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Extending the Earned Income Tax Credit and the Child Tax Credit to Puerto Rico

The Earned Income Tax Credit and the Child Tax Credit should be made available to Puerto Ricans on the island. This extension of these tax credit programs would be good policy: increasing the incentive to work, raising incomes of the poor, establishing fairness between the tax treatment of people in Puerto Rico and people in the states, and stimulating growth of the Puerto Rican economy.

Were the Earned Income Tax Credit and Child Tax Credit available to Puerto Ricans in 2006, the cost to the US would be approximately $1.08 billion. This cost, while not trivial, would be small compared to past programs of corporate tax incentives for Puerto Rico, and the positive impact of these tax credit programs on Puerto Rico would likely be substantially greater. If the present parameters of the programs are maintained and Puerto Rico experiences a reasonable rate of economic growth over the next decade, the annual costs would decline slightly each year. The ten year cost of extending the EITC and CTC to Puerto Rico would be approximately $10.1 billion.

Extending these tax credits to Puerto Rico could have a significant double impact on the island, providing a catalyst to move the economy from its listless growth of recent years onto a track of rapid development. The first of these impacts would come directly from the annual billion dollar infusion of the credits. The second, and perhaps of much greater long-run social as well as economic significance, would be a transformation of Puerto Ricans' relation to their work. The incentives embodied in these programs would move many people, now out of the labor market, to engage in productive, paying work. In addition, these programs would move many people from the booming but inefficient and problematic underground economy into regular employment.

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The Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) are currently not available to Puerto Ricans on the island. These tax credits are tied to the federal income tax, and Puerto Ricans on the island do not pay federal income tax on Puerto Rican source income.

There is, however, no good policy reason why these tax credits are not applied in Puerto Rico. After all, a primary justification for the EITC has been to offset the regressive payroll taxes, and Puerto Ricans pay both Social Security and Medicare taxes. It should also be emphasized that both credits have been put in place and expanded in order to alleviate poverty by supplementing earned income and thus providing an incentive for people to draw a paycheck. The poverty rate in Puerto Rico is substantially higher than on the mainland, with about fifty percent of Puerto Ricans living below the poverty line.

It is especially important that the EITC has been designed to encourage people to participate in the paid labor force, and Puerto Rico suffers from an especially low labor force participation rate (below fifty percent, as compared to roughly seventy percent in the states). In its May 2006 report on the Puerto Rican economy, the General Accountability Office took note of "the fact that government programs that are in place [in Puerto Rico], such as the Nutrition Assistance Program (NAP, the Puerto Rican food stamp program) and disability insurance, can discourage work; while the U.S. program that encourages labor force participation – the Earned Income Tax Credit – is not a part of the tax system in Puerto Rico."

There is also the issue of fairness. In 2006, a Puerto Rican single head of a household with two children and earning $25,000 from work would have paid Social Security and Medicare taxes of $1,912.50. A person living in the states with the same income form work and the same family circumstances – perhaps the sister of the person in Puerto Rico – would also have paid $1,912.50 in Social Security and Medicare taxes. But the person living in the states would have received a tax rebate of $3,627 because of the EITC and CTC. Both start off with $25,000 in earned income. The person in Puerto Rico, after paying federal taxes, ends up with $23,087.50. The person in the states ends up with $26,714.50. (These figures were generated using TurboTax 2006.)

Beyond its impact on individual families – the improvement of their living standards and moving them from welfare roles to paid employment – extending the EITC and CTC would provide a significant stimulus to the Puerto Rican economy. The stimulus would be both direct, by increasing consumer demand, and indirect, by encouraging a higher labor force participation rate. The impact from the expansion of consumer demand alone could raise overall income on the island by as much as three percent. (See Appendix III regarding the basis of this estimate.) Together, the infusion of funds and the greater engagement in productive work would make a major contribution towards transforming the island's economy out of relative stagnation and onto a healthy growth rate.

