PUERTO RICO:
INSIGHTS INTO ECONOMIC DEVELOPMENT POLICY
Volume II
Section 936, Banking Oversight, and Infrastructure

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ABSTRACT

This volume brings together four quintessential documents that extensively deal with Section 936, Banking Oversight, and Infrastructure in Puerto Rico. These papers include; "The Effect of 936" by Arthur MacEwan, "Puerto Rico and Section 936: A Costly Dependence" by J. Tomas Hexner and Glenn Jenkins; Eugene S. Weil's submission to Congressional Task Force on Economic Growth in Puerto Rico and "Reviving the Puerto Rican Economy Requires a Big Push of Public Infrastructure Investment" by J. Tomas Hexner and Arthur MacEwan.

First of all, rather than yearning for the return of 936, Puerto Rico would do well to abandon of the 936 myth. This recognition of reality could be one important step in laying the foundation for a new era of economic development for Puerto Rico. Secondly, Section 936 has ceased to be an efficient means of attaining employment-producing investments in Puerto Rico and other U.S. territory. While the initial rationale for the credit was the creation of jobs and the stimulation of economic activity in the territory, the outcome has been far different. Thirdly, in a submission to the Congressional Task Force on Economic Growth in Puerto Rico by Eugene S. Weil, Managing Director and Financial Institutions Group Co-Head, he reveals that The Congress is under the directive to reduce uncertainty in Puerto Rico; as such, he believes that the creation of regulatory exceptions for banks in Puerto Rico would likely be counterproductive to this mandate. Finally, the forth submission in this volume to the Congress by J. Tomas Hexner and Arthur MacEwan titled "Reviving the Puerto Rican Economy Requires a Big Push of Public Infrastructure Investment", emphasizes the need for effective policies and major reforms to be initiated immediately.

Key Words: Puerto Rico, Section 936, Banking Oversight, Infrastructure

JEL Classification: O1, O2

Puerto Rico: Insights into Economic Development
Submissions to the Congressional Task Force

Volume II:

Section 936, Banking Oversight, and Infrastructure

A. "The Effect of 936" by Arthur MacEwan - 2016
B. "Puerto Rico and Section 936: A Costly Dependence" by J. Tomas Hexner and Glenn Jenkins - 1995
C. Eugene S. Weil's submission - 2016
D. "Reviving the Puerto Rican Economy Requires a Big Push of Public Infrastructure Investment" by J. Tomas Hexner and Arthur MacEwan - 2016

A. The Effect of 936[1]

By:
Arthur MacEwan[2]

Section 936 of the Internal Revenue Code was not an effective means to promote economic growth in Puerto Rico, and the emergence of the current and long-continuing recession cannot be attributed to the termination of 936. Moreover, at this point, U.S. firms are able to operate in Puerto Rico as Controlled Foreign Corporations (CFCs), which provides them with virtually all the advantages of Section 936 (and does not impose some of the restrictions of 936). Section 936 is a failed policy. It would be the height of folly to reinstitute 936—or of a 936-like program—as a means for establishing economic expansion in Puerto Rico.

- Between 1976, when Section 936 was established, and 1996, when Section 936 began to be phased out, the Puerto Rican economy expanded by 2.5% annually, while the U.S. economy grew by 3.0% annually. That is, over this 20 year period, the U.S. economy grew 17% more than the Puerto Rican economy. In the 936 era, then, Puerto Rico was falling further and further behind the states.
- An even more dramatic comparison: In 1970, per capita gross national product (GNP) in South Korea was 65% less than in Puerto Rico. By 2000, per capita GNP in South Korea was 9% larger than in Puerto Rico. (By 2010, with the Puerto Rican economy in deep recession, Korean per capita GNP was 62% above that in Puerto Rico.)
- The termination of 936 did not bring about the severe recession that began in 2006. Employment in Puerto Rican manufacturing, where 936 firms are primarily located, did decline by 27.5% between 1995 and 2005, as 936 was being phased out. But employment declined by only 1.1% in those four sectors of manufacturing where 936 firms played a major role (pharmaceuticals and medicines, chemicals, computers and electronic goods, and medical equipment and supplies). These four sectors had accounted for 52% of manufacturing employment in 1995, but 72% in 2005.

[1] Arthur MacEwan is Professor Emeritus of Economics at the University of Massachusetts Boston. August 29, 2016An earlier version of this paper appeared as MacEwan, Arthur, "Quantifying the Impact of 936," Center for Global Development and Sustainability, Working Paper Series 2016-4, Brandeis University, May, 2016 (with a forward by R. Godoy), http://heller.brandeis.edu/gds/eLibrary/pdfs/Godoy-Foreward-May_5_2016_PuertoRico_2.pdf.
[2] Arthur MacEwan is Professor Emeritus of Economics at the University of Massachusetts Boston.

- Employment in 936 sectors (as well as the rest of manufacturing) did fall off sharply after 2005, dropping by 31%. But this was accounted for largely by the Great Recession in the states (the major market for these sectors) and by technological change. Moreover, in the states, manufacturing employment fell by 19% in this same period, indicating the Puerto Rican decline was not explained simply by factors particular to Puerto Rico.
- Furthermore, it was not the U.S. firms in Puerto Rico (the formally 936 firms) that were doing badly after 2005. They adopted Controlled Foreign Corporations (CFC) status and thus kept virtually all of the 936 tax advantages. But their employment declined because, unlike 936, CFC status contained no employment credits, and the firms rapidly changed their technology. Pharmaceuticals, the most important of the 936 sectors, saw exports (the largest share of it sales) rise by 40% (in current dollars) between 2005 and 2015, while employment declined by 51%. Good times for the firms, but not so good for Puerto Ricans.
- While some production facilities of 936 firms have closed in recent years, the causes of these closures cannot be attributed to the termination of 936. Other causes—for example, the ending of important patents—appear to have been more significant.
- In terms of its ostensible purpose of job creation in Puerto Rico, Section 936 was very expensive to the U.S. Treasury. According to a U.S. Treasury Department report, in 1987, the middle of the 936 era, it cost the U.S. government on average at least $1.51 in lost tax revenue for each $1.00 in wages paid in Puerto Rico by firms operating under the provisions of Section 936. Or, put another way, on average it cost at least $26,725 each year to maintain a job that was paying an annual salary of $17,725.
- Section 936 did generate large profits for the U.S. firms engaged in Puerto Rico. While profit data per se for these firms is not available, the large share of the value added in their Puerto Rican operations that the firms obtained indicates large profit. In pharmaceuticals, for example, proprietors' income (profits, interest, etc.) accounted for 94% of value added; in bottled water and soft drinks, 93%; 85% in non-electrical machinery, and 80% in professional instruments.

Section 936 did not generate economic catch-up with the states, but rather the 936 era in Puerto Rico was plagued with relatively slow economic growth. Also, the termination of Section 936 cannot account for the dismal condition of the economy in recent years. In the earlier era of the

1950s and 1960s, similar tax incentive programs were associated with rapid growth, but other conditions that were the foundations of that growth are long-gone. In recent decades it has been primarily highly capital intensive Fortune 500 companies that have benefited from the tax incentives, not the Puerto Rican people.

From the era when Rexford Tugwell governed Puerto Rico in the early 1940s, Puerto Rico has sought provisions in the U.S. tax code that provide special incentives for U.S.-based firms to operate on the island. These provisions, according to Tugwell and later Puerto Rican governments, would create a basis for Puerto Rico to catch up economically with the states. Special tax incentives have thus long been a central element in governments' economic development programs, and they are touted as promoting economic growth and increased employment.[3]

The principal such provision was Section 936 of the federal tax code, which allowed subsidiaries of U.S. firms operating in Puerto Rico to pay no federal taxes on their Puerto Rican profits, even if those profits were returned to the United States (i.e., to the parent company in the states).[4] However, the Puerto Rican government, with the concurrence of the federal government, established a 10% tax on profits that were returned to the states—a so-called "tollgate tax." But the tollgate tax would be reduced substantially (to 4% or less) if the funds were held in Puerto Rican financial institutions for a specified period.[5] In the early 1990s, when the federal government began to consider the termination of Section 936, there was a general outcry from Puerto Rican officials. This outcry continued when the ten year phase-out of 936 was set in place to begin in 1996, and the severe recession that began in 2006 is often attributed, at least in large part, to the termination of this federal tax incentive.

The phase out and termination of 936, whatever its impact on the overall Puerto Rican economy (about which more shortly), undercut a substantial gain that had accrued to the financial sector. The tollgate tax worked to the extent that 936 firms deposited a large amount of funds in Puerto

[3] The exception was the government of Pedro Rosselló, who held the governorship from 1993 to 2001. Rosselló was in favor of statehood for Puerto Rico and opposed 936 because it treated Puerto Rico differently, and outside of, the states.
[4] For a description of 936, see, for example, U.S. General Accounting Office, *Tax Policy: Puerto Rico and the Section 936 Tax Credit*, June 1993.
[5] See James L. Dietz, Puerto Rico: Negotiating Development and Change, Lynne Reiner Publishers, Boulder and London, 2003, p. 60. Dietz provides data showing the substantial impact of the tollgate tax on Puerto Rican banks' deposits.

Rican banks. In 1980, 936 funds amounted to 33% of all deposits in Puerto Rican commercial banks. By 1985, the figure had risen to 42%. Although the relative share of 936 deposits in the banks' total deposits dropped off in subsequent years, the role of 936 funds initiated a substantial expansion of the role of finance in the economy. Whereas in 1975, finance had accounted for 13.6% of total income, by 2000 it had risen to accounting for 23.9%.[6]

However, the rising role of the banks did not mean that they were playing a driving role in financing productive investment. Instead, their activity was concentrated in securities trading and mortgages. It seems that the banks did relative little to use 936 funds to support economic development and build a local basis for business activity, but they did gain a strong interest in the perpetuation of 936.

> In their analysis of Puerto Rican banking Rita Maldonaldo-Bear and Ingo Walter write: [7]
>
> "Commercial banks appear to have failed to allocate funds to economic development through commercial and industrial loans as much as would seem desirable in an economy such as Puerto Rico's. Moreover, they have not generated sufficient asset gathering in the form of savings and checking deposits from the household sector to underwrite the capital formation needed to create… self-sustained economic development…[A]ll the banks on the island…need to invest less in securities and instead to lend for commercial and industrial purposes at longer maturities, because doing so is more conducive to economic development…"

The gains to the financial sector notwithstanding, the "conventional wisdom" in Puerto Rico regarding 936 is a myth with little connection to reality. Section 936 and similar provisions have not been a favorable, driving force of the Puerto Rican economy. Equally, the current recession cannot be attributed in significant part to the termination of 936.

Furthermore, while 936 was failing to drive the Puerto Rican economy forward, it was quite costly for the U.S. Treasury. According to a U.S. Treasury Department report, in 1987 it cost the

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[6] See Dietz, as cited in the previous note, pp. 60-63.

[7] Rita Maldonaldo-Bear and Ingo Walter, "Financing Economic Development," in Susan Collins, Barry P. Bosworth, and Miguel A. Soto-Class, editors, *The Economy of Puerto Rico: Restoring Growth, Center for the New Economy,* San Juan, and Brookings Institution, Washington, 2006, p. 454.

U.S. government on average at least $1.51 in lost tax revenue for each $1.00 in wages paid in Puerto Rico by firms operating under the provisions of Section 936. Or, put another way, on average it cost at least $26,725 each year to maintain a job that was paying an annual salary of $17,725. For the pharmaceutical industry, the figures were $3.08 per $1.00 in wages, or $81,483 to maintain a job paying $26,471. [8]

In the late 1980s and early 1990s, when the program was at the center of economic policy in Puerto Rico, annual costs (in terms of lost revenue to the U.S. Treasury) were running between $2 billion and $2.5 billion. [9] In terms of 2016 dollars, this would amount to between $3.7 billion and $4.5 billion. This figure far exceeds the costs to the Treasury of alternative policies that would stimulate growth of the Puerto Rican economy.

The Era of 936: No Great Growth Impact In the 1950s and 1960s, the era of Operation Bootstrap, federal (as well as local) tax incentives may have played a role in the rapid growth of the Puerto Rican economy. While 936 did not exist in those years, similar provisions were put in place, implementing Tugwell's concept that Puerto Rico needed special tax treatment to attract investment to the island. In this early period, however, the major factors pushing the expansion of output and employment were low-wage labor and privileged access to the U.S. market. As wages rose and privileged access largely disappeared (as many lower-wage parts of the world obtained virtually equal access), the tax incentives remained but economic growth faltered. Since 1980, economic growth in Puerto Rico has lagged substantially behind that in the states.

During the twenty years from the implementation of 936 in 1976 to the initiation of its phase out in 1996, real (i.e., inflation adjusted) GNP in Puerto Rico grew at an annual average rate of 2.5%, while the U.S. economy grew by 3.0% annually. That is, over this 20 year period, the U.S.

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[8] U.S. Department of the Treasury, "U.S. Possessions Corporations Returns, 1987," Tables 1 and 2, as cited by J. Tomas Hexner et al., *Puerto Rican Statehood: A Precondition to Sound Economic Growth*, Second Edition, Hex, Inc. Cambridge, 1993, p. 27. The ratios of cost to wage benefits are excessively conservative as they are based on the assumption that the persons employed in the 936 industries would otherwise be unemployed.

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

economy grew 17% more than the Puerto Rican economy. In the twenty year 936 era, then, Puerto Rico was falling further and further behind the states.[10]

The association of 936 with years of relatively poor economic performance is often obscured by the fact that growth of gross domestic product (GDP) was fairly strong in the 1970 to 2000 period. GDP growth, after all, is the standard by which a country's or a region's economic expansion is usually gauged, and between 1970 and 2000 GDP (inflation adjusted) grew at a 3.8% annual rate. Gross national product (GNP), however, expanded at an annual rate of only 2.7% in this thirty year period. By 2000, GDP was almost 50% greater than GNP. This difference was largely, if not entirely, accounted for by the profits of firms based outside of Puerto Rico—mostly in the states. The growth of GNP is a much better measure of the improvement of the Puerto Rican economy—of the well-being of the Puerto Rican people and the condition of firms based in Puerto Rico—than is GDP. This is especially the case because much of the earnings of the firms based outside of Puerto Rico has been a result of the ownership of their patents being located in Puerto Rico and of transfer pricing, both designed to locate profits, but not real activity, in Puerto Rico. (For further discussion and a figure showing the GNP-GDP gap, see the Appendix.)

By the GNP measure, during these decades when 936 was in force, the Puerto Rican economy grew relatively slowly. In particular, by comparison with the U.S. economy in this 30 year period, Puerto Rican GNP was diverging downward, with its 2.7% annual growth rate well below the U.S. rate of 3.3%. The experience of these years is, then, hardly a brief for the success of 936 as driving the Puerto Rican economy forward.

The Decline in Manufacturing Employment

Yet manufacturing has played a large role in the Puerto Rican economy for many years, and this large role is usually attributed in large part to 936. When, from the mid-1990s onward, employment in manufacturing dropped off sharply, this was widely seen as evidence that the impending termination of this favorable tax treatment was a cause of decline. (Section 936 was phased out over the ten year period from the beginning of 1996.)

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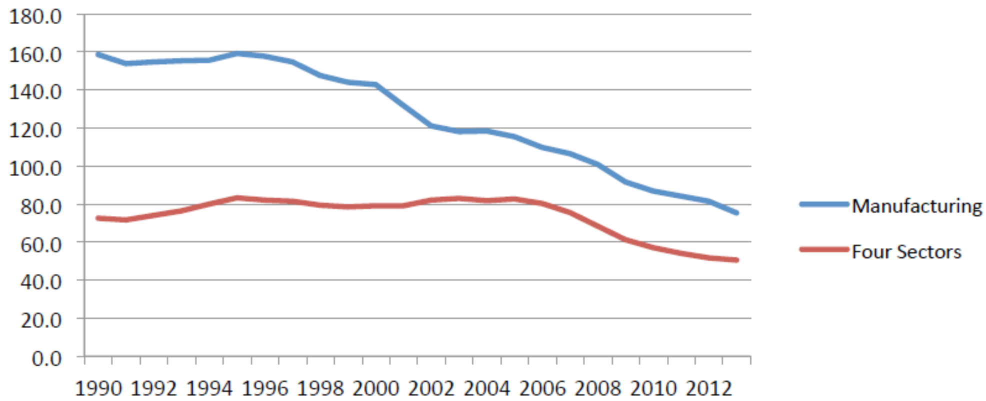
[10] Puerto Rican data are from Dietz, as cited in the previous endnote, Table 5.1, and *Informe Económico al Gobernador Puerto Rico, 2003;* U.S. data are from the *Economic Report of the President 2003*, Table B-2.

