

## **THE RECENT TAX REFORMS IN PUERTO RICO (2005 – 2007) AND ITS PERCEIVED EFFECTS ON THE MIDDLE CLASS.**

By

Hernán A. Vera Rodríguez  
Professor of Public Administration  
Dean of the College of Graduate Studies in  
Behavioral Sciences and Community Affairs  
Pontifical Catholic University of Puerto Rico  
Ponce, Puerto Rico

### **Abstract**

Since 2005, Puerto Rico's legislative branch began a public discussion and debate about the need for a tax reform on the Island. Such a reform took place and resulted in several changes on the Puerto Rican income tax system and the establishment of a 7.0% sales tax known as IVU.

This paper presents the results of a research performed on a sample of middle class individuals from Puerto Rico, who were inquired about their perceptions of various aspects of the implementation of a consumption (sales) tax and about the changes on Puerto Rico's income tax system. Specifically, the research was aimed at determining the impact of such changes on middle class individuals' daily lives.

The results revealed that participants were divided regarding the necessity of the implementation of a sales tax (IVU), but a great majority perceived it as an unfair tax, and that it promotes inflation and economic stagnation on the Island. Similarly, and at a micro-social level, participants tended to perceive that the sales tax has had negative effects on their families' budgets and their savings.

With regards to the participants' perceptions about the income tax in Puerto Rico and the recent changes it had undergone, the majority of the participants perceived our income tax system

as unjust or unfair. In fact, a segment of the participants perceived that there is a double taxation system in place on the island, that there is tax evasion among the high classes, and that the tax system posed disincentives to work.

Finally, the need for further study of the result of the implementation of these policies and their potential to raise revenue are presented.

## **Introduction**

Since 2005, Puerto Rico's legislative branch began a public discussion and debate about the need for a tax reform on the Island of Puerto Rico. Such a reform would among other objectives: a) Eliminate a 6.6 % import duty that was included in the price of most goods, b) Increase government revenue by reducing the evasion of income tax and duties, c) Reduce income taxes, d) Reduce government spending, d) Reduce the government dependency on credit, and d) Improve the government credit.

Thus, Law Number 117 was approved on July 4, 2006. This statute established a 7.0% consumption or sales tax (known as IVU, Tax on Sales and Uses by its initials in Spanish) applied to most goods. Similarly, this law promoted a slight reduction on income tax rates, beginning in 2007.

During its first year of implementation, it was reported that the sales tax collections fell short approximately \$300 million from the state government forecasts (Gonzalez, 2007). This research paper explores the perception of middle class tax payers about the recent tax reforms in Puerto Rico.

## **Review of the Literature**

On his works on the *Laffer Curve*, this author (Laffer, 2004 ) points out that increases in taxes will increase tax revenue, up to a (inflection) point, and that from that point forward, further increases in taxes will in fact decrease tax revenue. On the other hand, and after examining the effects of a five (5) percent Value Added Tax increase in Mexico in 1995, Pagan, Soydemir and Tijerina – Guajardo (2001) concluded that the Laffer Curve did not apply to Mexico. Hence, the increase of the value added tax, indeed increased tax revenue in that country. Consumer (citizens) behavior seems to be at the heart of this relationship between tax revenue and sales or value added taxes. If taxes rise too much, consumers may postpone or reduce spending, which may in turn, reduce tax revenue.

For instance, Steel and Lovrich (1998) studied the determinants of the support for tax and expenditure initiatives in Oregon and Washington. By means of mail and telephone surveys, the researchers explored if various socio - demographic factors such as age cohort, gender, education, income level, occupational sector (public v. private); the level of informedness; perceptions of self interest; and various political indicators, including partisan identification, ideology, degree of cynicism concerning state politics, and perceptions of state budget waste were related to their support for proposed tax and expenditure initiatives in the aforementioned states. The results showed that the perceptions of high state waste and political cynicism were strongly associated with support for tax and expenditure limitation in Washington and opposition to the adoption of a sales tax.

