The Impact of Federal Disbursements and Taxes on the Puerto Rican Economy Under Different Status Options

Jaime Bofill Valdés

Introduction

The U.S. Congress has been considering legislation to facilitate the choice of political status in Puerto Rico. Economic changes -- most notably, the fiscal relations between Puerto Rico and the federal government -- will result from any change in status. The aim of this study is to quantify the impact that changes in Puerto Rico’s political status would have on the economic growth and other macroeconomic variables, as a result of changes in the fiscal relations (taxes and transfer payments) between Puerto Rico and the United States for the period 1994-2000. The interaction between additional federal funds, the number of Section 936 firm relocation, and federal taxes would affect the revenues and expenditures of both the U.S. and the Puerto Rican governments as well as aggregate demand in Puerto Rico. This in turn would induce changes in the economic growth, employment and wages. The Commonwealth status option will serve as the base case for comparison.

The study reviews several studies that deal with the subject of equal treatment for Puerto Rico in federal programs and with the extension of federal income taxes to Puerto Rico under various political status options. These studies can be divided into two basic groups, depending on their methodology. The first group consists of several studies which describe the initial impact but ignores the secondary effects arising from the interrelationship among the variables. Of particular significance here is the relationship between manufacturing investment and the fiscal effects that a status change entails. Studies in the second group make use of a quantitative model in which the variables dealing with the relocation effect and fiscal changes are interrelated so that the models can deal with the effect of the interplay among them. Two modeling approaches have been used to analyse this issue. The Policy Economic Group used an income tax model.

The critical role is played by the number and importance of the Section 936 companies that decide to relocate their operations or preclude future investment in Puerto Rico. There is an absence of detailed studies comparing returns to investors by site (Puerto Rico vs. Mexico, Ireland, Singapore). Several recent studies deal with this issue, but they are incomplete and somewhat contradictory. In the absence of concrete evidence, it is necessary to simply assume various scenarios dealing with the relocation of Section 936 firms. The Congressional Budget Office (CBO, 1990) and the Policy Economic Group (1990) studies are limited because they only deal with one type of Section 936 company relocation. That is, relocation is exogenous and it is assumed that there will be a significant exodus of firms. Before specifying the scenarios, a brief description of the economic implications of Statehood and Independence is presented using the Commonwealth as the base case.

Economic Implications of Statehood and Independence

Statehood or Independence will bring changes in net transfers to Puerto Rico in several ways. Under

the Statehood option: the participation of Puerto Rican residents in the Food Stamp program, Medicaid, Medicare, and Aid to Families with Dependent Children (AFDC) would increase; Puerto Rican residents would be eligible for Supplemental Security Income (SSI), but their eligibility for Aid to the Aged, Blind and Disabled program would end; and Puerto Rican residents, both individuals and firms, would become liable for federal income and excise taxes. Individuals would, however be eligible for the earned income tax credit.

The income leakage caused by individuals and companies in Puerto Rico paying taxes to the U.S. Treasury under Statehood, could be more than compensated by greater federal transfer payments to island residents and government agencies. Assuming that no other major economic changes take place and that Section 936 firms are unaffected by U.S. tax rates (i.e., that non-tax advantages in Puerto Rico offset taxes), the net fiscal benefits, measured in terms of higher growth, lean toward Statehood rather than Independence or the current Commonwealth status. However, the loss of Section 936 tax incentives could lead to major changes in the structure of the Puerto Rican economy.

The Puerto Rican budget could be significantly affected by the loss of economic activity with the relocation of Section 936 companies, as well as by the redistribution of income resulting from the new tax constraints and federal entitlement program opportunities confronting Puerto Rican residents. On the one hand, reductions in government expenditures may occur as residents become eligible for federal government programs. On the other hand, tax revenues could be reduced in Puerto Rico in several ways. Hence, the public sector could be forced to cut back on its services and employment in order to remain competitive with other states in terms of taxation.

The critical issue is the extent to which existing operations would relocate, future investment curtailed, and compensating action taken by the government and the business community to cope with the uncertainty affecting Section 936 corporations.

Independence could have many short-term economic effects in Puerto Rico. Changes in the net fiscal flow between Puerto Rico and the United States is one of them. The net effect of these changes would be a decrease in federal revenues. This shortfall, compared to the amount Puerto Rico would receive if it maintains its current political status, can be expected to have two effects in Puerto Rico: reduced availability of financing via federal transfer for any current account deficit in Puerto Rico's balance of payments; and reduced stimulus of aggregate demand. Section 936 benefits would no longer be available to U.S. corporations, but a suggested tax scheme combining tax-sparing treaties and local subsidies could approach the attractiveness of the current Section 936 benefits (Negrón Rivera 1993).