Figure 1: Employment in All Manufacturing and in Four Heavily 936 Sectors of Manufacturing, 1990 - 2013 (thousands)



Source: U.S. Bureau of Labor Statistics

The top line in Figure 1 shows the course of manufacturing employment from 1990 to 2013. From its peak of 159.1 thousand employees in 1995, manufacturing fell off sharply. This sharp fall-off, however, cannot be readily attributed to the impending termination of 936. The bottom line in Figure 1 shows the course of combined employment in four sectors of manufacturing where 936 firms have played a major role—pharmaceuticals and medicine, chemicals, computers and electrical goods, and medical equipment and supplies. In 1995, these four sectors accounted for 52% of employment in manufacturing. As the figure shows, combined employment in these sectors was stable in the 1995 to 2005 decade, at virtually the same level in 2005 as in 1995. The data for Figure 1 are presented in Table 1.

Table 1:

Manufacturing Employment, Total and in Four 936 Sectors, 1990 - 2013 (thousands)

	All Manufacturing	Pharmaceuticals & Medicine	Chemicals	Computers & Elec. Goods	Medical Equip. & Supplies
1990	158.7	21.1	25.8	15.6	10.2
1991	153.9	20.6	25.3	13.6	12.2
1992	154.6	22.1	26.7	12.6	12.6
1993	155.4	23.5	28.0	11.8	13.3
1994	155.6	24.5	29.2	14.3	12.0
1995	159.1	25.1	29.8	16.1	12.3
1996	157.7	24.5	29.1	16.2	12.4
1997	154.7	23.6	28.3	19.2	10.3
1998	147.6	23.4	28.6	16.9	10.4
1999	144.1	23.8	29.0	15.5	10.3
2000	142.7	24.6	29.6	14.7	10.3
2001	131.8	25.2	29.9	13.0	11.0
2002	121.1	27.1	31.8	11.8	11.3
2003	118.2	28.1	32.4	11.1	11.3
2004	118.3	28.4	32.6	10.3	10.6
2005	115.3	28.3	32.7	11.1	10.5
2006	109.8	27.4	31.6	10.4	10.9
2007	106.5	25.2	29.1	9.5	11.7
2008	100.9	22.8	26.5	7.8	11.4
2009	91.6	20.2	23.6	6.2	11.3
2010	86.8	18.3	21.6	5.9	11.2
2011	84.3	17.0	20.4	5.6	11.2
2012	81.5	16.1	19.4	5.0	11.2
2013	75.4	15.5	18.7	5.0	11.4

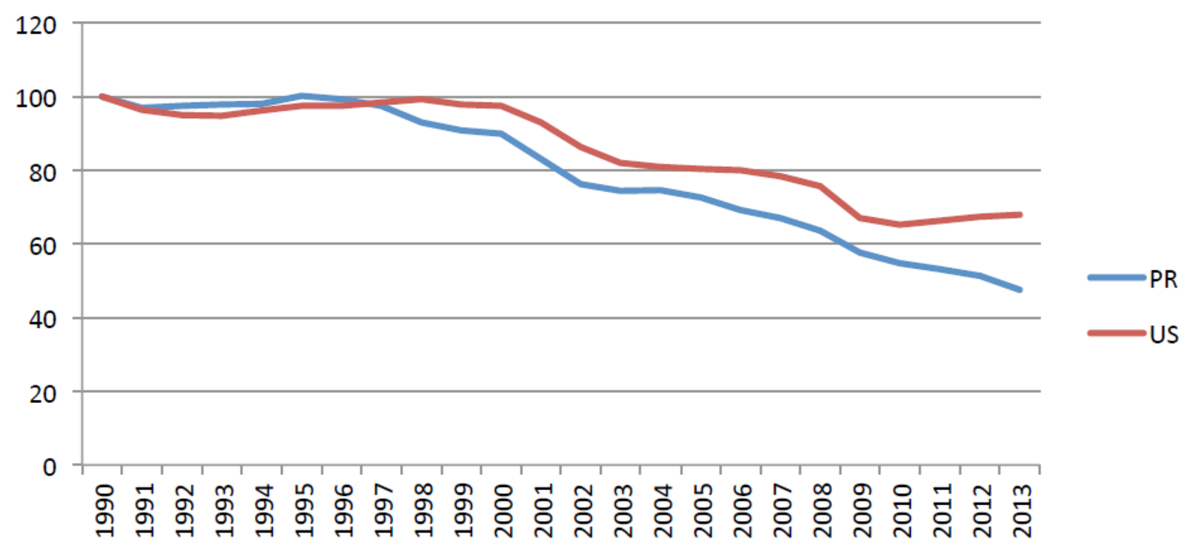
Source: U.S. Bureau of Labor Statistics

It was only after the recession began in 2006 that employment in these four sectors followed the same downward path as did manufacturing overall. Furthermore, as can be seen from the data in Table 1, while employment in all manufacturing fell by 28% between 1995 and 2005, employment in pharmaceuticals and medicines and in chemicals rose in that decade, by 13% and 10%, respectively. These two sectors accounted for 36% of manufacturing employment in 1995 and 53% in 2005.

Also, it is useful to compare manufacturing employment in Puerto Rico to manufacturing employment in the states. Figure 2 shows indexes of employment in Puerto Rico and the United States, with 1990 equal to 100. Between 1990 and 2010, when recovery from the Great Recession began in the United States, manufacturing employment fell by 35%. In Puerto Rico, for this same period, manufacturing fell by 45%, and no recovery is yet apparent. While the decline in Puerto Rico is somewhat greater, the similar experience in the states suggests that the decline is not primarily explained by factors particular to Puerto Rico—i.e., by the termination of

936. It is more likely that import competition from low-wage areas of the world and technological change account for most of the employment decline in both Puerto Rico and the United States.

Figure 2: Indexes of Manufacturing Employment in Puerto Rico and the United States, 1990-2012 (1990 = 100)



Source: U.S. Bureau of Labor Statistics

After 2006

One of the reasons that the termination of 936 is not accountable for Puerto Rico's current economic difficulties is that the advantages that U.S.-based corporations obtained from 936 did not end when this section of the federal tax code was terminated. By obtaining Controlled Foreign Corporation (CFC) status, firms were able to retain virtually all of the federal tax advantages they had had with 936. CFC status allowed the U.S.-based firms to continue to avoid U.S. taxes on their Puerto Rican operations as long as they did not return those profits to the parent corporation in the states.

Nonetheless, employment in the group of four 936 sectors shown in Figure 1 and Table 1 dropped off substantially from 2005 (except in medical supplies and equipment). Some of the employment decline can be attributed to the Great Recession in the United States, which is the principal market for the products of these firms. Something else, however, was going on, and here the switch from 936 to CFC status appears to have made a difference.

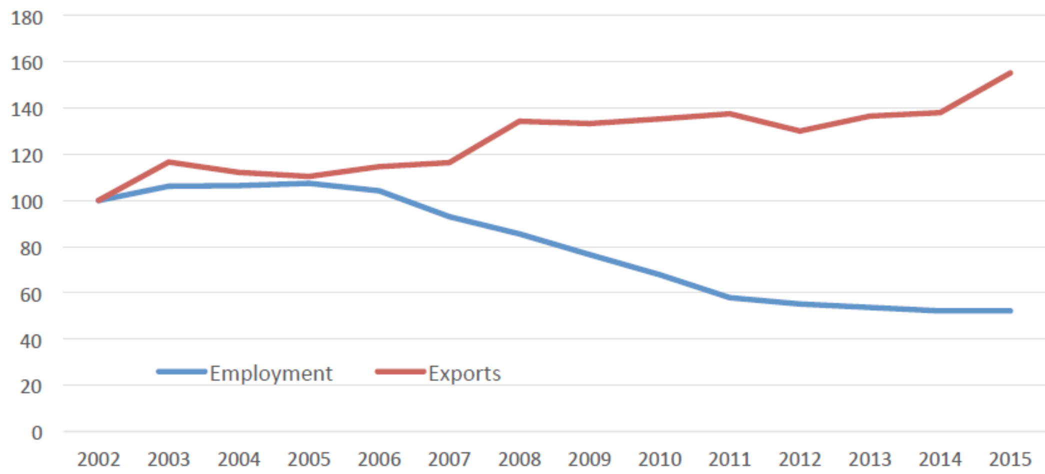
In Pharmaceutical Online in September 2006, Kevin C. Richards, Group Vice President Life Sciences, Reed Life Sciences/Reed Exhibitions, notes the following: [11]

"Most of the former Section 936 companies have converted to 901 CFC, which converts US companies operating in foreign countries into controlled foreign corporations, or CFCs. This strategy allows manufacturers to enjoy the benefits of operating within a U.S. jurisdiction, with the added tax benefits of operating under a foreign tax structure. It has also helped many facilities to become more productive with state-of-the–art automated systems. Under Section 936, which included wage credits, a typical packaging line was operated manually, by 35 or so employees. Now, under 901 CFC, it is not uncommon for automated lines to be operated by as few as ten employees."

That is, the particular structure of the 936 legislation gave employers credit for maintaining employment, but the CFC provisions did not. What happened in the pharmaceutical sector illustrates the results. Figure 3 shows indexes of employment and exports in the pharmaceutical industry from 2002 to 2015. In this period, exports rose substantially, by 55.2% (in current dollars), an especially favorable expansion in the context of the weak condition of the U.S. market in this period. Employment, however, was roughly stable until 2006 and then fell off sharply; by 2011 it was 57.8% of the 2002 level, and slid down further to 52.1% in 2015. By 2015 exports per worker were roughly 3 times as great as in 2002. (Because the export figures are in current dollars, an adjustment for price changes would reduce the difference between the two indexes, but by no means change the difference in the trends.)

[11] Available at http://www.pharmaceuticalonline.com/doc/puerto-ricos-pharmaceutical-industry-40-years-0003.

Figure 3: Indexes of Pharmaceutical and Medicine Sector Employment and Exports, 2002 - 2015 (2002 - 100)



Sources: Exports from Informe al Gobernador, Puerto Rico, various years; Employment, US BLS, Quarterly Census of Employment and Wages.

These figures on the Puerto Rican pharmaceutical industry hardly portray an industry suffering major difficulties from the termination of 936, but they do suggest that the switch from 936 to CFC status harmed employment and contributed to the decline following the 2006 onset of the recession. Nonetheless, there appears to be no basis to view the termination of 936 as a cause of the recession.

Firms Leaving Puerto Rico

In spite of the apparent positive export experience of the pharmaceutical industry, there have been numerous reports of firms, pharmaceutical firms in particular, departing Puerto Rico in recent years. These departures are sometimes attributed to the termination of 936. It seems, however, that other factors have been major problems for the pharmaceutical industry. According to a report in *Caribbean Business*: [12]

[12] The article, "Manufacturing at a crossroads," is online at http://www.caribbeanbusinesspr.com/cbdirectory/cb_manufacturing.php?cat_id=11. While undated, it appears to be from late 2011 or 2012.

> "…the future of the pharmaceutical manufacturing industry in Puerto Rico faces many challenges as many companies have patents on their products that already have or will soon expire, and the number of new drugs in the pipeline are [sic] not enough to replace those with expired patents. One dynamic now at play in the industry is the consolidation and purchasing of companies with promising medicines and patents that will help strengthen a company's overall product pipeline. In addition, local pharmaceutical companies are increasingly turning toward the outsourcing of certain products to India and China to help reduce costs."

And further:

> "The expiration of $91 billion in drug patents by 2013 will pose challenges for the pharmaceutical industry, particularly in Puerto Rico, where many of the blockbuster drugs used the world over are made."
>
> A November 22, 2013, article at PharmaTech.com: *Essential Insights for Pharma Manufacturing*, "Pfizer to Close Manufacturing Plant in Puerto Rico by 2017," explained the closing in the following terms: [13]
>
> "Pfizer will close one of its three manufacturing facilities in Puerto Rico by the end of 2017, the company announced in a Nov. 20, 2013 press release. Pfizer has determined that facility consolidation is necessary because of excess capacity in its manufacturing network created by the achievement of greater efficiencies in manufacturing processes and by changing global demand, which has resulted from the loss of patent exclusivity." [Emphasis added]

On January 30, 2014, Caribbean Business Online reported "Abbott closing one of its plants in PR." [14] According to the article, "The plant is the smallest of several that the drug and medical device maker operates in the north coastal town of Barceloneta…" And further: "The company announced in 2009 a planned expansion in its local operation estimated at $150 million in new investment. In 2007, Abbott inaugurated a $450 million, 330,000-square-foot biotech facility,

[13] Available at http://www.pharmtech.com/pharmtech/News/Pfizer-to-Close-Manufacturing-Plant-in-Puerto-Rico/ArticleStandard/Article/detail/829210?contextCategoryId=35097.
[14] Available at http://www.caribbeanbusinesspr.com/news/abbott-closing-one-of-its-plants-in-pr-93210.html.

Abbott Biotechnology Ltd. in Barceloneta, the largest-single capital investment for the company to date. It has another plant in Barceloneta, Abbott Pharmaceuticals P.R. Ltd."

In neither of these examples of plant closings by Pfizer and Abbott is 936 mentioned. Moreover, the expansionary steps mentioned in the Abbott article took place after the termination of 936. It is of course possible that the situation with taxes may have been a factor, but it was at most one of several factors in these cases. While these examples of plant closings are only examples, they do suggest that the termination of 936 or other tax issues were not at the center of firms' decisions to close plants in Puerto Rico.

Conclusion

The evidence does not support the claim that Section 936 was an important foundation for favorable economic expansion in Puerto Rico when it was in force or that the termination of 936 was an important factor bringing about the severe recession, which began in 2006. There is limited evidence that firms' switch from Section 936 to CFC status contributed to some extent to the employment decline of the recession. The firms themselves, however, have remained in good condition, as indicated by their post-2006 exports, and plant closings in recent years do not appear to have any substantial relation to the termination of 936 or other tax factors. The 936 myth should be abandoned. [15]

Although manufacturing has played a major role in the Puerto Rican economy for several decades, it has not driven the economy forward nearly to the extent that has been widely believed. The role that manufacturing has played can be explained by the favorable tax advantages that have been supplied by Section 936 and CFC status, but also by tax incentives provided by the Puerto Rican government. There is no reason to believe that, absent these tax factors, Puerto Rico would have a comparative advantage that would generate a substantial role for manufacturing. While labor costs are lower in Puerto Rico than in the states, other factors raise costs—e.g., energy prices, regulations, and transportation. Moreover, labor costs are probably partly accompanied by lower levels of productivity. Consequently, it would seem

[15] The fact that the firms appear to continue in good condition means that their tax payments to the Puerto Rican government—the tax breaks they are given notwithstanding—have remained an important source of government revenue.

reasonable to view the heavy reliance on manufacturing—a reliance that has not produced very positive results—as an artificial distortion of the Puerto Rican economy.

Rather than yearning for the return of 936, Puerto Rico would do well to abandon of the 936 myth. This recognition of reality could be one important step in laying the foundation for a new era of economic development for Puerto Rico.

B. Puerto Rico and Section 936: A Costly Dependence

By:
J. Tomas Hexner and Glenn P. Jenkins

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1. Introduction

For over 70 years, U.S. corporations have been granted tax incentives to operate in U.S. territorial possessions, most notably in Puerto Rico.[16] The purpose in so benefiting what have become known as "possessions corporations" is to attract U.S. capital to these developing territories, with the goal of creating jobs.[17]

At the outset, this approach as expressed first in section 262 of the Revenue Act of 1921, and ultimately in section 936 of the Internal Revenue Code was successful. In Puerto Rico during the 1950s and 1960s, it spurred the island's industrialization, infrastructure development, and the attendant growth in employment and gross national product (GNP). By the mid-1970s, however, the job-creation benefits of section 936 took a backseat to the tax planning that brought great financial gain to only a few U.S. companies, substantial cost to the U.S. Treasury, and a competitive disadvantage to "native" Puerto Rican enterprises.

This problem persists in large part because section 936 can have an immense impact on after-tax U.S. profits: possessions corporations receive full credit against U.S. taxes owed on the net income earned in a possession, regardless of whether that income is generated by the use of

These territorial possessions now include Puerto Rico, the U.S. Virgin Islands, the Commonwealth of the Northern Marianas, the Federated States of Micronesia, the Marshall Islands, American Samoa, and Guam. The Philippines was considered a U.S. possession until 1946, when it was given its independence.

