



September 2, 2016

The Honorable Orrin Hatch, Chairman
Congressional Task Force on Economic Growth in Puerto Rico
Submitted via Email: prtaskforce@mail.house.gov

Dear Chairman Hatch, Senator Rubio, Senator Nelson, Senator Menendez, Representative Duffy, Representative MacArthur, Representative Velazquez, and Representative Pierluisi:

On behalf of National Taxpayers Union's (NTU's) members in Puerto Rico and the rest of the United States, I write to offer comments regarding the economic challenges facing the Commonwealth and provide NTU's views on potential reforms. As you may know through your capacity as Members of Congress, NTU has been actively involved in the development of a legislative response to aid Puerto Rico's recovery. We have offered advice, on a granular level, concerning tax, budget, regulatory, and economic policy affecting the Commonwealth (and by extension the rest of the United States). We urge you to access those documents online [here](#), [here](#), and [here](#).

Introduction and Executive Summary

Under Public Law 114-187, also known as the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), the Task Force on Economic Growth will provide the very first indicators of the directions U.S. policy toward the island's future could take. It is therefore vital that the Task Force's status report of September 15 and the final report of December 31 reflect bold recommendations to complement the work of the Oversight Board, which will soon be empanelled and engaged deeply in many fiscal matters.

Throughout PROMESA's evolution, many Members of Congress and advocacy organizations (including NTU) expressed constructive concerns over individual provisions of the legislation, even as they supported the process of developing workable solutions for Puerto Rico's woes. The resulting package of reforms – PL 114-187 – was, from a pro-taxpayer standpoint, demonstrably improved.

Nonetheless, at numerous points in the debate, fiscal conservatives noted that PROMESA could only function properly with constant vigilance over its implementation. As current events demonstrate, such vigilance is direly needed now.

Specifically, we urge you to combat any politicization of the tools created by PROMESA by adhering to the core principles that must anchor Puerto Rico's economic renaissance. Among those principles are:

- Examining how federal tax laws could be restructured to facilitate the “free flow of capital between possessions of the United States and the rest of the United States” that PL 114-87's language stipulated;
- Upholding the rule of law between creditors and debtors, and thereby respecting Congress's clear intentions not to engage in a retroactive reprioritization;
- Encouraging fiscal discipline and expenditure restraint, especially in regard to government employee benefits;
- Eliminating obstructions to efficient commerce and affordable goods for Puerto Rico's consumers, such as federal Jones Act restrictions; and
- Removing regulatory barriers to private sector job creation on the island and to reform of programs that discourage Puerto Rico residents from fully participating in workforce.

The following comments provide more detail on many of the principles outlined above, aimed at providing specific, practical options for the near-term. And while we acknowledge the different roles and focus of the Task Force and the Oversight Board, NTU hopes to demonstrate that their work on behalf of a better future for the Commonwealth is often highly intertwined and interrelated.

1) Restructuring Federal Tax Laws. Much has been written and said about Section 936 of the U.S. Tax Code, and the degree to which it may have contributed to the volatility of the Commonwealth's economy. Section 936 is gone – but the questions surrounding the “hybrid” federal tax treatment of businesses on the island remain. This leads to further questions on how Puerto Rico's future status as a territory or a state should affect such treatment.

Sorting out these issues, which have implications far beyond the tax system, will occupy a great deal of time and energy that the Task Force cannot afford. The best course forward is to devise a remedy that: accounts for past federal tax law regarding Puerto Rico; works harmoniously with broader changes under contemplation for the entire federal tax system; and thereby avoids as much as possible conflicts with Commonwealth residents' desires about territorial status in years ahead. In addition, as a sovereign U.S. entity, Puerto Rico's tax treatment should allow the island to remain competitive with the tax systems of other nations, and attractive to investment from U.S. mainland firms.

