
America's Forgotten Colony

Ending Puerto Rico's Perpetual Crisis

Antonio Weiss and Brad Setser

When Hurricane Maria struck Puerto Rico in September 2017, Americans on the mainland were horrified by the scale of the damage—thousands of deaths, hundreds of thousands displaced, millions left without electricity, and, by some estimates, economic losses as high as \$90 billion. What few registered, as the hurricane's toll and the shocking inadequacy of the U.S. government's response became clear, was an underlying cause of Puerto Rico's condition: that the island is still effectively a U.S. colony.

Since 1898, when Washington took possession of it at the end of the Spanish-American War, Puerto Rico has been neither granted sovereignty nor fully integrated into the United States. Instead, it has remained an "unincorporated territory," a place that is simultaneously a part of, yet apart from, the rest of the country. Residents of Puerto Rico are U.S. citizens, subject to federal laws and eligible for the draft, but they do not enjoy the same political rights as their fellow Americans. They have only one, nonvoting member in the House of Representatives, and although they can vote in U.S. presidential primaries, they have no Electoral College votes in the general election.

Without any say in the federal policies that govern it, Puerto Rico has for decades been neglected by Washington. Such neglect has been costly: even before Maria, Puerto Rico's economy had been in sustained decline for years. Between 2004 and 2017, economic

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The 51st state? At a political rally in San Juan, November 2012

output dropped by 14 percent. If Puerto Rico were measured as a country, that decline would rank among the worst in recent history for a nation not at war. This economic crisis has sparked a wave of out-migration: Puerto Rico's population has fallen from over 3.8 million in 2006 to less than 3.2 million today. The island has a poverty rate double that of Mississippi, the poorest U.S. state: around 45 percent of Puerto Rico's residents and 56 percent of its children live below the federal poverty line.

The status quo cannot continue. The United States' continued economic and political neglect of the island is a stain on the country's moral authority. Puerto Rico did not choose to enter the United States—it was conquered in an expansionist war, and its wishes have been ignored ever since. For the United States to remain a voice for democracy and self-determination on the international stage, it must end its unjust colonial relationship with Puerto Rico and the damaging purgatory that the island's current status represents.

The decision over the island's future should be left to the people of Puerto Rico themselves, as it is a question not just of economics but also of identity, heritage, and values. But however complex the process, the U.S. government must commit to working with Puerto Rico to resolve the island's status once and for all. Americans on the mainland must stand ready to support whatever choice the Puerto Rican people make—

whether that's revising the current commonwealth status, becoming an independent nation, or joining the federal union as the 51st U.S. state.

A QUESTION OF STATUS

In 1898, the United States won the Spanish-American War and forced Spain to cede control of Guam, the Philippines, and Puerto Rico. Sovereignty over Puerto Rico was transferred to Congress, which under Article 4 of the U.S. Constitution has plenary power over all "Territory or other Property belonging to the United States." Immediately, the federal government had to determine the constitutional standing of the newly acquired territories.

In a series of controversial decisions known as the Insular Cases, the Supreme Court resolved this question by distinguishing between incorporated territories—those destined for eventual statehood, such as Hawaii—and unincorporated territories, including Puerto Rico. Although the Court ruled that the fundamental personal freedoms guaranteed by the Constitution extended to individuals in the unincorporated territories, those territories would not automatically enjoy the full scope of constitutional protections, such as birthright citizenship and the right to a trial by jury. There was a clear racial dimension to the rulings: in the opinion for the Court in the 1901 case of *Downes v. Bidwell*, Justice Henry Billings Brown worried that if Puerto Rico were recognized as part of the United States, then its inhabitants, "whether savages or civilized," would be "entitled to all the rights, privileges and immunities of citizens." In a prescient dissent, Justice John Marshall Harlan attacked the majority ruling for allowing Congress to "engraft upon our republican institutions a colonial system such as exists under monarchical governments."

