Puerto Rico's Debt Bomb. Could Puerto Rico become "The New Greece" in the Caribbean?

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Puerto Rico is heading towards a pivotal moment in history. Standard & Poor's (S&P), a US-based credit rating agency located in New York City has decided to put the Government Development Bank of Puerto Rico concerning the island's debt *"on watch"* concerning its credit rating according to a recent report conducted by Reuters titled 'S&P puts Puerto Rico's ratings on watch for downgrade.'

With a $70 billion debt combined with a weak economy including unfunded pension obligations estimated to be at $30 billion, an unemployment rate holding steady at 14.7% and the population in decline due to Puerto Ricans leaving for the US mainland in search for better opportunities is a formula that will propel the S&P to downgrade Puerto Rico's credit rating. Puerto Rico's credit rating is in jeopardy. The report stated the following:

> The move follows S&P's decision Friday to put the Government Development Bank of Puerto Rico on watch "with negative implications," increasing the chances of a downgrade. Puerto Rico's general obligation and appropriation debt ratings are on watch for a possible downgrade, along with several other ratings, including the territory's employee retirement system

Puerto Rico already has a low grade for investments with triple-B-minus making it one step above junk status. It is also important to note that Fitch and Moody's also downgraded its investment-grade-ratings for Puerto Rico. "The move reflects a view that the commonwealth has become too reliant on its Government Development Bank, which could have limited liquidity by its fiscal year-end of June 30, 2014" the report questions the financial stability of Puerto Rico and what they are facing in terms of their failed economic policies:

> Puerto Rico, battling population decline, chronic recession and perennial budget shortfalls, is under pressure to show it can access the bond market after delaying a debt sale late last year and promising to bring a deal to market by late February. Puerto Rico has about $55 billion of tax-supported debt and another $15 billion supported by other revenue streams, such as water and power rates

If Puerto Rico's credit rating is downgraded to junk status then the crisis *"could trigger accelerated debt repayments and demands for more collateral for interest-rate swap contracts"* the report said. Austerity measures could be possibly implemented if Puerto Rico's credit rating is reduced to junk status as in the case of Greek debt crisis. The Greek population suffered through pension cuts and an increase of the retirement age, civil service pay cuts and job losses, higher taxes and privatization of the Greek government's assets including ports, utilities and even the state lottery system. Anti-austerity demonstrations all across Greece took place resulting in violence. The Government Development Bank for Puerto Rico released a press statement following Standard & Poor's announcement on the same day:

Statement by Government Development Bank for Puerto Rico Comment on S&P Ratings Report

Government Development Bank for Puerto Rico (GDB) Interim President José V. Pagán Beauchamp today released the following statement:

> "As we have stated publicly, the GDB and the Commonwealth of Puerto Rico are comfortable with current liquidity levels and have a variety of options for raising additional liquidity, including a planned return to the public debt markets in the near term. S&P is correct in noting that Puerto Rico's constitution guarantees the payment of GO debt, and Puerto Rico will continue to do everything necessary to honor all of its commitments.
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> "Our administration is continuing its focus on creating sustainable economic growth through job creation, making ongoing progress towards our goal of a structural budget balance by fiscal 2016, and further strengthening our credit profile, market access and liquidity."

In other words more cuts to public pensions and an increase in taxes on every level including big and small businesses and individuals. It also includes interest-rate swaps by either a fixed or floating rate as a payment. In Puerto Rico's case, a fixed rate would most likely be the choice since it limits any possible future risk for investors. The question is how the Puerto Rico government plans to satisfy investors if such agreements are enacted? Perhaps cutting public pensions and raising taxes on businesses and individuals would be some of the options they would most likely consider. Main Stream Media outlet CNBC reported that taxes were implemented or increased on every level:

> As in all debt crises, taxes and fees have gone up on nearly everything and everyone. Personal income taxes, corporate taxes, sales taxes, sin taxes, even taxes on insurance premiums have been hiked or newly imposed."The report also said that "Water rates were hiked by 67 percent in order to improve the solvency of the water company. Government workers and teachers are facing cuts to their pensions

