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The Economic Implications of Puerto Rico's Status Options First Part: The Congressional Debate, Industrial Policy and Tax related Incentives

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editor

The Interamerican University of Puerto Rico will soon publish (December 1997) a collection of essays by distinguished economists from Puerto Rico and the United States, concerning the economic implications of Puerto Rico's status options. The book, entitled "The Economic Implications of Puerto Rico's Status Options," edited by professors Angel L. Ruiz and Edwin Meléndez, will be summarized in this and the following Boletín de Economía (July-September 1997).

The project was financed by the Mellon Foundation of the United States, thanks to the dedicated effort of professors Angel L. Ruiz and William Baumol of the Interamerican University and New York University, respectively. The Center of Applied Economics, under the direction of Heidi Calero, conducted and supervised the work done for the project in Puerto Rico.

Most of the essays were completed between the years 1991-1993, and were directed at analyzing the economic implications that different political alternatives may have for Puerto Rico. The studies based most of its assumptions on the proposals presented by the Island's political parties and Congress, during the 1989-91 Congressional hearings regarding Bill S. 712 (see Javier Colon's first article in this bulletin). The harmonization of these assumptions (including scenarios) in the different operational models used permitted researchers, up to certain extent, to compare the results and simulations of their models.

The first finished results of these investigations were made available for public debate a few months before the plebiscite was held in Puerto Rico in September of 1993, allowing the most important conclusions, methodology and results to be discussed in diverse forums, and to be made known to the national and international news media. The essays were partially revised during 1994 and early 1995, permitting the introduction of whatever important economic changes occurring during those years, along with suggestions brought up at the various forums and presentations. One of the most important changes in the economy that occurred was the Omnibus Budget Reconciliation Act of 1993, submitted by President Clinton and approved by Congress in the middle of that year. This legislation substantially amended one of the articles of Section 936, limiting the contributive credit and thus making companies partially tax exempt (see the article by Eric Negrón Rivera in this bulletin).

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On one hand, it is interesting to note that while some of the work was finished in '94 and some in '95, most of the essays anticipated the possibility of the eventual elimination of Section 936 under Commonwealth. The alternative is discussed in the research, as is the elimination of Section 936 under Statehood. The elimination of Section 936 occurred a couple of years later, in August of 1996.

The status theme remains very much alive in Puerto Rico and actually is before the consideration of Congress in the form of the Young Bill (see Javier Colón's second article in this bulletin, this article is not included in the forthcoming book) which calls for a plebiscite in Puerto Rico in 1998. What therefore arises, before the forthcoming publication of the book of essays and the real possibility of another plebiscite in Puerto Rico, are those questions concerning the validity and applicability of the book to the actual situation in Puerto Rico. More to the point, in what respect do the themes analyzed in the essays and the most important results and conclusions, have validity and applicability to the actual situation in Puerto Rico.

At first glance there doesn't seem to be a lot of doubt concerning the relevance of the principal themes of the essays regarding the actual situation in Puerto Rico, although their order of priority must have changed. The situation doesn't seem that clear with the scenarios, the results and the conclusions, given the radical change in fiscal relations between Puerto Rico and the United States. It does refer to the elimination of Section 936 and the uncertainty of Section 30A. Finally, although the relevance of these essays is not in question, it is very important to evaluate the validity and the applicability of their results and conclusions in light of the present situation.

It ought to be clarified, that although the purpose of this introduction is not to evaluate the validity and applicability of the combined essays and their results with the actual situation at hand (this would require a more detailed essay; see the introductory article by Edwin Meléndez presented in the book), it is important to comment on the themes, premises, scenarios and the methodology used to be able to integrate, in as many ways possible, the diverse results and, moreover, to start examining these results

in the light of their relationship with the present-day situation.

The main themes of the research papers can be grouped as follows:

- The Congressional Debate of 1989-91 and the political and economic assumptions that can be derived from these proposals, counter-proposals and agreements (see Javier Colón's first article in this bulletin)
- A discussion of those tools and strategies of industrial policy that are either status-neutral or status-dependent (see article by Caludia Green in this bulletin).
- The tax-related industrial incentive possibilities and the possible trade-offs for Puerto Rico under each of the status options (see article by Eric Negrón Rivera in this bulletin).
- The estimate of the magnitude of change in corporate investment under Section 936 due to changes in federal tax benefits (see article by Edwin Meléndez and Jorge Blum in this bulletin).
- The potential impact of the repeal of Section 936 on Puerto Rico's economy. The relative importance of 936 corporations and how the elimination of these tax benefits may affect the Puerto Rican economy. The question of linkages in the 936 sector and the role that the government and business sector have to play to compensate for the demise of Section 936 (see Angel L. Ruiz and Edwin Meléndez article in the next bulletin).
- Economic changes - most notably, the new fiscal relations between Puerto Rico and the federal government that will result from any change in status. The interaction between additional federal funds, the number of Section 936 firms relocating, and federal taxes, would affect the revenues and expenditures of both the U.S. and the Puerto Rican governments as well as aggregate demand in Puerto Rico. This in turn would induce changes in economic growth, employment and wages. (see Jaime Bofill's article in the next bulletin).
- Examination of the impact of the possible changes in the way income is socially distributed on

industrial profitability, based on the technical conditions of production and the distributive variables (see Jaime del Valle's article in the next bulletin).

- Estimation and analysis of the economic impact of different economic flows between the Puerto Rican and the U.S. economies (see the article by Angel L. Ruiz and Fernando Zalacaín in the next bulletin)

- Changes in the political and economic relationships between Puerto Rico and the United States and its impact on labor migration (see the article by Carlos Santiago in the next bulletin).

The interrelated areas that make up the background of the research, such as the Congressional debate concerning status (Javier Colón), the industrial policies (Claudia Green), the tax-related incentives (Eric Negrón) and the overall theme that surrounds the sensitivity of 936 investment to changes in contributive benefits (Edwin Meléndez and Jorge Blum), form this first bulletin regarding the status question. These essays serve as a background, conceptual base and a source of information for those essays dealing with the scenarios and the simulations. The essays dealing with the scenarios are to be included in the next bulletin, and for that reason the description of the premises, the scenarios and the methodology, will be discussed in the introduction of the next bulletin.

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**The Congressional Debate on
Political Status (1989-1991)**

*José Javier Colón Morera**

In 1989, for the first time in history, the Committee on Energy and Natural Resources of the United States Senate considered legislation that would allow Puerto Ricans to express their political preferences in a Federally mandated vote on the future of United States-Puerto Rico relations.¹ The Senate Committee recommended such legislation favorably on August 2, 1989.² Between January 1989 (before the S. 712 was introduced), and the summer of 1991 (when Congress opted to abort the self-determination process) private and public conversations, consultations and negotiations took place between the U.S. Congress and the Island's political parties about those plans for Puerto Rico.

Considerable analysis resulted concerning the economic aspects of the alternative political choices (Independence, Statehood, or "enhanced commonwealth"). To date, it is still the most Comprehensive record on the subject. This essay reflects on the contribution which the failed 1989-1991 attempt made to define the probable political economic scenarios for Puerto Rico, in light of political developments that have occurred after 1991.³

To understand the 1989-1991 process and the new political developments caused by it, it is important to briefly review some key elements of the contemporary United States-Puerto Rico's history. In

1. S. 712, 101st Cong., 1st Sess. (1989).
2. S. Rep. No. 120, 101st Congress, 1st Sess. 23 (1989).
3. See: *Letter of Representatives Don Young, Elton Gallegly, Ben Gilman and Dan Burton to the legislative leaders of Puerto Rico*. The letter is dated February 29, 1996, 3 lines 3-9, *The San Juan Star*, 26 March 1996, 6. See also H.R. 3024 presented by Representatives Don Young and Chairman of the Committee on Resources and Elton Gallegly, Chairman of the Subcommittee on Native American and Insular Affairs and House Speaker Newt Gingrich, 7, lines 11-19.

1950 Puerto Ricans were allowed by the U.S. Congress to convene a Constitutional Convention and write their own Constitution to govern their local affairs.⁴ After the U.S. Congress made modifications, this new Constitution went into effect in 1952.⁵ Although a step in the direction of full self-government, the creation of the new Commonwealth (the literal English translation would be Free Associated State) did not end the debate on the final political destiny of Puerto Rico. Commonwealth did not substantially alter the U.S. Congress authority over Puerto Rico.⁶ Instead, it

4. Congressional authority over Puerto Rico was initially granted by the Treaty of Paris of 1898 (30 Stat. 1754) which mandated that Congress, among other things, determine the civil and political rights of Puerto Ricans. For an articulate presentation of the colonial nature of Commonwealth see: Rafael Garzaro, *Puerto Rico: Una Nación en Busca de un Estado*, Río Piedras: Editorial Universitaria, 1974. For a description of the historical context in which Commonwealth was enacted see: Vicente Geigel Polanco, *La Farsa del Estado Libre Asociado*, Río Piedras: Editorial Edil, 1972.

5. See: David Helfeld, "Congressional Intent and Attitude Toward P.L. 600 and the Constitution of Puerto Rico", 21 *Revista Jurídica de la Universidad de Puerto Rico*, 255 (1952). Luis Muñoz Marín, "Puerto Rico and the United States: Their Future Together", 32 *Foreign Affairs* 541 (1954); Puerto Rican Bar Association, "The power of the Congress to enter into a compact with the people of Puerto Rico and the legal status of the compact", 22 *Rev Col Abog P.R.* 341 (1962). For a recent revision of the basic legal doctrines regarding Puerto Rico see: Efrén Rivera Ramos, "The Legal Construction of American Colonialism: The Insular Cases (1901-1922)", *Revista Jurídica Universidad de Puerto Rico*, Río Piedras, 65, 2, 1996.

6. See: *Harris v. Rosario*, 446 U.S. 651 (1980) and Carlos I. Gorrín Peralta, "Historical Analysis of the Insular Cases: Colonial Constitutionalism Revisited", en Boughton, George and Leary, Paul Eds.,

Conference papers presented: A Time of Change: Relations between the United States and American Samoa, Guam, the Northern Marianas, Puerto Rico and the United States Virgin Islands, University of

created a whole new set of challenges.

Since then, all the efforts to alter the current political relationship between Puerto Rico and the United States have been ineffective⁷ due to the U.S. Government's lack of response to the specific proposals, despite multiple efforts on the part of the P.R. Government, and notwithstanding the U.S. Government's international and domestic formal commitment to respect the right of self-determination.⁸ The contradictory territorial policy of formal non-incorporation and greater economic integration has been a constant element of the U.S. policy towards Puerto Rico.⁹ Such policy, however began to be reconsidered during the administration of President James Carter.¹⁰

In this essay the author argues that political pressure is favoring major reassessments of U.S. policies towards Puerto Rico, both in the Island and in the U.S. Congress.¹¹ The pressure is coming from all

Guam and the Virgin Islands, 1994.

7. See: José Trías Monge, *Historia Constitucional de Puerto Rico*, Vols. I, II, III, IV y V, Editorial Universitaria, Río Piedras, 1980-1995.

8. On the importance of the self-determination concept in recent U.S. history, see: Daniel P. Moynihan, *Pandaemonium, Ethnicity in International Politics*, Oxford University Press, New York, 1993.

9. For the roots of such policy see: Lyman, Gould, *La Ley Foraker: Raíces de la Política Colonial de Estados Unidos*, Río Piedras, 1975.

