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Let's Ask the Fundamental Question: Why Not Incorporate Puerto Rico Into the U.S. Tax Code?

by Lawrence A. Hunter

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Let's Ask the Fundamental Question: Why Not Incorporate Puerto Rico Into the U.S. Tax Code?

by Lawrence A. Hunter

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Today Puerto Rico is in the twilight zone of U.S. tax policy. Although in the past the United States has exercised its right to tax Puerto Rican residents, it has declined to do so for more than 87 years. In 1917 Congress made residents of Puerto Rico U.S. citizens protected by the Constitution, but it left residents and corporations "foreign" under the Internal Revenue Code. Puerto Rico was brought into the monetary, judicial, and tariff "fold" of the United States, but was otherwise considered foreign for tax purposes. U.S. corporations doing business within Puerto Rico are also considered foreign and subject to the confusing panoply of rules governing controlled foreign corporations and their Puerto Rican-source income.

Sometimes the mainland's tax laws add uncertainty to simple confusion. For example, when Congress considered the recent repatriation proposals (proposals to reduce tax upon repatriation of past earned income), the question of how Puerto Rico would be treated was raised, but only as an afterthought. If Congress knew the legal application of the repatriation proposal to Puerto Rico, it still hadn't answered the more fundamental question: How should Puerto Rico be treated under repatriation and why?

The U.S. General Accounting Office and the Joint Committee on Taxation have been charged with examining the alternatives to the tax treatment of Puerto Rico. Many await their research. Perhaps it will answer the perennial question on what to do about Puerto Rico. But as Congress considers whether to adopt the latest version of IRC sections 936, 30A, or 956 that allow for corporate welfare along with continued exclusion from the domestic code, it might want to go back to basics. How about asking the most fundamental question: Why should Puerto Rico not be incorporated into the Internal Revenue Code? Or, more bluntly, what, if any, benefits have inured to Puerto Rico, its people, or the U.S. mainland (not counting the benefits to lobbyists, the pharmaceuticals, and the upper-income strata of Puerto Rico) from Puerto Rico's exclusion from the domestic code? Congress might find that the answer is none.

Today, largely because of the WTO and NAFTA, global capital markets, and the vast labor cost differences between Puerto Rico (and the developed world in general) and the productive developing nations (the People's Republic of China, India, and so forth), exclusion from the code does not strengthen Puerto Rico's competitive position. Ireland, Malaysia, Mexico, and Costa Rica (and, in fact, Mississippi and Rhode Island) can offer similar tax incentives.

Puerto Rico's economic history can be divided into three phases: (1) subsistence agriculture, low incomes, and severe poverty for most of the first half of the 20th century, culminating with the consolidation of sugarcane production before World War II; (2) rapid industrialization through the garment industry and other labor-intensive industries from 1947 until about 1970; and (3) the growth of more capital-intensive production since 1970, highlighted by the pharmaceutical and electronics industries' expansion from the mid-1980s.

From 1921 to 1945, Puerto Rico remained an agricultural backwater, a territory not very different from Caribbean and Latin American countries. In 1940 agriculture still contributed 42 percent of total employment and one-third of total income. Exclusion from the domestic code meant only that the few Puerto Ricans who would have been taxable paid no taxes.

Fast-forwarding to 1972-1977, the beginning of the section 936 era, one can readily gauge the effect of Puerto Rico's exclusion. However, the most vivid picture emerges not from true economic gains but from the divergence between gross domestic product and gross national product. GDP measures the amount of production that takes place within a country, while GNP measures the amount of production that can be attributed to nationals of a country. See Graph 1 and Table 1.

Around 1970 something caused GDP and GNP to diverge. U.S. pharmaceutical and electronics firms became adept at manipulating section 936, transferring intangibles to and passing profits through Puerto Rico, and then repatriating billions of dollars of income back to the mainland tax-free, income that was not really generated in Puerto Rico and did not really benefit Puerto Ricans. U.S. Treasury Department reports from the 1980s observed that the emperor had no clothes. While sales soared by more than US $7 billion and federal tax breaks tripled from 1980 to 1995, section 936 corporations added only 13 percent more jobs on the island. Cost-per-job generally exceeded pay and benefits. Section 936 manufacturing created "enclave" development with few spillover benefits for the rest of the Puerto Rican economy.

