Petición Estadidad Al Congreso

PUERTORRIQUEÑOS EN ACCION CIUDADANA
PUERTORICANS IN CIVIC ACTION

TEL. (809) 833-4078

TESTIMONY TO BE OFFERED TO THE HOUSE INTERIOR AND INSULAR COMMITTEE FOR THE HEARINGS ON MAY 22, 1986.

Honorable Chairman of the House Interior and Insular Committee, Mr. Morris Udall; Honorable Members of this Committee; Distinguished Staff Members; Invited Guests and Friends.

My name is Miriam Ramírez de Ferrer, I am a medical doctor, and president and founder of a non-partisan grassroots movement, called **Puerto Ricans in Civic Action,** which gathers individually signed petitions for statehood. We have already delivered over 200,000 petitions to Congress.

It is a great privilege to be able to testify here again before this honorable Committee on behalf of my fellow citizens back home in Puerto Rico.

We also wish to express our most sincere appreciation to Congressman Morris Udall for his invitation to testify during these hearings. Issues affecting Puerto Rico and its economy have been discussed in Congress since the beginning of the century, and it is our most sincere wish that the present hearings will generate positive action.

At previous hearings, witnesses have talked about the symptoms, but have not grappled with the cause of our economic illness, which is the creation, over the past 35 years, of a monstrous welfare state. We have been drawing on the United States economy, which has resulted in increasing dependence, lack of incentives to work, save, and invest.

We have a giant government bureaucracy which employs one third of the Puerto Rican labor force. The string of government enterprises runs the range of maritime transport to unprofitable sugar mills which devour huge annual government subsidies. It is an economy without direction, slanted towards state socialism.

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When we realize that unemployment has risen over the double-digit mark, we must accept that the woes that have plagued Puerto Rico in the past decades are still unresolved.

Under such circumstances, a couple of aspirins and a good night's sleep will not provide a cure. My prescription would be a complete change of health habits. We should establish incentives to work, save, and invest. We should promote the privatization of the economic activities now conducted by the government and develop our own resources to the maximum. This last implies development of our agriculture and our tourism, and industry linked to the development of both. As our economy prospers, mainland corporations will invest in Puerto Rico because political stability results in a good climate for investment.

Perhaps what some will not recognize publicly is that our improved standard of living as compared to some of our neighboring countries can be attributed solely to our relationship with the United States. For that we are grateful, and if by chance no one has ever told you before, we want to leave on record that the people of Puerto Rico are very grateful to the people of the United States for having provided the means for us to be able to enjoy a better life today than those who chose to follow a separate road from the United States. As an example we will mention Cuba and the Philippines, the other two territories acquired by the United States during the Spanish-American War. How different their destinies have been!

But we want to bring up this very simple but important question, why? Why has Puerto Rico not kept up with the rest of the nation whose unemployment rate has fallen considerably and whose many economic problems are being solved successfully. There are hundreds of pages written on magic formulas that will supposedly place Puerto Rico on the road to a bright economic future. Most of these involve more "gimme, gimme" of federal funds. It all boils down to the undeniable fact that the positive results of our economic endeavours have come as a direct result of our relationship with the United States. Take away the United States and that's the end of all the magic formulas.

Testimony by Miriam Ramírez de Ferrer
May 22, 1986

Why continue to search for different palliatives and placebos which have all been tried out with no success? Today we ask you to seriously ponder these very important questions:

- Is it not true that some states such as Arizona, Ohio and others were considered too poor to enter the Union? Look at them now!
- Is any state of the Union plagued today with an unemployment rate of about 20 per cent such as Puerto Rico?
- Haven't you noticed the repeated entourages of elected officials from Puerto Rico who spend half their governing terms running up to Washington asking for more and more federal funds?
- Did you know that 33 per cent of the working population in Puerto Rico is working for the government, in one way or the other?
- Did you know that our telephone, electric, water, shipping companies and others are all in the government hands?
- Don't you agree with us that there is no need to try any more magic formulas to help Puerto Rico's economy when we already have a proven successful experimental program with fifty cases of fifty prosperous states which are a showcase to the world?

We have been led by you to enjoy the benefits of being an American citizen. We are now ready to accept new responsibilities and enter into a permanent relationship that will, without a doubt, as history has proven, develop our economic potential fully and stabilize our lives assuring our future.

Our future is not running around the world presuming we are an independent nation and signing economic treaties with foreign powers. If sovereignty is the magic formula needed to be prosperous, why hasn't it worked for Haiti, the Dominican Republic, Mexico, and other neighboring countries whose economic problems are all well known and have not been solved. Give me any day the economic formula of statehood as observed in Arizona, New Jersey, Hawaii, or any of the other fifty states of the Union, and I will safely predict what the economic future of Puerto Rico will be.

At the end of our statement, we include some insight provided by one of our advisors, Luis P. Costas Elena, Esquire, into the following three interrelated topics presently concerning Puerto Rico's relationship with the United States.

- Tax sparing in treaties with Puerto Rico
- Signatory status therein for Puerto Rico
- Higher interest costs for Puerto Rico from the "foreign country syndrome".

What will statehood bring to the United States and Puerto Rico? This question is very easy to answer. Look around your states and the answers are all there. To list a few.....

- Statehood for Puerto Rico would culminate our political evolution and earn new respect for the United States in the Caribbean and Latin America.
- With statehood, U. S. relations with Puerto Rico would be placed on a more orderly and predictable basis as with the undefined commonwealth.
- As a state, Puerto Rico would provide a stable, secure, and reliable base for the defense of our nation in the Caribbean.
- For Puerto Rico, statehood would also mean an increase in financial investments because of the stable political situation found in full fledged states.
- Intellectual efforts in Puerto Rico would be focused upon productive areas instead of sterile debates about status.
- Our tourism industry would prosper as the rest of the nation accepts Puerto Rico in its fold as happened in Hawaii.

But most important perhaps than all of the above mentioned is dignity. Let's not prolong this unending situation of handouts to our territory when a dignified transition into becoming a state of the union will end all these uncertain years. We understand your dismay when our elected officials continually come here to

you asking for United States taxpayers' money, while they simultaneously reject many of the symbols and responsibilities of United States citizenship. After all, it is the people of the United States who are contributing the money to help Puerto Rico.

Please don't hold it against our people. You are not alone. We share your feelings and are increasingly consternated and embarrassed by this situation. It is done with the purpose of perpetuating a dependent, socialized wellfare state which has been very convenient for politicians to retain incredible power, but place our economy and democracy itself in danger.

We not only want to receive the benefits of the political stability that statehood implies, but we also want to contribute our share to make this possible. We are presently suspended in the stagnant pool of the status quo. To correct this situation in the best interest of the 3.3 million United States citizens in Puerto Rico and the welfare of the nation as a whole, we again ask you to please initiate the necessary steps to admit Puerto Rico as the 51st state of the Union.

Miriam Ramírez de Ferrer, MD
President of PUERTO RICANS IN CIVIC ACTION

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May 13, 1986

Dr. Miriam Ferrer
President
Organización Puertorriqueña en Acción Ciudadana
Box 3225
Mayaguez, Puerto Rico 00709

Dear Dr. Ferrer:

You have asked me to provide some insight into the following three topics, presently concerning Puerto Rico's relationship with the United States: 1) Tax Sparing in Treaties with Puerto Rico, 2) Signatory Status therein for Puerto Rico, and 3) Higher Interest Costs for Puerto Rico from the "Foreign Country Syndrome". These three topics are interrelated. Indeed, to the extent that Puerto Rico enters into such treaties or status, the perception of Puerto Rico as "foreign" will increase among investors, and they will attach higher uncertainty and risk to Puerto Rico's debt, at the ultimate expense of Puerto Rican taxpayers.

1) Tax Sparing in Treaties with Puerto Rico:

Tax sparing in essence means that the United States will provide a federal income tax credit to someone for taxes never really paid. If the United States coetaneously imposes a federal tax to the extent of the credit, the result is a total offset, that is, 100% exemption from federal income taxes. But if the United States does not impose such coterminous tax, such credit alone will result not only in such total exemption but also in a federal expediture of funds via the refund of the credit. Thus, depending on its drafting or formulation, tax sparing is always an exemption and in addition is sometimes a federal subsidy.

Tax sparing, accordingly, is extremely abnormal. And the United States has historically refused to adopt such extreme discrimination against wholly domestic American business (that cannot even credit - only deduct - its state or local taxes really paid) in the treaties with Pakistan, India, the United Arab Republic and Israel. E.g., B. Bittker & L. Ebb, United States Taxation of Foreign Income and Foreign Persons 391, 468 (2ed. 1968).

The topic of tax sparing is thoroughly discussed by my former professor at Harvard Law School, Stanley S. Surrey, in his well known article, a copy of which I attach, "The Pakistan Tax Treaty and 'Tax Sparing'", 11 Nat. Tax J. 156 (June 1958). I do point out, however, that the same observation in said article on the illogic of tax sparing applies to Puerto

Rico. If Japaneese investment in Puerto Rico can adopt the form of a corporate subsidiary incorporated in Puerto Rico what exactly is the need or justification for federal tax sparing in a so-called treaty between Puerto Rico and Japan?

2) Signatory Status for Puerto Rico in Treaties:

The push for signatory status for Puerto Rico in treaties with foreign nations is greatly inconsistent with the long and expensive Fomento campaign to foster the image of "Puerto Rico, U.S.A." No state or municipality within the United States has such status. And such status would seem detrimental to the United States Treasury and to the overall federal coordination of trade, commerce and international relations by the U.S. State Department.