[17] A possessions corporation is a U.S. corporation, which is commonly the subsidiary of a U.S. parent corporation doing business in a U.S. territorial possession, and which otherwise qualifies for the special tax credit afforded to such corporations Tinder section 936 of the Internal Revenue Code (IRC).

tangible property and labor within the possession or is attributable to the use of intangible property transferred to the possession corporation. Companies have been quick to see the benefit in transferring intangible assets and their related income streams to their possessions-based operations. Therefore, to the extent that corporations are able to claim tax credits for income sourced in the possessions that has been generated by properties temporarily located there but for which no real investments have been made, the cost of section 936 to the U.S. Treasury has been wholly unrelated to the intended development benefits that underlay adoption of section 936 in the first instance.

Some analysts, considering the section 936 problem solely from the perspective of the revenue loss caused by the artificial transfers of intangible assets to possessions corporations, have sought remedies by linking section 936 with section 482 of the code. Other analysts, considering the 936 problem solely from the perspective of the lack of real, development-based investments in the possessions, have sought remedies in credit limitations based on measures of real investments in the possessions themselves. Recent additions to the Internal Revenue Code reflect solutions from both perspectives.

This paper argues that neither solution offers much hope of real success, and that the current mix of solutions, although well intended, most likely will have a serious negative impact on “native” possession enterprises and the revenues these enterprises contribute to possession treasuries.

It is time to admit that the attractiveness of section 936 as a tax scheme has come too far outweigh its role as an employment-producing incentive. The companies benefiting most from the credit have been capital-intensive firms such as pharmaceutical companies. Those benefiting least have been labor-intensive industries such as apparel manufacturers.

For example, in Puerto Rico during the 1980s, the pharmaceutical industry received about 50 percent of the total tax benefits from section 936 while providing only 15-18 percent of the section 936 jobs. In 1989, the latest year for which aggregate data are available, this translated into the pharmaceutical industry receiving $1.2 billion of all section 936 credits, while employing only about 18,000 of the 106,000 workers in section 936 firms. The average cost to the U.S. Treasury for each Puerto Rican job in the pharmaceutical industry that year was

$66,081, while the average compensation was $30,447. Thus, for each dollar of employee compensation, pharmaceuticals received $2.17 in tax benefits from the U.S. Treasury.[18]

The total cost of the section 936 tax credit to the U.S. Treasury in 1989 was approximately $2.5 billion.[19] The present value of its cumulative cost during 1973-89 is approximately $52 billion.[20] The Treasury Department's Office of Tax Analysis projected that the costs of section 936, were it not revised, would continue rising at some 10 percent annually,[21] while the Congressional Budget Office calculated that the incentive scheme would bring losses of $15 billion in potential tax revenues during 1993-97.[22] [23]

These conditions made section 936 a logical target for deficit- reduction legislation in President Clinton's 1993 budget. The revised section 936 provisions restructure and reduce the tax credit effective December 31, 1993. In particular, Congress has legislated a connection between the tax credit and employment and investment growth in the possessions.

Although reform is desirable, this paper argues on a historical basis that section 936 should not merely be fixed, and indeed, that it cannot be fixed. Our contention is that section 936 has:

- essentially operated as a costly tax benefit to a few corporations;
- resulted, through links with the Caribbean Basin Initiative, in substantial gains for possessions corporations with little corresponding boost in regional exports;
- created a tax-subsidy-oriented development strategy, which for the past 20 years has been a principal cause of stagnation in the Puerto Rican economy; and
- has generated, understandably, a powerful lobbying effort to perpetuate the 936 corporate financial benefits by delivering the message that the Puerto Rican economy would falter without the investment stimulus of 936.

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[18] J. Bradford, "U.S. Possessions Corporations Returns, 1989," U.S. Department of the Treasury, Office of Tax Analysis, p. 103.

[19] **Id.*

[20] U.S. Department of the Treasury, "The Operations and Effect of the Possessions Corporation System of Taxation, Sixth Report," 1989, Table 4-11. Figures for 1984 and 1986 were imputed by taking the mean between available data for 1985 and 1987. The discount rate used was 8 percent.

[21] P. Morrison, 'Testimony before the Committee on Finance, United States Senate," April 26,1990, p. 2.

[22] U.S. General Accounting Office, "Pharmaceutical Industry: Tax Benefits of Operating in Puerto Rico," Briefing Report to the Chairman, Special Committee on Aging, U.S. Senate, May 1992, p. 1.

[23] See J.T. Hexner, G. Jenkins, H.F. Ladd, and K_R. LaMotte, Puerto Rican Statehood: A Precondition to Sound Economic Growth, November 1993. This report shows that section 936 acts as an unsustainable crutch in the Puerto Rican economy and, in so doing, creates significant market distortions, thereby impeding the economic development of the island.

We find further that the revisions to section 936, as provided in President Clinton's 1993 budget, do not address these shortcomings. Moreover, like earlier attempts to fix the tax benefit, they promise a result that is inferior to the possibilities of abandoning the policy entirely.

Section II of this article reviews the historical background of section 936, and section III examines its mechanics and looks at the technical aspects of related legislation. In particular, this article explores the relationship between section 936 and regulations issued to limit transfer pricing abuses. Section IV analyzes the impact of section 936 on Puerto Rico. Section V explores the legal relationship between section 936 and the Caribbean Basin Initiative—an act that will prolong the tax incentive. Section VI outlines the elements of the most recent attempts to reform the tax credit. Section VII concludes that section 936 cannot and should not be fixed because, as a development strategy, it is expensive and ineffective—expensive to U.S. taxpayers and ineffective in stimulating the growth of the Puerto Rican economy.

II. The Legislative History of Section 936

A. Background

Since the Revenue Act of 1921 (with its section 262, the predecessor of section 936), the U.S. government has provided a tax incentive for U.S. corporations operating in its territorial possessions.[24] The original goal was to help American corporations compete with foreign firms in the Philippines.[25]

Section 262 exempted qualified U.S. corporations from taxes on all income derived from sources outside the United States. To qualify, a corporation had to derive 80 percent or more of its gross income from its operations in U.S. possessions, and 50 percent or more of its gross income from active trade or business in the possessions.[26] These gross income tests had to be met on an aggregate basis for the year of the exemption and for the two preceding tax years if the corporation had conducted a trade or business in a possession during that period.

[24]Revenue Act of 1921, ch. 136, section 262,42 Stat. 227,314.

[25]The vast majority of section 936 companies conduct business in Puerto Rico. In 1987, nearly 97 percent of all U.S. possessions corporations operated in Puerto Rico and over 99 percent of the total section 936 credit was claimed by companies with operations in Puerto Rico. *See* J. Bradford, "U.S. Possessions Corporations Returns," p. 51. Consequently, this article will focus on the operation of section 936 in Puerto Rico.

[26]U.S. Department of the Treasury, "Sixth Report," p. 5.

Under the 1921 act, dividends paid by the possessions corporation to corporate shareholders were fully taxable. In the Revenue Act of 1935, however, this policy was abandoned. Moreover, amounts received upon liquidation were made tax-exempt.[27]

In 1948, by coupling these U.S. tax incentives with various local tax incentives, Puerto Rico initiated a more aggressive program to attract major capital investment. This program, known as "Operation Bootstrap,"[28] attracted a surge of U.S. corporations, particularly in labor-intensive industries. From 1948 to 1972, Puerto Rico's real GNP grew at an average annual rate of 6 percent (compared to a rate of 3.7 percent for the United States).[29] At the same time, the island's economy shifted from its traditional agricultural base to manufacturing, where employment increased from 55,000 in 1950 to 142,000 in 1972.[30] Indeed, the program was so successful that during the 1950s and 1960s, Puerto Rico was dubbed the "economic miracle" of the Caribbean.[31]

After this boom, however, the Puerto Rican economy stagnated. And while the section 936 lobby has attempted to maintain and disseminate the historical boom illusion, the annual rate of physical investment declined by nearly 30 percent between 1973 and 1978, from $1.5 billion to $1.1 billion.[32] In the next five years, from 1978 to 1983, new physical investment fell another 35 percent, from $1.1 billion to $0.7 billion.[33] Private investment in plant and equipment also fell steadily from 10.3 percent of GNP in 1973 to 4.6 percent in 1983.[34]

By the mid-1970s, the possessions tax benefit began to be criticized as an insufficient stimulus for employment-producing investments in Puerto Rico and the other possessions. Later, during the 1980s, other criticism emerged to the effect that, because the tax incentive provided that liquidation receipts were tax- exempt, possessions corporations were accumulating and investing

[27]Revenue Act of 1935, ch. 829, sec. 112(b)(6), 49 Stat. 1014,1020.

[28]The Operation Bootstrap program was conceived by Puerto Rican Governor Luis Munoz Marin and promised U.S. corporations "cheap labor, exemptions from island taxes for up to 25 years (along with total exemption from U.S. federal corporate and private income taxes), and assistance in the building of plants." Tansill, "Puerto Rico: Independence or Statehood?" Revista del Colegio de Abogados de Puerto Rico 41 (1980): 93.

[29]U.S. Department of the Treasury, "Sixth Report," pp. 17,19.

[30]Id,, p. 17.

[31]*Id.*

[11] Id., p. 24.

[33]*Id.*

[34]Id. p. 17.

earnings in the Eurodollar market and other foreign markets for long periods before liquidating and repatriating these earnings tax-free to the United States.[35] By the mid-1980s, opponents of the tax benefit further argued that its cost in foregone tax revenue contradicted deficit-reduction efforts by the U.S. Treasury.[36]

Those favoring a continuation of the tax exemption countered that the incentives were needed to offset the costs of federally imposed requirements in the possessions. U.S. law, for example, set minimum wages and mandated the use of U.S. flag vessels to transport goods to the mainland. This was said to disadvantage Puerto Rico, and other U.S. possessions generally, in competition with other developing countries for U.S. investment.[37]

Congress responded to the early criticisms by creating a new section 936 of the Internal Revenue Code in the Tax Reform Act of 1976.[38] Congress stated that it sought to . . . assist the U.S. possessions in obtaining employment- producing investments by U.S. corporations, while at the same time encouraging those corporations to bring back to the United States the earnings from these investments to the extent they cannot be reinvested productively in the possession.[39]

The essence of the 1976 legislation remained intact and continued to apply until December 31, 1993. Its unsatisfactory performance, with respect to the goals of Congress, is, however, broadly apparent. The benefit to much- needed employment in Puerto Rico continues to be low (the unemployment rate in Puerto Rico is now 18.1 percent) relative to its mounting cost ($2.5 billion in 1989) to the U.S. Treasury. This result has occurred because the legislation supported (and continued to support until December 31, 1993) possessions corporations and their affiliates in the exploitation of transfer pricing.

[35]Id., p. 7.

[36]Id,, p. 6.

[37]*Id.*

[38]See generally U.S. House of Representatives, "Report of the Committee on Ways and Means, U.S. House of Representatives, on H.R. 10612," Report No. 94658, November 12,1975; and U.S. Senate, "Report of the Committee on Finance, U.S. Senate, on H.R. 10612," Report No. 94938, June 10,1976.

[39]U.S. House of Representatives, "Report on H.R. 10612," p. 255; and U.S. Senate, "Report on H.R. 10612," p. 279.

B. Combating Transfer Pricing Abuses

Before 1982, there were no explicit statutory guidelines on transfer pricing.[40] This statutory silence provided possessions corporations with tacit permission to minimize their tax liability by shifting the taxable income attributable to property transferred from U.S. affiliates. A U.S. pharmaceutical company, for example, might develop a patentable drug in its U.S. laboratory and receive deductions on its U.S. federal income tax obligations for the research and development costs it incurred. The company would then transfer the patent to its wholly owned possessions corporation, which would produce the patented drug and would claim the resulting income as possession-source income. As a result, the corporate group would owe little or no income tax, either in the United States or in Puerto Rico, for producing this drug.[41]

Congress and the Treasury have repeatedly reacted to this problem but have met with limited success. Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which added a new section 936(h) to the Internal Revenue Code to ensure that a sufficient percentage of income generated by such transferred intangibles would be allocated to the U.S. parent.[42] [43] Section 936(h) was revised again in 1986 to coordinate with section 482 provisions, which address transfer pricing in general. And, as recently as January 1993, Congress once again revised the regulations when it issued new temporary section 482 regulations, which refer to section 936(h).

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[40]U.S. Department of the Treasury, "Sixth Report," p. 8. U.S. corporations operating in the possessions usually show profits in two ways. First, they earn profits from real investment in plant and equipment in Puerto Rico. Second, they are sometimes able to increase the amount of accounting profits reported in the possessions without any new physical investment by allocating to a possessions corporation income from intangibles (such as patents, trademarks, and trade names) that had typically been developed and paid for by an affiliated U.S. corporation and subsequently were transferred to the possessions corporation at a transfer price that does not reflect the market cost or the costs of development.

[41]Id.; see also U.S. General Accounting Office, "Pharmaceutical Industry," p. 2.

The U.S. Treasury took the opposite position, however, and argued that income obtained from drug sales in these transactions should be allocated to the U.S. parent and was subject to federal taxation. This issue resulted in lengthy litigation. See, for example, Eli Lilly and Co. v. Comm'r., 84 T.C. 996 (1985) and G.D. Searle & Co. v. Comm'r., 88 T.C. 252 (1987).

[42]U.S. Department of the Treasury,
"Sixth Report," p. 8.

C. Section 936 Eligibility and Links to Investment and Employment

Congress has undertaken a parallel effort to tighten the eligibility requirements for the tax exemption. It has repeatedly revised the gross income test (the minimum percentage of a section 936 firm's income that must be earned from the active conduct of trade or business in the possessions to qualify for the tax credit). Revisions to section 936 in 1976 set the minimum at 50 percent— the same figure required under the antecedent legislation. The 1982 revision increased the minimum to 65 percent, and in 1986 it was raised again to 75 percent.[28] Hence, a section 936 firm may now derive no more than 25 percent of its gross income from passive investments.

Stipulations in the Clinton administration budget adopted in 1993 represent the most recent attempt to make section 936 "work." These provisions, which came into effect on December 31, 1993, aim to reduce the tax credit while strengthening its link to investment, employment, and wage growth in the possessions.

The following sections evaluate the specifics of the evolving section 936 legislation and related provisions.

III. The Mechanics of Section 936 and Related Legislation

A. The Section 936 Tax Credit

Section 936 grants to subsidiaries of U.S. corporations operating in the possessions a tax credit[44]

[28a]The 1986 act also expanded the range of types of investment income that qualify for the tax exemption. Income from deposits in Puerto Rican financial institu¬tions that are used to finance development projects in Caribbean Basin Initiative countries now qualify.

[29a]The dollar amount of the section 936 credit is determined as follows:

Tax Credit =

Taxable Business and

Investment Income

From Sources Within Puerto Rico Worldwide Taxable Income of Possessions Corporation x

U.S. Tax

See R. J. Boles, "Tax Incentives for Doing Business in Puerto Rico," International Lawyer 22, no. 1 (Spring 1988): 123, which explains the basis for this calculation.

equal to the U.S. federal income tax liability from such operations.[45] This credit is based on the taxable income derived from: (1) trade or business within the possession,[46] (2) the sale or exchange of substantially all of the assets used by the subsidiary in this trade or business,[47] and (3) "qualified possession source investment income, (QPSII)" (i.e., passive income resulting from investment in the possessions of the exempted profits).[48]

The credit is available to any U.S. corporation that during the three years prior to the close of the tax year (or for such part of such period immediately preceding the close of the tax year as may be applicable) earned 80 percent or more of its gross income from possession sources,[49] and earned 75 percent or more of its gross income from the active conduct of trade or business within the possessions.[50]

U.S. parent corporations are eligible for a dividends-received deduction on dividends received from a possessions corporation.[51] If the possessions corporation is a wholly owned subsidiary—as most of them are—the deduction equals 100 percent of the dividend.[52] Such a possessions corporation can therefore repatriate to its U.S. parent, free of any U.S. federal income tax liability, its income earned in the possessions. Possessions governments may, however, impose their own taxes on earnings of the possessions corporations. This can include, as is the case for Puerto Rico, a tollgate tax on the repatriated earnings.[53]

Gross income received on the mainland by a possessions corporation is only considered possession-source income if it is derived from trade or business with unaffiliated parties.[54] If a U.S. corporation deposits payments into a bank account on the mainland of a possessions corporation subsidiary as payment for goods manufactured by that subsidiary in Puerto Rico, the payment will not be considered possession-source income of the subsidiary.[55] The subsidiary must receive

[45]IRC section 936(a)(1) (1989).

[46]IRC section 936(a)(l)(A)(i).

[47]IRC section 936(a)(l)(A)(ii).

[48]IRC section 936(a)(1)(B). The operation of the qualified possession-source investment income provision of section 936 will be discussed in Section V.

[49]IRC section 936(a)(2)(A).

