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Federal Policy for Financially-Distressed Subnational Governments: The U.S. States and Puerto Rico

Cheryl D. Block*

INTRODUCTION

Between 2007 and 2009, an economic period now referred to as the “Great Recession,” the United States experienced its worst economic crisis since the Great Depression.¹ Congressional and federal administrative agency interventions during this period accordingly were as dramatic and proactive as anything seen since the 1930s.² As political controversy swirled around federal assistance to private firms, another economic storm was brewing in the public sector. In particular, the Great Recession took its toll on struggling municipal governments as unexpected shock from the economic crisis exposed serious fiscal mismanagement and underlying insolvencies. Though municipal bankruptcies historically have been

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1. The National Bureau of Economic Research (NBER) reports the period from December 2007 through June 2009 as the longest U.S. recession since World War II. NAT'L BUREAU OF ECON. RESEARCH, DETERMINATION OF THE DECEMBER 2007 PEAK IN ECONOMIC ACTIVITY (2008), <http://www.nber.org/dec2008.pdf> [hereinafter NBER REPORT].

2. These include: (1) Federal Reserve Bank exercising emergency authority not utilized since the Depression to assist American International Group (AIG), the largest U.S. insurance company, see BAIRD WEBEL, CONG. RESEARCH SERV., R40438, ONGOING GOVERNMENT ASSISTANCE FOR AMERICAN INTERNATIONAL GROUP (AIG) (2009); (2) Emergency Economic Stabilization Act, Pub. L. No.110-343, tit. I, 122 Stat. 3765, 3767–3800 (Troubled Asset Relief Program) (TARP), (codified at 12 U.S.C. §§ 5211–41) (2012), authorizing Treasury Department spending of up to \$700 billion for emergency assistance to banks and other financial institutions; and (3) Treasury Department assistance to General Motors and Chrysler under the TARP umbrella. See CONG. OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY (2009). See also Cheryl D. Block, *Measuring the True Cost of Government Bailouts*, 88 WASH. U. L. REV. 149 (2010) (regarding accurate budgetary assessment of bailout cost).

rare,³ the recent recession spawned a series of filings—which escalated between 2011 and 2013—when one high-profile bankruptcy after another broke “biggest ever” records.⁴ Honors for the “country’s largest ever municipal bankruptcy” passed to Detroit in 2013.⁵

Among the most dramatic illustrations of financial distress at the state level is Illinois, which responded to municipal bond credit-rating downgrades and dangerously underfunded state employee pension funds in 2013 with legislation reducing current and retired employee benefits.⁶ The State’s cost-reduction efforts were thwarted, however, by the Illinois Supreme Court’s ruling that the pension changes violated government employees’ state constitutional protections.⁷ Given insufficient funds to satisfy existing obligations to retirees—and no legal authority to reduce them—Illinois must make painful fiscal choices, many of which may not be politically palatable or even feasible.

Ultimately, the common last-minute approach to avoiding imminent default or government shutdown is more borrowing. Indeed, most governments depend upon borrowing, frequently relying on investor willingness to “rollover” existing debt, i.e., exchanging maturing obligations for *new* debt rather than demanding immediate repayment.⁸ Simply put, governments routinely pay their

3. See, e.g., Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 406 (2014) (reporting fewer than 700 municipal bankruptcies since 1938, most of which involved special-purpose districts rather than general purpose municipalities) (citations omitted). Eligible municipalities may file for federal bankruptcy under 11 U.S.C. §§ 901–46 (2012) (“Chapter 9 – Adjustments of Debts of a Municipality”).

4. Michelle Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1120, n.1 (2014) (listing bankruptcies by size). See also *id.* at 1120, 1130–33.

5. Matthew Dolan, *Record Bankruptcy for Detroit*, WALL STREET J., Jul. 19, 2013, at A1.

6. 40 ILL. COMP. STAT. 98-599 (2013). Underfunded pensions have been the most dominant fiscal problem for many U.S. state and local governments since the Great Recession. Jack A. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 10–16 (2013) (on debates over extent of the underfunded public pension crisis). See also STEVEN MAGUIRE, CONG. RESEARCH SERV., R41735, STATE AND LOCAL GOVERNMENT DEBT: AN ANALYSIS 3 (2011).

7. *Heaton v. Quinn (In re Pension Reform Litig.)*, 32 N.E.3d 1 (Ill. 2015).

8. See, e.g., Steven L. Schwarcz, *Rollover Risk: Ideating a U.S. Debt Default*, 55 B.C. L. REV. 1, 5 (2014) (discussing “why governments, including the United States, routinely depend on borrowing new money to repay their maturing debt”).

debts with more debt. Recurring rollovers are possible because markets tend to view government bonds as relatively safe investments on the common assumption that governments cannot “fail” in the same way that private entities do.

Excess borrowing is not only fiscally irresponsible, but also can be extremely costly, particularly for governments already tainted by credit rating downgrades. Even worse, investors ultimately may refuse to lend. Cut off from bond markets, a government that is out of funds, yet constitutionally or otherwise mandated to prioritize obligations to certain creditors, may simply be unable to pay for essential services. Though some U.S. states have come dangerously close, no state-level economic crises since the Great Depression has reached a point at which rescue aid was critical to the state’s very survival as a going concern. Nonetheless, governments that refuse to acknowledge even the possibility of such an emergency do so at their own peril.

Indeed, the Commonwealth of Puerto Rico has reached just such a financial precipice.⁹ According to expert testimony from 2015, “Puerto Rico’s economy is far-and-away the weakest of any state in the country. By many measures . . . it is already suffering an economic depression. Even more disconcerting, there is no prospect of the economic slide ending any time soon.”¹⁰ In its preamble to June 2016 emergency legislation authorizing the Governor to impose moratoria on certain public debt payments,¹¹ the Puerto Rican legislature similarly declared: “[t]he fiscal situation of the Government of Puerto Rico is more dire than at any other point in its history,” adding that “depleted resources and strained liquidity threaten to bind the Commonwealth to a choice between honoring its commitments to bondholders or continuing to provide the residents of

9. Though it does not have statehood, Puerto Rico is a U.S. territory treated as a state for some purposes, a foreign sovereign for others, and an ill-defined unincorporated U.S. territory for still others. *See infra* notes 128–47 and accompanying text.

10. *Puerto Rico’s Fiscal Problems: Examining the Source and Exploring the Solution: Hearings Before the Sen. Judiciary Comm.*, 114th Cong. (2015) (testimony of Mark Zandi, Chief Econ., Moody’s Analytics) [hereinafter *Puerto Rico’s Fiscal Problems Hearings*].

11. Puerto Rico Emergency Moratorium and Financial Rehabilitation Act, 2016 P.R. Laws 21.

Puerto Rico with essential services.”¹² The U.S. District Court for the District of Puerto Rico also bluntly observed that the island’s government “harbors significant doubt about the *Commonwealth’s very ability to persist as a going concern*,”¹³ adding that, “what started as a financial crisis has since metastasized into a deep humanitarian crisis requiring immediate action.”¹⁴

Part I of this Article begins with a description and explanation of Puerto Rico’s recent and dramatic financial disaster and the federal government’s response, concluding with a brief overview of the 2016 Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA),¹⁵ compromise legislation adopted by Congress after long, partisan debates over whether and how to assist Puerto Rico in resolving its economic crisis. Parts II, III, and IV respectively explore sovereignty, market, and equity-based arguments for a presumption against federal government assistance to financially-distressed subnational governments, contrasting the application of these principles to U.S. states and the unincorporated territory of Puerto Rico. Part V addresses similarities and differences in rebuttal arguments that the states and Puerto Rico might use to overcome the initial presumption against federal assistance, followed in Part VI with suggestions to facilitate the orderly, equitable, and transparent structuring of relief efforts in the rare circumstances when federal intervention is warranted.

12. *Id.*

13. *Wal-Mart P.R., Inc. v. Zaragoza-Gomez*, 174 F. Supp. 3d 585, 592 (D.P.R. 2016), *aff’d*, 834 F.3d 110 (1st Cir. 2016) (emphasis added).

14. *Id.* at 602. *See also* *Puerto Rico v. Franklin Cal. Tax-Free Trust*, 136 S. Ct. 1938, 1954 (2016) (“the government and people of Puerto Rico should not have to wait for possible congressional action to avert the consequences of unreliable electricity, transportation, and safe water—consequences that members of the Executive and Legislature have described as a looming ‘humanitarian crisis’”) (Sotomayor, J., dissenting) (citations omitted).

15. Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), 48 U.S.C. §§ 2101–2241 (2016).

I. PUERTO RICO'S FISCAL CRISIS

A. Recent Economic Conditions and Puerto Rico's Self-Help Efforts

Puerto Rico's economy has been contracting for almost a decade.¹⁶ Moreover, the Great Recession, which began on the U.S. mainland in late 2007,¹⁷ took a far greater toll in Puerto Rico, where the economic “downturn started earlier and was much steeper and more prolonged.”¹⁸ As of 2014, Puerto Rico's approximately \$72 billion debt exceeded 100% of its GNP, a far greater percentage than for any U.S. state.¹⁹ Also by 2014, all three major credit-rating firms had downgraded Puerto Rico's general-obligation bonds to junk status,²⁰ and the typical investor profile for Puerto Rican debtholders had shifted from individuals and pension funds to high-risk hedge funds and so-called “vultures” buying at steep discounts.²¹ Even after its debt was downgraded to junk, Puerto Rico nonetheless marketed an additional \$3.5 billion in new bonds, though largely only by

16. ANNE O. KRUEGER, RANJIT TEJA & ANDREW WOLFE, PUERTO RICO – A WAY FORWARD 3 (2015), <http://www.bgfpr.com/documents/PuertoRicoAWayForward.pdf> [hereinafter KRUEGER ET AL.].

17. See NBER REPORT, *supra* note 1.

18. FED. RES. BANK OF N.Y., AN UPDATE ON THE COMPETITIVENESS OF PUERTO RICO'S ECONOMY 1 (2014) [hereinafter FED. RES. UPDATE].

19. *Id.* at 16. Some say that Puerto Rico's debt to GNP ratio is actually closer to 160%—presumably as calculated after accounting for both debt and unfunded pensions. See, e.g., ADDRESSING PUERTO RICO'S ECONOMIC AND FISCAL CRISIS AND CREATING A PATH TO RECOVERY: ROADMAP FOR CONGRESSIONAL ACTION 5 (Oct. 21, 2015), www.whitehouse.gov/sites/default/files/roadmap_for_congressional_action__puerto_rico_final.pdf [hereinafter ROADMAP FOR CONGRESSIONAL ACTION]. Reports show just slightly lower public debt figures as of July 2016. COMMONWEALTH OF PUERTO RICO, FINANCIAL INFORMATION AND OPERATING DATA REPORT 174, tab 1 (Dec. 18, 2016), www.bgfpr.com/documents/CommonwealthReport/11-06-15.pdf (public sector debt table).

20. Al Yoon, Mike Cherney & Matt Wirz, *Global Finance: Puerto Rico to Test Interest in Bonds*, WALL STREET J., Feb. 12, 2014, at C3. Subsequent downgrades into even deeper “junk territory” caused some to conclude that “default [was] a virtual certainty” for “nearly all of the island's public sector debt not covered by bond insurance” D. ANDREW AUSTIN, CONG. RESEARCH SERV., R44095, PUERTO RICO'S CURRENT FISCAL CHALLENGES 4 (2016) (citation omitted).

21. Matt Wirz & Aaron Kuriloff, *Mutual Funds at the Forefront on Puerto Rico Talks*, WALL STREET J., Jul. 20, 2015, at C1. Some “bottom feeding” hedge fund managers even reported “waiting for bond prices to fall further before buying . . . banking on the federal government coming up with a financial rescue for Puerto Rico” Michael Corkery, *Investors Appear to Shrug Off Puerto Rico's Debt Downgrade*, N.Y. TIMES, Feb. 6, 2014, at B3.

selling to investors willing assume greater risk²² and “issued at yields above 8 percent—a borrowing cost that would clearly be unsustainable if applied to Puerto Rico’s entire debt load.”²³ One report observes that this “brew of incentives has produced truly staggering numbers. On a per-capita basis, Puerto has more than 15 times the median bond debt of the 50 states, according to Moody’s Investors Service.”²⁴ Subsequent credit downgrades depressed investor confidence to the point that Puerto Rico lost access to normal credit markets.²⁵ As its crisis deepened, Puerto Rico adopted fiscal austerity measures such as reducing public sector employment,²⁶ increasing taxes,²⁷ and reducing public expenses.²⁸ Despite success in negotiating voluntary restructuring agreements with some creditors,²⁹ holdout creditors made a privately-negotiated solution to the public debt crisis impossible.

At the same time, Puerto Rico’s unique treatment under federal bankruptcy laws left it without access to bankruptcy protections otherwise available to states for their municipal governments. On the

22. Michael Corkery, *Demand Stronger than Expected for Puerto Rico Debt*, N.Y. TIMES, Mar. 12, 2014, at B6.

23. N.Y. FED. UPDATE, *supra* note 18, at 20.

24. Mary Williams Walsh, *The Bonds That Broke Puerto Rico*, N.Y. TIMES, Jul. 1, 2015, at B1.

25. AUSTIN, *supra* note 20, at 4. *See also* KRUEGER ET AL., *supra* note 16, at 3.

26. AUSTIN, *supra* note 20, at 10.

27. *See, e.g.*, Tax Reform Process Act, 2015 Laws P.R. 72 (sales and use tax increased from 7% to 11.5%, beginning July 1, 2015). Another tax increase measure was so excessive that even a sympathetic court could not uphold it. *Wal-Mart P.R., Inc. v. Zaragoza-Gomez*, 174 F. Supp. 3d 585, 592 (D.P.R. 2016), *aff’d*, 834 F.3d 110 (1st Cir. 2016) (emphasis added) (“It gives us no pleasure, . . . to enjoin a revenue stream that flows directly into Puerto Rico’s general fisc. For we, too, are citizens of this island, and we, too, must suffer the consequences of the financial disarray on the horizon.”) (challenge to 2015 Alternative Minimum Tax (AMT) amendments). Puerto Rico had also previously increased rates and extended until December 2017 the expiration date for excise taxes on sales of Puerto Rican-manufactured goods to affiliates outside Puerto Rico. 2013 Laws P.R. 2.

28. AUSTIN, *supra* note 20, at 10–11 (referring also to public employee pension cuts, but noting that some were invalidated by the Puerto Rico Supreme Court).

29. For example, 60% of Puerto Rico Electric Power Authority (PREPA) creditors agreed to concessions in December 2015, including principal “haircuts,” extended maturity dates, and reduced interest rates. *See The Status of the Puerto Rico Electric Power Authority (PREPA) Restructuring Support Agreement: Hearings Before the H. Comm. on Natural Resources, Subcomm. on Indian, Insular and Alaska Native Affairs*, 115th Cong. (2017) (describing restructuring support agreement (RSA) details and evolution) (testimony of Luis Benítez Hernández, Chair, PREPA Governing Board) [hereinafter *PREPA Hearings*].

one hand, the Bankruptcy Code explicitly includes Puerto Rico in the definition of “state” for federal bankruptcy law purposes.³⁰ Thus, like U.S. states generally, it cannot file for its own bankruptcy.³¹ Chapter 9 nonetheless includes special rules authorizing *municipal* bankruptcies,³² but only for municipalities specifically authorized by state law.³³ In other words, had Puerto Rico been a state, it could have authorized its public corporations to file for bankruptcy. The obstacle for Puerto Rico was a 1984 Bankruptcy Code amendment, made with little explanation,³⁴ after which a “state” was defined as including “the District of Columbia and Puerto Rico, *except for the purposes of defining who may be a debtor* under chapter 9 of this title.”³⁵ Under this amended definition, Puerto Rico was precluded from granting access to federal bankruptcy protection for its municipalities. Faced with this obstacle, the Puerto Rican legislature took matters into its own hands, creating its own bankruptcy-like procedures for a fair and orderly restructuring of Puerto Rican municipal debt.³⁶ Creditors objected to this self-help effort, claiming that the Bankruptcy Code explicitly prohibits states from adopting their own state-level rules that would impose debt restructuring on non-consenting creditors.³⁷ Agreeing with the creditors, the Supreme Court held that Puerto Rico’s restructuring legislation was preempted by federal bankruptcy law.³⁸ As Puerto Rico argued in its brief to the Court, this holding effectively gives “the worst of both

30. 11 U.S.C. § 101(52) (2012) (“‘State’ includes . . . Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9”).

