

What in the past 50 years has led to the economic recession of Puerto Rico and how has hurricane Maria impacted the island?

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Abstract:

The economic state of a major United States possession, Puerto Rico, is in jeopardy. To understand the potential implications of its financial stress on the government and citizens of the U.S. one must study the island's history. The following thesis chronicles the history of 20th century Puerto Rico and details how the island has entered an economic recession. This research pools multiple government reports and historical accounts together to provide a concrete series of events which led to Puerto Rican recession as well as describes the impact of hurricane Maria. Based on this research, it is clear that the end of a major U.S. tax code provision was a primary cause in Puerto Rico's bankruptcy. It is also clear that certain Puerto Rican bonds contributed to its economic grief. The impact of hurricane Maria was a continuation of Puerto Rico's grapple with debt in addition to a massive loss of life. These results show that Puerto Rico will continue to struggle without aid from the U.S. The specific solutions regard the possibility of Puerto Rican statehood versus a direct financial contribution from Congress, both of which have the potential to impact the lives of U.S. citizens.

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Part I: Introduction

Seventy billion dollars in debt (Yasmeen 1) with 43% of its residents living in poverty (U.S. Census Bureau), Puerto Rico grasps for aid from the United States but is left struggling due to choices made by the commonwealth since the 1950's.

To study the gradual decline of a nation's economy over half a century yields a number of issues regarding the factors which have influenced it. A comprehensive review of such factors would be a near impossible feat, but can be attempted through the study of both tax code and aid-centric legislation. In this instance, tax code refers to laws implemented by a governing power, the United States, unto its territorial possession, Puerto Rico. These U.S. designed tax codes yielded economic prosperity while in place and contributed to economic hardship once repealed (Stathis 1). An analysis of responsive aid-centric legislation also provides insight into the development of an economy; based on the type of aid the legislation is offering. In total, the legislative relationship between the U.S. and Puerto Rico eludes to a detailed history which has led to Puerto Rico's economic recession and eventual declaration of bankruptcy (Yasmeen 1). After being devastated by two hurricanes during 2017, this relationship is now subject to change as Puerto Rico's only options for a path forward are to surrender economic control to the United States or face the future alone as a poverty stricken nation.

Part II: Historical Context/Background Knowledge

As a newly established commonwealth under the United States of America, Puerto Rico experienced an economic boost through the leadership of their first governor, Luis Muñoz Marín. He began his term in 1949 and propelled the island's government forward shifting its economy from an agrarian based system to capitalism. Marín focused on creating jobs for the residents of Puerto Rico and brought U.S. glass and ceramics manufacturers to the island which resulted in the establishment of Puerto Rico as a potentially profitable possession for the U.S. By the next decade Puerto Rico had increased its workforce by 100,000 people and passed an industrial incentives act to bring more manufacturers to the island (Carrion 256).

The 1960's also saw an addition to the Puerto Rican economy through the rise of global tourism. U.S. citizens began to travel internationally for the first time in history. However, paranoia about the Cold War caused this trend to stagnate. U.S. travel agencies realized this and partnered with Puerto Rico through multiple advertising campaigns that sought to bring American citizens to the island. Even though tourism never accounted for more of 10% of Puerto Rico's GDP. It did create a flow of people through the island and strengthened the relationship between U.S. agencies and Puerto Rico (Merrill 180).

After finding minimal profit in tourism, the U.S. searched for ways to further monetize their partnership with the Puerto Rican government and found them with the Tax Reform Act of 1976. This tax reform was primarily concerned with the amortization of real property construction -the incremental payments made after taking loans for property construction (Joint Committee On Taxation)- but also included a section which granted special tax credit, known as Section 936, to Latin American countries. Section 936 promised U.S. firms who developed in Latin American countries exemption from Federal income taxes and marked an important moment in Puerto Rico's modernization.

