Puerto Rican Statehood

A Precondition to Sound Economic Growth

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Preface

This report presents a revised and updated version of an earlier report of the same title. Although its arguments and data have been brought in line with recent developments, the report's fundamental conclusion has not changed since its first release: statehood is still a precondition to Puerto Rico's sustainable economic development into the twenty-first century. Critical areas remain in dire need of attention and reform in Puerto Rico's economy: the need to restructure and streamline the island's bloated and ineffective public sector; the need to repeal the inefficient and outdated section 936 tax credit; and the need to refocus the island's obsolete development strategy away from government subsidies and centralized decision-making, and toward private sector market-oriented policies. These problems, which we identified in the first version of this report, have not been resolved; indeed, they are further entrenched. Moreover, the conclusion that action on these issues is unlikely in the absence of statehood has also been supported by the static quality of the status quo. (Indeed, the present pro-commonwealth Governor attempted in a December 1991 referendum to entrench further the status quo. The Puerto Rican population rejected that effort.)

Much of the original report, released in September 1990 and circulated to Congress, was written in response to the pressured atmosphere surrounding congressional movement to provide for a referendum in Puerto Rico to determine the island's political status. In particular, the first edition concentrated on the economic and transitional issues contained in Senate bill S.712. Since then, the legislative context has changed: S.712 and its House counterpart did not survive the 1990 congressional term. Efforts in early 1991 to revive those bills (embodied in Senate bill S.244, for example) also failed in the face of time constraints to avoid conflicts with the 1992 election year. As a result, no legislative action on the referendum issue is likely until after the 1992 elections.

This edition therefore seeks to update its arguments (if not its conclusions) in light of developments in the past eighteen months. The report has been slightly restructured to highlight our main conclusions about Puerto Rico's economic development. Three main sections deal with the central problems facing the island: Section II now addresses the need for reform in Puerto Rico's development strategy and public sector; this section remains basically unchanged, but uses more recent data to support its conclusions on the need for change. Section III confronts the problems relating to section 936 and the need for its repeal. This edition demonstrates the continued inefficiency of that subsidy. And Section IV shows that a shift to statehood would represent a fiscal boon both to Puerto Rico and to U.S. taxpayers. Where the first edition reflected the provisions of S.712 directly, though, this one sets out the basic principles of any status legislation designed to deal with statehood — the critical importance of timing in designing a transition, revenue neutrality, equitable transition provisions, and the need for a development-oriented statehood grant.

Finally, the authors would like to thank Laura Reichenbach, a student at Harvard's Kennedy School of Government, for editing and research assistance that made this second edition possible.

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I. Introduction and Executive Summary

Introduction

This report highlights the principal economic issues related to Puerto Rican statehood in general and to the various legislative approaches toward that end. The report's basic theme is that future economic growth for Puerto Rico requires a development strategy that is oriented toward the private sector, that is gimmick free, that deals with the realities and dynamics of the 1990s and the 21st century, and that does not languish on the static rhetoric of industrialization through subsidy and state planning. In our view, statehood is a precondition for this essential development strategy.

We reach this conclusion based on the fundamental economic realities facing the island. Nevertheless, we also recognize that the most important element of the status issue is Puerto Rico's right to self-determination. Puerto Rico, above all, must be allowed to choose for itself the form of its relationship with the United States. Indeed, as we discuss below, resolution of this political question underlies the economic dimensions of Puerto Rico's problems because the uncertainty and political paralysis affiliated with the current situation pose an insuperable obstacle to needed reforms. We therefore strongly support legislative efforts in both the U.S. and Puerto Rico that would make a final resolution of this issue possible.

The report begins in Section II by asserting that Puerto Rico can be proud of its past growth but not sanguine about its future unless significant change occurs. We focus attention on the island's outmoded development strategy, identify areas of potential growth and promise, and then highlight the current problems facing Puerto Rico's public sector. As we emphasize throughout the report, Puerto Rico needs to focus on a long term strategy for development; while we sketch the contours of that strategy here (streamlined public sector, investments in infrastructure and education, respect for the environment), the bulk of that project is beyond the scope of this report. In this same section we show that with a well constructed fiscal framework and a prudent administration of state finances, the State of Puerto Rico could make room for federal taxes without diminishing the quality of public services provided to its citizens. Statehood, we maintain, is both a catalyst and a requirement for these changes.

Section III then focuses attention on section 936 of the Internal Revenue Code, the tax provision (benefiting Puerto Rican subsidiaries of U.S. corporations) that would be eliminated under statehood. Demonstrating that section 936 is an inefficient tool for economic development that has outlived its usefulness, we contend that its phase-out under any political status, including statehood, is desirable. Moreover, its phase-out need not harm the Puerto Rican economy, provided it is replaced with a more compatible economic development strategy that could be financed in part by an appropriately designed statehood grant.

Finally, in Section IV, we suggest a broad legislative framework to provide for the transition for statehood, and address the paramount importance of the timing in designing that strategy. If properly designed, such legislation can be revenue neutral to the U.S. Treasury, fair to the section 936 companies that have invested on the island, and helpful to Puerto Rico's long-term development strategy by providing for a statehood grant.

Appendix A provides a new perspective on the implications for Puerto Rico of the large increases in welfare programs that would accompany statehood. Appendix B identifies by type the public corporations in Puerto Rico, which we argue are ripe for reform.

Summary of Conclusions

1. *Puerto Rico's economy and government require a significant overhaul if the island hopes to compete in the 1990s and 21st century.* A new strategy for long-term economic development is essential. Puerto Rico's economy is currently plagued by high unemployment, low labor force participation, and a high rate of migration to the mainland. The economy is also dependent on an outdated development model based on government assistance and tax credits to attract investment; its centerpiece, the section 936 tax credit program, continues to exist only at the will of Congress. The public sector, meanwhile, appears politically paralyzed and incapable of reform.

2. *Important real reasons exist for investing and reinvesting in Puerto Rico.* These include a marvelous climate, a well-developed financial infrastructure, a trained, inexpensive and productive labor force, and a cultural and geographic background making it a natural conduit to the increasingly important Latin American market. The stability and certainty of statehood is needed to put those forces to work.

3. *Puerto Rico's public sector is not satisfying the conditions necessary for sustained growth.* We have identified the following problems: excessive growth in government spending and employment, insufficient investment in infrastructure and education, neglect of the natural environment, and an inefficient public corporations sector.

4. *Statehood would spur government reform.* Residents of Puerto Rico suffer a very high tax burden. The responsibility of full federal taxes will create pressure on the island to make fiscal adjustments in the range of $1 to $1.3 billion. Much of this amount could be generated through such measures as: improving income and excise taxes compliance; privatization and elimination of public corporations, such as the Sugar Corporation; increasing the self-sufficiency of remaining public corporations and imposing upon them the responsibility of making contributions to the central government through different means; and reducing the size of the central government, eliminating and consolidating agencies and programs, and implementing a hiring freeze and gradual personnel reduction.

5. *Statehood would result in the eventual elimination of section 936, a subsidy that is inefficient and costly, increasingly ineffective in providing jobs in Puerto Rico, and inconsistent with both U.S. Treasury policy and the island's future long-run growth.* Section 936 represents a monumental subsidy by the federal government, with little to show for it: over $2.4 billion in revenues foregone every year, an average annual revenue cost per employee of over $26,000, a revenue cost per dollar of wages paid averaging $1.51 (increasing to $8.61 for the incremental wage benefit). Perhaps most egregiously, it would take the federal government only 1.8 years at the current rate of tax costs to *buy back entirely* the net investments of section 936 companies in Puerto Rico.

With the shifting mix of 936 companies away from labor intensive manufacturing such as textiles toward industries such as pharmaceuticals and electronics with large manufacturing and marketing intangibles, section 936 increasingly rewards not real investment on the island, but rather the ability of U.S. companies to shift income to Puerto Rico through transfer pricing. Hence, regardless of the status issue, section 936 should be eliminated.

6. *Statehood not only requires that section 936 be phased out, but also provides an ideal opportunity to begin more effective development initiatives.* A well designed statehood grant could counter any possible adverse short-term economic effects of phasing out section 936 while at the same time providing an environment more conducive to the long-run economic growth of the island. Proper design of the timing of the transitional adjustments and the nature of the statehood grant are necessary to assure that statehood leads to the desired goal of promoting a more effective long run development strategy for the island.

The effectiveness of that statehood grant — as well as Puerto Rico's development prospects — requires that the grant *not* be co-mingled with normal government funds, as has been implicitly suggested in past legislation.

It should be set up as a trust in the context of an agreed upon development strategy.

7. *Statehood implementing legislation, appropriately designed, can achieve budget neutrality, allow for a reasonable transition, and provide for a statehood grant.* A properly designed transition package could generate well over $5 billion for the U.S. Treasury in the first 9 years of statehood alone. Thus, even with revenue neutrality for the federal budget, a significant pool of funds could be made available during the transition to Puerto Rican residents to promote economic growth under statehood. The success of the transition period depends on the rapid (but fair) phase-out of section 936, combined with a strategy of introducing federal taxes and federal entitlements together.

8. *The effect on work incentives of extending full federal welfare payments to Puerto Rico, as would occur under statehood, depends on the economy's ability to grow and create jobs.* By serving as a precondition for the long-term economic growth of the island, statehood would be a positive force in strengthening the work opportunities for Puerto Ricans. In this sense statehood, with its concomitant political renewal and empowerment, would build the foundation for economic growth and also assure a more adequate safety net of fair social welfare programs.

II. The Need for Change

Reforming the Development Strategy and the Public Sector

This section addresses the two major problems afflicting Puerto Rico's economy: an outdated and ineffective development strategy; and a public sector in dire need of reform and streamlining. In both cases, we argue that change is required irrespective of the status question if Puerto Rico hopes to grow, develop and compete into the 21st century. At the same time, the requirements of a new development model and a public sector overhaul also demonstrate how the shift to statehood would catalyze these needed reforms. Indeed, we conclude by arguing that these changes are unlikely in the absence of statehood.

Puerto Rico's Outmoded Development Strategy

The Problem with the Status Quo

Puerto Rico's economy is *not* a case of "if it works, don't fix it." Although the economy experienced strong economic growth during the 1950s and the 1960s as it was transformed from an agricultural to a manufacturing economy, development in recent years has atrophied. Currently the island is experiencing high unemployment (17.5 percent), low labor force participation (45.7 percent), and a high rate of migration to the mainland in search of jobs (hovering around 1 percent per year). Moreover, a 1992 snapshot of Puerto Rico bears a close and uncomfortable resemblance to the stagnation and frustration of many developing countries with the following features: a high degree of centralization, a capital city mentality, a decaying infrastructure, and an apparently bloated public sector, some of which is suitable for privatization. Indeed, nothing has changed since this report was first issued in 1990, except that the people of Puerto Rico rejected a political maneuver that threatened their U.S. citizenship and would have entrenched the status quo.

Unfortunately, Puerto Rico continues to rely on an outdated development model based on government assistance and tax incentives to attract investment. The use of a government agency such as Fomento to facilitate investment, for example, no longer fulfills a productive purpose given the availability of sophisticated financial institutions for such services. Indeed, this approach is inappropriate in today's economic and financial climate, particularly given the budgetary problems of both the U.S. and Puerto Rican governments.

Future economic growth in Puerto Rico cannot depend on a tax code provision that is as inefficient, expensive and uncertain as section 936. Instead, Puerto Rico should work toward providing the two most important factors in any long-term investment decision: consistency and stability. Yet section 936 — a tax loophole that benefits special interest groups at the expense of the U.S. taxpayer — exists at the caprice of Congress in a period of severe fiscal retrenchment.[1] At the same time, Puerto Rico's political status is as indeterminate as the longevity of section 936. That climate of uncertainty undoubtedly acts as a major impediment to future investment. In sum, mere adjustments of the status quo represent a wholly inadequate and insufficient base for Puerto Rico's economic health in both the short and long term.

The Potential for Growth

Sustainable growth in Puerto Rico demands something different. Government's role is to provide a consistent policy setting in a context of stability, not heavy-handed controls and regulations. Successful and sustainable economic growth in both the U.S. and throughout the world has been fueled by the response of the private sector to the forces of the marketplace.

Fortunately, Puerto Rico has the assets needed for such private sector growth. Labor is one such asset: it is highly skilled, productive, plentiful and relatively inexpensive. Its well developed financial, communication and transportation networks are other valuable resources. A multicultural heritage and strategic location give the island a specific advantage in the service industries in a period of rapid regional economic integration. These attractions, plus an ideal climate and natural environment, have already begun to attract major investments in the island's tourism sector. Under statehood, Puerto Rico would also offer permanent advantages that similar locations competing for investment simply cannot match, including exemption from U.S. tariffs, use of the U.S. dollar, and protection under the U.S. legal system. To realize fully and maintain its competitive advantages, however, statehood is necessary, particularly in light of the trend towards free trade throughout the region.

Statehood as an Alternative

None of these assets depends on an inefficient tax subsidy or congressional generosity. The potential exists for strong economic growth based on stability and private sector initiative. In particular, the tourism, agricultural and services sectors offer significant opportunities for growth if Puerto Rico were to expand its development strategy beyond the distorted policies encouraged by section 936. We believe that statehood, with its emphasis on self-reliance, its resolution of the status issue, and its stability and consistency in tax treatment, is a precondition of such diversified growth. Statehood offers both U.S. and foreign investors a more familiar, recognizable and permanent environment than commonwealth, for example.[2] The following section demonstrates that needed reforms of Puerto Rico's public sector are also likely to occur only with the fiscal pressures that would accompany the shift to statehood.