In a related study, García - Molina and Gómez (2005) performed a time series analysis on data related to 23 tax reforms that took place in Colombia between 1973 and 2002. The source of the study's data was Colombia's National Bank. The series used were: tax income as a percentage of the Gross Internal Product, Net Tax Income and Net Tax Income Per Capita. The results showed that out of the 23 tax reforms, only two had had positive effects on the government ability to increase revenue. The authors point out that those reforms that were successful in terms of increasing government tax revenue were part of more complex fiscal and economic reforms. They also established that in order for a tax reform to be successful, it has to take into account the following variables: 1) the ability of tax payers to adjust or react

to changes in tax rates and, 2) the existence of a big informal and sometimes illegal sector in the Colombian economy, factors that may erode the government's tax base. Hence, their conclusions imply that tax payer's behavior may affect the government's ability to increase revenue solely by increasing taxes.

In a like manner, in a paper that explored the suitability of the establishment of a Value – Added Tax in various Eastern Caribbean Countries (the English and French Caribbean countries) Peters and Bristol (2006) highlight that as result of the globalization of the economy and the need to be competitive in the global market, most Caribbean countries “are moving toward a liberalized trade environment with low tariffs” and that tax reform is at the forefront of the policy response since traditional sources of tax revenue such as import duties are on the decline” (Peters and Bristol, 2006). In this environment, the authors point out; many Caribbean countries (like Puerto Rico) have adopted or are considering the adoption of a Value - Added or consumption – type tax. They also quote Bain's (2002) six preconditions for the implementation of VAT in small OECS (Organization of Eastern Caribbean States) countries, which are: political will, extensive and effective education campaigns, appropriate legislation, skilled tax administrators, adequate computer systems, and an effective auditing system. Similarly and after analyzing various economic variables of the 15 countries members of the OECS Peters and Bristol (2006) point out several elements that have to be considered before the establishment of a VAT in the Caribbean region, namely the regressive nature of a VAT or sales tax, it's possible inflationary effects and increased administrative costs, and the possibility of short term revenue shortfalls that it might produce in economies that have been dependent of import duties and tariffs for decades. Despite these cautions, they ended their paper by supporting the establishment of a VAT for OECS countries.

One of the most complex studies of the citizens' perceptions of their fiscal (specially the tax) system was developed by the Institute of Fiscal Studies of Madrid (2001). The Institute interviewed 1,500 participants that represented various sectors of the Spanish Economy, which were categorized for the analyses as: business owners, farmers, professionals, blue collar workers and unemployed. The survey also independently gathered data on the citizens, experts and employees of that Nation's Tax agency. It followed a qualitative design (structured interviews) and was not aimed at comparing the perceptions or opinions of those sampled groups. However, it presented a comparison of the opinions from 1995 through 2000. In present study only the results related to the citizen's perceptions of their tax system will be discussed.

Regarding their evaluation of the adequacy of the taxes paid and the availability of public goods and services, the majority of participants indicated that the services were not adequate to the amount of taxes paid. However, when they were asked about the public services or goods that justified paying taxes, most participants chose medical services and hospitals, highways, and public colleges and universities. Inquired about the redistributive nature of their tax structure, 50% of the sample perceived that their tax system promoted the redistribution of income. On the other hand, 45% noted that it did not properly redistributed income and 5% indicated that the system was going too far in promoting income redistribution. Importantly, the results show that the percentage of participants that perceived that their tax system was redistributing income have been increasing since 1995 (Institute of Fiscal Studies, 2001).

Also, and with respect to the tax system's ability to deter tax evasion and fraud, the majority of respondents (67%) perceived that tax evasion had either diminished somewhat or significantly. However, the participants indicated highlighted business owners and professionals

as the segments of society that had evaded taxes more frequently. Lastly, the study inquired about respondents' ability to understand tax (especially VAT) laws, rules and regulations. Interestingly, 55% of the sample revealed great or some difficulties understanding the legal framework that surrounds Value Added Tax in Spain (Institute of Fiscal Studies, 2001).