Moreover, why does Puerto Rico need signatory status? If Puerto Rico has some economic problem that requires a solution by treaty, what impedes Puerto Rico from following the regular, normal, channels of communication through the U.S. State Department or the U.S. Treasury. When I was Special Assistant to the Puerto Rican Secretary of the Treasury, the International Tax counsel of the U.S. Treasury Department offered on November 21, 1972 to include Puerto Rico in the income tax treaty then under negotiation with the Netherlands and offered to arrange talks with the officials of that Kingdom. The Puerto Rican Secretary of the Treasury decided to have Puerto Rico expressly excluded from that tax treaty. Thus, officials of the U.S. Treasury Department have paid attention to Puerto Rico; and the present government of Puerto Rico has only to channel its Japaneese preocuppations via the appropriate federal agencies. Signatory status is not at all necessary for Puerto Rico, and very likely provenes from partisan puffery rather than from real or economic need.

At present, without such signatory status, treaties already have applied to Puerto Rico. For example, paragraph 19 of the Protocol to the Treaty of Friendship, Commerce and Navigation between the United States of America and the Kingdom of the Netherlands, TIAS 3942 (signed 1956, effective 1957) expressly states:

> "The provisions of Article XXII, paragraph 2, shall apply in the case of Puerto Rico regardless of any change that may take place in its political status." (emphasis added).

Also, in Greig v. Sec. de Hacienda, 86 D.P.R. 345 (1962) the Puerto Rican Supreme Court applied the Convention between the United States of America and the United Kingdom respecting Double Taxation and Taxes on Income via its "national treatment clause" to Puerto Rico.

3) Higher Interest Costs to Puerto Rico from the "Foreign Country Syndrome":

During his first administration Governor Hernández Colón commissioned

a study of Puerto Rico's finances that came to be known as the "Tobin Report", because of its Chairman, Professor James Tobin of Yale University. One of its sub-reports, R. Forbes, M. Hopewell, G. Kaufman & J. Petersen, the Outlook for Puerto Rico Municipal Bonds, App. (June 30, 1975) found:

> "All respondents generally agreed that Puerto Rican bonds - no matter what their particular quality or backing - suffer from the 'foreign country' syndrome. That is, although the Commonwealth is a United States territory, it is still viewed as being 'across the water'. Many investors and traders have not been there and are not familiar with its debt and tax structure. This makes the investors view Puerto Rican bonds as being different and perhaps hinders their analysis in comparison to mainland tax - exempt securities." (emphasis added).

Signatory status and/or the aforesaid tax sparing could only add further confusion, hence increase the risk attached to Puerto Rican bonds. The end result is higher interest costs on those bonds, costs that ultimately fall on Puerto Rican taxpayers.

Perhaps we should all remember the observation of Dr. Arthur E. Burns in 3 United States - Puerto Rico Commission On The Status of Puerto Rico, Hearings on The Status of Puerto Rico - Economic Factors in Relation to the Status of Puerto Rico, S. Doc. No. 108, 89 th Cong., 2d Sess. 634 (1966):

> "Uncertainty of political status and economic policy might account for the lag behind Puerto Rico's potential. Statehood would remove such uncertainties." (emphasis added).

Cordially,

Luis P. Costas Elena

Luis P. Costas Elena, Esq.

LPCE/jc
Enclosure

Puerto Rico's Economy: Is Chicken Little Right?

The Americas

by Roland I. Perusse

SAN JUAN, Puerto Rico—There has been a strong reaction in Puerto Rico, and among U.S. firms operating in Puerto Rico, to U.S. Treasury proposals that would modify and eventually eliminate Section 936 of the U.S. Internal Revenue Code. This section of the tax law exempts U.S. corporations operating in Puerto Rico from paying taxes on nearly all income earned on the island.

It has been said that such action would cause the flight of U.S. industry from the island, would deter new industries from coming in and would result in the loss of as many as 150,000 jobs and half the gross domestic product; in short, economic catastrophe.

But is the sky really falling?

Rather than scream about injustices and frightful consequences, it might serve a more constructive purpose to take a second look at what Section 936 has meant to the Puerto Rican economy and just how that economy operates.

The tax-incentive program worked well for many years. It lured hundreds of U.S. industries to the island, where their investments created thousands of jobs. Puerto Rico prospered to the point where, in the 1960s, it had one of the world's fastest-growing GDPs and one of the highest per-capita incomes in Latin America.

Problems began to develop in the 1970s. With prosperity came the demand for higher wages, and Puerto Rico lost some of its competitive edge. Some labor-intensive industries, notably textiles, began moving to neighboring countries, where wages were lower. Higher prices for Arab oil resulted in higher energy costs. The island's petroleum industry was automated, providing fewer jobs. Even so, the rise in crude prices caused some refineries to close, and placed others on the verge of bankruptcy.

At the present time, the only really viable "Section 936 industries" on the island are high-technology operations, such as makers of pharmaceuticals and electronics. But their benefit to Puerto Rico is marginal, since they generate little employment. The main benefits accrue to U.S. corporations that are able to allocate some of their earnings from, for example, patents and certain passive income to their Puerto Rican subsidiaries, thus lowering their total federal tax.

Also, the basic structure of the Puerto Rican economy bears thorough examination. While the industrial sector has expanded, agriculture has languished. Subsidies totaling $20 million a year are poured into a sugar industry that is no longer profitable. State Sugar Corp. is $450 million in debt. Thousands of dollars have been awarded to companies that cannot meet their payrolls.

Puerto Rico's economy is artificial, with a high degree of dependency on the U.S. The expectancy of federal assistance is built into each budget, as if federal aid were a river that flows forever. Dependency has become a habit. Planners have failed to face the fact that U.S. economic concessions can be withdrawn at any moment. These pols have spent more time and energy struggling to hold on to concessions than they have in fighting to place the economy on its own two feet.

The basic economic philosophy that guides the island is state socialism. A quarter of the labor force works for the government, which operates hotels, marine transport, the telephone company and all sugar mills, among other enterprises. The state-owned Maritime Transportation Authority is running a deficit of $145 million. A government-operated rice-farming experiment has failed because of poor administration (while one in private hands appears to be succeeding).

According to the present governor, the island's budget deficit has reached $117 million for the current fiscal year and will stand at about $279 million in fiscal 1985-86. Even though Puerto Rico spends not a penny on defense, it has the world's highest per-capita external debt ($3,000 per inhabitant). The island is kept afloat by U.S. federal transfer payments totaling nearly $5 billion a year (nearly half of Puerto Rico's GDP) and an underground economy that, according to the president of the First Federal Savings Bank of Puerto Rico, approximates $4 billion a year.

An antiquated tax system discourages productivity and the accrual of local capital. Government taxes can eat up half of an inheritance; as a result, many wealthy persons have left the island with their assets. The individual tax rate as a percent of taxable income tops out at 50% for those earning more than $150,000 a year.

The existing tax system stimulates consumer spending by allowing taxpayers to deduct interest paid on consumer loans from their taxable income. There are few incentives for people to save. Half the funds in Puerto Rican banks are Section 936 corporate earnings not yet repatriated. Some tax experts have estimated that the island loses from one-fourth to one-third of its potential tax revenue due to tax evasion.

Puerto Rico must devise a long-term economic plan based on its own resources (which are considerable) after long years of U.S. aid and local effort. The island needs to stimulate the private sector, reform its tax structure and cut back on government subsidies and spending.

For example, a modified flat tax rate with a 35% maximum should be considered. Instead of "importing" industries from abroad, the island should develop its own—agribusinesses, for example. It should divest itself of state-owned enterprises and reduce the size of the bureaucracy.

The current economic crisis has strong political implications. It is interesting to note that the proposed 11-year phase-out of Section 936 would run to Jan. 10, 1998. That year will mark the 100th anniversary of the U.S. invasion of Puerto Rico. It would constitute a dark blemish on the U.S. record if U.S. colonialism in Puerto Rico extended beyond the century mark.

Rather than oppose the Treasury's proposals with respect to Section 936, the government of Puerto Rico might consider going along with the Treasury timetable in exchange for a Statehood Enabling Act, with a commitment to put its economic house in order prior to admission into the union.

But if Puerto Rico makes the effort, the U.S. must help, for there will occur, inevitably, some serious short-term dislocations in the Puerto Rican economy. The Defense Department, for example, could assign additional military contracts to Puerto Rico. If the Puerto Rican economy falters, an inevitable wave of migration to the U.S. will follow.

The main problem is that Puerto Rico today lacks a leader of the stature and vision of Luis Munoz Marin, who devised Operation Bootstrap in the late 1940s and was capable of adapting government policy to meet new challenges. But, then, perhaps the island has found its own Joan of Arc in the young housewife from Mayaguez who is leading a petition drive (with a goal of a million signatures out of about two million registered voters) to prove to the U.S. Congress that statehood is, indeed, the will of the people of Puerto Rico.

Mr. Perusse is director and a faculty member of the Inter-American Institute of Puerto Rico.

Unemployment --an island tragedy

Wednesday, January 15, 1986 By AGNES J. MONTANO
CARIBBEAN BUSINESS Staff Reporter

More than two-thirds of the 78 municipalities in Puerto Rico are struggling with unemployment rates as high as 49%, while the overall island unemployment rate remains at a deceiving 20%, a CARIBBEAN BUSINESS investigation revealed.

Relatively high employment in the San Juan metropolitan area, and a few other densely populated areas, has had the effect of lowering the average unemployment figure for the entire island. Therefore, unemployment in some of the less densely populated municipalities has gone much higher than the overall island average.

Statistics from the Commonwealth Department of Labor and Human Resources indicate that 66% of the island's employment is located in the 10 municipalities that have the greatest concentrations of population and industry. These municipalities are San Juan, Ponce, Bayamon, Carolina, Mayaguez, Caguas, Guaynabo, Arecibo, Humacao and Aguadilla.

But approximately 66.7% of the municipalities have unemployment rates that officially fluctuate between 21% and 49%. To cope with the situation the municipalities have assumed, unsuccessfully, the role of work agencies.