Governor Alejandro Garcia Padilla wrote an article for the Huffington Post titled "Puerto Rico's Economy Is Stronger Today than It Was a Year Ago" claiming that his administration is *"confident that we have taken the right actions to rebuild Puerto Rico toward a brighter future."* Governor Padilla is quite optimistic on the economic decisions he made since he was elected to office. He wrote:

> We have driven the creation of over 25,000 jobs, and we are committed to creating 30,000 more in the upcoming months. Many of these new jobs have been spurred by the first law I passed when I got into office, the Jobs Now Act, which provides new grants, tax exemptions and energy consumption credits to

small, medium and large businesses, both local and foreign-owned

On November 7th, 2013 www.caribbeanbusinesspr.com published a report titled ‘Governor: We’ve Created 25,000 New Jobs’ about Governor Padilla’s claims:

> Gov. Alejandro García Padilla said Wednesday he is more than halfway toward reaching his often-repeated campaign pledge to create 50,000 new jobs during his first 18 months in office.
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> “We have surpassed 25,000 new jobs and there will be more, many more, because we won’t rest until desolation is replaced by the hope for a better, more prosperous and more just Puerto Rico,” he said. The governor said his administration has created 25,256 jobs since taking power in January. “This is a government that awards incentives to those who have the guts to provide jobs to people at a time of pessimism, that stems the emigration of our loved ones and halts the contraction in various economic sectors,” García Padilla said.
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> His comments came during a job fair at the Puerto Rico Convention Center where 5,700 positions were on offer. García Padilla credited the Jobs Now Law, the first piece of legislation he enacted, for spurring nearly 8,000 new posts (1,229 already created and another 6,730 pledged). The governor said the Industrial Incentives Law has prompted expansions by a range of manufacturers — including Covidien, Cooper Vision, Bristol Myers, General Electric and Eaton — that account for 1,643 new jobs and 7,585 pledged jobs. The governor said the Puerto Rico Tourism Company’s support for efforts to boost airlift, land more cruise ship passengers and launch new hotels has created 670 jobs this year.
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> “It fills me with deep pride to be able to say that the agriculture industry is playing a part in job creation and the island’s sustainable economic development for the first time in decades,” he said, touting efforts by his administration for creating 1,146 new jobs and 1,323 pledged jobs in farming. The governor said the permits office has signed off on construction projects that created 13,216 new jobs. A summer employment program for youths accounted for 374 jobs. The governor said 20 government-sponsored job fairs have put 3,203 people to work and drawn dozens of employers to commit to adding more than 4,000 additional posts.

According to the article most of the jobs that were allegedly created came in the form of a pledge which accounted for roughly 20,000 jobs. There is a difference between a pledge to create jobs and actually creating them. When you create a job, a person is at least gainfully employed which naturally reduces the unemployment rate. With 14.7% of people unemployed not counting those who simply gave up looking for jobs and those who had unemployment benefits expire, 25,256 jobs allegedly created is not nearly enough to recover from the last several years of job losses. In regards to Governor Padilla’s Huffington post article he says that *“All of these actions are part of a larger story. My administration has begun to put our economy back on track of sustainable economic growth. Our strategy of creating jobs and economic development has proved to be a winning model to rebuild our economy.”* The Economist magazine published an article back on October 2013 titled ‘Puerto Pobre’ disagrees with Governor Padilla’s assessment concerning his policies:

> The current administration has sought to shore up its finances by increasing

> taxes by $1.1 billion (about 1% of GDP) and raising the retirement age for government employees, as well as the share of their salaries they contribute to their pensions. It has promised to wipe out its budget deficit, projected at $820m this fiscal year, by 2016.
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> Such austerity could further hobble growth, making it harder to shrink debt ratios. Luis Fortuño, the previous governor, lost his job last year partly because of public anger at the cuts he oversaw. Like Greece in the euro zone, Puerto Rico has no control over monetary policy (the preserve of the Federal Reserve), and so cannot mitigate a fiscal tightening with lower interest rates or a cheaper currency.
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> Investors meanwhile are so wary, after years of missed deficit targets, tardy financial reports and accounts opaquer than those of other states that Puerto Rico has had to cut back on new bond issues. It is filling the gap with more short–term bank loans; but they come at punitive rates of interest and must be rolled over more often.

