Principles for tax reform

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Commentary

Puerto Rico currently has a tax system that no one consciously would have built from the ground up. It is unduly burdensome to administer and enforce; it is inequitable, along both horizontal and vertical dimensions; it oftentimes encourages the inefficient allocation of resources and it inflicts enormous damage to our competitiveness.

This tax system, originally designed in the 1950s when Puerto Rico was a small agricultural economy with a large labor surplus, had little or no local capital, an undeveloped local market, was initially tailored to promote economic development. In those days, efforts were focused on attracting foreign capital, matching it with the excess pool of local labor and exporting the resulting products to the rest of the world. By most accounts this model was relatively successful in jumpstarting the Puerto Rican economy.

However, with the passage of time, our tax system has evolved through the slow accretion of legislation, into a complex medley of credits, deductions, exclusions, and exemptions that are layered on top of multiple special tax rates. In addition, it imposes high marginal rates on income and it benefits only the very poor and the extremely wealthy, while imposing the heaviest burden on the middle class.

Thus, our tax system, which in theory should stimulate economic growth by channeling financial resources to the productive sectors of the economy, has actually undermined our competitiveness; penalizes work, especially at the lower levels of the wage scale; encourages the informal sector; and hinders entrepreneurial activity. It should not surprise us that Puerto Rico's growth rate has slowed down during the last 25 years, that close to half of its population lives in poverty and that more than 50 percent of its people do not participate in the labor force.

The consensus in Puerto Rico is that a broad-based tax reform is long overdue. It is important to understand, however, that tax policy involves trade-offs among various objectives, such as revenue generation, efficiency, simplicity, and equity. As a result there is no single "correct" policy answer; each society has to make a determination about the proper balance among these policy objectives.

We at the Center for the New Economy believe the following principles should guide any tax reform effort in Puerto Rico. First, reform needs to be comprehensive. This means that all the elements of the tax system — personal and corporate income taxes, sales taxes, excise taxes, and property taxes should be on the table. The objective is to look at the system as a whole and avoid the unintended effects and distortions produced by partial or stop-gap reforms.

Second, we need to expand the tax base. In plain English, this means eliminating some of those credits, deductions, exclusions, and exemptions that have proliferated through the years. Enacting all those tax advantages has resulted in (1) an increase in the complexity of the tax code; (2) high marginal tax rates to compensate for the multiple tax breaks and (3) all sorts of distortions in the capital allocation process. Replacing the plethora of existing tax breaks with a universal refundable credit (for individuals) of 15 percent would go a long way toward eliminating these distortions.

Third, we need to lower marginal tax rates. This may sound counter-intuitive at first, but recent research, especially in the field of behavioral economics, shows that high marginal tax rates make it worthwhile for people to change their economic activities and to spend considerable resources to both legally avoid and unlawfully evade taxes. Lowering marginal tax rates reduces the incentive to engage in this kind of behavior, and if complemented with an expanded tax base could actually lead to higher tax collections.

Fourth, any tax reform effort should aim to simplify the system. Puerto Rico's current tax code is insanely complicated, grossly unfair, and terribly inefficient. These defects hamper administration, compliance and enforcement efforts and, in the aggregate, they decrease the overall amount of tax revenue collected. A simpler tax code, if done correctly, would generate lower enforcement and compliance costs and higher tax collections.

Fifth, Puerto Rico should seriously consider imposing green taxes. These are taxes on activities that are harmful to the environment. They help reduce some of the most noxious effects of economic activity and provide an incentive to invest in environmentally friendly technology. In addition, they provide a new revenue stream for the government. In the words of former Vice President Al Gore "we should tax what we burn, not what we earn."

In sum, tax reform involves multiple trade-offs among revenue generation, efficiency, simplicity, and equity objectives. The difficulty lies in achieving a reasonable balance among these various considerations. Let's hope our policymakers succeed in this difficult balancing act.

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