**HOW DID THIS HAPPEN?**

**THE REAL STORY ON THE PUERTO RICAN ECONOMY**

**Ready Answers to Frequently Asked Questions**

**THE QUESTIONS**

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2. How bad is the economic situation today?
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**THE PURPOSE HERE**

Answers to these questions are important. Know the answers, and you begin to understand what’s going on. You might even start imagining solutions.

But the answers below don’t tell the whole story. There’s a context. Some important realities lie behind the economic mess. So keep in mind:

* **The U.S. Congress and the President control everything**. Although the Puerto Rican government appears to have a range of autonomy, ultimately it can only do what the Congress and the President allow it to do.
* **Puerto Rico must operate within the limits of the U.S. Constitution and U.S. laws**. Commentators on the Puerto Rican economic situation sometimes propose economic initiatives that the Constitution precludes, not only for Puerto Rico but also for the 50 states—initiatives affecting, for example, treaties, customs, taxation, and labor regulations.
* **Status is the elephant in the room**. Puerto Rico’s “territorial status” is seldom an issue in discussions of the economy or economic policy, but it should be. The territorial status has an enormous effect on the economy. There is no way to separate politics from economics.

**THE QUESTIONS WITH THE ANSWERS**

1. **Why is Wall Street freaking out over Puerto Rico’s government bonds?**

There’s a simple answer. The government does not have the money to both pay its debts and continue to perform its basic functions. The debt is over $70 billion, an amount roughly equal to the total gross national product (GNP)—or about $20,000 for every man, woman, and child in Puerto Rico. With the severe recession, the government has little hope of raising revenue. A federal bailout is unlikely. So it seems likely that the debt will not be paid and that the government will default on its debt. Wall Street would then lose a lot of money and thus is, understandably, freaking out.

But there’s more to the story.

The place to introduce the story is with the events of early February 2014. During the first week of February, first Standard & Poor’s (S&P) and then Moody’s—the two largest of the “big three” bond rating agencies—downgraded Puerto Rican government bonds to “junk” status. According to *The New York Times* of February 4, S&P “said it had decided that Puerto Rico was no longer qualified as investment grade because its government was losing its ability to raise cash.” Moody’s followed, saying, according to the *Times* of February 7, that “many years of deficit spending and underfunding of public pensions had taken a heavy toll on the island, leaving it with a high debt burden and scarce available cash.” Further: “While some economic indicators point to a preliminary stabilization, we do not see evidence of economic growth sufficient to reverse the commonwealth’s negative financial trends.”

The implications for Puerto Rico of its bonds sliding into “junk” status, no longer viewed as of “investment grade,” are severe. It will be even more difficult for the government to raise money to pay its debts. Whatever cash it can raise will come at a very high cost. That is, the government will have to pay extremely high interest rates, which will only make its budget problems worse.

For many years, the government of Puerto Rico has had an unbalanced budget. Instead of collecting enough taxes to support its operations, the government has borrowed money. It has borrowed by selling bonds—which are simply promises to pay back the borrowed money with interest sometime in the future. Even when the economy was growing in the 1990s (though not growing very rapidly), the government, including government enterprises such as thePuerto Rico Electric Power Authority (PREPA), borrowed heavily, keeping the debt level at about 60% of national output. Then, as the economy slowed and went into decline in the 2000s, the government borrowed even more. Puerto Rico is now simply over-mortgaged.

In the middle of 2013, government debt was about 90% of GNP. With the debt continuing to rise and GNP falling (or at best stagnant), the total debt in early 2014 is at least as large as GNP. Puerto Rico’s level of public debt is far higher per person than that of any state and far, far higher than any state in relation to per capita income.