The passing of Section 936 prompted a boom to Puerto Rican industry with manufacturing and pharmaceutical firms quickly establishing themselves on the island. The Puerto Rican government saw this as an opportunity to become an equal to their mainland counterpart which led them to invest heavily in the island's infrastructure with the mindset that developed cities would bring more U.S. firms to the island. However, the investment in infrastructure only contributed to Puerto Rico's growing debt. Officials at the time believed that increased business due to the tax credit would eventually erase this debt but they did not anticipate the U.S.' reservations surrounding Section 936. Since section 936's inception, the U.S. was consistently losing revenue while Puerto Rico took the benefits. The U.S. was spending more money on upholding the tax credit than they planned to, resulting in U.S. legislators deciding to phase out Section 936 by 2006 .

A post Section 936 Puerto Rico saw the government failing to manage the island's debt. Poverty rates grew topping off at 43.5% in 2016 (U.S. Census Bureau). In a desperate attempt to replicate the effects of Section 936 Puerto Rico took out bonds through U.S. investors with the goal of using the money to exempt firms from federal tax. The negative implications of this measure were ignored and resulted in the doubling of Puerto Rico's debt from 2006 to 2015. Puerto Rico declared a state of emergency in 2015 due to an inability to repay debt and unofficially declared bankruptcy in 2017 just before hurricane Maria devastated the commonwealth.

Part III: Summary and Analysis of Past Research

A New Commonwealth

Arturo Morales Carrión, Deputy Assistant Secretary of State for Inter-American Affairs under John F. Kennedy and President of The University of Puerto Rico, writes: “ In 1950, Puerto Rico had a visible momentum: the status, the economy, the society were in a state of flux”(Carrion 273). This momentum was accelerated by Puerto Rico's declaration of commonwealth status on July 25th 1952 which created ample opportunity for industry and undoubtedly led to future partnerships between Puerto Rico and the mainland U.S.

Carrión's comment on momentum created by early industry, feeds into a report carried out by Jennie S. Stathis directed towards the Senate Committee on Finance in 1993. Stathis' writing concerns the Section 936 tax code which aimed to capitalize on the Puerto Rican

economy's momentum: "This provision effectively exempts all possessions source income¹ from U.S. taxation. Dividends repatriated from a U.S. subsidiary to a mainland parent qualify for a dividends-received" (Stathis 2). Here it is explained that Section 936 both exempted participating U.S. firms from federal taxation as well as offered firms the opportunity to deliver finances from Puerto Rico to the U.S. free of tax through repatriation. It is explained that these incentives had driven the number of firms established in Puerto Rico up to such a degree that the U.S. spent the 1980's working to amend Section 936:

Congress periodically reconsiders the benefits and costs of the section 936 tax credit. In the 1982 Tax Equity and Fiscal Responsibility Act and the 1986 Tax Reform Act, Congress adjusted the section 936 provisions in an attempt to reduce the ratio of federal revenue loss to employment created and investments made in U.S. possessions (Stathis 3).

Multiple adjustments made by congress during the 1980's came in response to the fact that the: "Average tax benefits per employee were \$24,300 while average wages paid, including estimated fringe benefits, were \$22,800. For some industries, in particular the chemical industry and its pharmaceutical component, average tax benefits considerably exceeded wages paid" (Stathis 4). As much as Congress pushed tweaks to Section 936, change never came. The early 1990's still saw the U.S. providing per employee tax breaks which exceeded employee compensation. Based on this stagnation, the U.S. had a desire to end Section 936 but noted that: "A growing proportion of Puerto Rico's gross domestic investment has come from external

¹ Income made by a U.S. firm through a Puerto Rican branch

sources” (Stathis 13). Congress was concerned that Puerto Rico had taken loans to invest in island infrastructure and knew that if it ended Section 936 Puerto Rico would be left billions in debt. The impacts of a change to Section 936 were impossible to fully predict, but the U.S. estimated that it would continue to lose a substantial amount of federal assets if the policy did not end. It was this, ultimately, that drove U.S. president Bill Clinton to sign legislation with the intent to phase out Section 936 by 2006 ¹⁵.

Economic Decline

Section 936 ended in the beginning of 2006. A Harper's magazine article written by Petra Bartosiewicz elaborates on the end of Section 936: “...when the last of its benefits were gone, many of the remaining companies bailed and Puerto Rico fell into recession” (39). The poverty rate skyrocketed to just under 50% and unemployment rose to 10% ¹⁷ leaving many Puerto Rican residents unable to find work. According to Bartosiewicz:

Puerto Rico’s government aimed to make up lost revenue by issuing bonds with triple tax exemptions (federal, state, local) ... American financial firms gamely bought in ... from 2006 to 2015, through the sale of municipal bonds, the island’s debt nearly doubled. Default was certain (40).

