# Austerity in the Tropics

## Is Puerto Rico the New Greece?

BY ROBERT LOONEY

**The mention of Puerto Rico once conjured visions of a tropical tax paradise, complete with pristine beaches and overproof rum. While the beaches and rum remain, the island's increasing resemblance to debt-ridden Detroit, fiscally irresponsible Argentina, and austerity-bludgeoned Greece is enough to make all but the most adventurous think twice about investing there today.**


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In four decades, Puerto Rico has gone from a model of development to a minefield for unwary bond buyers. Currently saddled with over $72 billion in debt, nearly four times the amount accumulated by Detroit, Puerto Rico's annual debt service is close to $4.5 billion. The island's population has shrunk to 3.7 million. Thus, interest alone on the public debt exceeds $1,200 per person, a serious burden for a place with barely one-third the median household income of the United States as a whole.

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There are other ways to view this financial liability, but none of them makes for a pretty picture. Puerto Rico's public debt equals over 70 percent of its GNP. By way of comparison, profligate Argentina's government debt is under 50 percent of GNP.

Not surprisingly, then, Puerto Rico's bond debt was downgraded to junk status by all three major ratings agencies in February and downgraded further in July. Analysts are now debating the possible consequences for Wall Street, for tens of thousands of bondholders and, of course, for Puerto Ricans. One thing on which all agree: Puerto Rico's rocky footing is likely to get rockier.

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**IF IT WALKS AND TALKS LIKE GREECE...**

Until quite recently, Puerto Rico's unique hybrid status as a U.S. territory provided more than adequate inducements to lure bond buyers. The island's securities are triple tax-exempt, so holders do not pay federal, state or local taxes on their interest income. Government default is also prohibited – at least in theory. These attractions, com-


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bined with high ratings (before the fall) and a plentiful supply of securities, have prompted three-quarters of U.S. municipal bond funds to shovel in cash.

Puerto Rico's unique status also contributed to its indebtedness. The high demand for its tax-free municipal bonds has historically kept the cost of borrowing low, lulling the government into reliance on long-term debt to cover short-term spending. Its need to borrow, moreover, is exacerbated by the modest size of its tax base. Only Puerto Ricans employed by the U.S. government pay income tax on island earnings; others are exempt. To make matters much worse, Puerto Rico carries a number of large, unprofitable public corporations – notably, water and power utilities – on its balance sheets.

Puerto Rico's economy stalled in the late 20th century, prompting the government to step up borrowing in the hope that it could spend its way out of the doldrums. But slow growth has only morphed to no growth, and the overextended government now faces the prospect of severe fiscal austerity similar to that imposed by the European Union on Greece. Like Greece, Puerto Rico's lack of its own currency (and thus its own monetary and exchange-rate policies) severely limits what the government can do to manage the crisis. And just as many debated whether Greece would be better off if it left the euro zone, there is increasing debate over whether it would be in Puerto Rico's interest to retain its current status as a territory, to demand statehood or to move toward greater independence in some sort of confederation with the rest of the United States.

### BOOM AND BUST: 1940–2005

In the mid-1940s, Puerto Rico's sugar-cane-based economy was one of the poorest in the Caribbean. Since then, its development program and economic relationship with the mainland have moved through several phases, each powered by financial incentives designed to make the territory attractive to investors.