Under these circumstances, and with no sign of significant economic improvement in Puerto Rico, Wall Street has become concerned that the Puerto Rican government may not be able to pay back (with interest) the borrowed money—that is, the government might default. Those who are willing to buy these seemingly risky bonds at all have been demanding that the government pay interest rates as high as 9% or 10%—and this was before S&P and Moody’s downgraded the bonds. State and local governments in the states that are in decent financial condition are able to borrow at interest rates of less than 4%. Many firms and individuals that own Puerto Rican government bonds have been selling them. But they can only find buyers who will pay for the bonds at a steep discount. For example, at the end of 2013, Puerto Rican bonds were selling at only 67% of their face value. With the downgrades of February 2014, the discount is likely to be greater.

The problem, however, is not simply that the holders of these bonds are losing money and would lose much more if the government defaulted. When there is a major failure in the bond market, it can affect investors’ willingness to invest in other bonds. A large default event on Wall Street can be contagious, affecting investments that, before the event, would have been viewed as safe. A Puerto Rican bond failure would be a major event—much larger, for example, than the bankruptcy of Detroit. Detroit’s total debt is “only” around $18 billion—about one-fourth as large as Puerto Rico’s.

The Detroit default, while serious for people in Detroit and others directly involved, did not have widespread impact on the bond market. Not only was it small compared to a potential Puerto Rican default, but there are legal provisions that, though contested, provided for an orderly handling of the Detroit situation. There are no such provisions or precedents to guide a Puerto Rican default. And most importantly, Puerto Rican bonds pay tax exempt interest in all fifty states, and they are therefore widely held by mutual funds. Because of these various factors—size, lack of clear legal procedures, and the widespread holding of Puerto Rican bonds—the weak position and possible default of Puerto Rican government debt is having an outsized effect on financial markets in the United States.

The Puerto Rican government claims it will not default. As the crisis was emerging in 2013, the governor stated that it is a “moral” imperative for Puerto Rico to pay its debts. Even in the wake of February’s actions by the major rating agencies, government officials continued to claim that they have sufficient cash to meet their obligations. But the statements by the governor and other officials have done little to appease worried investors, as of course no government would ever say it is planning to default. There are provisions in the Puerto Rican constitution that protect some of the bonds from default, and, again, there are no legal provisions that would guide a Puerto Rican default. So it is not clear what will happen.

What is clear is that as long as the economic situation continues to slide downward, Wall Street will have reason to continue freaking out over Puerto Rican government bonds.

1. **How bad is the economic situation today?**

Very, very bad—worse than ever. People see the severe, long recession every day—no jobs, income declining, prices continuing to rise, houses for sale and no buyers, and people leaving Puerto Rico in droves, hoping for something better in the states.

Individual experiences are reflected in the data for the whole Puerto Rican economy:

* *Between 2004 and 2013, Puerto Rico’s population declined by 212 thousand, a drop of 5.5%.* By way of comparison, only two states showed any population decline at all in this period—Michigan, the epicenter of deindustrialization, and Rhode Island. And their percentage loss of population was much smaller than Puerto Rico’s. Moreover, the people departing Puerto Rico tend to be relatively young and well-educated, people with the potential to make important economic contributions.
* *Total output—Gross National Product (GNP)—fell from 2006 to 2007, and has fallen every year to 2012* (the latest year for which full data are available). In 2012, there was a tiny up-tick in GNP, but preliminary data indicate a further decline in 2013.
* *The Government Development Bank’s Economic Activity Index fell by 19.4% from its peak in 2006 to the late months of 2013*—seven years of decline and now heading into an eighth.
* *Official unemployment has soared to over 15%* of the labor force—twice the unemployment rate in the states—and many people have simply stopped looking for work. (Although some people have found jobs in the “underground” economy, the inclusion of these jobs into the official figures would not substantially change the shockingly high unemployment rate.)
* *Investment has dropped off drastically*. In the early 2000’s investment was about 25% of GNP, but has been below 15% of GNP since 2010. When the investment rate is lower than the unemployment rate, even for one year, a society is in real economic distress. Without much investment, prospects for the future are poor.

With these numbers, it is any wonder that Wall Street has little confidence that the government will be able to raise the revenue to pay its debts?