31. A government entity may be a Chapter 9 debtor “*if and only if* such entity is a municipality.” 11 U.S.C. § 109(c)(1) (2012) (emphasis added).

32. 11 U.S.C. §§ 901–46 (2012) (“Chapter 9 – Adjustments of Debts of a Municipality”). “Municipality” is broadly defined as “a political subdivision or public agency or instrumentality of a State.” 11 U.S.C. § 101(40) (2012).

33. 11 U.S.C. § 109(c)(2) (2012) (municipality must be “specifically authorized, in its capacity as a municipality or by name, to be a debtor . . . by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor . . .”).

34. Bankruptcy Amendments and Federal Judgeship Act, Pub. L. No. 98-353, § 421(j)(6), 98 Stat. 333, 368–69 (1984) (amending 11 U.S.C. § 101(44) definition of “state”).

35. Codified as amended at 11 U.S.C. § 101(52) (2012) (emphasis added).

36. Puerto Rico Public Corporation Debt Enforcement and Recovery Act, 2014 Laws P.R. 71, subsequently invalidated by the U.S. Supreme Court in *Puerto Rico v. Franklin California Tax-Free Trust*, 136 S. Ct. 1938, 1938 (2016).

37. 11 U.S.C. § 903(1) (2012).

38. *Franklin Cal. Tax-Free Trust*, 136 S. Ct. at 1946.

worlds: it is not entitled to the *benefits* of Chapter 9, but remains subject to the *burdens* of Chapter 9;” it is left “in a ‘no man’s land’ where its public utilities cannot restructure their debts under *either* federal law *or* its own law.”³⁹

For the first time in its history, Puerto Rico defaulted on a \$58 million bond payment in August, 2015.⁴⁰ Another default in May 2016 heightened fears about Puerto Rico’s ability to make \$2 billion in future public debt payments due on July 1, 2016.⁴¹ Puerto Rican Governor García Padilla shortly thereafter confirmed these concerns, announcing on June 29, 2015 that the Commonwealth’s debts were unpayable.⁴² Anxieties over the impending July 1 default were especially acute not only because the amount at stake was so enormous, but also because \$779 million of the total due was owed to holders of constitutionally-guaranteed debt.⁴³ Indeed, Puerto Rico’s missed payment on July 1, 2016 was its first ever default on constitutionally-guaranteed debt.⁴⁴

B. Explaining Puerto Rico’s Economic Decline

While there is no definitive explanation for Puerto Rico’s dramatic decade-long decline, studies identify numerous contributing factors. First, Puerto Rico’s weak fiscal discipline, inadequate long-

39. Brief for Appellant-Petitioner at 13–14, *Puerto Rico v. Franklin Cal. Tax-Free Trust*, 136 S. Ct. 1938 (2016) (No. 15-233).

40. Aaron Kuriloff, *Puerto Rico Defaults on Payment Due for Bonds*, WALL STREET J., Aug. 4, 2015, at C1.

41. Jackie Calmes, *Treasury Chief Puts a Face on Puerto Rico’s Debt Crisis*, N.Y. TIMES, May 10, 2016, at B3 (reporting \$422 million default in early May, and \$2 billion due in July).

42. See Michael Corkery, *Puerto Rico Faces its Creditors in Early Debt Resolution Talks*, N. Y. TIMES, Jul. 14, 2015, at B1 (reporting Governor’s meeting with investors in New York two weeks after the announcement). See also *Economy, Debt and Options for Congress: Hearings Before the S. Comm. on Energy and Nat’l Resources*, 114th Cong. (2015) (statement of Alejandro J. García Padilla, Governor of Puerto Rico) [hereinafter *Options for Congress Hearings*].

43. Mary Walsh Williams, *Deadline Nears in Puerto Rico, Amid Haggling*, N.Y. TIMES, Apr. 30, 2016, at B1. P.R. CONST. art. VI, § 2, provides guarantees for certain “direct obligations of the Commonwealth” See also *id.* at § 8 (priority for public debt payments if available revenues are insufficient to meet appropriations).

44. See Heather Gillers & Nick Timiraos, *Puerto Rico Defaults on Guaranteed Debt*, WALL STREET J., Jul. 2, 2016, at A3; Steven Mufson, *Obama Signs Bill to Help Economy of Puerto Rico*, WASH. POST, Jul. 1, 2016, at A14 (reporting Puerto Rican Governor’s June 30, 2016 executive order blocking payments on July 1).

term budget planning, budget accounting flaws,⁴⁵ poor cash management,⁴⁶ and lack of transparency seriously exacerbated its economic crisis and hampered recovery efforts. In addition, Puerto Rico's economic data is disorganized and inadequate. As the Krueger Report pointedly observed, “[b]etter statistics are not a luxury. Without them the Commonwealth is flying blind and market uncertainty about underlying developments is reflected in the risk premium on government debt.”⁴⁷ The New York Federal Reserve also concluded that, “the Commonwealth’s slow growth has been exacerbated by its inefficient tax system that encourages and rewards evasion.”⁴⁸

Other internal explanations for Puerto Rico's economic woes include its extremely low labor participation,⁴⁹ at least partially attributable to work disincentives triggered by generous welfare benefits and partially to hiring disincentives created by high minimum wage requirements relative to local averages.⁵⁰ Another factor is the extremely high cost of electricity, which weakened Puerto Rican manufacturers' competitiveness.⁵¹ Though Puerto Rico's higher reliance on oil may explain at least some of this electricity rate differential, another problem is that island electricity is provided by the Puerto Rican Electric Power Authority (PREPA), a weakly-regulated, “inefficient and overstaffed public enterprise . . . using technologies decades out of date.”⁵² In addition, PREPA's high

45. See, e.g., ROADMAP FOR CONGRESSIONAL ACTION, *supra* note 19, at 7 (unrealistic revenue estimates, which result in budgets that mask recurring deficits); KRUEGER ET AL., *supra* note 16, at 9 (optimistic revenue projections and systematic understatement of tax refunds due the public).

46. See, e.g., KRUEGER ET AL., *supra* note 16, at 10 (noting frequent precarious government cash deposits, leading to delayed payables, as well as other gimmicks for maintaining cash balances).

47. *Id.* at 22–23.

48. FED. RES. UPDATE, *supra* note 18, at 14.

49. KRUEGER ET AL., *supra* note 16, at 6 (“only 40% of the adult population—versus 63% on the US mainland—is employed or looking for work . . .”).

50. *Id.* at 6–7. See also FED. RES. BANK OF N.Y., REPORT ON THE COMPETITIVENESS OF PUERTO RICO'S ECONOMY 19 (2012) [hereinafter FED. RES. REPORT].

51. FED. RES. REPORT, *supra* note 50, at 12.

52. KRUEGER ET AL., *supra* note 16, at 8. Updating its earlier report, however, the New York Federal Reserve commended Puerto Rico for creating a new independent regulatory board for PREPA. FED. RES. UPDATE, *supra* note 18, at 7. See Puerto Rico Energy Transformation and RELIEF Act, 2014 P.R. Laws 57 (creating an independent Audit Committee).

rates for paying customers are partially attributable to its decades-long practice of giving free power to “all 78 of Puerto Rico’s municipalities, many government-owned enterprises, and even to some for-profit businesses”⁵³

Of course, the most obvious factor contributing to Puerto Rico’s financial crisis is excessive public debt. As Puerto Rico’s Government Development Bank (GDB) President dramatically testified in 2015, “while the economy has contracted by more than 20 percent over the past eight years, outstanding public debt has increased by more than 60 percent.”⁵⁴ On the one hand, Puerto Rico’s frequent debt rollovers simply resemble those routinely used by the United States and other governments to pay off maturing debt.⁵⁵ Several factors make Puerto Rico’s public debt problems more serious, however. First, Puerto Rico uses an unusually large number of public corporations, including PREPA, to provide public services such as electricity, banking, and health care. In fact, public corporation bond issues account for over a third of Puerto Rico’s public debt.⁵⁶ Second, the central government frequently extends financial support to its struggling public corporations. Ironically, this support may have led investors to feel more secure, and thereby enhanced the marketing of further public corporation debt even as it weakened the central government’s own fiscal circumstances.⁵⁷ Moreover, the “off-budget” status of such public corporations’ borrowing for purposes of Puerto Rican constitutional debt limits further enables public officials to over-borrow with little transparency.⁵⁸

53. Mary Williams Walsh, *How Free Electricity Helped Dig \$9 Billion Hole in Puerto Rico*, N.Y. TIMES, Feb. 2, 2016, at A1.

54. *Financial and Economic Challenges in Puerto Rico: Hearings Before the S. Finance Comm.*, 114th Cong. (2015) (testimony of Melba Acosta-Febo, Pres., Gov’t Develop. Bank) [hereinafter *Financial and Economic Challenges Hearings*].

55. See *supra* notes 8–9 and accompanying text.

56. See, e.g., FED. RES. UPDATE, *supra* note 18, at 16 (reporting that public corporation and agency debt accounted for 36.4% of total public debt as of December 2013).

57. AUSTIN, *supra* note 20, at 14; FED. RES. UPDATE, *supra* note 18, at 13 (central government financial support for public corporations “has reasonably led investors to believe that the Commonwealth provides some backing for these entities’ debts”).

58. AUSTIN, *supra* note 20, at 13.

Though Puerto Rico surely bears significant responsibility, it would be unfair to cast all blame for the financial crisis at its feet. The island has faced economic and demographic shocks over which it had little control, such as steep housing price declines, high prices for imported oil, high transportation costs,⁵⁹ outmigration and population loss, and—of course—a major global recession.⁶⁰ In addition, several U.S. tax and other policies may have significantly contributed to Puerto Rico’s public debt problems and general economic decline.⁶¹ Federal government acceptance of at least partial responsibility for Puerto Rico’s economic woes would add a new element to the policy debate over whether—and to what extent—the federal government should offer emergency assistance. These issues are considered more fully below in sections addressing Puerto Rico’s unique position within the American political system and its implications for financial intervention policies.

C. The U.S. Federal Government Response

Though U.S. officials were aware of Puerto Rico’s growing economic problems at least as early as 2013,⁶² significant congressional interest began only in 2015, when the U.S. House of Representatives held hearing after hearing without any formal action.⁶³ The Senate held further hearings later in the year,⁶⁴ but

59. Some of this cost is endemic to economically and geographically-isolated island economies in general. Puerto Rico’s import costs are at least double those of neighboring islands, however, because it is required by U.S. law to use exclusively U.S. ships and crews. KRUEGER ET AL., *supra* note 16, at 8. See also *infra* notes 211–26 and accompanying text.

60. See generally KRUEGER ET AL., *supra* note 16, at 4–8.

61. See *infra* notes 186–229 and accompanying text.

62. See, e.g., Mary Williams Walsh, *Worsening Debt Crisis Threatens Puerto Rico*, Oct. 8, 2013, at B1 (Puerto Rican officials’ meetings with “members of Congress and Treasury officials, providing details of the fiscal changes they have pushed through and discussing what else might be needed”).

63. See, e.g., *The Need for the Establishment of a Puerto Rico Financial Stability and Economic Growth Authority: Hearings Before the H. Comm. on Natural Resources, Subcomm. on Indian, Insular and Alaska Native Affairs*, 114th Cong. (2015); *The U.S. Treasury Department’s Analysis of the Situation in Puerto Rico: Hearings Before the H. Comm. on Natural Resources*, 114th Cong. (2015) [hereinafter *Treasury Department Analysis Hearings*]; *Puerto Rico Chapter 9 Uniformity Act of 2015: Hearings before the H. Judiciary Comm., Subcomm. on Regulatory Reform, Commercial and Antitrust Law*, 114th Cong. (2015).

partisans in Congress were unable to agree on a federal response.⁶⁵ In presenting his proposals for immediate congressional action in late 2015, President Obama presented a dire picture:

*[t]he 3.5 million Americans living in Puerto Rico have endured a decade of economic stagnation. Since 2006, Puerto Rico's economy has shrunk by more than 10 percent and 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 level. These challenges have sparked the largest wave of outmigration since the 1950's, and the pace continues to accelerate. . . . Puerto Rico's government is out of cash and running out of options.*⁶⁶

Proposed legislation that would have amended Chapter 9 empowering Puerto Rico to authorize municipal bankruptcies was never enacted.⁶⁷

D. PROMESA's Promise

1. Enactment and Objectives

As the July 1, 2016 deadline for \$2 billion in required public bond payments loomed,⁶⁸ administration officials became increasingly blunt, arguing to Congress that “the [Puerto Rican] government itself could be forced to shut down entirely” absent emergency

64. See, e.g., *Financial and Economic Challenges Hearings*, *supra* note 54; *Options for Congress Hearings*, *supra* note 42; *Puerto Rico's Fiscal Problems Hearings*, *supra* note 10.

65. See, e.g., Mary Walsh Williams, *A Chilly Reception*, N.Y. TIMES, Oct. 23, 2015, at B1.

66. ROADMAP FOR CONGRESSIONAL ACTION, *supra* note 19, at 1. See also KRUEGER ET AL., *supra* note 16, at 7 (reporting Puerto Rico's population loss “at a rate of about 1% per year—ten times more than West Virginia, the only US state with subzero growth”); Jason R. Abel & Richard Deitz, *The Causes and Consequences of Puerto Rico's Declining Population*, 20 CURRENT ISSUES IN ECON. & FIN., no. 4, 2014, at 1. FED. RES. UPDATE, *supra* note 18, at 4, n.9 (reporting Puerto Rico's estimated population decline as seventh highest among countries worldwide).

67. See, e.g., Puerto Rico Chapter 9 Uniformity Act, S. 1774, 114th Cong. (2015); Puerto Rico Chapter 9 Uniformity Act, H.R. 870, 114th Cong. (2015); Puerto Rico Chapter 9 Uniformity Act of 2014, H.R. 5305, 113th Cong. (2014).

68. See *supra* notes 41–44 and accompanying text.

congressional action.⁶⁹ In a last-minute compromise, Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA)⁷⁰ just days before the July 1 deadline.⁷¹ The statute embodies two key objectives, both under the jurisdiction of a new, presidentially-appointed Financial Oversight and Management Board.⁷² The first is for Puerto Rico—under the Board’s oversight and control—to achieve future fiscal responsibility and stability, economic growth, and access to capital markets.⁷³ The second objective is more direct intervention to manage and facilitate resolution of Puerto Rico’s immediate debt crisis. Mindful that arrangements for Puerto Rico might be perceived as setting precedent for troubled U.S. states, and sensitive to potential political backlash from voters angered by “bailouts,” however, Congress conspicuously did *not* include any emergency funding.⁷⁴

69. *Treasury Department Analysis Hearings*, *supra* note 63 (testimony of Antonio Weiss, U.S. Treas. Dep’t, Counselor to Sec.).