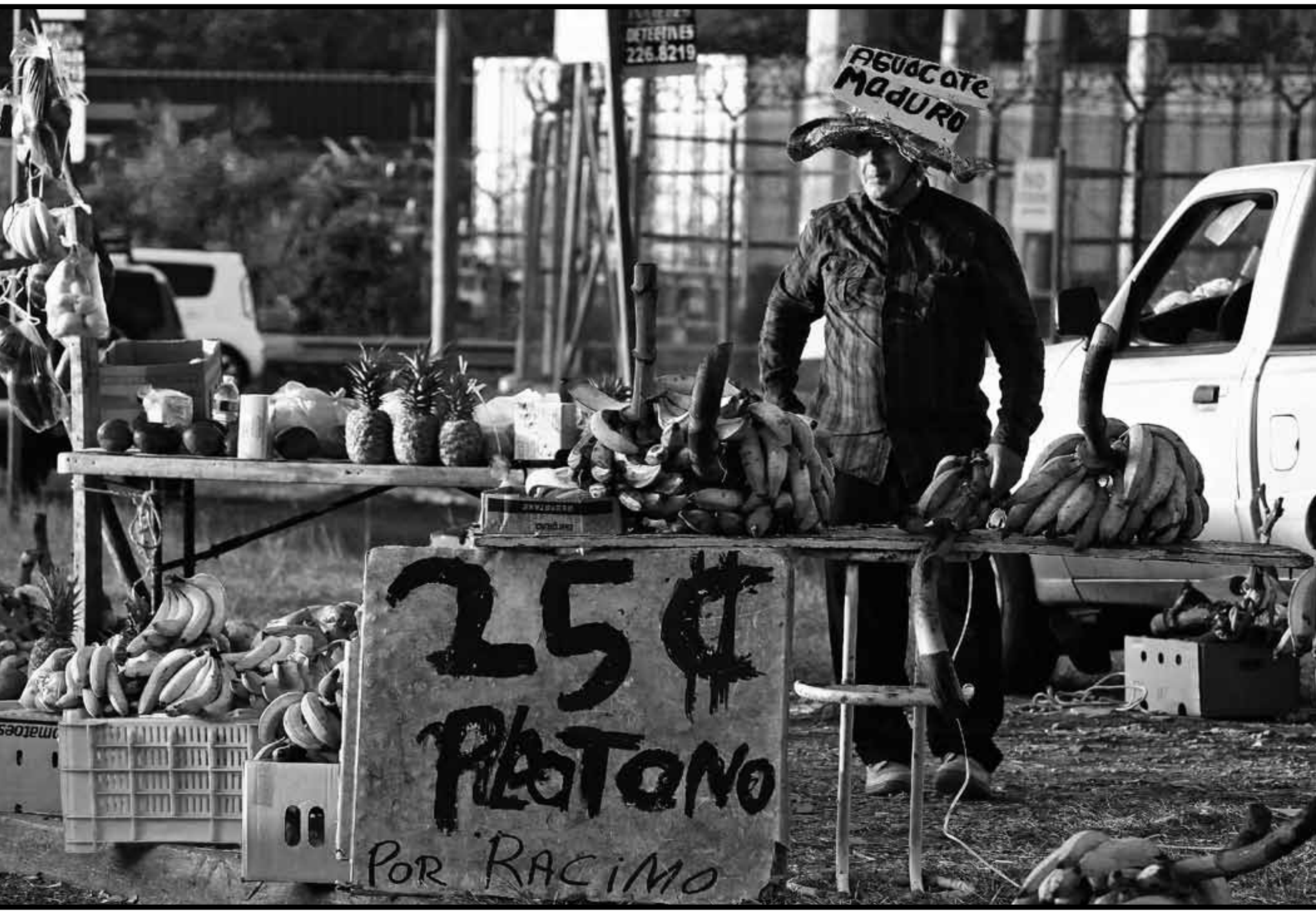
In 1948, Washington introduced Operation Bootstrap, a massive investment campaign aimed at rapidly industrializing the island. It seemed to work: Investment was accompanied by innovative economic and social programs that for a time won the island international praise as a development model.

With Operation Bootstrap, Puerto Rico's ties to the United States were sweetened by advantages not available elsewhere in the Caribbean. Under the umbrella of U.S. law, Puerto Rico offered investors assurances of contract and securities law enforcement unmatched in other parts of the developing world. What's more, this was a period in which substantial tariff and quota barriers put the U.S. market off limits to other developing countries. As a result, Puerto Rico enjoyed enviable advantages as an exporter.

The island economy grew impressively, presaging the awakening of the Asian Tigers – South Korea, Taiwan, Hong Kong and Singapore. GDP increased by 68 percent in the 1950s and 90 percent in the 1960s (albeit from a fairly low base). By 1970, manufacturing constituted a remarkable 40 percent of the island's GDP, and joblessness had declined to 10 percent – astonishing progress from a traditional agricultural economy with high seasonal unemployment and widespread underemployment. For a time, it appeared that Puerto Rico's per capita income might even converge with that of the United States.

Since then, however, growth has slowed drastically and income convergence has been reversed. The reasons are not difficult to discover. Unlike most U.S. states, Puerto Rico generated much of its electricity by burning oil. Thus, the 1973–1974 and 1979 oil shocks hit the island especially hard. At the same time, legislation that gradually extended the federal minimum wage to Puerto Rico and increasing competition from Asia eroded both Puerto Rico's production cost advantages and its attraction for corporate investors.