The Government of Puerto Rico has no real economic solution. Raising taxes and trimming public pensions will not fix the economy. Raising taxes on small, midsize and to an extent big businesses and individuals will not increase revenues or promote economic growth because it will only contribute to a worsening situation. Family owned businesses cannot grow if more taxes are imposed on them. Businesses need to make profitable returns so that they are able to reinvest in new equipment, machinery or hire new employees that would enable them to grow. Instead profits will be used to pay taxes which will eventually increase as the economy continues to decline.

But that is not the full story on the Puerto Rico’s new tax hikes. In an interesting article recently published by Forbes called ‘The Obama Administration’s Backdoor Bailout of Puerto Rico’ written by Martin Sullivan, a contributor and also a chief economist for Tax Analysts blog explains a different case of taxation when it comes to US-owned multinational corporations:

> But here’s a little secret that the powers that be inside and outside government don’t want you to know: The Obama administration has already provided a multibillion-dollar bailout to Puerto Rico. Nobody in the major media outlets has noticed because the issue is highly technical. But let me try to give you a plain English explanation.
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> In 2010, as part of his conservative agenda to expand Puerto Rico’s economy, Gov. Luis Fortuño wanted to enact large corporate and individual tax cuts. But like for all wannabe tax cutters, it was extremely difficult for him to identify ways to pay for those tax cuts, especially since Puerto Rico’s finances were in terrible shape. The governor appointed a tax reform commission and hired the Washington law firm of Steptoe & Johnson to advise it. Steptoe devised a plan whereby the Puerto Rican government would impose an excise tax on U.S. companies that operated manufacturing facilities in Puerto Rico. The excise tax was first revealed to the public on October 22, 2010. The legislature approved it the following day, and it was signed into law on October 25. The tax was estimated to raise approximately $6 billion over five years.
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> According to Steptoe & Johnson and the Puerto Rican government, the burden on U.S. companies would be minimal because the new tax paid by U.S. multinationals to Puerto Rico would reduce U.S. taxes by the same amount. For

> income tax purposes, Puerto Rico is considered a foreign jurisdiction, and foreign taxes can be creditable against U.S. tax. So in effect, the new tax would be paid by the U.S. treasury, not U.S. companies.
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> The Puerto Rico government's excise taxes were then approved claiming that that it would not affect US multinationals in any way. The US Treasury did not offer any "legal opinion" and would have to analyze the new tax law "On March 30, 2010, Notice 2011-29 was issued. In the notice, Treasury provided no legal opinion. The notice stated that the tax was "novel" and that Treasury would have to study it. But it the meantime, U.S. multinationals manufacturing in Puerto Rico could credit the tax until further notice." The report also said there has not been any action on part of the treasury:
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> Now, three years and billions of dollars later, there has been no further notice. Nor is there any prospect of any. Without committing itself to a legal position, Treasury has provided certainty that has enabled Puerto Rico to raise taxes in the most politically painless way imaginable. That being the case, in February 2013 the government enacted new legislation that extended the tax to 2017 — it was originally scheduled to expire in 2016 — and raised its rate. The revised tax is estimated to raise nearly $2 billion per year, more than 20 percent of Puerto Rico's general revenue.

According to another article by Martin Sullivan on wwww.taxanalysts.com, an online non-profit publisher that focuses on tax policies on a global scale explained the Puerto Rico government's actions regarding tax policies within the Padilla administration:

> In the November 6, 2012, gubernatorial election, Fortuño fell short of securing reelection by a margin of 11,000 votes out of about 1.8 million cast. On January 2, 2013, he was succeeded by Padilla, who became the 11th elected governor of Puerto Rico. Later in January, after receiving clearance from Puerto Rico's Government Ethics Office, Fortuño became a partner in the Washington office of Steptoe & Johnson.
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> Despite Fortuño's efforts at downsizing the government and stimulating growth, the Padilla administration had a mess on its hands almost as bad as in 2009. Between January 2010 and January 2013, the Puerto Rican economy shed 46,000 jobs — a decline of 4.4 percent during a period when employment in the 50 states increased by 4.2 percent. And with a budget deficit of $2.2 billion, the government still had an unacceptably large amount of red ink. Unless there were fiscal reforms, the bond rating agencies were threatening to downgrade Puerto Rico's already low credit rating even further.
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> To address the crisis, the Padilla administration promptly enacted a large tax increase, including new taxes as well as an increase in individual and corporate rates. All together, these measures were estimated to raise $1.4 billion in fiscal 2014. And despite Padilla's opposition to the tax before the election, the new revenue in his plan included an increase in and extension of the excise tax under Act 154. Under the legislation unanimously approved by the Puerto Rican House of Representatives and enacted in February 2013, the excise tax rate was increased from 2.75 percent to 4 percent for the rest of calendar year 2013. And instead of the rate declining to 1 percent in 2016 and the entire tax expiring at the end of that year, the rate was frozen at 4 percent and the life of the tax extended to the end of 2017.
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> The report also said that there was a "Backlash" regarding multinational corporations operating in Puerto Rico regarding Act 154 and the imposition of the new tax plan:

> The government of Puerto Rico repeatedly asserted that the new tax would be minimally burdensome because, based on the opinion letter from Steptoe & Johnson, it would be creditable against U.S. income tax. Despite this, manufacturers in Puerto Rico, their parent companies, and business groups were incensed. They were angry over the lack of consultation, the precedent set for other jurisdictions, and significant uncertainty about creditability. Even if the IRS did agree that the new tax was creditable, manufacturers with foreign parent companies often would be unable to credit it.
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> "Puerto Rico has historically proven itself to be a center of excellence in attracting foreign investment and venture capital from innovative bioscience companies and investors," said Jim Greenwood, president and CEO of the Biotechnology Industry Organization, in an October 27, 2010, statement. But "this new tax increase will profoundly affect the decision-making of foreign corporations as they consider whether to continue to do business and deploy their capital in Puerto Rico."

I am not defending multinational corporations in any sense; the point here is that many US corporations do not pay a fair share or no taxes at all in many cases not only in Puerto Rico, but worldwide. According to Sullivan's article published by Forbes, he clearly states who is in favor of Puerto Rico's tax system:

> A lot of powerful interests like the current situation. They include the government and both major political parties in Puerto Rico, the Obama administration, investors in Puerto Rico's municipal bonds, and U.S. multinationals that can credit the tax. The only ones on the short end of the stick are U.S. taxpayers, who are footing the bill that they would probably be unwilling to pay if they were ever asked

Not only has an increase of taxes seems problematic; reducing public pensions and raising the retirement age to collect pensions will also cause more anger among the population as teachers who went on strike recently proved. It will lead to more protests which could spiral out of control.

Can Puerto Rico become the New Greece in the Caribbean?

Greece is a perfect example of what can happen in Puerto Rico. On April 2010, Greece was downgraded to junk bond status which rattled the financial markets worldwide. Bond yields rose dramatically creating uncertainty among private capital markets that were reluctant to provide funding to keep the Greek government operating. The European Union (EU) and the International Monetary Fund (IMF) bailed out Greece with a €110 billion on May 2010 that resulted in austerity measures, the privatization of government assets and structural reforms that caused large demonstrations all across the nation. It eventually led to another bailout of €130 billion so that the EU, the European Central Bank (ECB) and the IMF can assist in the funding of Greece's finances until 2014. The second bailout was for the purpose of regaining the trust of private capital markets to refinance its debts and further assist the Greek government with additional funding for its daily operations. The Economist compared Puerto Rico to Greece's situation back on October 2013 in an article titled 'Greece in the Caribbean' and stated how they compare with each other financially:

> Puerto Rico, an American territory, risks a Greek-style bust. With $70 billion of debt outstanding, the equivalent of 70% of its GDP, it is more indebted than

> any of America's 50 states. (Puerto Rico is not technically a state, but its bonds are treated as if it were.) Yields on its bonds have soared as high as 10%, as investors fret it may be heading for a default.
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> Like Greece, Puerto Rico is a chronically uncompetitive place locked in a currency union with a richer, more productive neighbour. The island's economy is also dominated by a vast, inefficient near-Athenian public sector. And, as with Greece, there are fears that a chaotic default could precipitate a far bigger crisis by driving away investors, and pushing up borrowing costs in America's near-$4-trillion market for state and local bonds. Yet the Hellenic comparison is also helpful: it should show the Americans what not to do.