The present study used the Institute of Fiscal Study's of Madrid (2001) and to a lesser extension Steel and Lovrich's (1998) study as its framework for analysis of the perceptions of a sample of middle class individuals of the changes brought by Public Law 117 of July 4, 2006 to Puerto Rico. The research questions that guided this study were the following:

1. Do the participants consider necessary the implementation of a consumption (sales) tax in Puerto Rico?
2. Do they consider such a tax as fair or just?
3. What are the perceived effects of this tax on the island's economy?
4. What are the perceived effects of the reform on the participants' real income?
5. Do participants' consider that the sales tax has had an impact on their household budgets?
6. Which are some of the strategies that families have devised to deal with normal life expenses with less money on their pockets (if applicable)?
7. Do they perceive that the income produced (if any) increases the government efficiency and effectiveness?
8. Do participants' consider Puerto Rico's income tax system as fair?
9. Do they perceive that there is vertical equity in this Commonwealth's income tax system?
10. Do they perceive that the Commonwealth's income tax system horizontal equity?
11. How do they perceive the effects of the income tax system in their households' savings?
12. Do participants' perceive that the tax reform will improve their economic situation?

## **Methodology**

### **Participants**

Since the research was targeted at middle class people from Puerto Rico, the first intellectual exercise that researcher had to perform was to determine who was going to be sampled. Only economic criteria were used in order to determine a person's membership to a middle class in Puerto Rico. The criteria were the following:

- a) The person who was going to be interviewed had to belong to a family whose net annual income was between \$17,184 and \$50,000. This was decided for two reasons: first, the median family income in Puerto Rico for 2005 was \$17,184 (average family income was \$26,975) and that this segment of Puerto Rican society includes almost 40% of the families (US Bureau of the Census. American Communities Survey 2005: Puerto Rico).
- b) The person had to have filed tax returns in the previous year.
- c) The person had to have a job at the time of the interview.
- d) Had to live in the South or Western regions of Puerto Rico.

Participants were selected by availability and the students of the course PA 626 - Fiscal Policy and Budgeting at Pontifical Catholic University of Puerto Rico were given academic credit to schedule and perform such interviews.

### **Instruments**

The study's data was gathered through a structured interview which was comprised of 21 questions. The first seven questions inquired socio – demographic data such as the respondent's age, civil status, gender, household composition, amount of family members working, type of

industry, net annual family income, other sources of revenue, and the highest academic degree finished by all wage earners in the household. Later, four questions regarding the participant's use of government services (state and local) and their satisfaction with such services were included. Following, a series of open questions regarding participants' perceptions of various aspects of the implementation of a consumption (sales) tax in Puerto Rico (necessity, fairness, effects on the economy, effects on the family, etc.) were included. Also, a group of questions regarding the participant's perception on the changes on Puerto Rico's income tax system were included in the interview. Here, the perception of the fairness, vertical equity, horizontal equity, effects on the family, effects on the Island's economic development, etc. were measured by this section of the interview.

## **Procedure**

Students of the course PA 626 – Fiscal Policy and Budgeting at Pontifical Catholic University of Puerto Rico were trained to perform the interviews by the investigator. They were also instructed about informed consent policies and procedures for the investigation. Then, they were trained in the application of participants' selection criteria. Students were given academic credit for the data gathering tasks performed. They supplied the author with a list of the phone numbers (randomly organized) of the participants interviewed. Interviews were confirmed before academic credit was given to the student. Then, data was transferred to the SPSS – X (professional version 15.0) program. Simple descriptive and content analyses were performed on the participant's responses.

## *Results*

## **Socio – Demographic Variables**

The survey produced 24 valid interviews; 29.2% of respondents were male and 70.8% female. In addition, 25% were unmarried, 62.5 married and 12.5% divorced. The mean composition of the participants' households was three people ( $M = 3.00$ ,  $S.D. = .933$ ) and the average net monthly income was \$2,303.50 ( $M = 2,303.50$ ,  $S.D. = 738.03$ ). Also, the mean of people working per household was nearly two persons ( $M = 1.83$ ,  $S.D. = .917$ ). Similarly, the majority of respondents worked in the private sector (62.5%), while 29.2% worked in the government, 4.2% worked for not – for- profit organizations, and 4.2% were business owners. In terms of education, 8.3% had finished High School, 25% had an Associate degree, 37.5% a Bachelor's Degree, 20.8% a Master's and 8.3% a Doctorate.

Interestingly, 33.3% of the interviewed, reported that they do not receive any service from the state (Commonwealth) government, while 95.8% indicated that they receive services from the Municipal Governments, but at the same time mentioned that the services they receive from such level of government are related to waste collection and sports and recreation. Likewise, 54.5% of the participants pointed out that they were either totally unsatisfied or unsatisfied with the services provided by the state government, while only 47.6% were unsatisfied with the services provided by their municipal governments.