By 2000 GDP exceeded GNP by US $20 billion, an unprecedented 50 percent. GDP data reflect the accounting acumen of U.S. pharmaceuticals, not the strength of the underlying Puerto Rican economy. Sustainable growth benefiting Puerto Rico must in the long run depend on the success of local entrepreneurs.

The empirical evidence indicates that excluding Puerto Rico from the domestic code has not been very beneficial to the development of the island's economy. Half the population still lives in poverty and unemployment rates that exceed 10 percent belie the labor market's true state. More to the point, Puerto Rico has done little to close the gap with the United States since 1970. Per capita GNP is still stuck at about one-third that of the United States — US $10,906 compared to US $36,158 (2000).

While the evidence supports the proposition that exclusion from the domestic code has not benefited the Puerto Rican economy much, if at all, it cannot be directly inferred that exclusion has held the Puerto Rican economy back. One can infer, however, that the opportunity costs have been enormous because of the erroneous conventional wisdom, held by most policymakers, that exclusion was a major driver of Puerto Rican economic expansion.

Thus, the federal government took up the growing burden for a development model that, starting in the 1970s, couldn't deliver. Not only did it cost the U.S. Treasury an enormous amount of lost revenue over the years, it precluded the U.S. Congress from finding an effective and efficient way to assist Puerto Rico in developing economically.

The U.S. Treasury lost more than US $58 billion to section 936 corporations (from 1976 to 1999) and by 2000 was paying out US $8 billion annually to individuals in transfer payments. Since the late

Graph 1. The Puerto Rico GNP/GDP Gap

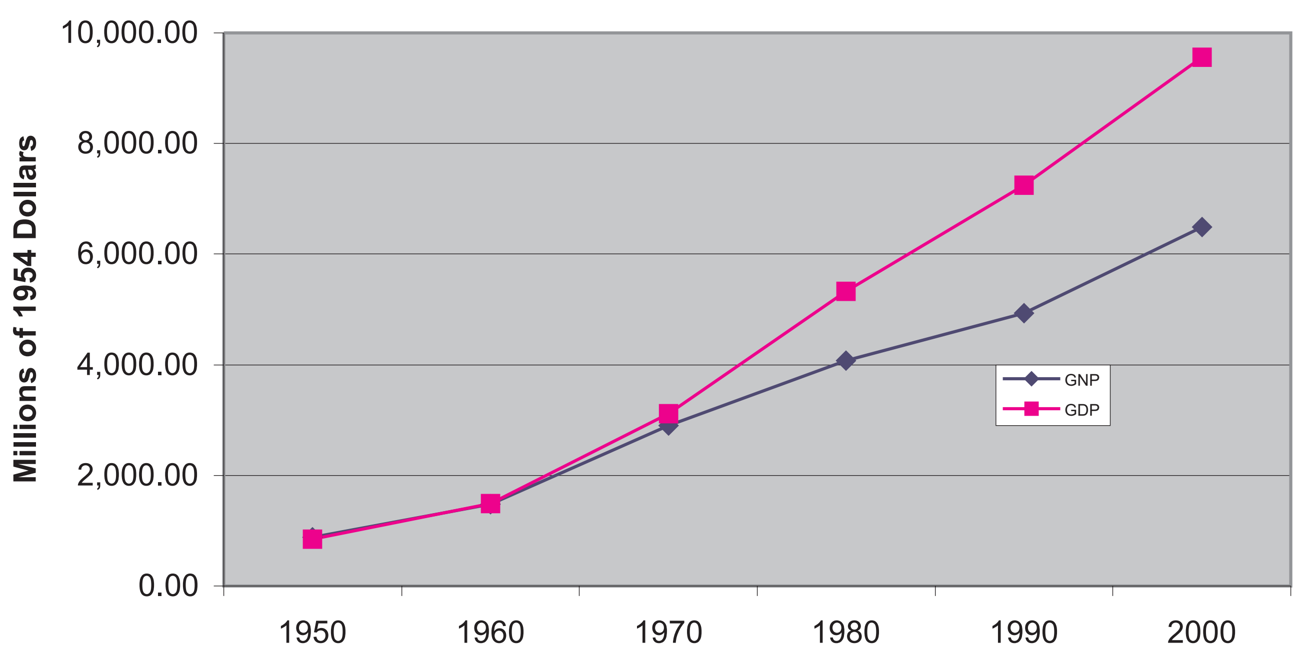


Table 1. Puerto Rican Gross National Product and Gross Domestic Product, 1950-2001

