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Is Puerto Rico Greece in the Caribbean? Crisis, Colonialism, and Globalization

EMILIO PANTOJAS-GARCÍA

In October 2013, *The Economist* compared the debt crisis in Puerto Rico to the Greek crisis, calling the island "Greece in the Caribbean." Among other criticisms, it called Puerto Rico a "chronically uncompetitive place locked in a currency union with a richer, more productive neighbor."[1] Nearly two years later, on June 29, 2015, after much fiscal maneuvering and requests for assistance to the U.S. Congress and the President, Governor Alejandro García Padilla announced on a televised message what everyone knew: that the debt of the Government of Puerto Rico was unpayable.[2] *The Economist* had recommended that (1) fiscal austerity alone was not the best route to solvency in an uncompetitive economy; (2) debt restructuring was best done sooner than later; and (3) American policymakers should ensure that Puerto Rican debt restructuring is orderly and provide interim finance to assist in the process.[3] However, the key measures for fiscal stabilization

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taken by the García Padilla administration were the opposite of these recommendations.

First, the government enacted an austerity program, passing Law 66 of 2014, "The Special Law for Fiscal and Operational Sustainability of the Government of the Commonwealth of Puerto Rico." Second, new taxes were levied and other regressive taxes were increased, including an increase in sales and value tax from 7 percent to 11.5 percent, while taxes on oil and its by-products increased by 68 percent. Third, the government borrowed USD 2.5 billion in 2014 to ensure cash flow until 2015. Finally, the government did not articulate a strategic plan for economic reactivation or a repositioning of the Puerto Rican economy in global value chains.

While the Puerto Rican and Greek crises share root causes of bad governance, they differ in the contexts, nature, and magnitude of their debts. A long-term solution to the Puerto Rican crisis must address the issues that brought the island to this point. What were the roots of the crisis, and what happened in both the polity and the economy to cause the politico-economic collapse of Puerto Rico, which in 1958 had been proclaimed by *TIME Magazine* a showcase of democracy and development?[4] The Puerto Rican crisis is not just an economic and fiscal crisis. It is, above all, a crisis of governance.

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WHAT HAPPENED TO THE PUERTO RICAN ECONOMY?

Trade liberalization and the end of protectionism led to a collapse in the Puerto Rican model of industrialization, disrupting its position in the global economy as a unique industrial tax haven for U.S. transnational corporations. .

Until 1996, the Commonwealth of Puerto Rico enjoyed a number of fiscal, trade, and economic preferences that gave the island distinct competitive advantages in the international economy. Since Puerto Rico is a possession (an unincorporated territory) of the United States, businesses operating and citizens residing on the island are exempt from federal taxes. Federal tax exemptions, complemented by local "tax holidays" and unrestricted access to the mainland market, fostered export-led industrialization between 1948 and 1996. These advantages were significantly increased in 1976 with the passage of Section 936 of the U.S. Internal Revenue Code, which allowed U.S. transnational corporations to operate as "possession corporations" (also known as "936 corporations"). Section 936 allowed these companies to repatriate all profits reported from operations in Puerto Rico free of federal taxes, once these profits had remained for a minimum of five years in earmarked bank deposits on the island and the company had paid a 2 percent tollgate tax to Puerto Rico's government.[5]

This tax status stimulated the proliferation of pharmaceutical industries in Puerto Rico. The island functioned as a unique tax haven, where companies transferred international profits to avoid paying federal taxes on their global income. American pharmaceutical companies, such as G.D. Searle, Merck, Sharp & Dohme, Eli Lilly, and others sold their patents and the components of patented medicines called "miracle drugs" (prescription pain killers, blood pressure and diabetes medication, etc.) to their Puerto Rican subsidiaries, used these subsidiaries to manufacture the final product on the island, and sold their top products in the U.S. market to final users, thus transferring global profits to the island for later repatriation free of federal taxes. In 1996, the year in which the U.S. Congress repealed Section 936, the profits of U.S. direct investments in Puerto Rico were the highest in the world, totaling USD 15.4 billion. The second- and third-ranking economies that contributed profits to U.S. direct investment abroad were the United Kingdom at USD 13.8 billion and Canada at USD 8.6 billion. Yet, measured by GDP, the UK economy was twenty-six times bigger than that of Puerto Rico, and Canada's was thirteen times bigger.[6] Thus, Puerto Rico became by far the most highly industrialized non-independent territory in the Caribbean, and perhaps, with the exception of oil-producing Trinidad and Tobago, the most industrialized in the insular region. The island also enjoyed a high living standard and, as U.S. citizens, Puerto Ricans enjoy free access to the U.S. labor market, where the island's poor and unemployed can move freely to search for jobs and secure higher public welfare benefits.