The fact that Puerto Ricans on the island do not pay federal income tax has sometimes been cited to justify their exclusion from the EITC and the CTC. The effort to use this legal albatross – Puerto Rico's exclusion from the "domestic code" – to reject the programs' extension to the island is the predictable reaction of those who have a long standing prejudice against poverty alleviation efforts. In fact, many recipients of EITC and CTC do not pay any federal taxes simply because their incomes are too low. Furthermore, illustrating that there is no need to tie the credits to federal income tax payment, Puerto Ricans who have three or more children can claim the CTC by filing a federal tax form but paying no federal income taxes. The same procedure could be adopted for the EITC and for families with one or two children. It is, then, disappointing that the authors of the Joint Committee on Taxation's June 2006 report felt compelled to treat the fact that Puerto Ricans are not libel for federal income tax as a substantial argument against extending the EITC to Puerto Rico.

There is, however, an additional and different issue of fairness. Were these credits extended to Puerto Rico, the fact that Puerto Ricans do not pay federal income tax would make it necessary to enact an adjustment in their application on the island. In the states, when the income level of a family is high enough so that without the EITC and CTC the family would be paying some tax, the family's refund from these programs amounts to the credits minus the tax owed. Applied to Puerto Rico, where the family would not be libel for any federal income tax, the refund would be larger for any level of income (at higher levels of eligibility for the credits). It would seem appropriate, therefore, in extending the EITC and CTC to Puerto Rico that the refund be no greater than it would be for an equivalent family in states. In all the cost calculations discussed here, it is assumed that such a "cap" on EITC and CTC refunds would be enacted for Puerto Rico. (See the example in Appendix IV.)

As to costs, estimates of the impact of extending the EITC and CTC to Puerto Ricans on the island indicate that for 2006 the cost would be approximately $1.08 billion. As the Puerto Rican economy grows over the next decade, costs would decline slightly each year because a smaller share of families would be eligible for these tax credits. By 2015, the cost would drop to 0.95 billion; over the ten years 2006-2015, the total cost (in 2006 dollars) would be approximately $10.12 billion. (The details of the procedures for these cost estimates are explained Appendix I; the estimates themselves are set out in the Appendix Table I-A and Appendix Table I-B.)

These estimates would certainly require official scoring. But it should be noted that they are relatively conservative because they do not take into account the degree to which extending these programs to Puerto Rico would raise the rate of economic growth on the island, as noted above through both direct stimulus and greater labor force participation. More rapid economic growth would raise incomes and move many Puerto Ricans to positions where they would no longer receive (or need) these credits. Thus, in a sense, the extension of the EITC and CTC to Puerto Rico would in effect be partially self-financing.

Recent reports by the General Accountability Office and the Joint Committee on Taxation, as well as the recent volume published by the Brookings Institution and the Center for the New Economy, have clearly demonstrated the poor condition and weak performance of the Puerto Rican economy. The high rates of poverty and unemployment have been accompanied by low rates of investment, all indicating that without substantial changes the economic prospects for Puerto Rico are dismal. The policy of providing incentives to corporations through special tax treatment stopped working in the mid-1970s; in fact, globalization has rendered this sort of approach ineffective. The policy advanced here, which focuses on a direct work-stimulating set of incentives that also provides a macroeconomic stimulus, offers the promise of real progress. Extending the EITC and CTC to Puerto Rico will contribute immediately to the well-being of the Puerto Rican people and provide a longer-run foundation for economic growth on the island.

Appendix I: Estimating the Cost of Extending the Earned Income Tax Credit and the Child Tax Credit to Puerto Rico

1. As a basis for the cost estimates, data were obtained from the Puerto Rican Junta de Planificación and the *Statistical Abstract of the United States*. These data for Puerto Rico included:

- total personal income
- population
- number of families
- average family size
- number of families with children under 18
- number of two families with two married parents present and two children under 18
- number of families headed by a female with two children under 18

These data are not yet available for 2006. Estimates were obtained for 2006 by assuming that the growth rate of the previous two years was maintained (in the cases of personal income and population) and assuming that the proportional breakdown of the population did not change (for the other categories). These basic data for 2006 are listed in Appendix II below.