	Current[a]		GNP as a % of GDP	Real[b]		Decade % Increase	
	GNP	GDP		GNP	GDP	Real GNP	Real GDP
1950	754.5	723.9	104.2	878.7	843.1		
1960	1,676.4	1,691.9	99.1	1,473.2	1,486.8	67.7	76.4
1970	4,687.9	5,034.7	93.1	2,901.4	3,116.0	96.9	109.6
1980	11,073.0	14,480.0	76.5	4,076.7	5,330.7	40.5	71.1
1990	21,619.0	31,783.3	68.0	4,929.8	7,247.6	20.9	36.0
2000	41,441.7	61,044.9	67.8	6,488.8	9,558.2	31.6	31.9
2001	44,211.3	67,897.1	65.1	6,602.3	10,139.4		

[a]Millions of dollars.
[b]Millions of 1954 dollars.

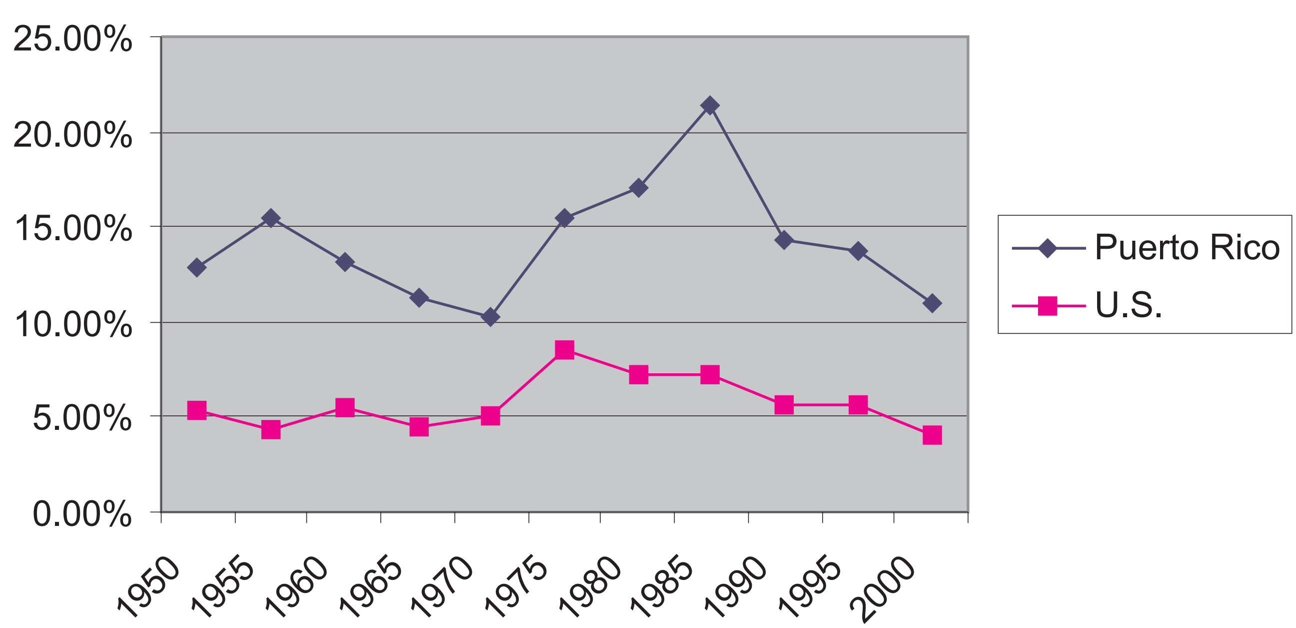
Source: 1950-1980, Dietz, *Economic History of Puerto Rico* (1986) Table 5.1; 1990-2001, Planning Board of Puerto Rico (2002). Real GDP has been calculated on the assumption that the deflator is the same as that for GNP.