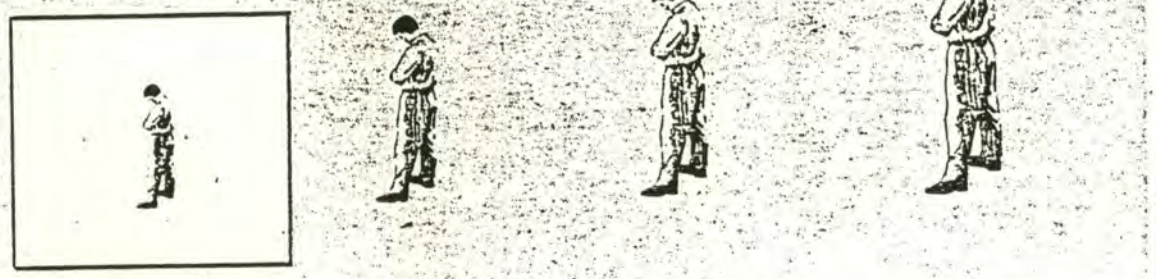
Furthermore, the unemployment rates in some of the rural municipalities could be even higher, because the Labor Department does not produce individual statistics for each of the 78 municipalities, claiming it lacks the funds and other resources to do so. The only official record on the matter is kept by the Bureau of Statistics of the U.S. Department of Labor,

See related story, page 2; editorial on page 16

(See Unemployment, page 8)

A grim look at unemployment in the municipalities

Source U.S. Department of Labor / Sept. 30, 1985



Puerto Rico 21.9% | San Sebastian 32.0% | Guayama 34.5% | Aguadilla 36.4%

Villalba 38.4% | Yauco 38.5% | Yabucoa 38.8% | Rincon 46.5%

Al frente

Es la tasa menor en últimos 6 años

Por Nelson Gabriel Berríos
REDACCION DE EL MUNDO

La tasa de desempleo en Puerto Rico bajó al 19.1 por ciento en abril, siendo la menor registrada en los últimos seis años, anunció anoche el gobernador Rafael Hernández Colón.

"Es para mí una gran satisfacción poder informarte que la tasa de desempleo en Puerto Rico ha bajado significativamente en casi un 4 por ciento desde abril de 1985 que estaba en 23 por ciento hasta abril de este año en que se registró un 19.1 por ciento", informó el Gobernador en su programa televisado "Conversando con el pueblo".

"En todas las áreas de la economía hemos puesto en vigor un diseño de incentivos para aumentar y acelerar la creación de oportunidades de empleo", dijo Hernández Colón.

La Oficina de Prensa del Gobernador informó que hubo 39,000 desempleados menos en abril de este año, en comparación con abril de 1985. Este año hubo 183,000 desempleados (139,000 hombres y 44,000 mujeres) mientras que en abril del pasado año hubo 222,000 desempleados (161,000 hombres; 61,000 mujeres).

En los sectores más significativos de empleo se registraron alzas con la excepción de la industria de la construcción. Hubo 153,000 empleados en el comercio (un alza de 13,000 comparados con el año pasado); 150,000 en servicios (aumentó 4,000); 135,000 en manufactura (aumentó 1,000) y en la construcción, con 32,000, hubo una pérdida de 6,000 empleos.

La tasa de 19.1 por ciento de desempleo es la más baja desde mayo de 1981, cuando se había registrado una de 18.8 por ciento. A partir de ese mes el desempleo se mantuvo regularmente sobre el 20 por ciento.

Hernández Colón indicó que entre los planes de creación de empleos "el potencial más prometedor está en la industria de la construcción. Las agencias de gobierno que ejecutan obraspermanentes tendrán en construcción entre abril y julio de este año 1,148 proyectos con 15,674 empleos".

En el mismo tono optimista, añadió que "estamos revitalizando igualmente a la industria, al turismo (hoteles Quality Royale y San Juan), a la agricultura (piñas) y al sector privado". Otros programas que destacó para continuar creando empleos fueron:

- El Programa de Empleos Remediales, de la Administración de Derecho al Trabajo, que atenderá el próximo año fiscal 13,922 participantes.
- El Programa de Verano de la ADT generará 54,589 empleos de unas cinco semanas, a un costo de $22.5 millones.
- El Fideicomiso Hipotecario, que utiliza fondos 936 para impulsar inversiones en la construcción, eventualmente generará unos 8,000 empleos, según el Gobernador.

Hernández Colón se refirió a la creación de empleos como una forma de combatir la criminalidad. "A mayor desempleo, mayor delincuencia", dijo y dedicó la segunda parte de su mensaje a enumerar los esfuerzos de su administración en la lucha contra el crimen.

* Unemployment Rate is Lowered by Government created employments.

December exodus drains pool of 936 deposits

Huge $2.4 billion repatriation is accomplished without simultaneous payment of tollgate taxes

By CIELA BEXON
CARIBBEAN BUSINESS Business Editor

The massive exodus of 936 funds from the local banking community last December has drained close to $2.4 billion from the pool of roughly $8 billion, according to a survey conducted by an investment banking firm last week.

Furthermore, the Commonwealth Treasury Department will not benefit from this massive repatriation through collection of tollgate taxes since the 936 companies repatriating funds had prepaid the tax to the previous administration through special arrangements made with former Treasury Secretary Carmen Ana Culpeper, a government source told CARIBBEAN BUSINESS.

According to the source, the tax, which may vary depending on several conditions, has been accounted for as income received in the Commonwealth's financial statements for previous years.

"Those taxes were collected at the time when, each year, the previous administration would encourage repatriation to collect the tollgate taxes in order to balance the budget, and the closing agreements extended at the time to some of the companies were very generous," said the source.

The source also said that this practice (encouraging repatriation to raise revenues) has been discontinued by Treasury Secretary Juan Agosto.

Hardest hit by the outflow of 936 funds have been Chase Manhattan Bank and Citibank, which reportedly held $1.6 billion and $1.2 billion in 936 deposits respectively. The two institutions hold the largest share of 936 funds in the island's banking system. Based on a prorata calculation made by an investment banker, each institution may have lost about $500 million in the December repatriation.

Traditionally, 936 companies repatriate the largest yearly share of 936 funds during the month of December. This year, however, the sum exceeds that of any previous year.

While most have attributed the massive exodus to the uncertainty that still prevails over application of new accounting principles approved by the House of Representatives last month covering 936 revenues, some bankers feel that this was not the primary reason for the exodus of funds.

"Treasurers of 936 companies have to seek a reasonable return on their investment portfolio. They have the pressure of the stockholders on them to increase company revenues. When interest rates inched up a little last month, they moved their money where it yielded the most. A lot was moved from local short-term bank deposits into

(See Exodus, page 10)

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stateside muni bonds," said a banker.

Locally, rates that banks may pay for 936 deposits are monitored by the Treasury Department through the well-known "tablita." The latter pegs the interest rate banks may pay for 936 deposits to the prevailing Eurodollar rate for similar deposits. Currently, the maximum allowed under the tablita is 65% of the Eurodollar rate.

Banks that pay a rate above that established by the tablita must generate additional eligible activity in proportion to the excess paid over the established rate. This means that more funds must be invested in loans considered eligible activity, which includes new construction, mortgages and automobile loans.

Because 936 funds cost less to institutions than other sources of funding, the deposits are supposed to have the effect of lowering the cost of loans to the borrower.

December exodus drains 936

As interest rates stabilize once more, some of the 936 funds moved out of the local banking system could return provided that rates paid by local banks remain competitive with those that can be earned elsewhere.

"I think some of the money that left in December will return. The problem is that we don't know when this will be," said a local banker.

Another problem other bankers foresee is that there may be several more million dollars in 936 funds still in the island's banking system for which the companies have also prepaid the tollgate taxes. If local conditions are not the most favorable for the funds, these too may be added to December's massive repatriation. ■

LACK of
Political stability is not
a good climate for investment!

12

Se fugan $9 billones de la Isla

Por María Judith Luciano
REDACCION DE EL MUNDO

El Alcalde de la Capital señaló ayer que en los últimos 12 años, ha habido una fuga de capital de empresarios puertorriqueños de $9 mil millones, producto de la desconfianza que tienen éstos para invertir en el sistema económico local.


Baltasar Corrada

El licenciado Baltasar Corrada del Río al afirmar que no existe una dirección en la planificación económica del país, argumentó que 10 ó 12 atrás la inversión puertorriqueña en el exterior alcanzaba los $3,000 millones.

"Hoy el capital nativo invertido en el fuera de la isla asciende a $12,000 millones. El dinero se está sacando fuera de Puerto Rico porque no tenemos confianza en nuestro propio sistema económico ", expresó Corrada.

Hablando ante la Asociación de Contratista Generales, el primer ejecutivo de San Juan hizo una exposición dirigida a sostener lo que llamó "gobernar la economía por pedacitos con remiendos e improvisación".

Corrada del Río a manera de ejemplo destacó la estrategia en defensa de las 936 que envolvió a los países de la cuenca del Caribe en el establecimiento de plantas industriales complementarias, "creando expectativas que de no realizarse, han de revertir en contra de los intereses puertorriqueños".

En la defensa de la 936 el gobierno local se comprometió a que corporaciones que reciben ese beneficio contributivo inviertan en el Caribe. Esa inversión fue estimada por los funcionarios del gobierno en $100 millones, lo que recibió el concurso del Tesoro de los Estados Unidos, el Presidente y la Cámara de Representantes.

Asimismo, explicó que la claúsula "reclamo de préstamos" incluida en los acuerdos de notas compradas por corporaciones 936 para el Fideicomiso Hipotecario podría poner en riesgo al Banco Gubernamental de Fomento.

El BGF vendió notas 936 por $200 millones el año pasado para financiar el programa de vivienda de interés social propuesto por el gobierno. En esa ocasión, las 936 solicitaron incluir una enmienda de garantía que en caso de eliminarse la Sección, el Banco $400 millones (esa instrumentalidad contempla una segunda emisión para el Fideicomiso por $200 millones adicionales?. Qué efecto tendría esto sobre nuestra economía. Cómo permitieron esta claúsula en medio de las negociaciones con la 936?, preguntó para sí Corrada.