The United States initially appointed a colonial government in Puerto Rico. But local resistance led to the Jones Act of 1917, which granted the inhabitants of the island U.S. citizenship and created a popularly elected Puerto Rican Senate. In 1947, Congress passed legislation allowing Puerto Ricans to elect their own governor. Three years later, driven in part by a desire to comply with UN rules related to the self-government of territories, it permitted the Puerto Rican legislature to draft its own constitution, subject to congressional approval. Since ratification of its constitution in 1952, Puerto Rico has officially been called a "commonwealth" in English, yet its Spanish title of "free associated state" implies a degree of autonomy that Wash-

ington, despite patchwork reforms, has consistently failed to grant it.

The question of status has long defined Puerto Rico's own politics. Its main political parties are centered on their support for statehood or commonwealth status, and policies are routinely designed and discarded in view of their implications for one or the other position. The island has held five nonbinding referendums on its status. The first two, in 1967 and 1993, indicated a preference for the commonwealth option, but in the third, held in 1998, "none of the above" won just over half the vote. More recent votes have appeared to show greater support for statehood. In 2017, for instance, in a referendum designed by the current, pro-statehood government, statehood received 97 percent of the vote, but turnout was a mere 23 percent, as both pro-independence and pro-commonwealth parties boycotted the referendum.

The federal government, for its part, has been largely content to maintain the colonial relationship. In response to the 1967 referendum, in 1970, U.S. President Richard Nixon created an ad hoc advisory group on Puerto Rico, which recommended that residents of Puerto Rico be allowed to vote in U.S. presidential elections. But that proposal failed to receive congressional support, and a later recommendation to grant the island greater autonomy was rejected by Nixon's successor, Gerald Ford, who favored statehood. Over the past three decades, Congress has periodically considered legislation to address the status of Puerto Rico, but the only measure ever passed was a small appropriation in 2014 that provided federal funding for a vote without any commitment to act on the results. And so the status quo prevails.

A HISTORY OF NEGLECT

The United States has not only asserted political sovereignty over Puerto Rico; it has fundamentally shaped the island's economy. Puerto Rico's currency is the U.S. dollar, its major banks are supervised by U.S. regulators, and its commerce with the 50 states is governed by U.S. law. When a foreign good enters Puerto Rico, it clears U.S. customs and faces no further duties or trade restrictions. The federal minimum wage has applied in Puerto Rico since 1983. Puerto Rican residents can move freely within the United States, and Americans can visit Puerto Rico without a passport. Yet the island is not fully integrated with the mainland: for income tax purposes, Puerto Rico is legally offshore. Companies operating in Puerto Rico pay no federal income tax on profits earned on the island. And although Puerto Ri-

can residents pay local and U.S. payroll taxes, most do not pay federal income tax. As a result, they receive only some of the federal benefits available to Americans on the mainland—Social Security, for example, but not Supplemental Security Income.

At times, Puerto Rico has benefited from its economic ties with the United States. After World War II, a number of manufacturers opened

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factories in Puerto Rico, drawn by the island's low wages, increasingly skilled work force, and tariff-free access to the U.S. market. Average annual growth topped five percent in both the 1950s

and the 1960s, and income levels, although low compared with those on the mainland, were far higher than those in the rest of the Caribbean. Many viewed Puerto Rico as the capitalist and democratic answer to communist Cuba.

Yet the island's postwar boom was not built to last. Puerto Rico's growth was heavily dependent on federal policies that shielded it from international competition. These policies began to change after the 1970s, when the United States became more deeply integrated into the global economy. In 1973, when the United States abandoned its oil import quota system, which had privileged Puerto Rican oil imports and thus helped stimulate the island's economic development, Puerto Rico's sizable petrochemicals industry collapsed.