The island functioned as a unique tax haven, where companies transferred international profits to avoid paying federal taxes on their global income.

The creation of the World Trade Organization (WTO) in 1995 and the repeal of Section 936 in 1996 effectively displaced Puerto Rico from its position of privilege in global value chains. The repeal of Section 936 marked the beginning of the end of unique corporate tax privileges, while the implementation of WTO rules and regulations fostered trade liberalization through free trade agreements and eroded Puerto Rico's free trade advantage with the United States. Before the creation of the WTO, for example, American pharmaceutical companies produced most "miracle drugs" for sale in the U.S. market on the island, as phytosanitary rules required that all medicines consumed in the United States be produced in its territory under supervision of the Food and Drug Administration (FDA). Hence, the privileges of Section 936, combined with the restricted market, gave Puerto Rico a unique competitive advantage for pharmaceutical industries. After the creation of the WTO, all corporations had to be afforded national treatment, and so production of drugs and other products could take place outside of the U.S. phytosanitary territory, as long as the FDA certified the manufacturing plant for production and export to the United States. After China's accession to the WTO in 2001, most pharmaceutical companies relocated operations to that country and other parts of Asia, where production costs were lower and the tax advantages were equal to Puerto Rico's, now covered only by Section 901 of the IRC.

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Between 2000 and 2005, employment in manufacturing fell from 153,000 to 117,000. During the current economic contraction (2006 to 2014), the manufacturing sector lost another 42,000 jobs, falling to 75,000 total, less than 50 percent of the jobs in 2000. Real gross investment decreased by an average of 2.3 percent annually between 2000 and 2014. Between 2006 and 2014, GNP decreased at a rate of 1.5 percent per year; 2012 was the only year when the economy grew again by 0.5 percent.[7] During the crisis, Puerto Rico has experienced a chronic USD 2.5 billion per year budget deficit (3.5 percent of GNP) and now confronts an unfunded pension liability problem of USD 33 billion.[8]

While in 1990 The Political Risk Services Group ranked Puerto Rico the number one competitive jurisdiction in the world, by 1997 had the same organization ranked the island only twenty-second.[9] While the Puerto Rican government opted out of the rankings for a period of time, in 2008 the World Economic Forum Competitiveness Report ranked Puerto Rico number thirty-sixth in the world. Although Puerto Rico in 2008 was the highest ranked jurisdiction in the Caribbean and Latin America, this was a far cry from where the island had been.[10]

The end of metropolitan preferences and protectionism meant the collapse of what had been called the Puerto Rican model of industrialization. Accustomed to preferences and "corporate welfare," the ruling political elite could not adjust to the new international politico-economic environment. Once the showcase of democracy and the cradle of export-led industrialization, Puerto Rico found itself as a marginal link in the global economy. Proposals to reposition Puerto Rico's economy as an international service center and a transshipment complex for goods from Europe and the Americas were not seriously considered. Miami became the American capital of the Caribbean, and Panama the service center for the Americas.

THE PATH TO THE BRINK OF DEFAULT

In order to cover the structural deficit and sustain economic expansion, the government borrowed money to finance public works, issue substantial service contracts, and pay for operational expenses. Puerto Rican government bonds were highly popular among U.S. pension funds and other corporate investors given their exemption from federal, local, and capital gains taxes.[11] Taking advantage of this "triple tax exemption," the Puerto Rican political elite developed three schemes to artificially stimulate economic expansion and sustain party patronage, not just for the average voter but also for the big party contributors.

Beginning with the Rosselló administration (1993-2000) of the New Progressive Party (which favors annexation as the 51st state of the Union), all governments developed mega public works projects financed with debt. Public corporations, such as the Puerto Rico Electric Power Authority (PREPA) and the Puerto Rico Aqueducts Sewers Authority (PRASA), issued bonds to finance major expansion projects. Example of major projects undertaken with bond issues guaranteed with future income to be realized from the fees of these utilities include the "Super Aqueduct" of the PRASA and two natural gas pipelines (*Gasoducto del Sur* and *Vía Verde*) of PREPA, which were intended to deliver natural gas from port to various power plants. Other projects included the "Urban Train" subway, a multi-purpose coliseum, and various municipal projects. Of these, the "Super Aqueduct" was the only functional project. The urban train operates with a large deficit, and the two gas pipelines were never completed, although the materials were

Governments developed mega public works projects financed with debt.

bought and contracts to develop them were issued, as a rule to party donors and affiliates. As a result, thirty-three members of the Rosselló administration were later indicted and convicted of corruption by the U.S. Federal Prosecutor in Puerto Rico. In general, these projects established a "pay-for-play" scheme, requiring contractors to kick back 10 percent of the contracts to the ruling party, a practice that became known as "tithing" (*el diezmo*).