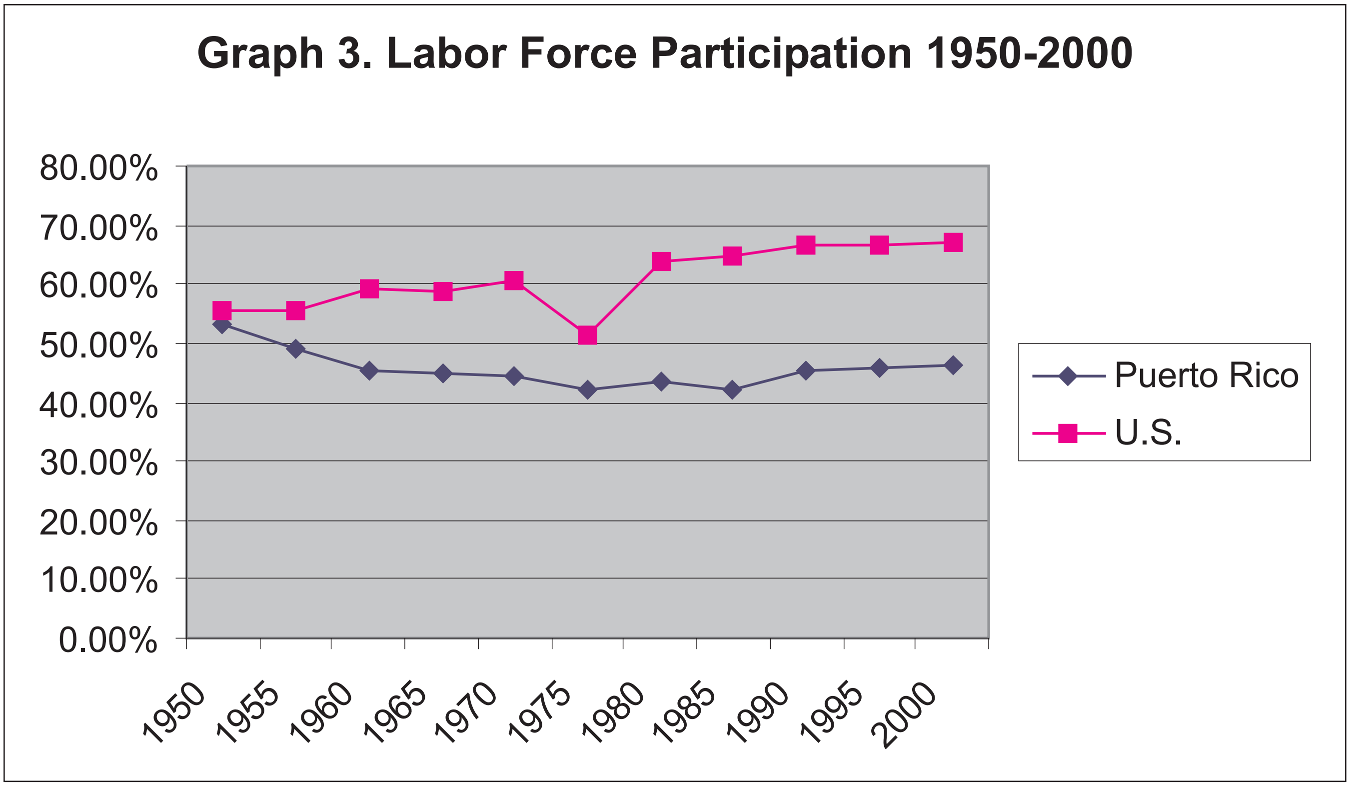
1970s, transfer payments have amounted to 20 percent of Puerto Rico's GNP, and one-third of island families now receive food stamps.

The Puerto Rican government picked up the slack in the private sector, creating more jobs than any other sector after World War II and ratcheting up local taxes to support its growth.