As Puerto Rico's traditional manufacturing sectors were exposed to global competition, the island became more and more dependent on its status as an offshore tax haven for U.S. firms. A 1976 change to the U.S. tax code, Section 936, allowed firms to repatriate income earned in Puerto Rico to the U.S. mainland without paying taxes. This made the island an attractive destination for U.S. companies, particularly those in the pharmaceutical industry, which could transfer intellectual property rights for a valuable drug to a Puerto Rican subsidiary, manufacture the drug in Puerto Rico, charge a high markup on its sales to customers on the mainland, and then repatriate the tax-free profit. Over time, other high-profit industries reliant on intellectual property also took advantage of Puerto Rico's tax status—but they failed to generate much local employment.

As a result, even with these tax incentives, Puerto Rico in the 1970s and 1980s never replicated the rapid, broad-based growth of the 1950s and 1960s. By the time the United States repealed Section 936 (through

a ten-year phaseout ending in 2006), the federal policies that had supported the Puerto Rican economy—high external tariffs, oil import quotas, and tax-free repatriation of offshore profits—were all gone. When the island's real estate bubble burst in 2008, Puerto Rico's economy collapsed, and then continued to decline even as the mainland recovered. Not surprisingly, the island's government began facing persistent revenue shortages and budget deficits, which it financed through excessive (and often hidden) borrowing and through sales of whatever marketable assets remained in its already depleted public pension system. Between 2005 and 2017, the island's total public debt rose from \$35 billion to over \$70 billion, or \$20,000 for every Puerto Rican. The last time that Puerto Rico tried to issue bonds, in 2014, the three major U.S. credit-rating agencies scored them as junk.

Puerto Rico has made its share of policy mistakes. The island's government never fully mastered its own finances, lacking modern systems to control and monitor spending by its constituent parts. It entered into shortsighted, opaque tax agreements with multinational corporations that sacrificed long-term revenue in order to address short-term budget shortfalls. It cut public investment as the economy shrank, weakening the island's infrastructure, and forwent critical initiatives, such as modernizing Puerto Rico's dangerously outdated electrical grid. But the U.S. government also bears a great deal of responsibility for the island's plight. When federal policies that aided Puerto Rico's economic development were repealed, no enduring replacements were put in place. Washington largely ignored Puerto Rico until it was clear that the island was in severe financial distress and would default on its debt without the protections granted to U.S. municipalities when they file for bankruptcy. In 2016, well before Maria, Congress passed legislation to create a process akin to bankruptcy that would allow the island's debt to be restructured in court. It also established an oversight board responsible for supervising the island's finances and ensuring that it would eventually regain access to credit markets. Although necessary to gain bipartisan support for the bill, the creation of the board—with seven members appointed by the U.S. president—was a stark reminder of the island's colonial status.

Yet Congress did nothing to address Puerto Rico's incomplete integration into the federal safety net, leaving the island's residents more exposed to poverty than U.S. citizens on the mainland. Residents of Puerto Rico do not receive the federal Earned Income Tax Credit,

which supplements the income of poor Americans. EITC benefits can be substantial: on the mainland, a family with two children earning the Puerto Rican median income of \$20,000 would receive around \$5,600 in tax credits every year. And although Puerto Rico participates to varying degrees in other federal safety net programs, including Medicaid and Medicare, a 2014 study by the Government Accountability Office estimated that Puerto Rico received between \$1.7 billion and \$5.4 billion less in annual federal benefits than it would if it were a state.

FIRST THINGS FIRST

The first priority for both U.S. and Puerto Rican policymakers must be to reduce the commonwealth's overwhelming debt burden, which, measured both in per capita terms and relative to GNP, is far higher than that of any U.S. state. Puerto Rico's contracted debt service amounts to around 20 percent of its annual revenue, compared with below five percent for the average state. Now that Puerto Rico has entered the bankruptcy-like process set out by Congress in 2016, it should be able to reduce its debt. But there is no guarantee that once Puerto Rico, the oversight board, and various creditor groups agree to a debt restructuring, the island will emerge with a truly sustainable debt burden.