10. Arnold Leibowitz, *Defining Status: A Comprehensive Analysis of United States Territorial Relations*, 1989.

11. In the congressional letter cited on note 2 the Republican congressional leaders recognize that: "Ultimately, Congress alone can determine Federal policy with respect to self-government and self-determination for the residents of Puerto Rico. It will not be possible for the local government or the people to advance further in the self-determination process until the U.S. meets its moral and governmental

political sectors dissatisfied with the U.S. Government's (specifically Congress as a body) failed attempts to meaningfully respond to the self-determination claims presented by 73% of the electorate in 1993.¹² This essay describes a critical phase of Puerto Rico-United States political relationship: the debate in Congress between 1989-1991. It focuses on the proposals of the three political parties (the pro-commonwealth Popular Democratic Party, PDP, the pro-statehood New Progressive Party, NPP and Puerto Rican Independence Party, PIP) during the failed congressional plebiscite process, and the congressional reactions to those. On the basis of this experience of consultations and negotiations the essay sketches future probable political-economic scenarios for the Island.

All the traditional political options under consideration faced very difficult obstacles for their implementation. In economic terms, the statehood option faced the challenge of convincing the U.S. Congress that it will not seriously disrupt the present economic structure and thus represent an additional significant amount of federal transfers. In view of the fact that this is an irrevocable political decision, statehood also has to demonstrate hegemonic electoral capabilities that it has never shown before. The three traditional Puerto Rican options faced only two alternate paths in the visions of Congress.

Independence, on the other hand, faced problems created by a historical context of forced economic dependency that has made Puerto Rican voters reluctant to sever the close economic ties with the United States. In addition the U.S. Government's

responsibility to clarify Federal requirements regarding termination of the present unincorporated territory status of Puerto Rico in favor of one of the options of full self-government." *Letter of Representatives*, 4.

12. After the 1989-1991 political status related congressional debates concluded, a political status consultation sponsored solely by the Commonwealth Government resulted in a virtual standoff between Commonwealth (48.8% of the total vote) and Statehood (46.7%) with Independence lagging behind with 4.5% of the vote. United States Government has, so far, failed to officially respond to the petitions raised by the 1993 plebiscite.

refusal to grant dual United States-Puerto Rico citizenship to those born after the proclamation of the new Republic makes this option electorally unattractive. There are signs, however, that such policy is being reconsidered at the present time.

Commonwealth supporters had great difficulty justifying its efforts to both obtain treatment as a state (parity of federal funds) and political tools reserved to sovereign nations (capacity to engage in international trade and tax treaties with developed nations). Congress seems reluctant to amend the current Commonwealth in such plainly contradictory directions. At the same time, Congress has been acting unilaterally to reduce the tax benefits enjoyed by U.S. multinationals located in Puerto Rico. These Section 936 alterations further erode the economic viability of the present Commonwealth and substantially reduced its political capacity as an hegemonic political proposal.

In the absence of an aggressive monitoring or steering process on the part of the U.S. Government, no decisive political change was expected. Traditionally the U.S. Government has invested too little politically in the effort to be a constructive partner in the consensus building process that is required to generate long-lasting and productive (for Puerto Rico and the U.S.) political change.

The 1989-1991 congressional record and public debate helps to evaluate the level of U.S. Government's receptivity to political change. However, support for any formula will depend in part on how well each of the political parties demonstrates, to the Puerto Rican people and the U.S. Congress, the economic viability of those scenarios. This consideration is paramount in view of the strong consensus regarding fiscal conservatism prevalent in the current political climate and among the United States' political elite and policy-makers.

Although a "fourth option," free-association, was not seriously considered in the U.S. Congress during the 1989-1991 period, this essay discusses the main points that define this option, since it has surfaced as an option to break the current political stalemate.

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The Congressional Debate, 1989-91 Federal Taxation

	Independence	Statehood	Commonwealth
Initial Request	Less costly formula for the federal treasury.	Gradual imposition of federal taxes	No formal estimation of costs
Congressional response		Full and immediate imposition of federal taxes	
Likely future response		Continuation of the revenue neutrality principle. Net transfers to the island would be nearly \$18 billion higher over the nine year period between 1992 and 2000	

Section 936

	Independence	Statehood	Commonwealth
Initial Request	a) In the context of S.712: Full application of the Section 936 benefits would remain for fifteen years after the proclamation of independence. b) In the House of Representatives: "a tax arrangement equivalent to those currently allowed pursuant to Section 936 of the Internal Revenue Code shall remain in full effect upon the proclamation of Puerto Rico's independence for no less than 10 years thereafter."	A long 25 year long gradual phase out.	
Congressional response	(S.712): Five year phase out. A joint commission, however, could negotiate tax treaties between the United States and Puerto Rico. In the S.712 report it is specifically mentioned that "under Independence unlike Statehood, the Section 936 credit would likely be replaced by a tax credit." The prospect of establishing these types of tax sparing treaties of other kinds of subsidy programs to secure the continuation of the 936 investment was very well received by Congress and by the multinational sector on the Island.	Five year phase out. The admission of Puerto Rico is delayed until all the tax benefits of Section 936 cease to exist.	
Likely future response	Rapid phase out of Section 936 and receptivity to the possibility of a foreign tax credit applicable for U.S. companies that remain doing business in the Island and qualify for such arrangement.	Rapid phase out	Major revisions to this Section of the Internal Revenue Code with possibilities of a significant reduction in the benefits granted. The specific content of those changes is not considered here,

Federal Assistance

	Independence	Statehood	Commonwealth
Initial Request	A transitional period "through an annual transfer block grant equal to the amount of grants, programs and services provided by the Federal government in Puerto Rico.	Parity in federal programs with the rest of the states.	Parity in federal funding with the 50 states like food stamps and Medicaid.
Congressional response	An amount grossly representing the current level of federal expenditure in the Island would be provided to the new Republic for a period of nine years as a block grant. The recent cost estimate of the amount is \$3,800,000 per year for a nine-year period without taking into account specific arrangements that would be made with regard to the Social Security program and other programs. Puerto Rico could ask for the continuation of these federal benefits after the expiration	Negative. The amount of federal funds to be available in the new state will be in direct proportion of the per capita income of the new state: In connection to bill, the Committee reexamined the parameters of the SSI and aid to the aged, blind, and disabled programs under current law. The Committee believes that it is appropriate to limit the amount of benefits for the aged, blind, and disabled under the Supplemental Security Income program of the Social Security Act to no more than 50 percent of per capita	
Likely future response	Positive	It could be part of the statehood formula that Congress is willing to consider based on the revenue neutral principle. It is less clear whether it would survive a congressional attack based on equal protection considerations after admission of the new state. The negative reaction is based in the following principle enunciated by the Finance Committee: The Committee has designed the amendment so that, if statehood is chosen, Puerto Rico will be treated in all aspects, after the day of admission to statehood, on an equal footing with the other States with respect to all matters within the jurisdiction of the Finance Committee.	Difficult to predict. Highly dependent on reforms in medical insurance area and the revision of Section 936 benefits.

**The "Young Bill":
Another turning point in the circle?**

*José Javier Colón Morera**

After the failed congressional attempt to have a congressionally sponsored plebiscite in Puerto Rico in 1991¹ new initiatives have emerged in Congress to try to "resolve" the Puerto Rico's political status question. The most important of such initiatives is HR 856² presented by Rep. Don Young (R-Alaska), the Chairman of the House's Natural Resources Committee. In this brief essay I intend to describe the main features of the bill and briefly discuss its content.

Although this bill was submitted by Young in January 1997 at the time of this writing³ there is going to be enough time to consider the issue in the 1997 House calendar. At the present time it seems that, once again, big expectations are created in Puerto Rico about a process of self-determination that continues to be postponed in a congressional agenda were other electoral issues that influence election or reelection of members of Congress take precedence.

The Young Bill's Contents

The "Young Bill" is a complex legislative proposal which defines, more than anything else, a procedure through which Congress would learn Puerto Rico's preferences regarding a set of options for changing the Island's present political status.⁴ The bill's

1. See: José Javier Colón Morera, *"The Congressional Debate on Political Status (1989-1991): Implications for a new Political-Economic Scenario for Puerto Rico"*, en *Economic Impact of Puerto Rico's Political Status*, Edwin Meléndez, Angel Ruiz, William Baumol (eds.), Editorial Universidad Interamericana, San Germán, 1997, a summary of which is included in the present bulletin.

2. United-States-Puerto Rico Political Status Act, HR # 856, February 1997.

3. September, 1997.

4. On different views or theories about the nature of ELA as a political status see: Antonio Fernós Isern, *Estado Libre Asociado de Puerto Rico* (San Juan:

stated public policy is to allow the Puerto Rican people an opportunity to express itself about its political choices before December 31, 1998⁵ and to achieve what is described as full self-government options.⁶

Those full self-government options are statehood, which provides sovereignty within the U.S. Government, or independence and free association which provide for separate political sovereignty outside the federal political structure.⁷ The proposed law enables Congress to promote a status referendum through which Puerto Rican voters could choose among several political status alternatives the essentials of which are defined by Congress.

Once the referendum is voted on, Congress would decide if the winning option is or not viable or desirable on the basis of U.S. Government interests and perspectives or under which specific conditions it would be acceptable to Congress.⁸ If a "full self government option" is chosen, then the transition phase

Editorial de la Universidad de Puerto Rico, 1974) Carmen Ramos de Santiago, *El gobierno de Puerto Rico*, (San Juan: Editorial de la Universidad de Puerto Rico, 1984); Rafael Garzaro, *Puerto Rico; una nación en busca de estado*, (Madrid: Editorial Tecnos, 1980) The latter book has been published under a revised edition under a different title: *Puerto Rico: colonia de los Estados Unidos*; José Trías Monge, *Historia Constitucional de Puerto Rico*, Editorial de la Universidad de Puerto Rico, San Juan, 1983-1994. A recently published discussion on the myths and realities surrounding the concept of Estado Libre Asociado is found in Angel Israel Rivera, *Puerto Rico: Ficción y mitología en sus alternativas de status* (San Juan: Ediciones Nueva Aurora, 1996).

5. HR 856, Sec. 4 (a).

6. HR 856, Sec. 3.

7. HR 856, Finding 15 and Sec. 3 (A). In contrast see definition of Commonwealth included in Section 4 (a).

8. HR 856, Sec. 4. This section provides for a ten year period to conclude the process towards full self-government.

towards a new political status could begin.⁹ Under HR 856 such transition would take no more than ten years.¹⁰

If, however, the voters choose to stay with the present Commonwealth, periodic referendums would be held in Puerto Rico "not less than once every 10 years" but the President still has the option of submitting a plan to complete the self-determination.¹¹

After achieving a majority in favor of full self-government, the President shall send Congress legislation for a transition plan to provide for a permanent political solution and providing for a smooth transition period.¹² Congress is mandated to give fast track consideration to such plan.¹³ Puerto Rican voters must approve such transition plan by majority vote. If the transition plan is accepted, the bill would mandate the President to submit a joint resolution with a recommendation for the date of termination of the transition period and the date of implementation of full self-government.¹⁴ If rejected, the bill provides for a consultation process to decide alternate routes.

Contrary to the legislation proposed and discussed in Congress during the 1989-91 process¹⁵, the Young Bill does not focus so much on the contents of the definitions of alternative formulas for United States-Puerto Rico future political relations. In 1996, when the Young Bill was considered as H.R. 3024, the

Committee on Natural Resources of the U.S. House of Representatives indicated in its Report accompanying the bill that *ELA* is a territorial condition not acceptable—juridically or politically—for the U.S. Government.¹⁶

This legislative proposal established that its purpose was to promote the termination of the current territorial relationship represented by the *ELA* through a process that would be initiated as soon as an electoral majority in the Island selects a decolonizing option under the terms previously described.