Hence, the interplay of changes cause by the flow of federal funds, the relocation of Section 936 firms and federal taxes, plays a crucial role in the growth equation under the different status options.

**Specification of Scenarios and Methodology**

It is evident from the above discussion that transfer payments, federal taxes, and relocation of Section 936 firms are the three key variables of our macro-econometric model. As in previous studies, several scenarios were designed to examine the fiscal impacts of Statehood and Independence using the Commonwealth status as the base-line. However, these scenarios are different to those presented in the CBO and Policy Economic Group studies. The main assumptions regarding the transition period for Statehood and Independence are basically the same as those described in Senate Bill 712, the time periods are different.

Based on the proposed legislation, the study assumes that: Puerto Rico would become a state on January 1, 1992, that at the moment it became a state, all federal taxes and programs, with some exceptions, would apply immediately. Federal taxes would become effective January 1, 1994, except for those related to Section 936. The credit allowed by this section would be eliminated gradually over a five-year period. In 1994, the credit would be 80% and would be reduced

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4. For example: The toll-gate tax would be repealed. Corporate relocations would reduce income tax revenues - both individual and corporate. Financial institutions would be down-sized and would pay lower taxes. Individual income tax revenues would be reduced.
by 20% each year for the following four years until it is eliminated completely. The project also proposed that the U.S. Treasury would transfer to Puerto Rico the federal tax revenues collected from Puerto Rico for 1994 and 1995. Federal excise taxes would become effective in 1992 and would be returned to Puerto Rico until October 1998. And, beginning in 1992, all federal programs would be extended to Puerto Rico with the exception of Supplemental Security Income (SSI) which would begin in 1994.

The first scenario assumes that the rate of retention and attrition of Section 936 companies is the same under all three status options. It is assumed that Section 936 companies remain in Puerto Rico independently of political status. Therefore, the rate of growth in exports, investment in machinery and equipment and construction will be the same for all three status options for the period 1994-2000. The key variables in Scenario I are federal transfer payments and federal taxes. It is assumed that under Commonwealth federal transfer payments will continue at the same rate as in recent years. Note that under Statehood, with respect to federal taxes, there exists a transition period in which funds are returned to the government of Puerto Rico for several years (cover-overs). Puerto Rico will be receiving an additional $1.3 billions in net transfers as a result of statehood during the year 2000. This result is the difference between change in total spending and the net flow of taxes from local sources ($3.5 - $2.2). In the case of Independence, change in net transfers. Are decreasing for one period 1994-2000. In the year 2000 net transfers under Independence will be $598 million less than under Commonwealth.

Scenarios II and III entail relocation of 936 companies, but are calculated from different perspectives. In both scenarios (II and III) the relocation margin is calculated for Statehood and Independence, taking Commonwealth as the base. That is to say, the relocation margin is assumed to be an endogenous variable and not exogenous as in the studies carried out by the CBO (1990) and the Policy Economic Group (1990) and as in Scenario I.

The objective of Scenario II as distinct from Scenario I, is to calculate the relocation margin measured through exports under Statehood and Independence with respect to Commonwealth. Commonwealth GNP is taken as the base figure for calculating the relocation margin. If in any given year, the relocation margin of a given status is positive, it means that its corresponding GNP is greater than Commonwealth, and if it is equal to zero then its corresponding GNP is equal to or less than Commonwealth. The difference in GNP between any status and Commonwealth is translated into exports, which is used as a proxy for relocation. Export is a good proxy for relocation because of the exporting nature of most Section 936 firms. Hence, the relocation margin, as measured by exports, is an indicator of the degree of flexibility any status has compared to Commonwealth in terms of relocation of Section 936 firms. In addition, in those cases where the relocation margin is zero and the difference in GNP between any status and Commonwealth is negative, the additional resources necessary to arrive at the level of GNP generated by Commonwealth, measured in terms of exports or in terms of relative GNP, is also computed. This is the additional resources indicator. Hence, in Scenario II the key variables are net transfers, relocation of Section 936 firms, exports and GNP growth. The scenario is examined for the year 2000, which falls out of the transition period, 1994-98.

Scenario III entails relocation of companies in which the relocation margin variable is endogenous. Scenario III is very similar to II, except that Commonwealth is awarded parity in federal funds through several federal programs in the year 2000.