Although these bonds were intended to bolster the Puerto Rican economy, they did not financially contribute to the extent that Puerto Rico had hoped for. This resulted in the sale of bonds increasing the island’s outstanding debt to nearly \$70 billion (for the bonds alone)¹⁰. It

became clear to Puerto Rico that its government would be forced to take drastic measures in order for the commonwealth to financially survive.

As Puerto Rico's economy further declined its government made several additional attempts to stabilize itself. The most prominent of these attempts was the Public Corporation Debt Enforcement and Recovery act. This initiative gave select companies the opportunity to pursue a system similar to Chapter 9 bankruptcy. The island was hoping that this measure would undo the lack of business on the island until the commonwealth as a whole could file for Chapter 9 bankruptcy, which would grant them Federal aid. As promising as this appeared for Puerto Rico, U.S. firms with investments in Puerto Rican bonds did not want the commonwealth to attain access to debt-relief pathways such as Chapter 9. Blue Mountain Capital Management, LLC² was one such firm who had finances invested into Puerto Rican bonds, which would go unpaid under the Public Corporation Debt Enforcement and Recovery act, and took issue with the measure. The Blue Mountain Capital Management, LLC v. Garcia-Padilla³, et al case came to an end in the United States Supreme Court with a ruling that stated: " A municipality seeking to adjust its debts pursuant to Chapter 9 must receive specific authorization from its state. Id. 109(c) (2). Puerto Rico municipalities are expressly prohibited from adjustments pursuant to Chapter 9" (Blue Mountain Capital Management, LLC v. Garcia-Padilla, Et Al, U.S. (2016)). This ruling was significant to Puerto Rico in that it revoked the commonwealth's right to file for Federal bankruptcy under Chapter 9. Meaning that no Federal aid could be awarded to help end the island's financial crisis. This was troublesome as Puerto Rico was still losing U.S. firms from

² A management firm that made profit off of the sale of Puerto Rican bonds

³ Puerto Rico's governor from 2013-2017

the island and did not have the capital to reimburse bond holders let alone address its economy.

Even though Puerto Rico's access to Chapter 9 bankruptcy had been blocked, the U.S. continued to formulate an act which would provide some opportunities for the commonwealth to receive assistance from the mainland. This act became known as the Puerto Rico Financial Stability and Debt Restructuring Choice Act (PROMESA). PROMESA saw the President of the United States appoint a financial control board to oversee Puerto Rico's debt and develop a plan for the commonwealth to successfully move forward. On June 29th, 2016, the act was passed in Congress with a 68 person in favor vote and was signed by President Barack Obama. In July of that same year, the International Financial Law Review, who describe themselves as providing readers with reports from industry leaders, published an article by Edward Price that explained what U.S. legislators were thinking when instating PROMESA: "“This bill empowers the Government of Puerto Rico with the choice to partner with the Federal Government and put the island on a path towards balanced budgets and a return to fiscal security," said Congressman Sean Duffy, the bill's sponsor”" (Price 1). As a supporter of PROMESA, Congressman Duffy had spent over a year debating the future of Puerto Rico and left the vote hopeful for a quick resolution for the island's economy. Price also provides an opinion from Alejandro Garcia-Padilla who was Puerto Rico's governor at the time and also served as a defendant in Puerto Rico's Supreme Court case concerning its loss of access to Chapter 9 bankruptcy. Garcia-Padilla kept his comments to: "The emergency measures we have taken are unsustainable, harm our economy, reduce revenues and diminish our capacity to repay our debts" (Price 2). It was clear that Garcia-Padilla considered PROMESA a lesser support system than

direct financial aid, due to his support towards the failed Public Corporation Debt Enforcement and Recovery act, but was accepting of the services it promised.