En otra parte de su mensaje, el Alcalde dijo que no se le puede pedir a un inversionista que arriesgue capital para crear fuentes de empleos adicionales, sin darle un estímulo real para la inversión.

"La presente administración dice que lo hizo, y de hecho bajaron la tasa contributiva de un 65.5 por ciento a un 50 por ciento sobre ingresos de $38,000 al año. ¿Cómo se va a fomentar capital nativo en inversión local si no creamos las bases para fomentar el capital?, cuestionó retóricamente.

Loss of Puertorican capital
Reported as 9 billion dollars
by the mayor of San Juan.

Lack of political stability, Not
knowing where we are headed
is not a good climate for
investment.

Fuster girds for battle on budget-balancing bill

By CARLOS GALARZA
Of The STAR Staff

Having survived the war to preserve Section 936 of the Internal Revenue Code, Washington Resident Commissioner Jaime B. Fuster said Thursday he is now gearing for what looms to be another mammoth battle on Capitol Hill — this time over Gramm-Rudman.

Fuster anticipates having "a hard fight" this year in Washington getting the president and Congress to spare millions of dollars in federal aid for Puerto Rico that may be cut by implementing the Gramm-Rudman budget-balancing law — a measure that aims to systematically erase the federal deficit by slashing government spending.

The resident commissioner made his assessment during a news conference held at the State Department in San Juan, to discuss his efforts in Washington during the past year and weigh what is in store for 1986.

"Most of my work in 1986 will be over Gramm-Rudman," said Fuster. "There are clouds in the horizons resulting from the uncertainties related to this new law."

The resident commissioner explained that some lawmakers on Capitol Hill are calling Gramm-Rudman unconstitutional, and said he is supporting efforts by certain congressmen challenging the law in court.

Should the Gramm-Rudman law prevail, Fuster said it would cost Puerto Rico about $40 million in fiscal 1986, an amount he admits is a trifle compared to the estimated $5.5 billion the island receives annually from Washington. However, he said, he is concerned with the effects of Gramm-Rudman in subsequent years.

STAR photo by Emilio López

Resident Commissioner Jaime Fuster talks to reporters Thursday about the effects on the island of the Gramm-Rudman budget-balancing act, during a news conference at the State Department in Old San Juan.

The deductions made through Gramm-Rudman are automatic and do not touch vital areas such as Social Security, Medicaid, Medicare and Nutritional Assitance Program (PAN) checks, said Fuster. Those federally funded programs that will feel the pinch are those related to housing, transportation and education, he said.

Fuster said the cuts in federal aid made through Gramm-Rudman will depend on the state of the U.S. economy and could therefore range from as little as 1 percent to as much as 6 percent.

"What concerns me is that aside from the automatic cuts made through Gramm-Rudman, Puerto Rico is also susceptible to any other cuts ordered by Reagan and that uncertainty is worrisome," Fuster said.

The commissioner added that his efforts in 1986 will also concentrate on keeping intact the accords reached on Section 936 in the tax-reform bill already passed by the House and now awaiting approval by the Senate.

Also on the agenda is an extensive study of Puerto Rico's economy with an eye toward new measures that may be adopted at the federal level to help increase the island's productivity.

Furthermore, Fuster said, he will seek all possible federal aid available to check the soaring crime rate in Puerto Rico.

The commissioner described 1985 as a fruitful year for his office and cited the preservation of Section 936, which exempts subsidiaries of U.S. companies on the island from federal taxes, as the administration's foremost accomplishment.

Among his accomplishments Fuster also cited the preservation of the PAN checks, which he said were in danger of being eliminated by Congress, and increasing federal funds for PAN by $278 million through the next four years.

"GIMME GIMME" SYNDROME

The San Juan Star

Virgin Islands 55 Cents | Friday, February 7, 1986. | Metro 25 Cents

Hernandez Agosto proposes $2 billion federal block grant

By HARRY TURNER
Scripps Howard News Service

WASHINGTON — Senate President Miguel Hernández Agosto proposed to Congress Thursday that the Puerto Rican government be given a $2 billion block grant annually to help get the island 's economy moving again.

Hernández Agosto said the funds should be taken from a number of existing federally-financed programs and be handed over to the Puerto Rican government to use with few or no strings attached.

"I have second thoughts about the idea. There could be ways of getting more flexibility with federal funds without getting block grants," Jose "Rony" Jarabo said.

The Senate president said the impending Gramm-Rudman budget cuts made approval of the block grant proposal all the more urgent.

He warned that the Gramm-Rudman cuts will mean a loss of 65,000 jobs in Puerto Rico and increase unemployment from the current 21 percent to 28 percent.

The pursuit of federal funds in block grant form has historically been a major goal of the Popular Democratic Party. However, Hernández Agosto's testimony marked the first time such a huge block grant has actually been proposed before Congress.

Hernández Agosto, who made his proposal before the House Interior and Insular Affairs Committee, said in

See GRANT, Page 16

Like Philippines?

("Gimme Gimme")

Grant

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a hallway news conference later that he had not discussed the idea with Gov. Hernández Colón.

Indeed, House Speaker José "Rony" Jarabo, another witness before the committee, indicated in the hallway news conference that he does not particularly like the idea.

"I know that that's traditional PDP dogma... but the problem is the federal funds are frozen or even cut when you get a block grant," Jarabo said.

"I have second thoughts about the idea. There could be ways of getting more felxibility with federal funds without getting block grants," Jarabo said.

Nevertheless, Hernández Agosto, one of the principal figures in the PDP hierarchy, said he will press for an Interior Committee study to be carried out within three months that could justify the block grant proposal.

"I'll be giving various members of Congress briefings" on the idea, he told reporters.

"It's the best approach for Puerto Rico and the United States. We could use the money more effectively in a block grant.

"I don't know what the idea's chances are. But it's important that the idea be discussed," Hernández Agosto said. "If you don't press for something, you don't get anything."

However, San Juan Mayor Baltasar Corrada del Río, another witness before the committee, which is investigating the effects of the Gramm-Rudman cuts on the territories and Puerto Rico, said he would vigorously oppose the block grant proposal in Congress.

"This is an example of using economic policy to further Commonwealth status," Corrada said in a hallway interview. "There are many dangers in the idea."

Corrada said he suspected that Gov. Hernández Colón would pursue the block grant idea he if he is re-elected in 1988.

The Interior Committee's afternoon-long hearings culminated in a long, bickering argument between Corrada and Resident Commissioner Jaime Fuster, who is a committee member.

Although they raised their voices, the two never quite reached the shouting stage. At one point Fuster refused to yield the floor to Corrada, who was his predecessor as resident commissioner.

AP Laserphoto

Senate President Miguel Hernández Agosto talks with reporters Thursday in Washington after testifying on Puerto Rico before the House Interior Committee. At right is Harry Turner, who reports for the STAR from Washington.

he's no longer a member of this committee," Fuster said, hanging on to his microphone.

The two men were arguing over two points: how much Puerto Rico lost, or gained, in federal funds from 1980 to 1984, and how much the island stood to lose in cutbacks due to the Gramm-Rudman law, which mandates a balanced budget by 1991.

In the latter argument, Corrada noted that two weeks ago Fuster had accused him of "creating hysteria" when the San Juan mayor had predicted that Puerto Rico could lose $267 million in fiscal 1987 as a result of the Gramm-Rudman cuts.

And yet, Corrada pointed out, Hernández Agosto had testified earlier in the day that Puerto Rico could lose $263 million from the budget cuts.

"Two weeks ago when I used much the same figure I was accused of spreading hysteria," Corrada told Fuster.

Fuster, who several weeks ago predicted that Puerto Rico would lose only $99 million from Gramm-Rudman in fiscal 1987, said he now "agreed" with Hernández Agosto's $263 million figure. He objected, however, when Corrada, in his testimony, raised the potential loss to $326 million in fiscal 1987.

Corrada reached the new total by melding in the $27 million increase to Puerto Rico's Nutritional Assistance Program that President Reagan has eliminated in his budget, and the more than $30 million that Puerto Rico stands to lose in federal rum excise taxes.

The General Accounting Office has ruled that a portion of the federal excise taxes which Puerto Rico gets back on the rum it sells on the U.S. mainland be withheld as part of Gramm-Rudman. The Hernández Colón administration is appealing the ruling.

Virgin Islands Delegate Ron DeLugo, acting chairman of the committee, brought the seemingly interminable bickering between Fuster and Corrada to a close by rapping his gavel and saying, "I declare the fight a draw. The two of you have done a pretty good job of working each other over."

Another committee member then remarked, "I'm almost sorry you stopped the fight, Mr. Chairman, it was getting

Thursday, February 27, 1986.

House unit votes to restore funds to P.R.

By HARRY TURNER
Scripps Howard News Service

WASHINGTON — The House Interior and Insular Affairs Committee has approved legislation calling for the restoration of cuts made in Puerto Rico's rum taxes, Custom duties and nutrition funds, Resident Commissioner Jaime Fuster announced Wednesday.

Fuster, noting the enormous pressure on Congress to cut programs wherever possible, said, "the odds are almost impossible" that the funds can be salvaged.

The report accompanying the legislation will also emphasize that the funds were improperly taken away in the first place, Fuster said.

The Interior Committee action, part of its recommendations to the House Budget Committee, would restore to Puerto Rico $10.5 million in rum excise taxes, $4.2 million in Customs duties and $5 million to the island's Nutrition Assistance Program (PAN).

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Rum Taxes

From Page 1

The General Accounting Office took away the rum and Customs funds under the mandate of the Gramm-Rudman balanced budget law, while the appropriations committees in Congress lopped off the PAN funds.

All the cuts were for the current fiscal year.

Fuster said the Interior Committee legislation also calls for the PAN program to receive $852 million next fiscal year, as approved earlier by Congress. President Reagan in his new budget would freeze the PAN budget at $825 million.

