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Leave No State or Territory Behind:
Formulating A Pro-Growth Economic Strategy For Puerto Rico

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Executive Summary

Puerto Rico faces a daunting economic challenge at the beginning of the 21st century. The Mainland and Puerto Rico must enter into a new contract that rejects the failed policies of the past. Through the tax, regulatory and fiscal reforms proposed in this study, Puerto Rico can become a thriving international center of commerce and innovation, to the benefit of both the Island and the Mainland.

Puerto Rico faces a daunting economic challenge at the beginning of the 21st century. It starts with a significant portion of its population below the federal poverty line (48 percent) and persistently high unemployment (13 percent). The manufacturing base created in the 1950s is eroding under the pressure of North American Free Trade Agreement (NAFTA) and other trade agreements as the Island's wage advantage in unskilled labor disappears. Puerto Rico's engines of growth must be overhauled, and those engines must be allowed to operate at peak performance, unencumbered by ill conceived and failed federal and Commonwealth government policies.

Expanding the Island's economy and putting more of its people to work is a multidimensional undertaking. First, the tax and regulatory shackles imposed by the federal and Commonwealth governments must be removed from Puerto Rico's investors and business owners. A new broad-based economic development strategy is required to spur local investment and entrepreneurial risk-taking. Second, impediments that currently disrupt the operation of an efficient labor market and create disincentives to work must be removed to unleash Puerto Rico's labor force and allow workers to achieve their highest potential. Third, Puerto Rico must create a highly educated and trained labor pool, especially in the area of Information Technology, who will make the Island competitive in today's global economy.

Three fundamental reforms are needed to put Puerto Rico on a high-growth path to prosperity:

1. **Replace tax-credit economic development strategy**. Scrap the failed government-centered economic development strategy to which Puerto Rico has become addicted. Puerto Rico should reduce tax rates across the board on all corporations and individuals, both foreign, Mainland and domestic, and devise a new pro-growth, pro-family tax system that rewards work, saving, investing and risk-taking, which will be conducive to all types of economic activity and generate adequate revenues for the legitimate activities of government.

Rather than treating Puerto Rico as a special political dependent reliant on handouts, Congress should create nation-wide super enterprise zones in which Puerto Rico and other poor regions of the Mainland, particularly those adversely affected by free-trade initiatives, could participate.

Specifically, this report recommends that Puerto Rico petition Congress to treat Puerto Rico as an *Island-wide enterprise zone* in which all companies would be allowed to elect whether they are taxed under the current Internal Revenue Code or under a reformed federal tax code.

2. **Enact fiscal reforms.** Reform and rein in the Puerto Rican welfare state, which breeds dependency and retards private sector growth. In particular, the report recommends restraining the growth of Puerto Rican government spending and employment in order to reduce the size and scope of government on the Island to something more comparable to that on the Mainland. The report recommends that:

   - Puerto Rico commit itself to meeting the national education standards established for all 50 states in the 'No Child Left Behind' legislation of 2001;

- Puerto Rico agree to phase out "cover-overs" on federal excise taxes; and,
- The federal government extend coverage of the Earned Income Tax Credit (EITC) and Supplemental Security (SSI) benefits to Puerto Rican residents who qualify [A good argument can be made that such a change not only is equitable but also will target those working poor most in need].

3. **Enact regulatory reforms.** Reduce counterproductive regulations, especially the system of business permitting, which retard business start-ups and expansions and generally clog up the economy. The report also recommends that Puerto Rico participate actively in regulatory reform efforts by state and local government associations to achieve relief from harmful federal regulations, the spirit of which can more appropriately and efficiently be implemented by state, local and territorial governments.

The federal government's direct cost of implementing the policies suggested in this report will be less than the cost of providing Mainland businesses doing business in Puerto Rico new tax subsidies through section 956 of the Internal Revenue Code as was proposed in the last Congress. If the policies recommended in this report are adopted in lieu of more tax-subsidy schemes, Puerto Rico can become a thriving international center of commerce and innovation. Puerto Rico can meet the challenge of the 21st Century with great hope and promise, but to do so, both the Mainland and Puerto Rico must enter into a new contract that rejects the failed policies of the past.

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LEAVE NO STATE OR TERRITORY BEHIND:
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OVERVIEW

It is important at the outset to define what this report seeks to accomplish by describing what it does not. This report does not advocate any particular permanent political status, nor does it seek to promote a hidden agenda that would advantage the ultimate attainment of any particular political status. It attempts neutrality. At the same time, the authors understand that the specter of the debate over the Island's political status hovers over the ideas expressed here, as it does over any serious discussion of Puerto Rico. Caught betwixt and between throughout its history—neither a state nor an independent nation—Puerto Rico's status is as unsettled as it is unsettling. Even the definition of Puerto Rico's "Commonwealth status" remains open. Throughout Puerto Rico's modern history, different groups, both on the Island and on the Mainland, have posited different visions of what it means (or should mean) for Puerto Rico to remain a Commonwealth of the United States of America, a disagreement that continues today and that will continue regardless of whether all policy suggestions made herein are adopted.

Instead, this report examines the current economic and fiscal situation in Puerto Rico and provides a roadmap for a new contract between Puerto Rico and the federal government. The primary focus of this report is on the extent to which current economic and fiscal policies (tax, spending and regulatory policies) of both the Puerto Rican government and the federal government of the United States create impediments to economic growth and prosperity on the Island.

This report does not advocate any particular permanent political status.

The Report calls on the Federal Government of the United States to adopt a new perspective on Puerto Rico that will fashion a new economic framework for the Island in which impediments to economic growth are eliminated. This new perspective is based on the premise that a free people engaged in commerce and trade in free and open markets—not government bureaucrats, elected officials and government-owned enterprises directing and often misdirecting, guiding and often misguiding markets through industrial policy—is the driving force behind economic growth and prosperity. In that direction lays the only sure way to achieve social progress for all Puerto Ricans.

The unsettled status situation remains a major obstacle to economic growth and prosperity. Instability and uncertainty caused by the unsettled political situation limits the interest and desire of investors to commit capital to the Island. Therefore it is essential that the Congress enable and facilitate an expeditious process by which the people of Puerto Rico soon can choose conclusively what the Island's permanent political status will be. It is also imperative that policies be adopted without delay to free the Island's economy from the government-created impediments that hold it back. It is critical Puerto Rico break out of the vicious cycle in which the adoption of pro-growth policies are routinely held hostage to the interminable status debate, which perpetuates stagnation and in turn makes an expeditious resolution of the political status question impossible. It is time to break the chains of political deadlock. Puerto Rico's people—its workers, small business owners and entrepreneurs as well as large corporations and global business partners—deserve a political and economic environment in which they can achieve their potential. Puerto Ricans, like all American citizens, should be able to look forward to a better life and a democratic future, and exploit opportunities, whatever the Island's ultimate relationship with the Mainland turns out to be.

Past and Present

Political Backdrop

The modern history of Puerto Rico–at least in its relationship to the U.S.–began in earnest little more than one century ago. During the Spanish-American War, the U.S. occupied Puerto Rico and installed a military government. Over the next fifty years events quickly changed.

In 1900, the Foraker Act (the Organic Act of 1900) formally established the political and economic relations between Puerto Rico and the U.S. and put in place a local civil government. In 1917, the Jones Act provided that Puerto Rico was a U.S. territory whose inhabitants were entitled to U.S. citizenship. The act provided for election of both houses of the Puerto Rican legislature and the governor was empowered to veto any legislation. The U.S. president appointed the governor and other key officials; indeed, it was not until 1946 that President Truman appointed Jesus Toribio Pinero as the first native-born governor of Puerto Rico.

One year later, Congress expanded Puerto Rican self-government by permitting Puerto Ricans to elect their own governor, and in 1948, Luis Muñoz Marín, the leader of the Popular Democratic Party (PDP), became the first elected Puerto Rican governor. Muñoz Marín was reelected in 1952, 1956, and 1960, until another Popular Democrat, Roberto Sánchez Vilella, ultimately succeeded him.

In 1950, Congress passed a law granting Puerto Rico the power to write its own constitution, which Puerto Rican voters approved in a 1951 referendum. A Puerto Rican convention then wrote a constitution. Puerto Rican voters ratified it. The U.S. Congress approved it on July 1, 1952. On July 25, 1952 Puerto Rico achieved a greater measure of local self-government but without representation in the United States Congress and subject to the plenary powers of the U.S. Congress.

The Spanish term for the Commonwealth of Puerto Rico is "Estado Libre Asociado de Puerto Rico." This Spanish term is somewhat illustrative of the ambiguities of Commonwealth status. The Spanish term connotes an associated free state or a state in free association. In reality Puerto Rico's status is neither that of an associated free state nor that of a state of the Union, but rather that of a territory. Many critics, both in Puerto Rico and on the Mainland, maintain that this arrangement continues to be nothing less than colonial.

Puerto Rico is exempt from most federal taxes and lacks voting representation in either house of the U.S. Congress and in presential elections.

In practice, the major differences between Puerto Rico's commonwealth status and statehood is Puerto Rico's exemption from most federal taxes, its lack of voting representation in either house of the U.S. Congress or the right to vote in presidential elections, and its lack of an allocation of some of the revenues reserved for the states. Both the Republican and Democratic Parties do hold presidential primaries in Puerto Rico. Further, both the Republican and Democratic Parties have Puerto Rican delegates that vote in the national presidential conventions.

Over the years, several attempts have been made through local plebiscites to resolve the Puerto Rican status dilemma. Congress authorized none of these plebiscites.

One example was the plebiscite held in 1967. The Commonwealth formula received 60 percent of the vote, statehood received 40 percent and independence, one percent. In 1968, after 28 years in power, the Popular Democratic Party was defeated by the New Progressive Party (NPP), which favored statehood. Luis A. Ferré, founder of the NPP, became governor.

Four years later, the PDP took back power with the election of Rafael Hernández Colón as governor. In the next election (1976), the NPP's Carlos Romero Barceló was elected governor, and he was re-elected in 1980. In 1984, power shifted back to the PDP with the election of Hernández Colón as governor, and he was re-elected as governor in 1988.

In 1991, Spanish was declared the island's "official" language, even though in 1991 a referendum soundly rejected the official status of Spanish language. In 1992 the NPP won the election, and Pedro Rosselló was selected as governor. In that year, the law was changed again making both Spanish and English official languages.

In 1993, another status plebiscite was held. A proposed "Commonwealth Status" formula, which was locally defined but widely criticized in congressional hearings as unconstitutional, received 48.6 percent of the vote; statehood received 46.3 percent of the vote; and independence received 4.5 percent of the vote.

In 1996, Pedro Rosselló was re-elected governor, and the NPP also won control of the Senate and the House with strong majorities. A third status plebiscite was held in 1998. This time there were five options on the ballot: 50.3 percent of the voters selected "none of the above options"; statehood received 46.5 percent and independence, 2.5 percent. The remaining two ballot options, "current commonwealth status" and "free association," received the remaining 0.7 percent. The "none of the above option" was supported by the PDP to protest the "territorial" definition of the commonwealth option on the ballot, which used the language of the "Young Bill," passed by the U.S. House of Representatives. Governor Roselló and the NPP supported statehood.

In 2000, the PDP regained power with the election of Sila M. Calderón as governor. Currently the PDP has 30 of 51 seats in the Senate and 19 of 28 seats in the House. The Puerto Rican Independence Party has one seat in each chamber and the NPP the remainder.

The Framework of the U.S.–Puerto Rico Tax Relationship

Under the Jones Act of 1917, as noted above, Puerto Rico is part of the United States for purposes of acquiring citizenship of the United States by place of birth. Thus, a person born in Puerto Rico is a U.S. citizen and thus is subject to the U.S. Internal Revenue Code (Code), or rather would be if there was no exception. However, the Code provides different tax rules for residents of Puerto Rico than it does for residents of the United States. Under section 933 of the Code, any U.S. citizen satisfying Puerto Rican resident requirements is exempt from federal income taxation.

Puerto Rico imposes more taxes at higher rates than U.S. states.

Since 1918, Puerto Rico has exercised its own taxing authority by enacting laws broadly similar to the U.S. However, Puerto Rico imposes more taxes at higher rates than states, and it layers taxes one on top of the other. Moreover, these taxes are of several types: income taxes, excise taxes (explained *infra*), ad volorem taxes and license fees. Taxes are imposed in Puerto Rico at the federal level, the commonwealth level and the municipal level. There is an income tax on both corporations and on individuals. Similar to the U.S., there is a withholding tax on Puerto Rican-sourced income that is paid by nonresident companies. There are employment taxes. There are significant real and personal property taxes. There are separate excise taxes that work largely like the old-fashioned customs duties for goods from the U.S. Finally, certain municipal license taxes are imposed.

The current Puerto Rican income tax system is the most significant source of revenue for the Puerto Rican government. In fiscal year 2000, individual and corporate income taxes totaled about 77 percent of Puerto Rico's total tax revenues. The Puerto Rico Treasury collected about $2.5 billion in individual income taxes. Puerto Rico's individual income tax collections amounted to 6.6 percent of the Puerto Rico's personal income in 1992. This percentage is higher than that of the state and local income tax collections in any of the states and the District of Columbia. New York State, where state and local income taxes amounted to 4.2 percent of state personal income, ranked closest to Puerto Rico. As of July 1995, the last year for which return data are available, 651,201 individual income tax returns for tax year 1992 had been filed with the Government of Puerto Rico. Some of the individuals filing those returns paid federal income tax because they had income from sources within the United States.[1]

Puerto Rico also collected about $1.755 billion in corporate income taxes in 2000. About 42 percent of the corporate tax (about $740 million) was paid by U.S. subsidiaries covered by the possessions tax credit. The remaining 58 percent (about $ 1.015 billion) was paid by corporations not covered by the credit. In addition, about $17 billion of income earned by corporations in Puerto Rico was exempted from the local corporate income tax as a result of Puerto Rico's industrial tax incentive legislation.

The Tax-Subsidy Strategy For Economic Development

In order to assist Puerto Rican economic development, the United States has extended certain special income tax provisions to Puerto Rico not available to the states. Paramount among those provisions is section 933, which exempts U.S. citizens residing in Puerto Rico from paying Federal income taxes.[2]

The United States also exempts from income taxation—at the federal, state, and local levels—all bonds issued by the Government of Puerto Rico.[3]

Finally, over the years the U.S. has enacted various iterations of tax exclusion and credit incentives for Puerto Rico—the most famous of which were section 936 and its limitation section 30A. While section 936 of the Code has been repealed (repealed in 1996 with a 10-year phase-out), the benefits of the law still linger on for a few hundred companies that were grand fathered in. The law effectively exempts from federal taxation a portion of the income these qualified subsidiaries of U.S. corporations (i.e., corporations organized in any state of the United States) earn in the possessions.

Section 933 exempts U.S. citizens residing in Puerto Rico from paying Federal income taxes.

In particular, the Omnibus Budget Reconciliation Act of 1993 significantly limited the §936 credits. Under the Omnibus Budget Reconciliation Act of 1993, the Clinton Administration passed legislation that limited possessions corporations after 1993 to the "Economic Activity Limit" method of accounting for the credit base. That limitation ensured the credit for any taxable year could not exceed the sum of: (1) sixty percent of the possession corporation's qualified possessions wages, plus (2) the allocable employee fringe benefit expenses; plus (3) a specified percentage of the possession corporation's depreciation expense with respect to qualifying tangible property. A possessions' corporation could elect within its first year after 1993 to apply the alternative "Percentage Limitation" method of base accounting, where the §936 credit was limited to a specified percentage of the otherwise allowable credit amount. The allowable amount of the credit decreases from 60 percent to 40 percent over a five-year period.[4]

Then, the Small Business Job Protection Act of 1996 began a phase-out process that will terminate the credit completely by 2006. For tax years beginning after 1995, the possession tax credit was repealed for all but "existing credit claimants" (corporations that elected the benefits of §936 for the tax year and which were engaged in the active conduct of a trade or business within a possession on that date).[5]

In addition, under the Internal Revenue Code, corporations organized in Puerto Rico are generally treated as foreign corporations for U.S. income tax purposes. U.S. corporations generally are subject to U.S. tax on their worldwide income; however, under long-established U.S. tax policies, income earned abroad by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until it is repatriated as a dividend to the U.S. shareholders.[6] In recent years, numerous U.S. businesses have restructured their Puerto Rico operations as Controlled Foreign Corporations (CFCs).[7]

As the phase-out of section 936 and section 30A proceed, at least one mainland company benefiting from the tax subsidies has proposed a successor tax subsidy. The best known proposal was H.R. 2550 (introduced by Representatives Crane and Rangel in the 107th Congress and its Senate companion S. 1475 (introduced by Senators Breaux and Hatch as a companion proposal in the 107th Congress).

The authors of the two section-956 bills represent the proposal as having several components. First, sections 30A and 936 would be allowed to expire according to their existing terms (and would not be amended to remove the limitations that are scheduled to take effect at the end of 2001). Second, a limited transition rule would be provided for companies now conducting operations in Puerto Rico (i.e., existing section 936 and 30A credit claimants). Third, section 956 would be amended to exclude from current U.S. tax 90 percent of the otherwise taxable investments in "U.S. property" made by a Qualified Possessions Corporation out of its Qualified Possessions Income. As an alternative to the section 956 exclusion, companies could elect an 85 percent dividends received deduction for dividends paid out of Qualified Possessions Income. More specifically, under the proposal, section 956 would be amended to exclude from current U.S. tax 90 percent of the otherwise taxable investments in "U.S. property" made by a Qualified Possessions Corporation, but only to the extent the investments are properly attributable to Qualified Possessions Income.