1. **Where did this very, very bad situation come from? Is it something new?**

Unfortunately, no, the poor economic performance of the Puerto Rican economy is not new. This severe recession has not been going on forever—“only” for seven or eight years. But for decades before that—since the late1970s—the economy has been relatively stagnant. Growing, yes, but growing much more slowly than the economy of the United States. So instead of catching up with incomes in the states (converging), incomes in Puerto Rico have been falling further and further behind (diverging).

There was a period in the past when economic growth was fairly rapid. There was hope in the 1950s and 1960s—during “Operation Bootstrap” or “*Operación Manos a la Obra”—*that rapid economic expansion was leading to a convergence between incomes in Puerto Rico and the states. Policy makers continue to look back on those decades with nostalgia, in the same way that some car owners long for a clutch and a manual gear shift. (For more on Operation Bootstrap and its ill-fit for Puerto Rico today, see Question 6 below.) During the 1970s, however, things slowed down. Between 1980 and 2000, while national product in the states grew by 90%, in Puerto Rico national product rose by only 59%. In the new millennium, the U.S. economy has not grown a great deal, by only 23% between 2000 and 2012. But the Puerto Rican economy has actually declined in this period, with national output in 2012 about 1% below the 2000 level. (All of these figures are adjusted for inflation.)

Of course the Great Recession in the United States hurt Puerto Rico because Puerto Rico’s economy is so closely tied to the United States. The United States is by far Puerto Rico’s largest trade partner and the largest source of investment. When the Great Recession hit in the states, Puerto Rican exports to the states and new investment from the states fell off sharply.

While events in the states hurt Puerto Rico’s economy, they do not account for the depth or severity of the recession. First, as noted, the economic decline in Puerto Rico has been much, much worse than in the states. But most importantly, there is the matter of timing. The Puerto Rican decline began in 2006 and signs of decline appeared in the Government Development Bank’s Economic Activity Index in late 2005. Growth in the U.S. economy, however, was positive until early 2008. Also, by late 2009, the U.S. economy was beginning to recover—although slowly—while the recession in Puerto Rico has gone on without relief.

The problems of the Puerto Rican economy are not new and cannot be attributed to the Great Recession in the states. The Puerto Rican economy has been weak for decades. In this context, when the downturn was set off in 2006, it was bound to be severe and long.

1. **So what set off the recession?**

The shutdown of the government in May of 2006 was the catalyst that sent the economy into its downward spiral. The shutdown, however, was itself a symptom of the weak condition of the economy: the relative stagnation that was in its third decade.

In the early 2000s, the government had been increasingly relying on borrowing to keep the economy going. By 2006, the public debt had grown to $58 billion, up by almost a third from 2001. Debt had been high in the 1990s, running about 60% of GNP and by 2006 it had jumped to 70% of GNP. While both the governor and the legislature seemed to agree that the growth of the debt should be curtailed, they could not agree on an appropriate policy. (The governor was from the Democratic Popular Party; the legislature was controlled by the New Progressive Party.) This deadlock led to a shutdown of the government in May of 2006, in which 100,000 public sector workers were put out of their jobs for two weeks.

The shutdown had two negative impacts on the economy. First, there was an immediate reduction in demand, as the salaries of these 100,000 workers were not being paid and their spending was thus reduced. Second, the shutdown sent a signal of instability to businesses, leading them to hold back on expansion and new investment. Had the economy been in generally good shape, perhaps these negative impacts would not have done lasting damage. But the economy was already vulnerable, and the result was devastating: the severe recession that continues to this day.

1. **Could a reestablishment of Section 936 get the economy going again?**

Please! Section 936 never worked—at least not for Puerto Rico, though it did put a lot of money into the hands of several large U.S. corporations. Also, although Section 936 was phased out in the early part of the last decade, the firms that received benefit from it were able to keep most of the same benefits through the Controlled Foreign Corporations (CFC) provisions of the federal tax code. So in essence 936 has never ended.

