

### Rationale for Statehood

The general and specific findings of *Puerto Rico: The Fiscal and Economic Dimensions* provide a broad foundation for the Puerto Rican Statehood argument:

1. ***The Puerto Rican economy, contrary to the opinion of many, is not a model of economic growth. In fact, the economy has been beset with slow growth, high unemployment, and little advance in productivity.*** The Puerto Rican economy has stagnated since the 1970's, after successful growth in the 1950's and 1960's. Growth in real per capita GNP dropped to 1.1% annually from 1975 to 1995, after increasing at 4.1% from 1955 to 1975. Unemployment reached 22% in the 1980's and currently stands at more than double the U.S. rate. In addition, the government sector grew more than three times as fast as the private sector during the period 1970 to 1990 to the point where it now comprises 32% of the workforce. Puerto Rico and the U.S. persisted with a development strategy based on government initiative and tax gimmicks long after it proved ineffective. *In short, the Puerto Rican economy is anything but a case of "if it ain't broke, don't fix it."*

Comparisons with developing economies in the Caribbean and Latin America mask the failure of the Puerto Rican economy and its development policies. Given the close political, economic, geographic, and social ties to the United States, Puerto Rico should be matched up with the fifty states. Puerto Rico's residents are also already U.S. citizens with the right to unrestricted travel to the mainland. This comparison reveals the paucity of economic progress on the island. The island's 1995 per capita income of \$7296 was *less than a third* of that in the United States.

2. ***Commonwealth status results in a drain on the U.S. Federal Treasury.*** In FY 1995, Puerto Rico received \$9.7 billion in federal outlays, or approximately \$2,620 for every person living on the island, which is approximately half of federal spending distributed to the average state. At the same time, however, the U.S. Treasury is forfeiting tax dollars that it would collect from individuals and corporations in Puerto Rico. U.S. citizens residing in Puerto Rico presently pay no federal income taxes. The most glaring loss of revenue is from corporations benefiting from Section 936 of the Internal Revenue Code ("section 936"). Since 1972, the federal government has forfeited at least \$70 billion in tax revenues in real terms. While the tax breaks are being phased out, section 936 still costs the federal government over \$3.8 billion in lost revenues as of 1994. As long as Puerto Rico remains a commonwealth, there remain political interests supportive of reinstating costly and ineffective tax subsidies.
3. ***Statehood would alter the perception of potential investors in Puerto Rico.*** In this age of globalization, the expansion of NAFTA, and the eventual normalization of relations with Cuba, Puerto Rico's once privileged trade status is no longer a source of

7. ***The fiscal impact of statehood on the U.S. Treasury would be favorable.*** Statehood would bring in federal taxes where none is presently collected and increased growth under statehood would continue to expand the federal tax base and collections. Statehood would also put a definitive end to potential tax breaks which remain a threat to deficit reduction (e.g. still an estimated \$3.8 billion a year) under the current status.

Had Puerto Rico been a state in 1995, it would have generated an additional \$3.52 to \$4.12 billion in tax revenues for the Treasury while resulting in an additional \$1.4 billion in increased federal transfers to the island. Thus, contrary to conventional wisdom, *statehood would have resulted in a net benefit to the federal budget of between \$2.1 to \$2.7 billion.*

8. **In summary,** Puerto Rico can only optimize its significant growth potential through statehood. Without conclusive resolution of the status question, no economic development strategy can hope to actualize this potential in the long-term. Through full integration, statehood will stimulate Puerto Rico to realize its capacity through faster growth and convergence with the U.S. Convergence with the U.S. has not occurred under commonwealth status as predicted by modern growth analysis; in fact, Puerto Rico has been converging with the developing economies of the Caribbean and Latin America.