Two more questions should be raised. What effect did exclusion from the code have on manufacturing employment, and what effect did it have on Puerto Rico's ability to catch up? Conventional wisdom presumes exclusion to be necessary for the flexible tax breaks necessary for rapid growth. The focus has been on manufacturing, and manufacturing employment peaked in the early 1970s.

Graph 2. Unemployment 1950-2000





Billions in tax breaks have done little to increase employment since then. In fact, manufacturing as a share of total employment in Puerto Rico has tracked the U.S. average almost perfectly for 20 years.

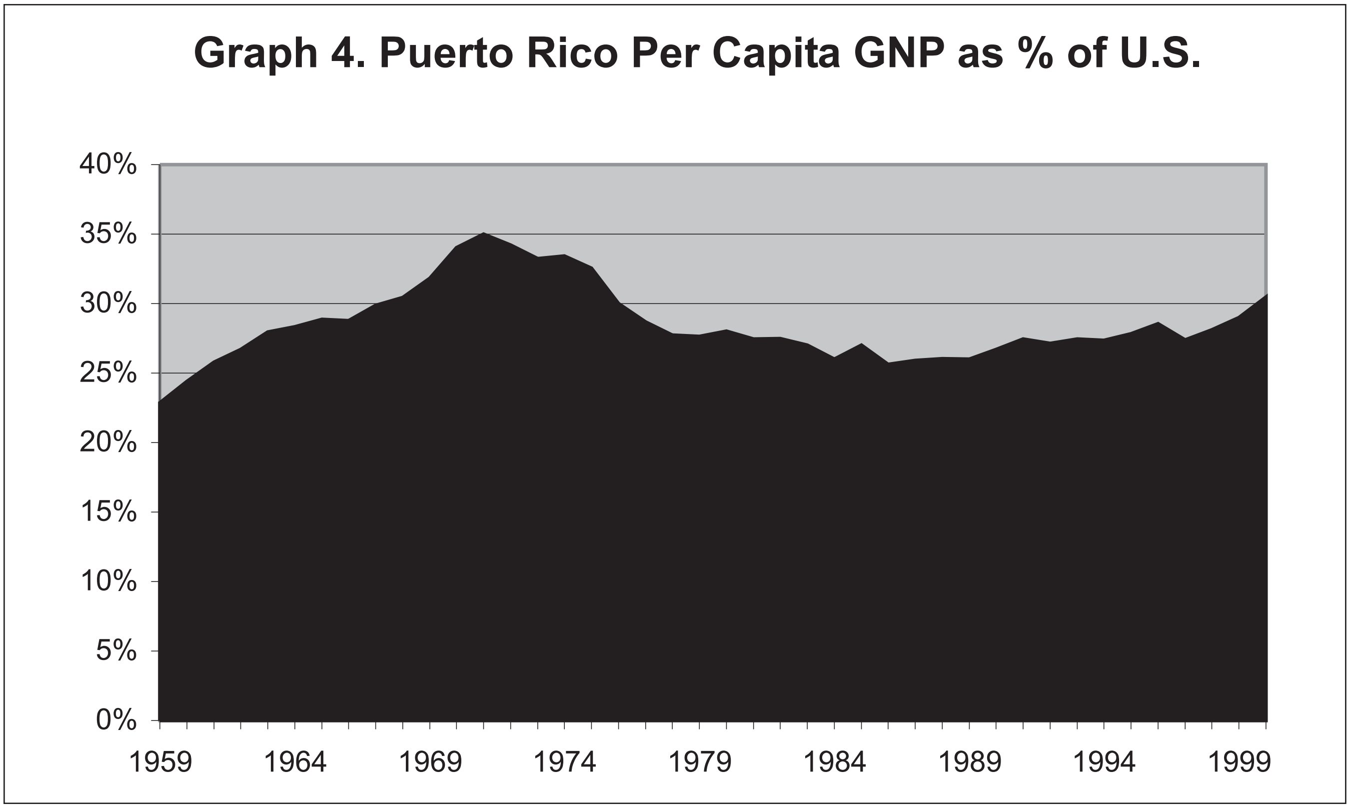
In terms of catch-up, Puerto Rico has more or less stagnated or lost ground. Although real progress was made in the 1950s and 1960s, per capita incomes have remained stuck at around one-third of U.S. incomes since 1970. U.S. per capita income as a multiple of Puerto Rico's income fell from about 6 times larger in 1950 to 4 in 1960 (U.S. GDP per capita = US $2,918) and then to 2.7 times greater in 1970 (U.S. GDP per capita = US $5,069). Progress then stalled. Ironically, the only recent gains have been made in the 1990s as section 936 incentives phased out. Meanwhile, poor southern states within the domestic code continue their impressive convergence with the rest of the United States.