A new development phase began with approval of Section 936 of the United States Internal Revenue Code in 1976. Under Section 936 (formally, 26 U.S. Code Section 936), subsidiaries of U.S. corporations operating manufacturing facilities in Puerto Rico received federal tax credits that all but wiped out U.S. taxes on their Puerto Rican profits.

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The tax credits proved a powerful enticement for U.S. corporate investment in Puerto Rico, an era in which federal corporate income taxes took a big bite out of their mainland earnings. Indeed, it signaled the beginning of an era of creative accounting in which companies would scheme to realize their profits in tax havens. The island's manufacturing became more capital-intensive and diversified, marked by substantial investment in pharmaceuticals, medical products, scientific instruments, computers, microprocessors and electrical goods.

But in 1996, Congress decided that Section 936, which encouraged capital-intensive investment, created too few jobs to justify the cost in lost tax revenue and repealed the law. The island's industrialization program began a gradual decline that eventually became a free fall: The 10-year grace period on tax advantages for companies operating in Puerto Rico at the time of repeal ended in December 2005.

### RUN-UP TO THE CRISIS

The phaseout of Section 936 revealed the downside of Puerto Rico's territorial status: When decisions critical to the territory's prosperity are made in Washington, U.S. concerns come first and Puerto Rico's second. Moreover, the creation of Nafta in 1995 allowed Mexico nearly equal U.S. market treatment – treatment that the subsequent establishment of Cafta-DR extended to include


Central America and the Dominican Republic. For the first time since the 1940s, the island's special status gave it no significant competitive advantage over other countries in the Americas that were operating at similar levels of economic development.

Worse was yet to come. The 2008–2009 international financial crisis and the subsequent slowing of the U.S. economy plunged the island into depression. Since 2006, Puerto Rico's real GNP is down by 12 percent, with no recovery in sight. The island's investment rate, which was around 30 percent of GDP in 2001, fell to 13 percent by 2010.

From 2006 to 2013, Puerto Rico lost 230,000 jobs in a workforce that numbered only 1.2 million. Federal transfer payments to Puerto Rican households – a mix of safety-net payments ranging from unemployment insurance to food stamps to Social Security Disability – increased from 6 percent of personal income in the early 1970s to 22 percent today. The portion of the population living in poverty is now almost three times higher in Puerto Rico than on the mainland (46 percent versus 16 percent), with children and the elderly particularly affected. Moreover, according to the Census Bureau, income inequality is higher in Puerto Rico than in any U.S. state.

With jobs scarce and emigration to the mainland unrestricted, it should be no surprise that Puerto Ricans have been leaving the island in droves. According to the Census, about 75,000 Puerto Ricans migrated to the mainland in 2012, nearly 46,000 of whom

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were younger than 35. The Puerto Rico Planning Board estimates that by 2050, the territory will lose another 1.3 million, more than a third of its current 3.7 million population.

### STUCK IN THE PAST

Although the onset of Puerto Rico's current economic woes appears at first glance to coincide with the revocation of the Section 936 tax incentives, the island actually began to lose its economic edge in the 1970s. Puerto Rico failed to adapt to globalization and changes in the world economy by switching to cheaper fuels to make electricity, by keeping wages low enough to compete with East Asian economies and by moving toward a more flexible industrial model. As a result, the island experienced a prolonged period of lethargic growth and ballooning government deficits, as every administration after 2001 issued additional debt rather than tightening its belt. Between 2008 and 2013 alone, Puerto Rico's debt increased by 55 percent.

Given the deteriorating fiscal situation and the unlikelihood of a federal bailout, the current administration of Alejandro García Padilla does not have the luxury of its predecessors to kick the debt can down the road. And he knows it: In 2013, Padilla's first year in office, the introduction of several new taxes to narrow the government's deficit heralded an era of austerity.

A cornerstone of the new taxes is the *patente nacional*, an additional tax on gross business income known elsewhere as a gross receipts tax. The *patente nacional* was expected to raise roughly $500 million annually, more than one-third of projected new revenue for the 2014 fiscal year. It covers all businesses with gross revenue of at least $1 million, regardless of whether they are profitable.

The business community has raised an outcry, warning that the tax would force many firms into bankruptcy. Total island tax revenues from July 2013 through April 2014 were $442 million below expectations, suggesting that many businesses were, indeed, unable to raise the necessary cash.