Once passed, PROMESA had promised to significantly reduce Puerto Rico's overall debt by 2026, but could only do so by reducing the budget for infrastructure measures and humanitarian causes on the island: "among the early austerity measures was a 10 percent cut to pensions, the closure of nearly 200 public schools, a \$450 million cut to the University of Puerto Rico, and the elimination of Christmas bonuses" (Bartosiewicz 40). Although this heavily impacted the day to day lives and careers of many Puerto Rican residents, it was believed to be a safe first step towards a debt-free Puerto Rico.

In May 2017 Puerto Rico acted on early PROMESA guidelines by cutting the budgets for certain government funded causes and filing for bankruptcy relief (Price 3) to extend deadlines on bond repayments (Yasmeen 1). Four months later the island was devastated by hurricane Maria..

Natural Disasters

Hurricane Maria hit Puerto Rico on September 20, 2017. The electrical grid immediately went down while harsh winds uprooted island vegetation and rain flooded the streets. In her article: Before The Deluge, Petra Bartosiewicz describes the immediate carnage: " A destroyed cellular network left most people without the ability to call for help...scores of villagers were trapped by washed-out bridges" (41). Panicked residents were told to secure any belongings they

could find and remain stationary while aid groups assembled to provide relief for the commonwealth.

Many living in remote villages knew that they would be without aid for weeks, but could do little to improve their situation so long as hurricane Maria continued to throttle the island. After a week had passed and travel to the island was deemed safe, FEMA and the Defense Department rushed thousands of emergency relief crews to the island. With them they brought 1.5 million meals alongside 1.1 million liters of water to Puerto Rico's major ports. The supplies were mainly distributed in San Juan, Puerto Rico's capital. The people of San Juan were finally able to breath a sigh of relief, but: "mayors of remote towns were unable to make contact with officials in San Juan... so the distribution of aid packages was slow" (Bartosiewicz 44). It often took weeks to reach certain communities that had been walled in by the devastation of hurricane Maria and when aid workers arrived they consistently found people on the brink of death: "dozens were dying... an early official count put the number of deaths at 16; later it rose to sixty four, but the Demographic Registry of Puerto Rico estimated that the toll was actually above a thousand" (Bartosiewicz 44). When the remnants of hurricane Maria finally passed in early October it was marked as not only the most economically damaging natural disaster in the island's history, but the deadliest as well.

As of early 2018 half of Puerto Rico's residents are still unable to access electricity due to both a longstanding problem in Puerto Rico and the mishandling of government funds around the issue. Bartosiewicz analyzes president Trump's comment on Puerto Rican infrastructure: ""Electric and all infrastructure was disaster before hurricanes." Trump's response was callous,

but he was right in one respect: Puerto Rico's infrastructure was in trouble before the storm"" (45). Alongside the government, the Puerto Rico Electric Power Authority (PREPA) has been struggling to attain financial stability since 2006.

When faced with the possibility of being forced to close in the late 2000's, PREPA issued bonds in tandem with the Puerto Rican government which led to an accumulation of debt and a current inability to meaningfully address the island's power issues. Directly after hurricane Maria, PREPA was responsible for fixing Puerto Rico's devastated electrical grid. Even after being granted funds to repair the grid, PREPA sought assistance from mainland power utility companies: "Only six days after the storm, Prepa granted Whitefish Energy Holdings, a young business with two full-time employees, a \$300 million contract to rebuild the grid" (Bartosiewicz 46). PREPA took a risk in contracting Whitefish, it was a hasty deal with the small company which left them uneasy.

After only three weeks PREPA revoked their contract with Whitefish. Due to the rushed nature of the deal PREPA was still required to pay the contracted linemen Whitefish had already sent to the island. These linemen understood the value PREPA had placed on them and demanded an hourly rate of over \$300, seventeen times the mainland average salary. Once the deal with Whitefish Energy had completely ended, PREPA was left with 60% of its original budget and no marked improvements to the islands power grid. Four months later, Puerto Rico is closer to regaining full power, but has sunk further into debt (\$45-\$95 billion dollars (Disis 1)) in order to do so.

As of present day, Puerto Rico still does not have control over its entire power grid, has no confirmed fatality count, and does not have a figure to represent the cost of hurricane Maria. Although the island's future remains unclear, the impact created on Puerto Rico's inability to attend to the devastation of hurricane Maria by the loss of capitol due to the end of Section 936 is visible to most living in the commonwealth and on the mainland.

