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THE CONVERSATION

Academic rigor, journalistic flair

Puerto Rico's long fall from 'shining star' to the 'Greece' of the Caribbean

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A protest in San Juan against government cuts. REUTERS/Alvin Baez

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While the world's attention focuses on the economic crisis in Greece, another financial debacle looms closer to home for the United States.

Puerto Rico is now being called "the next financial catastrophe," and the territory's outstanding debt is being compared to that of Greece.

Financial pundits are rushing to declare that both Greece and Puerto Rico are on the verge of financial collapse.

Perhaps the Puerto Rican government, like the Greek government, bears some responsibility for its financial crisis.

But a closer look shows how the Greek and Puerto Rican cases are very different. Moreover, Puerto Rico's fiscal woes cannot be resolved independently by its government.

Only changes in US territorial policy toward its Caribbean possession can help fix the problem.

Why Puerto Rico isn't Greece

Some facts are truly alarming.

Puerto Rico's **per capita** income is lower than any state in the union; its **unemployment rate** has hovered at 13% for years; since 2006 it has suffered a steep drop in manufacturing; and its revenue base is rapidly eroding since many working-age Puerto Ricans are leaving for the United States.

The territory's US\$73 billion **public debt** is a higher per capita debt than any state in the nation.

Keep in mind, however, that Greece is a sovereign nation and Puerto Rico is a territorial possession of the United States – in effect, a colony – with very limited powers to represent the interests of its people. The US Congress can impose federal laws on the island and can veto any legislation enacted by the Puerto Rican government.

Moreover, unlike Detroit and states in the Union, Puerto Rico is barred from declaring bankruptcy and restructuring its debt.

For Puerto Ricans, who in 1917 became US citizens, an undeniable feature of colonialism is that they are not allowed to elect representatives or senators to represent them in the nation's capital.

Puerto Ricans are profoundly dissatisfied with their current political status, and in a November 2012 referendum made it very clear they want a change: 54% voted against the current “commonwealth” setup.

But Puerto Ricans are also voting against the current situation with their feet, as scores of thousands emigrate to the United States every year.

The back story: rapid growth despite its 'colony' status

Despite its colonial status, Puerto Rico experienced rapid industrial development and widespread modernization for most of the second half of the 20th century, and it escaped the debilitating poverty of the 1930s and 1940s.

After World War II, Puerto Rico abandoned its stagnant sugarcane-based economy and embraced US manufacturing firms, primarily low-wage, labor-intensive factories. Puerto Rican policy makers created an investment climate for US manufacturing industries that was second to none.

During the Cold War, the US promoted Puerto Rico as the “Shining Star of the Caribbean,” a model to be emulated by population-rich, capital-poor nations of the Third World.

Puerto Rico was frequently cited as an alternative to Cuba, which was portrayed as a communist client state of the Soviet Union, and woefully dependent on Mother Russia for its economic survival.

Puerto Rico thus rose from the poorhouse of the Caribbean to an economic powerhouse – only to now fall back again.

Ironically, colonialism explains both the growth and decline of the Puerto Rican economy – even though this colonial relationship has not changed in more than six decades.

Influx of US capital

After World War II, Puerto Rico, as a territory, had access to US capital and financial markets. Its population had unrestricted immigration to the United States. Favorable US fiscal legislation exempted corporations from paying federal taxes on profits earned in the island, and until 1989, the territory was exempt from federal minimum wage requirements.

Funds also came from the American war chest: the US military controlled almost 17% of Puerto Rico's territory. Military expenditures contributed to the island's growth, employment, internal security and strategic value.

The Puerto Rican government also attracted investments.

Manufacturing companies willing to migrate to Puerto Rico were provided with lavish subsidies, exempted from insular taxation and virtually guaranteed a low-wage and peaceful labor force. For example, the Puerto Rican Electric Power Authority and the Aqueduct and Water Authority provided subsidized rates to US-owned manufacturing firms.