Puerto Rico's Public Sector and the Effects of Statehood

Effective Government: A Precondition for Growth

The ability to attract and retain businesses and investments depends on an effective and unoppressive government in Puerto Rico that meets several basic criteria. These preconditions for sound economic growth include:

- A streamlined and responsive public sector that provides public services efficiently;
- An adequate and well-maintained infrastructure;
- Quality education and human resource development for a literate and skilled work force;
- Resolution of the status issue; and
- A supportive economic climate that reaches beyond traditional cost concerns like taxes and regulation to include environmental and other quality-of-life issues.

In these areas particularly, government policy has a direct impact on economic growth. Recent empirical analyses of relative rates of growth across U.S. states demonstrate that government investment in education and infrastructure, for example, significantly affects economic development. Initial levels of public infrastructure (as well as changes in those levels) were found to have a significant impact on employment growth, private sector output and private investment; each additional $1000 per capita investment in public infrastructure was found to generate a 0.2 percent increase in the average annual rate of a state's employment.[3] Similar studies have shown that education levels — the percentage of workers with high school and college degrees — also directly affect economic growth.

State governments in the U.S. have recently begun to recognize and respond creatively to the importance of their role in economic development.[4] Competing in an increasingly integrated and competitive world economy now requires effective, efficient and competent government helping to create a framework conducive to economic growth.

The Current Situation

Does Puerto Rico's public sector satisfy these conditions? The evidence suggests that the answer is clearly "no." In fact, Puerto Rico's public sector currently faces a multitude of problems and challenges. Continued economic growth requires that they be addressed regardless of the status question. Clearly identifiable problems include the following:

RAPID GROWTH OF PUBLIC SECTOR EMPLOYMENT: A recent budget crisis has highlighted the growing costs of Puerto Rico's public sector, particularly with respect to public employment growth. Between 1975 and 1988 the average annual growth rate in government employment was 2.6 percent, substantially higher than the 1.4 percent growth rate of non-government employment. The government is now the single most important employment sector on the island; in 1988 it employed almost one in four workers. In contrast, government employment in the U.S. in 1988 accounted for 15 percent of total employment (one in six workers).[5]

RAPID GROWTH OF GOVERNMENT EXPENDITURES: Table II-1 shows that between 1980 and 1992 for the commonwealth government alone (not including the municipalities), nominal expenditures between 1980 and 1992 grew at an average annual rate of 8.2 percent, compared with 5.7 percent for personal income on the island.[6] Meanwhile, budget problems have plagued the government, evidenced by the use of a variety of budget gimmicks and one time revenue windfalls to balance the budget.[7]

INSUFFICIENT SPENDING ON EDUCATION: In fiscal year 1988, Puerto Rico spent only $1400 per pupil on elementary and secondary education, compared to $1594 per pupil for the lowest state expenditure.[8] Table II-2 shows that education spending accounted for only 18.3 percent of government expenditures in Puerto Rico, compared to 33 percent in the U.S. In 1992 the spending of the general fund alone was $1.2 billion, $1.7 billion with federal funds or 20%. The 1987-88 public high school graduation rate was 63.2 percent, 9.4 percentage points lower than the U.S. average (only two states and the District of Columbia had lower rates).

DECLINE IN INVESTMENT IN INFRASTRUCTURE AND PUBLIC WORKS: Figure A shows that inflation-adjusted government construction (including public enterprises) generally fell between 1975 and 1990, with an upturn only in 1987 and 1988. Government investment in "roads, schools, and other public works" has been even flatter. Figure B demonstrates that these downward

Table II-1

Commonwealth General Fund Budget Fiscal Years 1980-1992

Fiscal Year	Budget	Increase	Percent Change
1980	$1,792.5		
1985	2,774.1	$981.6	54.7
1986	2,851.3	77.2	2.7
1987	3,149.9	298.6	10.4
1988	3,390.7	240.8	7.6
1989	3,791.2	400.5	11.8
1990	3,984.9	193.7	5.1
1991	4,038.0	53.1	1.3
1992	4,227.2	189.2	4.7

1980 – 1992 Average percentage growth: **8.19**
1985 – 1992 Average percentage growth: **6.22**

Source: Budget documents, Office of Budget Management, Dr. Luis Montanez, Former Director of the Commonwealth Office of Management and Budget.

Table II-2

Budget Priority Elementary and Secondary Education Commonwealth General Fund and Federal Funds Fiscal Years 1976, 1980, 1990, 1991

($ Millions)

Fiscal Year	General Fund Only: Total	D.E.	% of Total	General Fund & Federal Funds: Total	D.E.	% of Total
1972	1130.3	320.1	28.3	1305.3	357.4	27.4
1976	1167.6	271.5	23.2	1550.2	367.4	23.7
1980	1792.5	410.3	22.8	2732.3	661.9	24.2
1985	2774.1	548.8	19.8	3589.1	820.8	22.8
1990	3938.2	738.7	18.7	4714.9	1054.2	22.4
1991	4036.9	736.3	18.3	4852.5	1082.6	22.3

D.E. = Department of Education

Source: Budget documents, Office of Budget Management (Provided by Dr. Luis Montanez, April 1992)

Figure A

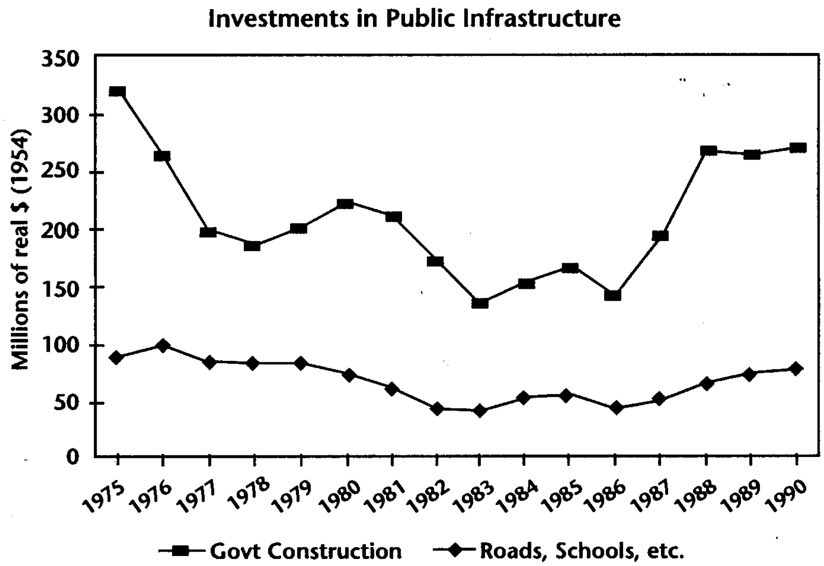
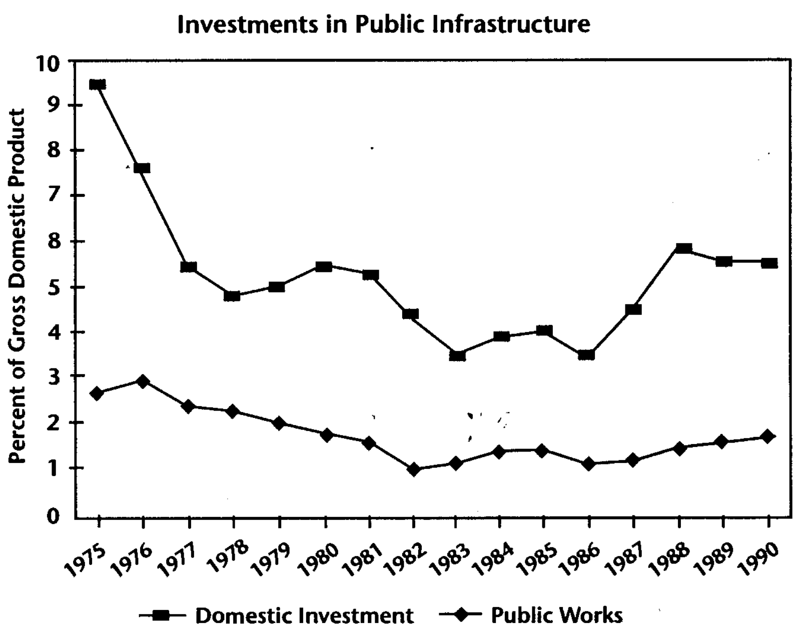


Figure B



trends are even more pronounced when investment is compared to the growth of the economy as a whole as measured by gross domestic product. Though the U.S. has also experienced a similar trend, it should be remembered that the less developed infrastructure in Puerto Rico requires investment and cannot afford the neglect like that of the more highly developed mainland.

NEGLECT OF ENVIRONMENTAL AND NATURAL RESOURCE REGULATION: Puerto Rico's 9 Superfund sites on the National Priority List[9], with a cleanup bill that could reach $20 million per site, amply demonstrate Puerto Rico's environmental negligence. A recent report by the Natural Resource Defense Council criticized the commonwealth government for its poor resource management, particularly with respect to Puerto Rico's forests and endangered species.[10] The report noted some specific lapses, such as the fact that the commonwealth government did not spend any of the $2 million appropriated for conservation land purchases by the legislature in 1988.

AN INEFFECTIVE REVENUE COLLECTIONS PROCESS: A 1987 study on income and excise tax reform in Puerto Rico prepared by Booz, Allen & Hamilton estimated that $1.5 billion in personal income went untaxed in 1984 because of non-filing and under-reporting, and that an additional $135 million could be collected annually by improving tax administration, enforcement, and compliance incentives.[11] Table II-3 shows that under reporting and non-filing were projected to grow rapidly in the absence of revenue reporting. No more recent evidence indicates that anything has changed to improve this situation.

LARGE FISCAL DRAIN ASSOCIATED WITH PUBLIC CORPORATIONS: Public corporations were originally designed to serve governmental and quasi-

Table II-3

Distribution of Reportable and Reported Income Projection of 1984 Booz, Allen & Hamilton Analysis, to 1990
($ Millions)

	1984	1990
Total Reported Income	7,300	10,200
Not Reported		
Non-Filing	1,500	2,400
Under-reporting	1,000	2,000
Total Not Reported	2,500	4,400
Total Reportable Income	9,800	14,600
Percent Unreported	25%	30%

Source: Booz, Allen & Hamilton, "Final Report on the Tax Reform Program," Prepared for the Department of the Treasury, Feb., 1987, Appendix C.

governmental functions with more flexibility in financing and management than agencies of the commonwealth government. But Puerto Rico's increasing dependence on this form of organization to provide the jobs that its development program fails to produce — there are fifty-four public corporations now[12] — creates several problems. One problem is the provision of services more suited to the private sector. A more immediate problem is the drain on the general fund. Public corporations which provide typically private services include the Automobile Accidents Compensation Authority and the Maritime Shipping Authority. If these activities were performed in the private sector, not only might they operate more efficiently but also they would generate tax revenue for the government; currently, the government indirectly subsidizes these corporations through tax exemptions.

Though most public corporations were originally designed to be self-supporting through fees and charges, the great majority are heavily subsidized by the commonwealth government. The Sugar Corporation, for example, derived 64 percent of its operating funds from the general fund in the 1990 budget. Direct subsidies are provided through annual legislative appropriations for capitalization, investment, and operations costs. In fiscal year 1991-92 public corporation appropriations totalled almost $1.3 billion, over 30 percent of the general fund budget.[13]

POOR PERFORMANCE IN SERVICE DELIVERY: A qualitative evaluation of the government's performance in service delivery obviously must rely on more subjective sources. But here again, evidence indicates that Puerto Rico's public sector is lacking in efficiency and responsiveness. For example, the swelling of the public payroll has been criticized as excessive and unnecessary. A 1985 report commissioned by the current governor and prepared by a committee of prominent citizens recommended a vast overhaul of the government's structure on the grounds that the payroll growth was an "ad hoc" response to employment crises on the island and did not represent improved service delivery.[14] The *San Juan Star* has more recently echoed this diagnosis, attributing the growth to the "twin traditions of political patronage and government expansion to reduce unemployment."[15]

Moreover, the increasing size of the public sector also has other indirect costs. An excessively large organization constrains both accountability and responsibility, causing delay and time-consuming red tape. An over-emphasis on functional centralization at all levels has contributed to this problem. Though government services were originally centralized to reduce costs, avoid duplication of responsibility, and take advantage of economies of scale, the 1985 report found that the drawbacks of centralization now outweigh the benefits.[16] The authors argued that the public sector now places a greater emphasis on structure and hierarchy than on service, resulting in a variety of ills ranging from low productivity and high operating costs to slow provision of services.

Desirable Changes

No economy preparing to compete in the twenty-first century can afford to be burdened with the problems noted above. Change is therefore desirable regardless of the status issue. Examples of possible reforms include:

- *Better government hiring practices.* The government should not be the principal employer nor the employer of last resort for a failed job development policy. Rather, its hiring should be closely linked to service levels and based on merit.
- *Enhanced tax collection and compliance.* Efficient revenue-raising is necessary to provide resources for important investments in education and infrastructure and to foster an atmosphere in which public obligations are respected.
- *A restructured tax system.* An increased emphasis should be given to decentralization by devolving more revenue-raising capability back to local governments. Steps have been taken to reorganize the administration of the property tax, but the outcome of this reform remains in the balance as of this writing. Such reforms must be encouraged as a matter of general policy, however.
- *A reorganization of the public corporations sector.* The goal should be to improve accountability and encourage efficiency, and reduce its growth rate.