Statehood will be particularly critical in light of the development of free trade throughout the region. In addition to NAFTA, trade liberalization is accelerating in the Caribbean under CARICOM, and in Latin America under MERCOSUR. Potential investors from the United States and elsewhere will not appreciate Puerto Rico's nebulous commonwealth status as a source of competitive advantage. Statehood will attract greater investment by creating a more stable, recognizable environment for U.S. and global investors. Faster economic growth under statehood will mean higher incomes for U.S. citizens in Puerto Rico, and higher incomes will bring in more tax revenues to the U.S. Treasury.

The theoretical underpinnings are summarized in Dr. Fernando Lefort's paper, "Is Puerto Rico Converging to the U.S.?" which states:

- "The main result of this study is that the per capita income of the Puerto Rican economy is not converging towards the per capita income of the United States. In other words, Puerto Rico is not closing the income gap that separates it from the U.S. Even after controlling for a set of standard determinants of growth variables, Puerto Rico remains well below the convergence frontier traced by the United States."

Dr. Lefort further concludes:

- “At the end of the day, the question has always been: what would be the cost of statehood? My analysis concludes the opposite question should have been asked: What *has been* the cost of Commonwealth?”

The rationale for Statehood from the cost to the U.S. taxpayer is summarized in the general and principal findings of *The American Perspective on the Fiscal Effects of Puerto Rico's Status*<sup>2</sup>:

- **Statehood for Puerto Rico would net the U.S. Treasury up to \$3.63 billion in additional revenues.** Puerto Rican residents and corporations are now exempt from paying the federal income tax on earnings in Puerto Rico. Unlike the States, Puerto Rico does not contribute federal excise taxes or customs duties to the U.S. Treasury. Most federal programs in Puerto Rico, however, are funded on the same basis as in the fifty States, with the exception of several health and income support programs. Fully imposing federal taxes would generate additional revenues of up to \$4.75 billion to the U.S. Treasury.<sup>3</sup> Increased revenues would more than outweigh potential additional spending of \$1.12 billion from fully funding federal programs on the same basis as in the fifty States.
1. **Statehood for Puerto Rico would net up to \$3.63 billion for the U.S. Treasury.** Fully extending federal taxation would generate revenues that would far exceed any benefit increases to fully fund federal programs. If the corporations and residents of Puerto Rico contributed federal income tax, excise taxes, and customs duties to the U.S. Treasury on the same basis as in the fifty States, additional revenues would total up to \$4.75 billion. Increased revenues would outweigh a potential 10% increase in federal spending of \$1.12 billion.<sup>4</sup>
  2. **Under Commonwealth status, federal spending in Puerto Rico totaled \$10.97 billion in 1997.** Federal spending amounts to about 37% of the island's gross product, about double the U.S. figure. Most spending, \$5.8 billion, takes the form of direct federal transfers to individuals. An additional \$3.7 billion in direct grants were provided to the Puerto Rican central and municipal governments. These transfers comprised about 20%

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<sup>2</sup> Figures differ slightly from the previous *Economic and Fiscal Dimensions* report because calculations are made using more up-to-date information from 1997 and drawing on more recent analysis from the Government Accounting Office.

<sup>3</sup> Congress has the authority to extend full federal taxes to Puerto Rico now under Commonwealth status. If this were to occur, the net fiscal benefits to the U.S. Treasury would be even greater than if Puerto Rico became a State; tax revenues would increase without the added costs of fully funding federal programs.

<sup>4</sup> Estimates based on figures for federal fiscal year 1997, or the most recent year when Puerto Rican and federal data are available.

of the consolidated budget of the Puerto Rican government. The federal government also spent \$730 million on its personnel and \$318 million in procuring goods and services in Puerto Rico.<sup>5</sup> Puerto Rico receives about \$7 billion more in federal spending than it bears in federal taxes, a more favorable balance of payments (federal spending received compared with federal taxes paid) per capita than all but three States.