As of late June, there was still uncertainty surrounding this fiscal year's deficit and next fiscal year's budget. Estimated projections for the 2014 deficit range from $365 million to $1 billion. For a time, the central government was without cash or credit, as were Puerto Rico's largest public corporations – the Puerto Rico Electric Power Authority, the Puerto Rico Aqueduct and Sewer Authority and the Highways and Transportation Authority – which together are responsible for almost 40 percent of the island's public debt.

In March, Puerto Rico did manage to float $3.5 billion in general obligation bonds, enough to service its debts and cover the budget deficit through the 2015 fiscal year. To the surprise of many, and despite the recent junk status downgrades, the debt issue was vastly oversubscribed. Initial yields on long-term bonds were as low as 8.7 percent, compared with expectations of yields above 10 percent. Investors' thirst for immediate income in an era of returns on U.S. Treasuries that hardly exceed the rate of inflation apparently worked in the island's favor.

But the budget relief looks to be short-lived. A few months later, the Puerto Rico Planning Board projected a fall in GNP of 0.2 percent for the 2014 fiscal year and 0.7 percent for the 2015 fiscal year, with independent economists predicting a revenue contraction of 1.5 to 2 percent for 2015. The credit-rating agencies were obviously unimpressed in July 2014, when they downgraded Puerto Rico's bond debt to even lower junk status.

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Even optimists are having a hard time spying a light at the end of the tunnel. The Economic Activity Index published by the Government Development Bank showed that the economy contracted for the 19th consecutive month in April 2014, with the decrease felt across sectors. As of April 2014, Puerto Rico's economy employed fewer than one million people, with the number of employed having decreased by about 25,000 since April 2013. At 14.1 percent, the unemployment rate was twice that of the mainland. Moreover, that figure doesn't reflect the ballooning numbers of discouraged workers who don't bother to register: The labor-force participation rate fell below 40 percent for the first time ever.

In late June, the government went into full austerity mode with the passage of an emergency fiscal law allowing the administration to make spending cutbacks necessary to achieve a balanced budget. The measure will be in place for three years. An extension is possible unless three conditions are met:

- The previous fiscal year must end with a balanced budget.
- A Wall Street credit rating agency must peg Puerto Rico's general obligation bonds at investment grade.
- The economic growth forecast must be at least 1.5 percent for the upcoming fiscal year.

The emergency measure was accompanied by the governor's $9.6 billion spending plan for the 2015 fiscal year. The plan attempts to achieve more than $1.4 billion in cuts and adjustments by consolidating 25 government agencies and, among other measures, closing around 100 public schools. Some $775 million is budgeted to amortize debt, $525 million more than in the 2014 fiscal year.

Classic fiscal austerity programs work only when the resources released through government cutbacks quickly translate into private spending to create jobs and private income. There is no indication that this will be the case in Puerto Rico.

Given the island's long-stagnant economy, threadbare electric power system and large-scale emigration of its best and brightest, the most likely result is a vicious circle in which economic contraction accelerates and tax revenues shrink faster than government spending. Even fiscally conservative organizations like S&P, Moody's Investors Service and Fitch, which for years have been advocating belt-tightening, have warned that Puerto Rico's push for a balanced fiscal 2015 budget could further weaken its economy.

Recent research at the International Mon-


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etary Fund has confirmed the shortcomings of similar austerity programs. Specifically, the fund warned that the impact of changes in government expenditures on GDP is generally higher than previously estimated, implying that austerity policies can do more damage than generally believed. Indeed, a report by the IMF's chief economist, Olivier Blanchard, concluded that the fund's austerity policies in Greece had backfired, making a bad situation worse.

Perhaps in anticipation of potential problems associated with austerity, the Puerto Rican government has introduced legislation that lays a foundation for the restructuring of a portion of the debt owed by the country's three major public corporations. The new law would create an orderly process in which to write off $22 billion of the $40 billion owed by the Puerto Rico Electric, Aqueduct and Sewer and Highways authorities.

Puerto Rico has been relatively lucky so far in terms of borrowing power, but the island seems to be drifting into uncharted waters. Attempts at restructuring the public corporation debt could well lead to contagion to other bonds. Some investors already worry the new law signals that Puerto Rican officials are willing to change the rules to relieve financial stress, making the island's general obligation bonds fair game for restructuring, too.

As things now stand, Puerto Rico cannot declare bankruptcy, and the island's constitution stipulates that debt payments on general obligation bonds receive priority over other spending. Should officials face a choice between honoring their bond obligations and firing large numbers of public employees who provide basic services, however, the outcome is far from certain.