A "Qualified Possessions Corporation" would be defined as a controlled foreign corporation, (as defined in IRC section 957) incorporated in Puerto Rico or another U.S. possession. "Qualified Possessions Income" would be limited to that portion of the Qualified Possessions Corporation's post-2001 foreign source income that is derived from the active conduct by that corporation of a trade or business in Puerto Rico (or another possession) or from the sale or exchange of substantially all the assets used by that corporation in the active conduct of such a trade or business. The proposed section 956 exclusion would be applicable only to income that is eligible for deferral under general U.S. tax principles.[8]

As an alternative to the 90 percent section 956 exclusion, Qualified Possessions Corporations could elect an 85 percent dividends received deduction that would be available to the U.S. shareholders of the Qualified Possessions Corporation for dividend distributions out of the CFC's Qualified Possessions Income earned after 2001.[9]

Puerto Rico's quest for economic convergence with the Mainland is stalled.

The section-956 proposal anticipates that in order to take advantage of the new section-956 exclusion or the new dividends received deduction, some companies now operating in Puerto Rico through domestic corporations will need to license or transfer technical know-how or other manufacturing intangibles from the domestic corporation to a Qualified Possessions Corporation. To enable these transactions to be accomplished without a reduction in the tax benefits now claimed by these companies, an elective transition rule would be provided.

This rule is limited to its intended beneficiaries. It would be available only for the transfer or license of *manufacturing intangibles* that were owned by a domestic corporation claiming benefits under section 30A or 936 on the date of enactment of the proposal and were either acquired by purchase or developed by that corporation.[10]

If a Qualified Possessions Corporation avails itself of the new section 956 exclusion by making interest-free loans to a U.S. person, no interest income would be imputed to the Qualified Possessions Corporation with respect to such a loan (and, correspondingly, no U.S. interest deduction would be allowed). The legislative history would clarify that Congress does not intend that the judicial doctrine of "constructive dividends" be applied to re-characterize loans or other investments in U.S. property made pursuant to the proposal.

A Stalled Quest For Economic Convergence

Most critics of the tax subsidy strategy of economic development, and Internal Revenue Code section 936 in particular, acknowledge the early success of granting preferential tax treatment under the Internal

Revenue Code to US firms doing business in Puerto Rico. However, in the view of the section 936 critics, something went wrong in the implementation of this development strategy under section 936 in the 1970s when capital-intensive companies really began to exploit section 936 without generating commensurate increases in standards of living on the Island:

> At the outset, this approach—as expressed first in section 262 of the Revenue Act of 1921, and ultimately in section 936 of the Internal Revenue Code—was successful. In Puerto Rico, during the 1950s and 1960s, it spurred the island's industrialization, infrastructure development, and the attendant growth in employment and GNP. By the mid-1970s, however, the job-creation benefits of section 936 took a back seat to the corporate tax schemes, which brought great financial gain to only a few U.S. companies, substantial cost to the U.S. Treasury, and a competitive disadvantage to "native" Puerto Rican enterprises.[11]

Despite their generally favorable view of pre-section 936 tax preferences, critics of section 936 have, by and large, given up hope that the tax subsidy approach to economic development can be "fixed:"

> Section 936 should not merely be fixed, and indeed it *cannot* be fixed . . .The revisions to section 936, as provided in 1993 in President Clinton's budget [Section 30A], do not address these shortcomings [and] like earlier attempts to fix the tax benefit, they promise a result that is inferior to the possibilities of abandoning the policy entirely."[12]

The economic reality is that a main objective, Puerto Rico's quest for convergence with the Mainland, is stalled:[13]

> ***The Puerto Rico economy was unable to accelerate sufficiently to catch up with even the poorest state on the Mainland.***

- During roughly the middle third of the 20th century, intensive investment in manufacturing plant and equipment in Puerto Rico by off-island companies—lured to the Island by a combination of tax incentives and relatively low labor costs—transformed Puerto Rico from one of the poorest economies in the Caribbean to one of the wealthiest.
- While the Island was being transformed from a backward agrarian society into a modern industrial society during this period, the Puerto Rican economy also was becoming almost completely integrated with the United States economy. Yet, while the tax subsidy development strategy was initially successful at creating economic ignition on the Island, it also created a harmful tax subsidy dependence that combined with the population's heavy dependence on government-transfers to thwart the development of a well-balanced dynamic local economy of small and medium sized businesses. Consequently, the Puerto Rican economy was unable to accelerate sufficiently to catch up with even the poorest state on the Mainland.

During the 1950s and early 1960s, the golden-years of economic growth in Puerto Rico, off-island investment was being lured to Puerto Rico through a combination of tax incentives and a relatively lower minimum wage rate. Even though Congress had narrowed the wage differential from where it stood in the 1940s, it was still sufficient to generate a high level of low-cost employment on the Island at wages that substantially improved Puerto Ricans' living standards, and more importantly allowed low-skilled workers entry into the labor force.[14] The Puerto Rican economy expanded at 12 percent a year.

A 1976 *Wall Street Journal* op-ed put Puerto Rican economic development in perspective:

> There is much less to these [tax] incentives than meets the eye. Because industries built with U.S. capital cannot repatriate earnings without being slugged with the federal profits tax, the investor ultimately cannot benefit much from the exemptions . . .Ironically, it was the U.S. minimum wage that was the real force behind the [1950s] boom . . . the marginal difference [in the minimum wage] permitted venture capital to hire skilled labor in Puerto Rico at a price lower than unskilled labor in the states.[15]

By the late 1970s, a number of anti-growth policies (both from the federal government and the Puerto Rican government) were weighing down on the economy. In 1972, in addition to other similar initiatives the government took over the privately owned telephone company and the privately owned shipping company, thus expanding the role and the size of the government. Congress had virtually eliminated the minimum wage differential, Puerto Rican tax rates on capital and labor remained substantially higher than those on the Mainland, the Jones Act requirement that Puerto Rico use high-cost American shipping for goods sent to the U.S. was lowering profits margins, and an array of other federal labor and environmental regulations were stifling economic growth.

The governor attempted something radical. George Gilder describes what the governor did:

> Barcello cut territorial income-tax rates and removed two 5 percent surtaxes in 1978. By the next year, according to official statistics, tax revenues increased by $15 million over the previous year, the unemployment rate dropped by 1.2 percent, and inflation slowed down. Further reductions were enacted in 1979, with a 13.5 percent increase in revenues and 100,000 more taxpayers coming onto the rolls in 1980s.[16]

Only a few years earlier, however, the U.S. Congress had planted the seeds of transfer-payment dependency that would eventually help overwhelm the positive benefits of the tax cuts. In 1974, it passed legislation to make Puerto Rican residents eligible for food stamps. By 1982, those seeds had grown into strangling tendrils of personal welfare dependency that, when combined with the stultifying effects of the minimum wage, were choking work incentives and keeping thousands of young Puerto Ricans from taking that first step on the ladder of economic success. The food stamps tab for Puerto Rico had reached a billion dollars a year, and Congress attempted to stem the run-away welfare program by converting it to a block grant.

To this, the Congress began the process of creating a sort of corporate tax welfare. No matter what tax subsidies were used in the Internal Revenue Code to target off-island companies, they were unable to compensate for the powerful downdraft created by a poisonous mix of bad policy, and the economy was faltering. Unemployment was over 20 percent, and the underground economy was flourishing. Hence began a cycle of dependency in which there was something for everybody.

Between 1970 and 1990, the government sector grew more than three times faster than the private sector.

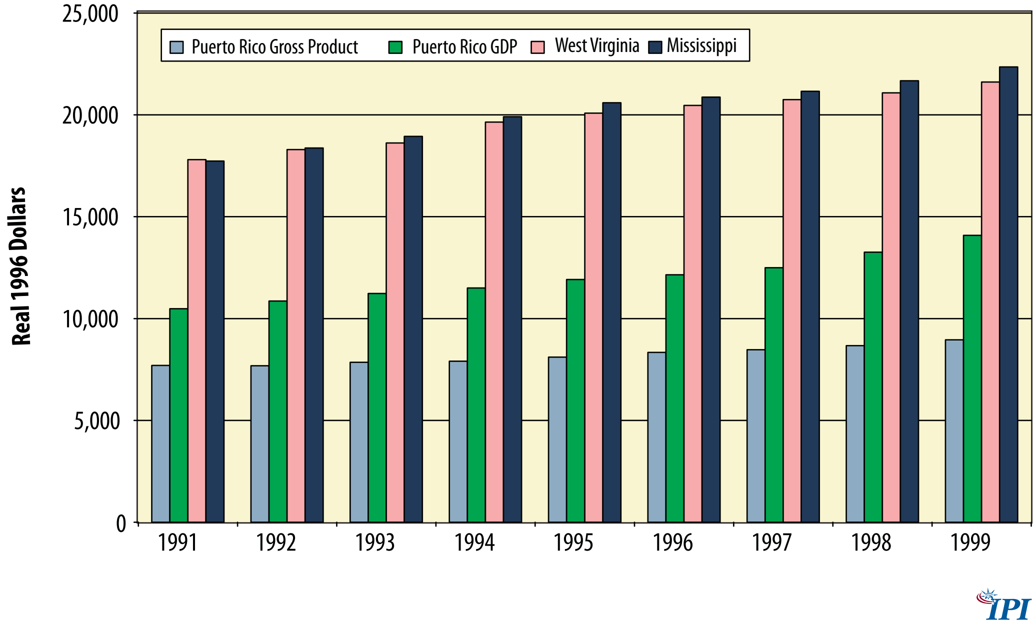
Unfortunately, the governor that so audaciously had kick-started the economy with tax rate reductions to create incentives for work, saving and investment, passed up the opportunity to use the block-grant monies to eliminate the worst of the work disincentives associated with the food stamps program. Instead, he simply mailed eligible families a monthly check in the name of "administrative efficiencies," a practice that continues today.[17]

Adding to the government-imposed tax and regulatory burdens on the Puerto Rican economy, the shear dead-weight burden of excessive and wasteful government spending combined with bloated public payrolls to sap resources and labor from the private sector. Between 1970 and 1990, the government sector grew more than three times faster than the private sector.[18]

Today, the trend continues. In the 2001–02 fiscal year, the number of government jobs increased. Excise taxes have been increased. Further, there has been a postponement in the reduction of income taxes.

Puerto Rico remains poor by Mainland standards. Per capita domestic product in Puerto Rico remains at about 43 percent of U.S. per capita domestic product, having increased only slightly from 40 percent in 1990. Puerto Rico has per capita domestic product equal to 65 percent of the SDP of the nation's poorest state, West Virginia's, having closed the gap somewhat from 59 percent at the beginning of the 1990s.

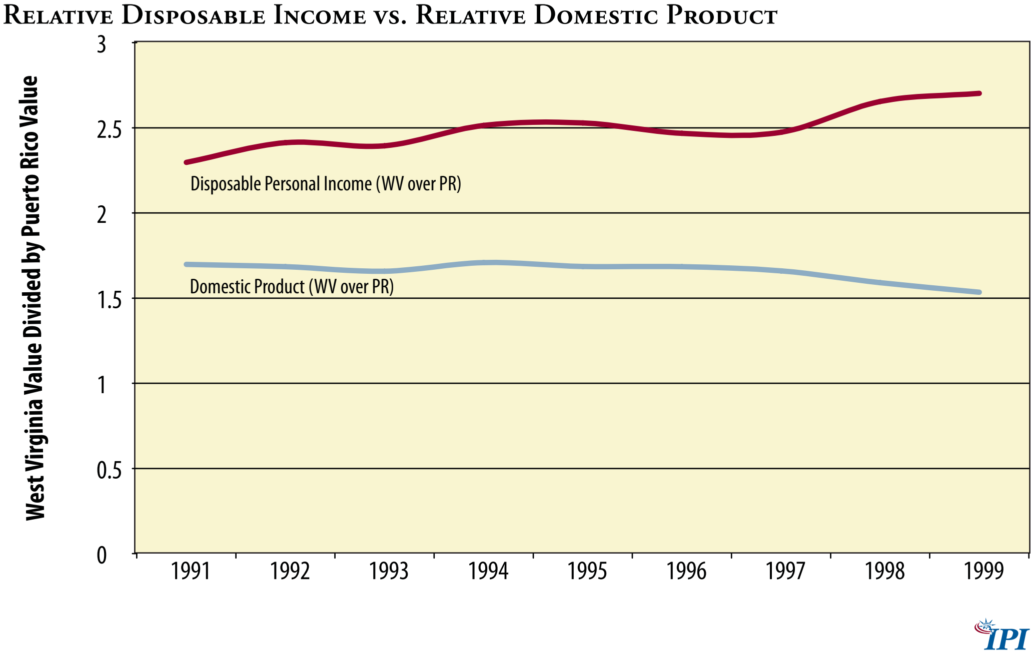
Figure 1 **Per Capita Gross State Product**



The standard benchmark of economic well being, GDP per capita, can be misleading, however, because it tends to overstate the degree to which measured output growth on the Island translates into improvement in the living standard of the Island's inhabitants. If, for example, gross national product—which includes the income that Puerto Rican companies earn abroad and on the mainland minus what they earn in Puerto Rico and expatriate back to the Mainland—is used in the comparison, Puerto Rico's relative situation looks even worse. Per capita gross product in Puerto Rico remains only about 58 percent of West Virginia's per capita gross state product and a mere 25 percent of the Mainland's overall gross national product.

Per capita gross product in Puerto Rico remains only about 58 percent of West Virginia's.

Figure 2 **Relative Disposable Income vs. Relative Domestic Product**



An even more direct measure of comparison between Puerto Rico's standard of living and that of the Mainland is per capita disposable personal income. Figure 2 plots the ratio of West Virginia's domestic product to that of Puerto Rico and compares it to the ratio of West Virginia's per capita disposable income to Puerto Rican disposable income per capita. On average between 1991 and 1999, West Virginia's domestic product was only slightly more than 1½ times that of Puerto Rico while its disposable personal income was more than 2½ times that of Puerto Rico.

The gap between the two lines illustrates visually the degree to which domestic product comparisons between Puerto Rico and the states understate the relative poverty of Puerto Rico inhabitants compared to the inhabitants of the poorest state.

The size of the gap can be represented numerically by calculating the percentage difference between the points on the lines (i.e., the percentage difference between the two ratios that yield the points on the lines). The resulting number provides a convenient measure of the extent to which per capita domestic product comparisons understate the disparities in economic development between Puerto Rico and the states. In 1991, domestic product comparisons understated the economic disparities between West Virginia and Puerto Rico by about 26 percent. By 1999, the understatement had doubled to 43 percent. The bottom line is this: Puerto Rico is actually falling behind.

The crux of the problem is twofold. Anti-growth policies of both Puerto Rico and the United States governments retard overall economic activity on the Island; at the same time these anti-growth policies skew the distribution of the benefits of the economic growth that does occur toward non-Island inhabitants. Tax-subsidy schemes like section 936 and its proposed successor, section 956, are incapable of compensating for the other anti-growth policies that drag Puerto Rico's economy down. These compensatory tax subsidies fail to translate aggregate output increases that do occur into a commensurate rise in personal income and living standards for Island inhabitants. The tax benefits go to a very small group of off-island concerns doing business in Puerto Rico that neither create broad-based employment for local inhabitants nor increase wealth on the Island.

Puerto Rico has arrived at a critical juncture.

Puerto Rico has arrived at a critical juncture. The old tax subsidy development strategy is ending with the phase-out of sections 936 and 30A leaving a choice among three alternative paths for the future:

1. Abandon the old tax subsidy development strategy altogether without replacing it with something new;

2. Resort again to the old tax subsidy development strategy with the hope that new variants on the old theme (say expansion of section 956) will produce sufficient economic acceleration to catch up with the Mainland; or

3. Replace the old tax subsidy development strategy altogether with a new economic growth strategy that combines status-neutral incentives for off-island investment in Puerto Rico with powerful local incentives to spur indigenous entrepreneurism and small business formation.

This report suggests alternative "three" as the only viable option. In particular, the report suggests that the United States government establish firm guidelines on Puerto Rico to eliminate extant anti-growth policies and replace them with pro-growth, pro-family, pro-entrepreneur policies that will unleash the awesome productive and creative potential of Puerto Rico's people and businesses. Before discussing specifics of this new approach, it is first necessary to explore the source of Puerto Rico's economic problems in greater detail.

The Source of Puerto Rico's Economic Problems

Allaying Old Myths

Even in the teeth of evidence that Puerto Rico's economy continues to falter, there is persistent widespread support on the Island for the tax subsidy approach to economic development. This pervasive nostalgic attachment to consistently and demonstrably failed policies can only be explained by the presence of a mythology underpinning the misguided commitment to these policies. The primary myth usually takes the following form.

- **The Tax-Subsidy Myth:** As a result of permanent tax subsidies from the Mainland, Puerto Rico has become a "model economy;" without the tax subsidies, Puerto Rico will turn into an economic basket case.

Advocates for continuing the *status quo*[19] argue that Puerto Rico is a "model of economic growth" as a direct consequence of the tax subsidy strategy of economic development pursued in one form or another for the past 80 years. As evidence of the strategy's success, they point to fact that the Island is the Caribbean region's fastest growing economy. They point out that U.S. firms have invested heavily in the Island's economy since the 1950s in order to take advantage the tax incentives provided by the U.S. Congress without having to sacrifice duty-free access to the Mainland's markets.

In some instances this myth approaches the status of "urban legend." For example, according to David Martin, a former economist for the government of Puerto Rico:

> "Section 936 of the Internal Revenue Code is almost completely responsible for transforming Puerto Rico from a backward agricultural island to a reasonably advanced industrial one. The U.S. companies lured by the tax deal also account, directly or indirectly, for a substantial share of the island's jobs."[20]

The contemporary flip side to the view that tax-subsidies have successfully powered economic expansion on the Island is that without the subsidies the Puerto Rican economy will sink like a stone. Implicit in this view is the underlying belief that there is something inherently wrong with Puerto Rico and its inhabitants that prevent it from doing on its own what other economies have done under much less conducive conditions; specifically Hong Kong and Singapore come to mind. This report rejects the proposition that something inherent in Puerto Rico, its people or its business community, holds it back. After a half-century of tax subsidy dependence in which the Island has failed to close the economic gap with the Mainland, the logical conclusion is not that something is wrong with Puerto Rico but rather that something is wrong with the policy; the tax-and-spend subsidy regime has now become part of the problem, not the solution.