3. **Puerto Rico receives approximately \$8 billion in unearned benefits and tax credits.** Not counting benefits earned through military service, work for the federal government, or payroll contributions, unearned federal benefits to Puerto Rico total roughly \$4.5 billion, and tax credits for U.S. corporations operating in Puerto Rico amount to an estimated \$3.4 billion.
4. **Federal taxes can and should now be fully imposed on the corporations and residents of Puerto Rico under the existing Commonwealth status.** The federal income tax, excise taxes, and customs duties not contributed by Puerto Rico to the U.S. Treasury could be fully extended under the existing status.<sup>6</sup> Alaska and Hawaii both paid all federal taxes prior to statehood, including corporate and individual income taxes.
5. **Residents of Puerto Rico do not pay the federal income tax.** Residents are now exempt from paying federal income tax on earnings in the Commonwealth. Residents of Puerto Rico do contribute payroll taxes like Social Security, Medicare, and Unemployment Insurance.
6. **Corporations are also exempt from paying federal income tax.** Corporations organized in Puerto Rico do not pay federal income tax on any income earned in the Commonwealth. Most U.S. corporations operating in Puerto Rico continue to receive significant benefits under the Puerto Rico economic activity credit, which effectively exempts them from paying tax on income earned on the island. As the credit is being phased out,<sup>7</sup> U.S. corporations are taking advantage of Puerto Rico's tax status to reduce and defer payment of federal income taxes.
7. **Puerto Rico does not contribute federal excise taxes and customs duties to the U.S. Treasury.** Puerto Rico is exempt from most federal excise taxes. Taxes are collected on some Puerto Rico-produced goods shipped to the U.S., although revenues are rebated to the Puerto Rico Treasury. U.S. customs duties collected in Puerto Rico are also returned, or "covered over" to Puerto Rico.<sup>8</sup> No State receives customs duties collections like

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<sup>5</sup> The federal government also spent \$404 million on other programs not within these categories.

<sup>6</sup> Federal case law indicates that Congress has authority under the territorial clause of the Constitution to alter the federal fiscal arrangement in Puerto Rico unilaterally, including extending federal taxes not currently applicable.

<sup>7</sup> The credit has cost the U.S. Treasury over \$72 billion in 1997 dollars since 1976, and will total an estimated \$3.4 billion this year, according to the Joint Committee on Taxation.

<sup>8</sup> Both customs duty and excise tax collections by the federal government are rebated to Puerto Rico after deducting for administrative costs and refunds.

Puerto Rico. Under equal tax treatment, these annual rebates totaling \$270 million would cease and federal excise taxes would be fully applied to Puerto Rico.

8. **Residents benefit from most federal programs on the same basis as mainland U.S. citizens.** Social Security, Medicare, Pell grants, and other major federal programs treat Puerto Rican recipients the same as other U.S. citizens. Several programs are now funded differently and could change under a move to statehood, particularly Supplemental Security Income (SSI), Food Stamps, and Medicaid.
9. **Federal funds finance highway projects in Puerto Rico, although the federal gasoline tax does not apply on the island.** The federal Highway Trust Fund finances highway construction and maintenance in Puerto Rico and the fifty States, through revenues from the federal gasoline tax, which is not paid by motorists in Puerto Rico.
10. **Puerto Rico could readily accommodate the fiscal changes (e.g., federal income tax) required by statehood.** Full federal taxes could be extended to Puerto Rico and its tax system harmonized with those of the fifty States, while maintaining current levels of government services. Congress could structure a transition to full taxation that would enable Puerto Rico to adjust its government finances over time.
11. **Congress has broad authority to control federal spending over the course of a transition to statehood.** Federal spending and taxation can be gradually phased in to reduce the cost to the federal government. A transition also offers the opportunity to implement innovative alternative federal taxes like the flat income tax as a full replacement for all federal taxes in Puerto Rico.

The origins for the economics of the Statehood argument were expressed in our 1989 study, *Puerto Rican Statehood: A Precondition to Sound Economic Growth*:

- “The basic theme of the study 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 1990’s and the 21<sup>st</sup> century, and that does not languish on the static rhetoric of the mid-twentieth century. In our view, statehood is a precondition for this required development strategy.”