Section 936 of the federal tax code allowed the subsidiaries of U.S. firms operating in Puerto Rico to pay *no* federal taxes on their profits as long as they did not return those profits to the states. The ostensible purpose of this provision was to encourage investment by U.S. firms, contributing to employment expansion and economic growth in Puerto Rico. Section 936 was very beneficial to many firms—especially the large pharmaceutical firms. Not only did it allow them to avoid taxes on the profits from their actual production activity in Puerto Rico, but also, through transfer pricing (charging low prices for materials and services that the firms sold to their Puerto Rican subsidiaries) and locating ownership of patents with the subsidiaries, the firms greatly inflated their Puerto Rican profits and kept their U.S. taxes low. (The CFC provisions have allowed pretty much the same thing.)

But positive impacts on the Puerto Rican economy were relatively small. If 936 and CFC provisions meant that the firms used their profits to reinvest in Puerto Rico, then this might have stimulated growth. But they can use the profits *anywhere in the world*, as long as they don’t return them to the United States. Also, in their operations in Puerto Rico, these 936 and CFC firms are not good job creators and are not connected well to the local economy for raw materials. The reality is illustrated by the information in a U.S. Treasury Report focused on 1987, when Section 936 was in full force. In that year, it cost the U.S. government on average at least $1.51 in lost tax revenue for each $1.00 in wages paid in Puerto Rico by firms operating under the provisions of Section 936. Or, put another way, on average it cost at least $26,725 each year to maintain a job that was paying an annual salary of $17,725. For the pharmaceutical industry, the figures were $3.08 per $1.00 in wages, or $81,483 to maintain a job paying $26,471. Another study, focused on 1992, indicated that 936 firms were less integrated with the Puerto Rican economy than were non-936 firms—a dollar of sales by the former generated a total output in Puerto Rico of $1.70, while a dollar of sales by the latter generated total output of $2.60.

But, again, all this was very good for the profits of the 936 firms (and now the CFC firms) as is evident in the experience of the pharmaceutical companies. When 936 was in full operation in the early 1990s—after inputs were paid for—94% of the remaining revenues of the pharmaceuticals went to capital (as profits, interest, etc.) and *only 6% went to labor (as wages and salaries)*.

Special tax provisions from Washington have been there all along, through the relative stagnation of the 1980s and 1990s and through the current recession. So, no, a new Section 936 could not boost or rejuvenate the Puerto Rican economy.

1. **What about Operation Bootstrap? That worked, didn’t it?**

Operation Bootstrap produced some substantial success. But that’s ancient history. The conditions that made Operation Bootstrap work are long gone. The idea that the economy could be improved by the policies of that era is a bit like thinking transportation could be improved by policies to promote the horse and buggy.

Economic growth in the 1950s and 1960s—the era of Operation Bootstrap—was extremely rapid. In 1970 national product (after adjusting for inflation) was three and a third times as large as it had been in 1950. Yet Operation Bootstrap was based on special conditions that would not last and that cannot be re-created.

Success in the 1950s and 1960s depended on low-wage labor and, relative to other low-wage sites in the world, preferential access to the U.S. market. Attracted by these conditions and by the very favorable tax treatment from the U.S. and Puerto Rican governments, many U.S. firms set up labor intensive operations. In that period, Puerto Rico was moving from a low level agricultural-based economy, producing sugar cane and coffee, to an industrially-based economy producing apparel and baseballs.

But the rapid growth pushed wages up, and the U.S. government has increasingly allowed unfettered access to the U.S. market for many other lower-wage countries—Mexico, then China, and now Bangladesh, as well as many others. Also, as the shift from a rural agricultural economy to an urban industrial economy progressed, the gains from this transformation came to an end.

Puerto Rican governments of both major parties seem to think they can get the economy going by reverting to the old policies of tax breaks for U.S. firms that worked in the era of Operation Bootstrap—tax breaks from both the Puerto Rican government itself and from the federal government. Indeed, these sorts of policies have failed over and over during the more recent decades of slow growth. Although these policies had some impact in the 1950s and 1960s, they would not work *when the special conditions of low wages and preferential access to the U.S. market were gone*.

