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What we do in Puerto Rico sets a precedent, like it or not

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The argument that setting aside Puerto Rico's constitutional guarantee to their general obligation bondholders will not spill over to impact the broader municipal bond market — one that the U.S. Treasury has enthusiastically propounded — seems to be predicated solely on the notion that a territory is unlike a state and that whatever legislation Congress passes will be *sui generis*, with no relevance to the rest of the country. Or, at least this is what most investors will assume.

However, a Treasury official pinky-swearing that such a thing won't be done again is not a credible promise and in no way binds the hands of a future administration from emulating the contours of the Puerto Rican rescue for the next state or major municipality that approaches insolvency. In fact, the safe bet in such an eventuality is that Treasury and Congress would hew closely to the eventual outcome here. In short, the debate over the fate of Puerto Rico extends far wider than the island.

The reason that Congress finds it necessary to address the island's rapidly approaching insolvency is that Chapter 9 of the Bankruptcy Code does not apply to Puerto Rico. However, even if it did, Chapter 9 does not extend protection state general obligation debt in a bankruptcy, only its municipalities and public corporations. One reason for this is that not providing such an option allows states to borrow at lower rates, and states also have the ability to increase taxes (substantially, if necessary) to cover their obligations.

However, there are limits to tax increases: One doesn't have to believe in the Laffer Curve to recognize that increasingly higher marginal tax rates produce proportionately less additional revenue as the wealthy hide their income, move elsewhere, retire or some combination thereof. In a country where it is exceedingly easy for the wealthy to change their domicile to a no-income-tax state like sunny Florida, revenue gains from higher tax rates can diminish rapidly.

Will many companies leave the nearly insolvent Chicago or the state of Illinois — by most measures the most indebted state in the union — if its top personal tax rate triples in an attempt to tax its way out of the budget morass?

The odds are that we will never find out: the safest bet to the approaching fiscal train wreck in the Prairie State is that the rapacious (get used to that adjective) hedge funds that own their bonds will be the ones paying for the state's fresh start, as that is much more politically palatable to the Democratic machine that runs the state than making voters or state pensioners take a hit. After Treasury is done denigrating the holders of Puerto Rican general obligation debt, why would they not employ the same playbook in a state that has a great electoral importance to the Democratic party or a city run by a close confidant of a former, current and future president? Or, more to the point, why would investors not presume such a thing is eminently possible, if not probable?

There is ample economic evidence that a Puerto Rican settlement that haircuts general obligation debt would reverberate past the island. A study published by the Federal Reserve looked at the 2014 Detroit bankruptcy — which reduced the debt owed to bondholders in contravention to bankruptcy law in order to protect retirees — and discerned a contagion effect that reached the municipalities with the worst credit ratings, like Illinois or Chicago. A report published by the European Central Bank found in the context of the Greek credit crises that contagion effects — being the result of what might be considered irrational behavior — are difficult to detect *ex ante*, but that negative sovereign shocks do impact the capital costs of neighboring dominions that also have a modicum of financial distress. In other words, declaring today that one cannot detect any impact that Puerto Rico's still-uncertain resolution has had on the broader municipal market is meaningless. How it is done will almost assuredly impact other debt-addled governments in the U.S, and there are more of them than most people realize.

Since 2008, the Treasury — aided and abetted by Congress — has done an amazing variety of things in order to prevent a replay of the 2008 financial crisis. When it comes to Puerto Rico, however, it's as if it has set those priorities aside. There are any number of states and municipalities facing insolvency in the near future, and little has been done to arrive at an orderly and comprehensive method for dealing with these eventualities. That such a plan has yet to gestate is understandable — a wise politician once quipped that no one gets any political gain from solving a problem before everyone realizes a problem exists, and this Treasury Department has shown itself more concerned with politics than any of its predecessors.

But when the time comes for a Chicago or Illinois bankruptcy and Treasury finds itself obliged to help, why would we expect it to do anything other than take what's already on the shelf and haircut general obligation bonds, regardless of any protestations to the contrary?

Like it or not, what we do in Puerto Rico sets a precedent that the market will assume will be followed to absolve future government insolvencies, and setting aside an explicit constitutional promise to general obligation bondholders will have repercussions. Pretending otherwise is absurd.

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