2. From "Development and Income Distribution: The Case of Puerto Rico" by Orlando Sotomayor (*World Development*, 32:8, 2004), data were obtained on income distribution by deciles for 2000. It was then assumed that the distribution of income was the same in 2006. Sotomayor's data are for households, they were used here as proxy for family income distribution.

3. It was assumed that families with two married parents present were spread across the income distribution in the same manner as families in general.

4. It was assumed that families headed by a single female parent were all in the bottom seven deciles of the income distribution, with one-seventh of these families in each of those decile groups.

5. With the data on total personal income and population, per capita income was calculated. Using data on average family size, average family income was obtained; this figure was multiplied by the number of families to obtain total family income (which was 90% of total personal income).

5. Using the figure for total family income and the distribution data, the total income received by each decile of the families was computed. Then, dividing this figure by the number of families in each decile, the average income received in each decile group was obtained.

6. For each such decile average, TurboTax for 2006 was used to calculate the federal refund that would come to each family (two parent and one parent families separately), with the assumption that all families had had two children. This average federal refund figure was then multiplied by the number of families in each decile category to obtain the total refund for each decile group.

7. The total refunds for each decile group – two parent and single parent – were then added to obtain the total refund for the year.

8. To obtain estimates for the remainder of the decade through 2015, it was assumed that population would grow at 0.5% per year, that per capita income would grow at 2.5% per year, and that the structure of the income distribution would remain unchanged.

Appendix Table I-A, "Estimates of Refunds Through EITC and CTC for Puerto Rico: 2006, 2007 and 2015," shows the calculations for 2006, 2007 and 2015. Refunds for other years were calculated in the same manner. Appendix Table I-B, "Cost of Extending the Earned Income Tax Credit and the Child Tax Credit to Puerto Rico, 2006-2015," shows the estimates of the total costs of the refunds for each of the ten years.

N.B. Please see Appendix IV below regarding the capping of the refunds in Puerto Rico.

Appendix II: Basic Data for 2006

Population	3,926,000
Families	1,035,028
with children <18	501,401
Married couples	703,849
with children < 18	347,582
Female headed families	276,750
with children <18	135,639
Average family size	3.41
Total Personal Income	51,846,000,000
Per capita income	13,206
Per family income	45,032
Total Family Income	46,609,000,000

Appendix III: Stimulus to the Puerto Rican Economy from Extending EITC and CTC to Puerto Rico

The preliminary estimate of GNP for Puerto Rico is 2006 is $56,688.4 billion. The $1.08 billion that would come to Puerto Ricans in EITC and CTC refunds would thus be 1.9 percent of GNP. Because these refunds would go to relatively low income families, it reasonable to assume that virtually all of it would be spent. Then, applying a moderate multiplier of 1.5 (moderate because of the high import coefficient for Puerto Rico) the resulting increase of GNP would be roughly 3 percent. (It should be noted that the inflow of the refunds themselves would be a transfer payment, and as such they would not count as a contribution to GNP.)

Appendix IV: “Capping” the Refunds in Puerto Rico at the U.S. Level

As pointed out above, on the mainland, when the income level of a family is high enough so that without the EITC and CTC the family would be paying some federal income tax, the family’s refund from these programs amounts to the credits minus the tax owed. Applied to Puerto Rico, where the family would not be libel for any income tax, the refund would be larger for any level of income (at higher levels of eligibility for the credits). The situation is illustrated by the following example:

In 2006, the average family in the 6^{th} (from the bottom) decile of the Puerto Rican income distribution would have an income (by the estimates used here) of $31,522. A family with this income on the mainland would have the following federal income taxes and credits:

Income	31,522
Taxable Income	8,022
Income Tax	803
CTC	803
Total Tax	0
EITC	1,437
Additional CTC	1,197
Refund	2,634

In Puerto Rico, however, there would not be any federal income tax liability. Therefore, if the EITC and CTC were applied, the family’s refund would be $3,437 (i.e., $803 + $2,634).

It would seem appropriate, therefore, in extending the EITC and CTC to Puerto Rico that the refund be no greater than it would be for an equivalent family in states. In all the cost calculations discussed here, it is assumed that such a “cap” on EITC and CTC refunds would be enacted for Puerto Rico.