70. PROMESA, 48 U.S.C. §§ 2101–2241 (2016). For an overall description and analysis of PROMESA, see D. ANDREW AUSTIN, CONG. RESEARCH SERV., R44532, THE PUERTO RICO OVERSIGHT, MANAGEMENT, AND ECONOMIC STABILITY ACT (PROMESA; H.R. 5278, S. 2328) (2016) [hereinafter AUSTIN, PROMESA OVERVIEW].

71. See Mike DeBonis & Steven Mufson, *Puerto Rico Fiscal-Rescue Bill Clears Congress Two Days Before Debt Cliff*, WASH. POST, Jun. 30, 2016, at A15.

72. 48 U.S.C. § 2121(b) (establishing Oversight Board). Though intended for Puerto Rico, PROMESA broadly applies to any “territory for which an Oversight Board has been established” pursuant to § 2121(b). 48 U.S.C. § 2104(8). Congress has not established an Oversight Board for any territory other than Puerto Rico.

73. *Id.* at § 2121(a) (purpose of Board). See also *PREPA Hearings*, *supra* note 29 (testimony of José B. Carrión III, Chair, Finan. Oversight & Management Bd.); *id.* at §§ 2141–43 (Board responsibility for approving fiscal plans and certifying compliance with statutorily-defined fiscal standards, certification of budget compliance with fiscal plan, authority to reduce budget expenditures, institute certain hiring freezes, and prohibit government instrumentalities from entering contracts or engaging in financial transactions in event of noncompliance). Many Puerto Ricans resent PROMESA’s imposition of federal government control, complaining of ongoing “colonialism” and referring to the new Board as a “junta.” Mary Williams Walsh, *New Puerto Rico Debt Relief Law Stirs Colonial Resentments*, N.Y. TIMES, Jul. 1, 2016, at B1.

74. See, e.g., Jackie Calmes, *Senate Votes to Approve Puerto Rico Relief Bill*, N.Y. TIMES, June 30, 2016, at B1 (“The rescue package will not prevent Puerto Rico from missing the payment due . . . , and Republican congressional leaders labored to reassure conservatives that the bill is not a bailout.”). Though some may disagree over labels, I define “bailout” as “a form of government assistance or intervention specifically designed or intended to assist enterprises facing financial distress and to prevent enterprise failure.” Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 960 (1992). In other words, a successful bailout might be accomplished at no cost, or sometimes even at a profit. See Block, *Measuring Costs*, *supra* note 2, at 163–65.

Rather than invoke its Bankruptcy Clause constitutional powers,⁷⁵ Congress instead used its Territories Clause authority⁷⁶ to establish two new emergency debt readjustment tools, both ultimately subject to Oversight Board control: (1) a largely out-of-court process for negotiating voluntary restructuring agreements,⁷⁷ and (2) a court-supervised, bankruptcy-like process.⁷⁸

2. PROMESA Title VII: Voluntary Debt Restructuring

Title VII's new "creditor collective action" rules provide at least some structure to the previously ad hoc process for voluntary bond restructuring. Its procedures require: (1) negotiations between the bond issuing entity and distinct bondholder pools representing different types of creditor interests;⁷⁹ (2) certification and acceptance of proposed debt restructuring terms by the Oversight Board;⁸⁰ and (3) favorable super-majority vote of qualified bondholders in each pool.⁸¹ Title VII is perhaps best understood in light of sovereign debt crisis management problems since the mid-1990s, when many countries—and territories such as Puerto Rico—began to generate capital primarily by selling bonds, most of which are traded by investors on secondary markets, rather than borrow through

75. U.S. CONST. art I, § 8 (empowering Congress to make "uniform [l]aws on the subject of [b]ankruptcies throughout the United States").

76. 48 U.S.C. § 2191(b)(2) ("Congress enacts this chapter pursuant to article IV, section 3 of the Constitution of the United States, which provides Congress the power to dispose of and make all needful rules and regulations for territories.").

77. 48 U.S.C. §§ 2231–32 (title VII) ("Creditor Collective Action").

78. 48 U.S.C. §§ 2161–77 (title III) ("Adjustments of Debts"). The federal Bankruptcy Code includes procedures for either liquidation (11 U.S.C. §§ 701–784 (Chapter 7)), or reorganization and potential rehabilitation (11 U.S.C. §§ 1101–1174 (Chapter 11)), of private insolvent businesses. Given that territories cannot be liquidated, PROMESA's title III provisions are modelled largely after Chapter 11. Indeed, title III makes numerous general and Chapter 11-specific federal bankruptcy provisions explicitly applicable. *Id.* at § 2161(1), (b).

79. 48 U.S.C. § 2231(d) (pools established by Board in consultation with the government bond issuing entity).

80. 48 U.S.C. § 2231(g) (requiring certification that debt modifications are in creditors' best interests and in compliance with other requirements specified in *id.* at § 2124(i)).

81. *Id.* at § 2231(j). The complex voting rules require that modifications be approved by the holders of not less than a majority of the total aggregate outstanding principal for each pool, and by holders of at least two-thirds of the outstanding principal within the pool who actually vote. *Id.*

syndicated commercial bank loans.⁸² In this new market environment, distressed sovereigns frequently face the challenge of negotiating debt modification agreements with large numbers of bondholders with diverging interests.⁸³ Of particular concern is the potential for “holdouts”—bondholders who refuse to negotiate, preferring instead to sue for full payment. Some fear that recent court rulings protecting the payment rights of bondholders who did not consent over those who voluntarily agreed to sovereign debt restructuring will further embolden holdouts, “exacerbate collective action problems and, accordingly, make the sovereign debt restructuring process more complicated.”⁸⁴

As collective action problems increasingly stymied successful ad hoc restructuring negotiations with sovereign bondholders, the IMF found itself with few alternatives other than to make large loans to distressed sovereigns or simply allow them to fend for themselves.⁸⁵ In fact, unpopular IMF bailouts of debtor nations between 1995 and 2002 ultimately led to two major reform models for sovereign debt resolution: (1) a statutory or treaty-based framework for formal international bankruptcy,⁸⁶ and (2) a private, contract-based approach, which focuses primarily on including “collective action clauses” (CACs) in sovereign debt contracts. These clauses generally enable “a qualified majority of bondholders (typically seventy-five percent) to bind all bondholders within the same issue to the financial

82. See, e.g., Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 GEO. J. INT’L L. 299, 308–10 (2005); W. Mark C. Weidenmaier & Mitu Gulati, *A People’s History of Collective Action Clauses*, 54 VA. J. INT’L L. 51, 56 (2013).

83. See, e.g., Anne O. Krueger & Sean Hagan, *Sovereign Workouts: An IMF Perspective*, 6 CHI. J. INT’L L. 203, 210 (2005).

84. MARTIN A. WEISS & ARLENE WILSON, CONG. RESEARCH SERV., RL31451, *MANAGING INTERNATIONAL FINANCIAL CRISIS: ALTERNATIVES TO “BAILOUTS,” HARDSHIPS AND CONTAGION* 94 (2013). See *NML Capital Ltd. v. Republic of Argentina*, 699 F. 3d 246 (2d Cir. 2012), cert. denied, 134 S. Ct. 201 (2013); *NML Capital, Ltd. v. Republic of Argentina*, 727 F. 3d 230 (2d Cir. 2013), cert. denied, 134 S. Ct. 2819 (2014) (Supreme Court refusal to hear appeals on lower court rulings enjoining Argentina from making payments on restructured debt until holdouts were paid in full).

85. See, e.g., *MANAGING INTERNATIONAL FINANCIAL CRISIS*, supra note 84, at 1.

86. The most prominent of these proposals is the Sovereign Debt Restructuring Mechanism (SDRM). See *MANAGING INTERNATIONAL FINANCIAL CRISIS*, supra note 84, at 11–14; Hagan, supra note 82, at 335–402.

terms of a restructuring. . . .”⁸⁷ Under such CACs, investors contractually agree *ex ante* to be bound by the results of a bondholder vote pursuant to contractually-specified procedures in the event that sovereign debt adjustments become necessary. As such, CACs ideally prevent holdouts from interfering with supermajority (or sometimes majority) bondholder agreements to reduce the distressed government’s debt burden, thereby increasing public-sector involvement (PSI) in burden sharing,⁸⁸ and limiting the need for taxpayer-funded bailout-type assistance.

Perhaps the most notable feature of title VII is its potential—loosely modelled after the CAC approach—for binding *non-consenting* bondholders within each pool to debt modifications approved by supermajority vote,⁸⁹ even though—in contrast to the sovereign-debt CAC model on which it is based—the bondholders did not contractually agree to any such collective action terms in advance. In other words, title VII permits involuntary retroactive changes to individual bondholder rights; it is not really a contract-based approach at all.⁹⁰ Moreover, PROMESA’s use of relatively narrowly-defined bondholder voting pools is oddly inconsistent with the modern CAC trend, which is to aggregate voting across different bond series rather than count votes on a “series-by-series” basis.⁹¹ As the IMF recently explained, series-by-series CACs are not very effective against holdouts because they “allow the possibility that . . . a group of creditors can obtain a ‘blocking position’ in a particular series.”⁹² Raising similar concerns about PROMESA title VII’s voting pools, Obama Administration officials testified that the complexity of Puerto Rico’s outstanding bonded debt and the large

87. Hagan, *supra* note 82, at 317 (describing this as the most important of two different CAC types). For more on CACs, see Weidenmaier & Gulati, *supra* note 82; Anna Gelpern & Mitu Gulati, *The Wonder Clause*, 41 J. COMP. ECON. 367 (2013).

88. *See, e.g.*, Gelpern & Gulati, *supra* note 87, at 374.

89. *See supra* note 81.

90. AUSTIN, PROMESA OVERVIEW, *supra* note 70, at 26.

91. AUSTIN, PROMESA OVERVIEW, *supra* note 70, at 27 (noting PROMESA’s contrast to trends to create larger, aggregated pools to facilitate consensus on restructuring).

92. INT’L MONETARY FUND, STRENGTHENING THE CONTRACTUAL FRAMEWORK TO ADDRESS COLLECTIVE BARGAINING PROBLEMS IN SOVEREIGN DEBT RESTRUCTURING 18 (Oct. 2014), <http://www.imf.org/external/np/pp/eng/2014/090214.pdf>. Responding to this concern, the European Union in 2013 began mandating aggregate-vote CACs for Eurozone sovereign debt issues. *Id.* at 19.

number and size of voting pools would make it “nearly impossible to reach the super-majority required for restructuring.”⁹³

3. Title III: Bankruptcy-Like Debt Restructuring

In some respects, title III’s formal “Adjustments of Debts” process affords even *broader* protection than Puerto Rico would have gotten from an expansion of Chapter 9 bankruptcy authority to the territory.⁹⁴ Unlike Chapter 9, which does not allow state-level bankruptcy proceedings,⁹⁵ title III treats the Puerto Rican government itself as a potential debtor eligible to participate in the formal debt restructuring process.⁹⁶ On the other hand, Puerto Rico has little say over the title III process, which is controlled almost entirely by the Oversight Board. Only the Board, for example, can commence a title III restructuring action by filing a petition in federal district court.⁹⁷ In any case, the Board cannot file a petition unless five or more members of the Board (out of seven total) vote to issue a “restructuring certification.”⁹⁸ These and other procedural obstacles could make it more difficult for Puerto Rico to use the title III restructuring process. Making a similar argument, Obama Administration officials testified that “the process for entering restructuring should not require a super-majority vote of the Board. A minority of the Board should not have veto power at the critical junction when all other options have been exhausted.”⁹⁹

93. AUSTIN, PROMESA OVERVIEW, *supra* note 70, at 27 (referring to Treasury Department testimony before the House Committee on Natural Resources). *See also, id.* (referring to testimony that Title VII “imposes an unworkable, mandatory process that will only delay ability to reach a comprehensive resolution.”).

94. Though clearly modelled on federal bankruptcy laws, see *supra* note 78, title III generally refers to the process as “restructuring,” not “bankruptcy.” See also *supra* notes 36–39, and 67, and accompanying texts regarding political efforts to extend Chapter 9-type municipal bankruptcy authority to Puerto Rico.

95. *See supra* notes 30–33 and accompanying text.

96. 48 U.S.C. § 2162 (“Who may be a debtor”).

97. 48 U.S.C. § 2164(a). PROMESA does not provide for proceedings in bankruptcy court.

98. 48 U.S.C. § 2146.

99. *Discussion Draft of the Puerto Rico Oversight, Management, and Economic Stability Act: Hearings Before the H. Comm. on Natural Resources*, 114th Cong. (2016) (testimony of Antonio Weiss, U.S. Treas. Dep’t, Counselor to Sec.).

4. Policy Priorities and PROMESA's Potential

In the end, PROMESA borrows from both contract-based and court-supervised debt restructuring models, effectively forging a hybrid procedural approach to restructuring Puerto Rico's otherwise unpayable debt.¹⁰⁰ Despite this mix, PROMESA's statutory language strongly indicates a preference for privately-negotiated solutions. Key to this preference is a restriction limiting the Board to issuing a title III restructuring certification for an eligible Puerto Rican bond issuer only after determining, in its sole discretion, that "the entity has made good-faith efforts to reach a consensual restructuring with creditors"¹⁰¹ Although Puerto Rican officials might argue that negotiations with creditors over the past several years—presumably in good faith—already satisfy the good faith requirement, PROMESA's hybrid structure suggests—and the Oversight Board Chair's recent congressional testimony confirm—that the Board will first require Puerto Rico to try title VII private negotiations before turning to title III. In recent congressional testimony, the Oversight Board Chair reported a major PROMESA milestone: the Board's March 13, 2017 certification of Puerto Rico's amended fiscal plan,¹⁰² further explaining that—with this certified fiscal plan in place—the Board's primary focus would be to secure consensual restructurings under title VII.¹⁰³ Puerto Rico's new governor, who took office in January 2017, also prefers to work first toward consensual agreements under title VII, for example, to extract even greater concessions from PREPA bondholders than those included in an earlier restructuring agreement.¹⁰⁴

100. See *supra* note 42 (announcement regarding unpayable debt).

101. 48 U.S.C. § 2146 (a)(1).

102. See *PREPA Hearings*, *supra* note 29 (testimony of José B. Carrión III, Chair, Finan. Oversight & Management Bd.).

103. *Id.*

104. *Id.* (testimony of Governor Ricardo Antonio Rosselló Nevares). See also *PREPA Hearings*, *supra* note 29 (testimony of Luis Benítez Hernández, Chair, PREPA Governing Board) (describing restructuring negotiations and agreement with PREPA creditors); Matt Wirz & Andrew Scurria, *Puerto Rico Deal Could be Altered – Governor Weighs Asking Creditors for More Concessions in Bond Agreement*, WALL STREET J., Jan. 28, 2017, at B9.

While PROMESA did not prevent Puerto Rico's substantial default on constitutionally-guaranteed debt,¹⁰⁵ its temporary automatic stay on litigation against Puerto Rican government entities at least bought time for Puerto Rico and the Oversight Board to begin their work without the distraction of litigation that otherwise would have ensued as creditors rushed to courthouses to protect their claims.¹⁰⁶ Also on the positive side, the Oversight Board's recent certification of Puerto Rico's amended fiscal plan—along with PROMESA's fiscal sustainability measures more generally—will hopefully increase investor confidence and calm otherwise chilly markets. In addition, PROMESA's emergency debt restructuring tools offer at least some structure and procedures for adjusting Puerto Rico's unsustainable debt obligations. Moreover, unlike true sovereign debt holders, for whom there is no formal international bankruptcy or title III-like alternative to voluntary restructuring, Puerto Rico's quasi-sovereign bondholders now have additional incentive to participate in negotiations for fear that they may be worse if the issuer can use the title III court-supervised process as a backstop in the event that voluntary negotiations fail. To the extent that Puerto Rico can use title VII to persuade creditors to further share any significant portion of its unsustainable public debt burden, the territory will improve its chances for economic recovery, and—more importantly—reduce economic and social burdens on the general public, and lessen the need for outside assistance.¹⁰⁷

On the other hand, for a voluntary restructuring agreement under title VII to be binding on non-consenting bondholders of the issuer, it must not only be approved by a separate supermajority vote of each pool with respect to changes affecting creditors in that pool,¹⁰⁸ but must satisfy other requirements. PROMESA title VII modifications are not binding, for example, until: (1) the holders of the right to vote

105. See *supra* note 44.

106. Originally set to expire on February 15, 2017, 48 U.S.C. §2194(d), the temporary stay was extended by the Oversight Board until May 1, 2017. *PREPA Hearings*, *supra* note 29 (testimony of José B. Carrión III, Chair, Finan. Oversight & Management Bd.).