After the debt has been restructured, the island must gain access to federal funds to rebuild its critical infrastructure. Since Hurricane Maria, Puerto Rico has been promised substantial federal disaster aid over the coming decades. Although the total amount of this aid could reach over \$80 billion, only half has been authorized by federal agencies, and just over \$10 billion had reached the island by the start of 2019. It is crucial that this money be used to modernize the island's outdated infrastructure rather than to service legacy debts. The Puerto Rico Electric Power Authority, for example, currently uses 40-year-old power plants that burn oil to generate much of Puerto Rico's electricity. This electricity is then delivered across the island's uneven and forested terrain via large transmission lines, which are vulnerable to hurricane-force winds. Puerto Rico's electrical grid is thus exposed both to higher oil prices and to damage from natural disasters. Puerto Rico needs to improve its electricity generation, reduce its dependence on imported energy by investing in renewables, and create a resilient power grid that can withstand future hurricanes.

Puerto Rico's government should also take measures to improve the environment for business, while recognizing that now is not the time

to implement austerity measures or punitive labor-market reforms. The economic stimulus provided by post-Maria reconstruction should result in a short-term increase in the island's tax revenues, allowing the government to avoid some previously planned budget cuts, including in its educational and health-care systems. Proposals to reduce Puerto Rico's minimum wage, advocated by some economists, or increase its at-will employment, pushed by the oversight board but rejected by Puerto Rico's elected representatives, would be less likely to stimulate economic growth than measures such as the introduction of a federally sponsored EITC.

THE ROAD AHEAD

The immediate economic crisis must be addressed through an ambitious program to restructure Puerto Rico's debt, rebuild its infrastructure, and revitalize its economy. But the path forward will be sustainable only if the island's political status is finally resolved. Although it is for the people of Puerto Rico to decide their future, the federal government has a responsibility to work with them to develop options for a referendum and clarify how each option would be implemented if chosen. The federal government must also make clear that the vote will result in action. Washington must commit, for the first time, to respect the will of the Puerto Rican people, regardless of which path they choose.

None of the options for addressing Puerto Rico's status is straightforward. Each raises complex economic, cultural, and constitutional issues and would require a multiyear transition process, designed together with the people of Puerto Rico. Yet however challenging it may appear, the task is a necessary one.

The first option for resolving Puerto Rico's status is to revise the current commonwealth arrangement. The initial step for such a revision would be to address the island's broken economic model. The federal government, for instance, must be willing to provide additional funds for Puerto Rico's health-care system, which currently relies on Affordable Care Act and Hurricane Maria relief appropriations that will soon run out. A revised arrangement should also ensure that any corporate tax incentives be tied to the creation of jobs in Puerto Rico, rather than providing multinational companies with a convenient tax haven.

Such changes to the economic relationship could be enacted through congressional legislation, but they would not by themselves end the island's colonial status, as a future Congress could overturn

or change them without Puerto Rico's consent. A revised arrangement would need to provide Puerto Rico with greater control over its destiny, through increased local autonomy, a more meaningful voice in the development of national policy, or both. Accomplishing this would arguably require an amendment to the U.S. Constitution, as over a century of federal actions and judicial decisions, including two recent Supreme Court cases, have suggested that Congress will continue to have absolute authority over Puerto Rico under the current constitutional arrangement. An amendment should enshrine Puerto Rican residents' equal status as American citizens with specific rights to self-government, voting representation in presidential elections, and equal treatment in social safety net programs. There is some precedent for such an amendment: the 23rd Amendment, ratified in 1961, guaranteed residents of Washington, D.C., representation in the Electoral College. Yet a constitutional amendment requires approval by two-thirds of both houses of Congress or two-thirds of the states and then ratification by three-quarters of the states—a high bar, but one that has been cleared 27 times.