Second, in 2006, a "sales and use" tax was imposed in order to allow refinancing of part of the existing central government debt and guarantee the payment of the new debt. But instead of reducing expenditures and debt, the new taxes were used, for example, to purchase privately owned lands for conservation. In three known cases, these purchases were paid triple over the assessed value of the properties. The sellers were developers linked to the governing Acevedo Vilá administration (2005-2008) of the Popular Democratic Party, which prefers Puerto Rico to remain a commonwealth, the current status of the island.[12]

The third spending scheme was the more traditional issuance of service and consulting contracts by government agencies and municipalities. During the Fortuño administration (2009-2012), in spite of drastic cuts that included the layoff of 17,000 public employees, 25 percent of the budget was spent in service and consulting contracts. Between 2009 and 20012, the Fortuño administration spent a total of USD 12 billion in service contracts, including USD 2.9 billion in "technical services," USD 2.6 billion in "trainings and orientations," and USD 1 billion in public relations.[13]

Major banks and financial brokers assisted the Puerto Rican political elite in their journey to the brink of default. According to Bloomberg, "[b] anks including UBS, Citigroup, and Goldman Sachs, reaped more than USD 900 million in fees to manage Puerto Rico's USD 126.6 billion of bond sales since 2000" A Washington Post editorial adds, "[t]he island's government frittered away funds on unproductive investments and bloated payrolls; Wall Street bankers enabled more borrowing, collecting USD 880 million in fees since 2000; the U.S. government's policy of tax-free status for Puerto Rico bonds, meant to boost its economic development, subsidized the island's habit of living beyond its means."[14]

PUERTO RICO AND GREECE

Although Greece is a sovereign country in a monetary union and Puerto Rico is a post-colonial colony in a relationship of political subordination, both countries confront not merely a fiscal crisis but a crisis of governance, institutions, and political leadership. Puerto Rico is a possession that "belongs to, but…is not a part of" the United States.[15] As such, sovereignty of the island is held not by Puerto Rico, but by the Congress of the United States. Greece is a sovereign country bound by a treaty to the European Community and its monetary union, the Euro.

If we compare Puerto Rico and Greece using a similar database, *The Global Competitiveness Report 2014-15,* the first noticeable difference is that Puerto Rico ranked higher than its European counterpart. This was true also in 2011-12 (Table 1).

Table 1

GLOBAL COMPETITIVENESS: PUERTO RICO AND GREECE (2014-15)[16]

	Puerto Rico	Greece
Global Ranking (2011-12)	**35**	**90**
Global Ranking (2014-15)	**32**	**81**
Basic requirements (20 percent)	**68**	**76**
Institutions	34	85
Infrastructure	58	36*
Macroeconomic environment	99	135
Health and primary education	103	41*
Efficiency enhancers (50 percent)	**28**	**65**
Higher education and training	27	44
Goods market efficiency	20	85
Labor market efficiency	46	118
Financial Market Development	21	130
Technological readiness	37	39
Market size	60	49*
Innovation and sophistication (30 percent)	**27**	**74**
Business sophistication	18	74
Innovation	29	79

At thirty-two, Puerto Rico was the highest ranked jurisdiction in the Caribbean and Latin America. Chile ranks thirty-three; Panama, forty-eight;

and Costa Rica, fifty-one.[17] One possible explanation for this is that businesses in Puerto Rico are part of U.S. transnational value chains, and therefore efficiency enhancers and innovation and sophistication measures are skewed to favor the island's performance. However, the above comparison was made before the Governor of Puerto Rico's announcement that the debt could not be paid, a game-changer for global perceptions of Puerto Rico. In 2013 and 2014, gross investment contracted by 8.2 percent and 6.6 percent, respectively,[18] indicating that investors are losing confidence in the island.

Puerto Rico is ruled by a kakistocracy, where cronyism, nepotism, and pay-for-play practices are common practices.