The Future

When looking towards Puerto Rico's future one must realize that the coming economic state of the island relies on its population. Studying forecasts regarding the future population of Puerto Rico details how outmigration will adversely impact the island's economy. One such forecast, appendix, *Fig 1 (Trading Economics)*, comes from tradingeconomics.com which has charted a roughly 5% decline in Puerto Rican population since 2010 followed by a drop after the declaration of a state of emergency in 2015 and a bleak prediction moving forward from hurricane Maria.

The predictions made by this graph hint at a disastrous future for Puerto Rico. With a smaller population, the government will have to downsize in accordance or face the risk of going further into debt. Although the forecast remains unproven by census data, it is clear that Puerto Rico's population, and therefore economic state, will continue to worsen as a result of hurricane Maria.

The Opposition

The decision to end Section 936 is largely accepted to be a major factor in the economic decline of Puerto Rico. However, some publications persist that it played little role in Puerto Rico's eventual bankruptcy. In August of 2016 puertoricoreport.com published their feelings on Section 936 through the piece: **The End of Section 936**. They conclude that: "One common misperception about Puerto Rico's financial woes is that they are the result of the end of Section 936" (Puerto Rico Report 1). They reach this conclusion off of the fact that: "...the benefits of Section 936, to the extent that they helped grow Puerto Rico's economy, were primarily felt by the investors, not by the residents of the Island" (Puerto Rico Report 1). Yet during the same period the U.S. Committee on Finance recorded a near 250% increase in employee compensation as recorded in *Fig 2 and Fig3 (Stathis)*.

Although the Puerto Rico Report is correct in their assessment that U.S. firms ended up making the most profit from Section 936, their comment on finances not reaching the island's residents is clearly incorrect as shown by the above graphs. Section 936 did have an impact on island employee compensation and resulted in the eventual doubling of average pay.

In addition, the Puerto Rico Report questions the effectiveness of Section 936 due to a consistent unemployment rate throughout the late 20th century. This point stands out among others as completely unrelated to the topic at hand. Section 936 was never meant or promised to be a solution to Puerto Rico's high unemployment rate and therefore cannot be faulted for it. It is

also important to note that Section 936 had a positive impact on the number of jobs available in the commonwealth creating some 105,000¹ positions before its termination.

The opposition provided by Puerto Rico Report not only spreads misinformation through rampant exaggerations of historical information, which are clearly untrue when compared to government reports, but dilutes the pool of information available on the subject and leads readers to false conclusions about a highly critical piece of legislation in Puerto Rican history.

Part IV: Discussion and Conclusions

Based on the content above the economic rise and recession of the commonwealth of Puerto Rico can be charted as follows:

- ❑ 1950-1960's: The commonwealth of Puerto Rico de emphasizes the previously utilized agrarian economic methods and adopts a constitution mirrored after the U.S.'. With the rise of tourism, Puerto Rico sees an influx of visitors to their island and establishes an economic connection with the U.S.
- ❑ 1970-1980's: Manufacturing firms are incentivized to create branches in Puerto Rico and other Latin countries due to Congress' passing of Section 936. Section 936 allows firms tax breaks which prompts many to pursue industry in Puerto Rico. Section 936 is so successful that firms end up saving more capital through government compensation than they pay their employees. This leads U.S. legislatures to spend the 1980's amending

Section 936 in an effort to reduce tax credit.

- ❑ 1990-2000's: The U.S. no longer supports the extreme benefits offered by Section 936 and decides to phase the tax credit out by 2006. In 2006 a multitude of firms leave Puerto Rico. The unemployment and poverty rates increase rapidly and the Puerto Rican government takes out bonds with the mindset that loans could help propel the economy upwards. The loans taken out through bonds only worsen the economy.
- ❑ 2010's: Puerto Rico declares bankruptcy due to unpayable debt and looks to the U.S. for assistance. Congress proposes PROMESA, which would appoint a board of financiers to take control of the island economically with the goal of paying off Puerto Rico's debt. Just as PROMESA is creating a plan to improve Puerto Rico, hurricane Maria ravages the island. The hurricane kills upwards of 50 island residents and adds another \$30-90 billion to Puerto Rico's debt.