In spite of its success under those special conditions in promoting economic growth, Operation Bootstrap established a pattern of reliance on externally based firms—mainly U.S.-based firms—as the engines of economic development. Some countries—the East Asian “Tigers” in particular—have succeeded in continuing strong economic expansion after a period of rapid growth based on low wages and exports. Countries such as South Korea, Taiwan, and Singapore, however, grew largely on their own steam, building with firms based within their countries. Puerto Rico has remained in a condition of dependence.

1. **Could Washington help?**

Certainly the federal government *could* help. But it seems unlikely that it *will* help any more than it has in the past.

Puerto Rico is a “territory of the United States,” and simply a “colony” in the eyes of many. Although Puerto Ricans are citizens of the United States, they have no representatives in congress and no vote in presidential elections. The federal government has ultimate control over Puerto Rico, and Puerto Rico is subject to U.S. laws. It seems, however, that Washington does not accept responsibility for Puerto Rico’s dire economic situation, and there is no indication of financial help for the government’s debt crisis.

Puerto Rico’s poor economic performance—currently and in previous decades—can be traced largely to its political status. Many of the benefits that go to state governments and people in the states do not go to the Puerto Rican government and the Puerto Rican people. Puerto Rico is not on a level playing field with the states—in fact, it’s not even on the same field!

For example, Puerto Ricans are not eligible for the Earned Income Tax Credit or Supplemental Security Income. Programs in which Puerto Rico is included are, unlike in the states, capped—for example, Medicare and the Supplemental Nutritional Assistance Program (SNAP or “food stamps”). If Puerto Rico were treated in the same manner as the states in all of these programs, people’s incomes would rise substantially, pressure on government finances would be reduced, and economic growth would be pushed ahead.

Yet programs ostensibly put in place to help Puerto Rico—such as the old Section 936 of the federal tax code and the current provisions for Controlled Foreign Corporations—do far more to increase the profits of U.S.-based firms operating in Puerto Rico than to improve conditions of the Puerto Rican people.

To be sure, Puerto Ricans do receive some funds from Washington. Social Security payments are important, and so are the various limited (capped) programs cited above. During the current recession, these payments have kept people’s incomes from falling as steeply as GNP. If Puerto Rico were on a level playing field with the states, however, it would get far more funds from Washington, improving the lives of families, stimulating economic expansion, and relieving the public debt crisis. (See question 8 below.)

Nonetheless, aside from these programs that have long been in place, Washington has done virtually nothing as Puerto Rico’s recession has dragged on and worsened. When the bond market crisis emerged and threatened in late 2013 to do broader financial damage in the states, Washington did respond—but only by sending advisors to San Juan. *While Puerto Rico has no representatives in congress and is excluded from a role in choosing the president, there is simply no political will in Washington to provide real aid for Puerto Rico.*

1. **How about Puerto Rico being called the “welfare island”? Is that right?**

No, it’s not right. This derogatory term is one more manifestation of the prejudice against recipients of food stamps and other social welfare programs. Puerto Rico does of course get money from the federal government, the various funds just mentioned above. However, *all the states get these funds on even better terms that Puerto Rico*.

In 2010, for example, on average the states received about $10,000 per person from the federal government. Puerto Rico received half of this, about $5,000 per person. These payments were in the following categories: retirement, disability and Medicare; other direct payments; grants; salaries and wages; and procurement. In each category except grants, Puerto Rico was at the absolute bottom, receiving less per person than all 50 states and the District of Columbia; in terms of grants, Puerto Rico was third from the bottom.

But some people might say: “Yes, but people in the states pay federal income taxes, and Puerto Ricans don’t. So the people in the states are paying their way, but the Puerto Ricans are getting a generous handout.” This is nonsense. While Puerto Ricans do not pay federal income taxes, they do make substantial payments to the federal government—most important are Social Security and Medicare taxes.