In other words, according to the terms of this legislation, the congressional process on Puerto Rico will not cease until *ELA* is destroyed and may give way to a "decolonizing solution". As expected, the main leaders of the pro-Commonwealth *Partido Popular Democrático* (PPD), are upset. Their vehement opposition is easily understood. For the first time in Puerto Rico's modern history these leaders find themselves in a defensive position within the context of a congress which is generally indifferent, at best cautiously receptive, and frequently openly hostile to their ideas for the maintenance or reform of the *ELA*. Forced by the events the PPD is making an offensive in congressional circles which is neutralizing the pro-statehood efforts made by the very effective pro-statehood lobby.

It is important to note, however, that this legislation is not self-executing in nature as was intended with S. 712 in the U.S. Senate during the 1989-91 process. Now, under the "Young Bill", Congress will have the last word on any changes proposed in Puerto Rico's political status. This is a very important aspect of the proposed legislation.

The present congressional initiative -as submitted at the time of this writing¹⁷- is clearly geared

9. See the transition stage in: HR 856, Sec. 4.

10. HR 856, Sec. 4, (b).

11. HR 856, Sec. 5, (c) (1).

12. HR 856, Sec. 4.

13. HR 856, Sec. 6.

14. HR 856, Section (4) (c).

15. José Javier Colón Morera, *"The Congressional Debate on Political Status (1989-1991) : Implications for a new Political-Economic Scenario for Puerto Rico"*, in *Economic Impact of Puerto Rico's Political Status*, Edwin Meléndez, Angel Ruiz, William Baumol (eds.), Editorial Universidad Interamericana, San Germán, 1997.

16. Report of the Natural Resources Committee on the United-States-Puerto Rico Political Status Act, H.R. 3024, 1996. See also Letter of Representatives Don Young, Elton Gallegly, Ben Gillman and Dan Burton to the legislative leaders of Puerto Rico, February 29, 1996.

17. The author recognizes the efforts of some members of Congress, like George Miller (D-California) to define the Commonwealth formula in terms that would

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to achieve of a pro-statehood majority in the proposed referendum. This is so because it presents the Puerto Rican people a choice between a path leading to statehood -with a guarantee for the retention of U.S. citizenship for the inhabitants of the Island and an offer of fiscal parity with the other fifty states in terms of federal expenditures- and an alternative path leading to a separate sovereignty for Puerto Rico either under free association or complete independence. Both independence and free association are defined as "sovereign options" but with little precision regarding their specific characteristics.¹⁸ The present commonwealth is defined as a non-incorporated territory subject to broad congressional powers.¹⁹

As it was presented in February, 1997, one of the main flaws of the "Young Bill" is that independence and free association seem to be almost identical options, although independence explained in more detail than free association.²⁰ Their differences are not adequately defined and they are both depicted as a political condition under which Puerto Rico would have a "separate sovereignty". The specifics of free association would be subject to future negotiations with the U.S. Congress based on the signing of a bilateral

be acceptable to the Popular Democratic Party. Those negotiations are however, inconclusive at this point. PPD leaders have publicly denounced efforts being made by Resident Commissioner Romero Barceló to define Commonwealth in an effort to discredit this formula.

18. The current "Young Bill" has avoided being specific as to the contours of statehood, specially in terms of the nature of the economic transition towards full taxation and the extent to which Federal programs will benefit the population of the new state. This could change in the future because both the Senate and the House have asked the political parties to submit their

pact terminable at will by both Puerto Rico and the United States.²¹

Right now many Puerto Ricans are uncertain and are debating about the possible decision of the U.S. Congress regarding U.S. citizenship for Puerto Ricans under free association.²² Under the Young Bill's explicit terms those already possessing U.S. citizenship at the time of independence or free association would retain it while Puerto Ricans born after the proclamation of the new republic or associated state would have a new Puerto Rican citizenship.

The citizenship issue could make it very easy for the pro-statehood *Partido Nuevo Progresista* (PNP) -currently in control of the Island's government- to design a referendum campaign claiming that the real option is between the retaining of U.S. citizenship under statehood and its elimination under independence as well as under free association.²³ Both, free association and independence, would be depicted by the PNP as forms of "separation from the United States", as distinct versions of the same essential status: independence. At the same time, the citizenship under *ELA* would be labeled as a "second class" statutory citizenship as described in the Young Bill.²⁴

For anyone knowledgeable about the main characteristics of Puerto Rican political culture, it would be obvious that, under such conceptual representations, statehood would be the preferred

21. H.R. 856, Section 4 (a).

22. H.R. 856, Section 4 (a) states that United States sovereignty, nationality and citizenship in Puerto Rico is ended". Those who are currently citizens would

Rico should become fully self-governing through separate sovereignty in the form of independence or free association....", as in HR 856, Section 4 (a).

Testimony of Howard Hills, Subcommittee of Ins Affairs, 1996.

24. H.R. 856, Section 4 (a).

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As it was presented in February, 1997, one of the main flaws of the "Young Bill" is that independence and free association seem to be almost identical options, although independence explained in more detail than free association.²⁰ Their differences are not adequately defined and they are both depicted as a political condition under which Puerto Rico would have a "separate sovereignty". The specifics of free association would be subject to future negotiations with the U.S. Congress based on the signing of a bilateral

be acceptable to the Popular Democratic Party. Those negotiations are however, inconclusive at this point. PPD leaders have publicly denounced efforts being made by Resident Commissioner Romero Barceló to define Commonwealth in an effort to discredit this formula.

18. The current "Young Bill" has avoided being specific as to the contours of statehood, specially in terms of the nature of the economic transition towards full taxation and the extent to which Federal programs will benefit the population of the new state. This could change in the future because both the Senate and the House have asked the political parties to submit their desired set of definitions of their respective formulas.

19. HR 856, Section 4 (a).

20. HR 856, Section 4 (a). In fact the ballot proposed by this bill would ask voters if they prefer that: "Puerto Rico should become fully self-governing through separate sovereignty in the form of independence or free association....", as in HR 856, Section 4 (a).

pact terminable at will by both Puerto Rico and the United States.²¹

Right now many Puerto Ricans are uncertain and are debating about the possible decision of the U.S. Congress regarding U.S. citizenship for Puerto Ricans under free association.²² Under the Young Bill's explicit terms those already possessing U.S. citizenship at the time of independence or free association would retain it while Puerto Ricans born after the proclamation of the new republic or associated state would have a new Puerto Rican citizenship.

The citizenship issue could make it very easy for the pro-statehood *Partido Nuevo Progresista* (PNP) -currently in control of the Island's government- to design a referendum campaign claiming that the real option is between the retaining of U.S. citizenship under statehood and its elimination under independence as well as under free association.²³ Both, free association and independence, would be depicted by the PNP as forms of "separation from the United States", as distinct versions of the same essential status: independence. At the same time, the citizenship under ELA would be labeled as a "second class" statutory citizenship as described in the Young Bill.²⁴

For anyone knowledgeable about the main characteristics of Puerto Rican political culture, it would be obvious that, under such conceptual representations, statehood would be the preferred

21. H.R. 856, Section 4 (a).

22. H.R. 856, Section 4 (a) states that United States sovereignty, nationality and citizenship in Puerto Rico is ended". Those who are currently citizens would continue to be so as long as they do not maintain allegiance with of other sovereign nation.

23. This was the strategy suggested by Howard Hills to promote the statehood as an option in Puerto Rico. See: Testimony of Howard Hills, Subcommittee of Insular Affairs, 1996.

24. H.R. 856, Section 4 (a).

option of Puerto Rican voters by an ample margin.²⁵ Still if *ELA* ends up winning by a majority vote, the net result of such a victory would be just a postponement of a final decision.

The "Young Bill", in addition, does not permit Puerto Ricans residing in the Continental United States to vote in the referendum. The rules for electoral participation would be those usually applied to internal general elections in Puerto Rico; i.e. permanent official residence in the Island.²⁶ Under such rules U.S. Island's residents, having only a temporary relationship with Puerto Rico could have a say about Puerto Rico's political future while *bona fide* Puerto Rican nationals who were mostly forced by economic circumstances to migrate to the United States would be excluded.

Although in the past Puerto Rican political parties have not wholeheartedly supported to date the idea of promoting the electoral participation of Puerto Ricans residing in the United States in a future referendums, the claim for participation is not likely to disappear. The three members of Congress with Puerto Rican roots: José Serrano, Luis Gutiérrez and Nydia Velázquez are actively pushing in favor of such participation. *Acción Democrática Puertorriqueña* (ADP), a non-governmental group favoring sovereign free association as the best status option, has insisted on the right of Puerto Ricans residing in the U.S. mainland to vote on any future status consultation in 1998.²⁷ The Popular Democratic Party officially supports such voting participation and the Puerto Rican Independence (PIP) now also favors it. On the other hand, the pro-statehood NPP is adamantly opposed.

The "Young Bill" could have an important permanent impact upon the course followed by the Puerto Rican status question. If the U.S. Congress, following on the procedure suggested by the bill, favors

a transition towards statehood, Puerto Rico could become, by congressional act, an incorporated territory of the United States. Once this happens, the process conducive to statehood could then become practically irreversible. This is so in view of the American tradition considering territorial incorporation as a first step leading to eventual membership in the federation as a state of the union.²⁸

Political sectors favoring sovereign free association in Puerto Rico have argued that when the "moment of truth arrives" Congress would reject annexation and offer in instead free association. Hence, these groups have supported the "Young Bill" process so far.²⁹ This strategy has been labeled as "playing Russian roulette" by pro-independence leader Juan Mari Bras who warns that the right to free determination and independence of the Puerto Rican people might end up the victim of a "lonely bullet".

Another pro-independence leader, Rubén Berríos Martínez, PIP President, has supported the process initiated by Young but has insisted in the need to substantially amend this initiative. In a position similar to that held by promoters of free association, Berríos believes that Congress will eventually reject statehood and adopt some form of "separate sovereignty" for the Island.³⁰

28. It should be born in mind that the U.S. Supreme Court in *Balzac v. Porto Rico* decided that the incorporation of a non-incorporated territory such as Puerto Rico had to be explicit and not subject to any other interpretation. That means that the congressional intent to incorporate should be stated clearly in the law. The reason for this requirement is to prevent a possible admission of a new State such as Puerto Rico without due and proper political deliberation. See *Balzac v. Porto Rico*, 258 US 298 (1928) in Raúl Serrano Geyls, *Derecho Constitucional de Puerto Rico y Estados Unidos*, Colegio de Abogados de Puerto Rico, San Juan, Puerto Rico, 1988, pp. 472-479.

29. Juan Manuel García Passalacqua, Testimony before the Natural Resources Committee, March, 1996, San Juan Puerto Rico.

30. See: Rubén Berríos Martínez, "Definición y convergencia", *El Nuevo Día*, November de 1996, p. 63.

25. Marty Gerard Delfin, "Poll: Statehood would win status plebiscite now", *The San Juan Star*, January 22, 1997. p. 9.

26. *United States-Puerto Rico Political Status Act* H.R. 856, Section 4.

27. See Leonor Mulero, "Abogan por los boricuas en EE.UU.", *El nuevo día*, January 23, 1997, p. 7.

If the President of the PIP is correct or not remains to be seen. What is obvious at the present time is that, as it is now, the "Young Bill" strolls in a direction which seems to be the opposite to one that would actually favor the procedural and substantive consensus that needs to be fashioned in Puerto Rico, in the United States and within the international community, in order to grant a final or enduring solution to "the Puerto Rican issue".

