

# The Puerto Rico crisis, explained

## *The Week Staff*

REUTERS/Alvin Baez

March 27, 2016

*The U.S. territory can't pay its debts and will soon run out of money. How did it get into this mess? Here's everything you need to know:*

### **How much does Puerto Rico owe?**

The island has more than \$72 billion of debt — nearly 100 percent of its total annual economic output — and an estimated \$30 billion shortfall in its state pension fund. Two government agencies have already defaulted on debts, and a \$2 billion payment is due on July 1. There's no way the territory will make it. Unemployment is over 12 percent and would be twice as high if so many Puerto Ricans hadn't taken advantage of their U.S. citizenship and moved to the mainland to find work. The poverty rate is 45 percent, compared with 15 percent stateside, and half of P.R. residents are on Medicaid. "We have no cash left," Gov. Alejandro Padilla said in a December appeal for help to the U.S. Senate. "This is a distress call from 3.5 million Americans who have been lost at sea." It's not just Puerto Ricans at risk of suffering: Two-thirds of U.S. pension and retirement funds hold Puerto Rico government and municipal bonds, and could lose billions of dollars if the island can't service its debts.

### **Why did it take on so much debt?**

Because it could. For decades, Puerto Rico issued bonds to cover budget shortfalls, and investors snapped them up because the bonds are exempt from federal, state, and local taxes in all 50 states. Then in 1996 the territory hit an economic crossroads. Congress ended hefty tax breaks for U.S. manufacturers operating in Puerto Rico, and American firms began shuttering their operations on the island, causing the economy to slump. Instead of restructuring its economy, Puerto Rico doubled its debt over the next 10 years, and Wall Street firms made nearly \$1 billion off the fees. Those bond sales let the territory's bloated government — which employs a quarter of the workforce — meet its budgets without laying people off. But the economy remained stagnant, and the government was soon overwhelmed by its vast debt obligations.

### **How have islanders reacted?**

Puerto Ricans with means and education are fleeing for the mainland. The island has lost some 440,000 people in the past decade, with about 1,200 decamping every week in 2014. Many have moved to Florida, which could make that state's demographics more favorable for Democrats in November's presidential election. (Puerto Ricans can't vote for president if they live on the island, but can if they move to a U.S. state.) With growing debt and a shrinking number of taxpayers, the island appears trapped in an economic death spiral. Those who stay face ever-higher bills: The sales tax rose last year from 7 to 11.5 percent — the highest in the country — and water and electricity rates have spiked. The foreclosure rate is soaring. "People are literally leaving their homes empty with the keys in the house," says resident Maria Milagros Rodriquez.

### **Could Puerto Rico go bankrupt?**

No. Like states, the commonwealth of P.R. cannot file for bankruptcy. But while municipalities on the mainland are allowed to seek Chapter 9 bankruptcy protections — the process Detroit used in 2013 to shrink and restructure its debt — a quirk in federal law bans Puerto Rico's towns and cities from doing the same. The Obama administration has proposed extending Chapter 9 protections to the island, which would cover about a third of its debt. Senate Democrats have gone further, putting forward two bills last week that would give Puerto Rico the power to restructure all its debt and let its governor decide which debts to pay first. But hedge funds and other large bondholders oppose this plan, as do many Republicans. "If we rewrote the rules on Puerto Rico's

sovereign debt now, what would that do to the sovereign debts of the 50 states?" says Rep. Thomas McClintock (R-Calif.). If banks got spooked and raised borrowing costs for all U.S. states and territories in response, he says, "that could sink a state like California." Republicans want the island to tackle its debt crisis by cutting and reforming government spending.

### **How much spending could be cut?**

A lot. Puerto Rico has made some bad financial decisions. The island's government-owned power utility, for example, has piled up \$9 billion in debt by providing free electricity to all municipalities and government-owned enterprises — although not to Puerto Rico's citizens. Because municipalities haven't faced electricity bills, they have happily invested in energy-intensive, economically dubious projects. Authorities in the city of Aguadilla operate a water park billed as the biggest in the Caribbean, a minor league baseball stadium illuminated by floodlights, and — believe it or not — an ice-skating rink. "Imagine how much it costs to have an ice-skating rink in the tropics," says economist Sergio Marxuach.

### **What happens if the debt crisis isn't resolved?**

The Obama administration has warned of a potential humanitarian crisis. Puerto Rico could find itself having to choose between funding health-care services, schools, and police and servicing its debt. Meanwhile, a default would set off a tsunami of litigation as hundreds of creditors sue the government. "Without a referee in the form of a bankruptcy court, it's going to be a mess," says Frank Shafroth, a public policy expert at George Mason University. Marielys Feliciano, a single mother of four who works in construction, is planning to take her family to the mainland. Last summer, her local school was shut to cut costs; she now has to wake at 4 a.m. to get her kids to another school. "I see the future here, and the doors are closing," she told *Bloomberg*. "I can't limit my kids to a place where there's no future."

### **A nonfinancial threat to the island**

As if Puerto Rico didn't have enough woes, the Zika virus sweeping Latin America has now hit the island. At least 249 cases of the mosquito-borne virus — which has been linked to paralysis and debilitating birth defects — have been confirmed since December. That number is expected to skyrocket when the rainy season starts in April, and tourism officials say they have already seen visitors cancel weddings and business conferences over fears of an outbreak. The debt crisis has left Puerto Ricans especially vulnerable to Zika. Many poor residents can't afford window screens, exposing them to almost constant bites. The island is also littered with hundreds of abandoned homes with water-collecting birdbaths and pools, perfect mosquito breeding grounds. "Before the year is out," says Tom Frieden, director of the Centers for Disease Control, "there could be hundreds of thousands of Zika infections in Puerto Rico."