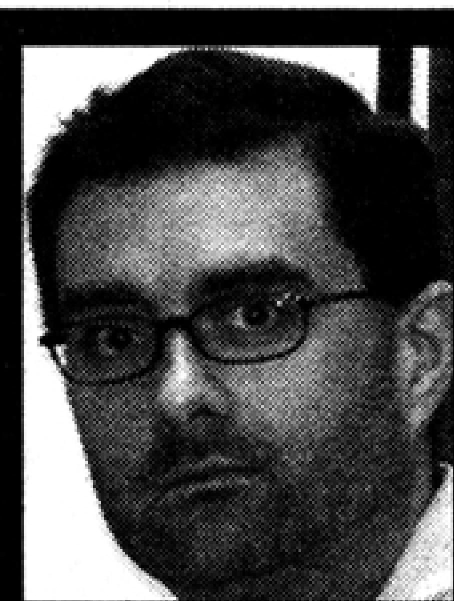
The San Juan Star
Viewpoint
Monday, March 3, 2008 | B-14

Send your opinions and ideas to: The San Juan Star P.O. Box 364187 San Juan, PR 00936-4187 c/o Viewpoint
Or send us a fax: (787) 782-0310
Or e-mail us at: viewpoint@sjstar.net

The 'Puerto Rico premium': A case study



Sergio Marxuach
Commentary

Local bankers and entrepreneurs have long complained of having to pay a "Puerto Rico premium" to entice U.S. and foreign investors to invest in the island. This premium often takes the form of a slightly higher yield or return on local investments that nonetheless have a risk profile similar to comparable investments in the United States. Some attribute this premium to racism or ignorance about Puerto Rico. While these two factors certainly play a role, as racist and ignorant people can be found anywhere, including Wall Street; in our view, the principal reason for the Puerto Rico premium lies in our propensity to improvise economic policy.

The saga of the sales and use tax is a good case in point. The SUT was enacted during a farcical legislative session "truly worthy of Shakespearean comedy" which took place after the commonwealth government had shut down for two weeks. About a year later, the first collections of the commonwealth sales tax (5.5 percent), up to a minimum yearly amount, were pledged to COFINA bondholders for the next 40 or 50 years to refinance a portion of the government's extra-constitutional debt. Then, on Feb. 6 the governor suddenly proposed "totally eliminating the portion of the SUT allocated to the central government from 4.5 percent to zero and reinstating the previous excise tax paid by importers."

The government offers two arguments in support of this policy change:

The old excise tax was paid by importers and not by the consumer: This argument is based on the novel and largely undocumented premise that importers "absorbed" the cost of the old excise tax and did not pass it down the distribution chain. This line of reasoning contradicts several studies which have established the inflationary impact of this so-called "cascade effect." For example, an analysis carried out during the 1994 tax reform, estimated the inflationary impact of the cascade effect at 1.1 percent. However, in some segments the impact was much higher; in the clothing and textiles segment, the average consumer price increased by 11.13 percent as a consequence of the excise tax, and in the wood furniture category the estimated increase was calculated at 10.35 percent.

In sum, while there are disagreements regarding the magnitude of the effect, there exists nonetheless a general consensus among the island's economists that the effect is real and that it reduces the overall efficiency of the economy.

The SUT had an adverse impact on the economy: According to a GDB analysis, more than half of the decrease in the Planning Board's Economic Activity Index can be attributed to the sales tax. This is a peculiar conclusion because the Planning Board's Index started its downward trend in February 2006, fully nine months prior to the implementation of the SUT, which did not become effective until Nov. 15, 2006. How could the recession have been "caused" by a factor that did not even exist at the time the recession began remains a mystery. If the argument is that the SUT reduced consumption spending, well, then, that is precisely what a sales tax is designed to do by making saving cheaper relative to consumption. The problem in Puerto Rico is that the SUT was implemented without a corresponding reduction in income taxes to offset the expected negative impact of the SUT.

In addition to being based on questionable evidence and flawed economic reasoning, the sales tax proposal is bad policy for the following reasons:

Impact on general fund revenues: The SUT is forecast to bring in $911 million to the general fund during the current fiscal year and the government expects the tax swap to be revenue neutral. It is unlikely, however, that the combined excise/SUT would raise that amount of revenue for two reasons. First, the excise tax, in contrast with the SUT, is charged only on goods and not on services, which make up 50 percent of consumption expenditures in Puerto Rico. Thus, the government is reducing the potential taxable base by half. Second, the excise tax generated only $550 million the last year it was in effect. Granted, the government says the new excise tax (unlike the old one) will have no exemptions, except for food and medicines. However, according to an estimate by Dr. Ramón Cao, this change would only increase revenues by $120 million, to approximately $670 million. Therefore, the new excise tax would fall $241 million short of the revenue target for the current SUT. Unless, of course, the new excise tax rate is higher than the old 6.6 percent effective rate.

Impact on the government's credibility: Some of the COFINA bonds have maturities in excess of 30 years, just like some tranches of the new Pension Obligation Bonds. The question pondered by investors now is: Can they trust the Puerto Rican government to keep its promises for that long? After the governor's announcement the answer appears to be no. If after only 14 months the government, based on anecdotal and unpersuasive evidence, is giving up on the SUT how can it be trusted to keep its word for next 50 years?

No stimulus effect: The administration asserts that reducing the SUT to 2.5 percent would stimulate economic growth. This assertion contradicts the other stated policy objective of keeping the change on a revenue neutral basis. If paying the 2.5 percent on top of the new excise tax is to be revenue neutral, then the tax change would have no stimulus effect whatsoever on the economy as no new money would be in circulation. The premise seems to be that the new excise tax would not be passed on to consumers down the distribution chain. Thus, revenues to the general fund would not be affected and consumption would increase due to the reduction in the SUT. As we have seen, however, this line of reasoning is based on erroneous economic assumptions.

In sum, the SUT proposal appears to have been designed with little attention to its potential economic, financial, and policy ramifications and to its adverse effects on importers, wholesalers, retailers, consumers, and bondholders. Future investors will certainly learn about this when they conduct their "due diligence" regarding the island. Therefore, we can only expect the Puerto Rico premium, the very real monetary cost of our penchant for off-the-cuff policymaking, to keep increasing in the near future.

Sergio Marxuach is director for policy development at the Center for the New Economy, a Puerto Rico-based think tank (www.grupocne.org).