Further complicating the situation, a

number of hedge funds purchased major tranches of the $3.5 billion general obligation bonds issued in March. If the hedge funds choose to exploit Puerto Rico's financial desperation, they could further destabilize the investment situation by insisting on terms that guarantee them first-lien status in the event of a default.

Then there are the hopeless economics of Puerto Rico's public corporations. While the corporations are supposed to be fiscally autonomous, they have been subsidized by the general fund for years and their employees are the best paid on the island. Since political pressure has made raising utility rates virtually impossible, the government may be forced in the not-too-distant future to acknowledge that public enterprises are a losing proposition that can no longer be tolerated.

Hedge funds are betting on privatization, with some already buying the electricity authority's bonds. The hope is that private operators could run the power plants more efficiently than the government and have some leeway to raise rates. Whether the Puerto Rican polity will cooperate remains to be seen.

### PONDERING THE FUTURE

Puerto Rico's long-term economic prospects are complicated by uncertainty about the island's status within the United States. Is the economy more likely to recover and prosper under its current territorial status, or with statehood, or with some sort of loose confederation with the United States? While advocates can be found for each, Puerto Ricans seem fairly evenly split between remaining a territory and becoming a state.

A recent General Accounting Office study suggested that Puerto Rico would probably receive a net benefit from statehood because it would be eligible for $9 billion to $10 billion in additional federal funding annually. But the GAO hedged its position by noting that "statehood's aggregate fiscal impact would be influenced greatly by the terms of admission, strategies to promote economic development, and decisions regarding Puerto Rico's government revenue structure."

Puerto Rico's governor, whose party supports continued territorial status, argues the GAO's calculations grossly underestimate the cost of statehood. According to García Padilla, if all residents were subject to federal taxes, the burden would turn Puerto Rico into a "Latin American ghetto." In any event, it's worth remembering that the choice of statehood is not entirely Puerto Rico's to make: Congressional Republicans wouldn't easily agree to give the heavily Democratic island two votes in the Senate and perhaps five in the House.

Puerto Rico's economic model has traditionally focused on keeping overhead and operating costs low to attract investment, encouraging manufacturing and relying on abundant federal funding to fill the economic potholes. With the public utilities immobilized by debt and island businesses forced to pay wages unjustified by productivity gains, there is little hope that operating costs can be controlled. This alone makes it unlikely that U.S. offshore manufacturing will again play a dominant role in creating critically needed jobs. Moreover, given Washington's shrinking budgets and the Puerto Rican government's massive debt, there's simply no chance that public spending will fill the gap left by the decline of manufacturing. Nor is it even remotely likely that the current austerity program will spur the sort of recovery needed to retain the island's better talent.

There is, however, a modest source of hope. Some local governments are stepping in to manage the damage done by Puerto Rico's failed economic model. The municipalities of Ponce, Barceloneta and Caguas are forging alliances with Puerto Rican business groups and mainland-based developers. Barceloneta, for example, has invested some $13 million in initiatives, including a technological innovation center to train workers, and has fostered business incubators to ease the creation of new enterprises. In rural areas, municipalities hope to pool resources in order to set up distribution hubs to deliver produce to urban markets. As of mid-2014, around $1.5 billion had flowed into these sorts of local projects.

Moreover, the unique interplay between the tax code of the United States and that of Puerto Rico still gives the island some room to attract investment, as evidenced by two laws passed by Puerto Rico in 2012. To promote the export of services from the island and draw new professionals, Law 20 reduced the corporate tax rate on service export revenue to just 4 percent. To encourage investors to immigrate to the island, Law 22 eliminates taxes on investment income (with the exception of dividends and interest from U.S. securities, which are generally taxed by the federal government) once their Puerto Rican residence is established. As of April 2014, Law 22 had already attracted more than 200 wealthy investors in search of tax goodies.

With a lot of luck, Puerto Rico may be able to build on grassroots development efforts and the new tax incentives to dig its way out of a very deep hole. The success of this approach depends not only on attracting sufficient investment, but on developing and sustaining a strong local economic base with market-driven policies and a business-friendly environment. Puerto Rico's governments, both central and local, will also need to make development their first priority, modernizing the island's badly worn infrastructure and carefully targeting education to job creation.

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Finally, given that markets, investors and prospective residents have all been spooked by political and economic uncertainty, it would probably make sense for Puerto Rico to make peace with its territorial status for the foreseeable future. Given the magnitude of Puerto Rico's economic problems, allowing the interminable, contentious argument over political status to simmer is a luxury it can ill afford just now.