[50] "IRC section 936(a)(2)(B).

[51]IRC section 243(b)(1)(C).

[52]U.S. Department of the Treasury, "Sixth Report," p. 7.

"Puerto Rican tax laws applicable to U.S. possessions corporations are discussed in the next part of this section.

[54]IRC section 936(b).

[55]*Pacific Basin Mfg. & Trade Co. v. Comm'r.,* 716 F.2d 638 (9th Cir. 1983); Rev. Rul. 79-168,1979-2 C.B. 283.

payment in Puerto Rico for goods and services in order for the payment to be considered possession-source income that qualifies for the section 936 tax credit.[56]

A possessions corporation may not join in a consolidated return with its parent or any affiliated corporations, even in a year in which it fails to satisfy either the 80-percent possessions-source test or the 75-percent active trade or business test.[57] Hence, operating losses incurred by a possessions corporation may not offset the taxable income of the parent or an affiliated corporation. This means that a subsidiary engaged in trade or business in a possession ordinarily will not elect to file under section 936 until it is no longer incurring start-up losses.[58]

The section 936 tax credit is not available for use against the environmental tax,[59] the tax on accumulated earnings,[60] the personal holding company tax,[61] or taxes arising out of recoveries of foreign expropriation losses.[62] For purposes of the accumulated earnings tax, the accumulated taxable income of a possessions corporation does not include taxable income eligible for the section 936 credit.[63] The credit is also unavailable to a corporation for any tax year in which that corporation is a domestic international sales corporation (DISC) or former DISC,[64] or for any tax year in which it owns stock in a DISC or former DISC,[65] or in a foreign sales corporation (FSC) or former FSC.[66]

A possessions corporation may elect to use section 936 by filing Treasury Form 5712. For the first tax year in which a possessions corporation applies for the section 936 credit, the form must be submitted on or before the date on which the federal income tax return is filed.[67] An election to use the credit may not be revoked for a period of 10 years without consent from the secretary

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[56]Nevertheless, the standard foreign tax credit may be claimed for foreign taxes paid or accrued on income that does not qualify for the section 936 credit. See U.S. Department of the Treasury, "Sixth Report," p. 7.

57R.J. Boles, "Tax Incentives," p. 125.

[58]To the extent that any losses prior to electing section 936 status have been used beneficially to offset the U.S.-source income of an affiliated group, the possessions corporation will ultimately be required to "recapture" such losses by treatingthem as U.S.-source income under the overall foreign loss recapture rules of IRC section 904(f).

[59]iRC section 936(a)(3)(A); IRC section 59A.

[60]IRC section 936(a)(3)(B); IRC section 531.

[61]IRC section 936(a)(3)(C); IRC section 541.

[62]IRC section 936(a)(3)(D); IRC section 1351.

[63]IRC section 936(g).

[64]IRC section 936(0(1).

[65]IRC section 936(f)(2)(A).

[66]IRC section 936(f)(2)(B).

[67]IRC section 936(e)(1); R.J. Boles, 'Tax Incentives," p. 123.

of the Treasury.[68]

B. Complementary Puerto

Rican Tax Incentives

In addition to the tax credit provided under section 936, the Puerto Rican government has, since 1948, provided its own complementary tax incentives for manufacturing and other specified business activities. Puerto Rico currently grants partial exemptions (of 90 percent) from income tax and other taxes to approved businesses for specified periods of time, usually from 10 to 25 years.[69] A business is generally eligible for an exemption if it is producing on a commercial scale in Puerto Rico a “designated service unit”[70] or a manufactured product not produced in Puerto Rico before January 1,1947.[71]

Companies that meet that criterion are entitled to a 90-percent income tax exemption, for a period that varies according to the level of business activity in the area where the business is located:[72]

Location	**Duration of Exemption**
High Development Zone	10 years
Intermediate Development Zone	15 years
Low Development Zone	20 years
Vieques or Culebra	25 years

Qualified manufacturers also receive partial exemptions (up to 90 percent) from property taxes

[68]IRC section 936(e)(2).

[69]Puerto Rico Tax Incentives Act, section 3,13 L.P.R.A. section 256b(a) (Supp. 1988) (approved Jan. 24,1987).

[70]13 L.P.RA. section 255a(d)(4). The term “designated service unit” applies to certain service production activities such as distribution, investment banking, public relations, publicity, consulting, and computer services.

[71]13 L.P.RA. section 256a(d)(l).

[72]13 L.P.RA. section 256(b)(d).

on the personal or real property that generates the exempted income. Moreover, a manufacturing company with gross income of less than $500,000 in any year and with average employment that year of at least 15 persons receives a 100-percent deduction of its first $100,000 of income. A 60-percent exemption from municipal license (gross receipts) taxes is also granted. Businesses that qualify for these exemptions are subject to a special surcharge equal to the lesser of 0.075 percent of sales or 0.5 percent of net income if their income is in excess of $100,000 in a tax year.[73]

A tollgate tax of up to 10 percent may be imposed on earnings repatriated to the United States or to a foreign country. The rate depends on the amount and the length of time that these earnings were invested in Puerto Rico prior to their repatriation. Holding earnings in certain designated investments in Puerto Rico (such as Puerto Rican bonds, bank savings certificates, participation in construction loans, or investment in the company's own additional plant and equipment) for five or more years will decrease the tollgate tax rate by 1 percentage point for each year that the investment is maintained. Thus, earnings invested in these instruments for six years will result in a 4-percent tollgate tax rate when the earnings are repatriated.

Example No. 1

XYZ Corporation
Hypothetical Subsidiary Operation in the U.S. and Puerto Rico
Pharmaceutical Industry

	Manufacturing United States	Plant Location Puerto Rico
Sales	$150,000,000	$150,000,000
Income Before Taxes	50,000,000	50,000,000
Effective Corporate Tax Rate	35%	4.5%
Income Taxes	17,500,000	2,228,750
Special Surtax Rate	—	0.075%
Special Surtaxes	0	112,500
Tollgate Tax[1]	0	4,765,875
Net Income After Tax	32,500,000	42,892,875
Tax Savings[2]	0	10,392,875

[1]The 10-percent tailgate tax applied assumes immediate repatriation of earnings.
^ax savings is the difference in potential income tax obligations between the U.S. and Puerto Rico. In this example, the tax savings equal $17.5 million minus $7.11 million.

If the amount invested is at least 50 percent of the income of the exempted business for a given

[73]13 L.P.RA section 256b(a).

year, then all of that year's earnings will qualify for the reduced tollgate tax rate. The 50 percent (or less) of net income not invested can be repatriated immediately at the reduced rate. At the end of the investment period, the invested funds also can be repatriated at the reduced rate.[74]

Example No. 1 illustrates how these rules operate.[75] It shows that if located in Puerto Rico, 90 percent of the income of the subsidiary of XYZ Company would be exempt from local income taxes. The remaining 10 percent would be taxed at a rate of 45 percent. Also, the 0.075-percent surtax on sales and the tollgate tax on repatriated earnings would apply. Consequently, the tax would be $2,250,000 (10 percent of the $50,000,000 in income taxed at a rate of 45 percent) less $21,250.[76]

This amounts to a total of $7.11 million owed to the government of Puerto Rico on income of $50 million, compared to an estimated $17.5 million that would be owed on similar income derived from mainland operations. The effective tax rate for this company thus is only 14.22 percent (the sum of $7.11 million in income tax, surtax, and tollgate tax divided by $50 million in income), compared to the 35-percent maximum corporate tax rate the corporation would face on similar operations in the United States. As this example shows, a U.S. company that operates in Puerto Rico under section 936 stands to reap a substantial increase in net after-tax profits through the drastic reduction in tax liability available on the island.

C. The TEFRA Amendments to Section 936

Since 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) has provided statutory rules for the allocation to a possessions corporation of income from intangibles that were developed or purchased by its affiliated corporations. The act is one in a series of attempts by the U.S. Congress to stem transfer pricing abuse.

TEFRA added a new section 936(h) to the Internal Revenue Code. This section provides that income from intangible property that is not owned by a possessions corporation is not eligible for the section 936 tax credit. Rather, it is generally taxable to the U.S. shareholders of the

[74] 13 L.P.R.A. section 256c(b).
[75] Based on examples given by the U.S. Department of the Treasury, Internal Revenue Service, in C.F.R.
[76] See R.J. Boles, "Tax Incentives," Appendix B, p. 142, which explains the basis for this calculation.

possessions corporation. TEFRA provides further that a possessions corporation and its affiliates may elect out of this general rule under either a “cost-sharing” option or a “50/50 profit-split” option.[77]

These two options provide methods by which a possessions corporation may claim an appropriate portion of the income from intangible property that is transferred from its affiliates. If the possessions corporation does not elect either method, it must compute its income from intangible property based on a reasonable profit on the costs that are attributable to such income.[78]

The cost-sharing and profit- split options apply only to “possession products,” products produced wholly or partially by a possessions corporation.[79] The possessions corporation must elect to treat all products in the same product area (defined by reference to three-digit classification using the Standard Industrial Classification (SIC) code) in a like manner.[80] If a corporation elects one of these options, it may, however, make a different election for export and domestic sales.[81] To be eligible to use either the cost-sharing or profit-split option, a possessions corporation must have a “significant business presence” with respect to a particular product in a possession. This requires meeting one of two tests:

25-Percent Value Added Test: The possessions corporation must show that it incurred production costs[82] with respect to the product that are not less than 25 percent of the difference of (1) gross receipts from sales or other disposition of the product to unrelated parties by the possessions corporation or its affiliates less (2) direct costs of materials purchased by the possessions corporation or its affiliates from unrelated parties in connection with the

[77]IRC section 936(h)(5).
[78]R.J. Boles, “Tax Incentives,” p. 129.
[79]The regulations under IRC section 936(h) provide a flexible definition of the term “possession product.” The term includes any item of property that is the result of a production process, including components and so-called “end-product forms.” End-product forms are products that are treated as not including certain other components for purposes of meeting the business-presence test and for the computation of the amount of income derived from the possession product.
[80]IRC section 936(h)(5)(C).
[81]IRC section 936(h)(5).
[82]For purposes of the value added test, the term “production costs” has the same meaning as in 26 C.F.R. section 1.471-11(b) except that the term does not include direct material costs and interest. Thus, production costs include direct labor costs and fixed and variable indirect production costs (other than interest). Fixed indirect production costs may include, among other costs, rent, and property taxes on buildings and machinery incident to and necessary for manufacturing operations and processes. Variable indirect production costs may include, among other costs, indirect materials, factory janitorial supplies, and utilities. See 26 C.F.R. section 1.471-ll(b).

manufacture of that product.[83]

65-Percent Labor Test: Alternatively, the possessions corporation must show that it incurred at least 65 percent of the total direct labor costs[84] of the possessions corporation and its affiliates in producing the product or service dining the tax year. The 65 percent refers to compensation for labor services performed in the possession.[85]

Start-up operations of new 936 corporations and new possession products of existing 936 corporations can meet the "significant business presence" requirement by satisfying a lower threshold of value added or labor cost than the percentages referred above. For such operations, a transition period is provided, as follows:

	Year 1	Year 2	Year 3
Value Added Test	10%	15%	20%
Labor Test	35%	45%	55%

1. The Cost-Sharing Option

Under the cost-sharing option, a possessions corporation is required to make a payment to its U.S. parent for 110 percent of its share of the cost (if any) of product-area research that is paid or accrued by the affiliated group during the tax year.[86] "Product area research" costs include research, development, and experimental costs, losses, expenses, and other related deductions, including amounts paid for the use of, or right to use, a patent, invention, formula, process, design, pattern, or know-how (or the amount paid for the acquisition of any of these) that are allocable to the same product area as that in which the possessions corporation conducts its

[83] IRC section 936(h)(5)(B).

[84] Direct labor costs include the cost of labor that can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. IRC section 936(h)(5)(B).

[85] IRC section 936(h)(5)(B).

[86] IRC section 936(h)(5)(C)(i)(I).

activities. Also included is a pro rata portion of any costs, expenses, and other deductions that cannot definitely be ad- located to a particular product area.[87]

The payment required of the possessions corporation is therefore 110 percent of a portion of the year's research expenditures of the affiliated group in the product area in which the possession product falls.[88] This portion is defined as the ratio of (1) third-party sales of the possession product made by the affiliated group to (2) third- party sales of all products in the product area made by the affiliated group.[89] The cost-sharing payment is determined separately for each product by using the following formula:

$$\frac{\text{Sales to Unrelated Persons of Possession Product}}{\text{Total Sales of Products in 3-digit SIC Code}} \; x \; \text{110\% of Worldwide Product-Area Research Cost-Sharing Payment}$$

A possessions corporation may credit its payments under cost sharing arrangements with unrelated persons against its share of the cost of product area research paid or accrued by the affiliated group. On the other hand, amounts paid to, or on behalf of, related persons and amounts paid under any sharing agreements with related persons may not be credited against the possessions corporation's cost-sharing payment for the tax year.[90]

Accordingly, a Possessions Corporation electing the cost-sharing payment method is treated as the owner of the manufacturing intangibles (but not marketing intangibles) associated with the possession product.[91]

[87]IRC section 482 is to be applied if no intangible property is related to a product produced in whole or in part by a possessions corporation (discussed in Section VI).

88IRC section 936(h)(5)(C).

[89]U.S. Department of the Treasury, "Sixth Report," p. 10.

[90]Treas . reg. section 1.936-6.

[91]IRC section 936(h) distinguishes between these forms of intangible property. "Manufacturing intangibles" refers to any patent, invention, formula, process, design, or know-how. "Marketing intangibles" includes any intangible property defined in IRC section 936(h)(3)(B), if it is used in marketing a product. Therefore, a determination must be made under the cost-sharing option as to what portion of the final sales price of the possession product constitutes a return to manufacturing intangibles (and is therefore tax-exempt income to the possessions corporation) and what portion is a return to marketing intangibles (and is therefore taxable income to the affiliates that perform the marketing). Regulations under IRC section 482 are applied to make this determination.

Example No. 2

XYZ is a possessions corporation engaged in the manufacture and sale of four products (A, B, C, and D), all of which are classified under the same three-digit SIC code. XYZ sells its production to a U.S. affiliate, P, which resells it to unrelated parties in the United States. P's third-party sales of each of these products produced in whole or in part by XYZ are $2,000,000 per product, or a total of $8,000,000 for A, B, C, and D. P's other sales of products in the same SIC code are $8,000,000. The worldwide product-area research of the affiliated group is $500,000. XYZ must compute its cost-sharing amount for each individual product A, B, C, and D as follows:

$$\frac{\text{Sales to Unrelated Persons of Possession Product}}{\text{Total Sales of Products in 3-digit SIC Code}} \times \begin{array}{c}\text{110\% of Worldwide}\\ \text{ProductAreaResearch}\end{array} = \begin{array}{c}\text{Cost-Sharing}\\ \text{Payment}\end{array}$$

$$\frac{\$2{,}000{,}000}{\$16,\ 000{,}00} \times \$550{,}000 = \$68{,}750$$

By virtue of a 1986 amendment to section 936(h)(5), the payment made under any cost-sharing option cannot be less than what would be required under section 367(d) or section 482 of the Internal Revenue Code if the electing corporation were a foreign corporation.[92] Section 367(d) and section 482 provisions essentially authorize the IRS to reallocate gross income and deductions between affiliated businesses. Such a reallocation is performed when the IRS, following specific guidelines, questions transfer prices and determines that a reallocation is required to stem tax evasion or to reflect income clearly.

Example Nos. 2 and 3 show how to determine the amount of the cost-sharing payment. They are based on examples given by the Treasury Department.[93]

Example No. 2 shows that the amount of the cost-sharing payment would be $68,750. If, however, XYZ also received $10,000 in royalty income from an unrelated person for the licensing of certain manufacturing intangible property rights, the amount of the product area research ($500,000) would be reduced by that amount, to $490,000.

Example No. 3 shows that a payment by the possessions corporation to an unrelated party under

[92]IRC section 936(h)(5)(c)(i)(I).
[93]Treas. reg. section 1.936-6.

a cost-sharing arrangement will serve to reduce the cost sharing payment, in this case by 31.36 percent.[94]

2. The 50150Profit-Split Method

If, for any product, the possessions corporation elects the profit- split method, it must also have manufactured that product in the possessions. In the case of Puerto Rico, this requirement is met if:

(1) the product has been substantially transformed by the possessions corporation in Puerto Rico;

(2) the operations conducted by the possessions corporation in connection with the product are substantial in nature and generally are considered to constitute manufacture or production; or

(3) the conversion costs incurred by the possessions corporation in Puerto Rico (including direct labor, factory burden, and testing of components) account for 20 percent or more of the total cost of goods sold by the possessions corporation. In this context, packaging, labeling, and minor assembly operations are not deemed to constitute the manufacture or production of product.[95]

Under the profit-split option, b50 percent of the combined taxable income of the possessions corporation and its U.S. affiliates, as derived from "covered sales" of the possession product, is allocated to the possessions corporation.[96] The remainder of the combined taxable income is generally allocated to U.S. affiliates.