This report rejects the proposition that something inherent in Puerto Rico, its people or its business community holds it back.

The primary myth is typically buttressed by another fallacy formulated as follows.

- **A Conditioned Reflex:** Integration with the Mainland economy is the answer.

Enthusiasts of the integration thesis argue that steps to more fully integrate Puerto Rico with the Mainland would stimulate the Island economy to grow 2.2 percent to 3.5 percent faster.[21] The theoretical basis of this estimate rests on the assumption that Puerto Rico's economy currently is not sufficiently integrated with that of the Mainland:

> "Modern economic growth analysis indicates that less developed regions of an integrated economy catch up with more affluent regions over time. Since 1940, for example, Mississippi has grown twice as fast as wealthier Northeastern states. It has rapidly narrowed the gap with the rest of the U.S. and now earns 50 percent as much per capita as the richest state, up from 22 percent in 1940. Fuller integration has enabled states to expand more than 2 percent faster than territories over time."[22]

Although there may be many reasons to integrate Puerto Rico politically more fully with the Mainland, not least of which would be to gain voting representation in the U.S. Congress, much more needs to be done in order for economic convergence to be achieved. In matter of fact, Puerto Rico's economy already is largely integrated into the U.S. economy:

- Inhabitants of the Island are citizens of the United States with all the attendant rights and privileges of citizenship;
- Puerto Rico is inside the U.S. tariff wall;
- Puerto Rico is under the U.S. defense umbrella;
- The Puerto Rican economy is fully dollarized;
- Inhabitants of the Island are partially covered by Social Security, Medicare, and most of the economic safety net, such as workers' compensation.

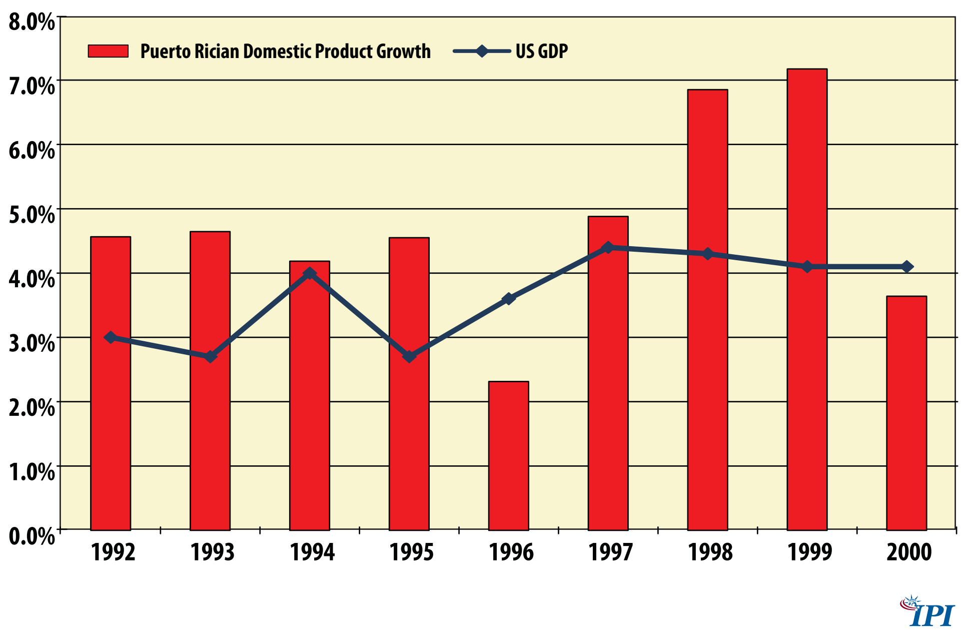
While it may be true that additional economic benefits would accrue to Puerto Rico by even closer integration, it is hard to imagine that even complete integration would precipitate rapid economic convergence as long as the current regime of anti-growth economic policies remain in place.

Puerto Rico is being prevented from realizing its full potential by a variety of government-imposed impediments.

Puerto Rico displays economic growth, but serious "catch up growth" is retarded. Obstacles to faster economic growth are less likely to be found in the economic "integration" ingredient with the Mainland or with inadequate "tax incentives" than with harmful policies imposed by the Puerto Rican government and the federal government.

The data indicate Puerto Rico is experiencing a degree of "convergence growth" but is being prevented from realizing its full potential by a variety of government-imposed impediments. As Figure 3 shows, until the worldwide economic slowdown and recession hit in 2000, the Puerto Rican economy remained resilient and economic growth actually improved substantially after the phase-out of section 936 and 30A began in 1994. The challenge for Puerto Rico today is to remove the policy obstacles that prevent its economy from growing at an accelerated pace for at least the coming decade.

Figure 3 **Puerto Rico Economic Growth Rate Compared to US**



Once the two prevailing views about Puerto Rico's economy are exposed as myths, only one explanation of the Island's lagging economic performance is left:

Bad Policies are the Source of Puerto Rico's Economic Problems.

There is no empirical justification for the idea that there is something inherent in Puerto Rico that inevitably will hold it back unless it receives subsidies from the Mainland. In fact, three major areas of policy are identifiable that impede the Island's economy from realizing its full potential. Removing these policy impediments is the fastest and surest way to ensure that Rico catches up with the Mainland.

1. Anti-Growth Tax Policy Impedes Economic Growth

The Puerto Rican economy labors under two sets of burdensome tax policies: 1) a regime of tax subsidies under the Internal Revenue Code that has outlived its usefulness, has become counterproductive, and stymies the emergence of a new-era entrepreneurial high-growth economy; and 2) a complex and economically damaging Puerto Rican tax code that penalizes work, saving and investment, hinders capital formation and discourages small business formation and job creation.

2. Not only do these anti-growth tax policies retard economic growth, they also freeze the Puerto Rico political debate and unnecessarily interfere with arriving at a decision on permanent political status.

The on-again, off-again Congressional support for the Mainland tax subsidies has had a deleterious effect on investors in Puerto Rico, but more pernicious still, the subsidies themselves have stalled final resolution of the question of political status by influencing that choice. Resolution of the serious status issue is the most critical factor in effective implementation of long-term economic planning in Puerto Rico. Without a definitive resolution of the relationship between the Island and the U.S., neither government officials nor companies can chart their fiscal and economic courses. Puerto Rican politics is dominated by the status issue, and the three major political parties hold out their support for statehood, commonwealth, or independence as their defining characteristics.

> *Tax subsidy schemes like section 936 shovel tax benefits to a very small group of off-Island concerns.*

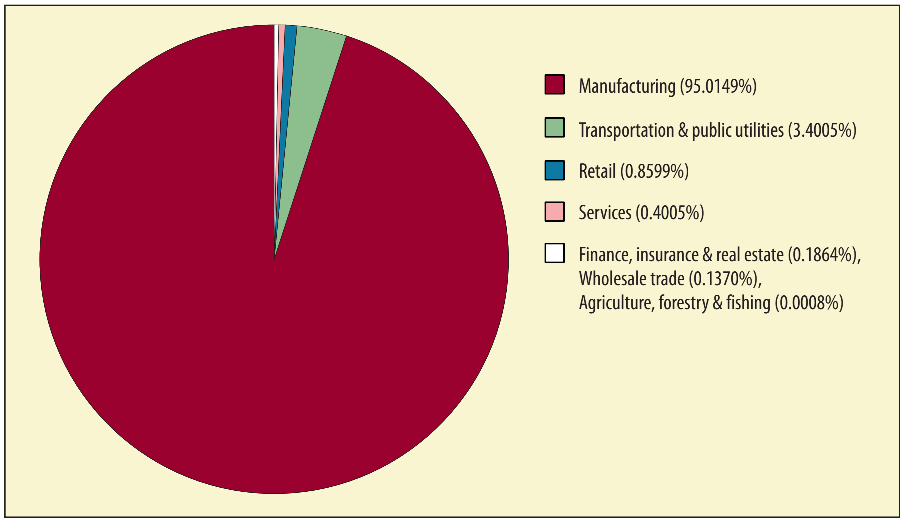
While this report shows no favor for any political status, it must be pointed out that the existence of the tax subsidy is not a neutral policy as to the question of status. Neither s 933, s 936, section 30A, nor the incentive contemplated in section 956 could exist if Puerto Rico were a state. And without the existence of these provisions, many Puerto Ricans believe they would pay considerably higher taxes. Nor would section 936, section 30A or the incentive contemplated in section 956 exist if the Island were independent. Therefore, the perpetuation of these subsidies interferes with the political decision over statehood or independence in the worst possible way: by creating a certain vested interest in indecision itself. Moreover, such perpetuation of these subsidies has the effect of creating political dependency and political risk for the Commonwealth because these subsidies are subject to the whim of Congress and can be changed at any time, creating great uncertainty.

3. The Benefits of the Proposed 956 (and its Predecessors) Bestow Largess without Efficiency

The myth about the indispensable relationship between U.S. tax incentives and Puerto Rico's economic survival has lost its luster. Even if the reform proposal to section 956 is enacted into law, there is little likelihood that it will produce lasting prosperity on the Island for the people of Puerto Rico.

The proposed successors to the Section-936 tax subsidy will always fail because they perpetuate the myopic policy of subsidizing a few large off-Island and largely itinerant companies in particular industries without building a vibrant local economy with indigenous Puerto Rican businesses, entrepreneurs and jobs. Tax subsidy schemes like section 936 and its proposed successors introduced in the 107th Congress (H.R. 2550 and S. 1475) shovel tax benefits to a very small group of off-Island concerns doing business in Puerto Rico that neither create broad-based employment for local inhabitants nor increase wealth on the Island. Figure 4 depicts the distribution of the section 936 benefits by industry.

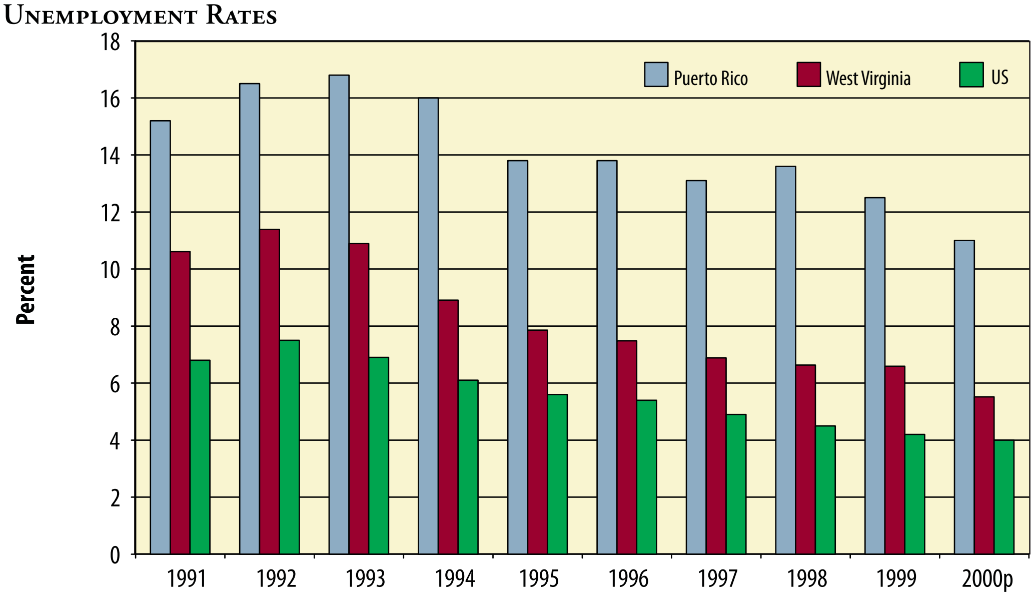
Figure 4 **Distribution of Possession Tax Credit**



Source: SOI. Table 3. - 1993, Returns of Active Manufacturing U.S. Possessions Corporations in Puerto Rico: Tax Benefits, Employment, and Compensation of Employees, by Selected Industrial Group.

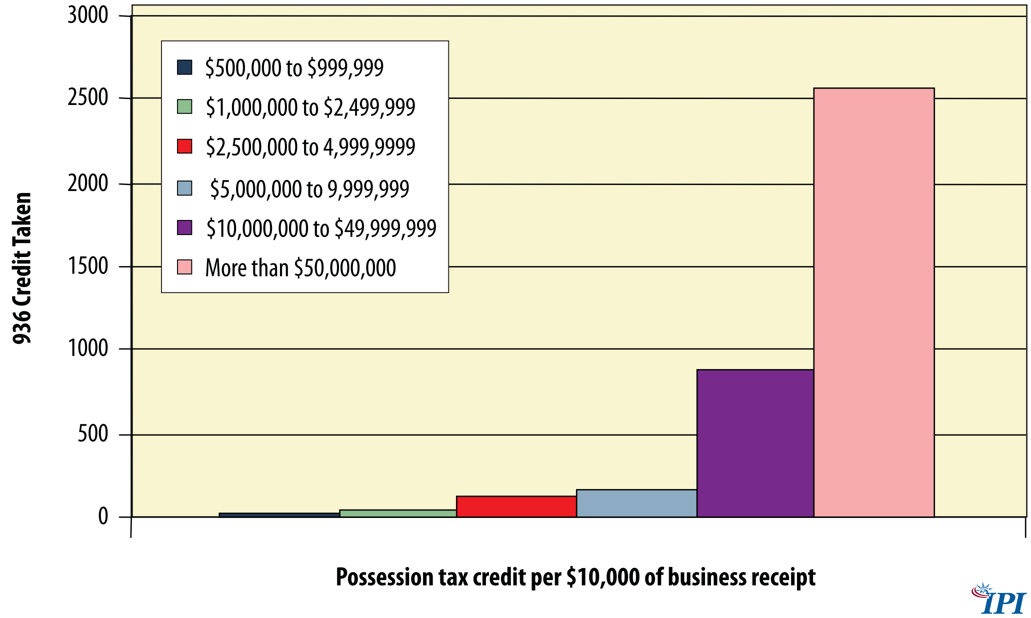
The benefits of the subsidy were skewed largely in favor of manufacturing, at the expense of other industries. In 1993, agriculture, forestry & fishing combined received only $23,000 of the subsidy, transportation & public utilities $92 million; whereas manufacturing received $2,586,474. Services received only 1 million, a negligible amount, considering that most small firms are in this industry.[23] Inter-industry inequities resulted because the distortive hand of government subsidies chose the winners and losers in the economy, not market forces. The persistently high unemployment rate on the Island relative to even the poorest states on the Mainland illustrates this point.

Figure 5 **Unemployment Rates**



Looking at the historical distribution of the tax credit by firm size reveals other inequities. The credit was not only taken by particular industries at the expense of others, but it has been inequitably distributed within the manufacturing sector itself. In particularly, the subsidy favors the largest manufacturers—those with more than $50 million in business receipts.

Figure 6 Possession Tax Credit by Size of Firm



Firms with sales between $500,000 to $999,999 took $395,000 of the credit; firms with sales between $1 million and $2.5 million took $2,941,000; firms with sales between $2.5 million and $5 million $7,372,000; firms with receipts between $5 million and $10 million took $11,530,000; firms with sales between $10 million and $50 million took $163,713,000; and firms with sales more than $50 million took $2,524,653,000.[24]

Table 1 Tax Benefits, Employment, and Compensation of Employees, by Selected Industrial Group

Selected Manufacturing Industries	Gross Compensation per worker (whole dollars)	Tax Benefits per worker (whole dollars)	Ratio of tax benefits per worker to compensation per worker
All Manufacturing Industries	$22,817	$34,296	1.50
Food and kindred products	18,979	44,422	2.34
Textile mill products	11,131	955	0.09
Apparel and other textile products	12,206	3,261	0.27
Paper and allied products	23,697	5,255	0.22
Printing and publishing	22,165	7,761	0.35
Chemicals and allied products	36,867	77,699	2.11
Petroleum (including integrated) and coal products	46,885	11,063	0.24
Rubber and miscellaneous plastics products	19,179	2,782	0.14
Leather and leather products	13,465	2,335	0.17
Fabricated metal products	20,085	3,331	0.17
Machinery, except electrical	22,142	16,178	0.73
Electrical and electronic equipment	21,527	49,705	2.31
Transportation equipment	19,106	39,516	2.07
Instruments and related products	23,239	21,683	0.93
Misc. manufacturing and manufacturing not allocable	20,085	7,562	0.38

Money amounts are in thousands of dollars, except as noted

Source: SOI 1997 Fall Bulletin (rev. 11-97)

Perhaps most revealing of its distorting effects is an analysis of the tax benefits as a function of salary for particularly industries [See Table 1]. In one industry, Food and Kindred Products, the tax benefit was actually 240 percent the average wages of the Puerto Rican employee of the firm. In 1993, the Gross Compensation of a worker in that industry was $18,979, the tax benefits per worker, was $44,422. Section 936 could hardly have been argued to be an efficient tax incentive, let alone an equitably distributed one.

Not only is the tax subsidy strategy proven inefficient by industry, by size of firm, and by the benefit per employee, but is also discriminates against new entrants into the marketplace. The phase-out of section 30A means that the incentive effect is essentially zero. Only companies and lines of business already established in Puerto Rico as of October 1995 are eligible for the credit. This prevents new on-island companies from taking the credit and precludes section 30A companies starting a new line of business from taking the 30A credit. Moreover, the "income caps" imposed on the credit in 2002, are equal to a company's average income for the years 1991–1994. This effectively discourages companies from growing and penalizes high-growth companies the most. For many congressional skeptics of section 936, who nevertheless feel compelled to "do something" to help Puerto Rico, the reform proposal to section 956, holds none of the same attraction as section 30A, which was more attuned to job creation because the tax break was tied to wages paid, not profits earned.