One of Puerto Rico's main industries is government (non-productive), which employs at least 20% of the population, manufacturing (pharmaceuticals, textiles, electronics etc) accounts for at least 48.6% as of 2011 which is dominated by large U.S. multinationals including pharmaceutical and medical device manufacturers. According to an article by www.caribbeanbusinesspr.com titled 'Manufacturing at a crossroads' stated what the reality was in terms of its pharmaceutical industry:

In fact, the number of jobs in the pharmaceutical sector has steadily declined in the past five years to 19,725 in August 2010, down from 28,567 in 2005, according to the U.S. Bureau of Labor Statistics Establishment Survey. Such employment was as high as 29,100 in 2004. The pharmaceutical sector generates another 90,000 indirect jobs, according to the Puerto Rico Pharmaceutical Industry Association (PIA).

> The nearly 20,000 jobs in the pharmaceutical industry made up 22.4% of the island's 89,400 manufacturing jobs and 2.2% of the total 921,500 nonagricultural salaried jobs, according to commonwealth Labor Department figures issued in September 2010.

Although Puerto Rico still has US Pharmaceutical corporations operating on the island, it does not provide enough employment opportunities for the Puerto Rican people. However, Raising their taxes would force them to leave taking with them much-needed jobs to other countries. Puerto Rico's services industry, including those working in restaurants and in the tourism industry (which do not produce goods for export markets) accounts for more than 25%.

In a New York Times report '$2 Billion Deal in Works for Puerto Rico' published earlier this month stated that Morgan Stanley is currently negotiating a financial deal and *"have been reaching out to about a dozen hedge funds, private equity firms and other large investors to gauge their interest in providing up to $2 billion in financing to Puerto Rico."*

The report also said that *"the debt could carry yields as high as 10 percent" which is "double what a highly rated city or state pays to borrow in the current municipal debt market."* Robert Donahue, managing director at Municipal Market Advisors said that *"It's unprecedented"* and that *"It's a reflection of the increasing realization that Puerto Rico has exceeded the risk appetite of the traditional municipal bond market"* according to the NY Times report. Investors are taking a risk if they decide to invest in Puerto Rico's debt since they are at risk of default. With a $2 billion deal comes austerity measures (pension cuts), privatization of public assets that includes the energy sector and raising taxes. Puerto Rico is starting to resemble Greece.

If Puerto Rico's credit is downgraded to Junk status, severe repercussions would follow. The details of the deal have yet to surface because *"a spokesman for the Government Development Bank for Puerto Rico, which oversees debt deals for the island, declined to comment. A Morgan Stanley spokeswoman also declined."* This is obviously not a good deal for the Puerto Rican people since none of spokespersons for both parties involved in the talks had no *"comments"* on the matter. Who will buy Puerto Rico's long-term debt next month is the question?

Back on October 15th, 2013, The Puerto Rico government hosted a webcast presentation to update the public on its economic status where Governor Padilla said *"We will do everything, and I repeat, everything that is necessary for Puerto Rico to honor all its commitments," he said. "It's not only a constitutional but also a moral obligation."*

Since the Government of Puerto Rico has a *"moral obligation"* under the constitution then the residents of the island nation would have to let their government cut their pensions, raise taxes, privatize public assets that would increase energy and water rates and allow Washington to financially control the entire economy on Wall Street's behalf. It will lead to social unrest as the people realize their livelihood has been sacrificed under austerity measures imposed by the Puerto Rico Government with Washington's support to meet its financial obligations. Puerto Rico will inevitably face its greatest depression in the future. Puerto Rico is a financial *"powder keg"* ready to explode in the heart of the Caribbean. Its economic downturn will rattle world markets especially in the US.

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