Table 2 shows that Puerto Rico and Greece share a critical problem of governance. Both entities experience problems of wastefulness, transparency, tax burden, favoritism, and distrust of politicians. In the case of Puerto Rico, bad governance is at the root of the debt problem. Puerto Rico is ruled by a kakistocracy, where cronyism, nepotism, and pay-for-play practices are common practices, as reflected in Table 2 below.

Table 2

PUERTO RICO AND GREECE: GOVERNANCE / INSTITUTIONS [19]

2014-15	Puerto Rico	Greece
Diversion of public funds	44	81
Irregular payments and bribes	44	78
Public trust in politicians	57	106
Transparency of government policymaking	66	120
Country capacity to attract talent	81	127
Favoritism in decision of government officials	83	109
General government debt, percent PIB	104	142
Country capacity to retain talent	106	96*
Government budget balance, percent PIB	109	66*
Wastefulness of government spending	112	131
Total tax rate, percent of profits	116	96*
Business cost of crime and violence	122	45*
Burden of government regulation	138	136
Country credit rating	n/a	119

But there are big differences in the nature and magnitude of the Puerto Rican and Greek debts. First, while Puerto Rico's debt is USD 72.4 billion, Greece's is over EUR 300 billion, over four times as much. Second, Puerto Rico's debt is held by private lenders, while Greece's is held by international financial institutions such as the IMF and the European Central Bank. In other words, the Puerto Rican debt is subject to United States and Puerto Rico federal and state laws, while the Greek debt is a sovereign debt subject to international treaties and regulations.[20]

This substantial difference surfaced in a highly publicized incident between German Minister of Finance Wolfgang Schaulbe and U.S. Treasury Secretary Jack Lew. At a Bundesbank conference in Frankfurt, Secretary Lew argued in favor of the parties coming together and "building enough trust that Greece will take the actions that it needs to take so that Europe will restructure the debt in a way that is more sustainable." Minister Schaulbe replied that "[Germany] would take Puerto Rico into the Eurozone if the U.S. takes Greece into the dollar union." Later he expanded on this comment, saying that, "the United States has no idea what it means to be in a monetary union… In the case of sovereign debts, the European treaties exclude a debt cut. That is a breach of the bailout clause in primary European law."[21]

Although the root cause of the fiscal crisis in both Puerto Rico and Greece is bad governance, there is a vast difference in the financial and juridical contexts of each case. Moreover, both countries have been impacted differently by the new global economy.

WHAT LIES AHEAD

Any attempt to solve the Puerto Rican fiscal crisis will need the intervention of the U.S. Congress, the Department of the Treasury, and the Federal Reserve Bank. The Government of Puerto Rico has not defaulted on its debt yet, but it has established that it cannot make the payments due without major disruptions to essential public services. Thus, it has withheld some payments.

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The Puerto Rican debt is not a single large obligation; it is fragmented and held by public corporations, the central government, and agencies of the insular government. There are different contracts and risk levels. For example, the Constitution of the Commonwealth of Puerto Rico establishes a borrowing limit for the central government of 15 percent of the average revenues of the previous two fiscal years. These are known as government obligations (GOs) and must be paid before any other disbursement is made. But a substantial part of the debt is held by public corporations and state government agencies. This part of the debt is not constitutionally protected, and this is the part of the debt on which payments have been withheld. Non-payment of GOs would mean a constitutional crisis.[22]

The governor's announcement that the debt could not be paid was preceded by intense consultations with experts on municipal bankruptcy processes and mainland-based legal counsel. As part of these consultations, a group of economists led by Ann Krueger, former managing director of the IMF and main proponent of the 2010 Greek economic adjustment plan, prepared the report entitled "Puerto Rico – A Way Forward." The key recommendations of the report were typical of structural adjustment packages: lower labor costs through reductions in minimum wages and benefits, lower energy and transportation costs, reform government, and development of a program of fiscal restraint.[23]

The governor also created the Working Group for the Fiscal and Economic Recovery of Puerto Rico. On September 29, 2015, the Working Group submitted its report entitled, "Puerto Rico Fiscal and Economic Growth Plan." The report projects a cumulative fiscal deficit of USD 27.8 billion between 2016 and 2020 and the exhaustion of government liquidity by the end of 2015. To bridge this financial gap, the report recommends: (1) gradual budget cuts amounting to USD 11.9 billion over the next five years, (2) a labor reform reducing marginal benefits and thus the real wages of workers; (3) a framework for debt restructuring and restoring the competitiveness of the Island, assisted by Congress and the federal government; (4) a reduction in the value of government bonds using a "voluntary exchange" mechanism that would discount the debt and restructure the terms of debt service for bond holders. The report argues further that in spite of all these measures there will be a projected deficit of USD 14 billion and that economic growth, if it happens, would only reduce the cumulative financial gap by a further USD 1.9 billion.[24]

