Including Puerto Rico
in the
Earned Income Tax Credit and Full Child Tax Credit

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Puerto Rican island residents should receive the Earned Income Tax Credit (EITC) and full participation in the Child Tax Credit (CTC). Extending these programs fully to Puerto Ricans would provide an important stimulus to the expansion of the island's economy, both by a direct injection of funds and by their positive impact on labor force participation. Immediately and in their impact on participation and economic growth, these two programs would significantly alleviate poverty on the island. Also, making Puerto Rican residents eligible for these programs is essential so that U.S. citizens on the island are treated fairly with respect to U.S. citizens in the states. There is no good policy reason to maintain the status quo of exclusion of Puerto Rican residents from these programs.

The Earned Income Tax Credit (EITC) is not available to Puerto Ricans on the island, and the Child Tax Credit (CTC) is available to families in Puerto Ricans only if they have three or more children (whereas families in the states with any number of children are eligible for the CTC).

If Puerto Rican residents were made fully eligible for these programs, the results would include a substantial stimulus to economic growth and a significant reduction of poverty, both from the direct receipt of the credits by as many as 60% of families and from the expansion output and employment.[2] Economic growth and poverty reduction are prime goals of PROMESA. Moreover, with these programs available in Puerto Rico, a severe lack of fairness between the federal treatment of U.S citizens in the states and U.S. citizens in Puerto Rico would be eliminated. All this could be accomplished with minimal cost to the U.S. Treasury.

The Credits, Their Purposes, and Taxes

Residents of the states receive the EITC and CTC through filing their federal income tax returns. Puerto Rican residents, however, are not liable for federal income taxes and, thus, do not file federal income tax returns (unless they have income from sources in the states). The fact that Puerto Ricans island residents do not pay federal income tax has sometimes been cited to justify their exclusion from the EITC and the CTC. In fact, many (perhaps most) current recipients of EITC and CTC do not pay any federal income taxes simply because their incomes are too low. Also, the EITC was established in part to offset the regressive payroll taxes—the Social Security and Medicare taxes—for low-income families. Puerto Rican residents pay these federal payroll taxes at the same rates as do residents of the states.

Moreover, both the EITC and CTC were put in place and then 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.

There is, furthermore, no technical need to tie these credits to federal income tax filing and payment. Puerto Ricans who have three or more children can claim the CTC by filing a federal income tax form but paying no federal income taxes. A similar procedure could be adopted for the EITC and for the CTC for families with one or two children. Existing EITC and CTC legislation could be readily amended to accomplish the change.

Stimulus to the Economy

Beyond its impact on individual families – the improvement of their living standards and moving them from welfare rolls 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. When all eligible Puerto Ricans are applying for and receiving these credits (which could take a number of years), the direct stimulus could be as much as $1.8 billion per year. When multiplier effects are taken into account, the overall impact of the infusion of these funds would raise income by close to 4%. 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 onto a healthy growth path.

Labor Force Participation

It is especially important that the EITC has been designed to encourage people to participate in the paid labor force. The labor force participation rate has been below 50% since the 1950s, and has dropped precipitously during the current recession, standing just below 40% in 2015. (By way of comparison, the U.S. labor force participation rate, though it has dropped in recent years from its peak at the end of 2006, was 62.6% in 2015.) In its 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."

Beyond the impact of labor force participation on individuals and their families, raising the participation rate is a necessary part of raising the level of economic activity on the island. That is, stimulating labor force participation is a stimulus to economic growth.

Furthermore, Puerto Rico has a very large "informal" economy, where workers and firms pay local taxes only to a very limited extent, regulations are not in force, and activity is poorly tracked. With the EITC and CTC in effect for Puerto Rican residents, these programs would provide a strong incentive for workers to come out of informal activity because they could only receive the credits by reporting earned income. As a result, the informal economy would shrink, the tax base would be enlarged, and local tax payments would increase. Moreover, in moving from informal to formal activity, workers would tend to move to more productive activity.

Fairness

Because residents of Puerto Rico are not eligible for the EITC and CTC, while residents of the states are eligible, there is a substantial difference—a lack of fairness—in the income they end up with as a result of their interaction with the federal government. Consider two families whose members are all citizens of the United States. One family is in the states and one in Puerto Rico. Each consists of two parents and two young children. Both families have earned income of $28,000 in 2015. Each family pays $1,736 in Social Security taxes and $406 in Medicare taxes. Neither family has any federal income tax liability, the Puerto Rican family because it is not covered by federal income tax requirements and the family in the states because its income is so low.

The family in the states, however, receives an EITC of $4,622 and a CTC of $2000. Thus, after federal taxes and credits, this family has income of $32,480.

The family in Puerto Rico, not eligible for the EITC and CTC, after federal taxes and federal credits (i.e., none) has an income of $25,858.