Change Requires Pressure

These important changes will not occur without the discipline required by statehood. Recent history, political reality, and vested interests indicate that needed reforms are unlikely in the absence of external prodding. Most of the problems discussed here are not new, nor are we the first to identify them. Yet little rehabilitative action has been taken. Witness for example the Commonwealth Administration's limited response to the reforms advocated in the 1985 report on the government's structure: virtually none of the recommended changes have been implemented. Nor has significant action been taken on tax reform proposals.

In contrast, statehood would entail certain collateral changes and adjustments that represent natural opportunities for the reform and renewal of political and economic structures. Specifically, statehood would definitively resolve the status question. Mainland residents unfamiliar with the island may underestimate the extent to which Puerto Rican politics revolve around this unsettled problem. One example of its influence is provided by the platforms of the three major political parties there, which hold out their support of statehood, commonwealth, or independence as central defining characteristics. Because this issue has so dominated Puerto Rican politics (often to the detriment of good government), we feel that substantial economic or political reform cannot take place until it is resolved. A more quantifiable change likely to produce reform is the fiscal pressure on the Puerto Rican public sector that would accompany statehood. The following section addresses this issue.

Reform Through Statehood: The Fiscal Impact

Under statehood, Puerto Rico's fiscal structure would be affected both by the extension of federal taxes to Puerto Ricans and by full federal funding for entitlement programs.[17] The magnitude of the fiscal pressure on Puerto Rico's public sector that would accompany this change can be determined by comparing Puerto Rico's fiscal structure with that of other U.S. states. Table II-4 shows the tax burdens — state (or commonwealth) and local tax revenue as a percent of personal income — of Puerto Rico, Mississippi (the lowest income state), and the U.S. as a whole. The table demonstrates that in 1989, Puerto Rico's total tax burden was 5 percentage points higher than both the U.S. average for state and local taxes and the total tax burden in Mississippi.[18] The difference in tax efforts largely reflects Puerto Rico's heavy reliance on the collection of individual and corporate income taxes. Because its residents are not required to pay federal income taxes on Puerto Rican source income, Puerto Rico is able to levy higher rates of income taxation than other states.

With statehood and the imposition of federal taxes, however, Puerto Rico would face pressure to bring its tax burden in line with that of other U.S. states. That pressure would come from individuals seeking relief from higher taxes

Table II-4

1989 Effective Tax Burdens
(Tax Revenues as a Percentage of Personal Income)

	Puerto Rico	Average State & Local (Total U.S.)	Mississippi	Difference Between U.S. Avg. and P.R (% Points)	Value of Difference ($ Billions)
Total Taxes	15.7	10.7	10.7	5.0	$0.95
Income	9.6	2.8	1.9	6.8	1.30
Sales & Excise	4.9	3.8	3.6	1.1	0.19
Property	0.8	3.3	2.6	-2.5	-0.48
Tollgate	0.6	—	—	0.6	0.11
Other	0.2	0.8	2.6	-0.6	-0.11
Charges and Miscellaneous	2.1	4.4	4.6	-2.3	-0.43
Total Own Source Revenue	17.8	15.1	17.0	3.7	$0.70

Source: U.S. Data: ACIR, "Significant Features of Fiscal Federalism, Volume II," (Washington, D.C.: ACIR, 1991) Table 85 and p. 205. Puerto Rico data: Puerto Rico Planning Board, "Economic Report to the Governor, 1990," Tables A-1 and A-27.

Table II-5

Estimated Local Savings for Entitlement Programs Under Statehood
(Estimates under S.712 Statehood Assumptions)
($ Millions)

	Medicaid[1]	A.F.D.C	SSI[2]	Food Stamps[3]	Total
1992	$266	$6	$0	$(30)	**$227**
1993	245	40	$0	(30)	**255**
1994	225	70	$0	(30)	**265**
1995	204	70	$5	(30)	**249**
Average, first 4 years					**249**

Source: CBO, "Background Materials on the Costs of the Puerto Rico Status Referendum Act," Prepared for the Senate Finance Committee, November 15, 1989, p. 10.

Note: These figures represent savings to the Puerto Rico Government under statehood through federal replacement of local entitlement programs. Figures based on CBO estimates of program options, benefit levels, and numbers of participants.

1 See footnote 25 for a description of this CBO estimate.

2 This estimate follows assumptions in bill S.712 that Supplemental Security Income (SSI) would not fully replace the Adult Assistance program until 1995.

3 Replacing Puerto Rico's Nutrition Assistance Program with food stamps would increase local administrative costs for eligibility certification, work programs, and quality control activities. This figure is from a September 6, 1989 CBO cost estimate.

as well as from businesses concerned about keeping Puerto Rico's tax burden competitive with other states. Hence the current disparity in tax burdens is one measure of the pressure likely to be placed on Puerto Rico's fiscal structure under statehood. Table II-4 shows that to bring its burden in line, Puerto Rico would need to reduce its tax burden by about 5 percentage points. At 1989 income levels, this translates to $0.95 billion dollars, 28 percent of 1989 commonwealth-source revenues.

Another measure of the fiscal pressure created by federal taxation under statehood is the additional amount Puerto Rico's individuals and businesses would have to pay. In 1990 testimony relating to bill S.712, the U.S. Treasury Department estimated federal revenues from non-936 corporate income taxes, individual income taxes, and new excise taxes at $1.2 billion in 1994, the first year under S.712 that federal taxes would have been fully imposed. To accommodate those new taxes without increasing the total (i.e. federal, state, and local) tax burden, the commonwealth tax burden would therefore have had to be reduced by $1.2 billion by 1994. Under the different transition model adopted by S.244, federal tax obligations would have been phased in over a four year period (after a one year delay); although the federal tax burden would be imposed gradually under this model, the same level of fiscal pressure would eventually obtain.[19]

Both measures indicate an approximate total annual fiscal pressure of $1 to $1.2 billion in the first years of statehood.[20] In other words, to avoid the negative effects of high marginal tax rates under statehood, Puerto Rico would need to reduce its tax burden, mainly through cutting income tax revenues.

One additional fiscal pressure caused by statehood would be the loss of tollgate tax revenues. The 5 to 10 percent tax Puerto Rico imposes on repatriated section 936 funds would be eliminated under statehood, since taxation of interstate commerce is unconstitutional. The annual value of this revenue source fluctuates to some degree depending on investment decisions of section 936 companies. However, from 1985 through 1990, average annual tollgate tax revenues were close to $109 million;[21] this average provides a rough estimate of the value of the tollgate tax.

On the other hand, additional federal funds (particularly for entitlement programs) will free up some locally generated funds for other purposes. Using CBO estimates tied to the original assumptions of S.712, Table II-5 shows that as a state, Puerto Rico would save an average of $249 million annually because some locally funded programs would be replaced by federally funded ones. For example, substituting federal Medicaid funds for the local public health program could yield up to $266 million for the commonwealth budget.[22] The food stamp program reduces these gains by an estimated $30 million annually due to increases in local administrative costs.

The bulk of the new federal funds, however, will arrive as additional transfers to individuals, not direct substitutes for commonwealth programs.[23] These funds could provide at most some indirect fiscal relief, since total increased federal funding will exceed new taxes,[24] leading to a stimulation of aggregate demand and an increase in taxable income.

In sum, new federal funding will ease some of the pressure caused by new federal taxation. But on balance, fiscal changes under statehood will still create pressure to reduce commonwealth income taxes. Hence, adjustments and cutbacks in the size and scope of the Puerto Rican public sector will be necessary.

Reform Through Statehood: The Constructive Response

Critics point to the costs and dislocations associated with such pressure. But those concerns are misguided. They fail to account for the weak and, at best, uncertain development prospects associated with the present situation. Given the inadequacies and deficiencies outlined earlier, we believe that future economic growth on the island requires reform and reduction in the public sector that will emphasize a sensible policy framework and a responsive tax administration. In this respect, fiscal pressure associated with statehood represents a useful stimulus for needed change. Moreover, with careful planning, that pressure can be constructively directed toward changes that are both economically desirable and fiscally feasible. (See Table II-6.)

Table II-6

Revenue Impact of Policy Measures
($ Millions)

Policy Measure:	
Substituting Federal Programs for Local Services[1]	$249
Central Government Savings in Personnel through Consolidation and Reduction of Agencies and Programs and Privatization of Services, starting with a Hiring Freeze[2]	$243
Increasing Self-Sufficiency of Public Corporations[3]	$50
Eliminating the Sugar Corporation[3]	$25
Reorganization of Public Corporations Sector, Imposing Taxes, Contributions in lieu of Taxes or Payment of Interest on Contributed Capital[3]	$200
Improving Income Tax Compliance[4]	$440
Improving Excise Taxes Compliance and Administration[5]	$150
Total	**$1,357**

1 See Table IV for a breakdown of this average figure.

2 Figure represents annual savings in the third year of implementing Reorganization Plan and hiring freeze for the Commonwealth Central Government only, based on the following estimates: a 5 percent annual attrition rate; a central government work force of 160,000 in 1988; and an average cost per employee of $10,625 in 1988.

3 Public corporations data from Luis S. Montanez, former Director of the Office of Management and Budget. Source: personal correspondence, June 1990, reviewed in March 1992.

4 The Booz, Allen report on Tax Reform, February 1987, estimated that $135 million in additional revenue to the Treasury would result from improved income tax compliance, based on $1.5 billion in unreported taxable income in 1984. Assuming only 50 percent of the projected $4.4 billion of unreported taxable income for 1990, and an effective tax rate of 20 percent, the projection of additional revenues could amount to $440 million.

5 The Booz, Allen Report estimated $83 million additional revenues to the Treasury. Presently the Treasury Department has been unable to implement measures against excise tax evasion, the underground economy and the smuggling of goods. A projection of the above figure to 1990 could be calculated as $150 million.

To minimize any adverse impact on service levels, the public sector will have to become more efficient or tap additional revenue sources. Government employment presents the most promising target for an efficiency drive because its rapid growth has not been related to improved levels of service. Hence, with careful planning the expanding payroll costs might be reduced without damaging the provision of public services. With an attrition rate averaging 5 percent per year and a commonwealth central government payroll numbering 160,000, a hiring freeze could reduce government employment by almost 23,000 employees in three years. At an average government salary of $10,625, by the third year annual savings could reach $243 million. (In the long run, Puerto Rico should consider bringing its ratio of government employment to total employment more into line with the U.S. level.)

Another potential source of efficiency gains and additional revenue is the public corporations sector. An overhaul of this quasi-governmental sector could yield substantial returns through a combination of increased self-sufficiency and privatization. Appendix B-1 shows that many public corporations can be classified as "business type" operations, which were originally designed to be self-sufficient through charges and fees. However, a glance at the general fund budget indicates that many of these operations draw heavily from the commonwealth government for capital and operating costs.[25] Several of these corporations provide services more suitably performed in the private sector and are therefore candidates for privatization. These include, for example, the Maritime Shipping Authority and the Farm Credit Corporation.

Other public corporations provide useful and needed public services and are therefore less suitable for full privatization, but could nonetheless become more self-sufficient by increasing fees and charges. Adjusting charges to more accurately reflect costs has a number of related fiscal benefits, such as increasing the public awareness of the true costs of various government services. Citizens are less likely to waste government services if their costs are more directly understood; moreover, a heightened public awareness of costs would increase government accountability. Though these adjustments would require difficult political choices, a streamlined government demands adherence to bottom-line responsibilities. One recent analysis estimated that $50 million from the general fund could be saved annually by increasing the self-sufficiency of the Metropolitan Bus Authority, the Aqueduct and Sewer Authority, and the Farm Services and the Agricultural Development Administrations.[26]

Still other corporations, especially those which provide limited public services, could be eliminated outright. The Sugar Corporation, which in the 1990 budget drew nearly two-thirds of its funds from the general fund, is a prime candidate: removing this expensive entity from the budget through privatization or dissolution would annually save $25 million in operating expenses (though $90 million in annual debt servicing will have to continue until 1996, when the government's debt service obligation expires). Moreover, eliminating the Sugar Corporation would benefit Puerto Rico consumers since sugar prices are currently controlled and set at four times the world market price.

Further revenue could be generated by extending a minimum tax liability on the public corporations. Currently, they are exempt from all taxes — an expensive exemption considering that net assets for eleven of the largest public corporations in 1987 reached almost $5 billion.[27] One estimate places the value of possible revenue from a public corporations tax at $200 million annually.[28]

Finally, Puerto Rico could take advantage of the fiscal changes that would accompany statehood by preparing a major tax reform package. The Booz, Allen tax reform study cited earlier demonstrates that improved collection procedures and increased enforcement could raise $135 million annually in revenues currently lost to fraud.[29] Statehood would assist that effort by bringing the formidable resources of the Internal Revenue Service to bear on under-reporting and non-compliance. Special attention would be paid to the estimated 15 percent of all licensed physicians, accountants, and attorneys who, it is alleged, fail to file income tax returns.[30]

Municipal governments in Puerto Rico currently have very limited powers of taxation and narrow responsibilities for the provision of services. These governments receive only one third of property tax revenues on the island; the remainder is kept by the commonwealth government. Other municipal revenue sources are limited to a very small general business tax (less than 1 percent), a share of contributions in lieu of taxes from the Electric Power and Telephone Authorities, and special collections for maintaining specific local public works. Correspondingly, many services commonly associated with local government in the U.S, such as police and fire protection, are supplied by the commonwealth government in Puerto Rico.