Fuster, noting the enormous pressure on Congress to cut programs wherever possible, said, "the odds are almost impossible" that the funds can be salvaged.

He added, nevertheless, "I'm doing everything I can, but it's an uphill battle. I'm working 18 hours a day and knocking on everybody's door."

The resident commissioner testified Tuesday before the Budget Committee asking for the funds' restoration, and he said he will appear before the Appropriations Committee soon to ask for full funding for the PAN program.

A wild card in the whole budget picture, as Fuster noted Wednesday in the telephone interview, is a pending Supreme Court ruling on the constitutionality of the Gramm-Rudman law.

If the court, expected to issue a decision in July, rules the law unconstitutional then, Fuster said, much of his present work will be rendered unnecessary.

GAO, in a precedent-setting action, took the rum funds despite Puerto Rico's claims that the funds were not part of the federal budget. The Puerto Rican Treasury gets back the federal excise taxes on rum produced on the island and sold on the U.S. mainland.

Customs duties collected in Puerto Rico on foreign goods being brought into the island are likewise rebated to the island's Treasury.

The PAN program sends monthly checks to low-income residents. The Hernández Colón administration claims the 1981 legislation creating PAN calls for the program to get full funding no matter what other cuts are made in the national food stamp program.

("Gimme Gimme")

U.S. will assist $2 billion plea for Philippines

WASHINGTON (AP) — Secretary of State George P. Shultz, in a shift of emphasis from two weeks ago, said Tuesday the Reagan administration will help lead an international effort to raise $2 billion to assist President Corazón Aquino in coping with "a real mess" in the Philippines.

Meanwhile, the archbishop of Manila, Cardinal Jaime Sin, said in Washington that former President Ferdinand Marcos has virtually no support left in the Philippines. Sin told reporters that with outside support and domestic self-help, Mrs. Aquino should have the economy "flourishing in three years."

Shultz, appearing on the NBC-TV "Today" show, said that although the administration is asking Congress to increase U.S. aid by $150 million this year, to nearly $500 million, "they need more, there is no doubt about it." He said the United States will try to help raise the $2 billion that Aquino has said is needed to repair the economic devastation left by Marcos.

"We'll have to try to help them piece it together from various places, other countries, Japan, European countries, Australia is ready to put up some money, and the various international financial institutions," Shultz said.

"We need to help do that and we'd like to get them more money from here, but the congressional picture, or the budget picture, I should say, just doesn't seem to allow that," he said.

Shultz' emphasis a change from two weeks ago, after he and President Reagan met with Vice President Salvador Laurel in Bali.noyed, he told reporters then, "Vice President Laurel, I must say, gave the impression that his needs were infinite, and we don't have infinite capacity to provide money."

END Result! ?

STAR ECONOMIC COUNCIL

Puerto Rico could learn lessons from Hawaii

President of P.R. Management and Economic Consultants Inc.

By MOHINDER BHATIA

The economies of Puerto Rico and Hawaii are fully integrated with the U.S. economy, yet they have different economic structures and the standard of living of Hawaiians and Puerto Ricans vary greatly.

Hawaii's physical location in relation to the U.S. Mainland is not as advantageous as that of Puerto Rico. Honolulu is 2,780 miles away from Anchorage (Alaska) and 2,397 miles from San Francisco. Puerto Rico is 1,600 miles from New york and 1,000 miles from Miami. In addition, Puerto Rico is only a few hundred miles from several Caribbean Islands. On the other hand, Hawaii is 5,300 miles from Manila and 3,850 miles from Tokyo.

Because of shorter distance from the center of economic activities, Puerto Rico should have been able to handle the physical disadvantages better than Hawaii.

Population of Hawaii is one million, which is about one third of Puerto Rico's population. However, personal income of Hawaii ($14 billion) is just about the same as personal income in Puerto Rico. Consequently, per capital personal income of Hawaii ($14,000) is about three times greater than that of Puerto Rico.

An average Hawaiian has a higher standard of living than a Puerto Rican because wage rates are high in Hawaii. A carpenter or an electrician earns $14 per hour in Hawaii, as compared to about $5 per hour in Puerto Rico. A typist earns $1,100 per month in Hawaii as compared to $800 in Puerto Rico.

In addition to high wage rates, the unemployment rate in Hawaii (5 percent) is about one-fourth of Puerto Rico (20 percent). Furthermore, out of a population of one million in Hawaii, 460,000 persons are employed; almost one person out of 2.2 persons is employed. On the other hand, one person out of 4.4 persons is employed in Puerto Rico. A Puerto Rican worker also has to support twice as many persons as a Hawaiian worker has to support.

There are some sharp differences between the economic structures of Hawaii and Puerto Rico.

In Puerto Rico, the manufacturing sector is predominant. In Hawaii, the economic predominance is shared by federal spending ($4 billion) and tourism ($4.5 billion). The manufacturing sector employs merely 4.8 percent of workers in Hawaii as compared to 19.2 percent in Puerto Rico.

Of course, Hawaii's performance in tourism is very superior. What Puerto Rico's Tourism Co. aspires to accomplish in 20 years, Hawaii already has. Hawaii welcomes more than five million tourists per year, who spend about $4.5 billion. On an average day, there are more than 100,000 tourists in Hawaii staying in its 66,000 hotel rooms. Average daily hotel room rates do not exceed $70.

Puerto Rico's tourism directly contributes about 3 percent of G.N.P. as compared to 30 percent in Hawaii. The number of hotel rooms in Puerto Rico is about one-ninth of the number in Hawaii.

One of the great differences between tourism in Puerto Rico and Hawaii is that the length of stay of a tourist in Hawaii (11 days) is almost four times higher than Puerto Rico's. In addition, the length of stay has not changed in Hawaii during the past 20 years. In Puerto Rico, it has shown a tendency to decline.

The American traveler is the mainstay in tourism in Hawaii and Puerto Rico. Visitors from the U.S. Mainland accounted for 67 percent of the tourist market in Hawaii and the remainder came from foreign countries, primarily Japan. Foreign tourists in Puerto Rico account for a fourth of the market.

The government sector in Hawaii is big business, just as it is in Puerto Rico. One worker out of five in Hawaii works for the government. However, unlike Puerto Rico, the federal government employs one-third of the workers. The remaining two-thirds are employed by state and local governments. Federal government, in both military and civilian sectors, employs 32,000 workers, as compared to about 10,000 workers in Puerto Rico.

Among the armed services, the largest spender is the Navy, followed by the Army and the Air Force. Together; they spend about $2 billion per year in Hawaii.

One of the remarkable similarities between Puerto Rico and Hawaii is that the cost of living in the both exceeds the U.S. by about 15 percent.

Like Puerto Rican businessmen, the Hawaiian businessmen are fond of saying that "Everything comes from thousands of miles away, and the shipping costs are exorbitant."

The economists in Hawaii, however, have found that "only a fraction of the cost differential can be pinned on shipping." Surface transportation cost per mile between Hawaii and the West Coast is "less than overland truck or rail movement of goods on the Mainland".

The Hawaiian economists report that "the cost of land, housing, and commercial structures have the greatest impact in the cost of living." In Hawaii and Puerto Rico, the cost of land is artificially kept high by landowners, and the governments have designed and implemented tax policies that perpetuate this phenomenon.

Hawaii has done much better than Puerto Rico in the supply of its need for food from domestic sources. About one-third of Hawaii's food requirements are satisfied by local farmers. However, the fishermen of Hawaii are not very productive. Their annual fish catch is less than eight million pounds. Puerto Rico's fishermen catch about five million pounds of fish in a year.

A brief comparative economic review of Puerto Rico and Hawaii shows that we can learn from Hawaii in the development of the tourism sector. Also, we can seek lessons from Hawaii's higher self-sufficiency in the production of food.

THE PAKISTAN TAX TREATY AND "TAX SPARING"

STANLEY S. SURREY *

THE United States has entered into a number of international income tax reaties with various European countries, ritish Commonwealth countries, Japan, nd Honduras. While these treaties are alled treaties for "the avoidance of ouble taxation," for the most part as ar as the United States is concerned our nternal Revenue Code use of the for- gn tax credit effectively prevents dou- le taxation for our citizens and corpo- ations. Under this credit, the United tates permits a taxpayer to apply for- gn income taxes against the income ax due to the United States, so that nly the excess if any need actually be aid to the United States.[1] As a conse- uence these treaties really deal with pe- ipheral matters. The usual pattern is or the country of source to reduce its ax on certain forms of income going to he country of the investor. Thus, as espects the United States, it may by reaty reduce its withholding tax on ividends paid by United States corpo- ations to citizens of say, Australia, in eturn for Australia's reducing its tax n dividends paid by Australian corpo- ations to citizens of the United States. n some situations this reciprocal reduc- ion brings foreign rates down to the evel of the United States, so that our orporate investors pay no more than 52 er cent. As another example, taxation at the source on compensation paid to foreigners temporarily residing in a country, such as teachers or businessmen on short trips, is usually waived by a treaty. The foreign country often agrees to institute a foreign tax credit system for its domestic taxpayers respecting their income from sources within the United States. A few source rules are sometimes inserted, which usually reflect the United States rules and probably as well the similar rules already existing in the other country. There are also some provisions for cooperation between the administrative authorities of the two countries.

Thus in the tax treaties in the past the United States has reduced its taxes only on foreign investors receiving income from the United States in return for similar concessions by a foreign country on income going to United States investors. These past treaties—and this is the important point—have not reduced United States tax rates on United States citizens or corporations receiving income from a foreign country.

The Pakistan treaty,[2] however, is the first treaty designed to reduce *the United States tax* on United States corporations investing abroad, thus fundamentally altering the entire tax treaty process. The treaty in all but one of its articles represents the pattern of existing tax treaties. But one sentence in the treaty fundamentally alters that pattern. This is the second sentence in Article XV(1), which grants the so-called "tax sparing credit."

