Puerto Rico: Hostage to U.S. Tax Reform
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An obscure provision of the Senate. passed tax-increase bill would, if enacted, heavily damage American policy in the Caribbean and cripple our efforts to promote economic development there through private initiative.

This provision would in effect cancel Puerto Rico's "Operation Bootstrap." a set of tax provisions. accommodated by a provision in the U.S. Internal Revenue Code. which creates significant incentives for U.S. companies to set up affiliates and to produce in Puerto Rico. The Senate provision would deal a stunning blow to Puerto Rico's economy, already reeling from the US. recession and from the setback to new investment resulting from the IRS's tax-audit policies and *its* litigation against *several* major U.S. firms with affiliates in Puerto Rico.

A Failure Before It Begins

The legislation would be construed throughout the Caribbean as a lack of firm commitment by the U.S. to fostering private-sector initiatives as the vehicle for economic development. The *Reagan* administration's Caribbean Basin Initiative. in which Puerto Rico was to be *the* linchpin, would fail before it began. Puerto Rico could no longer serve as a model for the region; it could no longer demonstrate what can be achieved when the private sector takes the lead in promoting econonuc progress.

The effects of the Senate action in overturning this important foreign policy initiative vastly outweigh any gains in the form of tax-policy niceties. The elimination of an alleged "tax abuse" and the supposed pick-up of a small amount of tax revenue would be purchased at the extraordinary price of forgone economic advances and political stability in Puerto Rico and throughout the Caribbean.

The "tax abuse" to which the Senate provision is directed is difficult to identify, even in the terms of the most zealous old-school tax reformers. The principal charge against the offending Internal Revenue Code Section 936 is that it affords U.S. mainland companies with Puerto Rican affiliates too much U.S. tax forgiveness. considering the number of jobs these companies provide in Puerto Rico. The tax revenue loss to the U.S. Treasury is alleged to be well over 140,000 per created job. The same number of jobs. the critics maintain. could be provided at a lower cost by direct federal outlays such as those under CETA. The "abuse," then. turns out to be the charge that the tax incentive is inefficient.

There is far less in this charge than meets *the eye. The estimated tax* revenue loss to the Treasury presupposes that in the absence of the tax credit. there would be the same amount of investment. employment, output and income in Puerto Rico (or that there would be an equal amount of investment, employment, output and income added in mainland U.S. operations) as there is under the present powerful incentives afforded by very nearly full tax exemption. This obviously is not true.

Even the most severe critics of Section 936 concede that a very substantial amount of U.S.-company investment in Puerto Rico is in response to the highly favorable tax treatment. Repeal or serious curtailment of Section 936 would result in prompt major disinvestments by U.S. companies in Puerto Rico and in the flight of capital to non-U.S. tax-haven jurisdictions. The revenue "loss" attributed to Section 936 is very largely fictitious; so, too. therefore. Is the revenue "gain" from the Senate action or any significant cutback on the tax benefits for Puerto Rican-produced income. The revenue loss per job created in Puerto Rico is nowhere near the extraordinary figure that is bandied about; it is, in fact. much closer to zero.

Even if one were to accept the revenue loss estimate upon which the Senate's proposal appears to depend, it doesn't follow that Section 936 is inefficient. The large amount of tax dollars per job reflects large capital returns per job which, in turn. reflect large capital investment per job. In the course of its development since Operation Bootstrap got underway in the late 1940s, the Puerto Rican economy has progressed from emphasis on agriculture and low-productivity. labor-intensive industries to capital-intensive, technologically advanced industries. This change has been associated with a rapid advance in the skill, productivity and real *wage* rates of an increasing number of Puerto Rican workers. If that's not what economic policy aims to achieve. If that's not the very essence of economic progress, if that's not what economic development strategy is all about, what *is?*

> *The elimination of an alleged 'tax abuse' would come at the* price *of forgone economic advances and political stability in Puerto Rico and the Caribbean.*

Indeed. isn't that just what we're looking for in the mainland U.S. as the achievement of the Reagan program? A large (putative) tax revenue loss per worker should. if anything, be taken as a measure of the success of Section 936 in making Operation Bootstrap an effective device for economic development initiated by the private sector.

It appears that the administration has some reservations about the Senate's proposed cutbacks of Section 936. The Treasury has offered a proposal that it claims would deal adequately with the uncertainties arising from the IRS's current audit policies and litigation stance. while raising substantial tax revenues. In fact. the Treasury proposal would erode much of the tax incentives for investment in Puerto Rico.

Treasury's Vengeful Pursuit

The administration's concern about the adverse effects of the Senate bill on the Puerto Rican economy has not been substantial enough to persuade the Treasury to forgo its vengeful pursuit of a relative handful of high-technology companies in favor of tax changes that would restore economic stability to Puerto Rico by continuing the demonstrably successful incentives of Section 936. Several suggestions for modifying Section 936, recently presented to the Treasury. the White House and the Senate and House conferees on the tax bill. would accomplish that result while providing a significant increase in U.S. tax revenues—substantially more than the amount estimated as raised by the Senate bill. These suggestions have been shunted aside by the administration.

One must hope that the conferees will *give them* careful consideration and will reject both *the* Senate and the Treasury proposals. If they do so, there may still be a reasonable chance for the Reagan administration to realize a successful Caribbean Basin Initiative, led by a thriving Puerto Rico.

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