[94]In neither example may the payment be less than the payment that would be required under IRC sections 367(d) or section 482 if the electing corporation were a foreign corporation.

[95]R. J. Boles, "Tax Incentives," p. 130.

[96] "Covered sales" are sales by members of the affiliated group (other than foreign affiliates) to foreign affiliates or to unrelated persons. See Treas. reg. section 1.936-6.

Example No. 3

The facts are the same as Example No. 2 except XYZ manufactures product D under a license from an unrelated person. XYZ pays the unrelated party an annual license fee of $25,000. Consequently, the worldwide product-area research amount increases to $525,000.

Example No. 4

XYZ, a possessions corporation, manufactures 200 units of possession product S. XYZ sells 100 units of S to an unrelated person in an arm's length transaction for $10 per unit. XYZ sells the remaining 100 units to its U.S. affiliate, A, which leases the 100 units to unrelated persons. The combined taxable income for the 200 units of S is determined as follows:

Sales	
1. Total sales by XYZ to unrelated persons (100 x $10)	$1,000
2. Total deemed sales by A to unrelated persons (100 x $10)	1,000
3. Total gross receipts	$2,000
Total Costs	
4. Total expenses[1]	$1,200
Combined Taxable Income and Allocation of Income Attributable to the 200 Units of S	
5. Combined taxable income (line 3 minus line 4)	$800
6. Share of combined taxable income apportioned to XYZ (50% of line 5)	400
7. Share of combined taxable income apportioned to A (line 5 minus line 6)	400

[1]Research, development, and experimental costs are the higher of (1) the research and development allocation under section 861 or (2) 120 percent of total research costs multiplied by the ratio of sales by the possessions corporation to total sales.

For purposes of computing the combined taxable income from the possession product, all direct and indirect expenses relating to the product are taken into account, including income attributable to both manufacturing and marketing intangibles associated with the product. The combined taxable income is computed separately for each product produced, or type of service rendered, by the possessions corporation in the possession.

Example No. 4 shows how to determine the combined taxable income under the profit-split method. It is based on a Treasury Department example.[97] The combined taxable income in Example No. 4 ($800) is the total gross receipts from the possession product ($2,000) minus the total expenses attributable to the development and production of this product ($1,200). The income from the subsequent leasing of the 100 units by A to unrelated persons is attributed entirely to A.

IV. The Economic Impact of Section 936 on Puerto Rico

A. The Broad Economic Trends

The special tax credit afforded to U.S. corporations operating in the possessions clearly was helpful in promoting Puerto Rican economic growth in the 1950s and the 1960s. During this period, the credit was instrumental in transforming Puerto Rico from an agricultural economy to one primarily based on manufacturing. Puerto Rico became the "economic miracle" of the Caribbean, as real GNP per capita rose at an average annual rate of over 5 percent, compared to an annual rate of 2.2 percent for the United States during the same period.[98]

Since the mid-1970s, however, the section 936 tax incentives have proved to be both ineffective and inefficient as a vehicle for sustained economic growth. Consistent with this conclusion are three telling concerns. First, both employment and new physical investment in Puerto Rico have stagnated. Second, the composition of section 936 production has declined in labor intensity and

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[97] Treas. reg. section 1.936-6(l)(b), Q&A 11. On January 11,1994, the IRS proposed controversial regulations under section 936(h) that amend the rules under the profit-split method for determining combined taxable income attributable to a possessions product that is a component product or an end-product form. For a summary of the proposed regulations (IL-068- 92), see 8 Tax Notes Int'l 226 (January 24, 1994). For coverage of an IRS public hearing on the proposed regulations, see 9 Tax Notes Int'l 129 (July 18,1994).

[98] U.S. Department of the Treasury, "Sixth Report," p. 19.

has become increasingly capital-intensive. Third, the total cost of the tax credit to the U.S. Treasury has increased substantially. Collectively, these trends indicate that the limited benefit of the incentive to the Puerto Rican employee is increasingly unjustifiable in relation to the tax revenues foregone by the deficit- plagued U.S. Treasury.

Manufacturing employment in Puerto Rico virtually stagnated during 1970-86, and total non-government employment remained steady or declined throughout 1974-83.[99] The island is currently experiencing very high unemployment (18.1 percent), low labor-force participation (45.7 percent), and a high rate of migration to the mainland in search of jobs.[100] Similarly, during the past two decades, aggregate physical investment in Puerto Rico has remained stagnant. The annual rate of investment declined sharply during the 1970s and early 1980s, and total fixed annual investment is only now approaching the levels of the early 1970s.[101]

The change in the composition of section 936 corporations parallels this trend and is equally dramatic. Specifically, the share of section 936 activity during the past three decades in such labor-intensive industries as textiles has diminished significantly, while the share in capital- and technology-intensive industries such as pharmaceuticals has increased commensurately. In 1960, for example, chemicals and machinery, two view technology-intensive industries, made up 22 percent of the net manufacturing income in Puerto Rico; by 1989, that share had increased to over 73 percent.[102] Clearly, capital-intensive firms—rather than the labor-intensive industries that section 936 was designed to attract—have made the most use of the provision.

The part of the section 936 tax incentive that goes toward wages could be the most meaningful contribution of external capital to the economic health of Puerto Rico. With the high level of capital intensity, the ratio of wages and salaries to the total value added of section 936 firms is low. One indicator of this is the ratio of proprietors' income (profits, interest, etc.) to total value added for section 936 firms. In 1991, this figure was 92.3 percent for the pharmaceutical industry and 81.2 percent for the electrical machinery industry. These two industries collectively account for over 60 percent of the entire section 936 credit. Therefore, for those corporations that benefit

[M]*Id.*

[100]National Bureau of Labor Statistics, by phone, August 1993. This rate of migration is currently hovering around 1 percent per year. See J.T. Hexner et al., Puerto Rican Statehood, p. 5.

[101]Id., pp. 25-26.

[102]U.S. Congressional Budget Office, "Potential Economic Impacts of Changes in Puerto Rico's Status under S.712," report prepared for the U.S. Senate Committee on Finance, April 1990, Table 3.

from the majority of the incentive, wages, and salaries accounted for less than 20 percent of the total value added.

In light of stagnant employment and investment on the island and the declining labor intensity of section 936 industries, the concern, therefore, is the increasing cost-ineffectiveness of section 936. In 1989, the average revenue cost of the tax credit per employee in a section 936 corporation was $22,375. Before-tax annual wages for the year were, however, only $20,540. Hence, the federal government paid approximately $1.08 for each dollar paid to employees of section 936 corporations. Section 936 is also ineffective with respect to its low impact on physical investment, as measured by total assets of section 936 corporations per dollar of foregone tax revenues. In 1989, the total assets of section 936 manufacturing firms amounted to $5.9 billion. Given the $2.5 billion tax revenue cost of the program in that year, it would take less than 2.5 years for the value of foregone tax resources to equal net assets. Put simply, raw cost-effectiveness would have supported buying the section 936 manufacturing plant and equipment and literally giving it away to the corporations to operate, rather than prolonging the tax credit.

The problems with section 936 are most evident in the pharmaceutical industry. For the period 1980-90, the amount of estimated income exempt from taxes for 26 pharmaceutical firms examined by the General Accounting Office (GAO) totaled about $24.7 billion.[103] This translates into an estimated total tax savings of about $10.1 billion in 1990 dollars for the Puerto Rican operations of these firms.[104] In 1989, however, the total assets of the pharmaceutical industry in Puerto Rico were only $2.53 billion. Perhaps the strongest indicator of the profitability of the Puerto Rican operations of these pharmaceutical firms is that 17 of the 21 most-prescribed drugs in the United States were authorized for manufacture in Puerto Rico.[105] One senator has stated that the GAO document "undeniably demonstrates that the American government has given the pharmaceutical industry a blank check to pillage the federal Treasury through the section 936 tax credit."[106]

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[103] U.S. General Accounting Office, "Pharmaceutical Industry," p. 21.
[104] ***Id.***
[105] ***Id.**,p.* 6.
[106] Richardson, "Pryor Blasts Drug Company Tax Breaks With GAO Ammunition," 4 Tax Notes Int'l 1093 (May 25,1992).

B. The Relationship between Section 936 and Transfer Pricing Abuse: The Results of the TEFRA Amendments

The cost-ineffectiveness of section 936 generally testifies to the ineffectiveness of the TEFRA amendments. These amendments were supposed to limit substantially the amount of profits a possessions corporation could claim as tax-free earnings from the transfer of intangible assets. The facts show that this goal has not been met.

Indeed, the data since 1982, the year in which the amendments were promulgated, show the continued role of transfer pricing in artificially increasing the profit rates of the possessions corporations. For example, in 1983, the reported before-tax annual rate of return on operating assets for manufacturing corporations participating in the section 936 program was 54.1 percent, more than five times the rate of return for mainland manufacturing operations (10.3 percent).[107] If the true rate of return for section 936 investments in Puerto Rico were this high, firms would have strong incentives to increase their real investment on the island, and investment would be booming.

[107] U.S. Department of the Treasury, "Sixth Report," p. 36.

This has not been the case, however.[108] In 1988, for example, total fixed investment in Puerto Rico was about 20 percent of GNP, compared to 25 percent in the 1966-73 period. What this suggests is that the TEFRA amendments are not blocking the transfer by corporations of large amounts of income into Puerto Rico, the Puerto Rican source generation of which is attributable to factors that are unrelated to real investments in Puerto Rico. Yet, the section 936 lobby was able to convince the Reagan administration to continue to rely on the section 936 tax subsidy as a development tool for the Caribbean Basin.

I. Section 936 and the Caribbean Basin Initiative

A. Targeting Section 936 at the Broader Goals of Regional Development

The Caribbean Basin Initiative (CBI) was introduced by the Reagan administration in 1983 to allow qualified Caribbean countries to trade on more favorable terms with the United States.[109] This should have worked to increase exports to the United States from CBI countries. The Tax Reform Act of 1986 served to integrate section 936 with this development initiative. Prior to the 1986 act, section 936 allowed the active income earned by a possessions corporation to be invested tax-free in certain eligible activities in Puerto Rico and other U.S. possessions.[110] The income earned from these investments is referred to as "qualified possession source investment income" or QPSII. The 1986 act expanded the area in which investments could be made to include the U.S. Virgin Islands and qualified CBI countries, as long as the investments were made through qualified financial institutions.[111] The income generated by such investment qualifies as QPSII and is exempt from U.S. tax. A similar exemption from Puerto Rican tax applies under Puerto Rican law.[112]

The 1986 act imposes a number of requirements regarding when earnings of section 936 firms will qualify for investment in a CBI country or possession. The first requirement is that investments can only be made in qualified Caribbean Basin countries as designated under the

[108]Hexner et al., Puerto Rican Statehood, for a discussion of why section 936 is incompatible with Puerto Rico's sustainable economic development and why statehood presents a much more efficient vehicle for continued growth.

[109]The Caribbean Basin Initiative is the common name of the Caribbean Basin Economic Recovery Act, Pub. L. No. 98-67, 97 Stat. 384 (1983) (codified as amended in scattered sections of 19 U.S.C. and 26 U.S.C.). Under the act, qualified countries receive a reduction or elimination of tariffs on certain products, along with access to relatively low interest rate loans, provided with certain section 936 funds.

[110]IRC section 936(d)(2).

[111]IRC section 936(d)(2)(B) and 936(d)(4).

[112]13 L.P.R.A section 256a(2)(j)(A).

Caribbean Economic Recovery Act of 1983.[113] Twenty-three countries have thus far qualified and are so designated.[114] To be eligible for these tax-exempt investments, CBI- qualified countries are required to enter into a Tax Information Exchange Agreement (TIEA) with the United States.[115] The purpose of the TIEA is to allow the United States and CBI governments to share tax and other information that could lead to the arrest of drug traffickers, tax evaders, and other criminals.[116]

Another requirement for these investments is that they be in "active business assets" or "development projects."[117] The Senate Finance Committee report that accompanied the CBI amendment to section 936 defines these as follows:

A development project generally means an infrastructure investment, such as a road or water treatment facility, that directly supports industrial development. Active business assets generally means plant, equipment, and inventory associated with a manufacturing operation.[118]

Treasury Department regulations further define these terms so that qualified investment is generally permitted in tangible property used in a trade or business in qualified CBI countries, including reasonable incidental expenditures (such as installation costs).[119]

A section 936 company cannot receive a tax exemption if it invests funds directly in an other-wise-qualified CBI project. Instead, the section 936 company must invest through a "qualified financial institution."[120] The Government Development Bank for Puerto Rico and the Puerto Rico Economic Development Bank are both defined as qualified financial institutions. Other than those two, a financial institution in Puerto Rico may qualify if it is: (1) a "banking, financing, or similar business" that is "organized under the laws of the Commonwealth of

[113]IRC section 936(d)(4).

"Those countries and possessions are Antigua and Barbuda, Aruba, the Bahamas, Barbados, Belize, British Virgin Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Panama, St. Kitts and Nevis, St.
Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago. Nicaragua has requested designation, and the U.S. is currently reviewing that request.

[115]IRC section 936(d)(4)(B).

[116]Flax-Davidson, "Tax-Exempt Investment for the Caribbean Basin Initiative Region," International Lawyer 25, no. 4 (Winter 1991): 1025.

[117]IRC section 936(d)(4)(A)(i).

[118]U.S. Senate, Committee on Finance, Tax Reform Act of 1986, S. Rep. No. 313, 99th Cong., 2d Sess. 384 (1986).

[119] "Requirements for Investments to Qualify under Section 936(d)(4) as Investments in Qualified Caribbean Basin Countries," Treas. Reg. section 1.936-10(c)(4),
(5) (May 10, 1991).

[120]IRC section 936(d)(4)(A).

Puerto Rico or is the Puerto Rican branch" of such a business and is an eligible depository institution for investments from section 936 firms, as qualified by the commissioner of financial institutions under Puerto Rican regulations;

(2) "such other entity as may be determined by the commissioner"; or (3) a "single-purpose entity" established in Puerto Rico as an eligible institution solely to invest funds from section 936 firms in qualified CBI assets.[121]

All lending of these funds to a qualified CBI recipient must be approved by the commissioner of financial institutions for Puerto Rico.[122] Additionally, the recipient of CBI funds must open its books to the United States and Puerto Rican governments to assure that the funds are being used in accordance with the law.[123] A1990 congressional amendment to section 936 requires the government of Puerto Rico to ensure that at least $100 million is invested annually in qualified CBI investments.[124]

B. Evaluation of the CBI: A

Weak Justification for Prolonging Section 936

Even among those who acknowledge the transfer pricing abuses of section 936 firms, there are proponents who justify the continued extension of section 936 benefits because of the tax credit's role in the CBI program. They argue that the elimination or any reduction in the section 936 tax credit would proportionately damage the CBI because of the close integration of the two programs. It has been asserted, for example, that at least $500 million of qualified funds have been appropriately invested under this program, creating close to 20,000jobs in the CBI countries and more than 2,500 jobs in Puerto Rico.[125] These statistics have been used to support the claim that the program is functioning as intended and that section 936 should remain untouched.

Other evidence, however, suggests that the CBI program has been unsuccessful. The Latin

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[121]Treas. Reg. section 1.936-10(c)(3).

[122]IRC section 936(d)(4)(A)(ii).

[123]IRC section 936(d)(4)(C)(iii).

[124]See IRC section 936(d)(4)(D) (West Supp. 1991) (effective for calendar years after 1989); H.R. 1594,101st Cong., 2d Sess., 136 Cong. Reg. H5887, H5896 (daily ed. July 30,1990).

[125]Price Waterhouse, "Section 936 Report, Volume 1: Benefits and Costs of Section 936," prepared for Puerto Rico, U.S.A. Foundation, May 1991, Table IV.B. See also R.J. Sierra Jr., "Funding Caribbean Basin Initiative Activities with Section 936 Funds," International Tax Journal (Spring 1992): 57-58.

American and Caribbean Economic Commission reported an average 17.2-percent reduction in per capita gross domestic product during the 1980s.[126] Latin America and the Caribbean also experienced a 0.8-percent decrease in real gross national product in 1990, and record loans in that year added to their already staggering foreign debts.[127] Thus, in relative terms, the very nations the CBI was intended to support have been steadily losing ground.[128] The claim of positive long-run development impact from the $500 million of CBI funds purported to have been allocated and the 20,000 jobs created in the CBI countries is dubious at best.