Despite the gloomy predictions of the Congressional Budget Office,[1] Puerto Rico actually grew after the shades were drawn on section 936. The tax implications of the exclusion are that the section 936 companies have switched to CFCs, still keeping the money out of federal coffers. Under the domestic code with the proposed enterprise zone legislation, Puerto Rico could accomplish the same ends in a simpler way.

For the complete picture, let us look at 1945 to 1970-1975, when the Puerto Rican economy transformed from agriculture to manufacturing. Incomes started to converge with the United States. Why? How much was due to exclusion from the code? It's hard to say. Manufacturing in the United States was moving south. Wages in Puerto Rico were even lower. Tariffs protected industry from global competition. Federal transfers to Puerto Rico mushroomed. No firm case can be established for what factors contributed to Puerto Rico's growth in this period. However, it's a safe bet that government planners (and pharmaceutical companies) have overestimated the importance of tax incentives and neglected the importance of key business drivers such as productivity, location, and business environment.

The dynamics of competition for labor-intensive industries had a blindsiding effect. From 1952 to 1970, manufacturing wages in Puerto Rico jumped from 28 percent of the mainland rate to 53 percent. By 1980 the gap had closed to 67 percent. The postwar period is now blurred history, but we should remember that Europe and Japan were

[1]U.S. Congressional Budget Office, Puerto Rico Status Referendum Act: Report to Accompany the Committee Amendments to S. 712 (including cost estimate of the Congressional Budget Office) (SuDoc Y 1.1/5:101-481), 1990.



considered low-cost areas until about 1960. Even by 1975, a production worker in Puerto Rico earned more than double the going wage in the Republic of China (US $2.50 compared to US $1.20). With the emergence of the P.R.C. and India, and global competition heating up in the service sector as well as manufacturing, Puerto Rico's disadvantage only grows.