NTU recommends that the Task Force urge the current Congress to consider a legislative proposal for Puerto Rico that:

- Reduces the U.S. tax rate on Puerto Rico-sourced income. Doing so could be made consistent with overall international tax reform.
- Addresses base erosion concerns with caution. Section 936's critics contended that it contributed to the deterioration of the U.S.-Puerto Rico tax base. Regardless of the degree of truth to that argument, NTU has joined with many organizations urging policymakers not to go to extremes, such as embracing the Base Erosion and Profit Shifting (BEPS) strictures from the OECD. Any rules for Puerto Rico should be easily harmonized with whatever limited alternative is developed under international tax reform.
- Deals in a reasonable manner with treatment of Subpart F income as it relates to broadly-defined investment in the island. Ultimately, under a tax system with more territorial features, Subpart F could be rendered superfluous. In the specific case of Puerto Rico, some kind of temporary deferred status for passive Subpart F income may be desirable to reduce disincentives for local investment. Such provisions should be made as simple and broad-based as possible.
- Sets a Puerto Rico repatriation or dividend deduction at a similar level to what policymakers have discussed recently for an international tax reform package. Among the models for reaching this objective would be the American Jobs Creation Act of 2004 and the Economic Revitalization Tax Act of 2001, as well as the Tax Reform Act of 2014. All of these proposals set the dividend exemption at 85 percent.

NTU has outlined this structure in previous communications to Congress. Thanks to a thoughtful amendment to PROMESA from your colleague, Representative MacArthur, impetus has been given to legislative language effecting tax reform for the Commonwealth. We believe that swift consideration and additional development of this language is feasible and desirable, not only for Puerto Rico's well-being but the progress of comprehensive tax reform. A vote could be taken on the resulting proposal in any of several vehicles related to taxpayer rights, taxpayer privacy, or miscellaneous Tax Code corrections. As we noted in an article this week on how leaders could get a “head start” on reform for next year:

Although Puerto Rico's residents are U.S. citizens, for tax purposes the IRS treats businesses there as if they were foreign corporations. [For good or bad] this means that Puerto Rico's situation is familiar to tax reformers on a larger scale, who are crafting policy toward how income should be treated when it flows between the U.S. and other countries. Several plans have been developed to revise corporate tax policy toward Puerto Rico that involve repatriation of earnings and treatment of “foreign”-sourced income. Current House and Senate Members could consider these well-vetted proposals before the year is out, and give the next Congress a frame of reference for broader discussions.

We urge the Task Force to bear in mind that attracting viable business activity to the Commonwealth through a repatriation and sourcing revision should be the immediate and most pressing tax priority. Still, the Task Force is doubtless confronting other elements of federal law such as whether to address the so-called “triple tax exemption” for certain Puerto Rico-related bonds. Any plans in these areas should follow the same “avoid harm, strive for harmony” philosophy. For example, enacting HR 5361, which would expand the types of government facilities eligible for public-private partnership bond financing, could be useful on several levels by: easing a transition away from the “triple exemption” (for future bonds only) and toward exemptions more common throughout the U.S.; aiding speedy infrastructure improvements; and, introducing more construction cost controls that have been proven in the private sector.

An additional recommendation, bearing upon tax and other areas, appears in a section to follow.

2) Upholding Rule of Law ... and Upholding Pension Reform. It is quite true that the Oversight Board created under PL 114-187 bears primary responsibility for ensuring prioritization of payments on debts owed by the Puerto Rican government and public enterprises. Yet, this issue has several vital connections to the Task Force's work as well. In the most basic sense, restoring the Commonwealth's good credit is key to attracting the capital which, *prudently managed and invested*, could help to put Puerto Rico's economy on a more sustainable path. More immediately, ensuring respect for the lawful order of debt payments will protect taxpayers on and off the island by encouraging a frank assessment of government retirement programs' affordability.