## **Perceptions and consumption (sales) tax**

When asked if the implementation of a 7.0% sales tax was necessary, 50% of the respondents said no, 37.5% answer on the affirmative and 12.5% provided a confuse or ambiguous response. The results of the content analysis showed that most respondents argued that the sales tax was not necessary and that was implemented without planning and

organization, that it established a system of “double taxation” and that it increased the cost of living. In addition, they pointed out that government inefficiency and the lack of visible public works make this sales tax unnecessary. Similarly 87.5% of the interviewees perceived that the implemented sales tax was unjust or unfair. Only 8.3% perceived it as fair and 4.2% provided an ambiguous or contradictory response. Most participants perceived that this sales tax was unfair because government waste, inefficiency and lack of proper planning were the real reasons beyond the government need for money. In a like manner, when asked about how they rated the average effects of the establishment of a sales tax, 78.3% of respondents evaluated the results as negative, while 21.7% rated them as positive. Their narratives point out at the inflationary effects of this type of tax. Indeed 83.5 % of the participants mentioned inflation as one of the main negative effects of the implementation of the IVU.

Moreover, the results reveal that 83.3% of the participants perceived that the implementation of the sales tax would not improve the island’s economy, while only 8.3% believed that it would improve it. Among the narratives with higher frequencies and interest, some participants highlighted that the government might have difficulties collecting tax revenue from businesses and that the use of the funds collected by this tax lacked transparency or accountability.

Also, and regarding the effects of the sales tax on household budgets, 100% of the participants perceived that it negatively affected it. The responses showed that consumers have been reducing their expenses since its implementation and that they perceive it as an additional household expense. Besides, 91.7% of respondents perceived that this new consumption tax has had negative effects on the savings of the household. On the other hand, 4.2% perceived that it

has had positive effects on their savings, while 4.2 % provided a contradictory or ambiguous response. When asked to explain their responses, most participants revealed that they were not able to save anything or that they were saving only a little since the implementation of the sales tax.

Moreover, 95.8% of the interviewees identified that they have had to make adjustments to cope with the additional expenses brought up by the implementation of the consumption tax, while 4.2% indicated that they have not have to make any adjustments. In fact, 37.5% of respondents revealed that they had limited entertainment expenses, and 29.4% indicated that they had limited their purchases and expenses in the last year as a result of the new tax. Interestingly, one participant pointed out that as a result of the increases in the cost of living her husband and she decided that he would quit his job and stay home with their kids. Another, stated that since the implementation of the sales tax, she has not had enough to give her kids lunch money for school.

### **The Income Tax: Participants' Perceptions**

With regards, to the participants' perceptions about the income tax in Puerto Rico and the recent changes it had undergone, it should be noted that 62.5% perceived this Commonwealth's income tax system as unjust or unfair, while 20.8% considered it as fair. In fact, of those who considered it unfair, 20.8% indicated that Puerto Rico's income tax system exploited the middle classes. Other arguments presented in the respondents' narratives were that there was a double taxation in place on the island, that there was tax evasion among the high classes, and that the tax system posed disincentives to work. One participant went further and expressed that was on a "forced diet" as a consequence of the tax system in Puerto Rico.

Posed with a question regarding vertical equity (Do you think that in Puerto Rico, people who earn more pay more taxes ?) 54.2% said “no”, while 45.8% said “yes”. Most participants that answered in the affirmative believed that the tax rate schedules provided by Puerto Rico’s Internal Revenue Department (Departamento de Hacienda) provide the system with the necessary amount of vertical equity. On the other hand, participants who answered it in the negative, tended to perceive that the income tax system in Puerto Rico posed disincentives to work and that vertical equity is not possible due to a high level of tax evasion among high classes.

Further and while asked, “Do you think that people with similar income levels pay similarly?” (Horizontal equity), 66.7% of the survey sample answered on the affirmative, 16.7% on the negative, and 16.7% were undecided. Participants who answered affirmatively tended to clarify that other circumstances in addition to income are taken into account to determine the amount of taxes, which provides the system with vertical equity. By contrast, tax evasion was highlighted more frequently among the participants that perceived that the system did not have horizontal equity.