The resulting distance between taxpayers and the government tends to induce frustration in taxpayers who do not see the direct manifestation of their tax dollars in either services or security. Devolving more revenue-raising capacity and service responsibility back to the local governments could increase both accountability and public acceptance of taxes. Hence, the fiscal reforms that are likely to accompany statehood offer an ideal opportunity to decentralize the commonwealth's government. In sum, Table II-6 demonstrates that with careful planning and constructive reforms in the public sector, changes associated with statehood could meet the roughly $1 billion in fiscal pressure that statehood would create.

Conclusion: Statehood as a Precondition for Reform

Puerto Rico not only can afford, but needs statehood. The current investments in both physical and social infrastructure are not occurring at levels necessary to promote long-term growth. In fact, they are lagging. The natural environment, one of Puerto Rico's greatest comparative advantages, is being neglected. Change and action are necessary, and statehood offers a natural opportunity and creates manageable pressure for a wide range of desirable reforms in Puerto Rico's government, In essence, Puerto Rico's present government structure should be replaced with a public sector responsive to its citizens, attractive to investors, and suitable for sustained growth.

Those public sector reforms are required for, and would help generate, a reorientation of Puerto Rico's development strategy. As this Section has repeatedly emphasized, an effective government is a precondition to sustainable growth in the future. Statehood would help move toward that goal; it would also refocus the island's development energies away from an outdated reliance on tax gimmicks and government subsidies, and toward an efficient, productive private sector built on the island's natural advantages. Moreover, as we argue below,[31] one of the most significant development opportunities opened by statehood is the possibility of an appropriately designed "statehood grant." Such a fund, provided to assist Puerto Rico in the transition to statehood, could be placed in a development trust (out of the government's hands) to provide resources for infrastructure, education, environmental protection and other worthy projects.[32]

A development strategy must be implicit in such a statehood grant. In broad terms the strategy will emphasize the developments of human and physical infrastructure and will underscore those factors which have created economic growth. (It should draw on some of the strategies used successfully in countries such as Malaysia, Singapore, Thailand, and Taiwan.) The following Section more closely analyzes the links between Puerto Rico's economic development and the island's misplaced reliance on section 936.

Endnotes

1 The uncertain future of section 936 is reflected in the Treasury Department's historical (and continued) hostility toward that provision. In addition, recent legislative actions point to the willingness of Congress to limit or eliminate the credit. See, for example, Senator David Pryor's proposed Prescription Drug Cost Containment Act of 1991, which would link section 936 benefits for pharmaceutical companies (the main beneficiaries of section 936) to cost limits on prescription drugs.

2 For a comprehensive treatment of Puerto Rico's economic prospects under statehood, see McKee, "The Economic Consequences of Puerto Rican Statehood," 1990, at Parts II-III.

3 Alicia H. Munnell and Leah M. Cook, "How Does Public Infrastructure Affect Regional Economic Performance?" in *Is There a Shortfall in Public Capital Investment?*, Federal Reserve Bank of Boston Conference Series No. 34 (1991) (Alicia H. Munnell, Ed.).

4 For a detailed look at how certain state governments are responding to this challenge, see Scott R. Fosler, ed., *The New Economic Role of American States: Strategies in a Competitive World Economy* (New York: Oxford University Press, 1988).

5 Government employment figures for Puerto Rico reflect federal, Commonwealth, municipal, and public corporation payrolls. In 1985, U.S. state and local government employment accounted for only 12.8 percent of total civilian employment. (Note: U.S. employment data refer to total civilian employment.) Source: U.S. Treasury Department, "Sixth Report," Table 3.3; U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the U.S., 1991*, Table 658.

6 Puerto Rico Planning Board, *Economic Report to the Governor, 1988*, Tables A-1 and A-2.

7 Examples include the commonwealth administration's 1990 proposal to raise $40 million by delaying a tax reform package that would have lowered income tax rates, borrowing from the Government Employees Retirement Fund, a tax amnesty in 1988, and $132 million in proceeds from the pending sale of the Communications Authority to the Telephone Authority.

8 GAO, "Puerto Rico: Information for Status Deliberations," March 1990, briefing report to the House Subcommittee on Insular and International Affairs, pp. 54 and 66.

9 *Caribbean Business*, June 7, 1990, p.30.

10 Natural Resources Defense Council, "Extinction in the Enchanted Isle: Protecting Our Puerto Rican Species," May 1990, p. 57.

11 Booz, Allen & Hamilton, "Final Report on the Tax Reform Program," prepared for the Department of Treasury, Commonwealth of Puerto Rico, February 12, 1987, p. 12. Figures in 1987 dollars. [Hereinafter, "the Booz, Allen report."]

12 Appendix B-1 lists the public corporations and classifies them by type.

13 See Appendix B-2, which lists general funds appropriations to public corporations.

14 Committee for the Economic Development of Puerto Rico, "A Study on the Organization and Function of the Executive Branch of the Puerto Rican Government," 1985.

15 *San Juan Star*, May 6, 1990.

16 For example, a 1987 study by the accounting firm Deloitte, Haskins, and Sells found that the General Services Administration took "several months or more to process a purchase order." (Quoted in the *San Juan Star*, May 6, 1990.)

17 Puerto Rico's fiscal condition also depends on the response of the economy under statehood: an economic slowdown, for example, would increase fiscal pressure since taxable income would fall. This section, however, is consistent with the overall thesis of this report — that economic growth will continue and eventually increase under statehood.

18 If we include charges and miscellaneous revenue in this calculation, Puerto Rico's total own source revenue burden is only 3.7 percentage points ($0.7 billion) higher than the U.S. average. Several considerations weigh against including charges and miscellaneous revenue in this analysis, however. For example, revenue from charges depends on the services provided by government, nearly half of miscellaneous revenue in the U.S. is from interest earnings, and rents and royalties also account for much of the miscellaneous revenue.

19 Under both S.712 and S.244, federal collections from Puerto Rico would have been returned ("covered-over") to the state government during the transition period. Therefore, although the tax structure would have been affected immediately (as local taxes were reduced and federal taxes were imposed), Puerto Rico's government would not have felt the full fiscal impact of the changes until those cover-overs ended. We argue in Section IV below (on financial flows) that this cover-over approach is counterproductive and undesirable precisely because it delays the pressure needed to reform Puerto Rico's public sector. See p. , below.

20 See also the McKee Report at pp. 127-30 which also arrives at a fiscal pressure figure of around $1 billion.

21 Puerto Rico Planning Board, Table A-27 (1990).

22 The exact amount depends on the number of program options Puerto Rico chooses. CBO estimates assumed that Puerto Rico would receive $900 million dollars in new federal Medicaid funds and would be required to pay $184 million in matching funds, a net savings of $266 million over the current $450 million Puerto Rico currently spends on health programs. Congressional Budget Office, "Background Materials on the Costs of the Puerto Rico Status Referendum Act," prepared for the Senate Finance Committee, November 15, 1989.

23 See Table A-2 in Appendix A (the federal entitlements section) for a breakdown of additional funds by program for 1994.

24 See Section IV below on financial flows, at pages 36 and 37.

25 See Appendix B-2.

26 Montanez, personal correspondence, June 1990.

27 GAO, "Puerto Rico: Information for Status Deliberations," March 1990, Table 6, p. 50.

28 Montanez, personal correspondence, June 1990.

29 The Booz, Allen report also advocated a reform of the excise tax, including simplifying the rate structure to improve administration and enforcement and expanding the tax base by reducing confusing and convoluted exemptions. Excise tax reforms were estimated to yield a possible $83 million.

30 Booz, Allen, p. C-6.

31 See Section IV, at p. .

32 In keeping with our belief that serious reforms are necessary in Puerto Rico's public sector, we believe it is crucial that such a grant *not* be provided to subsidize normal government. Unfortunately, past legislative proposals (S.712 and S.244) have provided statehood grants in the form of "cover-overs" to Puerto Rico's Treasury.

III. Economic Development and Section 936 of the Internal Revenue Code

Central to the discussion of the economic impacts of statehood isSection 936 of the Internal Revenue Code. This provision provides highly favorable tax treatment for the income of Puerto Rican subsidiaries of U.S. corporations. The annual cost of Section 936 in 1987 (the latest year for which Treasury Department data are available) was over $2.4 billion;[1] the present value of its cumulative cost from 1973 to 1987 is roughly $480 billion.[2] Under statehood, section 936 would be unconstitutional and would have to be phased out.

Proponents of continued commonwealth status argue against statehood on the grounds that eliminating this tax incentive will significantly slow down the island's rate of economic growth, a claim supported by the April 1990 study by the nonpartisan Congressional Budget Office. We reject this argument, however. First, as we explain in detail below, section 936 is a grossly inefficient subsidy to mainland corporations that has outlived its usefulness as a tool for Puerto Rican economic development. Moreover, it has increasingly become a less certain long-term incentive to real investment in Puerto Rico. That uncertainty drastically weakens the effectiveness of section 936 as a foundation for Puerto Rico's long-term development. Regardless of the status issue, then, we argue that section 936 should be eliminated.

In addition, not only does the movement to statehood require the elimination of section 936, but it also provides an ideal opportunity to initiate more appropriate development incentives. A well designed statehood grant[3] could counter any short term adverse economic effects of eliminating section 936 and could also provide an environment more conducive to the long-run economic growth of the island.

The Mechanics of Section 936

Since 1921, the U.S. government has provided some form of tax incentive for certain U.S. companies operating in Puerto Rico. The current form, section 936 of the Internal Revenue Code, grants Puerto Rican subsidiaries of United States corporations an annual tax credit equal to the amount of U.S. federal income tax liability on profits earned in Puerto Rico.[4] The tax credit applies to profits derived from doing business in Puerto Rico and to income earned from reinvesting the profits in activities that the Puerto Rican government has defined by regulation as benefitting the economy.[5]

Corporations are required to elect for section 936 treatment for a period of ten years. To be eligible for the credit, 80 percent of the subsidiary's gross income must be derived from Puerto Rican sources and 75 percent of gross income must be derived from active trade or business on the island.[6] The section 936 tax credit depends on the measured profits of firms operating in Puerto Rico. Firms can show profits in Puerto Rico in two ways. First, firms can earn profits from real investments in plant and equipment in Puerto Rico. Second, through transfer pricing, firms may be able to increase the amount of accounting profits reported in Puerto Rico without any new physical investment.[7]

Reported profit rates in Puerto Rico relative to the mainland indicate the large role of transfer pricing. In 1983, the reported before-tax annual rate of return on operating assets for corporations participating in the section 936 program was 54.1 percent, more than five times the rate of return for mainland manufacturing operations (10.3 percent).[8] If the true rate of return for section 936 investments in Puerto Rico were this high, firms would have powerful incentives to increase their real investment on the island. Investment should be booming. Unfortunately, it is not.

The large discrepancy in the rates of return between Puerto Rican and mainland firms is largely explained by the fact that income from intangible assets is being transferred to Puerto Rico by U.S. parent corporations. This transfer is mainly through patents from research and product development, and marketing intangibles. In other words, section 936 has allowed corporations to transfer large amounts of income into Puerto Rico through internal pricing policies without forcing them to make the corresponding real investments. Such transfer pricing is most beneficial to industries such as pharmaceuticals and electronics in which firms can develop new products in the United States, where they can deduct the development costs, and then transfer the patent to Puerto Rico to minimize federal tax burdens.

Reduced Effectiveness of Section 936 in Recent Years

While clearly helpful for promoting the growth of Puerto Rico's manufacturing sector in past decades, section 936 has outlived its usefulness. Recent years have witnessed a dramatic change in the composition of section 936 corporations. During the past three decades the share of section 936 activity in labor intensive industries such as textiles has diminished significantly, while the share in capital and technology-intensive electronics and pharmaceuticals has increased commensurately. In 1960, chemicals and machinery made up 22 percent of the net manufacturing income in Puerto; by 1989 that share had increased to over 73 percent.[9] Increasingly a subsidy for capital intensive firms and for those engaging in sophisticated tax planning, section 936 represents a perverse economic development tool for the labor surplus economy of Puerto Rico.

In addition, various proposals to change section 936 have increased the uncertainty associated with investments by section 936 firms and thereby reduced incentives for firms to make them. Since 1976, the Treasury has recommended scaling back section 936 and replacing it with a direct subsidy to labor. More recently, provisions in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Tax Reform Act of 1986 (TRA) reduced the advantages of section 936. Recent proposals by the Treasury on transfer pricing would effectively reduce the incentive further.[10] The resulting uncertainty has reduced the effectiveness of section 936 as a long-term incentive to real investments, while maintaining its current revenue cost. Section 936 represents more than merely an issue in the Puerto Rican statehood debate; rather, it poses important questions of sound taxation policy for a deficit-plagued U.S. budget.