Puerto Rico's Government Development Bank and the Highway and Transportation Authority invested billions of dollars modernizing the country's infrastructure. The capital to finance these enterprises came from US institutional investors who grabbed up Puerto Rican-issued bonds that were triple tax exempt and highly rated by Moody's and Standard and Poor's investment services.

Government employment mushroomed during this period, and combined with the massive emigration to the United States, Puerto Rico was able to sustain a manageable unemployment level.

Until the early years of this century, Puerto Rico could draw from internal revenue sources (primarily payroll taxes and taxes on locally owned businesses) to meet its debt obligation.

Colonialism thus seemed to work. At least it proved to be lucrative for US corporations and investors and of value to the military.



A Puerto Rican tattoo and flag. REUTERS/Andrew Kelly

The beginning of the fall

But starting in 2004, the “Shining Star of the Caribbean” rapidly lost its luster.

Roosevelt Roads Naval Station, the vast military base that housed the US Naval Forces Command, was relocated to Florida after years of popular protest. In 2006, IRS Code Section 936, which exempted US corporations operating in Puerto Rico from paying federal taxes, expired.

Then came the 2008 financial meltdown – especially the tightening of credit markets – that seriously impaired Puerto Rico’s ability to sustain debt-financed growth.

And now, the **normalization** of diplomatic relations between the US and Cuba, including its removal from the list of states that sponsor terrorism, has virtually eliminated Puerto Rico’s strategic value and created a competing Caribbean investment site for US firms.

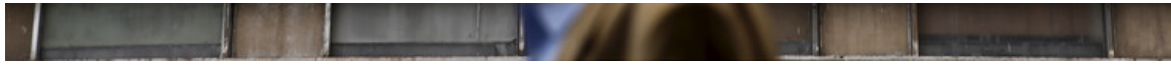
All these changes have resulted in **unemployment levels** not experienced in generations, a **declining population** as educated workers left the island and a diminished tax base.

Now the possibility looms of the government defaulting on its debt obligations.

Worried institutional investors who monitor the deteriorating investment climate concluded that the public debt is unsustainable and started to **offload** their bonds at huge discounts to hedge funds.

Hedge funds, for their part, saw the collapse of Puerto Rico’s vaunted bond rating to junk status as a speculative opportunity for healthy profits. And they are proving to be **particularly creative** in devising schemes to extract a profit out of the cheaply purchased yet virtually toxic bond holdings.





Is Puerto Rico on a Greek path? Above: an empty apartment building in Athens. REUTERS/Alkis Konstantinidis

The harsh reality now facing Puerto Rico

The stark reality is that the US is no longer an endless source of risk-free capital for Puerto Rico.

The future of the island's economy may ultimately rest with the hedge funds that are now monitoring the government's performance.

Puerto Rico's future is dim. If the **hedge funds** have their way, the Puerto Rican government will extract more revenue from its beleaguered citizens and small businesses, slash government services and employment, and enforce the austerity measures dictated by the **hedge funds**.

Yet a politically unstable, economically devastated Puerto Rico is not good for the US' image. The Federal Reserve is monitoring the situation, eager not to let the situation deteriorate much further.

However, a Band-Aid approach will not fix Puerto Rico's utter dependency on the US for its survival.

The US must develop a long-term program to redefine Puerto Rico's territorial relationship. The US has no other option.

Statehood for Puerto Rico is not a realistic option: neither Puerto Ricans nor the US want an independent Puerto Rico. But it is also the case that the long-standing "commonwealth relationship" doesn't work.

If nothing is done, Puerto Rico may well have to endure an economic and social crisis akin to that of the Great Depression that it managed to escape in the 1930s.

NB The article has been corrected to reflect the fact that while large Puerto Rico's per capita debt does not exceed that of Greece.

 [Economy](#) [US Economy](#) [Debt](#) [Greek debt](#) [Bailout](#) [Puerto Rico](#) 

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