government officials worried about expropriations by Argentina of their own industries – responded to the Argentine challenge with confusion and weakness.

[52] http://portfolios.morningstar.com/fund/holdings?t=ORMDX®ion=usa&culture=en-US
[53] http://portfolios.morningstar.com/fund/holdings?t=ORAZX

Arnold Kling and Nick Schulz stress in their 2011 book, *Invisible Wealth: Hidden Story of How Markets Work*, that "intangible assets" are vital to the global economy. The most important of those assets is adherence to the rule of law. Investors need certainty that a nation where they commit their money has a legal system that is sound, that laws are enforced, and that important standards don't change in the dead of night. Absent those assurances, investors will either refuse to invest, or will demand a high return if they do. The cost of capital for countries that flout the rule of law will rise, and, as a result, their economies will sputter. "Both policy makers and the research community agree that governance is the key to entrepreneurial decisions that underlie growth," says a World Bank report.[54]

The United States has an enormous stake in countries like Bolivia, Ecuador, Venezuela, and, yes, Argentina, getting back on the track of strong growth and the social stability it brings. Policy makers need to condemn corruption, the destruction of property rights, and failure to abide by the rule of law. But they must also reward nations that are moving in the right direction. A good example is Mexico, which, under its new president, Enrique Pena Nieto, is reforming many sectors of the economy, including energy, by ending price controls and subsidies and opening them up to new investment from abroad. Unfortunately, Mexican industries, such as sugar and steel, are now beset by anti-dumping actions from their U.S. competitors that violate the spirit of the North American Free Trade Agreement. Our officials should be promoting free trade with Latin America, not deterring it.

In addition to trade, U.S. policy makers should support innovations to attract foreign capital investment, even in countries that otherwise present difficult environments. An example is Honduras, where last year a constitutional reform allowed the creation of "semi-autonomous zones with distinct legal, economic, administration,

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[54] http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:22451020~pagePK:64165401~piPK:64165026~theSitePK:469382,00.html

and political (LEAP) protections for job creators."[55] These zones are modeled on the successes of Singapore, Dubai, and Hong Kong. The South Korean government has donated a $4 million feasibility and master plan for a zone near the Gulf of Fonseca, according to a recent article in National Review by John Fund, who notes that "China's special economic zone of Shenzen started with 30,000 people in the 1990s and now has 11 million who call it home and earn middle-class incomes." The U.S. should follow South Korea's lead. Good policies matter.

Mr. Chairman, in a tumultuous world, our government often cannot affect the course of events. But, when it comes to promoting prosperity and stability in Latin America by encouraging free-market policies and strict adherence to a just legal system, the United States should not stand by. We must take the lead. Our history and our destiny demand it.

[55] http://www.nationalreview.com/article/383899/honduras-says-yes-leap-zones-john-fund