107. Whether through title VII or title III, I believe that some significant portion of the financial sacrifice necessary for Puerto Rico to emerge with a sustainable debt profile should be borne by those who purchased Puerto Rican bonds at extraordinarily steep discounts.

108. See *supra* note 81.

in every pool of the issuer have approved modifications under the applicable voting procedures; (2) the Oversight Board makes further required certifications and submits them to the federal district court for Puerto Rico; and (3) the court enters a ruling that the approved modifications are conclusive and binding.¹⁰⁹ Though Puerto Rico may have some success renegotiating debt burdens with respect to lower priority bonds issued by its public corporations, the greatest challenge to title VII's success is likely to be the holders of constitutionally-guaranteed general obligation bonds backed by the full faith and credit of the Puerto Rican government itself.¹¹⁰ Title VII modifications would not only retroactively change these bondholders' contract terms, but also would alter the constitutionally-guaranteed status of their investments. This group of bondholders is likely not only likely to resist voluntary restructuring, but also to challenge the title III restructuring process through litigation. In other words, title VII's potential success hinges on the substantial buy-in of those holding general obligations bonds. Though I hope to be proven wrong, I am not optimistic that the unwieldy title VII process will result in fully successful voluntary agreements with creditors on debt modifications before the short-lived automatic stay on creditor litigation expires.¹¹¹ One additional factor that may limit PROMESA's promise is its failure to address the island's inadequate federal Medicaid funding, which is critical to remedying Puerto Rico's short- and long-term budgetary and economic problems.¹¹²

Puerto Rico's financial problems are far from over, and Congress may face continued pressure for assistance, including possible

109. 48 U.S.C. § 2231(m).

110. Among the required principles for establishing title VII pools is identifying separate pools based on the relative priority or security arrangements for different bonds, including "[b]onds that have been issued as general obligations . . ." 48 U.S.C. § 2231(d)(3)(A). In other words, holders of high priority, general obligation bonds will be in a separate pool for negotiation purposes.

111. *See supra* note 106. Title VII's potentially positive impact is also limited because it does not provide a structure for negotiations with stakeholders other than bondholders.

112. EDWIN PARK, CENTER ON BUDGET POLICY & PRIORITIES, ADDRESSING PUERTO RICO'S MEDICAID FUNDING SHORTFALLS WOULD HELP ENSURE FISCAL STABILITY AND GROWTH 1 (2016), <http://www.cbpp.org/sites/default/files/atoms/files/9-19-16health.pdf> [hereinafter MEDICAID FUNDING SHORTFALLS]. *See also infra* notes 221–27, and accompanying text (discussing the debate over the adequacy of federal funding for Puerto Rico's Medicaid program).

requests for direct funding. Indeed, at the new Board's first substantive meeting, Puerto Rico's governor already was arguing that the island will "still need the assistance of the federal government to bring this economic and humanitarian crisis to an end."¹¹³ Rather than pretend that it will never provide financial assistance to Puerto Rico or to a U.S. state in the event of a similar emergency, Congress should use the recent Puerto Rico episode as an opportunity to focus attention on U.S. policy regarding federal rescue intervention to aid distressed subnational state and territorial governments.

II. SOVEREIGNTY-BASED ARGUMENTS AGAINST SUBNATIONAL GOVERNMENT BAILOUTS

A. *The Quasi-Sovereign U.S. States*

The U.S. Constitution created distinct national and state-level governments, yet left many unanswered questions on the scope of federal and state authority. Though some might despair of such constitutional imprecision, the flexibility it provides actually may be one of American federalism's greatest virtues. According to Woodrow Wilson, for example:

The question of the relation of the States to the federal government is the cardinal question of our constitutional system. . . . It cannot, indeed, be settled by one generation because it is a question of growth, and every successive stage of our political and economic development gives it a new aspect, makes it a new question.¹¹⁴

Despite American federalism's nuanced and evolving interpretation of relative federal and state powers, U.S. states clearly have many sovereign-like features, including autonomous executive, legislative, and judicial government branches, and independent taxing, spending,

113. Mary Williams Walsh, *Puerto Rico Said to Face 'Death Spiral' Over Debt*, N.Y. TIMES, Oct. 15, 2016, at B3 (quoting Governor Alejandro García Padilla).

114. WOODROW WILSON, CONSTITUTIONAL GOVERNMENT IN THE UNITED STATES 173 (1911). As Professor Kenneth Dam argues, American federalism's fluidity is especially evident with respect to fiscal matters. Kenneth W. Dam, *The American Fiscal Constitution*, 44 U. CHI. L. REV. 271, 273 (1977).

and borrowing authority. At the same time, several U.S. state characteristics are clearly inconsistent with broad sovereignty notions. Perhaps most important, federal power constitutionally preempts some state regulatory authority under the federal preemption doctrine.¹¹⁵ At best, then, states can be described as “quasi-sovereign.”¹¹⁶

Even after a long post-New Deal period of expansively-defined federal regulatory power,¹¹⁷ notions of “state sovereignty” have retained powerful rhetorical and emotive force since the republic’s inception, especially among those advocating greater state autonomy.¹¹⁸ The Supreme Court’s renewed focus on state sovereignty in its “new federalism” decisions since the 1990s reinvigorated such sovereignty-based “states’ rights” arguments.¹¹⁹ Modern Supreme Court rhetoric on state sovereign immunity also emphasizes the doctrine’s primary function as “afford[ing] the States the dignity and respect due sovereign entities.”¹²⁰ Consistently applied, the same autonomy and dignity arguments used to keep the federal government and courts *out* of state affairs in stable times also support a hands-off approach during times of economic instability. In

115. A broad discussion of the complex, evolving, and sometimes ambiguous nature of federal preemption doctrine is beyond the scope of this Article. As samples from the vast academic literature, see, for example, Viet D. Dinh, *Reassessing the Law of Preemption*, 88 GEO. L.J. 2085 (2000); Stephan A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 767 (1994); Caleb Nelson, *Preemption*, 86 VA. L. REV. 225 (2000).

116. See, e.g., Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 891 (2012).

117. Some say that the Court during this period so broadly interpreted federal authority that “virtually no substantive area of law [was] beyond the national government’s reach.” Deborah Jones Merritt, *Three Faces of Federalism: Finding a Formula for the Future*, 47 VAND. L. REV. 1563, 1565 (1994).

118. See, e.g., MALCOLM M. FEELEY & EDWARD RUBIN, FEDERALISM: POLITICAL IDENTITY AND TRAGIC COMPROMISE 12 (2008).

119. Examples of the exhaustive “new federalism” or “federalist revival” literature include EUGENE BOYD & MICHAEL K. FAUNTROY, CONG. RESEARCH SERV., RL30772, AMERICAN FEDERALISM, 1776-2000: SIGNIFICANT EVENTS 15–18 (2000); Daniel A. Farber, *Pledging a New Allegiance: An Essay on Sovereignty and the New Federalism*, 75 NOTRE DAME L. REV. 1133 (2000).

120. Fed. Mar. Comm’n v. S.C. State Ports Auth., 535 U.S. 743, 769 (2002). See also Judith Resnick & Julie Chi-hye Suk, *Adding Insult to Injury: Questioning the Role of Dignity in Conceptions of Sovereignty*, 55 STAN. L. REV. 1921, 1923 (2003); Peter J. Smith, *States as Nations: Dignity in Cross-Doctrinal Perspective*, 89 VA. L. REV. 1, 3 (2003).

other words, states should both enjoy the full benefits and suffer the negative consequences of state-level policy choices.

Upon closer examination, though, sovereignty-based arguments for a presumption against federal assistance to financially-troubled states are weaker than they appear at first blush. First, as many scholars argue, constitutional state sovereignty notions are inconsistent with the modern political environment, which—at least since the New Deal—has instantiated a more cooperative federalist reality of substantially-intertwined federal and state policymaking and administration of government programs.¹²¹ Several scholars, for example, note modern tension “between the constitutional rhetoric and political reality of federal-state relations.”¹²² In any event, Professor David Super argues that traditional constitutional federalism principles, which focus on federal regulatory power over the states, are not as well suited to address questions about federal-state fiscal relationships.¹²³ At least with respect to the latter, which Super refers to as *fiscal* federalism, “[t]he New Deal amended our implicit fiscal constitution by recognizing a new federal responsibility to provide countercyclical assistance.”¹²⁴

Second, using “hard core” state sovereignty ideas to insist that states take full responsibility for their own financial messes fails to account for the unusual quasi-sovereign nature of state governments, which fiscally depend upon central government grants-in-aid in ways that true national sovereigns do not.¹²⁵ States have no power to

121. See, e.g., Philip J. Weiser, *Towards a Constitutional Architecture for Cooperative Federalism*, 79 N.C. L. REV. 663, 664–65 (2001).

122. *Id.* at 665. See also Edward L. Rubin, *Puppy Federalism and the Blessings of America*, 574 ANNALS AM. ACAD. POL. & SOC. SCI. 37, 38 (2001) (describing a nostalgic “puppy federalism,” used “to convince ourselves that we have not altered the conception of the government that the Framers maintained, when, of course, we have; that we are not a bureaucratized administrative state, when, of course, we are; and that we are a geographically diverse nation, . . . when, of course, we are highly homogenized.”).

123. David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544 (2005).

124. *Id.* at 2575.

125. See, e.g., John Joseph Wallis & Wallace E. Oates, *The Impact of the New Deal on American Federalism*, in *THE DEFINING MOMENT: THE GREAT DEPRESSION AND THE AMERICAN ECONOMY IN THE TWENTIETH CENTURY* 155, 156 (Michael D. Bordo, Claudia Goldin & Eugene N. White eds., 1998). Indeed, grants to state and local governments have increased in total outlay and number since the 1930s. See ROBERT J. DILGER, CONG. RESEARCH SERV., R40638, *FEDERAL GRANTS TO STATE AND LOCAL GOVERNMENTS: AN HISTORICAL*

control the money supply, and more generally lack access to the kinds of financial resources that the federal government may bring to bear when necessary.¹²⁶ Third, even though federal and state governments have similar debt issuing authority, virtually all states face balanced budget requirements and other borrowing constraints that do not apply to the federal government.¹²⁷ In the end, I contend that the concept of state sovereignty—standing alone—does not adequately support a strong presumption against federal bailout-type assistance to state governments.

B. Puerto Rico's Uniquely Hybrid Quasi-Sovereignty

Puerto Rico occupies an unusual space in the international and American federalist firmaments. As just one example, U.S. tax rules inconsistently treat Puerto Rico as sometimes foreign, sometimes a state, and sometimes a hybrid somewhere in between. The congressional Joint Tax Committee, for example, reports that:

Although Puerto Rico is generally treated as a foreign country for U.S. tax purposes, a person born in Puerto Rico is typically treated as a U.S. citizen for U.S. tax purposes. As a result of the hybrid foreign-domestic treatment, the general principles of U.S. taxation are qualified by many special rules . . . [which] have the effect of dividing tax authority between the U.S. Federal government and the government of Puerto Rico.¹²⁸

Another example is that despite its resemblance to emerging-market sovereign nations, Puerto Rico's status as a U.S. territory makes it ineligible for a variety of formal and informal international assistance

PERSPECTIVE ON CONTEMPORARY ISSUES 5 tbl.2 (2015) (total outlays); *id.* at 10 tbl.4 (total numbers).

126. Super, for example, identifies “superior capacity” as a model of federalism that “calls for the federal government to marshal its powerful fiscal resources and assist states with projects that they would have difficulty handling on their own.” Super, *supra* note 123, at 2574.

127. See DAVID M. PRIMO, RULES AND RESTRAINTS: GOVERNMENT SPENDING AND THE DESIGN OF INSTITUTIONS 82–104 (2007); David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CAL. L. REV. 749, 755 (2010).

128. JOINT COMM. ON TAX’N, JCX-41-12, FEDERAL TAX LAWS AND ISSUES RELATED TO THE UNITED STATES TERRITORIES 24 (2012) [hereinafter TAX LAWS RELATED TO TERRITORIES].

programs, available primarily through the International Monetary Fund (IMF).¹²⁹ At the same time, Congress denies Puerto Rico access to the same Chapter 9 federal bankruptcy law protections available to U.S. states.¹³⁰ As Joseph Stiglitz and Mark Medesh observed: “[t]he commonwealth of Puerto Rico is neither fish nor fowl in the constitutional order”¹³¹

The most fundamental difference between Puerto Rican and U.S. state status is the underlying source of governance authority. Aside from a brief period of military rule after the United States acquired Puerto Rico at the end of the Spanish American War in 1898,¹³² Congress has exercised or delegated regulatory authority over Puerto Rico under the U.S. Constitution’s Territories Clause.¹³³ And, until 2016, the congressional policy trajectory had been to gradually increase Puerto Rico’s self-governance rights.¹³⁴ Thus, with the exception of recent federal oversight controls under PROMESA,¹³⁵ Puerto Rico today enjoys autonomy and self-governance rights largely similar to those of the states.¹³⁶ Like states, for example,

129. Matt Wirz & Aaron Kuriloff, *Puerto Rico, Investors Enlist Ex-IMF Officials*, WALL STREET J., Apr. 13, 2015, at C1. (“As a U.S. commonwealth, the island . . . doesn’t qualify for IMF aid, but the excessive borrowing, inconsistent financial reporting and low tax collection that landed Puerto Rico in hot water are common in the developing countries that IMF economists deal with.”). Yet, Puerto Rico is recognized as an independent country eligible to compete in the Olympic Games. See, e.g., Charles R. Venator Santiago, *Countering Kulturkampf Politics through Critique and Justice Pedagogy*, 50 VILL. L. REV. 749, 770 (2005) (“Puerto Rican Olympic teams regularly challenge the United States in the international arena as sovereign opponents.”).

130. See *supra* notes 30–39 and accompanying text.

131. Joseph E. Stiglitz & Mark Medish, *What the United States Owes Puerto Rico*, WALL STREET J., Aug. 13, 2015, at A13.

132. Treaty of Peace between the United States of America and the Kingdom of Spain (Treaty of Paris), art II, Dec. 10, 1898, 30 Stat. 1754, T.S. No. 343 (Spanish cession of Porto Rico [sic] to U.S.). On the history and evolution of Puerto Rico’s status, see generally José A. Cabranes, *Citizenship and the American Empire: Notes on the Legislative History of the United States Citizenship of Puerto Rican Citizens*, 127 U. PA. L. REV. 391 (1978).

133. U.S. CONST. art. IV, § 3, cl. 2 (“Congress shall have power to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the United States.”).

134. See, e.g., *Puerto Rico v. Sánchez Valle*, 136 S. Ct. 1863, 1868–69 (2016) (describing evolution of self-governance rights). See also generally Cabranes, *supra* note 132.