"Tax sparing" is a term coined to describe tax concessions which some of the foreign countries grant to certain activities, in an effort to encourage those activities. Thus, Pakistan for example exempts from its income tax and super tax for a certain period profits up to 5 per cent of invested capital earned by a manufacturing corporation employing ten or more persons and using power, or employing 20 persons without using power. This provision has the effect of reducing the Pakistan tax on a United States corporation investing in Pakistan, since the United States corporation need not pay the full Pakistan tax—i.e. a part of that tax is "spared." The proposed treaty then states that for the purpose of our foreign tax credit the United States corporation shall still be treated as having paid the Pakistan tax which was spared. In other words the United States corporation is given a credit for the tax *not paid* to Pakistan. It can apply this credit for a tax *not paid* against its United States tax on income from Pakistan. It is obvious that to allow a credit against our tax for a tax *not paid* has the same effect as reducing the United States rate of tax. In fact, the Pakistan tax treaty could in some cases operate to produce just about the 14 point reduction for foreign income which the Congress has so far refused to grant by legislation. Conceivably, in other situations the United States rate on income from Pakistan could be reduced to zero.

This proposal changes the whole nature of the tax treaty process, for it would permit the rates of *United States tax* applicable to a United States citizen or corporation investing abroad to be fixed by treaty. Up to now this vital question of tax policy has been regarded as a matter to be determined by legislation. The tax sparing treaty would instead permit these tax rates to be determined by treaty action rather than legislation.

There are a number of serious objections to this treaty proposal. They are here stated in somewhat summary fashion: [3]

1. In recent years, the Congress has been urged by the Treasury Department and others to reduce the rate of United States corporation income tax applicable to income from foreign sources. Generally this rate is 52 per cent (with the exception of certain Western Hemisphere operations).[4] Thus, it has been forcefully suggested that Congress reduce this 52 per cent rate to 38 per cent. In 1954 this proposal was considered at length but not approved by the Con-

* The author is Jeremiah Smith, Jr. Professor of aw at the Harvard Law School.

[1] For a discussion of the foreign tax credit gen- rally, see Surrey, "Current Issues in the Taxation f Corporate Foreign Investment," *Columbia Law Re-*

[2] Taxation Convention with Pakistan, Executive N. [illegible]

[3] The pressures of publication schedules necessitate this approach. The arguments presented are taken from memoranda submitted to the Senate Committee on Foreign Relations at its Hearing on the treaty, 85th Cong., 1st Sess., August 9, 1957 (an earlier Hearing was held on July 30, 1957) and from a statement and testimony presented to the House Committee on Ways and Means at its invitation on the taxation of foreign income, see *Hearings on General Revenue Revision*, 85th Cong., 2d Sess. (1958), 1143. For further consideration of this matter see the article referred to in note 2, *supra*, and Surrey, "The United States Taxation of Foreign Income," to appear in the forthcoming *Journal of Law and Economics* (University of Chicago).

[4] The text does not take into account significant tax preferences granted to foreign investment under certain circumstances because of the formulas now followed, but probably inadvertently adopted at the beginning, in the calculation of tax credits in the case of subsidiary operation. Thus, where operation is in foreign subsidiary form, given a foreign tax rate of 26 per cent, the effective combined tax rate of foreign and United States tax is 45.25 per cent under the foreign tax credit formulas instead of the expected 52 per cent. Where operation is the form of a chain of a parent and 2 foreign subsidiaries, the bottom corporation being in a country with a tax rate of 25 per cent and the intermediate one in a country with a tax rate of 20 per cent, the effective overall tax for the chain is 40.45 or 43.5 per cent, instead of 52 per cent, depending on which interpretation of the applicable law is followed.

gress. Since 1954 the tax committees, House Ways and Means and Senate Finance, have not given approval to similar proposals. As the record therefore stands respecting direct tax legislation, the Congress opposes the grant of any preferential corporate tax rate on foreign income. The proposed treaty, which would grant a preferential tax rate to foreign income, is thus, as far as one can judge from the public record, directly in contrast to a general tax policy recently expressed against such a preferential rate, and in this particular instance the treaty can go far beyond the reduction to 38 per cent already rejected by the Congress—for it can reduce the effective rate to zero.

This policy conflict, and the consequent importance of the issue, are not limited to the Pakistan treaty. Once this preference is granted to income from Pakistan, it will have to be extended to a great many other countries of the world. The Pakistan treaty, if adopted, is thus the forerunner of what will amount to a general tax reduction respecting foreign income—a result directly opposite to that arrived at in the formulation of our legislative tax policy.

2. The full effect of the treaty can be realized only by placing it in perspective with our foreign tax credit. Congress for years in the internal revenue laws has permitted American corporations to credit foreign taxes paid against their United States tax. This credit is an accommodation to our investors abroad who are subject to tax both in a foreign jurisdiction and in the United States. The credit insures that the investor abroad is not adversely treated as compared with the investor at home—the United States Treasury simply accepts payment of the foreign tax as payment pro tanto of the United States tax bill. The burden of double taxation is thus borne by our Treasury Department. But the important fact is that so far as the United States is concerned the actual tax burden on the investor abroad is not lessened as compared with the investor at home. Both pay 52 per cent—but one pays it all to the United States Treasury and the other pays part to the United States Treasury and part to a foreign government.

The credit was thus directly designed to meet the added tax burden of foreign investment. It is not intended to—and until this treaty did not operate to—reduce the tax burden on the foreign investor below that of the domestic investor.

The tax sparing clause in the Pakistan treaty thus distorts the whole foreign tax credit procedure. Under it a credit is given for a foreign tax not paid. The lessened United States tax bill is thus not balanced by the payment of a foreign tax, as in the usual case—and therefore is a direct reduction in the tax rate applicable to the foreign investor as compared with the domestic investor.

3. If such a tax sparing clause is adopted in the Pakistan treaty and if the policy spreads to treaties with other countries, then the results would be one United States tax rate applicable to United States corporations in Pakistan, another rate applicable to United States corporations in country X, another in country Y, and so on. The United States rate would in effect be set by the finance minister of each foreign country, in the light of that country's overall domestic policies. This would be a far cry from the 52 per cent United States rate applicable today, whether operations are in Pakistan or Brazil or elsewhere. It is true today that changes in foreign tax rates affect the actual amount of tax dollars collected from a United States corporation. But these changes affect only the relative size of the two components of the corporation's overall tax burden—the United States component and the foreign component. They therefore really affect only the amount of loss suffered by the United States Treasury Department—they do not affect the tax burden on the United States corporation. If the foreign tax rises, our Treasury loses and the foreign treasury gains. If the foreign rate falls, our Treasury gains and the foreign treasury loses. But the United States corporation investing abroad still has its overall 52 per cent burden—just as does the domestic investor.

4. Tax sparing treaties would also discriminate among investors abroad. Thus, these treaties would not apply to all types of foreign source income; for example, patent and know-how royalties are not benefited in the Pakistan treaty. Nor can the treaties apply to all countries, since presumably only countries using income tax rate concessions can enter into tax sparing treaties. Thus, a United States corporation doing business in a tax concession country under a tax sparing treaty would in effect have a lower United States tax rate than a United States corporation doing business in a non-tax rate concession country, although the foreign rates after the concessions are taken into account did not appreciably differ. Hence a United States corporation investing in Mexico or Cuba, tax concession countries, would in effect be granted a lower United States tax than a United States corporation investing in Venezuela or Colombia, which basically are not tax concession countries.

5. The tax reduction which the tax sparing device involves can result in windfalls to United States corporations. The Pakistan treaty is applicable to United States corporations already investing in Pakistan. Thus, though they have invested without any stimulus from or reliance upon the tax reduction now to be granted, they nevertheless receive that tax reduction. Indeed, the United States Council of the International Chamber of Commerce, stresses that these retroactive benefits are just and proper: "The benefits of the tax-sparing provision in the Pakistan Treaty will, fortunately, be available to some American businesses which have already been established . . .".[5] In fact, the Chamber serves notice that it will push for even greater retroactivity if the principle is adopted. But the windfall aspects of this retroactive application of the treaty tax reduction are obvious.

Moreover, advantages which are in effect windfall gains are also present even in the case of future investment. Most sound American investment abroad is predicated on the long-range situation, and is planned to last long beyond the tax concession period of foreign tax laws. Consequently, the real inducement to this investment is the long-range investment climate and not the short-range tax concession. Hence, the United States tax reduction granted under this treaty proposal when effective for the initial period of investment, as it would be in the case of a branch or a foreign subsidiary distributing some profits to the United States parent, is in effect a windfall benefit—bestowed for engaging in an activity which would have been engaged in without that benefit.

6. This tax reduction could encour-

[5] See *Hearings*, July 30, 1957, note 3, *supra*, at p. 22.

age operators to seek a quick profit—to operate for the period of the tax concession, obtain a United States tax reduction, and then end their operations. This has been the case in some underdeveloped countries. Such a situation is hardly beneficial to the underdeveloped country and this is hardly the kind of activity which the United States should induce and favor with a United States tax reduction. The treaty proposal is thus really an incentive to a quick repatriation of foreign profits rather than to a continued reinvestment abroad of these foreign profits—whereas one would think that just the opposite effect would be desired. Moreover, as has been pointed out, what is to prevent the activity from being liquidated and then started over again in somewhat variant form with a new tax concession.[6] The treaty itself, and hence the United States tax law, does not prevent this. The question is simply one of Pakistan tax law—what is a " new undertaking " under that law. Thus the scope of the tax reduction in the United States tax depends on the interpretations, effectiveness of audit scrutiny, ability—and even honesty—of the foreign tax administrators. They and not we become essentially the policemen of United States tax reductions for United States taxpayers.[7]

[6] See remarks of Senator Kennedy, *Hearings*, July 10, 1957, note 3, *supra*, at p. 10.