The second option, independence, has relatively limited support within Puerto Rico, judging from the most recent polls. Independence would offer full policy autonomy, including, if Puerto Rico so desired, an independent central bank, a floating currency, and the ability to craft its own labor, tax, and trade policies. These would, in theory, allow Puerto Rico to set economic policies based on its own needs, rather than those of the broader United States. In practice, however, autonomy would require thorough reform. The benefit of a floating currency, for example, would be limited so long as Puerto Rico's debt was still denominated in dollars, as any depreciation of the island's currency would increase the cost of its debt.

Full independence would come at a cost, as Puerto Rico receives substantial economic benefits from being part of the United States. Before any referendum, the federal government and Puerto Rico would have to agree on how independence would be carried out, including a realistic timeline, a plan to replace or maintain the functions currently carried out by the federal government, and clarity about how the federal benefits that currently flow to Puerto Rican residents would be funded during the transition and maintained by the Puerto Rican government after independence. The two parties would also have to define their future trade relationship and deter-

mine whether Puerto Rican residents would retain their U.S. citizenship and the right to travel freely to the United States.

At the opposite pole from independence is statehood. Statehood provides a clear alternative to Puerto Rico's current patchwork of partial federal taxation and access to federal benefits. But it has been nearly 60 years since the last state, Hawaii, was admitted to the federal union, and there are several open questions related to possible Puerto Rican statehood that should be resolved prior to any referendum.

A crucial question is how the United States would respond to a vote in favor of statehood, as admission requires a joint resolution of Congress signed by the president. Washington must make clear that it is prepared to embrace Puerto Rico as a member of the union, including by granting it full congressional representation. Puerto Rico would immediately become the 30th-largest state by population, with two senators and perhaps five representatives. Statehood would also give Puerto Rican residents access to full federal benefits, including the EITC, Medicaid, and Medicare.

There has long been skepticism that statehood could gain sufficient bipartisan support, given Republican fears that most Puerto Ricans would vote for Democrats. But although U.S. President Donald Trump has voiced his opposition to statehood, previous Republican presidential candidates and party platforms have consistently supported it. In 2018, for instance, the Republican leadership of the House Committee on Natural Resources, which has jurisdiction over U.S. territories, called on the Department of Justice to oversee a Puerto Rican plebiscite on statehood.

If Puerto Rico became a state, its residents would receive full federal benefits, equal to those enjoyed by citizens on the mainland. Puerto Rico's population is already aging, and with a low birthrate and high levels of out-migration, the island will soon have the oldest population in the United States. It would benefit in particular from expanded access to federal health-care funding. Many Puerto Rican families would also receive significant EITC benefits when filing federal income taxes. Access to the EITC would not only alleviate poverty but also, by adding incentives for lower-income individuals to work, increase the island's labor-force participation rate, which, at about 40 percent today, is only two-thirds of the average on the mainland.

Perhaps the most difficult economic aspect of statehood would be the integration of Puerto Rico into the U.S. tax system. Even after the repeal of Section 936, firms operating in Puerto Rico can avoid

U.S. corporate income tax, paying the much lower “global minimum” rate applied to foreign intangible income. If Puerto Rico were a state, however, firms operating there would be subject to the federal income tax, eliminating their incentive to shift operations to the island. Individual residents of Puerto Rico would also have to pay federal income tax, making it hard for the island to maintain its high local individual income tax rate, which currently has a top marginal rate of 33 percent. Statehood could put at risk nearly \$5 billion of Puerto Rico’s annual revenue, or about one-third of its total. To help the island continue to cover its debt and pension obligations, the federal government would have to make up for a portion of the lost revenue, at least during the initial transition to statehood.

At its core, status is a question of ideology and identity. Resolving Puerto Rico’s status is not an alternative to restructuring its debt or revitalizing its economy. It is, however, a critical step in allowing Puerto Rico to chart a sustainable long-term economic course. And for the United States, which has ruled Puerto Rico as a colony for over a century, giving the people of Puerto Rico the chance to decide their own future is not only a wise policy decision—it is, for a country that prides itself as the leader of the free world, a moral imperative. 🌐