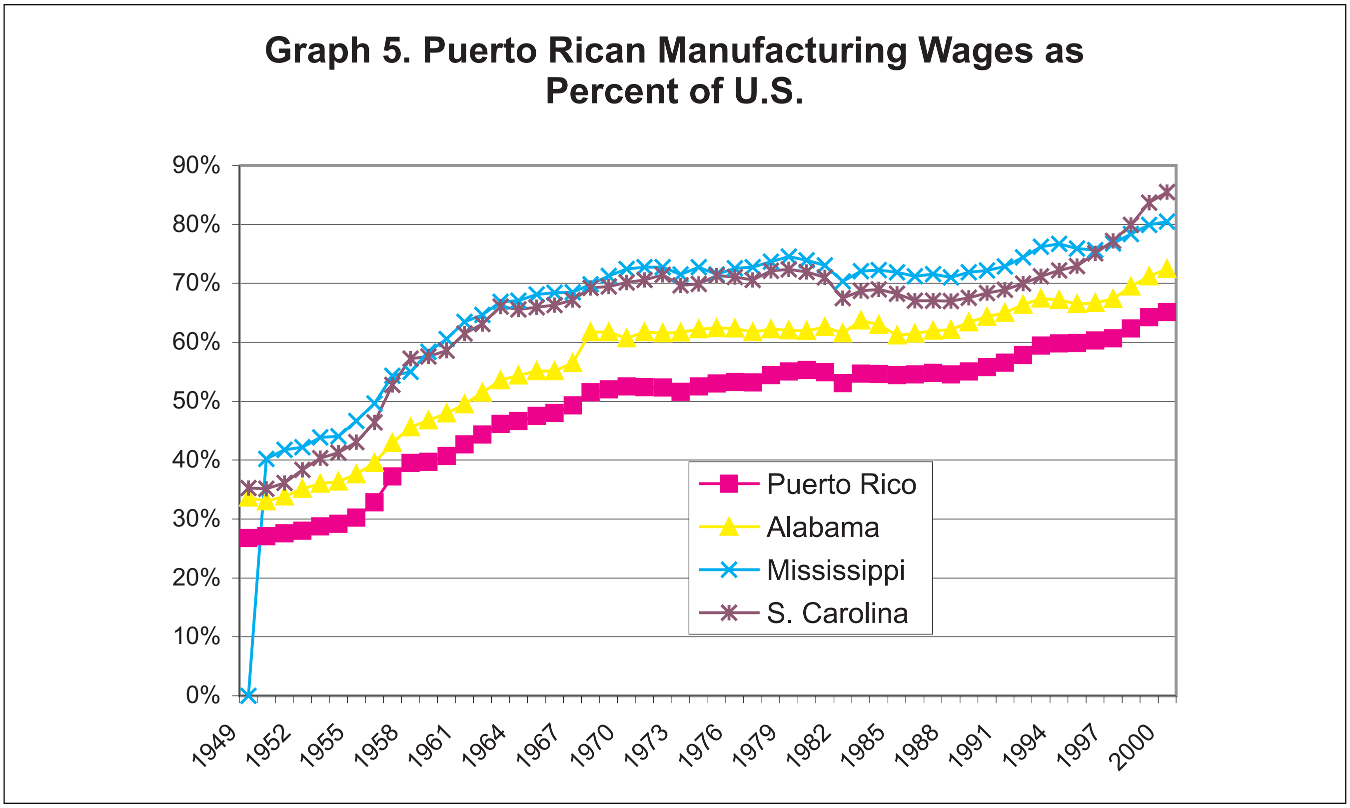
The Ripple Effects of Exclusion

The U.S. domestic code is undeniably a mess. However, sensible reforms could make it fertile soil for underdeveloped areas like Puerto Rico (and American Indian reservations, rural Mississippi, urban Detroit, and so forth). Maybe Puerto Rico wouldn't have been better off ensnared within the old domestic code. However, keeping Puerto Rico foreign and out of the code today creates unintended consequences that do real damage, namely:

- Exclusion breeds uncertainty over the fiscal rules of the game for Puerto Rico, because everything is in play. Firms need certainty to invest.
- As a result, exclusion generates constant debate over the right tax break, diverting attention from the fundamental problems that are holding the economy back. Discussion focuses on federal corporate tax breaks under section 936, modifications under section 956, or section 30A, not on creating the right conditions for local growth.
- Exclusion doesn't just create unproductive debate, it fosters an unhealthy dependence on federal incentives. It encourages the pursuit of "artificial grace" through federal incentives, rather than the heavy lifting needed to create the environment for growth.
- Exclusion also leaves federal tax policy for Puerto Rico open to the influence of U.S. corporations and not the U.S. citizens of Puerto Rico, who lack any vote in the process. The interests of the two do not align, as the history of section 936 illustrates.

Conclusion

Einstein defined insanity as doing the same thing over and over while expecting different results. Repeating the mistakes of the past and attempting to stimulate economic growth in Puerto Rico by keeping it out of the U.S. code and reinstituting a tax-credit strategy for mainland firms doing business in Puerto Rico would constitute a form of collective lunacy. Puerto Rico and the U.S. taxpayer would be far better off if Puerto Rico were brought under a reformed U.S. tax code that is hospitable to work, saving, investment, and entrepreneurial risk-taking. If that cannot be ac-



complished soon by comprehensive reform of the U.S. tax code, it makes sense to bring Puerto Rico and other economically lagging areas on the mainland under a reformed U.S. code as a grand experiment, perhaps in the framework of nationwide enterprise zones in which Puerto Rico could participate in its entirety. Not only would that experiment greatly benefit Puerto Rico and the other affected areas on the mainland, it also would provide a test case for extending the reformed code nationwide. ✦