As it moved toward enactment, PROMESA was admirably strengthened to ensure that Puerto Rico's unsustainable debts be resolved and restructured equitably. For instance, Section 201(b)(1)(N) of the bill requires that any fiscal plan approved by the Oversight Board "respect the lawful priorities or lawful liens, as may be applicable in the constitution, other laws, or agreements of a covered territory ... in effect prior to the date of enactment...."

What of actions taken prior to any fiscal plan, or prior to the Oversight Board's empanelment? Here again, the law is clear. Section 204 (c)(3) states that "[d]uring the period after a territory becomes a covered territory and prior to the appointment of all members and the Chair of the Oversight Board, such covered territory shall not enact new laws that either permit the transfer of any funds or assets outside the ordinary course of business or that are inconsistent with the constitution or laws of the territory as of the date of enactment."

NTU is troubled by recent actions from Puerto Rico's government that contravene the spirit and, to our reading, the letter, of these laws. On both July 1 and August 1 (a full month after enactment of PROMESA) the Commonwealth failed to make payments on various debts, including general obligations that are prioritized in Puerto Rico's Constitution. Shortly afterward, the Governor announced two special sessions of the legislature in which he intended to propose a new loan and debt-swap scheme designed to inject \$400 million into two government pension systems – even though earlier in the year the Governor rejected legislation that provided more pension resources and met general obligation debt payments. The FY 2017 budget perpetuates much of this problematic behavior.

NTU has previously warned of other bodies – such as the Puerto Rico Commission for the Audit of the Public Debt – attempting to move pension obligations to the "head of the line" for payment over more senior creditors. This is because such tactics also disadvantage taxpayers, who ultimately take the biggest "haircut" of anyone when necessary pension reforms are put off due to political expediency and favor-trading.

Fiscal conservatives long emphasized that PROMESA had to take a different tack. NTU argued against providing Puerto Rico with a Chapter 9-style bankruptcy regime because that process was failing taxpayers in the continental U.S. From Stockton and Vallejo, California to Detroit Michigan, Chapter 9 has too often resulted in higher taxes and a reluctance to address unsustainable programs, especially benefit payouts for politically-powerful government employees.

As the Congressional Budget Office's August update indicated, U.S. Government management of entitlement programs is hardly exemplary, even though some steps have been taken toward sustainability in federal employee pensions. Most U.S. states and localities, however, remain even further behind the curve. According to a [report](#) from the Pew Charitable Trusts, even under relatively modest GASB standards, state-level pension funds alone face a \$1 trillion actuarial shortfall. Other reports, which include local government systems or make less optimistic assumptions, have estimated burdens of several times that amount. The responses from states have often put taxpayers on the hook. An [analysis](#) by the Illinois Policy Institute determined that between 1998 and 2012, Illinois taxpayer "contributions" to the state's main pension plans rose about five times faster than employee contributions did.

These primary cost drivers of the debt, in Puerto Rico and elsewhere, portend a serious decline in living standards and economic vitality. PROMESA's alternative mechanisms for orderly debt resolution – as well as provisions to address the true state of Puerto Rico's pension plans – must work better. Otherwise, the "nightmare scenario" of incentivizing states (or more localities) to avoid confronting the sources of their long-term liabilities will only loom larger. The Oversight Board must act decisively to uphold the rule-of-law protections in PROMESA, but the Task Force must assist as well in alerting Congress now to this quickly evolving threat to Puerto Rico's economic stability. One practical recommendation Task Force Members could make is for the House and Senate to pass legislation clarifying and affirming that Sections 204 (c)(3) and 201(b)(1)(N) specifically militate against the recent and planned actions of Puerto Rico's government mentioned above.