For the three scenarios the levels of transfer payments and federal taxes used, for the period 1994-2000, were those calculated by the CBO and the U.S. Treasury Department. Detailed estimates of changes in net transfer as a result of Statehood were prepared by the CBO and the Department of Treasury. Net transfer is an exogenous variable equal to transfer payments less tax payments from local sources. Change in revenues

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from local sources consists of new excise taxes, custom duties, rum excise tax, and personal and corporate income tax. Total changes in revenues from local sources to the federal government amounts to $2.2 billion in the year 2000. On the other hand, changes in total spending by the federal government in Puerto Rico is estimated to reach $3.5 billion by the year 2000. Thus, Puerto Rico will be receiving an additional $1.3 billion in net transfers as a result of Statehood during the year 2000.

Change in net transfers to Puerto Rico as a result of Independence was also prepared by the CBO and the Department of Treasury\(^7\). Change in net transfer is defined as change in total spending plus change in revenues from local sources. Change in net transfers to Puerto Rico under Independence is decreasing for the period 1994-2000. This is a direct result of Puerto Rico losing the benefit of the rum excise tax cover-over and the reduction in total spending by the federal government in Puerto Rico. Under Independence Puerto Rico has been offered an annual federal block grant for a period of nine years fixed in nominal terms. This will reduce federal spending in Puerto Rico when compared to the Commonwealth base case. In the case of the rum excise tax, losing this source of income represents around $250 million per year for Puerto Rico. Federal payments for U.S. bases in Puerto Rico will partly compensate for this short fall in federal spending in Puerto Rico. In the year 2000, the $1268 million short fall in net transfers to Puerto Rico will be partly compensated by the $670 million federal payments for U.S. base in Puerto Rico, resulting in a net deficit of $598 million.

Results and Conclusions

The findings of this study confirm that the critical issue is the relocation and future investment of existing Section 936 operations. In the absence of detailed studies comparing returns to investors by site (Puerto Rico vs. other countries), three scenarios were designed, to examine the fiscal effects of Statehood and Independence, taking the Commonwealth as the basis for comparison.

In the first scenario relocation as an exogenous variable is the same under Independence, Statehood, and Commonwealth. In scenarios II and III relocation becomes endogenous. The objective of Scenario II as distinct from Scenario I, is to calculate the relocation margin through exports under Statehood and Independence with respect to Commonwealth. Scenario III presents the results of Commonwealth incorporating the addition of parity in several federal programs. The key variables in all scenarios are federal transfers payments, federal taxes, relocation of Section 936 firms and real gross national product growth (GNP).

The main conclusions that emerge from the analysis of the three scenarios are the following. Assuming no firm relocation under any of the three status options (Scenario I), the transition measures favors Statehood over Commonwealth and Independence. If net transfer payments favors Statehood and if the industrial structure of Commonwealth and Statehood are very similar (no relocation of Section 936 firms), the total amount of GNP will favor Statehood. The results pertaining to the transition period, 1996-1998, suggests that the time frame of the study must be extended beyond the year 2000.

In the year 2000, given the assumptions of Scenario II, Statehood has a relocation margin of 10.8 percent in terms of exports. Any reduction in exports beyond 10.8 percent places Statehood at a lower level of GNP than Commonwealth. The GNP of Independence in the year 2000 is less than Commonwealth, and therefore its relocation margin is zero. Note that although the reduction of 10.8 percent in exports under Statehood implies equal GNPs under both options (Statehood and Commonwealth), the composition of their GNP is different. The role of manufacturing is greater under Commonwealth than under Statehood, while commerce and services have a greater weight under the latter.

Parity in several federal programs for Commonwealth can compensate for the net addition in federal funds received by Puerto Rico under Statehood, bringing the Commonwealth's GNP to the same level as that of Statehood. In this case, the relocation margin under Statehood is zero. A significant reduction in the manufacturing base resulting from the loss of Section 936 benefits under Statehood entails a net GNP loss relative to Commonwealth with parity in certain federal programs. Hence, net transfers is the key variable determining the magnitude of the relocation margin. The bigger the difference in net transfers, other things equal, the bigger the relocation margin. In summary, the degree of relocation of Section 936 firms, the total amount of net federal transfers payments Puerto Rico will receive, and the transition measures negotiated are crucial in determining the macro-economic benefits of any status.

*Professor of economics, University of Puerto Rico, Río Piedras Campus.