

# Proposal for a post-partisan fiscal policy

There has been a heated public debate recently regarding the Commonwealth's General Fund budget for fiscal year 2009. This debate has concentrated, specifically, on the financing mechanism that will be used to plug the \$1 billion gap between expected revenues of \$8.488 billion and budgeted expenditures of \$9.488 billion. The narrow focus of the public discussion, however, begs the question of why do we have such a large deficit in the first place. Fiscal "liberals" would argue that deficits are largely a function of insufficient revenues, a problem made worse by the recent enactment of the tax incentives law. While fiscal "conservatives" would argue that deficits are largely a function of a bloated government and unrestrained spending.

Nonetheless, most economic analysts and politicians would agree, if only in private, that Puerto Rico's current fiscal mess is due as much to a revenue shortfall as to excessive spending. Due to the proliferation of tax incentives, an enormously complex and unfair tax system, and inadequate tax collection efforts that miss millions of dollars in owed taxes every year, revenues are too little. Due to government programs that continue in existence beyond their usefulness, government hiring based on political connections rather than on policy needs, and rent-seeking behavior by the private sector, which is constantly in the hunt for all sorts of special favors and goodies from the government, spending is too high.

Both sides, then, are partially right and partially wrong. They have to recognize, however, that policy proposals that address only one side of the equation are unlikely to be successful in fixing our fiscal situation. If Puerto Rico is ever going to put its public finances in good working order, then policy solutions must transcend party lines, go beyond traditional policy labels, and address comprehensively both sides of the issue.

On the revenue side, we need to:

**Expand the tax base** — The current proliferation of credits, deductions, exclusions and exemptions narrows the tax base and induces 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 per cent



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would go a long way towards eliminating these distortions.

**Simplify the Tax Code** — 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 revenues collected. A simpler tax code, if done correctly, would generate lower enforcement and compliance costs and higher tax collections.

**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.

**Impose 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 government.

On the spending side, we need to:

**Enact pay as you go procedures** — The governor should propose, and the Legislature should enact, legislation requiring that any bill increasing expenditures must include an offsetting decrease in other expenditures or an increase in taxes and

any bill decreasing taxes must include an offsetting decrease in expenditures or an increase in other taxes.

**Establish "sunset" rules** — The Legislature should establish a "sunset" commission to structure the process of terminating ineffective government programs. Sunsetting is the process of automatically terminating government agencies and programs after a period of time unless they are specifically reauthorized.

A sunset commission could review commonwealth government programs on a rotating basis and recommend major overhauls, privatization or elimination of programs that have outlived their usefulness.

**Limit General Fund outlays to growth in nominal GNP** — Growth in general fund expenditures should be limited to the growth rate of nominal GNP. For example, if the Planning Board forecasts nominal GNP growth for fiscal year 2009 to be 5 percent, then the growth in government expenditures for that fiscal year should be capped at that level too.

**Require zero-based budgeting** — Zero-based budgeting would end the current practice of baseline budgeting. Under baseline budgeting procedures, government programs can exist on autopilot, since budgets are written assuming an expected annual growth rate in all government programs. Zero-based budgeting would assume that every government program starts the fiscal year with zero taxpayer money and every program would have to justify its budget request from the bottom up.

We should think of the list above as a menu of policy options for our policy makers. As such, it is necessary to choose among them according to what is fiscally effective, economically reasonable, and politically possible in the current context. This task is quite difficult, but we have to start somewhere. What is clear, however, is that the partisan tax and spend policies of the past 30 years have been a colossal failure. It is time for a post-partisan fiscal policy.

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