So what happens when Puerto Rico is compared to the states in terms of what it gets from the federal government minus what it pays to the federal government? It turns out that in 2010, 17 states ranked higher than Puerto Rico by this measure. For example, Alaska, at the top of the list, received $11,123 per person more from the federal government than Alaskans paid to the federal government. Further down the list, the figures for West Virginia and Mississippi were $8,365 and $7,515. Arizona, right above Puerto Rico, got $5,116 per person more from Washington than its people were paying to Washington. For Puerto Rico that year, the figure was $4,697. (In 2010, the federal government was running a large budget deficit, spending more than it was taking in as taxes. As a result, most states were receiving more from Washington than they were paying to Washington.)

No one would argue that the funds going to Puerto Rico or to the states are being paid out in the most effective manner. There is plenty of room for reform in federal expenditure policies. But to single out Puerto Rico and call it a “welfare island” because of “generous” payments from Washington is nonsense.

In fact, Puerto Rico should be getting more from Washington! If it were put on a level playing field with the states—if it were treated just like the states in terms of all the programs mentioned above—Puerto Rico would get a good deal more. But getting things from the federal government depends largely on having some power in Washington, some representation, some votes.

1. **Once the current recession ends, will Puerto Rico get back on a solid path to economic development?**

The answer is no. Recessions do end, but the problem is that Puerto Rico has never been on a “solid path to economic development.” As pointed out, the conditions that made Operation Bootstrap a success are long-gone and will not return. Reliance on federal and Puerto Rican tax incentives to promote growth and employment has not worked. Sooner or later, the recession in Puerto Rico will most likely come to an end. But unless some very different course of development is put in place, the Puerto Rican economy is most likely to return to the doldrums of earlier years.

1. **What have Puerto Rican governments been doing the last few years to end this recession? What are they doing right now?**

Puerto Rican governments of both parties have focused on their problems in the bond market instead of actions that might bolster the economy and create jobs. Their policies have been classic “austerity” policies, dramatically cutting government employment to reduce spending and in 2013 imposing some substantial tax increases.

The record of austerity policies in Puerto Rico, as elsewhere, has been very poor. The governments’ actions have reduced demand, pushed the unemployment rate up, and discouraged investment. Both the current government and the previous government have substantially cut government employment. Between 2006 and 2012, central government employment dropped by 18.4%, while overall employment declined by 11.2% (according to the establishment survey). Between January and August of 2013, government employment was reduced by 5,310 people, including 1,328 people in the Department of Education. Major budget cuts have been imposed in health and welfare programs, as well as in education.

To be sure, government employment in Puerto Rico has long been high by reasonable comparative standards (for example, as compared to the states). With some carefully implemented steps to raise efficiency in government offices, it could well have been possible and desirable to reduce government employment over time. However, to lay off large numbers of people in the midst of a recession, when the private sector is not hiring, is most likely to pull the economy further downward (to say nothing of the well-being of the people being laid off).

Moreover, these austerity measures have been undertaken without any credible actions by the government that would improve economic conditions, either in the short-run or the long-run. The current government, like the previous government, does have a list—no more than a wish list--of changes that it claims would pull the economy out of recession. However, number one on this list is to “defend [the] traditional pharmaceutical base” of the economy, ignoring the failure of this “base” to bolster the economy in years past. Among the other items on the wish list are to make Puerto Rico “the knowledge services center of the Americas” and “the center for scientific R&D in the Americas,” to “re-capture historic strengths in tourism,” and to “reduce reliance on food imports by investing in high-productivity agricultural production.” While these appear to be laudable goals, one wonders how a government that neglects the conditions of the schools—and lays off over a thousand people in education during the past year—is going to achieve advances in knowledge services or R&D. Also, in setting out its wish list, the government gives no attention to where the funds will come from to invest in these lines of development. (These quotations regarding the government’s “wish list” are from its *Update on Fiscal and Economic Progress FY 2014 Q1 Investor Webcast-October 15, 2013*.)