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**Industrial Policy for Puerto Rico and
the Implications of Political Status**

*Claudia Green**

Introduction

While the debate over Puerto Rico's political status continues, there is general consensus among policy makers that changes in local and global economic conditions demanded new integrated approaches and new tools to strengthen the economy. Across the political spectrum, policy makers, planners and others recognized that it was no longer sufficient to tinker with existing economic development programs, but that they must rethink the concept of industrial policy altogether. Puerto Rico's industrial policy today must be as dynamic as the internal and external conditions it is designed to confront. It should be geared toward a vision of a Puerto Rican economy that is integrated and competitive on the global scale, but that it is also strong and diverse at the local level and can successfully retain profits on the Island. As a foundation, it should have education and training, research, financing, and marketing strategies that sustain economic growth.

Above all, policy should support a vision of Puerto Rico in which the quality of life at home continues to improve, and a basic standard of living and equity of economic opportunity is guaranteed to all. Given the loose consensus around the need for change and the ever pervasive question of status in economic policy making in Puerto Rico.

It is the purpose of this study to 1) assess the strengths and weaknesses of the Puerto Rican economy and establish a set of industrial policy goals based on that assessment, 2) present specific policy tools designed to realize those goals, and 3) indicate the role of status in Puerto Rico's ability to design and carry out policy. As I will demonstrate, the tools available in certain areas, such as the attraction of foreign capital, are distinct under Commonwealth, Statehood or Independence. *Specifically, to the extent that trade and tax policy weigh on the success of industrial policy, status is an important factor.* In other areas, however, such as the development of local capital and the strengthening of the Island's capacity to develop new production

technology, political status need not be a determinant of success. Indeed, by shifting the focus of its industrial policy from relying on the attraction of foreign capital to developing human and technological capacity, Puerto Rico makes itself less dependent on a particular status.

It is *not* our purpose to discuss the attributes of one status configuration over another, nor to answer the oft-raised question of which comes first: status or economic change? Rather, we endeavor to demonstrate ways in which Puerto Rico can improve its performance on the international stage, and the quality of life at home, and to determine how status can affect the pursuit of the policies presented.

Methodology

The methodology is consistent with the goals of presenting specific policy alternatives and determining how status matters. I first develop an analysis of the economy, based on current economic literature on Puerto Rico (multiplying exponentially due to the recent debates on the status and federal tax incentive issues). I then turn to strategies developed in Puerto Rico to respond to the needs of the industrial sector, as well as policies adopted by other small, newly industrializing countries, and by U.S. states. Interestingly, it is relatively common to affect comparison with other small nations, however attempts to draw comparisons or learn from the states has been minor. Perhaps the only exceptions are the studies of the Hawaiian economic development model.¹ Yet for reasons I will describe later, I believe that the economic challenges facing the states today merit consideration.

The use of non-Puerto Rican examples must be done with caution. That is, there are certain economic changes, such as the heightened pace of technological innovation and the new mobility of capital, that have universal effects. In these cases, examples from a range of economic entities — states, possessions, or independent nations — regarding the ways they have confronted these changes are useful. On the other hand, there are particulars of the Puerto Rican economy, such as its heavy reliance on U.S. investment and markets, which place limitations on the relevance of some models. Thus, when considering ways in which Puerto Rico might strengthen its local economy, for example, it is more

instructive to look at Singapore, which has had little control over foreign investment, than at Taiwan, which has long been able to exert control in this area.²

The examples drawn from independent nations and from states are useful, not only in that they expand the range of options, but also because they assist in the consideration of status.

New conditions warrant new strategies

For more than four decades, the main pillar of Puerto Rico's industrial strategy has been the attraction of U.S. manufacturing investment through a combination of local incentives and federal tax exemption. That strategy is unique to Puerto Rico's current political status in that it exploits a tax benefit extended only to U.S. companies operating in U.S. possessions.

The relative importance of Section 936 on the Puerto Rican economy — specifically on job creation — is a much-discussed issue. The change in the type of company that took take advantage of Section 936, less labor-intensive and more technology and capital-intensive has resulted in fewer jobs generated. The U.S. company coming to Puerto Rico today is often high tech and high profit.

But serving as a tax-free zone for U.S. companies has not come without costs. Puerto Rico has found that other industrializing countries in Asia, Latin America and the Caribbean could offer similar if not better benefits to foreign investors, either as low-wage or low-tax locations. These developments around the world make the arrangement between Puerto Rico and the United States less competitive.

Moreover, it is widely agreed that continued dependence on the U.S. Congress to sustain Puerto Rico's principal means of attracting foreign investment makes for excessive uncertainty. Indeed, the profitability of the typical U.S.-owned firm in Puerto Rico has landed Section 936 on Congress' chopping block several times during the last decade and a half, and most recently in 1996.³

The recent reduction in Section 936 benefits indicates that this policy tool could easily be altered or completely eliminated in the near future with or without a change in status. Thus long-term

alternatives and emphasis on the local economy are in order.

Changes on the international stage

Dramatic changes in production worldwide have had a significant impact on Puerto Rico. Advances in technology and communications allow multinational companies to transmit data, capital, production plans and orders immediately from one location to another. The new freedom of capital has heightened the competition for foreign investment and for markets. Multinational corporations are able to break up production, and take advantage of world labor markets to generate the highest return.

For Puerto Rico, this trend has led to greater dependency on Section 936, as evidenced by the pharmaceutical companies, which have chosen Puerto Rico for its tax scheme as a place to carry out their production operations. With the future of Section 936 uncertain, many of these companies have threatened to leave the Island in search of another tax haven. Competition has arisen from other small and medium-sized countries such as Singapore, Taiwan and South Korea, that have industrialized rapidly by focusing on exports and offering low labor costs and tax benefits to investors.

The decline of the U.S. role in the international economy is also affecting Puerto Rico. With the economic rise of Japan and its Asian neighbors, and the European Community, the United States no longer enjoys the world economic dominance it once did. This, in turn, affects Puerto Rico because of its dependence on the U.S. economy.

The expansion of "free trade" through such treaties as the General Agreement on Tariffs and Trade (GATT), the Caribbean Basin Initiative (CBI), and the North American Free Trade Agreement (NAFTA), has driven down the value of the privileged status Puerto Rico has in terms of access to U.S. trade markets. Predictions of the impact of NAFTA embody the global changes facing Puerto Rico. NAFTA will give Mexico free access to U.S. markets, serve as a new domestic market for the United States, and provide new access to natural resources and low-cost labor — all areas in which Puerto Rico has at one time or another relied on to sustain U.S. investment.

Production itself is changing. Today, knowledge and technology are expanding. Short-run, "flexible" production is replacing mass production, with industries attempting to achieve "economies of scope," rather than "economies of scale." According to Lockwood, the countries that will have an advantage in the world of flexible production will be those that save and reinvest in their businesses; adopt and generate new technology; have strong networks of internal marketing and export; can easily adjust their product lines to market changes; have superior communications and cooperation among management, engineers and marketing; and those that have the support of the state to achieve these goals (Lockwood, 1990).

This list runs contrary to a Puerto Rico heavily dependent on U.S. investment in mass production, attracted by tax breaks. Companies operating in Puerto Rico under Section 936, like U.S. companies in general, are under great pressure to yield short-term, high profits, rather than make long-term investments in technology, training and the development of markets. Further, production is dispersed around the world in such a way as to discourage close cooperation among engineers, production line workers and marketers, and hinder rapid response to changes in demand.

The pace of technological change in the international economy also places new demands on Puerto Rico. With the time between the research stage and commercial application of new products and production technologies dramatically reduced, Puerto Rico must play a more active role in adapting, developing and applying technology in order to remain competitive. Not only do industries new to Puerto Rico need to have state-of-the-art production methods, but existing ones, too, must modernize and be able to keep abreast of rapid changes in product demand. Entrepreneurial training, technical assistance to some businesses, capital and support from research institutions are all in order (Osborne, 1990).

Perhaps the most important implication of this new scenario is that the skill and knowledge base of Puerto Rico's human resources will be a key determinant in the Island's economic future. New developments such as NAFTA and changes in production and in the distribution of labor make acute

the need to ensure a place for Puerto Rico in the high skill, high wage economy.

Adaptation to new short-run production strategies may indeed be an order a small-scale economy such as Puerto Rico can fill, but only with a commitment to investment in technology and training, and support from government, financial and educational institutions. "Flexibility" from the labor force requires basic skills on which to base the acquisition of changing specific skills, as well as guarantees that technological transition will not result in displacement. It requires ongoing worker training, and public and private support for employment security. The demand for modern production technologies also requires strong government leadership.

Taking a comprehensive approach to industrial policy

Puerto Rico is not alone in feeling the effects of globalization and the pressure to develop and redirect policy. The changes in the global economy described here have affected state and national economies alike. In addition to contending with a decreased federal role in economic development, states have found that competition for jobs and economic growth lies not only across the state line but also on the other side of the globe.

Like Puerto Rico, U.S. states and developing countries have come to reconsider the use of tax breaks as the backbone of an economic development strategy. Literature on economic development in the United States indicates that as states have become more active in the field of economic development, they have adopted strategies that rely less on industrial recruitment through tax breaks, and more on strengthening their own entrepreneurial climate and existing industry. This is not to say that states are no longer offering tax incentives to business. On the contrary, the Council of State Governments reports that the number of states offering incentives has increased in recent years, and it is the majority of states that do provide tax and financial incentives as a way to compete with other states for industry. Yet such a trend does not bode well for the long-term effectiveness of this strategy: the more tax breaks, the less attractive and effective is each on its own (Walker, 1989).

While past studies have shown that incentives have no positive statistical impact on job creation, states use them because they are important in business ranking of locations. The federal government, as well, has long pondered the idea of creating "enterprise zones" in order to attract investment to impoverished urban areas. Business that agreed to locate in desiquated zones would be granted special tax reductions and relief from regulations. Legislation to create enterprise zones still being considered in Washington. (Leviatan and Miller, 1992). Notably, the enterprise zone concept has been raised by proponents of Puerto Rican statehood as a means for the new state to attract investment.

At the international level as well, nations in the process of industrialization rely heavily on tax-reducing arrangements to attract and maintain industry. Tax-sparing agreements and "tax holidays" encourage both foreign and domestic investment in selected countries (Negrón Rivera, 1993).

Yet to an ever-greater degree, incentives today are used as part of a comprehensive economic strategy, not alone. State level experience with tax-related incentives to attract direct foreign investment show that policies to improve the job skills of residents, infrastructure and business services, and to reduce crime were equally if not more important to business attraction and to the promotion of economic growth in a given location (Leviatan and Miller, 1992). As a result, while tax incentives continue to be the most commonly used type of inducement offered to investors, the fastest growth in state incentive programs is in the non-tax incentives. Economic development goals have expanded from traditional industrial recruitment to include business creation, expansion and retention. Studies indicate that most job growth results not from industry relocation, but from the expansion of existing firms or the creation of new firms (Walker, 1989). In the case of Puerto Rico, Section 936 has been very effective in importing foreign capital and in promoting high tech industries, but it has not proven effective in promoting local linkages or a diversified economy.

Like states and nations around the world facing the highly competitive global economy, Puerto Rico must consider which tax policies are the most appropriate for its needs, and employ them as just one component of a broad based strategy. Equally if not more important than a favorable tax climate is a coherent plan for developing an intellectual infrastructure; a skilled, educated workforce; an entrepreneurial climate; a market for new products and processes; and sufficient and targeted amounts of capital. Each component will help Puerto Rico to successfully negotiate changing economic conditions⁴.