135. See *supra* notes 70–112 and accompanying text.

136. Congress authorized the Puerto Rican people to adopt their own constitution in 1950. An Act to provide for the organization of a constitutional government by the people of Puerto Rico, Pub. L. No. 81-600, 64 Stat. 319 (1950), and approved the new constitution of the

Puerto Rico has independent executive, legislative, and judicial branches of government, independent taxing, spending, and borrowing authority, and federal courts generally recognize it as a “state” for sovereign immunity purposes.¹³⁷

Despite surface appearances, however, the relative “quasi-sovereignties” of Puerto Rico and the U.S. states differ in important ways. First, the *statutory* U.S. citizenship available to Puerto Rican residents since 1917 differs from the constitutional citizenship available to those born in the fifty states or the District of Columbia, or admitted to the United States as citizens.¹³⁸ Perhaps most significant, U.S. citizens residing in Puerto Rico cannot vote in U.S. presidential elections.¹³⁹ Moreover, unlike U.S. state citizens, Puerto Ricans are not represented in Congress by members with full voting rights.¹⁴⁰ Though Puerto Rico is considered a “state” for purposes of many federal programs, it is explicitly excluded or treated differently with respect to others.¹⁴¹

“Commonwealth of Puerto Rico” in 1952 on condition that any amendments or revisions be consistent with the congressional approval resolution, the U.S. Constitution, and other specified U.S. laws. Act of Jul. 3, 1952, 66 Stat. 327. *See also* Gary Lawson & Robert D. Sloane, *The Constitutionality of Decolonization by Associated Statehood: Puerto Rico’s Legal Status Reconsidered*, 50 B.C. L. REV. 1123, 1158 (2009) [hereinafter Lawson & Sloane] (noting that Congress has not interfered with Puerto Rico’s “de facto” self-governance).

137. *See, e.g.*, Ramirez v. P.R. Fire Service, 715 F.2d 694, 697 (1st Cir. 1983) (“Puerto Rico, despite the lack of formal statehood, enjoys the shelter of the Eleventh Amendment in all respects.”) (citations omitted).

138. 8 U.S.C. § 1402 (“All persons born in Puerto Rico . . . and subject to the jurisdiction of the United States are citizens of the United States at birth.”). *See also* Sam Erman, *Citizens of Empire: Puerto Rico, Status, and Constitutional Change*, 102 CAL. L. REV. 1181, 1238 (2014) (noting distinction between statutory and constitutional citizenship).

139. Technically, “[t]he territories can—and, currently, each of the five territories does—participate in presidential primaries, but the territories cannot participate in the general election for president.” CONGRESSIONAL TASK FORCE ON ECONOMIC GROWTH IN PUERTO RICO, REPORT TO HOUSE AND SENATE 82, 114th Cong. (2016) [hereinafter CONGRESSIONAL TASK FORCE REPORT]. *See also* Igartua-de-la Rosa v. United States, 417 F.3d 145, 146 (1st Cir. 2005) (rejecting constitutional right to vote claim of U.S. citizen residing in Puerto Rico).

140. U.S. territories, including Puerto Rico, do elect a single delegate to the House of Representatives, “who (under current House rules . . .) can introduce legislation, serve on House committees, and vote on legislation at the committee stage. However, the territorial delegates cannot vote on legislation on the floor of the House. The territories do not elect U.S. senators.” CONGRESSIONAL TASK FORCE REPORT, *supra* note 139, at 82.

141. *Id.* at 95–111 (Appendix 2 (“Federal Programs under Which Puerto Rico Receives Differential Treatment”). *See also infra* notes 175–81 and 211–26 and accompanying texts.

Serious debate over the precise nature of Puerto Rico's political and legal status has simmered since the effective date of its 1952 Constitution. Whatever Puerto Rico's practical political status, the Supreme Court recently settled the constitutional question. Though it acknowledged "Puerto Rico's transformative constitutional moment" in 1952, the Court nonetheless rejected the idea that the Puerto Rican Constitution or the "commonwealth" label significantly changed Puerto Rico's status. The Court in *Sánchez Valle* held that—unlike U.S. states, which retained inherent sovereign powers not delegated to the federal government when they joined the Union—Puerto Rico has been—and continues to be—subject to regulation by Congress: "[t]he island's Constitution, significant though it is, does not break the chain."¹⁴² In other words, Puerto Rico's quasi-sovereign qualities may be ephemeral; they remain vulnerable to congressional change at any time.

As the Court observed in *Sánchez Valle*, among the few things that can be said with absolute certainty regarding Puerto Rico's status is that it "boasts 'a relationship to the United States that has no parallel in our history.'"¹⁴³ In *Franklin California Tax-Free Trust*, also decided in 2016, the Supreme Court held that Congress may treat Puerto Rico as a "state" preempted from enacting its own municipal debt restructuring rules, and yet *not* a "state" eligible to authorize its municipalities access to Chapter 9 bankruptcy protections.¹⁴⁴ These recent Supreme Court decisions, together with PROMESA, make it clear that Puerto Rico remains subject to discretionary congressional authority, and that Congress will turn to its Territories Clause to regulate Puerto Rican affairs as it deems necessary.

Ultimately, the force of sovereignty-based arguments against a federal bailout of Puerto Rico is limited for many of the reasons

142. *Commonwealth of Puerto Rico v. Sánchez Valle*, 136 S. Ct. 1863, 1876 (2016). Referring to statutory grants of "autonomy comparable to that possessed by the States[.]" the Court acknowledged Puerto Rico as "'sovereign' in one commonly understood sense of that term." *Id.* at 1874. Nonetheless, the Court held that Puerto Rico was *not* sovereign under the narrow test used for double jeopardy purposes, which focuses solely on the ultimate source of prosecutorial power. *Id.* at 1876.

143. *Id.* at 1876 (citing *Examining Bd. of Eng'rs v. Otero*, 426 U.S. 572, 596 (1976)).

144. *Puerto Rico v. Franklin Cal. Tax-Free Trust*, 136 S. Ct. 1938, 1946 (2016).

described above with respect to the U.S. states.¹⁴⁵ Like the states, for example, Puerto Rico relies on substantial federal grants-in-aid,¹⁴⁶ lacks monetary authority, has access to fewer resources, and is constrained by balanced-budget requirements.¹⁴⁷ In fact, the sovereignty-based case against bailouts arguably is even weaker for Puerto Rico than the states because Puerto Rico simply is not autonomous or independent in the same way that states are. While Congress generally has been content to keep its distance, Puerto Rico's self-governance rights are subject to congressional whim. To be clear, I believe that there should be a presumption against federal bailout-type assistance to Puerto Rico. My argument here is simply that the rationale for such a presumption cannot be built around conceptions of Puerto Rico as a self-governing, independent, or quasi-sovereign entity in whose affairs the federal government should not meddle.

III. MARKET-BASED ARGUMENTS AGAINST SUBNATIONAL GOVERNMENT BAILOUTS

A. Competition for Taxpayers

Traditional laissez-faire theorists believe that robust private-sector competition allocates resources to their highest value use and efficiently and correctly prices goods and services. From this perspective, the problem with private-sector bailouts is that they interfere with valuable free-market functions. By analogy, federal bailouts of subnational governments also interfere with markets. "Competitive federalism" notions, for example, imagine markets in which relatively autonomous state and local governments freely compete by offering specific tax and public service "packages" to target constituencies, thereby facilitating the most efficient allocation

145. *See supra* notes 121–27.

146. COMMONWEALTH OF PUERTO RICO, FINANCIAL INFORMATION AND OPERATING DATA REPORT 58–60 (Dec. 18, 2016), <http://bgfpr.com/documents/CommonwealthofPuertoRicoFinancialInfoFY201612-18-16.pdf> (discussing importance of federal transfers to Puerto Rican economy).

147. P.R. CONST. art. VI, § 7 ("The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal Year unless the imposition of taxes sufficient to cover said appropriations is provided by law.").

of public resources.¹⁴⁸ At first blush, this “competition for taxpayers” model suggests support for a presumption against higher-level government aid to struggling subnational governments because such assistance might interfere with free-market advantages that competitive federalism otherwise offers to subnational governments.

Indeed, federal tax advantages already available to Puerto Rico in the competition for taxpayers suggest perhaps that the presumption against any further federal intervention should be even stronger than it is for the states. Specifically, U.S. citizens residing in Puerto Rico are exempt from federal income tax on their Puerto Rico-sourced income, other than income from services as a U.S. government employee.¹⁴⁹ Businesses located in Puerto Rico also are eligible for Puerto Rican and U.S. tax breaks, which offer incentives to locate business operations in Puerto Rico.¹⁵⁰ Whatever the apparent tax advantages, however, economic realities belie the notion that Puerto Rico is a stronger competitor than the states in the market for taxpayers.¹⁵¹

In any event, the free-market analogy between private and public markets used to support the “competition for taxpayer” model is imperfect to begin with. First, one valuable function of traditional free markets is that they eliminate poorly managed or inefficient firms. Whereas bankruptcy fears presumably check private firm inefficiency and misbehavior, state governments do not experience the disciplinary impact of potential bankruptcy. Second, competition for taxpayer models necessarily assume mobility, i.e., that taxpayers can easily relocate in response to competing public service packages.

148. The logic underlying “competitive federalism” is usually attributed to Charles Tiebout’s, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

149. 26 U.S.C. § 933 (2012). As U.S. citizens, however, Puerto Ricans must pay federal income tax on worldwide income from sources other than Puerto Rico. TAX LAWS RELATED TO TERRITORIES, *supra* note 128, at 9. In addition, all Puerto Rican workers and their employers must pay their shares of federal employment taxes. 26 U.S.C. §§ 3121(e); 3306(j) (2012). These so-called “employment taxes” include both the Federal Insurance Contribution Act (FICA) tax (codified as amended at 26 U.S.C. §§ 3101–3128 (2012)) to provide funding for social security, Medicare, and the Federal Unemployment Tax Act (FUTA) (codified as amended at 26 U.S.C. §§ 3301–3311 (2012)) to provide funding for federal unemployment insurance.

150. *See infra* notes 192–209, and accompanying text.

151. *See, e.g., supra* note 66 and accompanying text on Puerto Rico’s dramatic outmigration.

The models also assume that taxpayers opt to “reside” in jurisdictions that most closely match their public service preferences.¹⁵² Unlike economically-driven consumer behavior, however, individual decisions about where to live are often based on personal factors such as cultural and family ties rather than tax cost and public goods and services preferences. Also, while the mobility assumption may be somewhat stronger for business taxpayers, firm location decisions similarly are not driven entirely by tax cost and public service preferences, but also by other factors, such as proximity to necessary natural resources and labor markets. Another conceptual problem with the mobility assumption is that—with the exception of some regional economies—taxpayers arguably are more likely to move to another city or town within the same state than to move to another state. In other words, the assumption of taxpayer mobility seems less viable regarding the choice of *state*—as opposed to municipal—residence.¹⁵³ Thus, the “competitive federalism” theory offers modest support for presumptions against local government bailouts, but weaker support as applied to the states and Puerto Rico.

B. Competition for Debt

State governments compete for borrowing as well as for taxpayers. By analogy to private lending markets, government bond markets presumably consider borrowers’ risk profiles in pricing municipal bonds. In theory, the threat of high-risk premiums should incentivize officials to be fiscally prudent and similarly incentivize creditors to carefully monitor government activities that might decrease the value of their investments. Thus, one powerful argument for a presumption against federal rescue interventions in the states and Puerto Rico is the need to preserve fiscal prudence incentives for subnational government officials. Ironically, however, the federal

152. Edward A. Zelinsky, *Tax Incentives for Economic Development: Personal (and Pessimistic) Reflections*, 58 CASE W. RES. L. REV. 1145, 1148 (2008). See generally Todd E. Petts, *The Mobility Paradox*, 92 GEO. L.J. 481 (2004).

153. See, e.g., FEELEY & RUBIN, *supra* note 118, at 82 (noting that “subunits [states] that possess rights under a federal system are generally too large to generate the necessary range of choices”); *id.* (further noting that the article upon which the competitive federalism theory was based actually studied location choices within one metropolitan area’s suburbs).

government already interferes in municipal bond markets, not by providing direct financial assistance, but with tax incentives that encourage subnational government borrowing in the first place.¹⁵⁴ This irony is even more profound with respect to Puerto Rico, where public debt is eligible for “triple exemption.”¹⁵⁵

C. Moral Hazard and Precedent-Setting

“Moral hazard” is a related, economically-based principle, which provides perhaps the strongest support for underlying presumptions against both private and public sector bailouts. Despite its origins as an insurance and then as a broader economic principle,¹⁵⁶ moral hazard has broader intuitive appeal as an evocative, short-hand label to describe perverse incentives for people to behave more recklessly when they believe they will be not be fully accountable for the negative consequences of their actions. As applied to subnational government bailouts, the concern is that federal assistance expectations may make voters and public officials less inclined to suffer painful fiscal adjustments, and also may encourage lax budgetary oversight or greater financial risk-taking. Even the *perception* that government assistance might be available can not only increase the risk of poor fiscal decision-making, but also may leave unscrupulous politicians more comfortable with fiscally irresponsible or even corrupt behavior. Political economy approaches to federalism emphasize something similar to moral hazard, noting that central governments in multi-tiered regimes almost *always* face the possibility that lower-tier governments “will try to over-fish the common revenue pool”¹⁵⁷ The result of such “safety net” expectations is that subnational governments are ultimately subject only to “soft” budget constraints, i.e., they are not *truly* forced to live

154. See, e.g., 26 U.S.C. § 103(a) (2012) (federal income tax exemption for municipal bond interest). See also *infra* notes 186–88, and accompanying text.

155. See *infra* notes 189–91, and accompanying text.

156. David Rowell & Luke B. Connelly, *A History of the Term ‘Moral Hazard,’* 79 J. RISK INS. 1051 (2012).

157. Jonathan Rodden, *The Dilemma of Fiscal Federalism: Grants and Fiscal Performance Around the World*, 46 AMER. J. POL. SCI. 670, 671 (2002). See also Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281, 300 (2012).

within their means. The central government's policy challenge is to avoid setting expectation-creating precedent while nonetheless providing appropriate assistance in cases of genuine crisis.¹⁵⁸ As Martin Feldstein said when he reacted to International Monetary Fund (IMF) assistance extended during the Southeast Asian currency collapse in the late 1990s, "[t]here is no perfect solution to [the] 'moral hazard' problem,"¹⁵⁹ he then added that, "[i]n principle, the IMF and the Korean government should provide the guarantees needed to keep current creditors engaged *while swearing that it is the last time that such guarantees will be provided.*"¹⁶⁰ Though I hesitate to be so glib in an academic article, I cannot resist responding: good luck with that!

As in the state context, concerns that any federal intervention will create expectations for future rescue assistance provide the most powerful support for a presumption against federal bailout assistance to Puerto Rico.¹⁶¹ Nonetheless, I believe that Puerto Rico's status and circumstances, once properly framed, are unique enough to allay most congressional fears that federal assistance would set unwanted precedent or create expectations in financially troubled states such as Illinois.

IV. EQUITY, FAIRNESS, AND PRESUMPTIONS AGAINST SUBNATIONAL GOVERNMENT BAILOUTS

There simply is no easy answer to the equity question raised by most bailouts—they *are* unfair in the sense that most of us think of fairness. This in itself, is another reason to at least begin with a

158. One arguable way for central government to quell bailout expectations is to adopt a policy of "constructive ambiguity." See, e.g., Alison M. Hashmall, *After the Fall: A New Framework to Regulate "Too Big to Fail" Non-Bank Financial Institutions*, 85 N.Y.U. L. REV. 829, 842–45 (2010); James B. Thomson, *On Systemically Important Financial Institutions and Progressive Systemic Migration*, Fed. Res. Bank of Cleveland, Policy Discussion Paper No. 27, 8–9 (Aug. 2009). The first difficulty with this approach is that governments may not be in a position to fail to act in cases of genuine crisis. Moreover, participation in even *one* financial rescue creates expectations that others may follow.

