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Tax Reform Savaging of the Puerto Rican Economy

Included in the Treasury's tax reform plan is a proposal to repeal Section 936 of the Internal Revenue Code, the possessions corporations tax credit. Under this provision, affiliates of U.S. mainland companies engaged in business in a U.S. possession, chiefly in Puerto Rico, may claim a credit against their Federal income tax liabilities with respect to the income produced by these affiliates in the possession. Coupled with the tax holidays granted by Puerto Rico under Operation Bootstrap, qualifying possessions corporations are substantially free of income tax on their possessions source income. The Treasury Department proposes to repeal the Section 936 tax credit because it " . . . does not believe that there should be a permanent tax subsidy for operations in the possessions." According to the Treasury, the current possessions corporations tax system is complex, expensive and inefficient.

The complexity in the possessions corporations provisions is, of course, primarily of the Treasury's own making. Treasury is to be commended for acknowledging this complexity, but repealing a useful tax provision is hardly the best way to simplify it. The charge that the credit is expensive and ineffective is based on the Treasury's gross overestimate of the tax revenue it foregoes because of the credit and an equally gross underestimate of the number of jobs which are appropriately attributable to the operations of possessions corporations in response to the Section 936 credit.

The Treasury Department also acknowledges that repeal of the credit will cause disruptions in the possessions, particularly in Puerto Rico. It proposes, therefore, to replace the present Section 936 credit by a so-called wage credit which, it asserts, will be more cost effective.

The Treasury Department is wrong.

The so-called wage credit would be a fixed dollar amount per hour worked by all persons employed in the possession by an establishment engaged in manufacturing. This amount would be 60 percent of the minimum wage applicable to such employees in the first year—1987, decreasing by 10 percent per year beginning in 1993 until it was completely phased out in 1998. The credit would apply against the Federal income tax liability on the possession source profits of the company. For this reason, it is obviously wrong to treat the wage credit as a subsidy for employment. The credit would reduce the tax on profits, not on wages. It would, therefore, reduce the cost of using capital, although not to anywhere near the same extent as the present credit. It would not reduce the cost of using labor.

Plain and simple, the proposed wage credit is nothing more than a severe cut back in the existing Section 936 credit. As such, it would do little to reduce complexity, and it certainly would not be more effective in promoting employment. And unless one relies on the Treasury's implicit assumption of inert, nonresponsive taxpayers, it won't produce any of the revenue gains so extravagantly estimated by the Treasury Department.

Far more is at stake than merely the tax purity, tidiness, or revenue gains which the Treasury presumably is seeking by repeal of Section 936. The combination of Puerto Rican tax holidays and the Section 936 tax exemptions induced a flood of new business investment and business ventures into Puerto Rico from 1948 until the mid-1970s. The resulting expansion of production, employment, and income transformed the Puerto Rican economy from a dismally unproductive agricultural society into a highly advanced industrial economy. It has made the Puerto Rican economy the model for economic development and growth originating in the private sector.

When the Reagan Administration was seeking to develop a Caribbean Basin Initiative, emphasizing the private sector's responsibility for development and growth-generating activity, it could have done no better than to implement a Section 936 approach. Instead, the Treasury successfully pushed for highly punitive limitations on Section 936 that there were included in the misnamed Tax Equity and Fiscal Responsibility Act of 1982. The Puerto Rican economy, which had been faltering since the late 1970s as a result of Internal Revenue Service efforts to cancel the tax exemption afforded by Section 936, was stunned; it has yet to share in the mainland's economic recovery. Repeal of Section 936 as the Treasury proposes would be a devastating blow to the Island's economy and might well send it tumbling back towards its pre-1948 status as the poorhouse of the Caribbean.

Even if the Treasury and the Congress were to be unconcerned about these economic consequences, they would have to be concerned about the enormous increases in relief outlays of various sorts which the Federal government would have to make to attempt to relieve the Puerto Ricans' economic distress. The result would be a significantly greater fiscal burden on the Federal government and a far poorer, less productive Puerto Rico in which the unemployment rate would attain unthinkable levels. It is difficult to identify any significant tax policy gains that repeal of Section 936 might afford that would be worth the cost in terms of the resulting economic misery and increase in Federal outlay obligations.

As serious as these distressing outcomes would be, they do not tell the entire story. The geopolitical consequences of pulling the rug out from under the Puerto Rican economy should be clearly recognized in the State Department, the Department of Defense, and the White House, if not in the Treasury Department. Only the most naive believer in the beneficent intentions of Fidel Castro would accept the notion that a Puerto Rico in economic collapse would not be an irresistable enticement for a Cuban attempt to evict the U.S. from the most important jurisdiction in the Caribbean. Short of this the reversal of economic fortunes in Puerto Rico would utterly erode the credibility of U.S. efforts to promote economic development and progress elsewhere in the Caribbean and Latin America through private sector initiatives. U.S. political and economic influence and leadership in this hemisphere would be seriously undermined.

It is certainly to be hoped that President Reagan will have these considerations clearly in mind when he reviews the Treasury's tax reform proposals. He should insist that the Treasury demonstrate convincingly that the flimsy tax policy gains to be achieved by repeal of Section 936 outweigh the obviously huge losses which other policies will necessarily sustain. Failing any such demonstration, the proposed repeal should be unceremoniously excised from the reform plan.

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