These Inefficiencies are Magnified by Policy Problems With an H.R. 2550-Like Proposal

It is extraordinarily misleading to imply that a new generation of tax subsidies will enhance Puerto Rico's growth sufficiently to allow it to compete with Singapore, Malaysia, Ireland and other dynamic economies. In fact, there is a strong reason to expect that the reform proposal to section 956 could turn Puerto Rico into a "laundry" for the earnings generated by firms in these currently more attractive places for CFC operations. Recall that the reform proposal to section 956 confers a 90 percent exemption from the dividend imputation consequences of IRC section 956 when a qualifying CFC makes stateside investments. When the CFC pays an actual dividend, the full amount of the investment will qualify as previously taxed income, so that only 10 percent of the earnings and profits of the CFC would be taxed. A CFC can qualify for the tax credit under the reform proposal to section 956 if it is incorporated under the laws of a foreign country but engaged in the active conduct of a trade or business in the commonwealth of Puerto Rico or a possession of the United States.[25] Qualified income includes income derived from sources outside the United States from the active conduct of a trade or business within Puerto Rico.

The tax subsidy strategy effectively discourages companies from growing and penalizes high-growth companies the most.

A large problem is that the H.R. 2550 (107th Congress) placed no restrictions on the geographical source of the income that qualifies for this benefit. There is a major difference between "income generated by the economic activity carried out in Puerto Rico" and "income derived from sources outside the United States from the active conduct of a Puerto Rican trade or business." The former would be similar to the economic activity credit currently allowed under IRC section 30A, where the profit sheltered is a function of costs incurred in labor and property, plant and equipment; whereas the latter allows for a much broader base for measuring income.

Assume for example that a Puerto Rico branch of an Irish CFC were to operate as a key sales office for the product manufactured in Ireland. Because the Puerto Rico branch provided a material effort in the sale, it could skew the profit split between the Irish factory branch and the Puerto Rico sales and marketing (with rights to the income attributable to the intangibles) branch. It would do so by having the income element allocable to the trade or business of the Puerto Rico branch from the sale and marketing (including the corresponding marketing intangibles) of the product to represent a significant portion of the overall income generated by the sale, even though the Irish branch might have many times more employees than the Puerto Rico branch. It should be noted that under the example above, if the product were never to pass through Puerto Rico, virtually all of the income derived from that sale would likewise avoid Puerto Rico income tax jurisdiction.

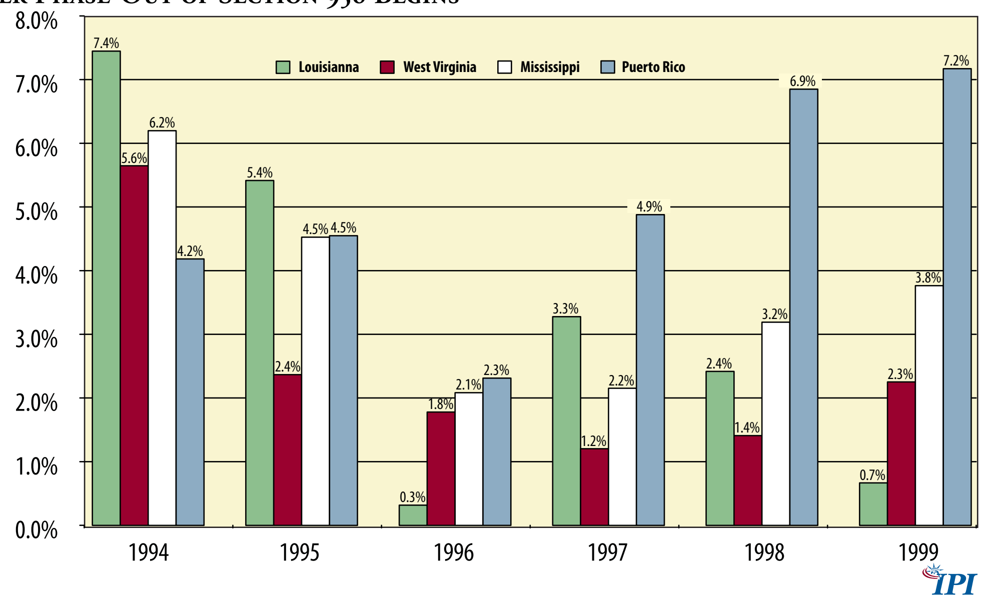
The new problems generated with cast further doubt on the success of a reform proposal to section 956.

The Phase-Out Has Not Had a Deleterious Effect

The best evidence that section 936 and 30A have been ineffective, at best, and most probably counter-productive, is the fact that until the world-wide economic slowdown and recession hit in 2000, the Puerto Rican economy remained resilient after the subsidy scheme phase-outs began in 1994. In fact, Puerto Rican growth actually improved substantially after the phase-out was underway. [See Figure 7.]

The recent trends in Puerto Rican economic indicators show an economy that is growing in income, employment, and investment in most years. Income and employment are traditional indicators of current economic performance, while investment is an indicator of the economy's capacity to increase income and employment in the future.

Figure 7 **Puerto Rico Growth Exceeds Poorer States After Phase-Out of Section 936 Begins**



Income as measured by Puerto Rico's gross domestic product (GDP) and gross national product (GNP) both increased between 1982 and 1996, with the increases continuing at about the same rates after the 1993 changes in the credit. GDP, a measure of the total income produced in Puerto Rico, grew at a faster rate than GNP, which measures the portion of total income received by Puerto Rican residents. The faster rate of growth of GDP compared with GNP means that an increasing portion of the income produced in Puerto Rico went to U.S. and foreign investors.

Although the share of domestic net income of Puerto Rican residents declined from 69.3 to 59.8 percent between 1982 and 1996, their net income grew in absolute terms from $16.3 billion to $23.8 billion. Unemployment declined in most years between 1982 and 1996 and also declined or remained unchanged in every year after the 1993 changes to the credit. Investment spending for the plant and equipment that increases the economy's ability to generate income also increased in most years during this period. After leveling off for several years after 1989, possibly due to the U.S. recession, investment increased again in 1995 and 1996.

Puerto Rico regulatory policies also stand out for special condemnation.

Excessive and Inappropriate Regulation Stunts Growth

Although this report does not go into the question of regulatory relief in detail, Puerto Rican regulatory polices also stand out for special condemnation. The problems raised by continued application of the economically harmful Jones Act "cabotage" law demand special mention. There may be other ways of dealing with the problem than outright repeal, but addressing the issue by whatever means should not be a condition of moving forward on the recommendations for a solid policy foundation for Puerto Rico's economic growth.[26] These are explored further below.

1. The Destructive Hand of the U.S. Federal Government

U.S. Jones Act

The so-called Jones Act "cabotage" laws impose significant restrictions on commerce between Puerto Rico and the U.S. Mainland, as well as restricting commerce between Alaska and Hawaii and the lower forty-eight states, by requiring that goods and produce shipped by water between U.S. ports be shipped only on U.S.-built, U.S.-manned, U.S.-flagged, and U.S. citizen-owned vessels. Approximately 97 percent of the goods and produce traded with the U.S. Mainland are transported by vessels and thus subject to this overbearing regulation, which has a substantially negative effect on economic growth in all non-contiguous states and territories.

Since the enactment of NAFTA, the Jones Act restrictions significantly disadvantaged non-contiguous states and territories relative to other members of the free-trade agreement, especially Mexico. In effect, the cabotage laws constitute a large barrier that goods coming from non-contiguous areas must surmount. Goods entering the lower forty-eight states from Mexico and Canada do not face this same barrier; since they are independent countries and not subject to the provisions of the Jones Act. One powerful stimulus to the Puerto Rican economy and the economies of all non-contiguous states and territories would be for the Congress to find a way to make U.S. flag ships competitive without imposing regulations on noncontiguous states and territories that put them at a competitive disadvantage.

Puerto Rican businesses are also greatly hampered by labor laws that raise the cost of doing business on the island.

2. The Destructive Hand of the Puerto Rican Government

Puerto Rican Permitting Regulations

Many believe governmental overhaul of the Puerto Rico permitting process will foster private-sector growth. Clearly this is important to the health and vitality of small firms and overall prosperity, as is the removal of all excessive regulations and downsizing of all bureaucracy. By comparison, the Congress thought permitting regulations were so deleterious to the formation of small firms in the U.S. that it required state and local communities wishing to qualify for special-enterprise-zone type incentives agree in writing to pursue a specified course of action that would, *inter alia,* reduce the burdens of permitting. [See Appendix B]

Under Code section 1400(d) for example, U.S. law provides that, as a condition of enjoying the benefits that come from designation of an area as a "Renewal Community," the state, and even neighborhood organizations, must commit in writing to at least 4 measures which may include a repeal of "permitting requirements."

Now is the time for a concerted effort to repeal and revamp the Puerto Rico permitting laws, and for the U.S. to make any tax benefit to U.S. companies contingent on the filing of and adherence to a course of action that reduces such onerous regulatory requirements.

Puerto Rican Labor Law

Puerto Rican businesses are also greatly hampered by labor laws that raise the cost of doing business on the island. Like the minimum wage requirements, labor laws essentially impose additional costs on job creation and make it illegal for employers who cannot afford to pass these costs along to hire workers who are in most need of those jobs. Labor laws let the perfect be the evil of the good, and provide another employment barrier on the Island much as a trade barrier. Low wage jobs that once would have been created in Puerto Rico are now going to Mexico, to Singapore, and to other parts of the world where labor costs are not artificially inflated by labor protections.

It will be politically difficult, but if Puerto Rico hopes to prosper, it must find the will to eliminate protectionist, "pro-labor" legislation that for decades has raised the cost of fringe benefits well above what is required on the U.S. mainland. These impediments to growth are so substantial that Puerto Rico's prospects for sustained economic development are severely hampered. In truth, there is nothing more anti-labor than adopting policies impede faster economic growth, which depresses workers' wages and stifle job creation.

To these good points we would add one more. The companies that typically disproportionately suffer from labor laws and other government-imposed fixed costs are small and mid-sized firms. Small firms spend a disproportionate amount of their income complying with government regulations. Worse yet, research suggests that while larger companies can and do pass these costs along to consumers, small companies must absorb these costs within profit margins. Lacking the ability to pass these costs forward, does not mean small business owners make less money or assume greater risks; it means that small firms that would form do not form, and when they do form cannot grow as rapidly. For this matter, labor laws are anti-competitive. They help large firms compete against smaller firms that may be island-based, and they make it illegal–not just undesirable–to hire a worker who truly needs the job.

Puerto Rico must examine its whole panoply of labor laws.

Puerto Rican Tax Laws

Puerto Rico's protectionist policies discriminating against Mainland companies are beginning to draw the attention of Congress.

The appendix contains a discussion of the seven layers of Puerto Rico tax laws that have grown like a thicket to support an overweight government. Puerto Rico's tax system inhibits growth, discourages work and savings, and encourages an underground economy. While the many taxes, particularly the income tax are problematic, a typical example of another onerous tax is the excise tax regime.

Puerto Rico levies excise taxes—not just on alcohol, tobacco, and gasoline—but also on most products at a general five percent rate. The manufacturer or importer bringing goods into Puerto Rico collects this excise tax at the point of sale. Local manufacturers must generally include 72 of the sales price in the taxable base. Those bringing goods into the country must generally include 132 percent of the sales price in the taxable base because of imputed freight and insurance. Therefore, the true rate of tax is 3.6 percent for locally produced goods and 6.6 percent on goods brought in from outside of Puerto Rico. These taxes are administered in a highly cumbersome and inefficient manner. Moreover, they are frequently implemented in a fashion that converts them essentially into a protective tariff against goods and services produced on the Mainland, which impedes free trade among Puerto Rico and the 50 states and other territories and harms Puerto Rican consumers.

This excise tax imposes nearly twice as high a burden on non-Puerto Rican produced goods. It is functionally equivalent to an import tariff and is protectionist. It is at variance with the principle of free trade and, in the final analysis, harms Puerto Rico. It is well established in theory and in practice that free trade is the most economically constructive policy. The United States is, in effect, one large "common market" but the Puerto Rico excise taxes and other policies place Puerto Rico outside of this U.S. common market. By excluding itself from the U.S. common market, Puerto Rico does nothing but harm its businesses, its consumers and its fiscal situation.

The government of Puerto Rico could collect this tax in a less economically destructive manner, if the tax were assessed as a consumption tax (a retail sales tax) instead. A consumption tax would shift the point of tax collection away from the manufacturer, importer or other party who brings goods to the Puerto Rican marketplace, to the point of final sale. It would tax all goods sold to consumers alike and impose no tax on business-to-business transactions. Unlike the currently constituted excise taxes, an end-point tax would not cascade. In other words, there would be no situations where a tax was imposed on a tax. Moreover, while excise taxes have been rightfully criticized as being invisible to the ultimate purchaser, and therefore not subject to the political constraints caused by voter understanding and discontent, sales taxes are the most visible form of tax.

A good illustration of the excise tax problem and the plethora of regulations is the case filed by UPS against the Treasury Department of Puerto Rico (Hacienda). Puerto Rican law requires air cargo transport companies to charge their clients a 6.6 percent excise tax in advance and prohibits deliveries of packages for which the transport company has not obtained a certificate from the Hacienda proving the tax has been paid in advance.

United Parcel Service sued in federal court claiming that this statutory scheme increases their costs substantially and impedes their ability to make timely deliveries, thereby continually harming their business and reputation among their customers. These kinds of provisions, however, slow commerce throughout Puerto Rico and are one more way that Puerto Rico keeps itself out of the U.S. common market and hinders its own prosperity. The Circuit Court of Appeals recently remanded the case for further proceedings in the District Court. It seems unlikely, however, that the current statutory scheme requiring common carriers to prepay the tax for their customers will survive.

Puerto Rico's protectionist policies discriminating against Mainland companies, while damaging to Puerto Rico even in the abstract, are beginning to draw attention and fire from members of Congress. For example, last year the Puerto Rican government increased its excise tax on beer by 78 percent but effectively exempted the Island's leading local brewery, Medalla, from the tax. In retaliation for this "protectionist" action, Senator Ben Nighthorse Campbell from Colorado, home of the Coors Brewery, proposed eliminating Puerto Rico's rum tax "rebate," which currently returns approximately $360 million a year to Puerto Rico treasury.

Government obesity is not an uncommon phenomenon in stagnant economies.

There are two types of "cover-overs" or "rebates." The first provides that the revenue from any federal excise tax imposed on any Puerto Rico manufactured goods coming into the mainland will be provided to the government of Puerto Rico rather than retained by the federal government.[27] Although it does not provide a tax preference to Puerto Rican manufacturers, this is a subsidy for the government of Puerto Rico that is not accorded to any other government within the United States other than that of the Virgin Islands. The second "cover-over" provides that all revenue collected from the imposition of the federal distilled spirits excise tax on rum will be paid over to the governments of Puerto Rico and the Virgin Islands.[28] The revenue is covered over no matter where the rum was produced. It is simply a subsidy to the government of Puerto Rico.

Campbell's proposal has been criticized by some people on the grounds that the rum cover-overs are tied to Puerto Rico's political status and are a permanent arrangement that cannot be changed. This criticism is baseless. The rebate on federal excise taxes levied on rum is granted completely at the discretion of Congress and has nothing whatsoever to do with the Island's political status. The cover over is provided to the Virgin Islands but is not provided to other territories or the District of Columbia. It is not provided to states. Tax rebates to the Puerto Rican government can be changed at any time Congress decides to change it. Indeed, Congress already was poised to take up the rum rebate this year since the current rebate—$13.25 per proof gallon—expires at the end of calendar year 2003. Unless Congress acts to prevent it, the rebate will fall automatically to $10.25 per proof gallon.

An Obese Government Has Imposed A Dead-Weight Burden

Another source of economic drag is the obese government sector weighting down the Island. In order to gain a full appreciation of the magnitude of the government sector in Puerto Rico, one must combine spending by all levels of government (Commonwealth and its subdivisions and the Federal government) and compare the overall level of government spending to Puerto Rico's domestic product.

Figures 8 & 9 compare the size of government in Puerto Rico to the Mainland, both in terms of total government spending and the number of public employees.

Clearly, Puerto Rico has allowed government growth to get out of control.

Government obesity is not an uncommon phenomenon in stagnant economies. It is an almost inevitable consequence of elected politicians' not knowing how to revive economic growth and who find it difficult to resist using the public payroll as a means to provide voters financial support they cannot secure for themselves in a stagnant economy with jobs and small businesses.