159. Martin Feldstein, *Refocusing the IMF*, 77 FOREIGN AFF. 20, 30 (1998).

160. *Id.* (emphasis added).

161. A less rigid presumption should arguably apply, however, in cases of subnational government economic crisis triggered by isolated, exogenous events over which officials and residents have little control.

presumption against them. In financial rescues, those receiving direct “bailout” benefits generally are not chosen because they are more *deserving*, and government assistance is *not* based upon equity considerations. In economic terms, those who benefit directly from government bailout protection are simply the fortunate recipients of positive spillover effects. More troubling, perhaps, is the notion of direct benefits going to those who are positively undeserving—or worse—of incidental benefits going to those who engaged in outright fraud or massive speculation, or to those who are substantially responsible for creating the economic crisis in the first place. An important related factor that should not be underestimated is political morale. Those who experience economic hardship without any federal rescue intervention understandably bear resentments when government attention and resources are targeted to assisting others.

I firmly believe that public policy should begin with a strong presumption against subnational government bailouts, and that the autonomy, integrity, and independence of these governments are important underlying considerations in support of such a presumption. In a genuine federalist regime, central government should not lightly interfere in the affairs of lower-level governments. Ultimately, however, the strongest case for a presumption against subnational government bailouts is not sovereignty-related, but a concern for the equitable allocation of scarce societal resources, public morale, and the danger of creating expectations that will encourage subnational government fiscal blindness or irresponsibility. Yet, rigid rules to preempt even the *possibility* of government assistance are short-sighted and ignore the reality that some future emergencies will undoubtedly lead to bailout-type intervention in any event. In the long run, undue resistance to early intervention can result in substantially higher public costs as economic distress conditions worsen and government intervention becomes increasingly inevitable.

With respect to Puerto Rico, I contend that the federal government has greater responsibility than it does to the states, which have deeply entrenched self-governance rights that cannot be altered simply by statute. Many have written of—and the Supreme Court has recently confirmed—the numerous ways in which Puerto Rico is effectively still treated as a colony. Focusing particularly on tax policy, for

example, Professor Diane Lourdes chronicles what she refers to as the U.S. government's "tax imperialism" toward Puerto Rico and claims that "the United States has used tax laws to advance its own economic and political interests at the expense of its island territory."¹⁶² As such, the United States should take some responsibility to help Puerto Rico in moments of extreme crisis. By agreeing with these claims, I am not arguing that Congress should be loose in deciding to intervene, nor am I suggesting that Congress needs to appropriate substantial federal revenue. Even in the case of Puerto Rico, where I believe Congress has a much greater obligation than for the states, federal interventions are appropriate only in rare and extraordinary circumstances, and responses should be tailored to particular circumstances. The section that follows assesses grounds and evidence relevant to decisions to overcome initial anti-intervention presumptions.

V. OVERCOMING THE PUBLIC SECTOR ANTI-BAILOUT PRESUMPTION: U.S. STATES AND PUERTO RICO COMPARED

A. Systemic Risk: Too Big, Too Interconnected, or Too Important to Fail

Once confronted with evidence that federal government inaction would lead to immediate economic Armageddon, it is hard to imagine that Congress would do nothing. In other words, the most straight-forward rebuttal argument to presumptions against bailouts is risk of imminent systemic economic harm. Some have already suggested that California is "too-big-to-fail" (TBTF), and that its economic collapse could dramatically interfere with the economies of neighboring states, regions, the country, or even the world.¹⁶³

In assessing potential system-wide harms, the *size* of a struggling state or territory's economy is undeniably relevant, but nonetheless

162. Diane Lourdes Dick, *U.S. Imperialism in Puerto Rico*, 65 AM. U. L. REV. 1, 85 (2015).

163. According to recent reports, "California passed Brazil and France to become the world's 6th-largest economy in 2015 . . ." California Jumps to the World's 6th Largest Economy; Leads All States in Growth in 2015, Center for Continuing Study of the California Economy (July 2016), <http://www.csce.com/PDF/Numbers-July-2016-CA-Economy-Rankings-2015.pdf>.

may be less important than other factors such as economic interconnectedness. The Greek economy, for example, is small relative to other European Union (EU) countries,¹⁶⁴ yet its collapse could have serious political and economic consequences for the EU.¹⁶⁵ The United States and Puerto Rican economies are sufficiently intertwined that serious problems in the United States would have a devastating impact upon Puerto Rico. On the other hand, while financial crisis in Puerto Rico might create disruptions in certain U.S. markets,¹⁶⁶ it is much less likely to have a dramatic impact on the overall U.S. economy.

Even so, a Puerto Rican financial crisis theoretically could have serious spillover effects with implications for overall U.S. economic stability. Just as private “banks runs” can result from rational or irrational market fears that problems at one bank might spread to another, word of economic difficulty or a bond rating downgrade for one state could trigger substantial economic harm to municipal bond markets elsewhere. One potentially serious concern in Puerto Rico’s case is that triple tax exemption and higher bond yields make the island’s public debt even more attractive than many other municipal debt issues.¹⁶⁷ For example, the *Wall Street Journal* in 2013 reported that, “[f]or decades, Puerto Rico was a bedrock investment in many municipal-bond portfolios, its bonds owned directly or through

164. *Economic Crisis: The Global Impact of a Greek Default: Hearings Before the S. Comm. on Banking, Housing, and Urban Affairs of the Subcomm. on Nat’l Security and Int’l Trade and Finance* 33, 114th Cong. (2015) (testimony of Jacob Funk Kirkegaard, Sr. Fellow, Peterson Institute for Int’l Econ.) (“Greece is a small country, accounting for only 1.8 percent of total euro area GDP, and hence does not pose a material risk to overall euro area financial stability.”). See also *id.* at 36 (concluding that “Greek default does not pose systemic risks to either the euro area or the global economy”); *id.* at 31 (testimony of Carmen M. Reinhart, Prof., Harvard Kennedy School of Gov’t) (noting limited contagion risk from Greek crisis via financial channels).

165. The Greek financial crisis has “taken the EU and Eurozone into uncharted territory . . . [and] significantly heightened political tensions and public dissatisfaction with the EU.” REBECCA M. NELSON, PAUL BELKIN, & JAMES K. JACKSON, CONG. RESEARCH SERV., R44155, THE GREEK DEBT CRISIS: OVERVIEW AND IMPLICATIONS FOR THE UNITED STATES 10 (2015). Some believe that the crisis could lead to Greece’s exit from the Eurozone, “which could seriously undermine the integrity of the Eurozone and even the EU itself.” *Id.*

166. See, e.g., CONGRESSIONAL TASK FORCE REPORT, *supra* note 139, at 19–20 (possible impact of Puerto Rican financial crisis on Florida).

167. See *supra* note 155 and *infra* notes 189–91, and accompanying text.

mutual funds.”¹⁶⁸ Another report in 2015 observed that “many of Puerto Rico's bonds have ended up in the hands of Main Street investors on the United States mainland, people who invested in mutual funds without checking to see what was in the funds’ portfolios.”¹⁶⁹ Some understandably were worried about potential contagion effects spreading from Puerto Rico to U.S. bond markets more generally.

Had the contagion dangers been more clear and imminent, Congress might have cited systemic risk to justify overcoming the general presumption against federal intervention. Though many mused about potential contagion from growing Puerto Rican public debt problems, the Financial Stability Oversight Council (FSOC), which is charged with responsibility for monitoring and identifying risks to U.S. financial stability,¹⁷⁰ was not immediately concerned, reporting both in 2015 and 2016 that, “[d]espite problems exhibited by Puerto Rico, there has been little spillover thus far to the broader municipal bond market.”¹⁷¹ Although the FSOC’s 2015 report cautioned that, “continued deterioration in the economic and financial conditions in Puerto Rico . . . could impact the municipal debt market,”¹⁷² its 2016 report included no such caveat. In other words, the FSOC was even less concerned with possible contagion from Puerto Rico to general bond markets in 2016 than it had been in 2015. Thus, even assuming that Puerto Rico’s financial disaster justified federal rescue intervention for other policy reasons, its dire economic circumstances in 2015 and 2016 were not sufficient to rebut the presumption against subnational government bailouts on systemic-risk grounds.

168. Mike Cherney, *Puerto Rico Debt Woes Grow—U.S. Regulators Concerned About Effects of Bond Declines on Investors, Market*, WALL STREET J., Oct. 7, 2013, at C1 (reporting that “about three-fourths of all municipal-bond mutual funds own debt issued by Puerto Rico . . .”).

169. Mary Williams Walsh, *Puerto Rico Fails to Pay \$58 Million Bond Debt*, N.Y. TIMES, Aug. 4, 2015, at B1.

170. The FSOC was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010). 12 U.S.C. § 5321(a) (establishing FSOC); *id.* at § 5322(a)(1) (FSOC’s purpose to identify financial stability risks, promote market discipline, and respond to emerging financial stability threats).

171. FINANCIAL STABILITY OVERSIGHT COUNCIL (FSOC), ANNUAL REPORT 34 (2015); FINANCIAL STABILITY OVERSIGHT COUNCIL (FSOC), ANNUAL REPORT 33 (2016).

172. FSOC, 2015 ANNUAL REPORT, *supra* note 171, at 29.

Under circumstances of financial distress that present no obvious *imminent* threat, a related plausible rebuttal argument is that the federal government's failure to act will result in future systemic harm at potentially higher costs than those that would result from early "preemptive" intervention. The reality, of course, is that genuinely imminent threats are rare, and the risks that inaction today will have devastating consequences tomorrow can be so difficult to measure. The real challenge for policymakers is considering subnational governments' appeals for assistance absent evidence of such extreme circumstances.

B. Creating "Public Goods"—or Avoiding "Public Bads"

Another related rebuttal argument is that rescue interventions provide a public "good" even for those not receiving direct financial support. For example, the financial stability benefits generated by central government actions to forestall imminent system-wide harm are presumably valuable to all stakeholders in the economic system. Argued from the flip side, the failure to prevent avoidable systemic harm creates a "public bad." Described as such, these arguments do little more than reiterate the systemic-risk rebuttal case, albeit dressed in different clothes. Given that recent events in Puerto Rico did not pose threats of systemic harm or contagion to general bond markets, the case for federal assistance cannot be based on systemic risk or related public good/public bad arguments.

Still, preserving fundamental economic stability is not the only conceivable public good that might result from central government assistance to a struggling subnational government. Though national public officials may have a difficult time persuading constituents that they should share any of the burden associated with assistance directly targeted to benefit others, central government assistance to one struggling subnational government sometimes provides benefits to citizens elsewhere. If the struggling state or territory provides widely-used critical energy or other resources, for example, the public good might be preserving an otherwise disrupted supply or distribution of resources. Another example might be assistance to a subnational government whose economy is dominated by goods manufactured for nationwide export. In this instance, the public good

generated might be protecting consumers against significant price increases, or preserving jobs in industries that might otherwise suffer collateral hardship from business failures in the distressed government's economy.

One unique argument that might appeal to the shared interests of those not receiving direct benefits from central government assistance to Puerto Rico involves the *statutory* U.S. citizenship of Puerto Rican residents. More specifically, because they obtain U.S. citizenship at birth, Puerto Ricans are free to migrate to the United States without special permission or visas.¹⁷³ Upon establishing residence in a U.S. state, such statutory citizens become full *constitutional* citizens entitled to benefits, privileges, and protections available under the U.S. Constitution.¹⁷⁴ At least for some Puerto Ricans, one incentive for relocating may be access to better federal government health benefits. For example, individual Puerto Rican citizens are not eligible to participate in the Supplemental Security Income (SSI) program; they are covered instead by an alternative program that typically pays lower benefits.¹⁷⁵ Indeed, reporting on federal health care funding debates, the Congressional Task Force on Puerto Rico recently noted the argument of some that “it is not appropriate to exclude U.S. citizens living in the territories from the SSI program, *especially considering that residents of the territories can simply relocate to the states and obtain full SSI benefits.*”¹⁷⁶

173. The U.S. Customs and Border Protection website advises, for example, that “U.S. Citizens . . . who travel directly between parts of the United States, which includes . . . Puerto Rico . . ., without touching a foreign port or place are not required to present a valid U.S. Passport . . .” *Needing a Passport to Enter the United States from United States Territories*, U.S. CUSTOMS & BORDER PROTECTION, https://help.cbp.gov/app/answers/detail/a_id/980/~/needing-a-passport-to-enter-the-united-states-from-u.s.-territories (last updated Feb. 24, 2017, 4:04 PM).

174. See Lawson & Sloane, *supra* note 136, at 1161 (noting “the bizarre state of affairs, which persists today, that resident aliens physically located with a state of the United States may enjoy greater benefits and rights under federal law than Puerto Rican *citizens* of the United States. Yet, those same citizens, simply by exercising their right to relocate to one of the states, can acquire ‘every right of any other citizen of the United States, civil, social, and political.’”). The reverse is also true; a constitutional U.S. citizen who relocates to Puerto Rico becomes a statutory citizen, thereby losing rights to vote in presidential elections and certain other benefits. See, e.g., *California v. Torres*, 435 U.S. 1 (1978).

175. 42 U.S.C. §§ 301–306 (2012); 42 U.S.C. § 1301(a)(1) (2012); 42 U.S.C. § 1382(e) (2012). See also CONGRESSIONAL TASK FORCE REPORT, *supra* note 139, at 19.

176. *Id.* at 54.

In addition to individual citizens' ineligibility for SSI, the Puerto Rican government's Medicaid program also suffers from what many argue is "historically inadequate" federal funding. As one policy analyst describes, for example, "[u]nlike the 50 states and the District of Columbia, Puerto Rico is limited to a low, fixed amount of federal Medicaid funding each year irrespective of its actual Medicaid costs."¹⁷⁷ Puerto Rico and other U.S. territories subject to this cap usually exhaust available federal funds before the end of their fiscal years, thereafter assuming the full cost of additional, yet mandated, Medicaid costs.¹⁷⁸ The result is that Puerto Rican residents do not receive all of the Medicaid benefits to which they are entitled.¹⁷⁹ Congress provided a temporary remedy by including a one-time increase to Puerto Rico's Medicaid funding in the 2010 Affordable Care Act,¹⁸⁰ but this supplemental funding is likely to be "depleted before the end of calendar year 2017, a date that has come to be known as the "Medicaid cliff."¹⁸¹

Concerned about the potentially disastrous impact of the cliff, the Obama Administration argued to Congress in 2015 that:

There are more than 1.6 million Medicaid enrollees in Puerto Rico's healthcare system, of which 600,000 people living in Puerto Rico could lose the healthcare coverage when one-time Medicaid funds run out. Congress should reform Puerto Rico's Medicaid program to increase access to coverage, raise the

177. See, e.g., MEDICAID FUNDING SHORTFALLS, *supra* note 112. See also 42 U.S.C. § 1308(a), (f), (g)(5) (2012) (Medicaid caps on U.S. territories).

178. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-75, U.S. INSULAR AREAS: MULTIPLE FACTORS AFFECT FEDERAL HEALTH CARE FUNDING 19-20 (2005) [hereinafter GAO, INSULAR AREAS REPORT]. See also *infra* note 226, and accompanying text.