Despite the preferential treatment offered to CBI countries under the program, there has been a constant decline in the value of U.S. imports from these countries. U.S. imports from CBI countries reached an all-time high in 1983, the year in which the program was enacted.[129] Between 1983 and 1986, however, exports from the CBI countries to the United States declined by a total of 31 percent.[130] By contrast, the level of U.S. exports to these countries has remained steady.[131] According to the U.S. International Trade Commission:

In 1986, for the first time in a number of years, the United States had a small surplus with the Caribbean countries collectively, making the basin one of the few areas in the world with which no U.S. trade deficit was recorded. This was the result of a significant decline in U.S. imports from the Caribbean Basin, from $9.0 billion in 1983 to $6.2 billion in 1986, while U.S. exports to the area remained approximately the same, fluctuating around $6.0 billion.[132]

Also, in 1986, U.S. imports from CBI countries represented only 1.7 percent of the total U.S. imports, while U.S. exports to these countries represented 3 percent of the total U.S. export market.[133]

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[126] "Mexico, Central American Countries Plan Free Trade Agreement to Be Reached by 1996," Inti. Trade Rep. (BNA) 8, no. 3 (Jan. 16,1991): 87.

[127] "Latin American Economies Register Decline of 0.8 Percent in 1990, IDB Report Shows," Inti. Trade Rep. (BNA) 8, no. 15 (Apr. 10,1991): 554.

[128] J.C. Malloy, "The Caribbean Basin Initiative: A Proposal To Attract Corporate Investment and Technological Infusion via an Inter-American Protection for Intellectual Property," University of Miami InterAmerican Law Review 23, No. 1 (1991): 184.

[129] U.S. International Trade Commission, "Annual Report on the Impact of the Economic Recovery Act on U.S. Industries and Consumers, Second Report 1986," September 1987, p. 6.

[130] Id., p. 8.

[131] /cf.,p. 1.

[132] *Id.*

[133] *Id.*

Recent data suggest a continuation of these trends. In 1990, U.S. imports from CBI countries were approximately $1.4 billion less than in 1983.[134] This constitutes a 2.1-percent annual rate of reduction in the amount of imports and a 16-percent gross decline.[135]
Indeed, the CBI might be judged as a program of phantom benefits and phantom results.
Over 93 percent of the exports generated from Caribbean countries designated under this program already entered the United States duty-free prior to the enactment of the CBI.[136] In addition, the elimination of already low U.S. tariffs (generally ranging from 5 to 7 percent) on Caribbean industrial products does not make these products significantly more competitive in the U.S. market.[137] Moreover, the CBI excludes from its list of qualified products a number of items produced by the most labor-intensive industries, including apparel and leather goods.
What the CBI program has successfully done, however, is expand the scope of political leverage for section 936 companies by broadening the scope of their potential investment. As dollars have been invested in more CBI countries, section 936 companies have gained increasing clout with these countries and enlisted their help in lobbying against the curtailment of the tax credit. Nevertheless, because of the lack of real benefits from the CBI and because the actual amount of imports from the CBI countries has been steadily decreasing, while U.S. exports have remained steady, the continued existence of the section 936 tax credit cannot be justified by linking it to the CBI program.

II. Further Reforms Affecting Section 936

A. Effects of Section 482

Regulations on Section 936

Section 482 of the Treasury regulations provides most of the guidelines concerning the proper allocation of income in a transfer pricing transaction. On July 1, 1994, final regulations were issued under section 482 that contain provisions that alter the manner in which transfer prices for intangible property will be reviewed by the IRS and that specifically coordinate with the transfer pricing requirements of section 936. The final section 482 regulations provide for

[134] U.S. Department of Commerce, Guidebook: Caribbean Basin Initiative (1991), p. 55.
[135] *Id.*
[136] T.L. Raleigh, "The U.S. Caribbean Basin Initiative," International Business Lawyer 15, no. 3 (March 1987): 137.
[137] *Id.*

greater taxpayer flexibility, at the cost of more stringent documentation requirements.[138] The IRS anticipates that this will diminish the number of disputes between the IRS and taxpayers. Some practitioners contend, however, that the policy, in its move toward greater flexibility, imposes an unmanageable administrative burden on the IRS.

The regulations reaffirm the applicability of the arm's length standard and continue to emphasize analysis that relies on the structure and circumstances of the individual transaction. However, added flexibility now comes via the applicability of a range of acceptable arm's length results as opposed to a single arm's length price. Also, consistent with the reality of varying market conditions and transaction circumstances, there is now no strict priority of pricing methods. Instead, the accuracy of the pricing method, with respect to the case in question, decides its appropriateness. In another move towards taxpayer flexibility, the prices actually charged in controlled transactions need not reflect the arm's length price that must be reported on the income tax return. Where reported price differs from the price actually charged, compensating adjustments are made to reflect the disparity.[139] Finally, the standards that must be met before transactions are considered comparable have been relaxed. Under all pricing methods, a reasonable number of adjustments is permitted where transactions are not exactly comparable.

With regard to possessions corporations, section 482 regulations provide that when a controlled taxpayer has elected for cost-sharing under section 936(h), the amount of the cost-sharing payment that is required under this section will not be less than the payment that would be required under the section 482 regulations (if the electing taxpayer were a foreign corporation). Also, the 936 corporation must apply the section 482 pricing methods for intangibles before giving effect to the provisions that treat the 936 corporation as the owner of this property.

One reviewer of the tax changes makes the following claim:

It is almost impossible using the arm's length method of section 482 of the Internal Revenue Code to determine accurately the tax obligations of multinational corporations dealing only in tangible goods; it is impossible to do so when these corporations are earning money from intangibles. ... In short, the IRS's section 482 enforcement efforts are unworkable because the

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[138] J. Turro, "U.S. Releases Final Transfer Pricing Regulations Under Section 482," 9 Tax Notes Int'l 79 (July 11, 1994).
[139] Reg. section 1.482-l(e)(2).

system is too complex, cumbersome and expensive to catch all but the most blatant tax evaders.[140]

This claim is troubling given the findings of a 1993 Ernst & Young study, which estimated that the government's transfer pricing initiatives would collect less than 10 percent of Treasury Department projections.[141]

In effect, the complexity of the section 482 regulations has the potential to render them unadministerable. Indeed, the true price of taxpayer flexibility is that the circumstances of transfer pricing arrangements will gain in subjectivity and will increasingly call for judgment on a case-by-case basis. Accordingly, cases involving highly differentiated products, for which benchmark arm's length transactions are not easily identified (more often true of intangibles), will rely on extensive cost, pricing, and market data—often from unwilling competitors.

Example No. 5

XYZ is a possessions corporation operating in the 1998 tax year with an active business income from possession-based operations of $900,000. QPSII is $100,000. With no section 936 tax credit, U.S. tax liability on this income would amount to $315,000 and $35,000, respectively. The corporation's section 936 credit would be limited to $161,000 (40 percent of $315,000 plus a full credit on the QPSII tax liability).

Further, XYZ incurred $60,000 in possession taxes. A partial deduction of possession income tax is permitted. This is calculated as the total in possession income tax ($60,000) multiplied by the ratio of (a) total U.S. income tax liability with no section 936 credit less the amount of the credit ($350,000 - $161,000 = $189,000) to (b) the total U.S. income tax liability with no section 936 credit ($350,000). The deduction in this ease would be $32,400 ($60,000 x $189,000/$350,000). This reduces total taxable income to $967,600. Hence, the pre-section-936-credit tax liability is $338,660, and the post-credit liability is $177,660 ($338,660 - $161,000).

In practical terms, then, the auditing requirements of the policy leave the short-staffed IRS at a disadvantage compared to the multinational corporations with their batteries of highly paid lawyers, accountants, and economists.

B. Further Limitations on the Section 936 Tax Credit

As a result of concerns about transfer pricing abuse by pharmaceutical and other capital-in-

12aLobel, Banta, and Gueron, 'Barclays: A Test of the Administration's Willingness To Collect Taxes from Multinational Corporations," Tax Notes, June 28, 1993, p.1841.

141 *Id.*

tensive firms and because of the low levels of employment-producing investments made by section 936 firms, section 936 has been increasingly opposed by the U.S. Treasury Department and members of Congress. Indeed, on December 31, 1993, legislation designed to curb transfer pricing abuses and increase levels of investment in employment-producing activities, enacted as part of the Omnibus Budget Reconciliation Act of 1993, came into effect.[142]

Under the new legislation, the section 936 credit will be calculated in a manner consistent to that used prior to December 31, 1993.[143] However, the amount of the credit will then be limited in one of two ways,[144] with the choice of method left to the taxpayer.

The first, the percentage limitation, limits the credit by a statutorily defined percentage (that decreases in future years) of the section 936 credit allowable under present law. The second alternative, the economic activity limitation, links the limitation on the credit to a composite of factors that serve as proxy for the firm's level of economic activity in the possessions. All affiliated[145] possessions corporations are required to choose the same credit- limitation alternative.[146]

1. The Percentage Limitation

Under the percentage limitation, the section 936 credit allowed to a possessions corporation against U.S. tax on business income for a tax year is limited to a specific percentage of the credit that would be permitted under the laws prior to the 1993 revision. A five-year transition rule governs the phase-in. The percentages are:[147]

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142 See H.R. 2264,103rd Congress, 1st Sess.

143 Under the new legislation, there is a new separate foreign tax credit limitation category for computing the alternative minimum tax (AMT) foreign tax credit.

The new category includes the portion of dividends received from a possessions corporation for which the dividends-received deduction is generally disallowed, and thus is included in alternative minimum taxable income.

144 In a measure to support Puerto Rican tax revenues, given the credit limitations, the revised legislation temporarily increases the cover-over of rum excise taxes to Puerto Rico and the Virgin Islands from $10.50 to $11.30 per proof gallon. The increased cover-over rate applies through 1998.

145 The consolidated return rules are used to determine whether a possessions corporation is part of an affiliated group. However, stock owned by attribution under the rules of IRC section 1563 is treated as if it were owned directly, and the exclusions from the definition of "includible corporation" listed in IRC section 1504(b) are disregarded.

146 Should a possessions corporation that employs the percentage limitation become a member of a group that uses the economic activity limitation, then the first corporation will be deemed to have revoked its election to use the percentage limitation. The Treasury secretary is authorized to develop regulations to treat two or more possessions corporations as members of the same affiliated group in order to prevent avoidance of the consistency rule.

taxable income is computed in accordance with the pre-December 31,1993 rules for-----------------------------------
determining the taxable income of a possessions corporation.

Start of Tax Year		Percentage Limitation
1994		60
1995		55
1996		50
1997		45
1998, and thereafter		40

A taxpayer that utilizes the percentage limitation is permitted a deduction for a portion of its possession income taxes paid or accrued during the tax year. The portion of the taxes so deductible is the portion that is allocable to the corporation's taxable income, the U.S. tax on which is not offset by the section 936 credit as a result of the limitation.

The operation of the percentage limitation is shown in Example No. 5. As the example shows, the

limitation clearly reduces the section 936 credit over time. However, a firm's choice to use this alternative will be a function of the magnitude of its potential credit in relation to the credit available under the economic activity limitation. This, of course, will be determined by the firm's capacity to claim credit from the expansion of new labor-intensive activities, as well as activities that purport to be so.

2. The Economic Activity Limitation

The sum of three proxy measures for economic activity in the possessions serves as an upper limit for the tax credit allowed to a possessions corporation for a tax year. The credit against U.S. tax on the possessions corporation's business income may not exceed the sum of the following components:

- 60 percent of qualified compensation;
- the applicable percentages of depreciation deductions on qualified tangible property claimed for regular tax purposes by the corporation; and
- a portion of the possession income taxes incurred during a given year, if the corporation does not elect the profit-split method to allocate income from intangibles.

U.S. tax liability, therefore, is computed by subtracting the sum of the above three components from the amount of precredit U.S.

Example No. 6

XYZ is a possessions corporation that elects to use the economic-activity limitation. XYZ does not choose the profit-split method for computing its income from intangibles. Wage and fringe benefit expenses for XYZ total $180,000 ($150,000 in qualified possession wages and $30,000 in employee health, accident, and life insurance plans). XYZ's depreciation deductions amount to $50,000 for short-life tangible property, $30,000 for medium-life tangible property, and $20,000 for long-life tangibles. XYZ has $1,000,000 of taxable income for the year.[1] Nine hundred thousand of this is income from active business operations. Of the remaining $100,000, $50,000 is QPSII and $50,000 is other taxable income. Sixty thousand dollars is paid in possession income taxes.

Under the laws in effect through the end of 1993 (assuming no deduction for possession income taxes), the section 936 credit amounts to $332,500 (35% of $950,000 in total income less other taxable income). U.S. tax liability equals $17,500 (35% of $50,000 in other taxable income).

The revised section 936 law does not change the credit attributable to QPSII. Thus, $17,500

(35% of $50,000 in QPSII) of the present law credit is not subject to the economic activity limitation. The remainder, $315,000 is, however, subject to the limitation.

Qualified Compensation

Qualified possession wages amount to $150,000. Potentially, $25,000 in fringe benefit expenses ($150,000/$180,000 x $30,000) could have been included in the credit limitation base. The 15% limitation on fringe benefits applies, however, limiting the allocable amount to $22,500 (15% of $150,000). Total qualified compensation thus amounts to $172,500 ($150,000 + $22,500), 60 percent of which is $103,500.

Depreciation Deductions

The depreciation component of the credit limitation is the sum of (1) 15% of the $50,000 depreciation allowance on short-life property, (2) 40% of the $30,000 depreciation allowance on medium-life property, and (3) 65% of the $20,000 depreciation allowance on long-life property, for a total of $32,500.

Possession Income Taxes

None of the $60,000 of possession income taxes (a 6% effective rate) is disqualified from the credit limitation base by virtue of the maximum 9% effective tax rate provision. However, only the portion of the $60,000 that is allocated to non-sheltered income may be included in the credit limitation base. This portion is a function of the ratio of the increase in tax as a result of the compensation and depreciation limitations, and the tax that would be paid in the absence of the section 936 tax credit.

In the absence of the compensation and depreciation limitations, XYZ's U.S. tax liability would be $17,500. With the limitations, it would amount to $350,000 (35% of $1,000,000) less (1) $136,000 ($103,500 + $32,500), the active business section of the 936 credit and (2) the QPSII credit of $17,500. That is, $196,500. Hence, the increase in tax liability is $179,000 ($196,500 - $17,500).

With no section 936 credit, the U.S. income tax liability would amount to $350,000 (35% of $1,000,000).

The amount of possession income taxes which may be included in the credit limitation base is therefore $30,686 [($179,000/$350,000) x $60,000].

Total Economic Activity Limitation

The total limitation on the active business credit is therefore $166,686 (that is, $103,500 for compensation, plus $32,500 for depreciation, plus $30,686 for possession income taxes) compared to $315,000 under the regulations before revision. The full credit of $17,500 on QPSII is also granted. The corporation's net U.S. tax liability is therefore $165,814 ($350,000 - $166,688-$17,500).

tax that, under general circumstances, would be owed.

a. Qualified Compensation

The first component of the economic activity limitation is 60 percent of qualified compensation. Qualified compensation is the sum of:[148] (1) the aggregate amount of the possessions corporation's qualified possessions wages for the tax year[149] and (2) allocable employee fringe benefit expenses for the tax year.[150] Qualified possessions wages are defined

148ffiC section 936(a)(4)(A)(i).

149Wages for this purpose include those defined under the Federal Unemployment as wages paid or incurred by the possessions corporation during the tax year to any employee for services performed in a possession.[151] However, such services must be performed while the principal place of employment of the employee is within that possession.

b. **Depreciation Deductions**

The second component is the sum of the following applicable percentages of allowable depreciation deductions:[152]

(1) 15 percent of the depreciation deductions allowable to shortlife qualified tangible property;

(2) 40 percent of the depreciation deductions allowable to medium-life qualified tangible property; and

(3) 65 percent of the depreciation deductions allowable to longlife qualified tangible property.[153]

c. ***Possession Income Taxes***

The final component of the economic activity limitation is a portion of the income taxes paid or incurred to a possession by corporations that do not elect the profit-split method.[154] Possession income taxes paid in excess of a 9-percent effective rate of tax are not included.[155] Moreover, only the portion of taxes that satisfies this effective rate requirement and that is allocable to nonsheltered income is included.[156]

Tax Act (FUTA). In computing the credit limitation for a tax year, the cumulative amount of wages for each employee may not exceed 85 percent of the maximum earnings subject to tax under the Old Age Survivors and Disability Insurance (OASDI) portion of social security (currently $57,600). Rules for making appropriate adjustments to this limit for part-time employees and employees whose principal place of employment is not within a possession for the entire tax year are to be made by the Treasury secretary. The bill does not include as qualified possession wages amounts paid to employees who are assigned by the employer to perform services for another person, unless the principal trade or business of the employer is to make employees available for temporary periods to other persons in exchange for compensation.