Figure 8 Government Employees As Percent Total Employment

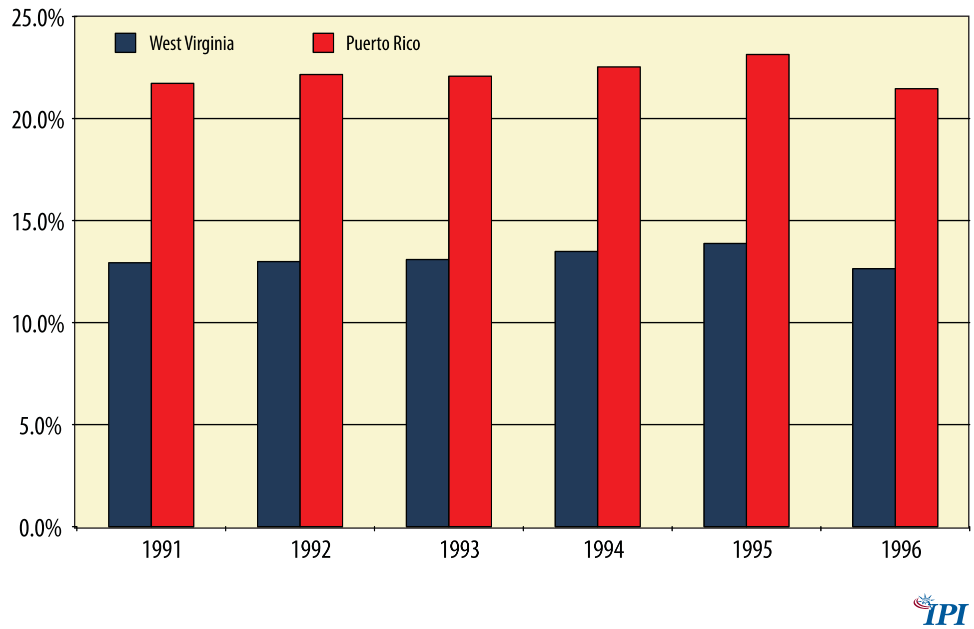
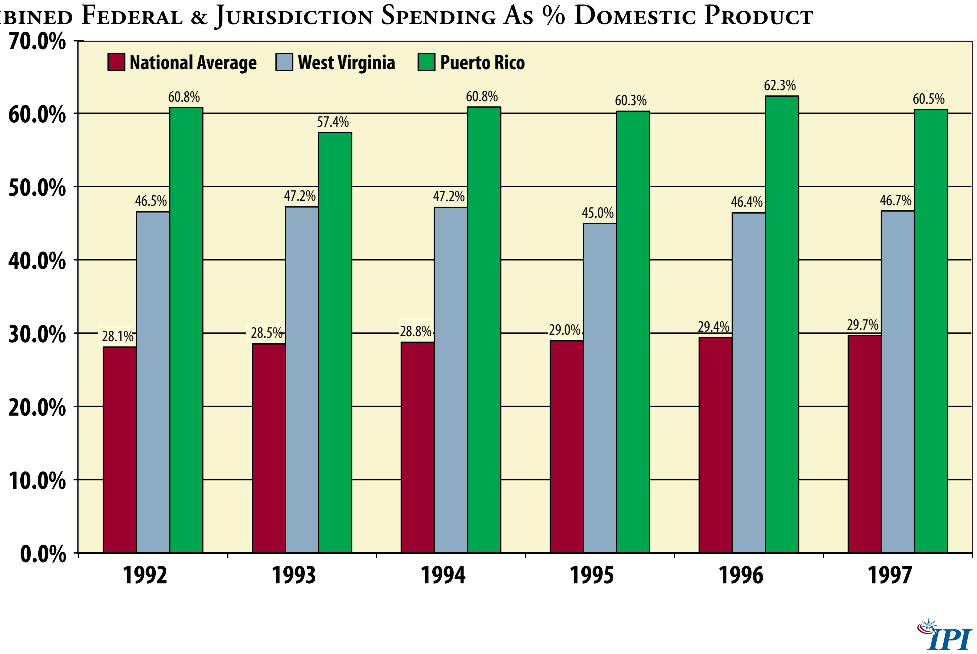


Figure 9 Combined Federal & Jurisdiction Spending As % Domestic Product



Combined with this political temptation to buy votes with public sector employment, elected officials in stagnant economies are also usually under extreme pressure to pursue contradictory policies that include high tax rates to pay for excessive government spending. This "austerity mentality," so universally and mistakenly accepted as the correct model for economic development, has also taken hold among many officials in Puerto Rico.

The solution to public-sector obesity is not fiscal austerity but rather a combination of a) spending restraint to slow the growth of government spending, b) hiring limits on new vacancies, and c) a rapidly growing economy and expanding private work force to "grow the government smaller" relative to the size of the overall economy. If the rate of growth of government spending is held to less than the growth rate of the economy, and if public payrolls are pruned by allowing vacancies to remain unfilled, it is possible with a fast-growing economy to "grow the government smaller" fairly rapidly without risking social upheaval and political instability, which would abort the reforms before they could produce results that improve the living conditions of everyone on the Island, from the poorest on up.

The classic illustration of how this optimum policy mix can work was the United States in the decade between 1991 and 2001 when the economy grew by 56 percent yet federal spending grew by only 41 percent. The result: Federal spending as a percent of GDP fell from 22.3 percent to 18.4 percent over the decade while the absolute level of spending rose from $1.3 trillion to $1.9 trillion to meet the increasing demands of a growing country. Over the same period, although cumulative budget deficits amounted to $754 billion, the public debt actually declined from 45.3 percent to 32.7 percent of GDP, again because the economy outgrew it.

The fat needs to be eliminated from the commonwealth government itself.

If Puerto Rico is searching for targets to reduce the size of the government, there are many to choose from in terms of eliminating costly and inefficient government enterprises. For instance, it might look to the excess bureaucracy at all levels. It could look at municipal government, it could look at the quasi-governmental organizations, and it could look at public corporations. The fat needs to be eliminated from the commonwealth government itself and all those that come under the umbrella of the public sector.

Toward A Pro-Growth Economic Strategy

Wiping the Slate Clean: Rejecting Tax Welfare

The proponents of continued tax-subsidization for the Island insist that sections 936 and 30A of the Internal Revenue Code should either be reinstated beyond 2006 or replaced with the next iteration of the tax subsidy scheme. Solely from the perspective of the personal interests of U.S. businesses and tax lobbyists, it matters not so much what the specific design of a replacement is, as long as it sheds a significant amount of tax largess to U.S. firms that depend upon it to subsidize investment choices that would not otherwise be made. And to accomplish this in a political atmosphere where the interests of Puerto Rico are of ostensible primary concern and actual rhetorical concern, the tax subsidy must at least enable the argument that local Puerto Rican interests are benefited.

The problem is that the interests of tax-subsidized Mainland firms and the Puerto Rican people are not in proper alignment. The engineering of the tax subsidy has always suffered from an internal conflict of interest that is visible just beyond the surface over marketing and reality. Although the subsidies have been sold as a means to help the Puerto Rico economy, the primary value of the subsidy has not been defined by the benefits it provides for active business in Puerto Rico, or for the Puerto Rican people. It is defined by the degree to which these benefits affect the bottom line of the U.S. company; worse still, subsidies of value to Puerto Rico because they are based on actual commitment, hiring and economic activity are not as valuable to U.S. companies who prefer the tax largess to be based on more ephemeral considerations, such as the licensing of intellectual property or inter-company pricing manipulations. This lingering tension impedes policy engineers from fashioning a proposal that both truly benefits Puerto Rico, and the U.S. companies who lobby for it.

The degree of separation between the corporate benefits and the actual investments that would improve the environment for Puerto Ricans is a function of politics. In other words, one cynical view is that the design of the tax subsidies can be looked upon as a spectrum, such as that which appears below.

U.S. COMPANY BENEFIT ←→ BENEFIT TO PUERTO RICO

Under this cynical view, the further down the road one goes to help the U.S. company, the less the benefit to Puerto Rico.

Continuing down the subsidy road is fraught with peril because it subjects proponents to the very real arguments that the real assistance to Puerto Rico is at best inefficient, and worst, illusory. The political atmosphere is aligned against meaningful success, and uncertainty over the fate of the tax credit limits its true incentive value by preventing long-term planning. Moreover, over the long term, the subsidy is counterproductive to the development of Puerto Rico. The very notion of a subsidy breeds dependency, the provision merely moves existing jobs in a zero sum game, and the looming specter of tax welfare prevents more substantial, long-range reforms that will truly create a fertile environment for lasting growth.

Section 936 and Its Progeny Are Destined to Failure

The response of the Puerto Rican government to the phase-out of section 936 indicates that it does not yet fully appreciate how severely the political winds have shifted. Rather than taking stock of the on-going evolution of "Commonwealth Status" within an unchanging legal framework, the government appears to be treating the elimination of section 936 as little more than a temporary setback in an otherwise unchanged relationship—not much different than the states might treat a temporary reduction in federal aid. Indicative of this misperception, the Puerto Rican government continues to pursue the strategy of tax subsidy redux, exemplified by the new tax-credit scheme (e.g., changes to sec. 956) to replace the repealed section 936.

There are many signs that the political climate regarding the Island has shifted in Washington.

There is of course some superficial sense to this strategy. After all, Puerto Rico has seen nearly annual changes to section 936-type subsidies before; and yet, at the last minute, some pared-down relief has always been forthcoming. However, there are many signs that the political climate regarding the Island has shifted in Washington. Consider the following:

- In December 1998, while the federal government was running a budget surplus of $69 billion, a congressional committee was planning to hold hearings on the possibility of applying federal taxes to island residents under existing commonwealth status. While Popular Democratic Party President Anibal Acevedo Vila insisted at the time "under no condition will we accept taxes" under Commonwealth Status, the Congressional Research Service stated that "Congress has full powers to tax the U.S. territories and there is nothing special under commonwealth relationship to stop it."[29]
- That same year, despite the surplus, Congress stopped treating the island like a state for road building funds, which meant a smaller increase in excise tax allocation than given to the 50 states.
- Increasingly the question is being asked quietly on Capitol Hill, 'why is Puerto Rico continuing to receive the benefit of some $12 billion in federal spending without contributing to the federal treasury?' With the federal government now projected to run budget deficits once again,

this question is likely to be asked more frequently. U.S. citizens residing in Puerto Rico presently pay no federal income taxes. The most glaring loss of revenue is from corporations benefiting from section 936 of the Internal Revenue Code ('section 936'). Since 1972, the federal government has forfeited at least $70 billion in tax revenues in real terms. While the tax breaks are being phased out, section 936 still costs the federal government over $3.8 billion in lost revenues as of 1994 at a time when U.S.-based expiring credit provisions are in jeopardy.

- In FY 1995, Puerto Rico received $9.7 billion in federal outlays, or approximately $2,620 for every person living on the island, about half of federal spending distributed to the average state. At the same time, however, the U.S. Treasury is forfeiting tax dollars that it would collect from individuals and corporations in Puerto Rico.

In truth, 1995 signaled the end of the golden age of Puerto Rico's tax subsidy schemes, and should instill grave doubt about the chances for resurrection of similar devices even for the most optimistic lobbyist.

In defense of the latest iteration of section 936, some assert, "for the first time, Puerto Rico is not asking for giveaways." Proposed reforms to section 956 will be much simpler to accomplish than an extension of section 30A, they argue, because such reform proposals will be buried in the existing tax structure under sections 901 and 956. In a nutshell, however, the reform proposal to section 956 (H.R. 2550–107th) is something of a tax earmark, allowing subsidiaries of U.S. companies who incorporate in Puerto Rico as CFC—something 936 companies have always enjoyed—the ability to repatriate a large share of their Puerto Rican profits free of tax to their U.S. parents or shareholders. When the dust settles, the reform proposal to section 956 will look, smell and sound awfully like section 936. The basic difference is that sections 936 and 30A were available to domestic (i.e. U.S.) corporations, whereas, section 956 would benefit U.S. subsidiaries incorporated in foreign countries under section 901.

1995 signaled the end of the golden age of Puerto Rico's tax subsidy schemes.

Proponents argue further that the proposed amendment would make setting up as a CFC in Puerto Rico more attractive than in a foreign country; accordingly, the loss to investment would be from other host CFC countries. However, the problem with this logic is that the worldwide taxing system has been justified on the basis of export neutrality, so that a decision to invest outside the U.S. is no different than investing in the U.S. The problem with the new proposal is that any preference shown to CFCs in Puerto Rico would also make it more attractive for a U.S. company to invest in Puerto Rico than to maintain their operations in, say, North Carolina or New Jersey. To the U.S. Congress, the proposed amendment to 956 will be a hard sell as a reheated leftover from 1995. Section 933, section 936, section 30A and the latest iterations of the subsidy are no longer being taken for granted, and not surprisingly, companies who would benefit are gearing up major lobbying efforts once again.

Reliance on section 936-type benefits as an economic strategy is risky and fundamentally flawed, not just economically but politically. It is a risky political strategy because if the reform proposal to section 956 fails, it may extinguish with it the last clear chance Puerto Rico has to any substantial federal assistance. The defeat of this new volley means that tax subsidies will fade away, and forever doom the chance of meaningful long-range assistance to facilitate true economic transformation.

The Chance That Reform Will Run Afoul of WTO Rules Increases Political Uncertainty

To exacerbate the political risks, any number of arguments, if they gain currency, can affect the political viability of the reform proposal to section 956. A much-feared argument alluded to above is that the reform proposal to section 956 will create "runaway plants;" ensuring Mainland jobs will run, not just from the Mainland but from Mainland and Puerto Rico tax bases. Another powerful argument with possible political momentum is that the section 956-type proposal could be violative of World Trade

Organization (WTO) in the same manner that Domestic International Sales Corporations were found to run afoul of the General Agreement on Tariffs and Trade (GATT), and both Foreign Sales Corporations (FSCs) and the extraterritorial income exclusion (ETI) provisions were found to run afoul of the WTO agreements (in addition to other provisions of the Code that could be found in violation if challenged) as export subsidies.[30]

The ETI provisions, which provide a partial exemption from tax for income from certain foreign sales and leasing transactions, were the best attempt by Congress to engineer a benefit for U.S. exporters that was WTO-compliant. In January 2002, only two years after the enactment of the ETI to replace the FSC provisions of prior law, the WTO Dispute Settlement Body adopted a final report finding that the ETI provisions, like the prior-law FSC provisions, were inconsistent with WTO rules. The WTO has authorized the imposition of trade sanctions against U.S. exports up to the level of $4 billion per year, which technically could be levied at any time except for the Administration's retort that "retaliation is a double-edged sword with economic consequences on both sides of the Atlantic."[31] The EU has gone so far as to pull together a select list of U.S. exports that it may target for retaliatory duties.

The Administration has repeatedly stated that the United States must comply with the WTO rulings in the FSC/ETI case, and has called on Congress to overhaul U.S. international tax rules, particularly those that offer tax breaks to certain exporters. The Congress has tried to comply[32] but the Administration has discounted any ETI/FSC like "solutions." In a U.S. State Department release dated February 3, 2003, the Administration stated, "Replicating the benefits of the FSC and ETI provisions through minor changes to the current-law ETI provisions or through enactment of a similar replacement regime will not bring us into compliance with the WTO rules as analyzed in the decisions…. The required changes to our tax law should be coupled with much needed reforms to ensure that our tax law and our international tax system in particular, do not operate to impose anti-competitive burdens on U.S.-based companies operating in the global marketplace."[33]

Companies must account for the possibility that a section 956-type proposal could be ruled an export subsidy.

In today's international political environment and the WTO's newfound aggressiveness, companies must take account of the possibility that a section 956-type proposal (like H.R. 2550 and S.1475 in the 107th Congress) could be ruled an export subsidy even though it is intended to benefit only Puerto Rico (and the companies that do business there).

To understand how the provision could be so viewed, examine the degree to which the reform proposal to section 956 would excepts export income from the normal U.S. tax base; and then consider in the context of the broad definition of a "subsidy" as interpreted by the WTO.

The general rule is that the U.S. taxes all income earned worldwide for U.S. corporations.[34] Like some of our major trading partners, the U.S. operates a worldwide system of income taxation. U.S. citizens and residents, including U.S. corporations, are taxed on all their income, regardless of where it is earned. The FSC and ETI, which both allowed U.S. companies to obtain tax breaks on exports if they used offshore subsidiaries as international trading arms,[35] were struck since the tax benefits they conferred were "contingent upon export performance"[36] as hidden export subsidies (even though their tax benefit to exporters was at approximately the same level of the subsidy provided to far fewer companies under section 936).[37]

A "Qualified Possessions Corporation" under the newly reconstituted reform proposal provides favorable tax benefits to a CFC on active trade or business income sourced in Puerto Rico (or another possession) provided the income *is eligible for deferral under general U.S. tax principles.*[38] IRC regulation section 1.954–3(a)(4)(iii) provides that if a CFC manufactures property sold to an unrelated party the income is eligible for deferral, because it is not foreign base company sales income (Subpart F income). Hence, income from goods manufactured in Puerto Rico and sold outside of Puerto Rico is eligible for a 90 percent exclusion from U.S. tax when repatriated. Here's the rub: in order to benefit Puerto Rico, the bill treats American exports favorably.

Admittedly, the reform proposal to section 956 is less of an explicit "export" subsidy than the FSC and ETI provisions. The reform proposal to section 956 does permit the CFC in Puerto Rico to sell products manufactured there to the U.S.—something the FSC would not have been given favorable tax treatment to do. It also requires the income to be from active trade or business. However, the WTO's Agreement On Subsidies and Countervailing Measures (SCM) provides "… a subsidy shall be deemed to exist if … (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)." Moreover, the provision offers no less a financial incentive. The 90 percent exclusion from income amounts to an effective tax cost of 3.5 percent under today's rates. To an objective observer, there is little difference between the reform proposal to section 956 and the FSC and ETI provisions the WTO and the appellate panels struck; especially if that observer is a signatory country that perceives it has lost U.S. manufacturing facility to Puerto Rico.[39]

Simply changing the location of the tax subsidy name from section 936 to section 956 will not drop all the political baggage.

In order to determine if a subsidy is actionable it must be specific to an enterprise or industry or group of enterprises or industries. "Where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions governing the eligibility for, and the amount of, a subsidy, specificity shall not exist…." Moreover, notwithstanding any appearance of non-specificity "there are reasons to believe that the subsidy may in fact be specific … [if] a subsidy program [is limited to] a limited number of certain enterprises, [there is] predominant use by certain enterprises, [or the subsidy is granted] disproportionately … to certain enterprises." A "subsidy which is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority shall be specific." According to Part II of that Agreement, a prohibited subsidy is one that is "contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance."