179. The GAO reports that "[d]ue to insufficient local funds, . . . some insular areas may suspend services or cease payments to providers until the next fiscal year." *Id.* Remarkably, the Congressional Research Service also reports that, "[i]n light of these statutory limits, CMS [referring to the Center for Medicare and Medicaid Services, which oversees many federal health care programs] does not hold insular areas accountable for providing all the mandatory Medicaid services, including nursing home care, which makes up nearly one-third of Medicaid expenditures in the states." *Id.*

180. Patient Protection and Affordable Care Act (ACA) of 2010, § 2005(c), Pub. L. No. 111-148, 124 Stat. 119, 284 (2010) (codified, as amended, at 42 U.S.C. § 1396d(b) (2012)). See also *infra* note 226 and accompanying text.

181. CONGRESSIONAL TASK FORCE REPORT, *supra* note 139, at 19.

standard of care and prevent Medicaid's unstable financing from worsening Puerto Rico's fiscal crisis.¹⁸²

Dire economic circumstances in Puerto Rico over the past decade have already led to dramatic outmigration.¹⁸³ Whether driven explicitly by the promise of better federal health care benefits in the United States, or more generally by the need to escape deteriorating economic conditions in Puerto Rico, further outmigration and the resulting influx of automatic U.S. citizens could substantially burden social service, healthcare, education, and other federal and state budgets. Additional costs for these programs and benefits, which presumably would be borne by general taxpayers, might ultimately be higher than the costs of early intervention measures that might have assisted in stopping or slowing Puerto Rico's downward economic spiral. Effectively making this "avoidance of public bad" argument, for example, the 2016 Congressional Task Force acknowledged that resisting increased Medicaid funding to Puerto Rico might save federal taxpayer dollars in the short-run, but nonetheless recommended increased Medicaid support for Puerto Rico not only to eliminate funding inequities, but also "to reduce the incentive for migration from the territories to the states and the associated financial costs to state governments and the federal government"¹⁸⁴

Finally, another possible "public good" argument for rebutting the presumption against intervention might be based on protecting a militarily strategic location. In other words, it may be in our collective interests to prevent any destabilization in Puerto Rico that might raise military or security concerns. A somewhat related Puerto-Rico specific argument builds on the premise that Puerto Rico plays a significant role in trafficking operations through which illegal drugs

182. ROADMAP FOR CONGRESSIONAL ACTION, *supra* note 19, at 3.

183. *See supra* notes 60–66 and accompanying text.

184. CONGRESSIONAL TASK FORCE REPORT, *supra* note 139, at 20. Given the U.S. citizenship of Puerto Ricans by birth, outmigration from Puerto Rico to the United States technically is not an immigration issue. Nonetheless, I am mindful of the ongoing—and politically loaded—debate over immigration restrictions. To my mind, general anti-immigration sentiments driven by concerns about increased government costs that newcomers might impose are not only misplaced, but also fail to account for the many benefits and values that immigrants bring to the United States. Thanks to Elizabeth Sepper for reminding me of the political sensitivities surrounding these cost issues.

reach the United States, and that these operations potentially threaten U.S. security. For these reasons, a 2014 report for the Center for Strategic & International Studies argues that continued economic decline in Puerto Rico should be “a concern not only for Puerto Rico but also for the United States as a whole.”¹⁸⁵ If the underlying premise is correct—though I’m not at all certain that it is—the argument would belong among those that might be considered in rebutting the initial presumption against federal rescue assistance for Puerto Rico.

C. Equitable, Structural, or Morally-Based Rebuttals

1. Federal Government as “Co-Investor,” “Co-Dependent” or Culpable Partner

One potential rebuttal to the initial presumption against federal interventions to assist subnational governments is the federal government’s participation in—and at least arguable contribution to—the latter’s economic difficulties. Federal and subnational governments today share funding, administrative, and policymaking responsibilities for a wide array of programs through many different, often complex, structural arrangements. To the extent that a state government’s fiscal problems are dominated by costs associated with such programs, one might argue that the federal government’s interest as partner or “co-investor” comes with some obligation to assist subnational governments with fiscal emergencies. Moreover, the central government is not completely free of culpability for subnational governments’ excessive debt, given that it *encourages* the very behavior that leads subnational governments into debt troubles in the first place. In fact, the federal tax exemption for interest on state and local bonds effectively provides a subsidy with no upper limit for state and local borrowing.¹⁸⁶ By providing such tax exemptions, the federal government arguably supports bad state habits, in a sense acting as “co-dependent.” Federal tax laws also

185. JOSÉ J. VILLAMIL & CARL MEACHAM, CENTER FOR STRATEGIC & INTERNATIONAL STUDIES REPORT, WHY PUERTO RICO’S ECONOMY MATTERS FOR U.S. SECURITY 10 (2014).

186. 26 U.S.C. § 103(a) (2012). *See also supra* note 154 and accompanying text.

include deductions for state and local tax,¹⁸⁷ which reduce residents' after-tax burdens, thereby enabling higher second and third-tier government spending at lower taxpayer cost. These effective federal subsidies may encourage subnational governments to over borrow and to support larger and less prudent spending programs than they would in the absence of federal exemptions and deductions. This is not to suggest complete repeal of the municipal bond interest exemption or the state and local tax deduction,¹⁸⁸ which may support other policy valid objectives. My point is that the federal government is not an innocent bystander; it plays a role in determining the extent of state and local government debt.

The case for at least partial federal responsibility for excessive subnational debt is even stronger as applied to Puerto Rico. Unlike U.S. state and local bonds, which are exempt only from federal—and, in some cases, from some state—income taxes on interest, Puerto Rican public debt is an especially attractive investment because it is free from federal, state, and Puerto Rican income taxes—a triple tax exemption.¹⁸⁹ At least theoretically, the exemption provides Puerto Rico with financial benefits, particularly by easing access to capital markets. While the exemption's early legislative history offers some evidence of congressional intent to aid the island's economic development and to provide humanitarian benefits,¹⁹⁰ the triple tax exemption, along with other bond features designed to protect

187. 26 U.S.C. § 164 (2012).

188. It might be appropriate, though, to cap amounts eligible for the municipal bond interest exemption, or impose some limits on state and local tax deductions.

189. The relevant statute provides that:

All bonds issued by the Government of Puerto Rico, or by its authority, shall be exempt from taxation by the Government of the United States, or by the Government of Puerto Rico, or of any political or municipal subdivision thereof, or by any State, Territory, or possession, or by any county, municipality, or other municipal subdivision of any State, Territory, or possession of the United States, or by the District of Columbia.

48 U.S.C. § 745 (2012).

190. See Dick, *supra* note 162 at 47–48 (referring to legislative history from 1917). On the other hand, Professor Dick is skeptical, arguing that a more likely explanation may be “the nearly insatiable U.S. demand for municipal bonds at a time when supply was less than normal[.]” and further suggesting that Congress “capitalized on the island’s plight by expanding the municipal bond supply for U.S. investors.” *Id.* at 48.

creditors, may have made Puerto Rican public debt *too* attractive and *too* easy to market.¹⁹¹

In addition to the longstanding tax exemption for Puerto Rican bonds, the United States also has a long history of tax incentives to encourage investment in its possessions and territories.¹⁹² In the 1940s, Puerto Rico began “Operation Bootstrap,” to supplement the U.S. “possessions exemption,”¹⁹³ with its own generous tax and economic incentives to encourage American businesses to invest in Puerto Rico.¹⁹⁴ In 1976, Congress replaced its “possessions exemption” with a new § 936 “tax sparing” rule.¹⁹⁵ To fully appreciate this provision’s generosity, keep in mind that the standard rationale for foreign tax credits is eliminating the double tax burden that results when U.S. taxpayers engaged in business operations abroad are taxed both by the foreign country or possession *and* the United States.¹⁹⁶ Tax credits available to such taxpayers are designed to offset U.S. tax liability by the taxes already paid to a foreign country or possession on the same activity. In contrast, the § 936 “tax sparing” incentive,¹⁹⁷ designed specifically to encourage economic

191. Puerto Rico added further enticements to make its debt attractive to investors by including various “backstops, lockboxes and guarantee mechanisms . . . , identifying specific revenue streams and promising them to certain groups of bondholders.” Walsh, *The Bonds That Broke Puerto Rico*, *supra* note 24. “In 2006, for example, the Puerto Rico government created an independent debt-issuing authority called Cofina, which had first claim to a fixed portion of all sales taxes on the island, to offer as collateral for bonds.” *Id.*

192. Federal income tax exemptions for certain income from sources within U.S. possessions began in 1921. Revenue Act of 1921, ch. 136, § 262, 42 Stat. 227, 271 (1921) (eligibility required that taxpayer’s gross income over a three-year period be 80% or more from sources within the possession, and—in the case of corporations—that 50% or more be from active conduct of a trade or business within the possession).

193. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 931(a), (c), 68A Stat. 3, 291 (repealed 1996).

194. Industrial Tax Exemption Act, Act of May 13, 1948, P.R. Laws Ann. §§ 221–38. See also Ann J. Davidson, *A Credit for All Reasons: The Ambivalent Role of Section 936*, 19 U. MIAMI INTER-AM. L. REV. 97, 107–115 (1987) (describing phases and impact of “Operation Bootstrap”).

195. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1051, 90 Stat. 1520, 1643–44 (adding new 26 U.S.C. § 936) (repealed 1996). For a general description of § 936 and its rationale, see JOINT COMM. ON TAX’N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, JCS-33-76, 272–78 (1976) [hereinafter GENERAL EXPLANATION]. See also Davidson, *supra* note 194, at 115–17; Dick, *supra* note 162, at 68–72.

196. 26 U.S.C. §§ 901, 904 (2012).

197. The U.S. General Accountability Office (GAO) reported that 98% of benefits from § 936 went to companies operating in Puerto Rico. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-

and job growth in Puerto Rico,¹⁹⁸ generously extended the credit even when the taxpayer incurred no Puerto Rican tax on its Puerto Rican operations.¹⁹⁹

The § 936 credit offered particular advantages to U.S. manufacturers, especially pharmaceutical companies,²⁰⁰ which took advantage of deducting high, up-front drug development expenses on their U.S. tax returns, even though they manufactured the drugs in Puerto Rico. The combination of U.S. tax credits and generous Puerto Rican tax exemptions effectively eliminated all corporate tax liability on drug sale profits.²⁰¹ Ultimately disappointed that § 936 failed to generate sufficient Puerto Rican job growth to justify the U.S. cost in revenue foregone,²⁰² Congress repealed the credit in 1996.²⁰³ Concerned about the potentially harmful economic impact of an immediate total repeal, however, Congress simultaneously added a new, slightly more restrictive credit, which was phased out between 1996 and 2006.²⁰⁴

A GAO report on the impact of § 936's repeal found that the Puerto Rican manufacturing sector overall suffered greater

06-541, PUERTO RICO: FISCAL RELATIONS WITH THE FEDERAL GOVERNMENT AND ECONOMIC TRENDS SURING THE PHASEOUT OF THE POSSESSIONS TAX CREDIT 2 (2006) [hereinafter GAO, FISCAL RELATIONS].

198. GENERAL EXPLANATION, *supra* note 195, at 272.

199. See, e.g., LaBrenda Garrett-Nelson, *A Framework for Evaluating the Legislative Viability of Proposals to Provide Foreign Direct Investment Incentives Through the Internal Revenue Code*, 35 GEO. WASH. INT'L L. REV. 315, 323 (2003) (describing the possessions credit as “tax sparing” because it is granted without regard to whether the electing corporation pays income tax to the possession”).

200. See generally U.S. GOV. ACCOUNTABILITY OFFICE, GAO/GGD-92-72BR, PHARMACEUTICAL INDUSTRY: TAX BENEFITS OF OPERATING IN PUERTO RICO CREDIT (1992). See also Andrew E. Gerow, *Shooting for the Stars (and Stripes): How Decades of Failed Corporate Tax Policy Contributed to Puerto Rico's Historic Vote in Favor of Statehood*, 88 TUL. L. REV. 627, 642 (2014).

201. See Dick, *supra* note 162, at 62 (describing United States and Puerto Rican incentives together as “amount[ing] to a total holiday from virtually all forms of taxation”).

202. U.S. COMM. ON FINANCE, FISCAL YEAR 1994 BUDGET RECONCILIATION RECOMMENDATIONS OF THE COMMITTEE ON FINANCE, 103d Cong. 148 (Comm. Print 1993) (recognizing importance of § 936 credit to Puerto Rico, while noting studies indicating “that a disproportionate share of the tax benefits attributable to section 936 is realized by certain industries that create relatively few jobs in the possessions”).

203. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1601(a), 110 Stat. 1755, 1827–30 (repealing § 936).

204. *Id.* at § 1601(b), 110 Stat., at 1831–33 (Section 30A “Puerto Rican Economic Activity Tax Credit,” to expire at the end of 2005).

percentage declines than those experienced on the U.S. mainland, but that economic declines in the chemical industry were “largely offset by the increased activity of other members of the same corporate groups”²⁰⁵ In other words, the pharmaceutical industry—the primary beneficiary of § 936 tax incentives—did not suffer dramatically when the credit was repealed.²⁰⁶

On the other hand, the New York Federal Reserve saw the repeal’s impact somewhat differently, noting first that § 936 incentives had artificially concentrated resources in Puerto Rican-manufactured pharmaceuticals for export to the U.S. mainland. The Federal Reserve observed that the pharmaceutical industry has not only lost an artificial economic boost, previously provided by § 936 tax credits, but has also suffered from increased economic pressures from other sources. As such, the report concluded that “there appears little prospect of regaining a significant share of the jobs that have been lost.”²⁰⁷

To be sure, it is difficult to determine the extent to which American tax policy contributed to Puerto Rico’s economic growth after the credit was introduced, or to the island’s economic declines as Congress increasingly restricted the credit, finally ending it as of 2006. Though surely not the only factor, the § 936 tax credit phase-out is prominent among explanations cited for Puerto Rico’s declining manufacturing sector and reduced employment.²⁰⁸ The Krueger Report also notes that “[b]ecause negative growth coincided with the final phase-out of IRS Section 936 provisions . . . , it is customary to cite the loss of tax preferences as the original sin behind Puerto Rico’s travails. The loss undoubtedly hollowed out the manufacturing base but was hardly the only blow.”²⁰⁹

205. GAO, FISCAL RELATIONS, *supra* note 197, at 11.

206. *Id.* In part, many pharmaceutical corporations survived the repeal of § 936 by changing their status “to controlled foreign corporations, or CFCs, and this status has enabled them to continue to receive some federal tax advantages while located on the Island.” FED. RES. REPORT, *supra* note 50, at 16.

207. *Id.* at 16. As further evidence of the §936 repeal on Puerto Rico’s monetary reserves, the Federal Reserve reported that “[t]he rollback of [§936] tax incentives, . . . , prompted a shift to brokered deposits. In recent years, regulators have taken steps to curtail the banks’ reliance on brokered deposits . . . introducing renewed constraints on bank lending capacity.” *Id.*, at 15.

208. *Id.*

209. KRUEGER ET AL., *supra* note 16, at 4.

2. Unique Federal Government Restrictions on Puerto Rico

A related argument for at least partial federal responsibility for Puerto Rico's economic crisis stems not from the former's role as partner or "co-dependent," but from U.S. government policies that actively interfere with Puerto Rico's ability to compete freely in the global markets. Given Puerto Rico's dependence on shipping, for example, maritime laws are critically important to its economy. Though Congress placed harbor areas and navigable waters under Puerto Rico's control in 1917,²¹⁰ a federal law in place since 1920 requires Puerto Rico—for purposes of transporting merchandise between U.S. and Puerto Rican ports—to use only vessels built and registered in the United States, owned by U.S. citizens, and that hire primarily U.S. citizen crews.²¹¹ This mandate results in crewing costs averaging five times more than foreign flag carriers,²¹² and limits Puerto Rico's options to a small number of carriers.²¹³ This limited supply and high demand for a small number of ships puts upward pressure on freight rates, thereby further increasing Puerto Rico's already extremely high shipping costs.²¹⁴ In addition, virtually all authorized carriers—as reported in 2013—were using containerships and barges well beyond their average expected useful lives, which caused them to burn more fuel, operate at lower speeds, and to require greater repair and maintenance expenses.²¹⁵ Though opinions differ on the extent to which Jones Act-mandated shipping costs contributed to Puerto Rico's financial decline and crisis, "most agree that the net effect is negative—largely because the act boosts the cost of imported goods to Island residents but also because it makes

210. Jones Act, Pub. L. No. 64-368, at § 8, 39 Stat. 951, 954 (1917) (now codified as part of the Puerto Rican Federal Relations Act, 48 U.S.C. § 749).