In his book on the surge in economic development activity among states, *Laboratories of Democracy*, David Osborne outlines the new structural foundation upon which states are building their economies. Rather than assist one industry or another, or simply lure investment, the goal of industrial policy should be to improve the competitiveness of a given economy by targeting economic processes. That is, it should intervene in ways that support capital formation, new business formation and expansion, technological innovation and the commercialization of research, and the adoption of new manufacturing technologies.

As Osborne and others point out, the lessons lie not in the multitudes of new programs, government departments, etc., but in gaining a sound understanding of the strengths and weaknesses of a particular economy, the global economic forces affecting it, the critical points of intervention and new institutional arrangements available.

The development of a sound foundation for economic development through industrial policy as we are conceiving it here is difficult. Transformation of the education system, for example, requires careful analysis of existing services and gaps, and garnering support from teachers, parents, labor and private industry. Results may not be evident for a decade or more. Yet such strategies are far less sensitive to external changes and lay the groundwork for economic progress for decades to come.

In the case of Puerto Rico, such comprehensive planning is invaluable not only in strict economic terms, but also in that it moves economic development in Puerto Rico to a position

less dependent on status. Unlike tax benefit packages, which are consistent with particular status configurations, measures to improve Puerto Rico's human resource base, for example, can be taken under Commonwealth, Statehood or Independence. Ultimately, this would allow Puerto Ricans to make a sound decision on status without fear of negative economic consequences.

Puerto Rico, like its counterparts in the States and around the world, has begun to adopt changes in economic strategy toward these goals. The following sections of this study describe these changes and point out where greater emphasis should be placed.

Assessment: Strengths of the Puerto Rican Economy. Implications of Status

Puerto Rico is positioned as a U.S. possession has played an important role in shaping its industrial economy. Many of the features of the Commonwealth relationship with the United States have had both positive and negative repercussions. The tax benefits offered U.S. corporations to locate in Puerto Rico, for example, have heightened investment and the pace of industrialization dramatically, but stunted the development of a local entrepreneurial class and local investment. Much of the profit generated by U.S. subsidiaries are not reinvested locally, but is repatriated to the home company. Likewise, free access to U.S. markets and U.S. goods have permitted economic growth, yet Puerto Rico is vulnerable to shifts in the U.S. economy and exercises limited or no control over imports, the levying of tariffs and the negotiation of foreign trade agreements.

If its position as a U.S. Commonwealth has made for certain idiosyncrasies in its economy, Puerto Rico has also developed a unique set of strengths upon which to forge industrial policy. The rapid pace of industrialization — much of it externally driven — has made for a skilled, educated labor force, with a high level of bi-lingualism. Average education level is 12.5 years, and the percentage of the population with university and technical training is high. While Puerto Rico is no longer internationally competitive as a low-wage location, the technological and managerial skills of the labor force hold great potential, especially given the rapid rate of change in technology and production processes.

The attractiveness of tax incentives offered by the federal and local governments have also resulted in a high concentration of high-tech and pharmaceutical industries. In 1988, some 28 percent of the 2,100 manufacturing operations on the Island were directly involved in the production of high-tech goods including scientific and professional instruments, electrical and non-electrical machinery and pharmaceuticals. In 1991, these three industries accounted for 57 percent of the Island's gross domestic product.

The Island's physical infrastructure and well-developed communications systems put it ahead of many other industrializing countries, especially in the Caribbean. In telecommunications, Puerto Rico's sophistication is an attraction for both manufacturing and service, particularly finance industries.

Puerto Rico's location, once coveted by foreign powers for its strategic military importance, continues to be an asset today. Together with its dual languages, the Island's position between North and South American and the Caribbean makes it apt for commerce transactions among its neighbors.

Integration of the Economy, Diversification of Industrial Structure

In 1989, policy advisors to the Puerto Rican government noted the troubling lack of integration throughout the economy. As part of their report they stressed the need to diversify industrial structure (Consejo Asesor Económico del Gobernador, 1989). The call for change in strategy is long overdue. The issue of diversification is severalfold. Not only must Puerto Rico place greater emphasis on the non-manufacturing sectors and the linkages between them, but it must diversify production, ownership and markets within the manufacturing sector itself, as well as the actual phases of production that take place locally. The strategies that follow are based on a careful mix of internal and external measures geared toward strengthening the local economy. Some involve direct assistance to local entrepreneurs and businesses, others involve negotiating new terms with foreign-owned businesses, and still others require changes in Puerto Rico's trade policy. Accordingly, some steps can be taken under any political status, while others are dependent on a particular status.

A. Diversify sectors

Investment, productivity and employment should all be increased in the non-manufacturing sectors. Agriculture, tourism, and the service sector are all promising areas for Puerto Rico and demand attention — not at the expense of manufacturing, but rather to complement it. Increased investment in modern agriculture, for example, would allow Puerto Rico not only to expand its share of the internal market for agricultural goods, and add high-end tropical plants and fruits to its exports, but would also serve food-manufacturing industries. Much of Puerto Rico's agricultural land is currently underutilized, and productivity is below its potential. Business services, too, such as export and marketing companies, can meet the needs of stepped up production of Puerto Rican manufactured and agricultural goods.

The tourism industry provides a useful example of the interdependency of the different sectors of the economy, and how strengthening one will, in turn, fortify another. Services themselves can play a greater role in the economy, particularly if Puerto Rico can fully exploit the opportunity to be a trade service center for the Americas and the Caribbean.

Under any status, Puerto Rico cannot escape changes in manufacturing technology that have already begun to diminish the ratio of labor to capital. The need for increased emphasis on non-manufacturing sectors holds regardless of the future of the status issue, and indeed has been emphasized in the economic reform platforms of the political parties supporting all three status options. Resources dedicated to other productive sectors such as services, agriculture and tourism will be well-spent in that increased productivity in each will have spill-over effects into other sectors. The longterm effect of generating output and employment in non-manufacturing sectors, especially in the local sector, will also help to reduce dependency on Section 936.

It is important to point out that status presents a trade-off between the potential for increased federal agriculture support under

Statehood, versus a greater ability to perfect local goods under independence.

B. Diversify Manufacturing

If Puerto Rico can learn anything from the economic development experience of other nations and states, it is the imperative for flexibility and evolution of policy itself. James Dietz, author of several works on Puerto Rico, Latin America and East Asia, argues that a successful "developmentalist state" must be able to recognize "strategy switch points." The key is not making the right decision between exports or import substitution, as many have argued, but rather understanding the limits of each and being able to employ both in a durable development strategy.

Given the present conditions of Puerto Rico's manufacturing sector — a strong set of foreign-owned, largely high-tech industries that export, along with another set of locally owned, low-tech industries serving mainly the local market — dynamic policy should move Puerto Rico toward greater internal integration. Policy can be designed to strengthen the local economy in four ways: 1) promote linkages between the foreign and local sectors, 2) maintain a balance between capital and labor-intensive industries, 3) substitute imports with locally produced goods, especially intermediate ones, in conjunction with a strong export sector, and 4) increase exports by local producers.

Strategies to diversify manufacturing are in part dependent on political status due to the importance of trade policy. Import substitution, in particular, would be best supported by tariffs, central over import licences, etc. These tools would be available under Interdependence and to some extent under an enhanced Commonwealth since Congress agreed to grant Puerto Rico greater benefit in informing duties on certain goods. Trade policy of states, however, is reserved for the federal government.

The other three diversification measures discussed may be carried out relatively free of status considerations. Under any status, Puerto Rico's economic development agency could promote industries with linkages to foreign-owned businesses, negotiate for increased local purchases by

multinationals through subsidies, incentives or decree. It can also exercise greater selectivity in its business promotions in order to achieve a healthier balance between capital and labor-intensive industries, and assist local exporters.

C. Diversify phases of production

A third area of concern regarding the diversification and integration of the economy is that of the phases of production carried out locally. Since the majority of the manufacturing industries in Puerto Rico are U.S.-owned and largely attracted by tax incentives, they are effectively encouraged to carry out those phases most profitable under the tax benefits on the Island. Other phases of production are carried out — with no actual reportable gain and often deductible from taxable income anyway — on the mainland (Negrón Rivera 1991). Backward and forward linkages with the rest of the economy are often stronger in the United States than in the local economy.

The resulting lack of integration suggests the need for a policy designed to encourage businesses to add financing, research and development, and marketing to the production operations they carry out in Puerto Rico. This is another mean to fortify the local economy by strengthening both forward linkages (from the product back to the raw materials) and backward linkages (from the product to the consumer). The demand for raw materials, business services and labor should also increase.

The Governor's Council of Economic Advisors recommended that based on the success of Section 936 and the Industrial Incentives Law in drawing production operations to the Island, Section 936 companies should now be structured to encourage the establishment of all phases of operations in Puerto Rico (Consejo Asesor Económico del Gobernador, 1989). This recommendation is a good one, although it is not specific to Commonwealth status nor to the continued existence of Section 936. Puerto Rico could encourage a diversification of phases of production through local tax incentives, low cost financing and technical assistance, and subsidies returned to businesses in exchange for high local taxes.

What role will status play in future industrial policy?

Puerto Rico faces a new global context, in which capital is highly mobile, where the tools of technology and knowledge exhibit greater durability than low production costs in the struggle to remain competitive. Recognizing the limitations of prior economic development efforts that relied almost entirely on the attraction of U.S. investment through tax breaks, Puerto Rican officials have begun to develop new programs to confront these conditions.

Adoption of such programs comes with an evolving consciousness that industrial policy today must reach far beyond traditional goals in order to promote growth and generate employment. Industrial policy should continue to include strategies to attract foreign investment, but it should also include strategies to strengthen the local sector and integrate it with the external one. Policy should target the very processes by which Puerto Rico participates in the international economy, through the creation of new businesses, technological innovation and adaptation, and the commercialization of research. These process are facilitated by policies that train entrepreneurs and the labor force at large, that stimulate cooperation among academia and industry, and that provide non-traditional sources of capital. Broad and comprehensive industrial policy of this nature is slow and difficult, but it is aimed at a strong domestic economy rooted in its own strengths in technological, human and infrastructure capacity.

Since the mid-80's, Puerto Rico has appropriately implemented programs to assist local businesses; consortia to spur the development, adaptation and implementation of technology; and legislation to pave the way for new risk capital funds. Without doubt, these are steps in the right direction, and should be integrated into a comprehensive strategy such as the one described in this study.

As we seek to understand the role of Puerto Rico's political status in this context, what becomes apparent is that many of the tools of industrial policy are status-neutral. They do not require a change in Puerto Rico's current status, and would continue to be available given a change from Commonwealth to either Statehood or independence. Significantly, the adoption of human resource, technology, marketing

and sectoral diversification strategies will alleviate dependency on Section 936 to drive economic development, and mitigate the relative weight of status in economic considerations.

The diminishing ratio of labor to capital in manufacturing, demands that Puerto Rico concentrate on non-manufacturing sectors to provide employment. Manufacturing has certainly been the principal emphasis of Puerto Rico's industrialization program, through the use of Section 936, unique to the Commonwealth status. For the future, however, an integrated strategy that supports manufacturing, services, agriculture and tourism will increase local linkages, and reduce Puerto Rico's dependency on external manufacturing investment. Even in the presence of Section 936, a diversified local economy is in order. Puerto Rico's potential as a business service center for the region is just one of the ways Puerto Rico can develop in non-manufacturing areas. Its own success up to this point, as well as the examples of Miami and even Singapore testify to the flexibility of this strategy vis-à-vis status.