Of course, the beneficiaries of section 936 and the projected beneficiaries of the reform proposal to section 956 are a few hundred U.S. companies,[40] and Puerto Rican divisions of U.S. companies who export will largely take the benefits. Consequently, the new proposal can have the practical effect of subsidizing exports from these U.S. companies. The fact remains that under the reform proposal to section 956 a few companies, in a possession of the U.S., would be able to exclude export income from U.S. taxation indefinitely where the general rules would have imposed tax upon that income.

The Provision Is "Scored" as Costly

Simply changing the location of the tax subsidy name from section 936 of the Code to section 956 and making a few changes to the rules of the game will not drop all of the political baggage. In a broad sense, the provision would engraft the previous, expired provisions onto the relatively permanent structure relating to CFCs. Because possession-source income derived from the active conduct of a trade or business could be repatriated to the U.S. largely without tax consequence, revenue forecasters will find this exception to the baseline results in a significant tax expenditure (i.e. is very costly). Because of the similarities between sections 936 and proposed changes to 956, it is doubtful that the provisions of the reform proposal to section 956 would be considered to cost less than section 30A under any iteration, unless extremely diluted.

Preliminary estimates are not encouraging. If, for example, all "936 firms" switched to CFC status, the "revenue loss" in 2000 would have been on the order of $3.5 billion to $4 billion. The "official" scorekeepers of the costs of tax breaks, the U.S Congress Joint Tax Committee on Taxation staff, estimated that it would cost $32.1 billion through 2011, and $18.3 billion of the cost would occur through 2007—an even greater problem than the 10-year cost since federal budgets are primarily projected over five years. The costs reflect taxes that the federal government would give up.

Worse yet, however, is the basis for the cost projection. The estimate is based on an assumption that the proposal would cause plants now enjoying dwindling benefits under section 936 and 30A to leave faster. In fact, the estimates assume that the proposal would cause the federal treasury to lose $4.6 billion next year as companies take advantage of the 90 percent tax exemption to close shop in Puerto Rico. The loss would decrease to almost a half, $2.4 billion, in 2008 before slowly inching up to $3.1 billion in 2011, a decline of a third over the period that would also be reflected in business activity in Puerto Rico.

The Joint Committee estimate agreed with a U.S. Department of the Treasury rough estimate of $25 billion to $50 billion over 10 years. Although there may be ways to limit the "revenue cost" of the proposal with clever engineering, there is a Catch 22 attached to any perception of an austere subsidy: Clearly, the more costly the reform proposal to section 956 becomes to the American taxpayer, the harder it will be to enact; but the less costly it is, the less of a real incentive it can be argued to provide to investment in Puerto Rico.

The Joint Committee staff report has also given figures for two contemplated variations. One would increase the cost $1 billion through 2011. The other alternative, which would delete a provision of the proposal that would enable companies to transfer patents, trade names and other "intangible property" on a tax-free basis to the largely tax-exempt CFC's, would lower the proposal's cost $20.8 billion through 2011. There are fears, however, that this approach would not be an effective incentive for investment in Puerto Rico. Approximately $2.3 billion of the cost would come next year as plants take advantage of the proposal to close in Puerto Rico earlier than they otherwise would.

> ***The extension of the Puerto Rican incentive will not occur at a fiscally propitious moment.***

Regardless of the price tag at the political cash register, the extension of the Puerto Rican incentive will not occur at a fiscally propitious moment. As this report goes to press, there are efforts underway to revise and re-tailor the section-956 bills introduced in the 107th Congress for re-introduction in the current Congress with a smaller price tag, either as an amendment or as freestanding legislation. This new tax-subsidy proposal will be considered at a time when the total federal budget is projected by the Congressional Budget Office to show a deficit of $250 billion in 2003 and $200 billion in 2004 and total five-year deficits of $635 billion through 2007.[41]

Moreover, there will be mounting fiscal pressure on the federal budget in 2006, just when section 30A is scheduled to expire. Three provisions of last year's tax cuts (EGTRRA) expire by the end of calendar year 2006, and the rest—representing the majority of the law's budgetary cost—expire on December 31, 2010. Many other provisions of the tax code, enacted before EGTRRA, either expired at the end of 2001 or are scheduled to expire in the next 10 years. They include the treatment of nonrefundable credits under the alternative minimum tax (AMT), which ended last year, and the research and experimentation credit, which expires in 2004. The constituencies for the R&E tax credit are the same constituencies that would argue for a new incentive for Puerto Rico. The new reform proposal will be weighed against these perennial favorites by both Congress and the corporate benefactors, and against rate increases in the U.S. tax rates. The revenue foregone from the reform proposal to section 956 will not be ignored simply because the provision seeks to blend within the interstices of an existing tax Code scheme.[42]

Political Uncertainty Creates Obstacles to Economic Development

More than anything, entrepreneurs, venture capitalists and corporate planners abhor uncertainty in the rules of the game. There is no doubt that the uncertainty of Puerto Rico's political status has created significant economic obstacles to economic development over the years. Investors knew that Congress could at its whim change the rules of the game by changing tax and other "incentive" schemes or even altering political status itself. This fact has been demonstrated since 1993 when Congress drew a connection between the section 936 tax credit and employment and investment growth in the possessions.

Companies are still using the threat that they will pull out of Puerto Rico as a means of arguing for the stopgap measure. In this manner, they are holding the economy hostage. Even the rhetoric of the sponsors of the new incentive employs this argument:

> Many of the companies that have chosen to remain in Puerto Rico have restructured their operations as CFCs and are in direct competition with CFCs in countries such as Malaysia, Ireland and Singapore. While CFCs operating in Puerto Rico (and elsewhere) do benefit from the deferral of U.S. tax on most of their active business earnings, they are nevertheless at a significant disadvantage compared to CFCs operating in many countries.

It is at the same time contradictory and a self-fulfilling prophesy for company executives to argue that an extension of a temporary tax credit is necessary for them to make long-term investments in Puerto Rico. Long-term investments can never be optimized as long as the principal policy inducements for the investment are subject to the vagaries of the economy and the whims of Congress. Sections 936 and 30A should be allowed to expire as scheduled without replacement by an expanded section 956 as proposed in the reform proposal to section 956.

Sections 936 and 30A should be allowed to expire as scheduled without replacement.

Tabula Rasa: Complete Overhaul of the U.S.-Puerto Rico Fiscal and Regulatory Relationship

Academic research suggests that a far more effective means of increasing the income and wealth of Puerto Ricans is to reduce the tax disincentives to entrepreneurism and small business creation. Economists Douglas Holtz-Eakin and Harvey S. Rosen conducted empirical research that demonstrates how greatly taxes matter. Specifically, they found that taxes go a long way in determining how much is invested in small businesses, how fast small businesses grow, and how many workers they hire.

> As tax rates go up, entrepreneurial enterprises grow at a slower rate, they buy less capital, and they are less likely to hire workers. These results are significant from a statistical point of view, and they are quantitatively important.[43]

The Holtz-Eaken/Rosen effects were substantial. First, they found that, "marginal tax rates have a substantial effect on the growth of entrepreneurial enterprises . . . a decrease in a sole-proprietor's marginal tax rate from 50 percent to 33 percent would lead to an increase in his receipts by about 28 percent."[44] Second, they concluded that, "the greater the percentage increase in a sole-proprietor's user cost of capital . . .the lower the probability that he or she undertook capital outlays . . .a 10 percent rise in the user cost [of capital] . . .lowers the mean probability of undertaking investment from 0.335 to 0.251, a decline of 25 percent."[45] Third, they discovered that, "a 10 percent rise in the tax price . . . increases the mean probability of employing labor from 0.215 to 0.241, or 12.1 percent . . . .It appears that marginal tax rates have a substantial effect on the propensity of entrepreneurs to hire workers."[46]

Higher rates of economic growth for Puerto Rico and greater increases in the standard of living for the Puerto Rican people will come from a tax system that is neutral with respect to savings and investment and has low marginal tax rates. Such a tax system will reduce the bias against work, savings and investment and attract investment from throughout the world. The combination of a rational federal tax system and a sound Puerto Rican tax system will lead to unprecedented economic growth, spur capital formation and entrepreneurship and promote opportunity for all Puerto Ricans.

Thus, rather than reverting to an obsolete and contentious tax subsidy economic development strategy, there is available to Puerto Rico a proven way to improve permanently the economic well-being of its people and remove the matter of economics from the ubiquitous debate over statehood, independence or continued commonwealth status. By rejecting fiscal austerity and instead implementing a coordinated pro-growth strategy of tax rate reduction and tax reform, government spending-growth and hiring restraint along with regulatory relief, the Commonwealth can move to a high-growth trajectory without suffering the social and political instability that arises when nations attempt to implement IMF austerity.

What are the principles by which this new relationship should be governed?

- The primary goal should be the economic betterment of Puerto Rican U.S. citizens through sound, market-based solutions.
- These solutions should benefit U.S. companies only to the degree that income is actively generated in Puerto Rico.
- Any new benefit for Puerto Rico should not be fashioned in a manner that makes its continued enjoyment dependent on the political status of the Island.
- The U.S. should neither continue dependency tax policy nor reward bad policy.
- The benefit should not be specific to Puerto Rico, but accommodate uniquely Puerto Rican concerns.
- The benefit should not invite opportunity for inefficiencies at the local level, but rather leverage efficiencies.

To meet these principals, the tax reform component of the economic growth plan would be relatively straightforward. The main element of the proposal for U.S. companies recommends an entirely new approach: an offer from the federal government to Puerto Rico. It would consist of the federal government making a commitment to Puerto Rico that if Puerto Rico adopts pro-growth incentives for all businesses–Puerto Rican, mainland and foreign direct investment—then the United States will modify the federal Internal Revenue Code such that Puerto Rican income derived from an active conduct of business in Puerto Rico by mainland companies is subject to favorable treatment as an enterprise zone. Such a proposal would make Puerto Rico an extremely attractive place to invest whether the investor is from Puerto Rico, the United States or abroad.

Puerto Rican income derived from an active conduct of business in Puerto Rico by mainland companies is subject to favorable treatment as an enterprise zone.

The suggested tax program consists of three parts.

- First, create a national enterprise zone program and allow Puerto Rico, in its entirety, to participate as an enterprise zone.
- Second, allow Puerto Ricans to be eligible for Supplemental Security Income (SSI) benefits and the Earned Income Tax Credit (EITC) provided that the Puerto Rican government agrees to and adheres to a program for fiscal restraint.
- Third, phase out cover-overs of federal excise taxes to the Puerto Rican government.

1. Enact National Enterprise Zones

Overview of the National Enterprise Zone Concept

The poorest parts of the United States would be eligible for designation as "national enterprise zones." Territories of the United States would be included as enterprise zones in their entirety. Businesses operating within these zones would be given the choice between either 1. the current federal tax system with an enhanced federal research and experimentation tax credit, or 2. a business flat tax for active income generated within the designated zones. Individuals currently subject to income tax who reside within the zones would have a choice between the current federal income tax and a reformed income tax on individuals that defines "income" in the economically proper manner.

States and territories would apply to the federal government to qualify proposed zones. In order for a zone to be approved, the territory seeking approval, or the state and local government where the zone is located would have to agree to give their residents subject to U.S. tax a choice between being taxed under current law or under a reformed state/local/territorial tax system in which the income tax base was conformed to that of the federal reformed tax base with respect to businesses and individuals within the zones. However, the state, territorial or local governments would remain free to set the state, territorial or local tax rates applied to that base.

Enterprise communities and empowerment zones existing under current law[47] would be eligible to become National Enterprise Zones instead. The incentives under current law would remain in place and phase out in accordance with current law.

What Areas Would Qualify as a Zone?

States and territories would submit proposed zones to the federal government by a deadline early in the calendar year (March 31, for example). If the zones meet the criteria set forth in federal law and the requisite state, territorial and local governments adjusted their tax laws as required, then the federal government would be required to quickly announce approval of the proposed zone (by August 31, for example) and the zone would become effective at the beginning of the next calendar year.

Residents could choose between the current federal tax code and a reformed federal individual tax.

Zones would be required to (a) be contiguous, (b) contain no fewer than a specified number of residents (e.g. 5,000) and (c) be composed of census tracts where, in each tract:

1. The poverty rate (as measured by the Census Bureau using the Census Bureau threshold) is a specified multiple of the national poverty rate (e.g. 2.5 times) over a testing period, and
2. The median household income (as measured by the Census Bureau) is no greater than a specified percentage of the national median (e.g. 50 percent) household income.

In addition, the state or territory in each zone would be required to be in full compliance with the educational standards set forth in the No Child Left Behind Act of 2001.

Every five years, zones would be analyzed to see whether they continue to meet the national enterprise zone criteria. If not, then the zone benefits would terminate five years later. In possessions, the calculations would be performed possession-wide rather than census tract by census tract.

How it would Work?

■ **Businesses**

As notes, businesses within the zone would have a choice between two favorable tax schemes. The could choose to be taxed under current law, but with an enhanced research and experimentation (R&E) credit for research conducted within a national enterprise zone. Companies which choose to be taxed under the current Code, would be eligible for an enhanced R&E credit would be simply an additional, permanent, non-incremental credit at a specified rate (e.g. 5 percent) for research and experimentation actually conducted within a national enterprise zone.[48]

Alternatively, businesses could choose to have their active business income attributable to the national enterprise zone taxed in accordance with proper economic principles of taxation, e.g. income is taxed only once in an economically neutral fashion and tax rates are kept as low as possible. The new framework for taxing business income in the enterprise zones would be based on a newly defined tax baseline. The new tax base would be gross receipts attributable to an active trade or business carried on within the zone less purchases of goods and services from other businesses and less wages attributable to an active trade or business carried on within the zone.[49] It would, therefore, allow for the immediate write-off of equipment and inventories.[50] The federal tax rate on businesses could be 20 percent or lower.

■ Individuals

Individual residents living in the enterprise zones who are subject to federal individual income taxation (and who are not residents of Puerto Rico) could elect how they would be taxed as well. Residents could choose between the current federal tax code and a reformed federal individual tax. Two possible options are described below.

Option 1. The Hall-Rabushka Flat Tax. The flat tax could be imposed on wages above the poverty level for a particular family size. There would be no deductions. All savings would be treated as if it were in a Roth IRA. Interest would be neither taxed nor deductible. The tax rate could be 20 percent.

Option 2. A Consumed Income Flat Tax. The tax rate in this option as well could be 20 percent. The tax would be imposed on all income less any amount saved. A standard deduction equal to the poverty level for a particular family size could be provided.

2. Require Fiscal Restraint

Enterprise Zones offer the ability to tailor policies to the particular situations of the areas involved. In the case of Puerto Rico, the report suggests that in addition to tax reform and relief, the program also provide at least partial relief from the above-mentioned federal regulations and provide for Puerto Rican eligibility for the earned income tax credit and SSI benefits if and only if the Puerto Rican government agrees to and adheres to its own program of regulatory relief, fiscal restraint and educational excellence.

> ***Enterprise Zones offer the ability to tailor policies to the particular situations of the areas involved.***

The fiscal restraint program would provide that Puerto Rican government spending as a percentage of Puerto Rican domestic product must be reduced over a period of ten years to an established benchmark equivalent to the highest spending state. More precisely, Puerto Rico would have to reduce its spending so that the ratio of its spending to domestic product is less than or equal to the highest comparable ratio of state government spending to state domestic product. Furthermore, that the Puerto Rican budget deficit would be required to be a fraction that is less than 5 percent of Puerto Rican domestic product. Moreover, Puerto Rico would agree to end the “cover-overs” on federal excise taxes and to meet congressionally defined educational standards for Puerto Rico with regard to expenditures made under the No Child Left Behind Act of 2001.

The proposed statute would provide that upon application by the government of Puerto Rico and execution of an agreement satisfactory to the Secretaries of Health and Human Services and Treasury by June 30 of any year, the EITC and SSI benefits would commence on January 1 of the subsequent year. The agreement would provide for administration of the EITC and SSI benefits and provide specific fiscal restraint targets.

Compliance by the Puerto Rican government would be assessed annually. If the Puerto Rican government was out of compliance, the Treasury would issue a warning. If the Puerto Rican government was out compliance for two consecutive years, then SSI benefits and the EITC with respect to Puerto Rico residents would be terminated.

3. Extend the Earned Income Tax Credit to Puerto Rico

The earned income tax credit (EITC) provides a refundable credit to low-income workers. The credit ranges from 7.65 percent (for a single person) to 40 percent (for families with two or more children). It is generally available for wages below $4,760 for single persons and $10,020 for families with two children.

Although it has been modified and liberalized over the years, the earned income tax credit was originally conceived as a means of refunding payroll taxes to poor people while still allowing them to receive Social Security benefits. Such a policy encourages the poor to work and helps them climb out of poverty. This approach should be extended to Puerto Rico since there is just as much need to lift Puerto Rican poor out of poverty as mainland poor. Poor Puerto Ricans should have their payroll taxes refunded by means of the earned income tax credit.

Section 32 of the Internal Revenue Code should be amended so that residents of Puerto Rico receive an earned income credit equal to 15.3 percent of income up to the poverty level (which varies by family size). This amount would be phased-out beginning at 150 percent of the poverty level and entirely phased-out at 2 ½ times the poverty level.[51]

4. Extend Supplemental Security Income Benefits

A downsizing is needed in the size of the government that now employs more than 28 percent of the workforce.

The Social Security Administration administers the Supplemental Security Income (SSI) program. It is a means tested program (by income and assets) that is generally only available to those who are genuinely destitute and who are either 65 or older, blind or disabled. In order to receive SSI currently, one must live in the U.S. or the Northern Mariana Islands.

Puerto Rico is already a participant in the general Social Security program and the Social Security Administration is active in Puerto Rico. Puerto Rico has a disproportionate number of genuinely destitute seniors and disabled persons who need assistance, are unable to work and are American citizens. To help alleviate their poverty, SSI should be made available to Puerto Rico just as it is currently available in the Northern Mariana Islands and the mainland.