High Annual Revenue Costs of Section 936 to the U.S. Treasury

Section 936 is a very costly tax preference to the U.S. Treasury. The last column of Table III-1 indicates that in 1987 the annual revenue cost of this tax benefit was $2.4 billion. Moreover, the Treasury Department's Office of Tax Analysis (OTA) estimates the projected growth of section 936 tax costs at 10 percent a year.[11] For 1987, the total value of taxes foregone was the highest for the pharmaceutical industry ($1.3 billion) and lowest for the apparel industry ($35 million). The value of the taxes foregone annually for all "other" industries was about $503 million. With the exception of the instruments and related products industry, which accounted for $151 million of this amount, no other industry contributed more than $50 million to the total revenue cost of section 936.[12] These high revenue costs are unacceptable in light of the ineffectiveness of section 936 as a development tool, the issue to which we now turn.[13]

Cost-Ineffectiveness of Section 936 as a Subsidy to Labor

A major purpose of section 936 was to promote investment by U.S. corporations to create jobs in Puerto Rico. In 1987 (the latest year for which disaggregated data are available), section 936 industries employed approximately 101,000 workers, slightly more than half the total number of people employed in manufacturing in Puerto Rico.[14] In terms of total employment in Puerto Rico, section 936 workers represent about 10 percent of the work force.[15] The average annual wage compensation in 1987 for all workers employed in section 936 industries was $17,725. Column 3 of Table III-1 shows that compensation was highest in the pharmaceutical industry (with an average wage rate of $26,471) and lowest in the apparel industry (with a wage rate of $10,778).

Whether measured as a subsidy per employee or per dollar of wages paid, the costs of the tax credit are astoundingly high, especially in the pharmaceutical industry. Table III-2 demonstrates those extreme costs. Column 1 indicates the revenue cost per employee, and column 3 shows the revenue cost per dollar of wages paid. The average revenue cost per employee over all the industries was $26,725 in 1987; revenue cost by sector ranged from about $81,000 per employee per year in the pharmaceutical industry to about $2200 in the apparel industry. The high revenue cost per employee in the pharmaceutical industry results from the fact that while that industry received the

Table III-1

Asset and Payroll Information for Selected Section 936 Industries, 1987

	Net Fixed Assets (Millions)[1]	Number of Employees	Average Wage Comp. Per Year	Rev. Cost to U.S. Treasury (Millions)
Pharmaceutical	$1,748	18,384	$26,471	$1,302
Electrical and Electronic Equip	972	23,180	16,859	381
Apparel	128	17,363	10,778	35
Food	515	10,364	16,795	189
Other	1,073	31,625	N/A	503
Total Manufacturing	4,436	100,916	17,725	2,410

Source: Unites States Department of the Treasury, "U.S. Possessions Corporations Returns, 1987," Tables 1 and 2.

1 Net fixed assets includes final inventories.

Table III-2

Revenue Cost per Employee, 1987
(Thousands)

	Revenue Cost per Employee	Average Employee Compensation	Revenue Cost per $ Wages Paid	Revenue Cost per $ Incremental Wage Benefit[1]
Pharmaceutical	$81,483	26,471	$3.08	$17.60
Electrical and Electronic Equip	18,981	16,859	1.13	6.43
Apparel	2,246	10,778	0.21	1.19
Food	21,902	16,795	1.30	7.45
All Manufacturing Industries	26,725	17,725	1.51	8.61

Source: Unites States Department of the Treasury, "U.S. Possessions Corporations Returns, 1987," Tables 1 and 2.

1 Revenue cost per dollar of incremental wage benefit is calculated by dividing the revenue cost per employee by the incremental wage benefit. The incremental wage benefit is calculated by determining the difference between average 936 compensation per sector and the average non-936 employment by sector. Overall 936 wages have averaged 17.5 percent higher than non-936 wages.

largest share of the tax benefits (55.5 percent), it employed only 18.2 percent of the section 936 workers. In contrast, the apparel industry received only 1.4 percent of the tax benefits but employed 17.2 percent of the total section 936 workers.

Because the average revenue cost per employee exceeded $26,000 while the annual wages in 1987 were only about $17,700, the revenue cost per dollar of wages paid across all industries was $1.51. In other words, the federal government gave up more than one dollar and fifty cents for each dollar paid in wages to employees of corporations benefitting from the section 936 tax credit. In the pharmaceutical industry, the subsidy per dollar of wages paid was more than double the average, at $3.08 per dollar of wages paid. As already noted, these effective subsidy rates are obviously exorbitant.

But even these high subsidy rates understate the true cost of the tax credit as a job creation device, since most of the workers employed by section 936 industries would have been employed and been earning normal wages from this or other employment elsewhere. Thus, the true amount of the benefits received by labor should be measured by the *additional* wages that workers receive as compared to what they would have earned otherwise.

A comparison of the annual wage compensation of section 936 industries ($17,700) with that of all Puerto Rican production workers ($11,100)[16] shows that section 936 manufacturing employees receive a higher compensation than employees in other manufacturing industries.[17] If that difference is attributed entirely to the effects of section 936, the cost to the U.S. Treasury of section 936 can be expressed as a cost per *incremental* dollar of wage benefits received by the workers.[18] For illustrative purposes, we assume that section 936 has the same differential impact on the wage rates across all sectors; that differential has been estimated at an average of 17.5 percent.[19] Taking all section 936 industries as a whole, column 4 of Table III-2 shows that an incremental dollar of wage benefit paid to workers cost the U.S. Treasury about $8.61.

One final indication of the bankruptcy of section 936 as an incentive to hire labor emerges from outcome data: while manufacturing's share of Puerto Rico's gross domestic product increased from 29 to 40 percent between 1975 and 1988, the share of manufacturing income accruing to labor declined precipitously from 48 to 27 percent over the same period.[20]

Section 936 and the Subsidy to Real Investment

The development strategy used to justify a tax preference such as section 936 assumes that promoting investment in manufacturing is a necessary condition for the creation of modern high paying jobs. Through such investment, Puerto Ricans would achieve a higher standard of living. In fact, such investment may or may not be the key to good jobs. But even if the link between investment and high paid jobs were clear, section 936 could be criticized as a grossly inefficient way to promote such real investment.

To evaluate the degree to which section 936 has been a cost effective incentive for real investment in Puerto Rico, we compare the revenue cost of section 936 with the dollar amount of net assets in these industries as of 1983. Column 1 of Table III-1 shows that by 1987, the investments of manufacturing firms that received section 936 income tax treatment reached a net asset level of over $4.4 billion.[21] (Of this amount, $1.7 billion (39 percent) was owned by the pharmaceutical industry.) The comparison with section 936's revenue cost is made by calculating the number of years that it would take to pay back the investment costs using only the tax savings received via the section 936 tax credit. These estimates are shown in Table III-3, column 1.

For all the industries combined, it would take only 1.8 years for the value of tax resources to be equal to the total amount of net assets cumulated by these corporations up to 1987. In the pharmaceutical industry it would only take 1.3 years of the tax saving to pay for the industry's total capital stock in Puerto Rico. Although the conclusion may seem bizarre, these figures suggest that it would have been less costly for the U.S. Treasury to buy the plants and equipment and give them to these corporations rather than to give them this annual tax break.

Table III-3

Cost of Section 936 per Dollar of Capital, 1987

	Number of Years for Revenue Cost to Equal Net Assets (1)	Subsidy Rate as a Percentage of the Annual Cost of Capital (2)
Pharmaceutical	1.3	372%
Electrical and Electronic Equip	2.6	196
Apparel	3.7	137
Food	2.7	183
Total	1.8	271

Source: Unites States Department of the Treasury, "U.S. Possessions Corporations Returns, 1987," Tables 1 and 2.

Another way of evaluating the section 936 tax credit is to compare its annual revenue cost with the annual capital cost of these corporations. By definition, the annual cost of capital is equal to the rate of depreciation of the assets plus the real cost of financing them (the rate of interest). An upward-biased estimate of this real cost of capital in Puerto Rico would be 20 percent a year. By using this high estimate, we are biasing downward our estimates of the rate of subsidy provided to capital that are reported in Table III-3, col. 2.

In 1987, the average estimated subsidy rate was 271 percent of the annual cost of capital for section 936 firms, meaning that the subsidy rate of all industries benefiting from the tax credit was over twice as high as the real annual cost of capital. The subsidy rate was highest in the pharmaceutical industry (372 percent) and lowest (137 percent) in the apparel industry.

Summary

Whether the section 936 tax credit is viewed as a device to promote employment or as a subsidy to capital, the revenue costs are excessive for the results obtained. The annual revenue costs to the U.S. Treasury of maintaining the section 936 Program are extremely high compared to the employment and wage benefits the tax credit produces in Puerto Rico. Overall, the annual revenue cost per worker ($26,725) in 1987 was 51 percent higher than the annual compensation received by these workers, yielding a subsidy cost of $1.51 per dollar of wages paid. Moreover, we estimate that the cost to the Treasury for every *incremental* dollar of wage benefit given to workers was about $4. These extremely high rates demonstrate the cost-ineffectiveness of section 936 as a subsidy to labor.

In the past, tax incentives were an important factor in promoting economic development in Puerto Rico. But section 936 is no longer a cost effective way to attract real investment to the island. The annual subsidy rate for all industries benefiting from the tax credit is currently more than twice the cost of financing the capital used. Because the section 936 tax credit is a function of profits, firms are less interested in making real fixed investments in Puerto Rico than in reducing their tax liabilities by transferring income from their U.S. parent companies to their Puerto Rican subsidiaries. Through this transfer of income, these firms increase the reported amounts of profit on the island that qualify for the tax credit.

Section 936 is now primarily a transfer of income to the U.S. parent corporations and not an effective way to move investment onto the island. In other words, the section 936 tax credit serves more as a subsidy to tax planning than as a subsidy for the employment of capital and labor in Puerto Rico that would promote economic development. The economic development of Puerto Rico should be promoted. The present situation of high unemployment and the necessity to migrate to the U.S. to find jobs is unacceptable. To be effective, such promotional policies must be focused upon employment and creation of real investment opportunities.

Countering the Short-Term Economic Impact of Eliminating 936

Despite the inefficiency of section 936 as a subsidy for labor and capital, its phase-out under statehood presumably could have some adverse short run effects on the Puerto Rican economy that need to be immediately counteracted. As emphasized throughout this report, the move to statehood provides an ideal opportunity to initiate more appropriate development incentives for the long term development of the island. Moreover, as discussed in the next section, a carefully designed statehood grant that is invested in the physical and human infrastructure of Puerto Rico would help counter any short-run adverse economic effects of eliminating section 936 tax preferences.

Endnotes

1 See J. Bradford, U.S. Department of Treasury, "U.S. Possessions Corporations Returns, 1987" p. 52.

2 See Treasury Department, Sixth Report, Table 4-11. Figures for 1984 and 1986 were imputed by taking the mean between available data for 1985 and 1987. The discount rate used was 8 percent.

3 The statehood grant is discussed below in Section IV, at p. 38.

4 Section 936 also applies to U.S. corporations operating in the same circumstances in the Commonwealth of the Northern Marianas, the Federated States of Micronesia, the Marshall Islands, American Samoa, Guam and the Virgin Islands.

5 The amount of the credit is determined as follows:

$$\text{TAX CREDIT} = \frac{\text{TAXABLE BUSINESS AND INVESTMENT INCOME FROM SOURCES IN PUERTO RICO}}{\text{WORLD WIDE TAXABLE INCOME OF PUERTO RICAN SUBSIDIARY}} * \text{US FEDERAL TAX}$$

6 For a detailed analysis of the operation of Section 936 and other tax incentives in Puerto Rico, see Richard J. Boles, "Tax Incentives for Doing Business in Puerto Rico," *International Lawyer* (22): 121-42 (1988).

7 The existence of the Section 936 credit has placed tremendous administrative burdens on the U.S. Treasury as a result of Section 482 of the Internal Revenue Code, which authorizes the Secretary of the Treasury to allocate income, deductions, and other tax items among related taxpayers to prevent evasion of taxes. For a further discussion of this issue, see Nancy Kaufman, "Puerto Rico's Possessions Corporations: Do the TEFRA Amendments Go Too Far?", *Wisconsin Law Review* (1984): 531-66.

8 U.S. Department of the Treasury, "Sixth Report," p. 36.

9 April 1990 CBO Report, Table 3.

10 See, for example, U.S. Treasury Department, Office of Tax Analysis, "A Study of Intercompany Pricing," October 18, 1988.

11 Philip Morrison, Testimony Before the Committee on Finance, United States Senate, Washington, D.C., April 26, 1990, p. 2.

12 The source for all 1987 data on section 936 costs is U.S. Department of Treasury, "U.S. Possessions Corporations, 1987," Tables 1 and 2.

13 If section 936 were eliminated, the U.S. Treasury would not gain all of the current revenue cost of the provision. The 936 corporations would be expected to minimize their taxes by moving some of their operations to tax havens or undertake other tax minimization techniques. However, the Treasury Department has estimated that the net gain in tax revenues to the U.S. from the elimination of section 936 would be nearly 80 per cent of the credit that would otherwise be given under the present provision. See Philip Morrison, Testimony Before the Committee on Finance, United States Senate, Washington, D.C. 1990, p.10.

14 Column 2 of Table III-1 provides a breakdown by sector of section 936 employment data.

15 The source for 1987 section 936 employment data is U.S. Department of Treasury, "U.S. Possessions Corporations, 1987," Table 2.

16 See J. Bradford, U.S. Department of Treasury, "U.S. Possessions Corporations Returns, 1987," p. 53 (citing U.S. Department of Commerce, Bureau of the Census, *1987 Census of Outlying Areas: Puerto Rico*, July 1990).

17 U.S. Department of the Treasury, "The Operation and Effect of Possessions Corporation System of Taxation," Fifth Report (draft), May 1985, Table 4-5.