[136]Fringe benefits may include: (1) employer contributions under a stock bonus, pension, profit sharing, or annuity plan;
(2) employer-provided coverage under any accident or health plan for employees; and
(3) the cost of life or disability insurance provided to employees. Fringe benefit expenses do not include any amount that is treated as wages. Allocable employee fringe benefit expenses are equal to a fraction of the aggregate amount that is consistent with the conditions listed above. The numerator of this fraction is the aggregate amount of the possessions corporation's qualified possessions wages (as defined above). The denominator is the aggregate amount of compensation (wages and benefits) paid or incurred during the tax year. Fringe benefit expenses may not, however, exceed 15 percent of the aggregate amount of qualified possession wages for that year.

[137]IRC section 936(i)(l)(A).

[138]IRC section 936(a)(4)(A)(ii).

[139]The terms of IRC section 168 apply to the definition and classification of depreciable tangible property.

[140]Possessions corporations that utilize the profit-split method may deduct a portion of their possession income taxes paid or accrued during the tax year. This portion is the part of U.S. taxable income, the U.S. tax on which is not offset by the revised section 936 credit.

The operation of the economic activity limitation is shown in Example No. 6.

d. ***Election To Treat Affiliated Corporations as One Corporation***

For purposes of computing the economic activity limitation, an affiliated group of corporations may elect to treat all affiliated possessions corporations as one corporation. For a group so electing, the available consolidated credit amount is to be allocated among the possessions corporations of the group under rules prescribed by the Treasury secretary. Any election to consolidate applies to the tax year for which such election is made and to all succeeding tax years unless revoked with the consent of the Treasury secretary.

e. ***Analysis of the Economic Activity Limitation***

In concept, over the course of five years, section 936 credits will be effectively linked to growth in employment wages and tangible investment. From a practical standpoint, however, the policy is less promising.

The correlation between tax avoidance and development strategies based on complex tax incentive schemes is well established. Indeed, the compounding negative results of repeated efforts by Congress to patch the loopholes of section 936 verify this correlation.

The revisions to section 936 made by the Omnibus Budget Reconciliation Act of 1993 significantly increase administrative complexity and auditing. This, in turn, enhances the potential for tax avoidance by presenting new opportunities for tax manipulation of corporation expenses and transfers to maximize tax benefits under section 936. Payroll padding, for example, is certain to replace transfer pricing as a means of increasing the credit to 936 firms in the absence of substantive real growth in employment and investment.

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[141]IRC section 936(i)(3)(A)(ii).

[142]The portion of possession income taxes allocated to nonsheltered income is determined by computing the ratio of two hypothetical U.S. tax amounts that are computed under the assumption that no credit or deduction is allowed for possession income taxes. This ratio is then multiplied by the taxable income of the corporation as computed under the assumptions that no credit or deduction is allowed for possession income taxes and that all other deductions are allowed as under present law. The numerator of the above ratio is the U.S. tax liability of the possessions corporation that would arise under the bill by virtue of the economic activity limitation determined without any credit or deduction for possession income taxes. The denominator is the U.S. tax liability of the possessions corporation that would be imposed on the income (computed under existing section 936 rules) of the corporation without any credit or deduction for possession income taxes.

In addition, since December 31, 1993, Puerto Rican firms, which pay a 42-percent income tax rate, are being forced into unfair competition with firms from the mainland. Mainland firms will benefit not only from Puerto Rican tax incentives but also from the tax credits that subsidize 60 percent of wages in section 936 firms and significant percentages of depreciation on tangible investment. Payroll and employment expansion under the revision will not be market-based and will be unsustainable in the absence of the tax credit. Accordingly, the tax credit will foster a dependence not just on the part of U.S. multinationals, but also by Puerto Rican workers, whose livelihoods will increasingly be directly dependent on revenues foregone by the U.S. Treasury.

VII Conclusion

History should have taught us the following lessons:
Section 936. If a tax credit is offered based on the amount of possessions-source income a corporation generates, then methods will be found to transfer income streams from the mainland to the possession. The income streams most easily transferred will be those related to intangible assets. These assets represent little or no real investment to the possession.

Section 482 and the TEFRA Amendments. Both the TEFRA amendments and the IRS's track record in enforcing section 482 indicate that almost nothing can be done to stop intangible income transfers in either a useful development time frame (482 cases take more than 10 years to resolve), or in any but the most egregious of violations.

The Caribbean Basin Initiative. Reinvestment of section 936 profits flows readily into profit-maximizing and risk-minimizing, rather than development-maximizing, uses.
Under the current state of the law, if these lessons have been learned, the future holds the following for the possessions:

(1) If section 936 remains, nothing can or will be done to stop the diversion of income derived from intangibles to possessions corporations.
(2) Unless a possessions corporation determines that it will be unlikely to secure new intangible assets in the future (a proposition very unlikely in the pharmaceutical industry), the new percentage limitations on the section 936 credit will not be elected.
(3) Possessions corporations will have plans drawn up targeting pre-existing possessions-

based labor-intensive businesses for mergers. Premium targets will have low risks but high balance- sheet (wage and tangible property) attributes. These targets will not necessarily be those best suited to the long-term economic development of the possession. Similar to the CBI, these plans will be investment plans to "buy and hold," not development plans to "buy and further develop" local industries.

(4) Very quickly after income starts to flow to a possessions intangible, the possessions corporation will implement its acquisition strategy. The possessions corporation will aggressively strive to maximize the elements of the three-factor economic activity limitation formula.

(5) Development officials in the possessions should see ownership changes in the assets base in two steps. Initially, properties that the possessions corporations had leased will be purchased, and delivery, cleaning, or security- type subcontractors will be absorbed as in-house departments. Secondly, because neither the Internal Revenue Code nor regulations have any requirements linking the wages paid or the tangible property owned by the possessions corporation to the income stream that actually generates the credit, a more wide-ranging absorption of possession-based assets and wage-paying businesses will be observed.

(6) The possessions economy will stagnate. Each target absorbed will dilute the pool of possessions-based entrepreneurial talent. Each business not absorbed will struggle at a competitive disadvantage against possessions owned competitors. Section 936 will function as its mirror opposite. In the extreme instance, section 936 will subsidize the dismantling of the Puerto Rican entrepreneurial system and the local tax base it represents.

In summary, section 936 has ceased to be an efficient means of attaining employment-producing investments in Puerto Rico and other U.S. possessions. While the initial rationale for the credit was the creation of jobs and the stimulation of economic activity in the possessions, the outcome has been far different. Firms with intangible assets now take advantage of transfer pricing laws to maximize profits without making the investments that would create sustainable growth in Puerto Rico.

The fundamental questions then are: First, can the long record of disappointment be ended? Second, can the legislation provided in the 1993 budget transform section 936 into an instrument of public benefit, rather than of private profit? We conclude that the costs of section 936 will continue to outweigh its benefits.

C. Submission to Congressional Task Force on Economic Growth in Puerto Rico Puerto Rico Financial Institutions Oversight

By:
Eugene S. Weil

Puerto Rico Financial Institutions Oversight [157]

Thank you for the opportunity to submit the following input to the Congressional Task Force on Economic Growth in Puerto Rico. As the Co-Head of the Financial Institutions Group at Houlihan Lokey and former founder and CEO of Milestone Advisors, I believe that I am uniquely qualified to provide insight on the Puerto Rican market. Over the last decade, I have been one of the most active financial advisors in Puerto Rico with experience advising public financial institutions, large private companies and government agencies. I believe that Puerto Rico's banks will play a key role in the revitalization of the territory's economy. As such, the Task Force should continue to align regulation of Puerto Rico's banking system with that of the mainland United States.

I am uniquely qualified to opine on the Puerto Rican economic condition due to my range of experience across the Puerto Rican market including:

- My role serving as advisor to Doral Financial Corp. as it explored strategic alternatives for its Puerto Rican platforms and U.S. operations, managing the sale of the bank's ~$1.5 billion UPB portfolio of residential and commercial non-performing loans and REO
- My role serving as advisor to two Puerto Rican banks in the quarterly valuation of loan portfolios and annual goodwill impairment analysis
- My role serving as advisor to the FDIC with respect to the valuation of loss share agreements relating to three Puerto Rican banks that entered receivership in the aftermath of the 2008 Financial Crisis, including the ongoing, annual evaluation of

[157] Congressional Task Force on Economic Growth in Puerto Rico
Submission from Eugene Weil
October 13, 2016

the portfolios as to the performance and migration of both performing and nonperforming assets over time

- My role serving as advisor to San Juan, PR-based Plaza Las Américas, Inc. and its affiliate Empresas Fonalledas, Inc. in a number of capacities for over a decade
- My role serving as advisor to Sunwest Mortgage on a number of transactions, including the disposition of over $10 billion of mortgage servicing rights. Sunwest is headquartered in Puerto Rico and has a growing presence on the island

I believe that Puerto Rico's banks will play a key role in the revitalization of the territory's economy and assert that additional special treatment for the Puerto Rican banking system may contribute to its instability. Congressional intervention on behalf of Puerto Rico's banks could destabilize the system further by incentivizing future gamesmanship and perpetuating the uncertainty that clouds the market today.

Small- to medium-sized enterprises are the foundation of the Puerto Rican economy and will ultimately be the source of its recovery. In order for the banking system to make sufficient credit available to fuel this recovery, however, investors and depositors must have adequate comfort to supply banks with capital and liquidity. Furthermore, regulator's support for SBA lending, including United States-regulated financial institutions' issuance of SBA 504 and 7a loans, will play an essential role in providing growth capital to Puerto Rico's small- to medium-sized enterprises.

Trends towards reduced oversight and increased self-regulation have historically contributed to a reduction in stability in the banking system, starting with the savings and loans scandals in the late 1980s and peaking in 2008 with the Financial Crisis. In the aftermath of the 2008 Financial Crisis, Puerto Rico's banks were hit especially hard, forcing reliance on the FDIC for protection of certain of the banks' deposits. In order to support its continued viability though largely recovered, the Puerto Rican banking system should be held to regulatory standards, control and supervision that are congruent with that of mainland United States. Any regulatory treatment otherwise may continue to diminish investor confidence, further isolating Puerto Rico from the rest of the United States and casting it among comparable systems seen in developing nations.

The Congressional Task Force on Economic Growth in Puerto Rico is under the directive to reduce uncertainty in Puerto Rico; as such, I believe that the creation of regulatory exceptions for banks in Puerto Rico would likely be counterproductive to this mandate. We thank you for your consideration in this pivotal and significant matter as we continue to work together towards a strengthened Puerto Rico.

D. "Reviving the Puerto Rican Economy Requires a Big Push of Public Infrastructure Investment" [158]

By:
J. Tomas Hexner and Arthur MacEwan

Overcoming Puerto Rico's immediate debt crisis is essential. Fixing the severe debt problems, however, will be little more than putting a bandage on a chronically ill patient. The real need is to revive the economy, to begin to generate sustainable growth.

Effective policies and major reforms must be initiated immediately. Private investment is essential, but conditions must be altered to attract private investment. Puerto Rico cannot wait.

Over the next decade public investment will be indispensable to re-establish economic growth. Not only will public investment increase growth and generate jobs, but, if targeted on much-needed infrastructure investment, it will create conditions that will directly support private activity, which will continue over the long-run.

The purpose here is to show the impact on economic growth and employment expansion of a decade-long, $20 billion Big Push of public investment. In addition, the potential sources of funding this investment will be laid out. The role that a Rehabilitation Trust Fund (RTF) could play in both the funding and implementation of the Big Push will be explained. To a large extent, this Big Push would be the implementation of Title V of PROMESA, "Puerto Rico Infrastructure Revitalization," and an RTF is a mechanism through which the Revitalization Coordinator could operate.

[158] An earlier version of this paper appeared as Hexner, J. Tomas, and MacEwan, Arthur, "Reviving the Puerto Rican Economy Requires a Rehabilitation Trust Fund, Center for Global Development and Sustainability, Working Paper Series, 2016-2, Brandeis University, April 2016 (with a forward by R. Godoy),http://heller.brandeis.edu/gds/pdfs/reviving-the-puerto-rican-economy.pdf.

The Big Push for Economic Growth

Puerto Rico needs a game changer. The Big Push of public investment in infrastructure is the game changer that could set the economy on a rehabilitated path of development.

The Big Push would involve an immediate, very large increase of public infrastructure investment, followed by a tapering off towards a lower, but still substantial amount of public investment in subsequent years. In particular, this scenario calls for $20 billion of new public investment over ten years, with FY2018 as the first year.

Twenty billion is an amount that is necessary to generate a substantial upsurge in the Puerto Rican economy, sharply raising output and employment, and, crucially, providing a catalyst to a resurgence of private investment. At the same time, when spread over a decade, $20 billion is a feasible amount, an amount that could be raised (as explained below) through borrowing and from other sources and that could be effectively spent.

Over the decade, the Big Push would raise GNP by more than 10% and would yield employment growth of nearly 100,000, roughly 10% above the FY2016 level. Yet, these estimates of the GNP and employment impacts are conservative because they do not include the extent and impact of new private investment, which would surely be substantial. Indeed, the surge of public infrastructure investment, while valuable in terms of immediate growth and employment effects, is justified largely because of the impetus it will create for private sector development.

The Big Push calls for $3 billion of new public infrastructure investment in each of the first two years of the decade (FY2018 and FY2019), $2.5 billion in each of the next two years, three years with investment at $2 billion, and the final three years of the decade at $1 billion. The results would be an immediate increase of GNP (as investment is part of GNP) and the creation of over 60,000 jobs connected, directly and indirectly (through the multiplier process), to the investment activity in each of those first two years. The levels of expanded output and of job creation generated by the investment activity itself would taper off in subsequent years as the level of new investment declines. However, by the third year, the investment activity would start giving rise to new production activity, as the new capacity comes on line. This new production would then augment the level of GNP and the level of employment. By the end of the 10 year period, output and employment would be more than

10% higher than in FY2017, including both output from the new productive capacity created by the investment over the decade and the investment activity itself in that last year. As the new productive capacity from investment in the last two years of the decade comes on line in the subsequent two years, production and employment from new capacity would have risen by almost 7% as compared to FY2017. This would be continuing output and employment (assuming the productive capacity is maintained).

A summary of the investment and outcomes of the Big Push over the decade are shown in Table 2. Year to year investments and outcomes and explanation of the assumptions on which the figures are based are provided in Appendix A.

Table 2: Investment and Outcomes of the Big Push for Boosting the Puerto Rican Economy Over the FY2018 to FY2027 Decade

Public Infrastructure Investment	$20 billion
New Lasting Output Capacity	$6.67 billion
New Lasting Jobs Created	92.5 thousand
Total Addition to Output During the Decade	$60.5 billion
Job-Years of Employment Created During the Decade	834 thousand

Beyond these gains by the end of the decade, two additional consequences of

the Big Push should be emphasized. First, much of the increase comes in the first year of the decade, as the investment level is very high at the outset. By the five-year mark, output and employment would have each increased by over 8%. Second, and *especially important, this surge of new activity, by significantly altering the economic climate in Puerto Rico, would give rise early-on to new private activity, bringing gains well beyond those attributable to the public investment alone. While private activity resulting from the multiplier process generated by the investment spending is included in the impact estimates, the rise in private activity resulting from the improved investment climate is not included. Therefore, the expansion estimates in Table 1 should be viewed as conservative.*

Questions might exist as to whether or not Puerto Rico would be able to absorb the high rate of investment called for in the Big Push. That is, it might not be able to effectively invest funds in new infrastructure at such a high rate. Yet, given the starved condition of the economy, the large amounts of investment seem both necessary and reasonable. The roles of the Revitalization Coordinator, working under the Oversight Board, in exercising oversight of the choice and operation of projects, would reduce the likelihood of ineffective investments. Nonetheless, if the Big Push is rejected as unrealistic, more moderate approaches to rehabilitation of the Puerto Rican economy could be undertaken. In Appendix B one such more moderate approach is laid out.

The Source of Funds

The Big Push set out above would require \$20 billion in new funds over the FY2018 to FY2027 decade, for an average of \$2 billion each year. While the actual amount of funds needed would vary from year to year, the source of the funds here is shown for the "average" year—that is, for \$2 billion. Clearly, in the early years of the decade, with the very large amounts of investment, a larger amount of funds would be needed, but the larger amounts of these years would be offset by the lesser needs of later years.