5. Phase Out Cover-overs on Federal Excise Taxes

Federal excise taxes applicable to goods manufactured in the U.S. are "covered over" (i.e. rebated) to the treasury of the Puerto Rican government with respect to goods manufactured in Puerto Rico).[52] The Treasury Department's Bureau of Alcohol, Tobacco and Firearms administer this process. The amount rebated generally exceeds $320 million annually.

Precedent For Conditioning These Benefits on Fiscal and Other Reform

When discussing the problems imposed on the Puerto Rican economy by the U.S. and by the Puerto Rican government itself, we noted that similar enterprise zone legislation in the Code requires the state and local communities agree in writing to follow a specified course of action designed to reduce various burdens imposed on employers and employees. This is so that tax benefits do not reward inefficiencies, or more particularly, ensure that they are able to continue unabated.

Under Code section 1400(d) for example, U.S. law provides that, as a condition of designating an area as a renewal community (which entitles it to some additional tax advantages), the state, and even neighborhood organizations must commit in writing to at least 4 measures, which may include the following:

- A reduction in tax rates or fees,
- An increase in the level of efficiency in local services,
- Actions to remove, simplify or streamline government requirements, or
- The gift or sale of surplus real property.

Similarly, as a condition of the benefits provided herein, the benefits should be conditioned on a written plan to reduce bureaucracy. The enlargement of a national empowerment zone to Puerto Rico fits in with this report's thrust for economic growth. However, sustainable long-run economic growth requires the elimination of Puerto Rico's bureaucratic quagmire. On the top of that list should be the reduction of permitting costs, labor laws, the improvement of its tax base, a reduction in its tax rates, and above all perhaps, a downsizing in the size of the government that now employs more than 28 percent of the workforce.

Conclusion

Enabling Puerto Rico to grow will help the U.S. economy. A strong economy in Puerto Rico means more jobs in the fifty states: Puerto Rico is the tenth largest purchaser of goods produced on the U.S. mainland. In 1999, Puerto Rico purchased $16 billion worth of U.S. goods, which translates into 320,000 U.S. jobs. Puerto Rico purchases more from the rest of the U.S. than does China, Italy, Russia, Brazil, and Australia.

Jobs will remain on U.S. soil. Corporations in Puerto Rico will have less of an incentive to relocate to foreign countries. By retaining jobs in Puerto Rico, the U.S. will be relieved from social welfare expenditures. Higher employment and payroll in Puerto Rico will mean more U.S. revenue from Social Security and Medicare taxes.

From a short-run budgetary perspective, operating Puerto Rico as an enterprise zone of growth will impose lower direct costs on the federal budget than the pricey section-956 schemes. Moreover, with Puerto Rico operating as an enterprise zone of growth, the $14 billion-plus drain on the federal treasury that the U.S. Government currently pays in subsidies to Puerto Rico will decline and eventually cease as Puerto Rico's economy revives, Puerto Rican revenues rise, public assistance payments decline and the Island prospers.

However, two obstacles stand in the way of Puerto Rico being able to overhaul its tax code and launch its economy on a fast track to economic convergence with the Mainland. First is the perception that reducing tax rates across the board and reforming the tax base to treat work, saving, investment and risk-taking neutrally will cost the government revenue. Second is the perception that such a reform will benefit only the rich. These mistaken beliefs arise out of a fundamental confusion between tax *rates* and tax *revenues* and a static view of the economy.

John F. Kennedy understood the difference when he said:

> "In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low, and the soundest way to raise the revenues in the long run is to cut the rates now...The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus." [53]

Jack Kemp also understood the difference when he said:

> "Want to soak the rich? Cut their tax rates. It's time to soak the rich again, don't you think?"[54]

Several times during the 20th century, tax rates were significantly increased or decreased in the United States. Three times individual income tax rates were reduced, in the 1920s, the 1960s and the 1980s. Each time, individual income tax revenues increased.[55] Each time, the amount of taxes paid by the rich rose.[56] All three episodes also corresponded with an acceleration of economic growth.

Conversely, in the late 1970s and early 1980s, tax rates were effectively increased as individuals were being driven by inflation into progressively higher tax brackets while their real income fell, remained constant or did not rise commensurately with inflation. In the early 1990s, tax rates on upper-income individuals were increased. In every instance, the relative share of revenue shifted from higher to lower income individuals, and economic growth fell persistently below its long-run trend while incomes stagnated.[57]

Puerto Rico does not have to be content with evidence from the mainland. In 1987, Puerto Rico performed its own limited experiment in growth economics when it cut tax rates across the board and lowered to top tax rate from 67.6 percent to 41 percent. While the changes did not address the fundamental problems with the Puerto Rican tax system, they did; nevertheless, provide a natural experiment in cutting marginal tax rates, which is described in Appendix A.

Enabling Puerto Rico to grow will help the U.S. economy.

Puerto Rico also cut tax rates across-the-board twice again in the last 15 years, which is laudable, however the top tax rate still remains too high at 33 percent, and the tax code continues to define taxable income in such a manner as to seriously discourage saving, investment and entrepreneurial risk taking.

The results are in. Tax reform and lower tax rates increase economic growth, move the burden of taxation up the economic ladder, expand opportunity at the bottom of the ladder and raise revenues. Puerto Rico has an opportunity unsurpassed in the modern history of developing economies. It can lead the way to more rapid economic development for itself; but it can also it offer a beacon for the rest of the world, including the United States Mainland, to follow.

Appendix A: Puerto Rico on The Laffer Curve

"Puerto Rico has a thriving underground economy. An estimated one out of three employed Puerto Ricans report no income at all. But when Puerto Rico cut marginal tax rates on personal income across the board as part of its 1987 tax reform—and reduced the top rate from 67.6 percent to 41 percent—the response was dramatic.

- Puerto Rican taxpayers declared 50 percent more income than in 1986.
- The total number of registered taxpayers increased by one-third.
- Total tax revenues increased by 28 percent.

Cutting marginal tax rates across the board also shifted more of the tax burden to upper-income taxpayers.

- Those in the highest income brackets ($30,000 and above) paid 45 percent of Puerto Rico's taxes in 1986.
- A year later, their share had risen to 62 percent.
- Lower income taxpayers not only paid a lower share of total tax revenues, but also paid fewer tax dollars after adjustment for inflation."

Irene Philippi de Soto,
"Is There Life after 936 in Puerto Rico?"
Wall Street Journal, *April 2, 1993.*

Appendix B: Seven Layers of the Puerto Rican Tax System

Layer 1: Business Income Taxes and Capital Gains Taxes

Under the corporate tax system, Puerto Rico imposes an initial "flat" rate of 20 percent on a corporation's (a partnership is treated as a corporation for tax purposes) "normal tax net income." This concept of normal tax income is essentially the corporation's total net income.[58] After that, Puerto Rico imposes a "surtax" on the corporation's "surtax net taxable income." Surtax net taxable income is this normal tax net income minus a surtax credit (actually a deduction against normal tax net income), generally equal to $25,000. Additionally, the graduated surtax rates are phased out for corporations with taxable income of more than $500,000, meaning that the flat tax rate of 30 percent applies to corporations with taxable income equal to or exceeding $905,000.

Table B1 illustrates how these rates generally apply:

Table B1 Combined Marginal Rates of Surtax and Normal Tax

Net Taxable Income		Combined Marginal Rates
Exceeding	Not Exceeding	
$0	$25,000	20%
$25,000	$100,000	25%
$100,000	$150,000	35%
$150,000	$200,000	36%
$200,000	$250,000	37%
$250,000	$300,000	38%
$300,000	—	39%

The rates are applied accumulatively to each segment of income, so a cliff effect is avoided.

As in the United States, corporations are subject to an alternative minimum tax (AMT), which seeks to prevent a corporation from using preferential deductions, exclusions and credits to reduce its Puerto Rican tax liability below that of regular tax liability. This flat rate of 22 percent is applied to the amount by which the alternative minimum taxable income (AMTI) exceeds $50,000.[59] This AMTI is determined by first making adjustment to regular taxable income and then by adding certain tax-preferences. For instance, the deductions for accelerated depreciation are converted into less favorable deductions under the AMT system. Also, AMTI is increase by 50 percent of the amount by which book income exceeds its AMTI before deducting any net operating loss for AMT purposes. AMT net operating losses and AMT foreign tax credits generally may not be used to reduce AMT by more than 90 percent. There is a thin silver lining: a corporation can credit the net amount of AMT paid against the regular tax in succeeding years if a corporation's regular tax exceeds its AMT. The benefit of this provision is mitigated by the time value of the operating revenues lost to taxes.

Puerto Rico does allow for certain pass-through entities, which are taxed at the individual level. Although partnerships are taxed as corporations, so-called "N corporations" may be exempt from Puerto Rican income taxes and AMT. Similar to S corporation under U.S law, the shareholders of N Corporations are taxed currently on their share of the N Corporation's income, regardless of whether any distributions are made to the shareholders. Also, current-operating losses may be passed along to and deducted by the shareholders subject to certain limitations.

The base of the income taxes is broad, and parallels to a great extent the U.S. Puerto Rican domestic corporations (firms incorporated in Puerto Rico) are taxed on worldwide income, as in the U.S. Consequently, a Puerto Rican business is taxed on the income of its foreign branch, regardless of whether or not the income is repatriated. Domestic corporations are generally not taxed on the earnings of their foreign subsidiaries until the earnings are distributed or the subsidiary is sold. As in the U.S., for both regular income and AMT tax income purposes, Puerto Rican corporations are permitted a foreign tax credit for foreign income taxes imposed by the United States or a foreign country, which is limited to the equivalent of Puerto Rican tax on the foreign-source portion of taxable income. Also, as in the U.S., they may take a deduction in lieu of this credit.

Long-term capital gains derived from the disposal of investments and other business assets held longer than six months are taxed to domestic corporations at a maximum rate of 25 percent. Business expenses are deductible to domestic corporations if they are "ordinary and reasonable." A corporation engaged in a Puerto Rico trade or business may deduct 85 percent of the dividend income they receive from a Puerto Rican corporation; and if the recipient is a Puerto Rican corporation receives a dividend from a controlled domestic corporation or partnership, it may deduct 100 percent of the dividend income. Employers are allowed to provide retirement benefits, subject to nondiscrimination rules, and to take a deduction for benefits that are then excludable from the employee's immediate income. Business are permitted to use a version of the U.S. Accelerated Cost Recovery system, straight-line depreciation, or if the business is in a particular industry, a flexible depreciation method.

As in the U.S., resident foreign corporations (foreign corporations engaged in a trade or business in Puerto Rico) are taxed on income that is effectively connected to the Puerto Rican trade or business, and deductions are allowed by resident foreign corporations to the extent they are allocable to that effectively connected income.

The treatment of dividends to foreign corporations and individuals and expatriation of earnings from foreign corporations engaged in a trade or business in Puerto Rico also generally parallels U.S. treatment. Dividends paid by domestic corporations to their foreign affiliates are subject to withholding tax at a rate of 10 percent. Nonresident foreign corporations are also subject to Puerto Rican income tax on their Puerto Rican-sourced gross income. A rate of 20 percent applies to Puerto Rican-sourced royalties paid to a U.S. or non-Puerto Rican corporation; a rate of 29 percent applies to fixed or determinable, annual or periodical gains, profits and income; and, a rate of 29 percent applies to capital gains.

As in the U.S., nonresident foreign corporations are subject to branch profits tax in addition to income tax and AMT on effectively connected income to the extent that income is not reinvested in Puerto Rico. This branch profits tax, which applies to the dividend equivalent amount, is 10 percent. There are, however, certain twists. The branch profits tax does not apply if 80 percent of its gross income for the three preceding years is from Puerto Rican sources, and it does not apply if the income is industrial or tourism-development income.

Layer 2: Individual Income Taxes and Capital Gains Taxes

Puerto Rican residents are U.S. citizens. However, as noted, *bona fide* residents of Puerto Rico are exempt from U.S. federal income tax on their income derived from sources within Puerto Rico. Whether an individual is considered a resident or nonresident is generally a question of intent, determined on the facts and circumstances of each case. In this regard, Puerto Rican residency parallels the U.S. concept of "domiciliary." Additionally, Puerto Rican law incorporates the general concept of the U.S. "substantial presence test" although not its formulaic rules, under which individuals are presumed to be resident if they are domiciled in Puerto Rico for a period of 183 days or more in a calendar year.

Like Puerto Rican corporations, Puerto Rican residents are subject to Puerto Rican tax on their worldwide income. Under Puerto Rican tax law, nonresidents are also taxed on their Puerto-Rican source income and on income treated as effectively connected with the conduct of a trade or business in Puerto Rico. The tax rates imposed upon them are the same as those for resident individuals. All income, gains or losses from sources within Puerto Rico–including passive income–are treated as income, gains or losses effectively connected with a trade or business in Puerto Rico. Self-employed individuals conducting a business for profit in Puerto Rico are subject to income tax at the regular individual income tax rates. Self-employed individuals generally compute taxable income but deduct directly related ordinary and necessary business expenses from their gross income. In general, a nonresident alien who performs personal services as an employee at any time during the tax year is considered to be engaged in a Puerto Rican trade or business or business. Self-employed individuals have the same deductions as employees and may also deduct business expenses.

The applicable Puerto Rican individual income tax rates depend on the taxpayer's filing status. Table B2 presents the tax rates for 2001 for a single taxpayer.

Table B2 Marginal Rates of Individual Income Tax

Exceeding	Not Exceeding	Marginal Rates
$0	$2,000	7%
$2,000	$17,000	10%
$17,000	$30,000	15%
$30,000	$50,000	28%
$50,000	—	33%

For taxable incomes exceeding $75,000, the benefit of the lower rates, as well as the personal and dependents exemptions are phased out.

Under the general individual income tax regime, dividend and interest income is taxed at normal individual income tax rates. However, dividend income from corporations deriving 80 percent of more of their gross income from sources within Puerto Rico is taxed at a maximum rate of 10 percent. Bank-account interest of more than 2,000 is taxed at 17 percent, and untaxed below $2,000.

Capital gains are taxed as in the U.S., with some twists. Net long-term gains are subject to tax at a maximum rate of 20 percent. Net long term capital gains equal the excess of net gains from the sale of capital assets held longer than six months over losses from the sales of capital assets held for six months or less. Net short-term capital gains are taxed as ordinary income. Capital losses are fully deductible against capital gains and against $1,000 of ordinary income. Unused capital losses may be carried forward for five years to offset capital gains.

Like the U.S., individual income taxes are calculated on two levels: gross income is subjected to various specific deductions to obtain adjusted gross income, and adjusted gross income is subjected to itemized deductions to achieve taxable income.[60] In lieu of itemized deductions, a standard deduction may be claimed.[61] In addition to the deductions above there are personal exemptions that may be subtracted from adjusted gross income to arrive at taxable income. For a married taxpayer filing a joint return, the exemption is $3,000; for a single taxpayer, $1,300.

There is one more category of individual–a nonresident alien not engaged in a trade or business in Puerto Rico. Such an individual is taxed at a rate of 29 percent on Puerto Rican-sourced fixed or determinable, annual or periodical gains, profits and income. This consists of investment income; including, interest, dividends, rental income and capital gains. A nonresident alien is entitled to the deductions allowable to a resident only to the extent that the deductions are related to income effectively connected with conduct of a trade or business in Puerto Rico.

Layer 3: Death Taxes

In addition to the individual and corporate taxes, there is a significant death tax, which can be imposed on non-Island born residents of Puerto Rico[62] at rates ranging from 18 percent to 50 percent on the net taxable value of property transferred at death or by gift. For residents, gift tax is imposed on the value of the property transferred if that property is located outside Puerto Rico. In general, no estate or gift tax is imposed on transfers of property located in Puerto Rico by residents.

A tentative tax is imposed on the value of all taxable gifts made during the year and all priors years, but the current year's tax is reduced by the aggregate amount of tax imposes on taxable gifts during prior taxable years. There is a $10,000 per donee exclusion. The estate tax is computed by first calculating a tentative estate tax on the value of the taxable estate. This tentative estate tax is then reduced by the aggregate amount of gift tax paid with respect to gifts made after 1982. There is a fixed exemption of $400,000, reduced by any deduction claimed for property located in Puerto Rico. Nonresidents are subject to Puerto Rican estate tax on estate property located in Puerto Rico only.

Layer 4: Indirect Taxes

Puerto Rico also imposes personal and real property taxes at rates that differ according to the municipality within which the property is located. Real property tax rates range from 6.33 percent to 8.58 percent. Personal property tax rates range from 4.33 percent to 6.58 percent.[63] These rates apply to the assessed value of the property, which generally equals book value for personal property and about 50 percent of book value for real property. Personal and real property taxes are collected by the Municipal Revenue Collection Center.

Layer 5: Excise Taxes

Puerto Rico imposes significant excise taxes as well. An excise tax is imposed on most goods used or consumed in Puerto Rico and is generally payable either when the goods are introduced into Puerto Rico or sold. The amount of the tax is determined on the basis of the "taxable price in Puerto Rico," which generally equals 132 percent of the price for goods brought into Puerto Rico and 72 percent of the price for locally produced goods. Thus, the effective excise tax is 3.6 percent for locally produced goods and 6.6 percent for goods brought in from outside of Puerto Rico. In addition to the general excise tax, certain transactions such as jewelry sales, hotel occupancies, public shows and certain horse-related winnings and prizes are subject to a transaction excise tax. Some businesses are also subject to a license excise tax. This report has already noted the problems with the excise taxes, including their propensity to cascade, their invisibility and the difficulty in enforcing them.