[7] A number of other matters will turn on Pakistan law. Thus, the amount of capital invested is determined under Pakistan law, and not United States law. This amount is not an easy matter to determine, as experience in a somewhat similar situation in United States excess-profits tax history shows. Not only must the capital invested be determined precisely, but so the amount of capital allocable to the exempt activity. Where some exempt and some nonexempt activities are involved, this allocation can be quite complex. Here again the policeman of the United States tax reduction is the foreign tax administrator, or his decisions on these difficult legal, accounting and factual questions decide the point.

7. It is asserted in support of the tax sparing treaty proposal that the United States tax laws " nullify " and " frustrate " the tax concessions which some underdeveloped countries grant under their tax laws and that therefore these tax sparing treaties are necessary. This assertion is one of the basic arguments offered in support of the proposal. However, this assertion is "greatly exaggerated," to use the characterization given to this assertion by Professor Dan T. Smith, Deputy to the Secretary of the Treasury, in a speech on this subject before the National Foreign Trade Council, November 28, 1956. To quote Professor Smith:

> " It is asserted that our tax system nullifies the tax advantages which other countries attempt to offer because the taxes which they forego, by reducing the tax credits which we allow, simply increase the tax in this country by the same amount. This criticism is greatly exaggerated; it is valid only when foreign operations are conducted directly rather than through foreign subsidiaries or through foreign subsidiaries from which all income is currently withdrawn. Where foreign subsidiaries are used the common expectation is that early earnings will be retained indefinitely and used for expansion. Typically the period of retention for expansion will equal to exceed the period of tax concessions, and when this is the fact, the foreign tax concessions are fully effective."

Thus, the basic reason advanced for this treaty proposal, that of nullification of foreign tax concessions, simply cannot be supported. When American business invests abroad in foreign subsidiary form, these foreign tax concessions are effective. Only the foreign tax is applicable to a foreign subsidiary, and the United States tax does not apply until dividends are paid to the United States parent. Moreover, in the overwhelming majority of cases when our industrial concerns operate abroad they do so in foreign subsidiary form. Branch operations abroad—the situation in which the foreign tax concession may not be fully effective—are found generally (aside from certain Western Hemisphere operations which already enjoy a favored status) only in the case of oil and other natural-resource industries. But in these natural-resource activities the investment basically follows the resource and not the tax concession.

8. It is pertinent to note at this point that Britain has concluded a tax treaty with Pakistan and this tax treaty does not have any tax sparing provision in it. In fact, though the British originally suggested in 1953 that consideration be given to the tax sparing device, they have not adopted it and instead have sought other solutions. The solution adopted in 1957 in Britain embodies the tax deferral approach inherent in our tax rule regarding foreign subsidiaries. Under that solution, a special class of British corporations known as overseas trading corporations may engage in foreign operations, under certain conditions, free of tax until distribution is made to shareholders. In effect, the British in their 1957 solution have really gone no further than where we in the United States have always been as respects our foreign subsidiary rule, except that actual foreign incorporation is not required.[8]

9. Another argument presented for the tax sparing treaty device is phrased along this line: Since the United States concedes the power of the foreign jurisdiction to tax, we can just as well through tax sparing concede them the power to forego taxes. Thus far, of course, the assertion is meaningless for we do not in any way tell a foreign country that it cannot reduce its taxes if it so desires. Hence, the assertion must be made even more strongly: We must recognize the right of the source country to forego some of its tax without our " stepping in " and " nullifying " their action. The phrase regarding our " stepping in " is a curious one. For what this assertion comes down to is that we must recognize the right of the source country to forego taxes and that such recognition requires that we stop levying United States taxes on United States corporation on profits subject to United States tax, even though this means that these corporations end up with tax burdens less than those of other United States corporations. So stated, it is obvious that the recognition granted under the foreign tax credit to the jurisdiction of the foreign country to tax at source hardly carries with it the corollary that we must also accommodate our tax laws to waiver or absence of tax in the foreign country.

What the proponents of this treaty device are really asserting is that the United States should give up its basic principle of equality of tax burden on United States taxpayers. For this principle can only be maintained by adherence—as we have done from the start of the income tax—to the concept that the United States can tax its citizens and corporations on their worldwide income. Yet it is this basic and longstanding concept which the proponents of the tax sparing device are asking the Congress to abandon.

10. The underdeveloped countries dif-

[8] See in general Harvard Law School, International Program in Taxation, World Tax Series, Taxation in the United Kingdom, prepared by Brudno and Bower, 1957 and 1958 Supplements; Bronheim, Overseas Trade Corporations—A United Kingdom Experiment,

adopt tax concessions to encourage investment and in the types of concessions used. There are differences in the taxes involved—income tax, excess-profits tax, company tax, customs duties and import taxes, sales taxes, property taxes; in the activities affected—manufacturing, mining, "new industries," "essential industries," "convenient industries," "pioneer industries," "basic industries," "approved industries;" in the period for which the concession is granted—5 years, 10 years, 20 years, 25 years; in the amount of reduction in income tax granted—complete exemption, 100 per cent in the first few years down to 25 per cent at the end, 40 per cent of tax, all profits up to 5 per cent, 10 per cent, etc. of invested capital; in the type of income tax concession used—exemption, rate reduction, increased depreciation allowance, deduction for profits reinvested. Some countries, of course, do not grant any concessions.

The tax sparing device inevitably involves the United States and the Senate Foreign Relations Committee in picking and choosing among all of these concessions. It requires our becoming directly involved in the fiscal policies of all of these countries. It will bring pressures to bear on the use of the exemption-type concession. For the tax sparing device requires the type of concession that permits ready identification and calculation of the "tax spared," so as to make administration of the device at all possible. After all, to credit a tax not paid one must be able to identify accurately what was not paid. The exemption concession is of this type, though it is not without its many problems. Yet many underdeveloped countries are finding that other concessions, such as increased depreciation or an investment allowance, are more desirable. The tax sparing device, with the pressures it exerts in one direction, can be more of an interference with foreign tax laws than anything yet suggested in this field.

Suppose the United States places its blessing on a particular income tax exemption or rate reduction in a particular country and enters into a tax sparing treaty with that country. The result will be a decrease in the United States tax rate. Then suppose the country adopts a different concession, or drops concessions entirely in favor of a lower tax rate generally. Thus, Pakistan as a result of a tax revision study now in progress may decide that its tax rates—which are among the highest in the world—are too high to encourage domestic capital formation and they should be reduced for all taxpayers, with concessions limited or even abandoned. The United States tax rate would then increase on the taxpayers involved. A device that has the *United States tax burden* bobbing around as foreign countries experiment with different fiscal policies is an almost fantastic approach to international tax problems.

11. The use of tax treaties to establish rates of tax on United States corporations has serious political considerations both here and abroad. The result will be to focus intense lobbying pressures by a combined group of United States foreign investors and tax concession countries on the Treasury Department to obtain favorable treaties, and for the first time saddle the tax treaty process with intensive lobbying activity. Also, this device will focus pressures on United States corporations to obtain tax concessions from underdeveloped countries and then have the tax concessions written into a treaty—since this is the route which will reduce their United States taxes.

A searching question exists whether a resort on our part to the tax sparing device would not in the end be basically injurious to the economies of underdeveloped countries. This device favors a country with an unstable and unrealistic high rate tax system shot through with tax concessions, many of which are contradictory and self-defeating. As such it tends to postpone intelligent revision of foreign tax systems. Moreover, these countries desperately need revenue for public projects. Encouragement on our part to pressures for tax concessions by these countries—an encouragement inherent in the tax sparing device since the tax concession means reduction in United States tax—may well result in depriving them of revenues they could just as readily obtain. The rash of incentives and concessions might well pass more quickly and be followed by stable and realistic laws but for a treaty device which encourages our investors abroad to bring pressures on foreign countries to grant tax concessions.

12. The tax sparing device has been defended on grounds of the need of a United States tax incentive to encourage United States private capital to invest abroad. The wisdom of using tax incentives for this purpose is itself highly debatable.[9] But whatever the outcome of this issue, it would certainly appear that the particular device here suggested, the "tax sparing device," is fundamentally an unsound one to offer as a worthwhile tax incentive. It does not begin to answer any of the problems that must be faced when a tax incentive is to be used. Thus, is there any evidence as to how one can tell in using this tax-sparing device just how much tax relief is needed for an effective incentive? If the effect of the incentive is insignificant—and an experienced witness stated to the Senate Committee on Foreign Relations that no serious amount of capital would be attracted because of this device in the Pakistan treaty[10]—then a tax windfall has resulted and our Treasury has lost revenue for no real purpose. Further, how do we recognize which are the countries to which American investment should be directed by tax incentives? Certainly the test cannot be simply those countries which offer tax concessions. Yet this appears to be the sole criterion under the tax sparing device. Further, how do we recognize which are the types of activties to which American investment should be directed and how do we devise methods which would channel the tax incentive so as to draw forth new investment? The tax sparing device, if it answers these latter problems at all, does so really by relegat-

[9] See Surrey, "Current Issues in the Taxation of Corporate Foreign Investment," *Columbia Law Review*, June, 1956, p. 815.

[10] The representative of the United States Council, International Chamber of Commerce, stated to the Senate Foreign Relations Committee: "I want you gentlemen to know and anyone else who wants to know, including the executive departments and Pakistan, that in my humble opinion virtually no capital from the United States will be attracted to Pakistan under the present Pakistan regime and under this treaty." He urged approval of the treaty, however, because the "psychological repercussions of disapproval" would be bad. See *Hearings*, August 9, 1957, note 3, *supra*, at 52.

See also the statement of John M. Barker, House Ways and Means Committee, *Hearings on General Revenue Revision*, 85th Cong., 2d Sess. (1958), 1173, which reaches the same conclusion in effect, but goes on to say that the treaty should therefore be approved since no United States corporation will benefit and no harm is done. But this view completely ignores the precedent aspect of the treaty, which is the heart of the problem. See point 16 in the text.