With regards of the potential of the income tax to promote economic development, 16.7% of the interviewees indicated that it promoted the island’s economic development. In contrast, 62.5% perceived that it inhibited economic development, and 20.8% were not clear about the income tax effects on this variable. Among the explanations provided by participants, the legislative and administrative corruption was mentioned by 25% as a reason why taxes are not promoting economic development. In addition, other participants mentioned that the island’s income tax was not promoting economic development or was promoting economic stagnation.

Likewise, when asked if the income tax system affected their family's budget, 87.5% of respondents said "yes", 8.3% said "no", and 4.2% were undecided or provided an ambiguous answer. Most of respondents' comments were related to their perceptions of a double taxation system; some were looking for additional sources of income to cope with the tax system, and others that the money was not sufficient to cope with daily life expenses.

Similarly, 83.3% of the sample perceived that the income taxes in Puerto Rico were affecting their capacity to save, while 8.3% indicated that they didn't. On the other hand, 8.3% offered contradictory responses. Among the explanations provided by the surveyed, it was emphasized that the new tax system limited or eliminated their capacity to save. Indeed, 100% of the participants (even those who provided ambiguous responses) mentioned this in different ways.

Posed with the question, "Have you had to put in place any strategies or arrangements to pay your income taxes?" 52.2% answered in the affirmative, and 47.8% on the negative. Most of the respondents that answered on the affirmative stated that they had to negotiate payment plans with Puerto Rico's internal revenue agency (Departamento de Hacienda), utilize some of their savings to pay income taxes, and even get commercial loans to comply with their obligations with the state government.

In response to the last question of the interview, that investigated if the participants expected the tax reform to provide some economic relieve in the near future, 33.3% said "yes", 38.1% said "no", and 28.6% had doubts about this topic. Among the ones that expected economic relief most indicated that they hoped for that relief, although some indicated doubts about this possibility. Among the ones that indicated that they did not expect any relieve in the

near future, explanations were very diverse. They ranged from “we are worse than we were before” to those that pointed out that they did not believe in government reforms.

## **Discussion**

As the results have demonstrated, most of the participants perceived that they did not receive any services from the state government and only a few services from the municipal governments. However, they were more satisfied with the services provided by the municipal governments, than with those provided by the Commonwealth or state government.

In terms of the newly implemented consumption or sales tax, participants were divided regarding the necessity of its implementation, but a great majority perceived that it is an unfair tax, and that it promotes inflation and economic stagnation on the Island.

At a micro-social level, participants tended to perceive that the sales tax has had negative effects on their families’ budgets and their savings. In addition, most of them pointed out that they have had to make adjustments or implement strategies to cope with the increases in daily life expenses resulting from this tax. This is consonant with the warnings that Peters and Bristol (2006) gave regarding the implementation of consumption taxes in Caribbean countries.

With regards to the tax system, the majority of respondents perceived it as unfair. However, most participants perceived that it provides vertical equity, which is, according to them, is possible by the tax rate schedules established by the state government internal revenue agency (Departamento de Hacienda). On the other hand, most of them perceived that the system lacked horizontal equity. One of the main reasons for this is the perception of the pervasiveness of tax evasion, which was pointed out by Garcia – Molina & Gómez as one of the challenges for state government revenue collection. Similarly, most interviewees perceived that the tax system

did not promote economic growth, mainly because it does not provide incentives to work and because the perceived prevalence of government corruption.

Regarding its effects on the family, most participants perceived that the prevailing income tax system negatively affects their families, and that it reduces their savings potential. In addition, the majority stated that they had implemented strategies to pay their income taxes during the last year. Finally, participants were seemed to be unclear regarding the possible economic relief that the government promised before implementing these reforms.

The researcher concludes that there is a negative perception of the recent tax reform implemented in Puerto Rico. Specifically, interviewees perceived that both, the sales tax and the changes in the income tax have had negative effects on the family and the economy. Similarly they seem to perceive that the state government could have used other revenue raising strategies, besides putting additional financial loads to the middle class. People of middle class income seem to perceive themselves in a lose – lose situation, as they are struggling to meet their financial responsibilities and, on the other hand, they perceive that the government is not spending their tax dollars wisely.

As an analyst of Puerto Rico's public administration, it is our believe that the Government of Puerto Rico should begin a serious study of the tax changes brought by Public Law 117, specially its effects to the middle classes and its potential to increase revenue.

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