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To implement government and labor reform and to ensure that the difficult decisions needed are taken, the governor submitted to the Puerto Rican legislature the Fiscal Responsibility and Revitalization Act. If this act becomes law, a Puerto Rican financial control board appointed by the governor will monitor its proposed package of reforms. The board would have extraordinary powers to implement the law, as the governor's office relinquishes some of its executive powers to the Board. The proposal has provoked unanimous opposition from political parties and labor unions, which see it as a way to extend the current administration's policies beyond the end of the term in 2016.

Another way to interpret the proposals of the governor's Working Group and the Fiscal Responsibility and Revitalization Act is as political tools for lobbying and negotiating with Congress, federal agencies, and bond holding corporations. The government of Puerto Rico is maneuvering to elicit support in Congress for the enactment of the Puerto Rico Chapter 9 Uniformity Act (HR 5305 in 2014 and HR 870 in 2015) that would allow the island to restructure its debts using the federal bankruptcy laws, which do not currently apply to Puerto Rico. The possibility of Congress appointing a financial control board as it did for Washington D.C. in 1995 has also been floated in Washington as a potential solution.

Bondholders are divided at the moment. Hedge funds are willing to negotiate, and—in the case of the Energy Authority (PREPA)—have agreed to discount the debt by 15 percent and soften debt service requirements over the next five years. This agreement is now under the consideration of the Puerto Rican legislature, as it requires changes in the law regulating PREPA. The original lenders to the government of Puerto Rico, such as Oppenheimer Funds, Goldman Sachs, and Franklin, are opposed to any reductions.[25]

The White House, U.S. Department of the Treasury, and U.S. Congress have stated that they will not set any precedents with a Puerto Rican bailout. Yet, as government default appeared to become a reality, the U.S. President and the Secretary of the Treasury presented a plan to help Puerto Rico restructure its finances. The President's plan supports the approval of a "super" version of Chapter 9 bankruptcy for Puerto Rico that would cover all of the island's debts, not just the debts of its public corporations, and provide the island's residents with an extension of earned-income tax credit and a substantial boost in Medicaid spending in Puerto Rico. Although the Republican-dominated Congress has rejected the proposal, lobbying and maneuvering continue.[26]

A long-term solution to the Puerto Rican crisis must deal with the issues that brought the island to this point: the collapse of a colonial, protectionist politico-economic system in a post-colonial world, that is, the world of globalization. Rafael Cox Alomar, former candidate to Resident Commissioner in Washington and now professor at the David A. Clarke School of Law at the University of the District of Columbia, recently proposed a path to a long-term solution to the crisis. He favors establishing a fiscal control board and solving the political status question:

A long-term solution to the Puerto Rican crisis must deal with the issues that brought the island to this point: the collapse of a colonial, protectionist politico-economic system in a post-colonial world.

> Federal legislation establishing a fiscal control board for Puerto Rico must also contain explicit provisions detailing a fixed timetable for Puerto Rico's decolonization. As soon as Puerto Rico hits the applicable fiscal and economic growth benchmarks, the people of Puerto Rico should face a stark choice between sovereignty and annexation. The status quo must be discarded from the outset because it is both the source of the structural crisis besieging the island and a colonial anachronism at odds with U.S. geopolitical interests in the Americas. The sovereignty formula presents, in and of itself, a dual choice between separate sovereignty and associated sovereignty. The annexation alternative, for its part, would amount to Puerto Rico becoming a "part" of the United States as an "incorporated" territory—bearing in mind that it befalls on Congress to spell out the conditions the island would then have to meet in order to enter the Union as a state on an equal footing with the fifty states.[27]

There are ways out of the crisis. Federal assistance and debt restructuring are only a point of departure for a long-term solution. Government reform should include a redefinition of the status of Puerto Rico and a cleansing from the corrupt political elite that has ruled the island over the past two and a half decades. The reluctance of Washington to assist the island, however, can be attributed in part to the fact that—unlike the Greeks, who ousted their corrupt political elite—Puerto Ricans continue to elect a leadership linked to the bipartisan kakistocracy that brought about its politico-economic collapse. *f*

ENDNOTES

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5 Emilio Pantojas-García, *Development Strategies as Ideology; Puerto Rico's Export-led Industrialization Experience (San Juan and Boulder:* University of Puerto Rico Press, 1990), Chapter 5.

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