Layer 6: Municipal Taxes

Municipalities also impose municipal license taxes on businesses within their jurisdiction based on a business's gross receipts. However, this tax is limited to 1.5 percent for financial enterprises and 0.5 percent for all other types of businesses. To take an example, in San Juan, a rate of 1.35 percent applies to financial enterprises, and rates of .27 percent to .35 percent applies for other types of business depending on whether the sales exceed a dollar threshold ($1 million). There are exemptions for companies operating within trade zones.

Layer 7: Employment Taxes

Although the Code provides that income derived from sources within Puerto Rico by an individual who is a resident of Puerto Rico generally will be excluded from gross income and exempt from U.S. taxation (even though such resident is a U.S. citizen), section 933 does not exempt residents of Puerto Rico from paying federal taxes on U.S. source income and foreign source income. Nor does section 933 affect the federal payroll taxes that residents of Puerto Rico pay. Federal employment taxes for Social Security, Medicare, and unemployment insurance apply to residents of Puerto Rico on the same basis and for the same sources of income that they are applied to all other U.S. residents. Section 933 does not affect the federal payroll taxes that residents of Puerto Rico pay.

Endnotes

1. Due to § 933 of IRC, which excludes Puerto Rico source income from federal taxation, the vast majority of Puerto Rican taxpayers were not subject to the federal income tax.
2. The reader may find it interesting that the possessions subpart of the Code has seven sections, but not one of them applies to all U.S. possessions. Under § 931 an individual's income is excluded from U.S. taxation for American Samoa, Guam and the Northern Marianas if certain percentage standards are met. Section 932 serves to coordinate U.S. and Virgin Island taxes. Section 933 as noted applies to Puerto Rico. Section 934 applies to corporations and individuals in the Virgin Islands.
3. U.S.C. 745.
4. The applicable percentage limitation for any income year beginning in 1994 is 60 percent; in 1995 is 55 percent; in 1996 is 50 percent; in 1997 is 45 percent; and in 1998 and thereafter, the rate is 40 percent. Note that the IRC §936 tax credit for any QPSII is not limited.
5. However, if an existing credit adds a substantial new line of business after October 13, 1995, it will cease to be treated as an existing credit claimant, which means that it will no longer be entitled to claim the credit. In general, an existing credit claimant that uses the economic activity limitation under §936(a)(4)(A) will continue to determine its §936 credit under that method for taxable years beginning before January 1, 2002. Beginning in 2002, the possession income eligible for the credit will be subject to a cap. The credit will terminate completely for taxable years beginning after 2005. (Note: For businesses conducted in Puerto Rico, IRC §30A contains some additional provisions regarding the application of the §936 phase-out rules.) An existing credit claimant that uses the Percentage Limitation method under §936(a)(4)(B) will continue to use that method for taxable years beginning before January 1, 1998. Beginning in 1998, the possession income eligible for the credit will be subject to a cap. The credit will be terminated completely for taxable years beginning after December 31, 2005.
6. However, under the "subpart F" provisions of the Code, enacted in the Kennedy Administration, 10 percent shareholders of a CFC (generally a company 50 percent or more owned by greater than 10 percent U.S. shareholders) are taxed currently on certain categories of the CFC's income (Subpart F Income) even if it is not distributed to them. For example, dividends, interest and other passive income received by a CFC generally is taxed on a current basis even if it is not in fact repatriated as a dividend to the CFC's U.S. shareholders. In addition, if a CFC uses a portion of its foreign earnings that is otherwise eligible for deferral to invest in U.S. property, the investment transaction is taxed as if the underlying earnings of the CFC had been distributed to the U.S. shareholders of the CFC as a dividend.
7. Even though they thereby forfeited their eligibility under special tax incentives provided under §§ 30A and 936 of the Code (discussed *infra*).
8. Thus, for example, passive income received by a Qualified Possessions Corporation could not be converted from income that is currently taxable under subpart F into income eligible for deferral by the investment of such amounts in U.S. property pursuant to the proposed amendment to § 956.
9. This election could be revoked, but the dividends received deduction could not be re-elected for five taxable years. As under the § 956 exclusion, dividends paid by a Qualified Possessions Corporation electing the new dividends received deduction would be deemed to be made first out of post-enactment Qualified Possessions Income. Rules would be provided to coordinate the dividends received deduction with the § 956 exclusion to ensure that there would be no "double counting" of Qualified Possessions Income.
10. In applying this transition rule, manufacturing intangibles would not be treated as having been "purchased" if they were acquired by the domestic corporation claiming benefits under §§ 30A or 936 in a tax-free reorganization or any other transaction in which the tax basis of the corporation in the intangibles was determined in whole or in part by reference to the transferor's tax basis in the intangibles.
11. Hexner, J. Tomas and Glenn P. Jenkins, "Puerto Rico and Section 936: A Costly Dependence, International Institute for Advanced Studies," Cambridge, Massachusetts, 1993, p. 1.
12. *Ibid.*, pp. 2 and 3 (emphasis in original).
13. Thomas Hexner and Glenn Jenkins sum up the Puerto Rican economic experience this way: "The economy has been beset with slow growth, high unemployment, and little advance in productivity. The Puerto Rican economy has stagnated since the 1970s, after some successful growth in the 1950s and 1960s. Annual growth rates averaged only 1.7 percent from 1975 to 1984, and unemployment reached 22 percent in the 1980s and currently stands at more than double the U.S. rate." See, "Puerto Rico: The Economic and Fiscal Dimensions," Citizens Educational Foundation, 1998.

14. "In 1938, when the U.S. [minimum wage] act was passed at a 25 cents per hour rate, the top skilled rate in Puerto Rico was below 25 cents, and the island economy was instantly sent reeling into a crushing depression with the Great Depression, 75 percent of the needle-work industry was wiped out in two years. In response, Congress in 1940 amended the act to permit lower minimum wages in Puerto Rico on a selective, industry-by-industry basis. Thereafter, the marginal difference permitted venture capital to hire skilled labor in Puerto Rico at a price lower than unskilled labor in the states. The boom of the 1950s was slowed only to the extent organized labor on the main-land forced an acceleration of the minimum wage in Puerto Rico. In 1974, the AFL-CIO pushed Congress into phasing out the differential, and the exodus or collapse of the 'tax exempt' factories began in earnest." See Jude Wanniski, "How Bad Laws Penalize Puerto Rico," *The Wall Street Journal,* March 9, 1976.
15. *Ibid.*
16. Gilder, George, *Wealth and Poverty,* Institute for Contemporary Studies, San Francisco, 1993, p. 198.
17. In fact, checks were recently replaced by a debit card.
18. Hexner and Jenkins, 1998, *op cit.,* p. 1.
19. Here the *status quo* is labeled simply "Commonwealth status" for short, although there is no inherent reason that a perfected and perma-nent Commonwealth compact need necessarily look like the *status quo.* Indeed, any successful permanent "Commonwealth status" almost certainly would *not* resemble *the status quo.*
20. Martin, David, "Puerto Rico: The Imminent Dangers of Statehood," () Zola Times, 1997, p. 8.
21. Hexner, J. Tomas and Glenn Jenkins, "Puerto Rico: The Economic and Fiscal Dimensions," Citizens Educational Foundation, 1998, p. 2.
22. *Ibid.*, p. 2.
23. Statistics of Income.
24. Out of every $1,000 in sales, firms with between $500,000 to $999,999 took 10.63 dollars of credit; firms with between $1 million and $2.5 million took $42.85; firms with between $2.5 million and $5 million took $114.39; firms with between $5 million and $10 million took $163.56; firms with between $10 million and $50 million took 883.50; but firms with more than $50 million took $2,577.57. Clearly the benefit of § 936 was almost wholly available to the largest firms.
25. In addition to one which has been incorporated under the laws of the commonwealth of Puerto Rico or any other possession of the United States.
26. H.R. 2046, introduced in the US House of Representatives by Congressman Nick Smith, would allow foreign-owned, built, flagged and crewed ships to operate not only within the continental U.S., but also between the U.S. mainland and remote states, territories and posses-sions, including Puerto Rico.
27. Internal Revenue Code §7652(a)(1). The federal government retains a small administration fee. See IRC §5314(a)(4).
28. Internal Revenue Code §7652(e)-(f) and §5001(a)(1).
29. Friedman, Robert, "Expert Says Congress Has Power To Tax Puerto Rico: Nothing Could Prevent It Under Commonwealth," The San Juan Star, December 18, 1998.
30. For a more thorough discussion, see Desai and Hines, 'The Uneasy Marriage of Export Incentives and the Income Tax' (October 2,000), who argued that U.S. manufacturing sourcing rules and expense allocation rules would also run afoul of the WTO. On August 20th, 2001, a Panel of the WTO concluded that the ETI Act was inconsistent with Article 3.1(a) of the Agreement On Subsidies and Counter-vailing Measures.
31. Transcript of the press statement of Presidential spokesman, Ari Fleischer, May 7, 2003 concerning U.S. reaction to WTO. FSC Sanctions Authorization.
32. Congress will soon resolve the outstanding dispute with the European Union. House Ways and Means Committee Chairman Bill Thomas proposed a repeal of ETI as part of his American Competitiveness and Corporate Accountability Act of 2002 (H.R. 5095). The Senate Fi-nance Committee has convened a "working group" consisting of key congressional tax writers and Administration representatives to work on a long-term resolution to the ETI problem. Having indicated that there may be a solution other than complete ETI repeal advocated by Thomas, Baucus and Grassley formed the working group to study possible solutions and the ramifications of ETI repeal on various in-dustries that currently take advantage of ETI benefits.
33. U.S. Department of State, International Information Programs.
34. In general, when a United States citizen or resident is subject to tax, in the United States, on income which is also subject to tax in a for-eign State, the United States grants the taxpayer tax credits, subject to certain limitations, in respect of the amount of foreign taxes paid. This maintains what economists refer to as "capital export neutrality" in an attempt to ensure there is no relative difference between deci-sions of a U.S. company to invest here and abroad.
35. Traditionally, the United States has permitted the foreign portion of such income to be allocated outside its taxing jurisdiction through the use of a foreign-incorporated subsidiary of a United States taxpayer.
36. FSCs required "use outside the United States." That was not a measure to avoid the double taxation of foreign-source income within the meaning of footnote 59 of the SCM Agreement. Europeans complained that §§ 114, 941, 942 and 943 IRC, which were inserted into the IRC by virtue of § 3 of the ETI Act, created inappropriate subsidies under which certain income is excluded from United States taxation.
37. The roots of the conflict go back to a 1976 ruling by the General Agreement On Tariffs and Trade, the WTO's predecessor, that an earlier U.S. export tax relief law which established Domestic International Sales Corporations (DISCs), violated trade rules. In 1984, the U.S. re-placed DISCs with the FSCs, but in the mid-1990s, Brussels began making a WTO case against FSCs.
38. Referred to as "Qualified Possessions Income."
39. The proposal would come under even greater scrutiny because foreign subsidiaries of the U.S. would be given an advantage for pulling out of disfavored CFC nations. This could happen if proposal is refashioned to avoid a charge that it is encouraging 'runaway plants" in the U.S. (i.e. which Congress could do by making H.R. 2550 available only for CFCs now established in foreign countries).
40. In the year 1993 for instance only 474 companies filed possessions corporation returns.
41. Congressional Budget Office Current Budget Projections, September, 2002, (www.cbo.gov/showdoc.cfm?index=1944&sequence=0.)
42. See, "Cold Water Thrown on Calderon Corporate Tax Exemption Request," February 15, 2002, The Puerto Rico Herald.
43. Holtz-Eakin, Douglas (Syracuse University) and Harvey S. Rosen (Princeton University), "Economic Policy and the Start-up, Survival, and Growth of Entrepreneurial Ventures, A Report Submitted to the Small Business Administration, May 2001."
44. *Ibid.*, p. 28.
45. *Ibid.*, p. 36.
46. *Ibid.*, p. 42.
47. Internal Revenue Code §§ 1391 et seq.; §§1400 et seq.
48. Research and experimentation would be as defined in § 174 and the regulations thereunder. For purposes of determining whether research was conducted within a zone, wages would be allocated based on whether the work was performed within the zone (in accordance with the principles of § 861(a)(3)), depreciable property used in connection with research and experimentation would be allocable to the zone if it

was placed in service within the zone and capital cost recovery allowances would be provided for as long as the property was in service in the zone, and other costs would be allocable to the zone if the good or service was used or consumed in the zone.

49. An active trade or business would be a trade or business that was not (a) passive activity within the meaning of § 469, (b) a financial institution within the meaning of § 265, (c) a regulated investment company, or (d) an insurance company. Purchases from and sales to related parties of goods would be transferred at the cost they would be carried as inventory were they held on the last day of the taxable year (including any 263A capitalizations). Purchases from and sales to related parties of services would be at cost (including allocations of attributable employee benefit costs and payroll taxes).
50. In a flat tax, interest is neither taxable nor deductible. Since the business may have operations outside of the zone, a rule would be provided with respect to real property placed in service within a zone such that interest on indebtedness used to finance the purchase or construction of structures in the zone would not be deductible and that some portion of the firm's overall interest deduction (if any) would be disallowed if the real property was purchased without significant debt financing that encumbered the property.
51. For single employer individuals, this entire program could be administered through payroll withholding without any need for a tax return to be filed.
52. See IRC §§ 7652(a), 7652(E) and 5001(a)(1).
53. John F. Kennedy, speech to the Economic Club of New York, December 14, 1962.
54. Jack Kemp, speech to the Investor's Business Daily's Second Annual Conference, "2002: A Business and Economic Outlook," at The Ronald Reagan Presidential Library, February 15, 2002.
55. "The Revenue Acts of 1921, 1924, and 1926 slashed individual income tax rates and reduced the top rate from 73 percent to 25 percent. Notwithstanding (or perhaps because of) the dramatic reduction in tax rates, individual income tax revenues increased substantially during the 1920s, rising from $719 million in 1921 to $1,160 million in 1928, an increase of more than 61 percent (with near zero inflation) . . . Legislation dropped the top tax rate from 91 percent in 1963 to 70 percent by 1965. Income tax revenues grew strongly, climbing by more than 16 percent between 1963 and 1966 . . . Tax legislation reduced the top individual income tax rate from 70 percent in 1980 to 28 percent by 1988. Earnings for all income groups rose during the 1980s once tax rate reductions went into effect. Beginning in January of 1983, income tax revenues climbed dramatically, increasing by more than 54 percent by 1989 (28 percent after adjusting for inflation)." See, *Unleashing America's Potential: A pro-growth pro-family tax system for the 21st century,* The National Commission on Economic Growth and Tax Reform, January, 1996, p. 34.
56. The share of the tax burden paid by the rich (incomes over $50,000 in the 1920s) rose dramatically, climbing from 44.2 percent in 1921 to 78.4 percent in 1928 . . . As happened during the 1920s the share of the income tax burden borne by the rich increased [in the 1960s]. Tax collections from those making over $50,000 per year climbed by 57 percent between 1963 and 1966 while tax collections from those earning below $50,000 rose 11 percent. As a result, the 'rich' saw their portion of the income tax burden climb from 11.6 percent to 15.1 percent. . . The share of income taxes paid by the top 10 percent of earners jumped significantly, climbing from 48.0 percent in 1981 to 57.2 percent in 1988. The top 1 percent saw their share of the income tax bill climb even more dramatically, from 17.6 percent in 1981 to 27.5 percent in 1988. " Ibid.
57. "Ironically, even though tax rate increases in 1990 and 1993 were supposed to make the 'rich' pay more, the rate increases have backfired. In 1991, income taxes paid by those earning more than $200,000 fell by 6.1 percent while income taxes paid by those with lower earnings rose by 1 percent. The adverse consequences of the 1990 tax increase are being matched by similar evidence from the 1993 tax increase. According to IRS data, taxable income among those with earnings of less than $200,000 climbed by 3.3 percent between 1992 and 1993. For those with earnings over $200,000, however, taxable income declined by 2.3 percent . . . The deficit is higher today [1996] than it was when President Reagan left office [1989]. . Individual income tax revenues totaled 8.6 percent of economic output in 1989. By 1994—two large tax increases later—individual income tax revenues had fallen to 8.2 percent of economic output. Ibid.
58. Normal tax income is net income minus the "dividends received deduction." See *infra.*
59. However, the $50,000 exemption is phased out by 25 percent of the amount by which the AMTI exceeds $500,000. Consequently, a corporation with $700,000 of AMTI is not entitled to any exemption ([$700,000 - $500,000] * .25 = $50,000).
60. Deductions to compute adjusted gross income include deductions attributable to rents and royalties, losses from the sale or exchange of property, and distributive shares of special partnership losses. Itemized deductions include certain residential property taxes, limited childcare expenses, mortgage interest, charitable contributions, annual rent of up to $500 on a principal residence, investment interest to the extent of investment income and disaster losses.
61. $3,000 for a married taxpayer living with a spouse and filing a joint return; $1,500 for a married taxpayer living with a spouse and filing a separate return; and $2,000 for a single taxpayer.
62. The Puerto Rico tax code provides a full exemption for estates of all sizes in the case of native-born Puerto Rican deceased.
63. Act No. 347 of 1999 provides an exemption from the property tax for stock, bonds and other securities issues by foreign corporations, partnerships and companies that are owned by corporations or partnerships organized under the laws of Puerto Rico.

About the Author

Dr. Lawrence A. Hunter is Chief Economist at Empower America. He served as a member of Presidential candidate Bob Doles Task Force on Tax Reduction and Tax Reform. During the 103rd and 104th Congresses, Dr. Hunter served on the staff of the Joint Economic Committee, first as Republican Staff Director and later as the Chief Economic Advisor to the Vice Chairman where he was the lead staff person in charge of putting together the economic growth and tax cut component of the Contract With America. Prior to joining the JEC staff in 1993, Dr. Hunter was with the U.S. Chamber of Commerce for five years where he served first as Deputy Chief Economist and later as Chief Economist and Vice President. Dr. Hunter received his Ph.D. from the University of Minnesota in 1981.

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