Perhaps government officials believe that the failed policies of tax incentives will somehow take on a new, successful life. Or perhaps they believe that they will regain the confidence of the bond market and borrowing at reasonable rates will be an option.

Yet, the irony of the austerity steps that the government took in 2013 is that, while doing damage in Puerto Rico, they appear to have failed to assuage the concerns in the bond market. According to a December 10, 2013, report by *The Wall Street Journal*, “The price of Puerto Rico's 5.75% bond due 2041 has fallen 10% over the past month to 67 cents on the dollar, while the yield of the bond has risen to 9% from 8%, according to the Municipal Securities Rulemaking Board.” And a report in *The New York Times* of January 22, 2014, indicated that, in order to borrow, the Puerto Rican government would have to pay “as high as ten percent, more than double what a highly rated city or state pays to borrow in the current municipal debt market.”

1. **So what can Puerto Ricans do to get the economy going, to improve people’s lives?**

There is no easy solution to Puerto Rico’s current economic problems—no quick fix to either the recession itself or the public debt crisis that has emerged. But there are certainly better approaches than those that have been taken by the Puerto Rican governments.

Unfortunately, the governments have let the debt situation expand so that it is now a severe, immediate problem. A failure of the Puerto Rican government to meet its bond obligations could have substantial negative consequences, further undermining the operation of the economy and the well-being of the Puerto Rican people. The austerity approach, however, is not working. So what can be done?

One answer is that there is no solution to the debt crisis that can be put in place by the Puerto Rican government. Without help from Washington—which appears highly unlikely—there may not be anything the Puerto Rican government can do to avoid default. Then the Puerto Rican government should face reality and plan to default in the least harmful manner. There are of course limits to what the government can do because of constitutional provisions that give priority to bond payments in the government’s budget. Yet not all of the debt is covered by the constitutional provisions. Facing default, bond holders will often be willing to accept measures such as rescheduling of debt payments. At the very least, this sort of option should be considered.

Beyond the debt crisis, there are many steps that the government could take to improve the Puerto Rican economy. The first step would be a stronger appeal—a demand?—that Washington start treating Puerto Ricans fairly. This means placing Puerto Ricans on a level playing field, treating them in the same manner that other U.S. citizens are treated in all government programs. For example, Puerto Ricans should:

* be eligible for the Earned Income Tax Credit (EITC);
* be fully eligible for the Child Tax Credit (CTC); and
* receive un-capped payments for Medicare, Supplemental Security Income (SSI), and the Supplemental Nutritional Assistance Program (SNAP, or “food stamps”).

Simply placing Puerto Ricans on a level playing field with other U.S. citizens in these programs would bring billions of dollars annually to Puerto Rico. Just the EITC and CTC, when fully implemented, would provide at least $1.2 billion to Puerto Rican families, both helping those families and stimulating the economy. (Today, a family of four living in the states with an annual earned income of $25,000 would end up after all federal taxes and these credits with a net income *$6,000 more* than a family with the same members and same earned income in Puerto Rico.)

Relations with the federal government aside, there are steps that can and should be taken by the government within Puerto Rico to build the foundations for long-run development, to get the economy on that “solid path to economic development.” Not only is the long-run important in itself, but a realistic long-run program is necessary for dealing with the immediate situation. Investors will only begin to take action when they have confidence that there are realistic positive prospects over the long-run.

Perhaps the most important (but not the only) steps the government could take would be building the social and physical infrastructure of the economy. This means dealing with the schools, which will require both more money as well as various other reforms. It also means improving the roads and other aspects of the transport system, and, especially, reducing the cost of energy—these are also steps that will require both more money and reforms.

But where will the money come from to take these steps? One source would be the elimination of the tax expenditures that have long been used to provide subsidies to many firms. Another would be a more general reform of the tax system, giving special attention to eliminating tax evasion.

Again, there is no easy solution to Puerto Rico’s economic problems. But there are alternatives to the failed policies of the past—tax favors to firms and pleas to Washington for a new Section 936—and to the failing austerity programs of the moment.