211. Merchant Marine Act of 1920, Pub. L. No. 66-261, § 27, 41 Stat. 988, 999 (1920) (codified at 46 U.S.C. §883). Though distinct from 1917 legislation, *supra* note 210, sometimes referred to as the "Jones Act," the 1920 Merchant Marine Act is also frequently known as the "Jones Act").

212. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-260, PUERTO RICO: CHARACTERISTICS OF THE ISLAND'S MARITIME TRADE AND POTENTIAL EFFECTS OF MODIFYING THE JONES ACT 15 (2013).

213. Writing in 2013, for example, the GAO reported only four available "Jones Act" carriers. *Id.* at 6.

214. *Id.* at 14.

215. *Id.* at 6, 15.

exports less competitive and diminishes the viability of the Island as a major regional transshipment port.”²¹⁶

3. Puerto Rico’s Differential Treatment Under Federal Subsidy Programs

Another possible rebuttal to the presumption against federal government assistance intervention in Puerto Rico focuses on Puerto Rico’s unequal treatment under certain federal programs. Like the U.S. states, Puerto Rico participates in numerous federal programs and relies heavily on federal transfer payments.²¹⁷ For many of these programs, Congress treats Puerto Rico as a state.²¹⁸ For others, eligibility rules and reimbursement rates for the island differ based in part on explicit statutory rules.²¹⁹ Medicaid is perhaps the most salient illustration of such programmatic differences.²²⁰ Though

216. *Id.* at 13. *See also* FED. RES. REPORT, *supra* note 50, at 13 (citing Jones Act as responsible for “import costs at least twice as high as in neighboring islands,” noting further that “[e]ven those that consider the negative effects of the Jones Act to be exaggerated . . . concede it is a clear net negative”).

217. *See supra* note 125 and accompanying text.

218. *See, e.g.*, 42 U.S.C. § 410(h) (2012) (social security old age and survivor benefits and disability insurance). Puerto Rico and its citizens are eligible to participate in federal Medicaid and Medicare programs, but subject to different programmatic rules than those applicable to U.S. states. *See* GAO, INSULAR AREAS REPORT, *supra* note 178 at 9 (U.S. territories, including Puerto Rico, participate in three major federal health care financing programs: Medicare, Medicaid, and State Children’s Health Insurance Program (CHIP)).

219. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-14-31, PUERTO RICO: INFORMATION ON HOW STATEHOOD WOULD POTENTIALLY AFFECT SELECTED FEDERAL PROGRAMS AND REVENUE SOURCES 7 (2014) [hereinafter GAO, INFORMATION ON STATEHOOD]. The Supreme Court permits the federal government to “treat Puerto Rico differently from the States so long as there is a rational basis for its actions.” *Harris v. Rosario*, 446 U.S. 651, 651–52 (1980) (rejecting a constitutional challenge to lower Aid to Families with Dependent Children (AFDC) assistance payments to Puerto Rico than to the states. *See also* *Califano v. Gautier Torres*, 435 U.S. 1, 4–5 (1978) (constitutional for U.S. citizen residing in the states to lose Supplemental Security Income (SSI) benefits upon becoming a U.S. citizen residing in Puerto Rico, where SSI is not available).

220. To varying degrees, Puerto Rico is treated differently—sometimes better and worse—under many other federal programs as well. For illustrative purposes, this Article uses only a sliver of the many programmatic differences with respect to health care funding. A more thorough treatment of even the health care differences is beyond the scope of this Article. For more detail, see generally ANNIE L. MACH, CONG. RESEARCH SERV., R44275, PUERTO RICO AND HEALTH CARE FINANCE: FREQUENTLY ASKED QUESTIONS 21–22 (2016); GAO, INSULAR AREAS REPORT, *supra* note 178. For a general description of Puerto Rico-state differences for a

subject to various mandatory federal requirements, states are the primary administrators of Medicaid, and have significant discretion regarding its implementation.²²¹ The formula for determining percentages of state Medicaid cost eligible for federal matching payments is designed to account for state variations in ability to pay by comparing each state's per capita income to the national average,²²² with the highest Federal Medical Assistance Percentage (FMAP) reimbursements going to states with the lowest per capita incomes. Based on recent calculations, for example, the highest current FMAP of 74.6% applies to Mississippi.²²³ Even though Puerto Rico's per capita income is lower than the poorest state, its FMAP was statutorily set at 50%,²²⁴ until the Affordable Care Act (ACA) increased the fixed rate to 55%.²²⁵ Another dramatic contrast is that—unlike to the unlimited federal Medicaid matching payments available to U.S. states—matching funds paid to insular areas, including Puerto Rico, are subject to an annual statutory cap; the result is that Puerto Rican citizens may not receive all Medicaid benefits to which they are entitled.²²⁶

Some argue that Puerto Rico's reduced Medicaid participation is warranted because Puerto Rican residents do not pay federal income taxes.²²⁷ While it may seem initially plausible, this argument does not

wider array of federal programs, see GAO, INFORMATION ON STATEHOOD, *supra* note 219, at 15–22 (fig. 3).

221. See GAO, INSULAR AREAS, *supra* note 178, at 9–11 (general description of Medicare and Medicaid).

222. 42 U.S.C. § 1396b (2012).

223. ALISON MITCHELL, CONG. RESEARCH SERV., R43847, MEDICAID'S FEDERAL MEDICAL ASSISTANCE PERCENTAGE 1–2 (2016) (reporting matching rate ranges between 50 and 83%).

224. This rate applies to all U.S. “insular areas,” the largest of which are Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa, and the Commonwealth of the Northern Mariana Islands. GAO, INSULAR AREAS, *supra* note 178, at 1. The report further observes that the percentage match “for insular areas does not recognize their capacity to pay for Medicaid expenses; instead, the FMAP is set at the lowest rate . . . although all of the insular areas, except Guam, had a lower median household income than the poorest U.S. state.” *Id.*

225. Patient Protection and Affordable Care Act (ACA) of 2010, § 2005(c), Pub. L. No. 111-148, 124 Stat. 119, 284 (2010) (codified, as amended, at 42 U.S.C. § 1396d(b) (2012)).

226. 42 U.S.C. § 1308(a), (f), (g)(5) (2012). See also U.S. GOV'T ACCOUNTABILITY OFFICE, MEDICAID AND CHIP: INCREASED FUNDING IN U.S. TERRITORIES MERITS IMPROVED PROGRAM INTEGRITY EFFORTS 1–17, GAO-16-324 (2016) (regarding temporary funding increases under the ACA). See *supra* notes 177–81.

227. See, e.g., CONGRESSIONAL TASK FORCE REPORT, *supra* note 139, at 19.

account for several countervailing considerations. First, the federal income tax exemption available to residents applies only to income from Puerto Rican sources. In addition, Puerto Rican employers and their employees are required to pay federal employment taxes, some of which are designed to cover federal health care program costs.²²⁸ Second, the Medicaid matching formula is designed precisely so that the poorest states—whose residents presumably contribute the least to federal income tax receipts—are entitled to the highest percentage federal funding rates.²²⁹ In other words, as a state, Puerto Rico would be entitled to substantially more than its current 55% Medicaid federal match despite its residents' relatively small contributions to federal income tax revenues. I contend that Puerto Rico has a reasonable rebuttal argument to overcome initial presumptions against U.S. government assistance to the extent that the federal government's unequal treatment of Puerto Rico under Medicaid contributed to the latter's financial crisis.

VI. STRUCTURING RELIEF AND ALTERNATIVE TYPES OF ASSISTANCE

Central governments simply cannot credibly commit in advance to refuse any assistance to its distressed subnational governments. Should such government assistance ever be required, however, the federal government could reduce at least some moral hazard risks by clarifying in advance that: (1) rescue assistance will be provided only in rare and unusual circumstances, and the amount and type of such assistance will be tailored as narrowly as possible to address particular crisis circumstances; (2) conditions attached to any federal assistance will be sufficiently onerous that subnational governments should consider every plausible alternative before seeking federal help; and (3) any agreement to provide federal monetary assistance will include "claw-back" provisions that will require the subnational government to repay—to the extent possible, and over time, if necessary—an appropriate portion of any federal expenses incurred.

228. 26 U.S.C. § 933 (2012). *See also, supra* note 149.

229. *See supra* notes 224–27, and accompanying text (Puerto Rico, though poorer than the poorest state, receives a 55% federal Medicaid matching rate subject to a cap, whereas the poorest states approach an 80% match without any cap).

One final observation is that difficult judgment calls are required in deciding whether, when, and how the federal government should intervene to assist struggling subnational governments. Such decisions would be challenging enough even for one person; they become almost immeasurable when they must be made through a partisan political process. Delays that are merely frustrating in everyday politics are far more troubling in moments of crisis when time is of the essence. When Congress is stymied, a sympathetic executive branch can sometimes engage in independent interventions. One such action, is to expedite federal payments for which the subnational government is already eligible.²³⁰

Certain federal agencies, particularly the Treasury Department, also can often be in a position to quietly extend “covert” bailout-type relief to struggling entities by relaxing interpretation or application of tax rules. With the help of expert advice from a major U.S. law firm, whose partners include former high-ranking Treasury Department officials, Puerto Rican executive branch officials and legislators, for example, deftly worked with Treasury Department officials in 2011 to take advantage of just such a “back-door” bailout. A short article by tax expert, Martin Sullivan, describes the scene: as the President’s Task Force on Puerto Rico over several years issued long reports and came up with wish lists for Congress that were unlikely to go anywhere, “Treasury officials were drafting a three-page document that would deliver billions of dollars of cash benefits to Puerto Rico.”²³¹ The document was an IRS Notice, which announced that the IRS had not yet determined whether a Puerto Rican excise tax—adopted in 2010 and extended in 2013 as part of the legislature’s explicit efforts to “overcome Puerto Rico’s economic crisis”²³²—was

230. See, e.g., U.S. Dep’t of Transp., Press Release, U.S. Transportation Secretary Foxx Joins Puerto Rico Governor García Padilla to Sign Historic Memorandum of Understanding (Feb. 25, 2016), <https://www.transportation.gov/briefing-room/us-transportation-secretary-foxx-joins-puerto-rico-governor-garc%C3%ADa-padilla-sign> (announcing federal assistance enabling Puerto Rican officials “to expeditiously access about \$400 million in previously obligated federal funds for infrastructure projects . . .”).

231. Martin A. Sullivan, *Economic Analysis: The Treasury Bailout of Puerto Rico*, TAX NOTES TODAY (Jan. 27, 2014) (also describing the importance of Steptoe & Johnson’s role in providing advice and tax opinion letters).

232. 2013 Laws P.R. 2 (legislative preamble’s “statements of motives”). See also *supra* note 27 and accompanying text.

one for which U.S. taxpayers would be entitled to a foreign tax credit.²³³ More remarkably, the Notice further declared that until the legal and factual questions were resolved, the IRS would not challenge U.S. taxpayers claiming the credit, and that any later determination that the excise tax did not qualify for the credit would apply only prospectively.²³⁴ The end result was that Puerto Rico has been able—and continues—to raise substantial revenues from its excise tax collections from U.S. affiliates of Puerto Rican manufacturers while imposing little effective tax burden on those paying the tax. In effect, the substantial revenues collected in Puerto Rico are at the expense of substantial revenue foregone by the U.S. Treasury. When federal agencies engage in such regulatory forbearance or specific legal interpretation deliberately designed to assist private taxpayers or subnational governments in financial distress, they should be required to comply with an appropriate reporting mechanism designed to ensure greater transparency.

CONCLUSION

While federal government culpability or shared responsibility for the Puerto Rican financial crisis may not be immediately obvious, a closer look at the impact of past or ongoing federal government policies suggests that Puerto Rico's economic woes may not be attributable solely to its own actions or inactions. Though quantifying the extent to which U.S. policies contributed to Puerto Rico's economic problems over the past decade would be extraordinarily difficult, I believe there is ample evidence to suggest that the federal government bears at least some responsibility. Along similar lines, Joseph Stiglitz and Mark Medesh argue that Washington has essentially treated Puerto Rico as an absentee landlord, "want[ing] the benefits of an offshore tax haven without the responsibilities to rescue it in time of need."²³⁵

233. I.R.S. Notice 2011-29, 2011-2 C.B. 663 (regarding the creditability of Puerto Rico's excise tax against U.S. federal income pursuant to 26 U.S.C. § 903).

234. *Id.*

235. Stiglitz & Medish, *supra* note 131.

And, even if the federal government did not contribute to Puerto Rico's economic problems, providing support in times of critical need may simply be the right thing to do. As President Obama argued in one of his 2016 weekly addresses,

Puerto Ricans are American citizens, just like folks in Maine or Oklahoma or New Mexico Right now, Puerto Rico doesn't have the tools it needs to restructure its debt—tools available elsewhere in America. And only Congress can fix the problem, and put Puerto Rico on a path to recovery I want the people of Puerto Rico to know that my administration is committed to your success We don't turn our backs on our fellow Americans.²³⁶

Though Puerto Rico may eventually need direct financial assistance, providing appropriate help in times of need may be incremental and does not necessarily require a commitment of substantial federal resources.²³⁷ Though more may be required, Congress for now has taken positive steps that at least should help Puerto Rico begin its economic recovery. PROMESA's inclusion of the Puerto Rican government itself within the definition of "who may be a debtor,"²³⁸ extends even greater bankruptcy-like protections than those available under Chapter 9, which do not extend to the states themselves. On the other hand, providing these protections subject to the ultimate control and authority of a presidentially-appointed oversight board arguably is inconsistent with democratic self-governance principles and does not treat Puerto Rico with the dignity it deserves. The policy and politics of deciding whether, when, and how the federal government should assist financially-distressed subnational governments are fraught with difficulties and uncertainties. Over the past two or three

236. Office of the Press Secretary, *Weekly Address: Addressing Puerto Rico's Economic Crisis*, WHITE HOUSE (June 11, 2016), <https://www.whitehouse.gov/the-press-office/2016/06/11/weekly-address-addressing-puerto-ricos-economic-crisis>.

237. In 2015, for example, the Treasury Department, organized teams of experts to advise Puerto Rican officials and otherwise took small actions to assist. *See, e.g.*, Michael Corkery & Mary Williams Walsh, *Treasury Considers Plan to Help Puerto Rico*, N.Y. TIMES, Oct. 15, 2015, at B1; Mary Williams Walsh, *Puerto Rico Officials to Testify on Debt Crisis Before Senate Panel*, N.Y. TIMES, Sept. 29, 2015, at B7.

238. 48 U.S.C. § 2162 (2016) (including as a debtor entity, a "territory that has requested the establishment of an Oversight Board or has had an Oversight Board established for it . . .").

years, policymakers and legislators devoted extraordinary amounts of time and energy struggling with these questions and fashioning a response to the Puerto Rican crisis. This would be a good time to reflect on the most appropriate response in the event of similarly dire circumstances for one of the U.S. states.