The family in Puerto Rico, earning the same as the family in the states, and the same as the family in the states in terms of family members and earned income, has an income $6,622 less than the family in the states after both families' tax and credit interaction with the federal government. (In percentage terms, the family in the states has a 26% greater income than the Puerto Rican family after federal taxes and credits.)

A Caveat

While the current situation is unfair, as just pointed out, there is an additional and different issue of fairness that could arise were the EITC and CTC extended to Puerto Rican island residents with no adjustment to take account of the fact that Puerto Rican residents are not liable for the federal income tax. In the states, when the income level of a family is high enough so that the family would be paying some income tax, the family's refund from these programs amounts to the credits minus the income tax owed. Applied to Puerto Rico, where a family with the same earned income would not be liable for any federal income tax, the refund would be larger. In the example above of the two families, each with earnings of $28,000, this issue was irrelevant because at that level there would be no income tax liability for the family in the states.

However, if the level of earned income of these two families in 2015 had been $30,000, the family in the states would have had a federal income tax liability of $141. If the EITC and CTC had been extended to Puerto Rico in 2015, both families would have received a credit of $6,201, but the family in the states would have had to pay a federal income tax of $141. Thus after federal taxes and credits, the Puerto Rican family would have had a net income $141 greater than the family in the states.

It would seem appropriate, therefore, in extending the EITC and CTC to Puerto Rico that that total of these credits be “capped” at an amount equal to the credits less the federal tax that the equivalent family (in terms of income and structure) in the states would have received. (This would not involve any great complexity, but could be readily computed from the information the Puerto Rican family would have to provide simply to obtain the credits.)

Costs

Estimates of the impact of extending the EITC and CTC to Puerto Ricans on the island indicate that over ten years the costs would be approximately between $11 billion and $12 billion—or a somewhat over $1 billion annually on average. This estimate is based on the assumption that in the early years of implementation, many eligible Puerto Ricans would not take advantage of the credits but would “learn” to do so as time progressed. This estimate of costs is relatively conservative (i.e., on the high side) because it does 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 these credits. Thus, in a sense, the extension of the EITC and CTC to Puerto Rico would in effect be partially self-reducing.

The costs of extending these credits to Puerto Rico would be small compared, for example, to the costs that have been incurred by the U.S. Treasury (in terms of lost tax revenue) as U.S. firms operating in Puerto Rico took advantage of Section 936 of the U.S. tax code in the 1976 to 2006 period. In the late 1980s and early 1990s, when the program was at the center of economic policy in Puerto Rico, *annual* costs were running between $3.7 billion and $4.5 billion (in terms of 2016 dollars)[3]—that is, about four times as much as would be the costs associated with the EITC and CTC. And in terms of job growth, output expansion, and poverty reduction, the 936 program had very weak results.

As well as being a relatively inexpensive boost to the Puerto Rican economy, these credit programs would have a virtually immediate impact. The injection of funds would go directly to low-income families, who would tend to spend the money quickly.

And, finally, extending the credits to Puerto Rico would be relatively simple, requiring no new legislation but only an amendment of existing legislation.

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Since 2006, Puerto Rico has been suffering a severe recession. Moreover, for many years leading up to this recession, economic growth was slow. The high rates of poverty and unemployment have long been accompanied by low rates of investment, all indicating that without substantial changes the economic prospects for Puerto Rico are dismal. The policy advanced here, which focuses on a direct work-stimulating set of incentives that also provides a macroeconomic stimulus, offers the promise of making a major contribution to moving the Puerto Rican economy out of recession and onto a path of the real progress. What's more, fairness alone would argue for extending the EITC and full CTC to Puerto Rican residents.

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[2] The figure here for the percent of families affected and the figure provided below on the annual inflow of funds and the total costs of extending the EITC and CTC to Puerto Rico are based on an unofficial scoring of the effect of these programs.

[3] Estimates of the costs of 936 to the U.S. Treasury are from Angel L. Ruíz and Edwin Meléndez, "The Economic Impact of Repealing Section 936 on Puerto Rico's Economy," in *Economic Impacts of the Political Options for Puerto Rico*, edited by Edwin Meléndez and Angel L. Ruíz, Universidad Interamericana de Puerto Rico, San Germán, Puerto Rico, 1998, p. 126. ; P. Morrison, "Testimony before the Committee on Finance, United States Senate," April 26, 1990, p. 2, as cited by J. Tomas Hexner and Glenn P. Jenkins, "Puerto Rico and Section 936: A Costly Dependence," *Tax Notes International*, January 16, 1995, p. 236; and United States Department of the Treasury, "U.S. Possessions Corporations Returns, 1987," Tables 1 and 2, as cited by J. Tomas Hexner et al., "Puerto Rican Statehood: A Precondition to Sound Economic Growth," Hex, Inc., Cambridge, MA, 1993, pp. 25-26. Also, for a full discussion of the costliness of 936, see the 1995 *Tax Notes International* article by Hexner and Jenkins.