Likewise under any status, Puerto Rico can promote industries with linkages to foreign-owned businesses and negotiate for increased local purchases by multinationals through subsidies, incentives or decree. This process of inducing linkages will be facilitated through the promotion of local businesses that can provide inputs or services to larger, foreign-owned businesses such as pharmaceuticals or producers of scientific instruments. It can also exercise greater selectivity in its business promotions – Section 936 or non 936 – in order to achieve a healthier balance among capital and labor-intensive industries. With the assistance in financing and technological needs, small and medium sized local producers can meet the demands of new flexible production methods.

Assistance to local exporters can also be carried out almost entirely free of status considerations. The government can provide information, technical assistance and financing to potential and current local exporters, with an eye toward capturing specific markets in the United States and abroad.

Policies to enhance Puerto Rico's human resource base are relatively free of status constraints.

Greater emphasis on enhancing its intellectual infrastructure and human resources is required of Puerto Rico in today's global context. In the long run, neither tax policies nor status alone will serve to maintain competitiveness. They will take a back seat to new strategies including changes in education, far-reaching technology policy and cooperation among universities, government and the private sector. The examples provided by even the poorest of states and developing countries demonstrate the non-constraining nature of status in these areas.

Two principal elements of industrial policy are dependent on political status. Tax policies designed to attract investment would be distinct under Commonwealth, Independence and Statehood. Trade policies, which would support other strategies such as import substitution, assistance to local exporters, and marketing, are also status dependent. A policy of import substitution, carefully designed to focus on intermediate goods, will help encourage foreign-owned entities to buy locally. Tariffs and import controls can also protect Puerto Rican goods in the local market. In addition, while the opening of new markets abroad can be done under any status, Puerto Rico's ability to oversee formal trade agreements would support these efforts. An Independent Puerto Rico would have the freedom to negotiate its own trade policy. Under "enhanced Commonwealth" Congress would likely grant Puerto Rico greater leeway in imposing duties on certain goods. Trade policy is not within the purview of states.

These changes in the relative importance of status thus certainly do not eliminate it as a factor in Puerto Rico's economic future. Rather, they provide policy makers a degree of freedom from the constraints of status, and allow the public to make a decision on the status question without fear of economic down.

Notes

1. The relevance and the appeal of the Hawaiian statehood case for Puerto Rico have been argued from both sides. For the affirmative case, see Michael McKee, "The economic consequences of Puerto Rican Statehood," Quick Finan & Associates, Washington, D.C., June, 1990, pp. 79-83; for an argument as to why the Hawaii statehood/economic model is not relevant or attractive vis-a-vis Puerto Rico, see Jose I. Alameda Lozada, "Estadidad y progreso economico en Hawaii," Dialago, October, 1989, pp. 12-13.
2. William Lockwood Benet groups Puerto Rico with Singapore and Ireland, and Taiwan with South Korea in his characterization of externally dependent economies and how well prepared they are to confront a new global context. "Los modelos exitosos de economias dependientes en mercados externos y su aplicación a Puerto Rico: Irlanda, Corea del Sur, Singapur, y Taiwan," Puerto Rico en los 1990, Centro de Investigaciones Sociales, Río Piedras, PR, 1987, pp. 122-125.
3. During the budget crunch of 1982 and again prior to passage of the Tax Reform Act of 1986, Puerto Rico was brought to the bargaining table over Section 936. On the first occasion, Puerto Rico used its support for the Caribbean Basin Initiative as a bargaining chip. In 1986, Puerto Rico again saved 936 by agreeing to make 936 deposits for a CBI loan fund. (Martin 1989-90). In 1996, (just prior to final publishing of this book) Section 936 was completely eliminated by Congress.
4. Negrón Rivera (1993) proposes that Puerto Rico require U.S. companies to pay high local taxes and then receive a foreign tax credit from the U.S. Treasury under the U.S. foreign tax credit. In turn, the Puerto Rican government could return these funds in the form of subsidies, some of which could be designed to encourage R & D or marketing.

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**Tax Related Industrial Incentive Impact
of Political Status Options for Puerto Rico**

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Introduction

This paper will analyze the tax-related industrial incentive possibilities for Puerto Rico under each of the three status options: Commonwealth, Independence and Statehood. These possibilities will be significantly affected by the Omnibus Budget Reconciliation Act of 1993, signed into law by President Clinton on August 11, 1993. Provisions of such legislation most likely to affect the subject of our analysis are discussed below, albeit their actual impact is difficult to forecast with complete specificity.

Until 1993, tax incentives available to U.S. investors in Puerto Rico under Section 936 of the U. S. Internal Revenue Code were generally regarded as more attractive than tax incentives available for U.S. investments in states of the Union or in foreign countries. In the case of foreign country tax rules, the incentive differential for U.S. investors vis-a-vis Section 936 was deemed to be of little or no significance with respect to income from the active conduct of business. This differential was countered by the foreign jurisdictions' capacity (unavailable in Puerto Rico under Commonwealth status) to enter into tax sparing agreements with industrialized countries other than the United States.

In the case of U.S. investments in states of the Union, the tax differential vis-a-vis Section 936 had decreased over the last decade, but was still considerable. As a result of the 1993 Budget Reconciliation Act, federal tax treatment of active income from foreign countries may well become more advantageous for U.S. investors in several manufacturing categories especially the "high-tech" ones than the now sharply reduced tax benefit of Section 936. These foreign country provisions apply in Puerto Rico under Commonwealth status as they would under Independence status, although under Independence the possibility of a tax treaty with the United States could vest some of these provisions with a fixity they lack under Commonwealth.

Statehood's tax disadvantage vis-a-vis Independence and Commonwealth, though perhaps lessened by the 1993 Budget Reconciliation Act, is

likely to remain substantial for U.S. investors. Third country investors and locally owned corporations would also become subject to the impact of full federal corporate taxation under Statehood; a situation disadvantageous vis-a-vis Commonwealth and, in the case of third country investors, even more so vis-a-vis Independence.

**Tax Consequences of Commonwealth
Background**

U.S. tax exemption provisions pertaining to Puerto Rico-originated industrial profits have existed in various forms since 1921. Such provisions, usually applicable to all other U.S. possessions, were originally intended to eliminate disadvantages faced by U.S. corporations operating in the Philippines against their British competitors, which were allowed deferred taxation on foreign income until it was remitted back home. A few years after World War II, the government of Puerto Rico decided to embark on an industrialization program that offered U.S. investors, on top of the already available federal tax exemption, a combination of local incentives such as low rents, low-interest loans, and above all, little or no local income taxes. This program survives as the cornerstone of the island's development model under Commonwealth status.

Until 1976, profits of U.S.-owned manufacturing firms in Puerto Rico were tax exempt at the federal level through Section 931 of the U.S. Internal Revenue Code, under which dividends paid by the exempt companies to their U.S. parents were taxable to the latter but liquidation distributions were not. In 1976, Congress replaced Section 931 with a newly created Section 936. Section 936 provided a full credit against U.S. tax on Puerto Rico-source income (rather than exempting such income, as section 931 did) while granting affiliates a full deduction for dividends received from the latter.

Congress has recently curtailed Section 936 incentive in such a manner as to make most participating companies only partially tax exempt. Pursuant to the Omnibus Budget Reconciliation Act of 1993, for tax years beginning after December 31, 1993 Section 936 taxpayers must elect one of two alternative methods for capping the 100 percent credit they enjoyed heretofore on their manufacturing income.⁶ The first method, known as the "economic-activity

limitation", limits the company's credit to the sum of a percentage of wages, depreciation, and taxes.

The second method, known as the "percentage limitation," limits Section 936 credit to an applicable percentage of the credit that was allowable for tax years beginning prior to 1994. Under a transition rule providing a 5-year phase in, the resulting "income-based credit" shall fall to 60 percent of the present full credit in 1994; 55 percent in 1995; 50 percent in 1996; 45 percent in 1997; and 40 percent in 1998 and thereafter.

Prospective Outlook under Commonwealth

The history of Section 936 is, thus, one of periodic cutbacks in the value of its tax benefit. Puerto Rico, in fact, may in the intermediate future experience further congressional curtailments to the remnants of this provision. After the recent amendments to the Section 936 credit, it is even doubtful that the island will attract any significant *new* investments under it. High technology companies will probably do better under the foreign source income rules, while labor intensive companies are no longer attracted in large numbers for reasons unrelated to tax considerations.

Nonetheless, companies operating in Puerto Rico under Commonwealth status have the option of being treated like foreign operations for U.S. tax purposes. Tax incentives under Commonwealth, therefore, would remain at least as advantageous at present as those under Independence from the point of view of U.S. investors. In contrast with the situation under Independence, however, the permanence of foreign-source income incentives cannot be guaranteed under Commonwealth through a tax treaty with the United States; a disadvantage which the unstable experience of Section 936 demonstrates to be of considerable weight. Since Puerto Rico is treated more favorably than foreign countries on the outlay side of the U.S. budget, future cutbacks in the applicability to the island of advantageous revenue provisions tailored to international tax norms cannot be ruled out.

Tax Consequences of Independence Fundamental Scenario

Under independence, Section 936 would probably cease to apply to Puerto Rico. Yet, regardless of the transition period granted by the United States, eventual elimination of Section 936 need not imply a reduction in tax-related incentives for investment on the Island. In fact, the relative immunity of the post-independence tax scenario to congressional modifications, coupled with the improved prospect for tax-related attraction of third country investments, would probably constitute a more advantageous tax regime for Puerto Rico.

Thus, income from manufacturing activity in Puerto Rico was not deemed to be subject to substantially greater tax advantages than similar activity in low-tax foreign countries. Although dividends received by a U.S. parent from a Section 936 company were not taxable while dividends from a foreign affiliate were, the ability to defer this latter liability until repatriation represented for many corporations an advantage comparable to total exemption. Many multinationals have simply kept their foreign profits reinvested abroad for long periods, after which the real tax liability due upon repatriation is reduced to a fraction of its original value. Also, U.S. companies have carried excess foreign tax credits from operations in high-tax locations that can be used to offset the U.S. tax on dividends from low-tax foreign countries. A U.S. parent with sufficient excess credits would currently be attracted to Puerto Rico only because of its *local* tax incentives, since the excess credits would in any event cancel any federal liability on dividends received.

Economic studies examining the likely outcome of an elimination of Section 936 in Puerto Rico have usually argued that firms would react by reincorporating as foreign subsidiaries.

Third Country Tax Sparing

The following scenario applies to comparable investments from foreign nations *other than* the United States. Independence would empower the island to enter into tax sparing treaties, i.e., treaties providing for total tax exemption at the investor's home country, just as Section 936 did, with industrialized countries such as Japan, Canada, Germany, France, the United Kingdom, or others that customarily adopt tax sparing provisions in their tax treaties with developing nations. Other European nations like, Sweden or the Netherlands also

include tax sparing provisions in their treaties with developing countries.

Under Commonwealth status, Puerto Rico lacks legal authority to enter into such treaties. Since the Island is not ordinarily subject to the internal revenue jurisdiction of the United States, tax treaties between the United States and third nations for the avoidance of double income taxation do not apply to income derived in Puerto Rico either. Hence, foreign companies in the Island may find themselves with no legal guarantee against double taxation (i.e., both in the Island and in the home country).