1. **How does the status of Puerto Rico affect the economic situation? Would things be different if Puerto Rico, instead of being a territory of the United States, were a state? Or independent?**

Status is the elephant in the room. Although the status issue is a constant matter of political controversy in Puerto Rico, the role of the current territorial status in bringing about the poor economic conditions of life is seldom recognized.

The overarching fact of economic and political affairs is that Puerto Rico is controlled by the U.S. government but has no voice—no votes—in determining what the U.S. government does. To a large extent, the federal government simply ignores Puerto Rico. When it takes actions that directly affect Puerto Rico, those actions are largely determined not by the interests of Puerto Ricans but by the interests in the states. The history of policies affecting U.S.-based firms provides numerous examples (as noted above).

Puerto Rico is included in the overall realm of the United States, but it is included on an unlevel playing field with respect to the states. One way to view this differential treatment is that it simply is not fair—as illustrated by the example above of the families with $25,000 incomes. But it is more than unfair. It also deprives Puerto Rico of federal funds that would provide a major stimulus to the economy. (Not incidentally, with the resulting better economic conditions, there would be less pressure on the government to continually turn to the bond market to finance its operations.)

Not only is Puerto Rico excluded from important federal programs, but it is also not free to establish its own economic policies. The government’s power to do so has been fully eviscerated by the overriding authority of the U.S. Congress. Puerto Rico does not have the authority to make policies that could continue to drive their economies forward, like the Asian “Tigers” mentioned above. Those countries, however, are independent, and therefore their governments have had the authority to make policies that could continue to drive their economies forward—regulating foreign trade and investment, for example, and favoring the development of indigenous business. Such authority is denied to the Puerto Rican government. (While independence has been important to the success in some countries, small economies that have become independent have generally had poor economic records. In any case, there seems to be very limited support for independence among Puerto Ricans. Moreover, not only is the U.S. government unlikely to grant independence, but, if it were to grant independence, it is virtually impossible that it would both do so and allow Puerto Ricans to have U.S. citizenship indefinitely—an important provision for many advocates of independence.)

Unfortunately, the limits on the Puerto Rican government’s policy-making are not simply determined by formal authority. Puerto Rico’s long experience under the thumb of the U.S. government has created a mentality of dependence, deeply affecting the approach to economic issues by policy makers. Over many years and through many governments of both major parties, policy makers have manifested this dependence by looking to external sources for economic development. One aspect of their approach has been to seek special favors from the federal government, with Section 936 being the most prominent example. Another aspect has been a continual effort to attract external—mainly U.S.—firms to invest in Puerto Rico, largely by providing costly tax breaks to the firms. *Insufficient attention has been given to local foundations of development—either by supporting the expansion of locally-based businesses or by the extensive education and training of a modern labor force.*

Even while there is little public discussion of the link between status and the economy, this link is recognized by the Puerto Rican people. Twenty-first century voters seem well aware of the fact that politics and economics cannot be separated. Motivated by the hardships they have experienced for decades and by the economic debacle of recent years, in November 2012 Puerto Rican voters declared that the current status is an inadequate foundation for their future. A majority voted against maintaining the current territorial status and then voted a preference for statehood. (Independence received only a small share of the votes.)

Meaningful and lasting improvement of the material lives of Puerto Ricans cannot be achieved without a status change. The people of Puerto Rico announced this clearly by their vote in November 2012.

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For elaboration and details on the points discussed here, see:

J. Tomas Hexner and Arthur MacEwan, *Puerto Rico: Continuing Socio-Economic Deterioration and the Need for Change*, October 2012. Available on request from

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Eugenio J. Alemán, *Puerto Rico: Failure of the State*, Wells Fargo Securities, Economics Groups, Special Commentary, May 24, 2012, p. 10. Available at <http://mediaserver.fxstreet.com/Reports/f94cca42-c3fa-47e4-88dd-b4c17a0cdced/d8b5822a-a0a2-4400-88cc-dbc573a21a9e.pdf>.