A combinations of the aforementioned events led to the bankruptcy of Puerto Rico with hurricane Maria only sinking the island into further debt.

The current uncertainties surrounding the settlement of Puerto Rico's staggering debt hinge on what role the U.S will take in helping to address a resolution to it. To both begin paying off the debt its accrued since the end of Section 936 and repair the island's devastated infrastructure following hurricane Maria, Puerto Rico will need substantial financial aid from the U.S. Without aid from Congress, Puerto Rico will not be able to rebound from these dual disasters in a timely fashion. All the while, interest on Puerto Rico's loans will continue to mount

leaving the island further in debt. The Puerto Rican government continues to consider the additional step of a public referendum which would allow the people to vote for one of two options: Puerto Rico remains a commonwealth, or, Puerto Rico moves for statehood. Puerto Rican statehood is enticing but ultimately unlikely as the U.S. Federal government would be then directly responsible for the islands massive debt with no foreseeable material benefit. At this point no executive action has been taken, but the implications of these options threaten to affect the three million United States citizens residing in Puerto Rico.

To add to this research one could further examine the process of a Puerto Rican referendum as well as the political divide on the island. A better understanding of how the commonwealth could become a state and which political parties are for and against that change would develop one's understanding of the options Puerto Rico has regarding a referendum. This could be paired with an analysis of the types of aid the mainland U.S. has provided to its other possessions after past natural disasters. Research such as this would illuminate any differences between aid during past disasters and hurricane Maria allowing one to assess the amount of aid Puerto Rico has received in a critical sense. Analyzing both of these topics further would further develop one's understanding of the options Puerto Rico will face in the coming years.

By fully examining the detailed history of the commonwealth of Puerto Rico the sources of its economic hardship are revealed. It is clear that a combination of the end of Section 936 in tandem with Puerto Rico's bond indebtedment drove the island to bankruptcy. In addition, it is

apparent that hurricane Maria impacted the island by setting it further into debt as well as annihilating the island's infrastructure and resulting in one of the deadliest natural disasters in U.S. history. The choices made by both Puerto Rico and the mainland U.S. moving forward are critical as they will not only provide a path for Puerto Rico's recovery, but set a precedent for the ways in which the mainland interacts with one of its possessions during economic and natural crisis.

Appendix 1:



Fig. 1 “Puerto Rico Population.” *Trading Economics*

Appendix 2:

Figure I.2: Percentage Distribution of Domestic Net Income by Employee Compensation and Property Income,