Policy Options

As pertains to the attraction of both U.S. and third country investments, the foregoing discussion makes evident that one major tax-related option available to an independent Puerto Rico would be simply to remain a low-tax jurisdiction in the fashion of other Caribbean and international "tax havens." While federal tax provisions applicable to U.S. subsidiaries in low-tax foreign countries have provided incentives comparable to those of Section 936, the substantial changes approved under the 1993 Budget Reconciliation Act will probably make Section 936 less attractive on an overall basis, particularly for the hard hit "high-tech" sector, than the less affected provisions. Non-U.S. foreign investors, moreover, could start enjoying the currently unavailable advantage of home country tax sparing.

An independent Puerto Rico could also seek to attract manufacturing investment by offering, in addition to a low tax option, the alternative of paying higher local taxes while also qualifying for government subsidies. This arrangement may facilitate profitability levels comparable to those prevailing even under the pre-1994 version of Section 936. Under this second alternative, Puerto Rico could impose relatively higher rates of direct corporate tax and/or dividend withholding tax at aggregate rates intended to replicate those which the IRC would levy on profits received by U.S. parent companies from their Puerto Rico sources. The Dividend Withholding Tax, which maintains the deferral advantage, also yields a foreign tax credit under IRC sections 901 et seq. The Island's government, in turn, could use these new revenues to provide participating companies with financing or capitalization at below-market rates of return. It could also provide other direct or indirect subsidies on pre-

determined company costs, such as plant and equipment, labor, energy, transportation, insurance, pollution control, technology acquisition or development, locally provided services or components.

These subsidies, if amounting in the aggregate to the entire sum of new local tax revenues (i.e., beyond those already collected under the prior low tax option), could be targeted in such way as to make participating companies retain after-tax earnings resembling the income amount that would have been exempt had full federal tax exemption continued to apply.

Unlike the deferral principle, the foreign tax credit is a standard concept in U.S. tax treaties with other nations. This could make the program just described relatively immune to unilateral U.S. curtailment than the low tax option. Such a program would have to meet U.S. legal and regulatory provisions designed to prevent companies from claiming U.S. foreign tax credits in certain situations or from introducing to the U.S. market, penalty-free, products that have been subject to subsidies by foreign governments. These provisions, arising from Section 901(i) of the U.S. Internal Revenue Code and from the countervailing duty standards in the U.S. Tariff Act, require that Puerto Rico's subsidies be uniformly available to industrial taxpayers in general and that they not be determined by reference to the tax base or tax liability of each taxpayer. To the extent that Puerto Rico's subsidy program covered, for instance, pre-established percentages of certain categories of company costs, regardless of the tax base or tax liability of each participating company, it would be acceptable for some industries to benefit more from the program than others.

Because of the "general availability" requirements just described, any such program should be made applicable not only to the multinational sector but also to locally owned manufacturing companies. The latter are currently entitled under Puerto Rico's Industrial Incentives Act to the same exemption grants that Section 936 companies enjoy. The locally owned sector is small when compared to the Section 936 sector, and its inclusion in any such program would be unlikely to cause a major impact. Nevertheless, the experience of countries such as Singapore and Ireland suggests that a subsidy strategy focusing on financial, technological and marketing criteria may foster the strengthening of linkages between foreign-owned manufacturers and the local economy, while also

facilitating the technological upgrading of local entrepreneurs and workers. Thus, in addition to serving as a promotional tool for the multinational sector, such an incentive orientation could have important consequences for Puerto Rico's evolution into a truly autonomous and self-sustaining economy.

Tax Consequences of Statehood Fundamental Scenario

Because of the uniformity clause in the U.S. Constitution, under Statehood Puerto Rico would become subject to the same federal tax provisions applicable to all other states. These provisions include the federal corporate tax system. As of 1993, the maximum statutory rate of this provision applicable to income categories currently exempt under Section will be 35 percent.

The U.S. Congress would probably offer some kind of transition from pre-statehood to the full introduction of federal corporate taxes. It is less clear, however, whether such a transition would occur before or after the island's actual incorporation as a state. Constitutional concerns were posed during the Congressional negotiation process over the Energy and Natural Resources Committee version of the bill S.712, with respect to a five-year phase-out for Section 936 occurring after Statehood comes into effect. Such concerns led the Senate Finance Committee to amend S.712 in order to postpone the advent of Statehood until phase-out had been completed.

Regardless of any transition method eventually enacted, Statehood would signify in its final form, the full applicability of federal taxes not just to U.S.-owned corporations, but also to companies owned by Puerto Rico or third country residents. The island could no longer count on economically significant tax-related incentives to attract multinational manufacturing investment or promote locally-owned ventures.

Rate of Return Impact of Federal Taxation

Table I estimates the possible increase in federal burden that manufacturing companies currently subject to Section 936 would experience under Statehood. Using 1989 data, the table presents a set of comparisons based on firms' return on assets for that year vis-a-vis possible post-statehood scenarios. Such comparisons are made for the entire Section 936

manufacturing sector as well as for each separate industrial category listed in the U.S. Treasury Department's published balance sheets.

The table provides two "pre-statehood" return on assets scenarios. The "100 percent credit" scenario presents the return on assets ratio estimated for Section 936 companies under actual 1989 statistics. The "40 percent credit" scenario provides (where applicable) the corresponding ratio that would have resulted had the same companies been subjected in that year to income-based limitation as it will become effective by 1998. Two post-statehood scenarios are presented, showing estimated return on assets ratios based on a 35 percent federal tax rate. The first scenario assumes that under Statehood Puerto Rico would collect the same amount of taxes that it did prior to Statehood, and takes into account the deduction of these Puerto Rican taxes from U.S. taxable income. The second scenario assumes that no Puerto Rico taxes are collected under Statehood from former Section 936 companies.

Finally, the possible range of percentage point reductions in return on assets ratios resulting from these two post-statehood scenarios is shown vis-a-vis the two pre-statehood scenarios. Under the first post-statehood scenario "with PR tax," the return on assets ratio for the entire Section 936 manufacturing sector would decrease by 5.2 percentage points vis-a-vis the "40 percent credit" scenario, and by 14.6 percentage points vis-B-vis the "100 percent credit" scenario. Under the "no PR tax" scenario, the reduction would be of 3.3 percentage points vis-B-vis the 40 percent credit and 12.6 percentage vis-B-vis the 100 percent credit.

For industrial categories where the 40 percent limitation is inapplicable, the post-statehood ratios are only compared against the 100 percent credit to determine Statehood's estimated impact. For the rest of the industrial categories, including Section 936 manufacturing sector as a whole, the impact of Statehood would be somewhere within the ranges shown in the table. In most instances, the lower bound of each range (e.g., 5.2 in the "with PR tax" Statehood effect for "manufacturing/total"), would probably be further from reality than the upper bound (e.g., 14.6 for the same case). A number of companies in those industrial categories would face lower effective tax rates under the economic-activity limitation and, more important, the effects of the 1993 amendments could be minimized or eliminated by companies reorganizing themselves as foreign subsidiaries.

As shown earlier, federal tax rules for U.S. subsidiaries in foreign countries were considered to yield incentives comparable to those of Section 936 prior to the 1993 Budget Reconciliation Act. Puerto Rico's capacity to use these foreign country rules for attracting U.S. investment under commonwealth or independence remains substantially unimpaired. Consequently, the upper ranges in Table I may still provide a reasonable idea of Statehood's tax-related impact on firms' profitability.

Conclusion

The foregoing analysis has depicted the probable tradeoffs for Puerto Rico under the Commonwealth, Independence and Statehood status options from the standpoint of tax-related industrial incentives. No attempt was made to determine the relative weight of such tradeoffs within a wider context of aggregate economic advantages and disadvantages under each status option.

Industrial tax incentives have played a key role in Puerto Rico's economic development for more than four decades. Such key role, however, may be interpreted as indicative of the limitations rather than the benefits of Commonwealth status. As a state, it may be argued, the island could become vested with stability and familiarity within the U.S. federal framework, thus eliminating the need for tax concessions or other premiums required under today's hardly permanent status. The net value of federal tax exemption, moreover, could be more than offset by heightened federal transfer programs to which Puerto Rico could be entitled as a state. It may be argued that whatever tax or other benefits the United States has granted to a politically subordinate Puerto Rico are only a glimpse of what the bargaining power of congressional representation and presidential vote could gain for the islanders.

Independence, in turn, could signify an eventual phase-out of net federal transfer programs currently applicable to Puerto Rico. Yet the benefit of such transfers, and of whatever economic advantage may additionally stem from the Island's subsidiary relationship to the United States, might be more than compensated by the commercial and entrepreneurial options that political sovereignty would make available. Cheaper imports, greater and more

varied access to international export, capital and credit markets, and the capacity to adapt locally applicable rules and incentives to the specific needs of the Island's economy, could be the formula for Puerto Rico's break away from its slow growth in the last two decades.

For their part, supporters of the Commonwealth highlight the risks and of the other two status options. To world investors, who are usually averse to rapidly changing scenarios, Commonwealth represents the historic pillar upon which any important strategic change in the island's economy, or even in its political status, should gradually be built. A tax view of Puerto Rico's status dilemma is thus very limited view, even from a purely economic standpoint. Economic analysis, in fact, will always sacrifice accuracy to the extent it remains too "pure." Economic life can never be dissected from the wider social, political, and even psychological realities affecting a society in the first place.

With these caveats, our focus on tax aspects reveals Commonwealth and Independence to be more beneficial for Puerto Rico than Statehood. Independence, in the long run, offers greater stability and versatility than Commonwealth, with no apparent disadvantage in its immediate impact when compared with the now curtailed attributes of the Commonwealth. The continued deepening and evolution of this type of assessment, should definitely play a role in any future status decision made for Puerto Rico.

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Table 1

Return on Assets Ratios for Seccion 936 Companies

Industrial Category	Pre-Statehood Ratio		Post-Statehood Ratio		Statehood Effect	
	40% credit	100% credit	with PR tax	no PR tax	with PR tax	no PR tax
Manufacturing Total	32.3	41.7	21.1	29.0	-5.2 to -14.6	-3.3 to -12.6
Food & Kindred Products	28.6	37.1	24.1	26.0	-4.5 to -13.0	-2.6 to -11.0
Textile Mill Products	n/a	16.2	10.5	15.1	-5.7	-1.1
Apparel & Other Textile Products	n/a	21.6	14.0	16.8	-7.5	-4.7
Paper & Allied Products	n/a	11.9	7.7	10.6	-4.2	-1.2
Printing & Publishing	n/a	48.3	31.4	33.7	-16.9	-14.6
Chemicals & Allied Total	37.2	47.1	30.6	31.2	-6.6 to -16.5	-6.0 to -15.9
Chemicals & Allied Drugs	34.9	44.4	28.9	29.4	-6.0 to -15.5	-5.5 to -15.0
Petroleum & Coal Products	13.7	17.9	11.6	13.1	-2.1 to -6.3	-0.6 to -4.8
Rubber & Miscellaneous Plastic Products	n/a	21.4	13.9	15.3	-7.5	6.1
Leather & Leather Products	n/a	23.1	15.0	17.3	-8.1	-5.8
Stone, Clay & Glass Products	n/a	23.8	15.4	26.1	-8.3	+2.4
Fabricated Metal Products	n/a	23.4	15.2	17.9	-8.2	-5.5
Machinery Except Electrical	148.2	189.7	123.3	128.2	-24.9 to -66.4	-20.0 to -61.5
Electrical & Electronic Equipment	36.8	47.3	30.7	32.3	-2.1 to -6.3	-2.1 to -6.3
Transportation Equipment	n/a	41.2	26.8	29.1	-14.4	-12.1
Instruments & Related Products	37.8	48.3	31.4	32.6	-6.4 to -16.9	-5.2 to -15.7
Miscellaneous Manufacturing	n/a	30.4	19.7	20.5	-10.6	-9.9

**The Tax Elasticity of Section 936
Investment in Puerto Rico**

*Edwin Meléndez**
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Introduction and Summary

The debate on the economic consequences of Puerto Rico's political alternatives has concentrated on the potential effect of the federal tax exemption on the Island's economy and the costs it represents to the United States Department of the Treasury. Advocates of the federal tax exemption provided under Section 936 of the U.S. Internal Revenue Service Code claim that it has been the most important factor in promoting industrial development and economic growth in Puerto Rico during the last few decades (Economic Development Administration, 1984). In 1991, Section 936 corporations accounted for 72 percent of manufacturing jobs and 13 percent of the Island's total employment (Price-Waterhouse, 1991a). This sector is extremely important to the Puerto Rican banking system, as well, because it has represented one-third of the total bank deposits in recent years (Estudios Técnicos, 1989, 1993; Government Development Bank, 1993).