The Puerto Rican experience with tax incentives, whatever it does show, is hardly typical in view of the free and close access to the United States market, no currency problems, participation in United States legal and political institutions, and the like. As to Puerto Rico in general, see Stead, *The Economic Development of Puerto Rico* (National Planning Association, 1958).

ing all these problems to the policy decisions and rulings of foreign finance ministers and foreign officials. Yet these are exceedingly difficult problems to solve and it is certainly a curious solution that says the course and application of United States tax incentives basically should be decided not by us but by foreign officials, especially when these very foreign officials recognize their own limitations and even failures in meeting these problems. It is not enough to say in response that all of this is a matter of treaty negotiation. For the very insistence on negotiation indicates the inherent weakness of the tax sparing device as a method of developing a clear-cut policy for granting a tax incentive for United States investment abroad. While the absence of any guiding standards to solve the basic questions enumerated above undoubtedly means that the tax sparing device can only be applied through ad hoc negotiations in treaties, this absence of standards hardly thereby becomes a virtue.

13. It is sometimes argued that all these admitted serious defects of the tax sparing device are counterbalanced by the international benefits which the device will provide. However, it is generally agreed that tax sparing will not increase United States investment abroad.[11] Rather, in defense of tax sparing, it is said that underdeveloped countries resent the United States policy of taxing foreign source income and that tax sparing will therefore remove some of that resentment and create good will. This resentment, however, is really the reflection of an assertion that only the source country should control the taxation of international investment—an assertion which the United States and many other countries, including some Latin-American countries, have long rejected.[12] Moreover, as respects a balancing of the claims of the investor country and the source country, the United States has already gone far in seeking an international accommodation through its foreign tax credit and foreign subsidiary rules. To ask the United States to go further and violate its own basic principle of not discriminating among its own nationals—which is what the tax sparing treaty asks us to do—is not warranted as an international matter. In effect, the United States so long ago acted by unilateral legislation to relieve these problems of international taxation that the underdeveloped countries experiencing significant United States investment for the first time tend to forget what we have done. To the extent that resentment exists in these countries, it is in many instances due to a lack of information as to our tax rules and a failure to appreciate the effects of the basic accommodations we have already made to international investment.

Thus, there is probably no real recognition of the aid to economic development represented by the foreign tax credit. As between developed countries, the foreign tax credit when used by both countries is really an exchange between Treasury Departments. Investment and business profits flow both ways, and credits granted by the United States for payments at source to the other country are offset by taxes withheld by the United States at source and credited by the other country.[13] But between the United States and an underdeveloped country, the foreign tax credit is a one-way flow from the United States Treasury, since the underdeveloped country usually does not have investments in the United States from which our Treasury can collect a tax at source. Here our foreign tax credit permits appropriate tax revenues to be collected in the foreign country on investment from abroad without the deterrent effect on the importation of outside capital that would otherwise exist if the resulting double taxation were not eliminated by the credit. As a striking example, the economic development of Venezuela is in a sense being financed to an appreciable extent by the United States Treasury through the foreign tax credit granted for the Venezuelan taxes on oil. As a continuing aid to underdeveloped countries and one that does not have to be directly reflected through budget appropriations, the foreign tax credit is very significant.

All this being considered, a case cannot be made on the basis of international goals which is at all strong enough to justify the admittedly undesirable effects of the tax sparing device.

14. It is urged that the tax sparing device has a " symbolic value " and that it is justified by its " emotional appeal." But symbols and emotions will hardly be of aid to the Senate Foreign Relations Committee when it must decide the questions that lie ahead and when it must face the pressures that this device will inevitably bring. Already warning has been served by American investors that these pressures are to come: The National Foreign Trade Council has said that the tax sparing device in the Pakistan treaty " should be implemented more broadly in future treaties." [14] The United States Council of the International Chamber of Commerce has critized the restriction of the Pakistan law to new undertakings. It therefore urges that the Committee make it clear that the Pakistan treaty is not a precedent that discrimination by foreign countries against existing businesses should be accepted by the United States. Moreover, it points out that the Pakistan tax concession is keyed to a fixed rate of return on invested capital and urges that application of the tax sparing device to this concession not be considered as limiting use of the device in future treaties to this one type of concession.[15]

It is clear that strong pressures are in the making for a wider and wider application of the tax sparing device and its accompanying reduction in United States taxes once a precedent is set in the Pakistan treaty. And, judging from our experience in tax legislation, one can hardly be sanguine about any attempts to confine a tax reduction proposal once it has been adopted and pressures such as the above set in motion. Certainly " symbolic value " and " emotional appeal " will not furnish strong guidance to the Senate Foreign Relations Committee. Tax history is replete with examples of the fact that major loopholes develop from preferences that initially appear to be quite limited.

15. Perhaps this view of the matter may mean fewer tax treaties with underdeveloped countries. But, as noted earlier, these treaties are distinctly marginal matters. In fact, since the pattern of the treaties is for the country of source to yield tax revenue, these treaties

[11] Mexico, for example, has jurisdictional tax rules respecting foreign income that are about the same as the United States—it taxes the world wide income of its citizens and corporations and grants a foreign tax credit. A number of Latin-American countries also tax the foreign income of resident individuals and corporations under their global or complementary taxes and corporate income taxes.

[13] Frommkin and Wender, " Revenue Implications of United States Income Tax Treaties," *National Tax*

[14] See *Hearings*, July 30, 1957, note 3, *supra*, at p. 20.

are not suited to underdeveloped countries hard pressed for revenue. Certainly the United States should not be pushing for tax treaties of this character as respects underdeveloped countries. A pattern of tax treaties with underdeveloped countries under which the United States would grant tax sparing, despite all its basic defects, as the concession for obtaining tax reductions at source from the underdeveloped countries, despite their desperate revenue needs, would certainly be the wrong policy on both sides.[16] It would match two ill-advised concessions with no basic gains achieved, since it is generally agreed that such treaties would not achieve any real increase in desirable international investment.[17] And probably underdeveloped countries seriously desiring tax treaties would in time be willing to negotiate them without the tax sparing device.

16. It is clear that a very significant precedent is involved in the adoption of this tax sparing device. It is not just a little clause in the Pakistan convention. It presents a very fundamental question of tax policy. Once adopted, it will be a precedent which cannot be withdrawn. Arguments in support of tax sparing based on the small amount of tax spared in the Pakistan situation and examples showing how little United States tax will be saved are thus completely beside the point. The basic issue is the tax sparing device itself, and not its application in the Pakistan treaty. Once the tax sparing path is taken, the United States and the Senate Committee on Foreign Relations are involved in endless choices among foreign countries, among different tax concessions and among different United States taxpayers. Moreover the Committee will be thrown into these problems without any rules or standards to guide it.[18]

[16] As respects Pakistan, the Department of State, *Hearings*, July 30, 1957, note 3, *supra*, has said that the United States must insist in a tax treaty that the country of source, here the underdeveloped country, give up its tax on royalties paid to United States licensors of patents, know-how, and the like. Yet by and large, as a result of our foreign tax credit, taxation at the source is not a basic obstacle to licensing abroad. At the same time, as a result of the increasing desire of United States corporations to license abroad and of the desire of underdeveloped countries to receive such technological aid, our insistence that underdeveloped countries yield their tax on outgoing royalties can deprive them of needed revenues. In view of the foreign tax credit, moreover, this insistence does not benefit the United States taxpayer but only the United States Treasury.

This insistence, therefore, is hardly in keeping with the arguments earlier advanced that tax sparing is necessary because otherwise the United States Treasury would benefit from the tax concessions in the foreign country. This is but one example of the contradictions involved in insisting that underdeveloped countries yeild their general source taxes and at the same time insisting that we should aid their economic well-being. Taxation at the source on income flowing to the United States is onerous to the United States taxpayer if it brings his effective tax burden above the United States rate. But unless it does this, the effect of the foreign tax is not felt, and the real loss is to the foreign country if it must yield beyond this point. There is therefore little reason to insist, as the State Department memorandum urges we must, on any sacrifice in revenue by these countries. Once having decided to eliminate double taxation through the foreign tax credit device, there is no reason for us to insist on eliminating it all over again in another way by making the underdeveloped country sacrifice its revenue sources.

There are some marginal cases where the foreign corporate rate is in excess of the United States rate. [illegible] want by treaty to lower that rate to the United States rate if the higher rate is actually a deterrent to foreign capital. But as respects these underdeveloped countries, they will probably come to realize that such extremely high corporate rates are also a deterrent to domestic capital formation and therefore they will have to revise their revenue system generally. Giving encouragement to tax concessions in such a situation really postpones desirable tax reconsideration of these tax systems. See point 11 in the text.

[17] Tax treaties with underdeveloped countries could consider various matters as administrative cooperation, source reduction as respects short trips of scholars and businessmen, and the smoothing out of uncertainties in source rules, all without any significant concessions being required.

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In sum, the tax sparing proposal is a fundamentally unsound and dangerous approach to the problems of international taxation. It should be firmly rejected, so that consideration may be given to other approaches that appear to be far more fruitful.[19]

[18] Pakistan in its recent tax law, the Finance Act of 1958, approved March 26, 1958, apparently has refused to extend the tax concession here involved past March, 1958. Hence, no business established after that date in Pakistan can obtain the concession. This action underscores the transitory nature of these concessions. One hears that other underdeveloped countries are also giving a severe second look at their tax concessions. If Pakistan itself is so dubious about these tax concessions, there is certainly no reason for the United States to have to adopt tax sparing as a precedent, with all its admitted problems and difficulties, just because it happens to be in the Pakistan treaty presented to the Senate Foreign Relations Committee. The situation is thus one in which that Committee can with no real difficulty stop at the very start what would otherwise be the commitment of the United States to an unsound position in the international tax field.

[19] For example, it would be desirable to explore a deferral approach, similar to that of Great Britain, which has been suggested for the United States through recognition of a special type of United States corporation having only foreign source income. House Ways and Means *Hearings*, note 3, *supra*, 1153 and article cited in *Journal of Law and Economics*, note 3, *supra*.