The funds would come from four sources:

• Reduction in debt service payments on pre-existing debt;

• Government revenue from equal treatment in federal programs;
• Increased effectiveness of tax collection; and
• New bonds.

Table 3 lists the amount from each source for the "average" year (i.e., for $2 billion).

Explanation of each category follow.

Table 3: Sources of $2 Billion Annually for New Public Infrastructure Investment

Reduction of Debt Service Payments (one-third of reduction in debt service of public enterprises and municipalities)………………………	$450 million
Revenue from Equal Treatment in Federal Programs (share that accrues to the government)……………………………………………	.$200 million
Increased Effectiveness of Tax Collection (10% increase in collection of individual Income tax and an additional $100 million from all other taxes)……..……………………………………..…	$300 million
New Annual Borrowing (RTF bonds at 5%)……..……………………………………	$1,105.3 million
First Year's Interest on New Debt*..………………..………….	-$55.3 million
Total……..…………..	$2,000 million

* This set of sources of funds does not include funds to pay the interest on the new debt beyond the initial year of that debt. It seems reasonable to assume, however, that, as the economy begins to grow and creates an impetus for private investment, the increased economic activity will generate sufficient government revenue to pay the interest on the new debt in subsequent years.

Reduction of Debt Service Payments. A reasonable resolution of Puerto Rico's debt crisis would result in a halving of the debt service payments of public enterprises and municipalities through some form of restructuring. In FY2016 (i.e., before any restructuring), total debt servicing payments due on Puerto Rico's public debt were about $4.7 billion. However, as much as $2 billion of this is servicing "General Obligation, Guaranteed and Publically Issued Appropriation Debt." The assumption here is that only the remaining debt service—i.e., $2.7 billion—will be halved. Also, it is assumed that, although the savings of $1.35 billion will directly accrue to public enterprises and municipalities, it will be available for general government use. Here it is further assumed that two-thirds of this, $900 million, will go to meet current needs (e.g., schools and other public services, maintenance of existing infrastructure, and the immediate needs of public enterprises). This will leave $450 million that that could be devoted to new public infrastructure investment.

Revenue from Equal Treatment in Federal Programs. Any program for economic growth will depend in significant part on Puerto Rico being treated in the same manner as the states (i.e., U.S. citizens in Puerto Rico being treated in the same manner as U.S. citizens in the states). One aspect of this equal treatment would be to extend the Earned Income Tax Credit and the Child Tax Credit fully to Puerto Rico. Also, equal treatment would affect Medicare and Medicaid programs and other social support programs, "food stamps" in particular. Taken together, equal treatment in this set of programs would inject up to $1 billion annually to the Puerto Rican economy. Most of this injection of funds would go to families and directly to services (e.g., medical services). Some, however, would offset medical services currently funded by the government. Also, this injection of funds would yield some tax income for the government and would induce a higher level of economic activity, which would also raise tax revenue. All in all, it is reasonable to estimate that equal treatment would result in a $200 million increase in government revenue that could be directed towards new infrastructure investment.

Increased Effectiveness of Tax Collection. Any program to alleviate the current debtcrisis will require steps by the Puerto Rican government to increase the effectiveness of its economic policies, most importantly its tax collection policies. More effective tax collection policies should raise collection of the individual income tax by 10%, or roughly $200 million. From increased effectiveness in the collection of all other taxes, which accounted for $6.6 billion in revenue in FY2015, an additional $100 million could be raised. (The shift from the sales and use tax to a value added tax is ignored here, as its implementation is too uncertain at this time.)

New Annual Borrowing. While these three sources of funds totaling $950 million would be important, they would not be sufficient to fund the level of infrastructure investment that would generate substantial growth and employment increases. New borrowing will be needed. With the existing debt burden greatly reduced and with the role of the Oversight Board and Revitalization Coordinator well established, bond investors should have a level of confidence that would make new borrowing possible at lower interest rates (as compared to the over 8% interest rate that has been charged recently on Puerto Rico's bonds). Moreover, repairing the Puerto Rican economy would be most effective if the U.S. Treasury would guarantee payment on the new bonds. (The possibility of federal guarantees is suggested in PROMESA, Title V, Sec. 505, Paragraph b.) Assuming the Puerto Rican government could borrow under these circumstances at 5%, it would need to borrow $1,105.3 million each year. After allowing for the $55.3 million for first-year servicing of the 5% payment on this new debt (see note to

Table 2), the net addition to funds would be $1,050 million and would bring the total available for new infrastructure investment to $2 billion each year. (If a Rehabilitation Trust Fund were created—see below—one of its major roles would be to manage the issuing of these new bonds, which should create additional confidence in the bond market.)

A Rehabilitation Trust Fund (RTF)

Through PROMESA, Congress has created the Oversight Board for Puerto Rico. This Oversight Board is to play a major role in restructuring the Puerto Rican government's debt and in guiding the government's fiscal and financial actions for some period to come. While there has been controversy regarding the extent of the Oversight Board's authority and duration, as conceived its purview seems to be limited to the two realms of debt restructuring and fiscal and financial oversight. These two realms are not enough.

As the discussion above indicates, a third realm must be added to the Oversight Board's charge: the rehabilitation of the Puerto Rican economy. Recognizing this need for setting the Puerto Rican economy on a path to economic growth, Congress also established in PROMESA the Task Force on Economic Growth in Puerto Rico with the charge of making recommendations, particularly on federal laws and programs, that would advance economic growth in Puerto Rico. Also, PROMESA specifies the establishment of a Revitalization Coordinator, who would have a major role in selecting and supporting major infrastructure investments in Puerto Rico.

A Rehabilitation Trust Fund, which is being proposed here for the Task Force to recommend, could be the instrument by which the Revitalization Coordinator could most effectively advance a growth agenda. Congress should authorize the Oversight Board to create and oversee the operations of the RTF. The RTF, under the direction of the Revitalization Coordinator and working with the Puerto Rican government, would play a determining role in selecting investments, organizing the financing of those investments, and overseeing their implementation. This combination of roles is critical. The projects cannot proceed without financing, and the roles of the RTF selection and oversight of projects could create the confidence in bond markets that would facilitate raising funds at a moderate cost.

Because the Oversight Board would be an instrument of the U.S. government and would be made up of people with widely recognized credentials of expertise and integrity, its roles overseeing the RTF would provide a foundation for confidence among potential investors. Those investors—i.e., purchasers of bonds floated by the RTF— would expect that the funds would be used for projects with substantial payoff in terms of economic expansion and catalyzing private investment. Moreover, they would expect that the projects would be run efficiently, eliminating concerns about waste and corruption. The economic growth generated by the RTF investments would yield rising tax revenue that would be the basis for paying off the bonds.

The confidence in RTF bonds by potential investors, based on their confidence in the Oversight Board, would make it feasible for the RTF bonds to pay reasonable interest rates—as opposed to the very high interest rates that have of late been demanded by investors on other Puerto Rican bonds. In the calculations used here to examine the impact and costs of a Big Push program, a rate of 5% on the RTF bonds is used.

Necessary Provisions

Because the payments on RTF bonds would come from the Puerto Rican government's tax revenue, some additional provisions are necessary in order to justify the assumption of a 5% rate of return on those bonds:

- Of primary importance is that the federal government will act to create a mechanism for restructuring a substantial part—half is assumed in the calculations above—of the Puerto Rican government's debt, resulting in a large reduction of the government's debt service obligations. This federal action is a necessary condition for Puerto Rico to re-enter the bond market.
- Furthermore, to ensure reasonable rates, the credibility and the reputation of the Oversight Board must be behind the bonds. In fact, after testing the market the Oversight Board may determine that U.S. Treasury assurance, perhaps a guarantee, is necessary. (Again, the possibility of federal guarantees is suggested in PROMESA.
- Confidence in the RTF bonds (or any other Puerto Rican bonds) will also depend on the extent to which the government undertakes fiscal reforms. While thesereforms should affect significant areas of government spending, *the primary change will need to be an increased effectiveness of tax collection*.

- Substantial improvement in the economy could be accomplished forthwith if the federal government would enact changes that would treat Puerto Rico in the same manner as the states with regard to major social support programs—in particular, the Earned Income Tax Credit, the Child Tax Credit, Medicare, Medicaid, the Supplemental Security Income program, and the Supplemental Nutritional Assistance Program.

Appendix A: Details of the Big Push

The estimates of the impacts of the Big Push are based on three relationships:

- The amount of output and employment created with $1 billion in public infrastructure investment. The $1 billion of investment would directly add $1 billion to GNP, and, assuming a multiplier of 1.5, the total increase of GNP would be $1.5 billion. On the basis of past experience in Puerto Rico, $1 billion of new construction investment is associated with 13,700 new jobs. Applying the 1.5 multiplier to this job creation yields a figure of 20,550 for both the direct and indirect jobs created. (The rationale for this figure is explained below.)
- The amount of new, continuing output capacity created by that $1 billion infrastructure investment. This figure is referred to as the incremental capital output ratio (ICOR). Evidence from many countries under many circumstances indicates that ICORs vary widely. However, it seems reasonable, as the basis for a rough estimate, to use an ICOR of 3.0 for Puerto Rico. This means that for $1 billion of new investment, the level of economic activity would rise by $333 million and would stay at that level as long as the capital created by this new investment is maintained. It is assumed here that there is a lag of two years between when investment takes place and when the productive capacity created by thaT investment comes on line.

- The number of jobs that would be created by the new, continuing production. This figure is obtained by assuming the ratio of GNP to employment in FY2016 remains unchanged. Thus a 1% increase in output over current output yields a 1% increase in employment over the current employment. The output and employment figures for FY2016 used here are $72 billion and 1 million, respectively. (These are, of course, rough figures because FY2016 data are not yet fully available.)

As to employment, past experience in Puerto Rico indicates that each $1 billion of investment is associated with 13,700 construction jobs in the year in which the investment is taking place, and public investment in infrastructure would be largely in construction. If the multiplier is 1.5, an additional 6,850 jobs would be created elsewhere in the economy in the year of the investment—thus a total of 20,550 jobs associated with the higher level of investment. These construction related jobs, would not be permanent jobs. While important—for the workers and for the growth of the economy— they would only exist as long as the new investment was maintained.

Table A below sets out the year-by-year impact of the Big Push scenario.

Table A: The Big Push to Bolster the Puerto Rican Economy and Its Impact on Output and Employment

Fiscal Year	New public investment in infrastructure, billions of dollars	Direct and indirect increase of GNP, billions of dollars	Direct and indirect increase of employment	Increase of output due to new investment, billions of dollars	Cumulative increase of out-put due to the new investment, billions of dollars	Increase of employment due to the production	Cumulative increase of employment due to the production	Total increase of Output, billions of dollars	Total increase of employment
2018	3	4.5	61,650	0	0.00	0	0	4.50	61,650
2019	3	4.5	61,650	0	0.00	0	0	4.50	61,650
2020	2.5	3.75	51,375	1.00	1.00	13,875	13,875	4.75	65,250
2021	2.5	3.75	51,375	1.00	2.00	13,875	27,750	5.75	79,125
2022	2	3	41,100	0.83	2.83	11,563	39,313	5.83	80,413
2023	2	3	41,100	0.83	3.66	11,563	50,875	6.66	91,975
2024	2	3	41,100	0.67	4.33	9,264	60,139	7.33	101,239
2025	1	1.5	20,550	0.67	5.00	9,264	69,403	6.50	89,953
2026	1	1.5	20,550	0.67	5.66	9,264	78,667	7.16	99,217
2027	1	1.5	20,550	0.33	6.00	4,625	83,292	7.50	103,842
2028				0.33	6.33				
2029				0.33	6.66				

Appendix B: A More Moderate Approach

If the Big Push approach is not accepted, because of either political constraints or the belief that the economy cannot effectively absorb the early large amounts of investment, a more moderate approach could be initiated. An example of a more moderate approach presented here would still be based on $20 billion of new infrastructure investment over a decade, but the pattern of investment would be different—with a much smaller amount of investment in the initial years and building to larger amounts in later years.

Because the more moderate approach involves the same total amount of new investment over the decade as does the Big Push, the resulting production from new capacity (once all the capacity has come on line) is thus the same as with the Big Push. In the moderate scenario, however, in the first four years of the decade, the amount of this investment would be $1 billion, $1.5 billion, $2 billion, and $2.5 billion; in years 5 through 9, each year would see investment of $2.5 billion, and in the final year investment would drop back down to $2 billion. (See Appendix Table B.2 for the year-to year pattern of investment of the moderate path and for the impact of that investment.)

At first, the moderate path might appear as preferable to the Big Push, as the levels of output and employment in year 10 are higher in the former than in the latter. This, however, is only a result of the output and employment from the investment activity itself, which is higher in the final years of the moderate path than in the Big Push. The increase in output from new productive capacity, as noted, is the same once the new capacity has come on line (which would be two years after the end of the decade of expansion). Furthermore, because the Big Push generates earlier expansion, the total amount of output and the total amount of jobs created are greater with the Big Push than with the moderate path. The total new output during the ten years associated with the new investment of the Big Push is $60.5 billion, while the moderate path generates $51.4 billion; similarly, the total job-years created during the ten years with the Big Push is 834 thousand, while only 708 thousand job-years are created by the moderate path.

Table B.1 compares aspects of the Big Push and the more moderate approach.
Because the two approaches involve the same amount of total investment over the decade, both would be based on the same funding sources described earlier. Also, the assumptions on which the Big Push calculations are based, as described in Appendix A,
are also used as the basis for the calculations of the more moderate approach.
While the Big Push has clear advantages (Table B.1), it also has a potential important advantage that is not so clear. With the large injection of funds in the early years, it could have a greater impact of “jump starting” private investment. Ultimately, it is this private investment that would place the Puerto Rican economy back on a growth path.

Table B.1: Outcomes of Two Scenarios for Boosting the Puerto Rican Economy Over the FY2018 to Fy2027 Decade*

	The Big Push	The More Moderate Approach
Public Infrastructure Investment	$20 billion	$20 billion
New Lasting Output Capacity	$6.67 billion	$6.67 billion
New Lasting Jobs Created	92.5 thousand	92.5 thousand
Total Addition to Output During the Decade	$60.5 billion	$51.4 billion
Job-Years of Employment Created During the Decade	834 thousand	708 thousand

* Both scenarios have the same overall new investment and therefore the same new lasting output capacity created and the same new lasting jobs created. However, with the Big Push, jobs and output come earlier and therefore, as compared to the more moderate approach, more output is generated and more job-years of employment created during the decade. Moreover, with the earlier generation of output and jobs, the Big Push is likely to elicit an earlier and larger upsurge of private investment, which is not included in the figures here.

Table B.2: The Moderate Path Approach to Bolster the Puerto Rican Economy and Its Impact on Output and Employment

Fiscal Year	New public investment in infrastructure, billions of dollars	Direct and indirect increase of GNP, billions of dollars	Direct and indirect increase of employment	Increase of output due to new investment, billions of dollars	Cumulative increase of output due to the new investment, billions of dollars	Increase of employment due to the new production	Cumulative increase of employment due to the new production	Total increase of output, billions of dollars	Total increase of employment
2018	1	1.50	20,550	0.00	0.00	0	0	1.50	20,550
2019	1.5	2.25	30,825	0.00	0.00	0	0	2.25	30,825
2020	2	3.00	41,100	0.33	0.33	4,625	4,625	3.33	45,725
2021	2.25	3.38	46,238	0.50	0.83	6,938	11,563	4.21	57,800
2022	2.25	3.38	46,238	0.67	1.50	9,250	20,813	4.87	67,050
2023	2.25	3.38	46,238	0.75	2.25	10,406	31,219	5.62	77,456
2024	2.25	3.38	46,238	0.75	3.00	10,406	41,625	6.37	87,863
2025	2.25	3.38	46,238	0.75	3.75	10,406	52,031	7.12	98,269
2026	2.25	3.38	46,238	0.75	4.50	10,406	62,438	7.87	108,675
2027	2	3.00	41,100	0.75	5.24	10,406	72,844	8.24	113,944
2027				0.75	5.99				
2029				0.67	6.66				

[1] An earlier version of this paper appeared as Hexner, J. Tomas, and MacEwan, Arthur, "Reviving the Puerto Rican Economy Requires a Rehabilitation Trust Fund, Center for Global Development and Sustainability, Working Paper Series, 2016-2, Brandeis University, April 2016 (with a forward by R. Godoy), http://heller.brandeis.edu/gds/pdfs/reviving-the-puerto-rican-economy.pdf.

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