3) Eliminating Obstructions to Commerce. Even though NTU has offered comments on a number of policies affecting commerce in Puerto Rico, in our opinion one overriding imperative should concern the Task Force. Jones Act shipping restrictions have been a recurring topic of discussion over impediments to Puerto Rico's economic competitiveness. In NTU's view, this is for good reason. We believe that cabotage requirements are actually counterproductive in ensuring that efficient vessels are procured and deployed in trade as effectively as possible. The result is higher costs to consumers. From the University of Puerto Rico, to the Federal Reserve Bank of New York, to the World Economic Forum, [research institutions](#) have raised trenchant questions over the degree to which the Jones Act contributes to higher prices for raw materials and finished goods on the island. One survey, reported by the World Bank, indicated that the cost of shipping a standard cargo container from the United States to Puerto Rico was roughly twice the rate of that same container porting in the Dominican Republic, and nearly twice as one porting in Jamaica.

For these and other reasons, NTU has long favored repeal of Jones Act restrictions. As an alternative, however, we have supported a plan from the [Hawaii Shippers Council](#) known as Noncontiguous Trades Jones Act. This would provide relief from federal "U.S. build" dictates that drive up the cost of shipping between the U.S. mainland and Hawaii, Guam, Puerto Rico, and the Virgin Islands. The proposal, which would not change U.S. flag, ownership, or crewing provisions in any other portion of commerce, is targeted to address some of the worst aspects of the Jones Act. According to the Council, NTJAR would "allow U.S. shipowners to purchase large self-propelled merchant ships meeting U.S. Coast Guard standards from qualified shipbuilders in other industrial countries and renew their aging noncontiguous fleets (average age 28 years while the international norm is 12 years) with much lower-cost, more efficient modern ships." Another worthy proposal, already in legislative form, has been authored by one of your colleagues, Rep. Pierluisi. H.R. 2838, introduced in the 113th Congress, would allow non-U.S.-built, self-propelled vessels to transport bulk cargo between mainland ports and Puerto Rico.

Some elements of the U.S. maritime industry, which have a vested interest in preserving U.S. build and flag requirements for shipping, dispute the notion that the Jones Act is the cause of any price disparities in goods sent to Puerto Rico. They cite a Government Accountability Office (GAO) study from March 14, 2013 concluding that "the effects of modifying the application of the Jones Act for Puerto Rico are highly uncertain."

It is quite true that GAO's researchers expressed concern over attempting to pinpoint the effect of Jones Act-related mandates; they noted that "the impact of any costs to ship between the United States and Puerto Rico on the average prices of goods in Puerto Rico is difficult, if not impossible, to determine with precision." The agency did, however, cite U.S. Maritime Administration statistics indicating that various labor rules surrounding U.S.-crewed ships raised personnel costs aboard vessels to a level five times greater, on average, than for foreign-flagged carriers. Furthermore, despite noting insufficient data to conduct a rigorous analysis, GAO did acknowledge that "shippers doing business in Puerto Rico reported that freight rates for foreign carriers going to and from foreign ports are often – although not always – lower than the rates they pay to ship cargo to the United States."

Again, NTU believes that a preponderance of arguments exists on behalf of repealing or permanently reforming the Jones Act. Still, in the interest of resolving a contentious debate, the Task Force should recommend to Congress a temporary suspension of certain Jones Act restrictions for Puerto Rico. The Federal Reserve Bank of New York study mentioned above suggested a five-year moratorium, which would provide sufficient time and data to afford a solid analysis of the effect. This approach could even be attempted on a smaller scale. In previous years, proposals were drafted to allow the Port of Americas in Ponce to serve as a regulatory "freeport" of sorts, where Jones Act strictures would not interfere with the transport of goods between that point only and others in the United States.

4) Removing Regulatory Barriers to Job Creation. NTU has offered an abundance of suggestions on how federal laws could be improved to facilitate more employment opportunities on the island, such as:

- Further easing minimum wage mandates so that employers and local regulators would have more flexibility to set compensation at levels that are more competitive with neighbors in the Caribbean. PL 114-87 has provided a helpful start in this regard, by allowing the Governor to establish a "first minimum wage" for a period of up to four years pertaining to employees hired after the date it is declared. NTU's members were likewise pleased to see that PL 114-87 suspended implementation of the Department of Labor's recently finalized and highly flawed overtime rule, pending completion of a GAO impact report and a determination from the Secretary of Labor that the rule would not have a negative effect on the island's economy. More definite actions granting additional wage-control relief would be helpful.