18 It appears that the employees of section 936 companies possess higher skills. To the degree that they do, their higher wages should not be attributed entirely to the impact of section 936; our analysis therefore presents the benefits of section 936 in their most favorable light.

19 See U.S. Department of the Treasury, "The Operation and Effect of Possessions Corporation System of Taxation," Fifth Report (draft), May 1985, at Table 4-5.

20 Puerto Rico Planning Board, "Economic Report to the Governor," Tables 9 and 11 (1988).

21 Net asset data for 1987 comes from U.S. Department of the Treasury, "U.S. Possessions Corporations Returns, 1987," Table 1. Total investments include inventories.

IV. Designing a Transition:

Fiscal Flows Related to Statehood

Introduction: Basic Transition Principles

This section focuses on the importance and sensitivity of the short-run financial flows and the critical role of timing in the transitional adjustments package. Fiscal concerns have obfuscated much of the political debate in the U.S. and Puerto Rico about statehood. Mainland residents are concerned about their own tax burdens, budget deficits, and social problems; Puerto Rico residents, meanwhile, need the opportunity for economic growth but fear the potential impact of losing section 936. Thus, while we reassert the centrality of Puerto Rico's fundamental right to choose its own destiny, we also recognize that in practice, fiscal flows represent an important component of the statehood debate.

Any implementing legislation for statehood should satisfy four central conditions: (1) the transition period should be specifically designed to achieve U.S. budget neutrality; (2) section 936 should be phased out quickly, but with due deference to those companies whose investment policies relied on the tax credit; (3) the phase-in of full funding for federal entitlement programs should occur simultaneously with the introduction of full federal tax responsibilities on the island; and (4) the federal government should provide a "statehood grant" in the form of a trust fund for economic development, but this trust fund should not be used to subsidize the operations of the already oversized Puerto Rico public sector.[1]

These principles apply regardless of the *form* of the transition chosen. That is, they apply whether the transition period follows the entry of Puerto Rico into statehood (as favored by early versions of S.712) or precedes the actual achievement of statehood (as adopted by the most recent legislative formulations in S.244). The Senate Finance Committee's recommendation that statehood should follow a five year economic transition period in order to avoid conflicts with the Uniformity Clause[2] has sparked a fairly heated constitutional debate.[3] The Finance Committee's approach has been contested by the Justice Department, which argues that a post-statehood transition period would be constitutional.[4] In any case, a choice between these options reflects legal and political considerations beyond the scope of this report. Our concerns apply mainly to the relationship between the phase-in of entitlements and new federal taxes during the transition period.

Benefits and Costs

This section addresses the fiscal concerns surrounding the statehood question by analyzing the two issues at the heart of the matter: whether Puerto Rican statehood will impose costs on the federal budget, and whether statehood will provide the resources necessary for economic growth in Puerto Rico.

Impact of Statehood on the U.S. Treasury

Relative to commonwealth status, statehood has four potential impacts on the federal budget. First, the federal government will spend more on health and welfare programs in Puerto Rico. Second, U.S. corporate subsidiaries in Puerto Rico operating under section 936 will pay federal taxes. Third, Puerto Rico residents and businesses will have to pay federal corporate income, personal income, and excise taxes from which they were exempt under commonwealth status. Fourth, as it has done historically for most other new states, the federal government may choose to smooth the transition under statehood by providing some form of statehood grant.

Estimated impacts on the budget of each of these components have been provided to accompany the proposed transition approaches in both S.712[5] and S.244.[6] These estimates depend on two factors: (1) assumptions about how firms, people, and the economy will change their behavior in response to statehood, and (2) policy decisions about the phase-in of the various components of the change and of the form of the statehood grant. Although we will make some minor comments about the behavioral assumptions, in general we believe it makes sense to accept the official estimates as a first approximation of the impacts. This acceptance makes it possible to focus on the central issues: the timing of the transitional adjustments under statehood and the size and nature of the statehood grant.

The timing of the financial flows in the transitional adjustments under statehood greatly affects statehood's short run impact on the federal budget. In the first version of this report we criticized the Energy Committee's 1990 S.712 proposal for immediately extending federal entitlements to Puerto Rico but delaying federal taxation for two years. By extending the entitlement programs immediately while delaying the imposition of taxes, S.712's phase-in program frontloaded the federal costs. We believe such frontloading is undesirable and inappropriate. It is incongruous with the atmosphere of mainland budget problems and program cutbacks. Furthermore, the extension of the entitlement programs should not be seen as a "welfare windfall," which might encourage abuse and dependence, but rather should reflect a collateral assumption of the responsibilities inherent in a federal system.

We therefore recommend that the expenditure and revenue sides of the transition be made consistent with each other to achieve financial and political harmony and provide the appropriate setting for vigorous economic growth. The most recent bill, S.244, adopted this balanced approach: it would have phased in federal tax responsibilities and gradually increased funding for federal entitlement programs over a five year transition period. We agree with this framework and strongly urge future statehood implementing legislation to emulate S.244's phased model.

Although we have argued that section 936 should be eliminated as rapidly as possible,[7] we also support the five year phase-out of 936 adopted in both S.712 and S.244. This transition period may be justified to insulate Puerto Rico against possible short term disruptions in the economy associated with the move to statehood. In addition, fair treatment of section 936 firms demands that they have time to make their investment decisions with full knowledge of changes in tax laws.

Based on these balanced transition assumptions, and not counting any special statehood grants, the shift to statehood from commonwealth status would have a beneficial effect on the U.S. Treasury almost immediately. In particular, the shift to statehood would reduce the present value of net federal outlays over a period between 1993 and 2001 by $5.6 billion.[8] Moreover, the savings realized by the phase-out of section 936 would continue indefinitely; those savings should be compared to the continuing drain on federal resources that commonwealth status represents.

Table IV documents this conclusion and also shows the effects by year, using data provided by the U.S. Departments of Health and Human Services, Agriculture, and Treasury in testimony on bill S.244.[9] The table shows an early net outflow from the federal treasury as the phase-out of section 936 and the imposition of federal taxes in Puerto Rico initially provide insufficient revenue to offset the higher costs of entitlements. But by the second year, the situation is reversed and for that year and subsequent years, additional tax revenues more than offset the higher costs of full entitlements.[10] Taken together in present value terms, the overall impact of the immediate move to statehood is thus to *reduce* pressure on the federal budget.

Thus, with the reasonable transition plan and economic assumptions adopted in S.244 and discussed here, Puerto Rican statehood would free up federal budgetary resources relative to the continuing drain posed by commonwealth status. We remind the reader, however, that these estimates exclude the costs of any special statehood grants that Congress may choose to provide to Puerto Rico. Past proposed legislation has provided for such

Table IV

Financial Benefits and Costs of Statehood Relative to Commencement.
No Statehood Grants
(Assumes Eligibility and Benefit Standards Conforming to Mainland U.S.)
($ Millions)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total
From Perspective of U.S. Treasury										
Entitlements										
Aid to Families with Dependent Ch	30	70	70	70	70	70	5	5	5	
Aged, Blind, and Disabled (SSI)	0	40	340	705	1145	1245	1330	1415	1505	
Medicaid	51	151	301	501	701	1001	1351	1751	2251	
Foster Care	0	3	3	3	4	4	4	4	4	
Food Stamps	0	113	250	338	1380	1433	1487	1544	1603	
Increased Outlays	81	377	964	1617	3300	3T53	4177	4719	5368	
Increase in Revenue	0	724	1881	3118	4708	5544	5971	6436	6942	
Section 936		471	1275	2110	2977	3519	3854	4222	4626	
Personal Tax (Net of EIC)		106	226	372	533	595	625	656	689	
Corporate Tax		63	175	298	432	503	528	554	582	
Excise Taxes		84	205	338	484	540	567	596	625	
Rum Taxes					161	217	219	221	223	
Tariffs					121	170	178	187	197	

Table IV (continued)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total
Net Outlays	81	-347	-917	-1501	-1408	-1791	-1794	-1717	-1574	
Present Value of Net Outlays (10% discount rate)	67	-261	-626	-932	-795	-919	-837	-728	-607	-5638
From Perspective of Puerto Rico										
Net Inflow to Puerto Rico	81	124	358	609	1569	1728	2060	2505	3052	
Present Value of Net Inflow	67	93	245	378	886	887	961	1062	1177	5755

1 These figures represent the best estimates available at the time of publication relating to the provisions of S.244. Revenue data from February 7, 1991 from memorandum Kenneth Gideon, Department of Treasury, to Senate Committee on Energy and Natural Resources. Federal entitlement data are from the Departments of Agriculture and Health and Human Resources, in Hearings before the Senate Committee on Energy and Natural Resources on S.244, 102nd Cong., Ist Sess., at 229 (January 30 and February 7, 1991).

2 These revenue figures represent increased revenues resulting from the phase-out of section 936 the phase-in of personal, corporate and excise taxes, and rum taxes and tariff collections that were previously covered over to Puerto Rico. Revenue figures do not include the potential costs of any statehood grants or cover overs to Puerto Rico; our assumptions therefore differ from the provisions of S.244. Table IV and our accompanying analysis differs from our first report (and other proposed Legislation) in that we include as revenue the gains from customs tariffs and run taxes previously returned to the Puerto Rico treasury. The treatment of these provisions during the transition period is open to debate, but at a minimum they can be considered as funds of these provisions during the transition period is open to debate, but at a minimum they can be considered as funds available for a statehood grant.

Source: Hearings before the Committee on Energy and Natural Resources, 102nd Congress, Ist Sess., on S.244, January 30 and February 7, 1990.

special assistance in the form of a cover-over (that is, a transfer to the Puerto Rico Treasury) of federal taxes paid by Puerto Rico residents for a limited period of time. Because we feel that this cover-over approach provides a wholly inadequate base for sustained economic growth, we treat the "statehood grant" issue separately below. The analysis in this section sets the stage for that discussion by clarifying that even within the constraint of federal budget neutrality, substantial federal revenue would be available for a special statehood grant to Puerto Rico should Congress deem that desirable. However, before turning to the design of such a pool of funds, we look at the net financial flow from the perspective of Puerto Rico.

Impact of Statehood on the Net Flow of Funds to Puerto Rico

At the same time that statehood imposes no additional costs on the U.S. Treasury, it substantially increases the flow of funds to Puerto Rico. The explanation for this apparent paradox lies in the source of funds. Much of the additional tax revenue received by the federal government would come neither from mainland taxpayers nor from Puerto Rico residents, but rather from the mainland corporate parents of the section 936 corporations which still enjoy a lucrative tax shelter there.

The bottom panel of Table IV documents the magnitude of the increased flow of funds to Puerto Rico. The big inflow reflects the expansion of the entitlement programs, only part of which in each year is offset by higher taxes paid by individuals and firms on the island. The magnitudes are large. By the year 2001, the net inflow is estimated to be $3 billion dollars and the present value (in 1992) of the total additional inflow through the year 2001 is $5.75 billion.

The observation that the net inflow of funds under statehood to Puerto Rico is positive and large should dispel the fear that statehood would require Puerto Rico residents to contribute more to the Federal Treasury than they would receive in financial benefits. No other state either is or should be required to meet that condition in a federal system of government. The very essence of federalism is that all citizens of the country, regardless of their state of residence, are entitled to full and equal benefits of federal programs in return for federal taxes that are uniformly applied across the country.

The Statehood Grant

The Need for A Statehood Grant

In terms of net financial flow, statehood is clearly beneficial for Puerto Rico. However, these financial flows require further analysis. One needs to consider as well their economic effects as documented most fully and carefully in an April 1990 report by the Congressional Budget Office (CBO). The CBO concluded that on the one hand Puerto Rico's economy will be stimulated by the increased aggregate demand associated with the large net inflow of funds, but that on the other the economy will be significantly disrupted by the reduced investment occasioned by the elimination of the section 936 tax provisions. The net effect, argues the CBO, will be a reduction in the rate of growth of the Puerto Rico economy relative to what would occur with the continuation of commonwealth status. In particular the CBO speculates that, absent any counter measures to offset the adverse effects on investment of the elimination of section 936,[11] the growth rate of real (inflation adjusted) gross national product (GNP) might be 1 to 2 percentage points lower than under commonwealth status. If this lower growth rate were to occur it would translate into a reduction of 10 to 15 percent in the level of Puerto Rico's GNP in the year 2000 relative to the baseline prediction for that year. This presumptive disruption of the Puerto Rico economy provides a strong argument for a statehood grant (or "development endowment") that addresses the needed boost for economic development.

Historical Basis for the Statehood Grant

Every state that has entered the Union since 1803 has received some form of statehood grant. During the nineteenth century, Congress typically favored land grants, but then and later also provided assistance in the form of transfers of valuable natural resources, partial exemption from certain federal taxes, special statutory treatment, and special monetary aid.

Hawaii and Alaska provide recent examples of special statutory treatment. Alaska was allowed to use foreign vessels in trade relations with other states, while Hawaii benefitted from a special provision that allowed American vessels engaged in foreign trade to keep their subsidy even when calling upon Hawaiian ports.[12]

Originally, Congress typically provided monetary aid indirectly such as through provisions for the sale of public lands and the operation of government mines as in Alaska. However, in 1907 Oklahoma was given a direct grant of $5 million for public schools in the impoverished Indian Territory; and other monetary grants have been given since.[13] In summary, Congress has recognized the desirability of enacting special assistance measures for new states and has shown remarkable flexibility in tailoring the statehood grants to the particular needs of the state.