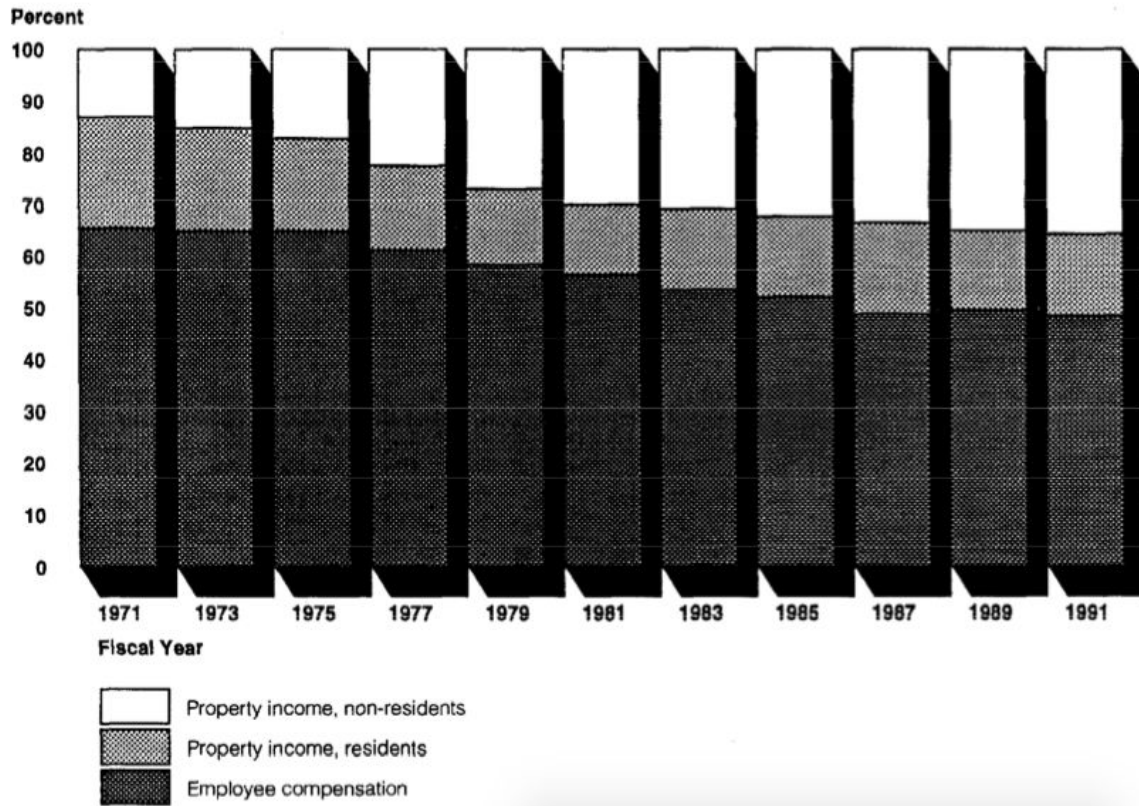


Fig 2 "Percentage Distribution of Domestic Net Income by Employee Compensation and Property Income" *J. Stathis*

Appendix 3:

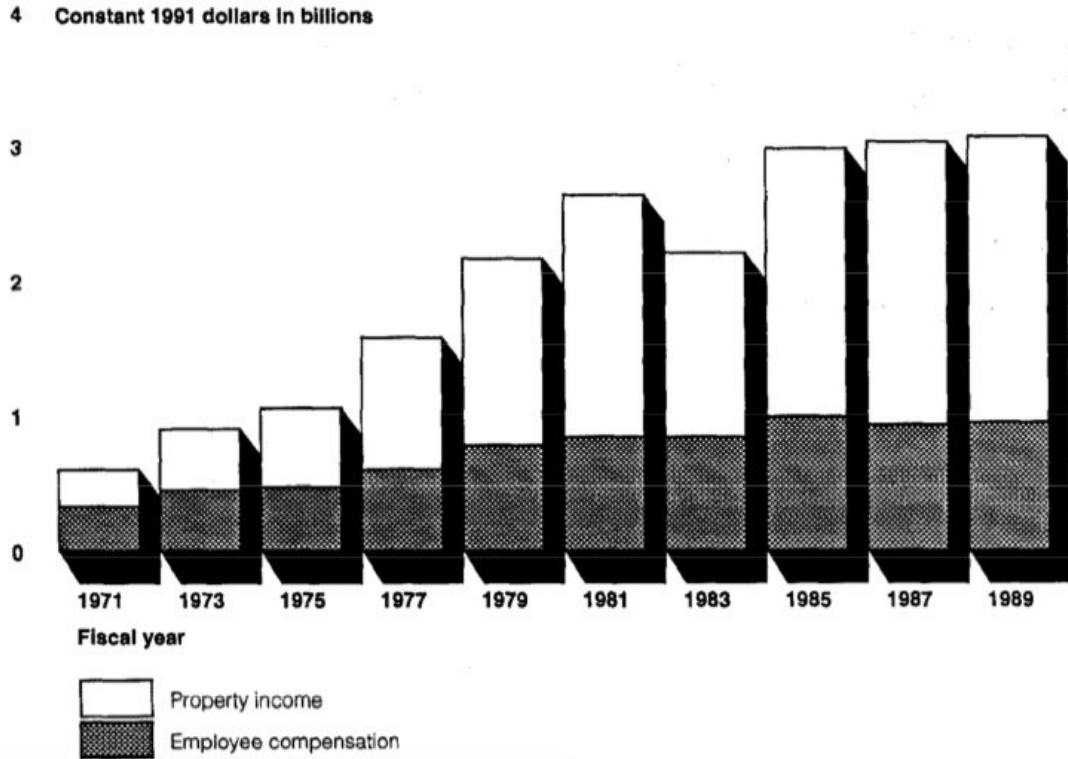


Fig 3 "Employee Compensation and Property Income" J. Stathis

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