- Clearing away federal red tape that could prevent the government of Puerto Rico from putting lucrative assets to their highest economic use, including airports and seaports, government buildings, and other infrastructure. This would include construction of a new liquefied natural gas terminal on the north side of the island, and a quick survey of federally-owned properties that are still suitable for efficiency upgrades through energy-saving performance contracts.
- Reducing infrastructure costs (and thereby making near-term construction more viable), by requiring open procurement policies for projects in which the federal government has a share of the expense.

An additional proposal to boost employment, which could function quite effectively with the federal tax reforms mentioned above, suggests itself through legislation offered more than a decade ago. In 2005, Delegate Fortuno and Representative Paul Ryan introduced the National Enterprise Zone Act (HR 2182, 109th Congress), which would have allowed Governors of all states and territories to nominate areas in their jurisdictions experiencing particularly difficult economic circumstances for less burdensome federal tax rates on individuals and businesses. Qualifications included a population of more than 10,000, a median household income below 60 percent of the national median, and an unemployment rate at least 2.5 times the national average. Areas whose nominations were approved by the Secretary of the Treasury could offer a low tax rate of 17 percent on the enterprise zone income that individuals and active businesses residing within the jurisdiction earn. Other desirable policies included a 0 percent rate on long-term capital gains attributable to assets held and sold within the zone, and a low 17 percent estate tax rate. In the case of income and death taxes, these would be less than half of the present system's top rates.

To be clear, NTU has always maintained that the best type of "national enterprise zone" would be one that, indeed, covers the entire nation – providing tax and regulatory relief for all. We do recognize, however, practical realities that counsel the relief to be implemented where it is needed most. We likewise recognize the demonstrative value that enterprise zones could have on tax policy for the rest of the country. Enactment of something like H.R. 2182 today would actually provide for a greater margin of tax relief than when it was first proposed, and could benefit communities still struggling to find their footing after the Great Recession.

For its part, the Task Force could simply recommend that the framework of H.R. 2182 be adapted and confined to Puerto Rico, as well as updated to reflect proposals now in Congress for tax reform. Should nationwide tax reform become a reality, the rate for Puerto Rico could be adjusted further downward in subsequent statutes to preserve the attractiveness of the Commonwealth's federal tax climate.

Granted, some types of tax relief would be more effective than others. For instance, individuals in Puerto Rico are generally not liable for federal personal income tax unless they have reportable income off the island. Yet the concept is a powerful one that can be molded to many circumstances. Workers on the island are subject to federal payroll taxes – offering a favorably low rate (rather than more ephemeral rebates) through Puerto Rico enterprise zone legislation could be a helpful alternative. At the same, a federal enterprise zone could provide guidance to officials in Puerto Rico seeking to optimize the Commonwealth's own tax system.

Conclusion

The Task Force's activities and recommendations provide one of the first opportunities to keep the "promise" of PROMESA. The ongoing operations of the Oversight Board, as well as the cooperation of Puerto Rico's government, will also be key. All, however, are interrelated. For example, NTU has these past two years urged Puerto Rico's leaders to consider updating the Commonwealth's constitution with a stronger tax and expenditure limitation. One model to examine is Colorado's Amendment 1, adopted by citizen initiative in 1992. This law requires voter approval for state and local tax expenditure growth above certain limits (generally, inflation and population increases). Although the Task Force is charged with examining federal policies affecting economic growth, it could still have a productive role in its remaining charter of directing Commonwealth leaders to research on the experiences of other governments in fiscal adjustment as well as fiscal discipline.

NTU stands ready to assist you in your deliberations and recommendations for Congress. We, as you, are committed to securing a brighter, more prosperous future for Puerto Rico's taxpayers.