Treatment of Statehood Grant in Past Legislation

Both S.712 and S.244 provided for the return of federal revenue collections to Puerto Rico during the statehood transition period that in effect functioned as "statehood grants" — that is, the legislation would have made special statutory allowances to help Puerto Rico in its transition to statehood. The first version of S.712 would have turned over to the Puerto Rico Treasury all the proceeds from the federal tax on individuals and corporations for 2 years (1994 and 1995), as well as the revenue from federal excise taxes for the first six years of statehood. We calculated the present value (in 1991) of that statehood grant at $2.6 billion.[14] S.244 would have similarly returned the increased revenues resulting from the phase-out of section 936 and the phase-in of personal, corporate, and excise taxes for 3 years (from 1994 to 1997), to the extent that those revenues were not needed to cover additional entitlement costs. In either case, then, a significant contribution to the Puerto Rican government during the statehood transition period was contemplated by legislators formulating previous proposals.

This approach to the statehood grant requires modification based on two considerations. First, the cover-over approach may reduce incentives for the island's public sector to adjust to statehood. And second, the statehood grant should be used to offset more directly any economic disruptions that may accompany the elimination of section 936 and to help Puerto Rico restructure its economy to move into the twenty-first century.

As we noted above in Section II, fiscal pressure associated with statehood offers a natural opportunity for needed reforms in the way Puerto Rico's government operates. The imposition of federal taxes would create pressure to reduce Puerto Rico's income tax revenues by roughly $1 billion, forcing the public sector to streamline, increase efficiency, and enact reforms necessary for sustained economic growth.

Under the cover-over approach, however, the driving pressure for that change would be delayed. We see no reason for this delay and question whether Puerto Rico's government — particularly given its past performance (as discussed in Section II) — is the most appropriate beneficiary of the statehood grant implicit in past legislation. While a period of adjustment is clearly necessary, it is likely that the gap between the referendum and the beginning of the transition period will provide time to prepare for the change.[15] Even if some cover-over is deemed desirable to ease the government's adjustment under statehood, it should at most be partial and should be made consistent with policies emphasizing private-sector fueled economic growth and the need for public sector reform.

Our Recommendation: The Statehood Grant as Leverage for Economic Growth

The second and more compelling argument for creative thinking about the statehood grant is the need to help Puerto Rico restructure its economy to provide growth in private, not public, jobs. As discussed throughout this report, the elimination of tax gimmicks such as section 936 is in the long-run interest of the Puerto Rico economy. Even with this tax provision, unemployment has been high. The elimination of section 936 simply focuses attention on the need to develop new approaches to economic development and some basic structural problems in the Puerto Rico economy which need to be corrected.

In this light, we draw these conclusions: First, some portion of the $5.6 billion that statehood would yield for the U.S. Treasury over its first ten years should be considered an endowment for Puerto Rico's future growth and prosperity. (In subsequent years, those savings should also be recognized as a federal windfall as compared to the continuing drain posed by commonwealth status.) Second, the cover-over approach detailed in previous legislation does not satisfy these conditions and is inconsistent with private-sector oriented economic reforms taking place in the U.S. and throughout the world. Third, the priorities, philosophy and administration of this endowment should be carefully designed to respond to Puerto Rico's long-term development needs. In general the endowment should assist Puerto Rico to abandon tax breaks and other temporary subsidies in favor of investment in its physical and social infrastructure and protection of its natural resources.

Endnotes

1 Some of these principles, such as revenue neutrality and a gradual transition period, were incorporated into the Senate's recent transition proposals, first in S.712 and then in its successor, S.244. Both of these bills also contained provisions for a statehood grant, but in the form of a cover-over of federal income and excise taxes collected during the transition period to the Puerto Rico Treasury. For reasons articulated below, we continue to oppose such an approach.

2 The Uniformity Clause requires that "all Duties, Imposts and Excises...be uniform throughout the United States." U.S. Const. art I, § 8, cl. 1. Proponents of a delayed entry into statehood believe that this approach would allow Puerto Rico time to phase out its favored tax status and achieve tax uniformity before being subjected to the limits imposed by the Uniformity Clause.

3 See Philip Joseph Deutch, "Note: The Uniformity Clause and Puerto Rican Statehood," 43 *Stanford Law Review* 685 (1991).

4 See Statement of Dick Thornburgh, Attorney General, February 7, 1991, in Hearings Before the Committee on Energy and Natural Resources on S.244 (To Provide for a Referendum on The Political Status of Puerto Rico).

5 See, for example, April 1990 CBO Report.

6 See Hearings before the Committee on Energy and Natural Resources, 102nd Congress, first session, on S.244, January 30 and February 7, p. 229.

7 See Section III, above.

8 As discussed below, this figure is derived from estimates provided during hearings on S.244. While the numbers may not be exact, they are the best estimates available, and at the very least demonstrate the order of magnitude of savings associated with statehood.

9 See Hearings before the Committee on Energy and Natural Resources, 102nd Congress, 1st Sess., on S.244, January 30 and February 7, p. 229. Our table differs from the assumptions implicit in bill S.244 in that we include as federal revenue the value of personal, corporate, excise, and section 936 taxes (as well as rum taxes and tariff collections) that under S.244 would be returned to Puerto Rico as a "cover-over" statehood grant between 1994 and 1997. We also assume that eligibility and benefit standards for government entitlements will conform to mainland levels; in this respect our estimates of the savings in net outlays are therefore more conservative than the assumptions of S.244 (which assumed limits on Puerto Rican benefits).

10 Table IV and our accompanying analysis differs from our first report (and other proposed legislation) in that we include as revenue the gains from customs tariffs and rum taxes previously returned to the Puerto Rico treasury. The treatment of these provisions during the transition period is open to debate, but at a minimum they can be considered as funds available for a statehood grant.

11 As we noted above in Section II, the CBO assumption that no offsetting benefits would accompany the shift to statehood is open to question. Statehood would provide stability and recognition that would attract investment to offset possible dislocations associated with the loss of section 936. See the McKee Report, p. 42-47.

12 Grupo De Investigadores Puertorriquenos, *Breakthrough From Colonialism: An Interdisciplinary Study of Statehood,* (Santo Domingo, Dominican Republic: University of Puerto Rico: 1984), p. 1155.

13 *Id.*, pp. 1153-54.

14 See p. 12 of the September 1990 version of this report.

15 Both S.712 and S.244, for example, provided a period of delay (of two years and at least one year, respectively) before starting the phase-in provisions of the transition period.

V. Conclusion

In sum, we have argued throughout this report that Puerto Rico faces some hard choices in the near future. The report confronts critical areas in need of attention and reform in Puerto Rico's economy: the need to restructure and streamline the island's bloated and ineffective public sector; the need to repeal the inefficient and outdated section 936 tax credit; and the need to refocus the obsolete development strategy away from government subsidies and centralized decision-making, and toward private sector market-oriented policies.

In particular, we emphasize in Section III that the section 936 tax credit cannot stand as the cornerstone of Puerto Rico's hopes for development. Section 936 is constantly threatened with repeal in the U.S., where the Treasury Department is particularly hostile to it due to the excessive subsidy rates and revenue costs we detail in Section III. Furthermore, the investment decisions critical to Puerto Rico's future will not be based on tax gimmickry and government incentives. Instead, investors will seek a stable, productive, and efficient environment for their location decisions.

These points represent concerns that must be addressed irrespective of the status question. The report concludes, however, that action on these issues is unlikely in the absence of statehood. In particular, the needed reforms of the bloated public sector will not occur without the major adjustments occasioned by a shift to statehood, since there is virtually no political incentive to make such changes. This fact of life applies regardless of the political party in charge under the Commonwealth status. In addition, continued Commonwealth status represents a long-term, growing drain on mainland fiscal resources, whereas statehood would eventually alleviate those pressures. This expense cannot be overlooked in a period of severe federal budget deficits.

Yet the report demonstrates that statehood offers a viable and cost-effective alternative. A shift to statehood would not only occasion a critical—

though manageable — streamlining of the public sector, but it would also produce significant revenue gains to the U.S. Treasury as compared with commonwealth (on the order of $5 billion over the first nine years). At the same time, statehood would create a net inflow of federal funds into Puerto Rico. The source for these funds would not be U.S. mainland taxpayers, though, but rather the corporate parents of section 936 companies that could no longer take advantage of the lucrative tax benefits currently available on the island.

In the final analysis, then, statehood presents a welcome opportunity for change. Indeed, given the bleak future of Puerto Rico unless significant reforms are soon implemented, statehood is a precondition for those reforms, which are essential to sound economic growth in the near and foreseeable future.

Appendix A

Federal Entitlement Programs and Economic Development

Introduction

Statehood would involve the extension of full federal entitlement programs to Puerto Rico. For many of these programs, Puerto Rico is already treated as if it were a state. But federal spending on several of the larger programs — notably food stamps, Aid to Families with Dependent Children (AFDC), and Medicaid — is capped under commonwealth. This section examines the effect that extending these programs will have on the economic development of the island.[1]

Critics claim that expanding federal entitlement programs in a distressed economy will have an adverse effect on labor market behavior by increasing economic dependency and reducing incentives to find work. Proponents of statehood, in contrast, downplay these potential hazards. They point to the stimulation of aggregate demand associated with the inflow of federal funds and draw attention to the national trend toward linking government benefits with work or training programs. Moreover, they point out that additional federal funds will help alleviate the worst symptoms of Puerto Rico's chronic poverty (the 1980 census identified 62.4 percent of the population with an income level below federal poverty guidelines).

While neither set of arguments is without merit, both miss the main point. The real issue is not what increased entitlements will do to stimulate demand or reduce work effort, but rather how Puerto Rico can grow and generate jobs. Without more jobs and sustained economic growth, residents of Puerto Rico will continue to be poor, to be dependent on welfare, and to migrate to the mainland to find work, regardless of the structure or scope of federal entitlement programs. Hence, the central question is the one discussed throughout this report: can Puerto Rico develop and maintain an economic strategy that will generate growth through productive jobs? In our view, statehood is a precondition to a productive development strategy. Statehood erects the foundation for economic growth, assures a more adequate safety net of fair social welfare programs, and should reduce the need for such social insurance.

Changes in Benefits

Table A-1 documents 1989 per capita federal expenditures for Puerto Rico, Mississippi, and the U.S. states. The table shows that Puerto Rico receives equal treatment under many programs, notably social security[2], unemployment insurance and child nutrition. However, federal restrictions on other programs — Medicaid, Medicare, and Supplemental Security Income(SSI) in particular — are reflected in relatively low per capita expenditures in Puerto Rico, despite a per capita income roughly half that of Mississippi (the state with the lowest per capita income). Statehood would lift these restrictions and put Puerto Rico on an equal footing with other U.S. citizens living on the mainland.

Probable changes (which are difficult to estimate with precision due to uncertainties in benefit levels and numbers of participants) are highlighted below; increases in federal funding by program are summarized in Table A-2:[3]

FOOD STAMPS: In 1983, the Food Stamp Program in Puerto Rico was replaced by a block grant for a Nutrition Assistance Program (N.A.P.), which reduced the availability of federal funds and limited benefits and eligibility. Though recent average monthly benefits under N.A.P. ($48) appear similar to those on the mainland ($50), Puerto Rico's intense poverty and higher cost of living[4] mean that federal caps such as a lower maximum monthly allotment have a direct impact on the program's reach. Under statehood, Puerto Rico would again qualify for the Food Stamp Program, resulting in an additional $1.38 billion in funding in 1997 the first year of full eligibility under S.244.[5]

SSI: Supplemental Security Income, which is fully federal funded, would replace the jointly funded Adult Assistance program for the aged, blind and disabled. (SSI replaced Adult Assistance in the federal system in 1974.) Federal funding would increase $1.145 billion in 1997, the first year under S.244 that SSI would fully apply.

AFDC: Under statehood, Puerto Rico's AFDC program, because of its relatively low payment standards, would not be significantly affected: lifting the federal spending cap (currently $82 million) and increasing the federal match rate from 75 percent to 83 percent would increase federal outlays only $70 million in 1997.

Table A-1

Federal Expenditures by State and Territory — 1989

	$ Per Capita		
	Puerto Rico	Mississippi	U.S. States[a]
Grants to State and Local Governments — Total	490.61	513.76	466.35
Medicaid	22.80	158.87	138.68
A.F.D.C.	30.34	28.09	44.55
Social Services Block Grant	3.98	12.44	10.73
Child Nutrition Programs	34.64	44.11	17.08
Compensatory Education Aid	42.99	28.46	16.07
EPA Wastewater Trtmnt. Const.	9.32	7.79	9.28
Community Development	35.06	12.55	11.37
Housing Assistance	50.44	30.73	33.16
Job Training Partnership Act	28.40	14.18	11.76
State Employment Services	5.58	9.05	9.68
Highway Trust Fund	18.61	42.11	52.51
Urban Mass Transit Aid	7.27	2.11	14.14
Other	201.18	123.27	97.34
Nutrition and Food Stamps[b]			
Food Stamps	0.00	144.08	53.07
Nutrition Assistance Grant	273.60	0.00	0.00
Direct Payments to Individuals—Total	970.85	1744.66	1778.79
Medicare	100.80	332.75	379.16
S.S.I.	0.00	107.27	45.87
Social Security	597.13	836.73	905.57
Student Loan Subsidies	4.72	6.58	8.52
Pell Grants	76.28	26.03	18.76
Veterans Benefits	84.78	96.63	63.69
Federal Retirement	47.64	189.75	202.36
Other	59.50	148.91	154.86

Source: U.S. Department of Commerce, Bureau of the Census, "Federal Expenditures by State for Fiscal Year 1989," (Washington, D.C.: G.P.O., 1990), Tables 2 and 4.

a Category includes only U.S. States; derived from source by subtracting funds for territories and undistributed appropriations.

b In Puerto Rico, the food stamp program is administered as the Nutrition Assistance Program in the form of a block grant to the Commonwealth government. Food stamp figures for the states include both grants to individuals and grants to governments for administration.