Since the reform of the U.S. Internal Revenue Service Code, detractors of Section 936, spearheaded by the Treasury Department (1978, 1979, 1980, 1983, 1985, 1989), have argued that the benefits are not only excessive, but that only a small number of industries profit from them. The Treasury Department claims that these tax credits are not the most effective way to create jobs, and that they cost more than the salaries generated in many of the industries that benefit from them. The U.S. General Accounting Office (1992, 1993) pinpoints the apparently excessive profits of the pharmaceutical industry as an example of the problems caused by Section 936. The possibility of repealing this tax-exemption mechanism, which is implicit in the issue of Statehood, places the discussion of the costs and benefits of the amendment at the center of the political debate. The irony of this debate is that tax benefits have been gradually and substantially diminished, even under Commonwealth status.

The objective of this study is to estimate the magnitude of change in corporate investment under

Section 936 in response to changes in federal tax benefits. In contrast to other studies that have relied on the arbitrary assumption that no new investments are likely to occur if Section 936 is eliminated, we use an inter-industrial investment model based on 1977 to 1989 data to estimate the tax elasticity of Section 936 corporate investment. This elasticity model measures the percentile change in the investment of Section 936 corporations as a result of a percentile change in tax benefits.

The results of the simulations are revealing. The elasticity of Section 936 corporate investment with respect to federal tax credits is 17.5 percent during the first year after a change in benefits. In other words, the reduction of all tax benefits, as expected under Statehood, will result in an imminent 17.5 percent reduction in Section 936 corporate investment in Puerto Rico. Moreover, the effect of this external shock can be expected to continue for two years. The end result will be a decline of 23.4 percent in Section 936 corporate investment in Puerto Rico, a substantial decline from current levels, but far from a total cessation of investment.

The estimated elasticity of investment can be applied directly to current public policy considerations. The model predicts that a 40 percent reduction in benefits—as projected for 1994 by the 1993 Omnibus Budget Reconciliation Act (OBRA)—will bring about a 7 percent reduction in investment during the first year. These estimates indicate that investment were reduced in 1994 by approximately 11 percent and in 1998 by 16.4 percent in the most affected industries, including manufacturing of chemical products, scientific instruments, and electric machinery. A discussion of the findings and their implications for public policy follows.

Up to now, only two studies have attempted to estimate the probable effects of a reduction or total elimination of tax benefits to Section 936 corporations. The Congressional Budget Office (CBO, 1990) made the first attempt to estimate the impact of Statehood on the Puerto Rican economy. The CBO made the assumption that Section 936 corporate desertion (i.e., plant closings) would remain unchanged under Statehood and that the remaining corporations would reinvest at a level adequate enough to compensate for the capital depreciation rate. That is, Section 936 corporations would invest enough to preserve capital

assets, but not to expand current operations or start new ventures. In other words, the CBO assumed that there would be no new investment in the Island's industrial sector to compensate for the loss of investment that normally takes place among Section 936 industries. Such a total loss of new investment represents a 54 percent to 65 percent reduction in investments and a 37 percent to 47 percent loss in the capital assets and production of Section 936 corporations by the year 2000. Obviously, this projection is based purely on the CBO's speculation regarding the behavior of Section 936 corporations.

The second study was carried out by Price-Waterhouse (1991b) on behalf of the Puerto Rico-USA Foundation. This study is based on a survey of Section 936 corporations operating in Puerto Rico before the 1993 congressional amendments to Section 936. The survey asked corporate policy makers what the investment levels, employment rates, wages and levels of exports would be under two possible political scenarios: (1) if the present legal situation were to remain unchanged, and (2) if the tax benefits offered by Section 936 were no longer available. The conclusions of the Price-Waterhouse study were fairly similar to the CBO's findings on investments: there would be no new investment in the Island's industrial sector if the tax benefits were no longer available. The Price-Waterhouse survey did differ from the CBO's survey in its projected reduction of exports.

These studies take an extreme position in estimating the effect of repealing tax benefits. According to the logic of the CBO study, a repeal of Section 936 or the admission of Puerto Rico to the Union would prompt U.S. corporations to stop investing on the Island. In other words, the CBO study simply assumes that none of the other factors that influence the decision to invest in a given country, or a combination of them, can provide an offsetting stimulus to U.S. investments on the Island. The research method of the Price-Waterhouse study, likewise, has an inherent propensity toward pessimism on the subject. The Price-Waterhouse study relies exclusively on the opinion of those who will be most detrimentally affected by a change in the tax-exemption program, that is, corporations operating in Puerto Rico before the 1993 congressional amendment. Not surprisingly, they prefer continuation of the tax benefits. Presumably, this preference may have influenced their estimates.

Model specification

Following the vast literature in this area, we have, for two reasons, defined the investment (dependent) variable as the *change in depreciable assets*. On a theoretical level, changes in investment are a function of changes in the capital stock, depreciation rates, and capital growth rates, all of which are captured by changes in depreciable assets. On empirical grounds, we found that the correlation between the change in depreciable assets and investment expenditures was 0.967 for all industries during the period 1984 to 1989. Since investment data exist only for 1984 to 1989, but data for depreciable assets are available for the entire period 1978 to 1989, the chosen definition provides additional observations for estimation of the model.

The list of independent variables is included in Table 1. As is conventional in this type of empirical study, the tax elasticity estimates were based on regressions using the natural log of both dependent and independent variables. A few of the dependent variables warrant further observation. First, to capture the tax effects in the most comprehensive way possible, we included several tax definitions. *Tax* refers to the actual tax credit or benefit derived by Section 936 corporations, summarized for specific industries and for each particular year. Following Denson and Johnson (1986), who found that tax effects are significant for three years, we included the tax-credit variable lagged by one and two years. Since it is important from the policy point of view to assess the effects of recent changes in tax-benefit regulations, we have included a *dichotomous* (dummy) variable (OBRA93) in the model that is intended to measure the possible effects of these policy changes on industry investment. Finally, two dichotomous variables (DUMMY82, DUMMY86) were introduced to capture the effects of the policy shocks of 1982 and 1986 brought about by tax reforms during those years. These time controls also help to eliminate the possible auto-correlation in the model introduced by the time-series data (see Sayrs, 1989, on this point).

Other central variables include costs, firm size, government expenditures, foreign profits, and labor productivity. *Cost of sales* is a catch-all cost variable that incorporates all the operating expenses minus depreciation and interest charges. In a way, cost of sales is a volume variable that captures the higher

investment needs of such industries as pharmaceuticals and scientific instruments which require a continuous introduction of new technologies in order to remain competitive in global markets. *Average industry firm size* is estimated using firms' assets. Industries with a concentration of production in large firms can devote a larger proportion of resources to research and development which requires expansion of capacity. *Government consumption* has been incorporated, following Mofidi and Stone (1990), as a proxy for the level of social spending, which excludes military spending. Foreign profits are represented by the difference between the income produced by residents (GDP) and the income available to residents (GNP). Presumably, this variable should control for increased investment activity induced by increased foreign profits. The next two control variables, *assets-to-labor* and *sales-to-labor*, capture inter-industrial differences in labor productivity.

Conclusion

The empirical results presented above introduction question the validity of the assumptions used by previous studies about the reduction of investments likely to result from changes in tax benefits. Both the CBO and Price-Waterhouse studies overestimate the impact of a reduction in federal tax benefits on Section 936 corporate investments. Our estimates indicate that the total effects for manufacturing industries are approximately half of the lowest estimate (37 percent) used by the CBO and certainly much lower than the result of no-reinvestment (equivalent to a 100 percent of tax-benefit elasticity) assumed by Price-Waterhouse and built into their

econometric simulations. The CBO and Price-Waterhouse assumptions regarding Section 936 corporate behavior in response to reductions in tax benefits underlie the devastating macroeconomic effects predicted in their studies.

In political terms, it can be argued that these studies favor the Commonwealth position—the political alternative associated with continuation of Section 936 tax credits. In actuality, however, the loss of tax benefits to Section 936 corporations need not be associated with a change in political status. Section 936 has already been the object of several congressional reforms. As previously suggested, some of these reforms seem to have been ineffective in influencing, positively or negatively, Section 936 corporate investment. But, the reforms introduced by OBRA could very well result in actual declines in tax benefits and, thus, affect corporate investment. As long as the prevalent opinions in key Washington policy circles continue to be skeptical of the long-term benefits of Section 936 for the economic development of Puerto Rico and the U.S. taxpayers, Congress may continue to trim, little by little, the tax credits granted to U.S. corporate subsidiaries operating in Puerto Rico.

From a more practical point of view, our estimates justify a major revision of the assumptions behind some of the econometric studies intended to measure the impact of the political alternatives on the Puerto Rican economy. There is no question that the elimination of Section 936, or the reduction of the benefits it grants, will have a detrimental effect on Section 936 corporate investment and, thus, on employment and income from the manufacturing sector as well as the economy, as a whole. Discussions of Puerto Rico's political status or the future of its economy surely should not be based on faulty assumptions about the magnitude of such adverse effect.

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Table 1
The Independent Variables

Variable	Description
COS	Cost of Sales
FIRMSZ	Average Industry Firm Size
GC	Government Consumption
GDP-GNP	Gross Domestic Product minus Gross National Product
K/L	Assets to Labor
PRODC	Sales to Labor
DUMMY 82	1982 Tax Reform Dummy
DUMMY 86	1986 Tax Reform Dummy
TAX	Current Tax Credit
TAX1	Tax Credit, lagged One Year
TAX2	Tax Credit, Lagged tow Year
HIGHTECH	High Technology Industry Duanny
OBRA 93	High Technology Industry Dummy
TAXOBRA	

Table 2
Percent of Benefit Loss Due to Amendments to Section 936 (OBRA, 1993)

Industry	1994	1988	Average 1994-98
Beverage	38.0	75.0	47.2
Apparel	0	0	0
Drugs	38.0	40.9	43.0
Machinery	0	5.4	1.5
Electrical	12.0	17.8	14.9
Instruments	15.0	23.8	18.8
Manufacturing	28.0	33.8	32.6

Source: Government Development Bank, 1993

Table 3
Tax Elasticity of Section 936 Investment (1977-89)

	Estimated Cumulative Percent of Change in Investment as a Result of Reduction in Section 936 Benefits		
	Statehood 100%	Commonwealth 40% BY 1994	OBRA* 60% by 1998
Current Year	-17.5%	-7.0%	-10.5%
1 year later	-22.8	-9.1	-13.7
2 years later	-23.4	-9.4	-14.0
Industries affected by OBRA*	-27.4	-11.0	-16.4

*Omnibus Budget Reconciliation Act of 1993.

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