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The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

In "Measuring The Benefits & Costs Of Section 936" (IRET Fiscal Issues, No. 5, 1985), Norman B. Ture discussed how Puerto Rico was successfully using reduced federal corporate income taxes to spur economic development. Ture also explained that efforts in Congress and the U.S. Treasury to change the law and limit the tax benefits threatened the Puerto Rican economy.

With IRET's permission, *Tax Notes* reprinted the study's summary (*Tax Notes*, July 22, 1985, pp. 441-442).

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The Section 936 Issue: Employment Gains Vs. Revenue Loss

By Norman B. Ture

Summary of Measuring The Benefits & Costs Of Section 936

IRET Fiscal Issues, No. 5, 1985

Late in the 1940s, Puerto Rico undertook a new economic development strategy, relying on tax holidays to complement the federal income tax exemption of possessions corporations' earnings. The response to these tax incentives over the next three decades was dramatic. Puerto Rico was transformed from one of the most impoverished lands in the Western Hemisphere to a technologically advanced industrial economy. Puerto Rico's economic, social, and political progress demonstrates the effectiveness of public policies that rely on private sector initiatives for new business and capital formation as the principal vehicle for economic development and growth.

Notwithstanding their demonstrated success, the possessions corporations tax provisions -- formerly section 931, now section 936 of the Internal Revenue Code -- have been increasingly criticized as affording tax benefits which are excessive compared with the number of jobs in Puerto Rico that are created by possessions corporations. The 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) cut back these tax benefits in the case of possessions corporations that rely significantly on manufacturing intangibles in their production operations, but proposals to eliminate section 936 persist in the current wave of tax reform proposals.

The fundamental issue is whether section 936 effectively serves its stated purpose of assisting " . . . the U.S. possessions in obtaining employment-producing investments by U.S. corporations" at an acceptable revenue loss to the Treasury. Addressing this issue requires correct identification and measurement of the effects of possessions corporations' activities on employment in Puerto Rico; it also demands appropriate identification and measurement of the effects on federal income tax revenues.

Neither of these sets of effects is properly conceived or measured by the Treasury Department in its report on section 936. Employment effects are measured merely by reference to the number of persons on possessions corporations' payrolls. Tax revenue effects are measured on the assumption that, with minor adjustments, the amount of federal tax liability for which section 936 tax credits are provided would be the same as if section 936 (and its predecessor provision, section 931) had never existed. The result is a gross underestimate of employment gains attributable to the response to section 936 and a gross overestimate of the revenue cost to the federal government.

Measuring Employment Gains

The appropriate measure of the benefits resulting from the section 936 tax incentives should include all of the gains from the economic development made possible by these tax incentives. Because economic development is a many-faceted and complex phenomenon, estimates of increases in employment alone cannot begin to capture these gains and seriously understate the development and growth accomplishments attributable to section 936. If, nonetheless, increases in employment are to be relied on as the only measure of economic benefits section 936 has provided, every effort should be made to include all of the increases in employment which have resulted from the operation of possessions corporations. By confining its measure of employment gains attributable to section 936 solely to persons on possessions corporations' payrolls, the Treasury Department very substantially understates these gains.

At the very least, the estimate of employment gains should include the increase in jobs in those industries supplying goods and services to possessions corporations. Using the relationship between the output of each industry and that of the industries supplying its various production inputs, as developed by the U.S. Department of Commerce, it is estimated that for every 100 persons on possessions corporations' payrolls, there are 45 persons employed in other companies in Puerto Rico that produce goods and services the possessions corporations use in their production activity. Assuming the same relationship between employment by these suppliers and employment in companies producing goods and services as imputes to them and on through the production chain, the total indirect employment in Puerto Rico directly associated with possessions corporations' activities in 1980 was 59,221. Total direct and indirect employment attributable to possessions corporations in that year totaled an estimated 131,637 jobs.

This estimate does not include the large number of jobs in both the private and public sectors which arose in connection with activities responding to increases in demands by businesses and households resulting from the gains in employment and income attributable to possessions corporations' activities. Assuming that as few as five percent of the persons employed in jobs not directly or indirectly associated with possessions corporations' businesses were engaged in jobs created in response to these demands, the aggregate employment attributable to section 936 in 1980 was 162,705. If the percentage was no more than 15, total employment attributable to section 936 in 1980 amounted to 224,841 jobs. These employment gains attributable to possessions corporations' activities are 21/4 to more than three times the number of jobs estimated by the Treasury for 1980.

By even this very limited measure of benefits, section 936 must be seen as a highly successful means for promoting economic development. This success is greatly magnified if account is taken of the gains in the quality of employment and in other attributes of economic, social, and political development.

Measuring the Loss of Tax Revenue

Just as employment gains are an inadequate measure of benefits, loss of tax revenue is a shorthand for measuring the costs of the economic development resulting from section 936. The Treasury Department's estimates of tax revenue loss from section 936 are misleading in concept and measurement.

The correct measure of tax revenue loss is the amount of revenue the federal government has foregone because of section 936. The Treasury instead attempts to measure the amount of tax revenue that would be gained if section 936 were repealed. In doing so, Treasury relies on the unrealistic assumption that there would be little, if any, change in possessions corporations' operations in Puerto Rico compared with the volume and character of these operations if the law were unchanged.

With more realistic, albeit conservative, assumptions about business response to the repeal of section 936, the resulting revenue gain would be much lower than the $1.233 billion estimated by the Treasury for 1980. Instead of the $17,026 of lost revenue per section 936 company job as estimated by the Treasury, the revenue loss per job gained as a result of possessions corporations' operations was in the range of $2,740 to $3,790 and may well have been as low as $1,370 or even less.

Compared with virtually any other job-creation program of the federal government, the possessions corporations tax provisions have been dramatically more cost efficient. Indeed, the Puerto Rican experience under Operation Bootstrap and the possessions corporations provisions should be seen as overwhelming evidence of the effectiveness and low cost of relying on tax incentives for the private sector as the principal vehicle for energizing the process of economic development and growth.

Geopolitical Considerations

More than just the economic, political, and social well-being of Puerto Rico, vitally important as these considerations are, hinges on the fate of section 936. Curtailing these tax incentives is likely not only to bring the remarkable progress of Puerto Rico to a halt, with attendant political and social unrest, it is also likely to lead to serious impairment of the United States' defense and foreign policy position throughout the Western Hemisphere. Improving the effectiveness of section 936, therefore, should be perceived as vital to the geopolitical and defense interests of the United States.