Table A-2

Estimated Federal Outlays in Puerto Rico For Certain Entitlement Programs Under S.244 in 1997[1]

	$ Billions	Percentage of Increase
Baseline Outlays[2]	1.40	
Increases Under Statehood:	3.30	100.0
Which might affect labor market		
Food Stamps	1.40	42.4
AFDC	.07	2.1
Unlikely to affect labor market		
Medicaid	.70	21.2
S.S.I.	1.10	33.3

1 1997 is the first year under S.244 for which full federal funding would apply.

2 Baseline outlays for these programs include projected federal expenditures under current law and increases associated with the commonwealth option under S.244.

Source: Hearings before the Committee on Energy and Natural Resources, 102nd congress, 1st Sess., on S.244, January 30 and February 7, 1990, p. 229.

HEALTH CARE: A $701 million increase in federal Medicaid funding in 1997 would replace much of the island's public health program. Puerto Rico could reduce its expenses from $450 million to the $184 million required by Medicaid grant matching stipulations.

In all, then, statehood would result in an additional $3.3 billion of federal funds for the food stamp, AFDC, Medicaid, and SSI programs; under the commonwealth option of S.244, this spending would be limited to $1.5 billion.

The Labor Market Response

Some observers worry that the massive infusion of these new federal funds will have a detrimental effect on Puerto Rico's labor market. As noted earlier, we consider these concerns to be secondary to the broader issue of economic development, which is the underlying question in any study of welfare and its effects. Nevertheless, this section briefly addresses some of those concerns.

The fundamental dilemma inherent in all welfare programs is that the expansion of entitlement programs necessarily entails some labor market disincentives: "Because welfare programs are means-tested, they discourage work, since the more you work, the less assistance you receive. Moreover, any effort to increase benefits to combat poverty more effectively will only further decrease the incentives for recipients to take low-paying jobs and work."[6] In Puerto Rico's case, however, two mitigating factors must be considered.

One factor is that the labor market behavior argument is largely immaterial for the majority of the additional federal funds. Most new funding (54.5 percent) would come in programs that have little or no effect on work-related decisions, such as SSI and Medicaid. SSI, for example, provides aid to the blind, aged and disabled — individuals for the most part already removed from the work force. Table A-2 shows that of the $3.3 billion total projected increase in Federal outlays for 1997, only $1.5 million (46.5 percent of the increase) are of the type significantly related to labor-marked behavior, namely AFDC and food stamps.

The other factor is the trend linking federal benefits with programs designed to facilitate the movement of welfare recipients into work through mandatory training, job search, and "workfare" programs. In such programs, government agencies provide services to help welfare beneficiaries find and keep jobs; in exchange, recipients are required to fulfill certain training or job search obligations. This trend recently gained political and legislative expression in the passage of the Family Support Act of 1988, which (among other things) required states to tie AFDC benefits to participation in work-related programs. Incentives to leave the welfare rolls, such as child care and a one year continuation of Medicaid benefits, would be implemented under statehood, but not under continued commonwealth.

The food stamp program has had a similar requirement in effect since 1987. The Food Stamp Employment and Training Program requires that states provide employment and training services for food stamp recipients, who (unless exempt from the requirements) must participate in programs designed to move them into private sector employment. Program areas include job search, job search training, educational classes, and work experience. Under statehood, Puerto Rico would be required to meet the same program guidelines as other states.

Hence, an increase in those funds linked to labor market behavior — AFDC and food stamps — would be accompanied by federal program obligations designed to minimize their adverse impact. How effective, then, are these programs at mitigating welfare's adverse impacts?

Studies to determine the effectiveness of "work and welfare" programs have been inconclusive for the most part, generally suffering from a lack of sufficient data over time.[7] A recent study of seven representative employment initiatives in the U.S. by the Manpower Demonstration Research Corporation (MDRC), however, showed that despite the limited scope of these early experiments, such programs in most cases "led to a notable substitution of earnings for welfare and proved cost-effective, suggesting that the success can be repeated on a larger scale."[8] But the MDRC study also found exceptions to this rule: West Virginia's employment program, for example, did not lead to increased employment and earnings, mainly because of the state's high unemployment and rural character.

Other program evaluations have echoed MDRC's findings. A Food Stamp jobs demonstration program conducted in the early 1980's, for example, also found that such programs led to a reduction in government food stamp payments and an increase in participants' income.[9] But a clear difference emerged between early programs, implemented in 1981 during a deep recession, and later programs operating during the economic growth of 1984. The final report on the demonstration project concluded that employment opportunities and economic stability play a crucial role in determining the effectiveness of job search programs.

While "work and welfare" programs are clearly no panacea, particularly for Puerto Rico's labor surplus economy, they still represent an important trend. Furthermore, these programs may also provide significant intangible returns, such as expressing community values that favor participation and work if possible.

Conclusion

In general, the "work and welfare" debate merely reinforces the importance of our original assertion. That is, job creation and a strong labor market are the most important factors in the entitlements equation. Aside from their role in addressing the needs of Puerto Rico's poor and their possible stimulation of the economy due to an increased demand for goods and services[10], the federal entitlement programs are largely a secondary issue in the status debate. All projections about the impact of expanded entitlements hinge on the economy's ability to grow and create jobs.

Endnotes

1 The financial and fiscal impacts of increased federal funding are dealt with in the main body of the report. See Sections II and IV, above.

2 The lower per capita social security payments in Puerto Rico reflect the lower level of earnings on the island.

3 Cost estimates are from the November 15, 1989 testimony of the Congressional Budget Office before the Senate Finance Committee. Benefit levels are from: U.S. Department of Health and Human Services, Social Security Administration, "Social Security Bulletin: Annual Statistical Supplement, 1989," (Washington D.C.: GPO, 1990); and GAO, "Puerto Rico: Information for Status Deliberations," briefing report to the House Subcommittee on Insular and International Affairs, March 1990.

4 Recent estimates put Puerto Rico's cost of living at 12 percent higher than the mainland average. Puerto Rico Department of Social Services, "State Plan of Operation for the Administration of the Nutrition Assistance Program of the Commonwealth of Puerto Rico, Fiscal Year 1989-90," p.7.

5 Data on additional entitlement programs comes from the Departments of Health and Human Services and Agriculture in testimony on S. 244. See Hearings before the

Committee on Energy and Natural Resources on S.244, 102nd Cong., 1st Sess. (Jan. 30 and Feb. 7, 1991), p. 229.

6 Judith M. Gueron, "Work and Welfare: Lessons on Employment Programs," *Journal of Economic Perspectives*, 4 (Winter): 1990.

7 An evaluation of the Food Stamp Employment and Training Program is currently under preparation; the interim report on the program came to no conclusions about the ability of the program to cut welfare costs, increase employment and decrease dependency. (Abt Associates, Inc., "Report to Congress on Program Implementation," December, 1988. Prepared for U.S. Department of Agriculture, Food and Nutrition Service.)

8 Gueron 1990, p.94.

9 U.S. Department of Agriculture, Food and Nutrition Service, Office of Analysis and Evaluation, "Food Stamp Work Registration and Job Search Demonstration, Final Report," July, 1986.

10 Determining the extent to which aggregate demand will be stimulated depends largely on broad assumptions about economic performance. See the April 1990 CBO report for one such model.

Appendix B-1

Public Corporations, by Type

Type I

Business type operations; supposed to be self-sufficient; obtain most or all revenue from charges for services or products.

Puerto Rico Telephone Authority
Communications Authority
Ports Authority
Electric Power Authority
Aqueducts and Sewer Authority
Automobile Accidents Compensation Authority
Cooperative Deposits Insurance Corporation
Government Development Bank
Shipping Authority
Housing Bank and Finance Agency
Economic Development Bank
Land Authority
Land Administration
Infrastructure Financing Authority
Industrial, Medical, and Environmental Control Financing Authority
Caribbean Basin Financing Corporation

Type II

Business type, but not self-sufficient; depend on government taxes, legislative appropriations, and other subsidies; some can issue debt guaranteed by central government.	Metropolitan Bus Authority Highway Authority Industrial Development Company Commercial and Farm Credit Corporation Sugar Corporation Tourism Company Correctional Enterprises Corporation Industries for the Blind Corporation Rural Housing Administration Agricultural Insurance Corporation Mineral Resources Development Corporation Institute for the Development of the Cinematographic Industry Housekeepers Services Corporation

Type III

Governmental service type; generate some income, but not self-sufficient; depend partially or totally on government appropriations; cannot issue bonds or debt.	Health Facilities and Services Administration Agricultural Services Administration Agricultural Development Administration Medical Services Administration Cardiovascular Center Corporation Solid Waste Management Authority Rural Development Corporation Agricultural Experimental Station Agricultural Experimental Station Technological Transformation Corporation Technological Resources Corporation Marine Resources Corporation Right to Work Administration Recreational Development Company Parks Conservation Corporation Workers Enterprises Development Corporation

Type IV

Internal governmental services; can issue debt with central government guarantee; resources are obtained from charges for services to own government.	Public Buildings Authority

Type V

Educational and Cultural type; depend on government appropriations, although some may generate own revenues; cannot issue debt (except the University of Puerto Rico).	University of Puerto Rico Institute of Puerto Rican Culture Musical Arts Corporation Fine Arts Center Corporation Public Broadcasting Corporation — WIPR Music Conservatory Puerto Rico Symphony Orchestra Corporation School of Plastic Arts

Source: Luis Montanez, former Director of the Office of Management and Budget, personal correspondence, June 1990; revised March 1992.

Appendix B-2

Commonwealth General Fund Appropriations to Public Corporations Fiscal Year 1991-92

	($ Millions)
1. University of Puerto Rico	322.8
2. Musical Arts Corporation	6.4
3. Institute of Puerto Rican Culture	9.3
4. Fine Arts Center Corporation	1.3
5. Cardiovascular Center Corporation	6.5
6. Aqueduct and Sewer Authority	41.6
7. Solid Waste Management Authority	1.8
8. Housing Bank	38.7
9. Farm Credit Corporation	5.3
10. Rural Development Corporation	2.7
11. Land Authority	2.7
12. Sugar Corporation	102.3
13. Economic Development Bank	8.0
14. Infrastructure Financing Authority	40.0
15. Tourism Company	18.2
16. Metropolitan Bus Authority	27.2
17. Maritime Authority	10.0
18. Public Broadcasting Corporation	3.1
19. Farm Services Administration	25.1
20. Agricultural Development Administration	57.2
21. Industrial Development Company	15.5
22. Health Facilities and Services Administration	513.8
23. Right to Work Administration	32.3
24. Others	2.0
TOTAL	1,293.8
General Fund Budget, Total	4,227.2
Appropriations to Public Corporations Percent of Total Budget	30.6

Source: Budget Document, Fiscal Year 1991-92 Office of Budget and Management Provided by Dr. Luis Montanez, April 1992.

Appendix C

Employment Multipliers and the Effectiveness of Section 936

The estimates appearing in Table II-1 were computed by the U.S. Department of the Treasury. Among other estimates that are lower than the Treasury's estimate of $18,523, the lowest available cost estimate is $6,221 per employee.[1] This estimate is based on 1982 data and considers the effects of employment multipliers and the proposed reduction in the U.S. corporate tax rate from 46 to 33 percent.

When estimating the opportunity cost per job of section 936, it is misleading to use employment multipliers. To the degree that such secondary effects are created by section 936 investments, these effects will also be present if alternative measures are taken to promote investment. Furthermore, the impact of section 936 industries on the Puerto Rican economy through their use of intermediate inputs is minimal because most of these items are imported. The increase in the demand for services in Puerto Rico as a result of the purchases made by employees of section 936 companies is also reduced because the companies are so capital intensive.

The magnitude of the multipliers is also questionable. With an employment multiplier of about 1.5 as is implied by these studies, for every public sector job created a further expansion of employment of 1.5 jobs would occur. Considering only the impact of the public sector and section 936 firms on the economy, such a multiplier would have resulted in the creation of more additional jobs than there are people available in the labor force on the Island. Given the Island's observed high unemployment rates, obviously, such an employment multiplier is not realistic.

If the above estimate of $6,211 cost per job is recomputed taking out the effect of employment multipliers, but incorporating the 1986 tax rate reduction, the cost per job becomes $15,808. In that year, average employee compensation was $14,210. Therefore, even under the most conservative cost estimates, the annual cost of creating a job through the section 936 tax incentive is greater than what the job pays in wages.

Endnote

[1] This estimate was produced by Robert R. Nathan Associates, Inc., Consulting Economists for the Puerto Rico-U.S.A. Foundation. Robert R. Nathan Associates, Inc., "An Assessment of the Administrations Proposal to Substitute a Wage Credit for Section 936", (Washington, D.C., June 1985).

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