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Treasury Prepares a Caribbean Austerity Initiative

by Norman B. Ture

A Treasury Department official once calculated on the back of an envelope what the "cost" was of not applying the corporate income tax to Puerto Rican subsidiaries of mainland corporations. It went like this: You figure out what the corporations would pay if they had to pay the tax and, of course, nothing else changed. You assume, that is, that the plant would still be in Puerto Rico, or at least in territory subject to U.S. taxes. Then you divide this number by the number of Puerto Ricans on the payrolls of these plants. You find that it's "cheaper" to give the Puerto Ricans more food stamps.

Ever since this idiot calculation was first made, the Internal Revenue Service has been gunning for Section 936 of the IRS code, the possessions corporation 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's tax-reform proposal wants to repeal the Section 936 tax credit because it believes that 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 forgoes because of the credit and an equally gross underestimate of the number of jobs that result from the operations of possession corporations in response to the Section 936 credit.

The Treasury Department, not willing to give the Puerto Ricans cold turkey, 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 with a "wage credit" that, 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 people employed in the possession by an establishment engaged in manufacturing. This amount would be 60% of the minimum wage applicable to such employees in the first year -- 1987, decreasing by 10% a year beginning in 1993 until it is 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 labor.

The proposed wage credit is nothing more than a severe cutback 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, non-responsive 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 that 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 were included in the 1982 tax increase. The Puerto Rican economy, which had been faltering since the late 1970s as a result of IRS 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 toward its pre-1948 status as the poorhouse of the Caribbean.

Even if the Treasury and 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 that the federal government would have to make to attempt to relieve the Puerto Ricans' economic distress. The results 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.

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 recognized. Only the most naive believer in the beneficent intentions of Fidel Castro would believe that a Puerto Rico in economic collapse would not entice Cuba to try and foment revolution on the island.

For the Treasury and Congress to consider repealing Section 936 without providing equally effective incentives would not only be unfair but would utterly erode the credibility of U.S. efforts to promote economic development and progress throughout the Caribbean and Latin America.

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