Serie 2 4

STATEMENT BY

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PRESIDENT OF THE SENATE

COMMONWEALTH OF PUERTO RICO

ON THE

SENATE FINANCE COMMITTEE PROPOSED AMENDMENTS

TO SECTION 936 OF THE U.S. - I.R.C.

July 19, 1982

EXECUTIVE SUMMARY

The revenue Bill Congress is presently considering contains a provision which is extremely damaging and will have far reaching effects on Puerto Rico's economy.

The Senate Finance Committee versions of the bill place stringent restrictions upon "Possession System Corporations." (Section 936 of the U. S. I. R. C.).

While we recognize that there was a need to revise this provision, it is our collective opinion that the measures provided in the Senate Finance Committee report have gone too far and constitute an over reaction.

We do not defend the accumulation of profits by 936 corporations. We defend the 936 mechanism as a source of funds to be used for the economic and social development of our people.

Puerto Rico almost unanimously is against the Senate proposals. The two leading political parties as well as the main business, banking and financial institutions oppose the amendments.

The Senate language threatens the means by which Puerto Rico, and the Puerto Rican people, have been able to pull themselves out of the abject poverty that prevailed in the 1930's and 40's to a much improved standard of living.

"Operation Bootstrap", a successful joint venture of the government and the private sector, entailed the attraction of manufacturing enterprises to set up plants in Puerto Rico through the provision of Puerto Rican tax preference for limited periods. Section 936, and its inmediate predecessor, have made this program work.

Both the Puerto Rican and the U. S. legislation have been required to work jointly to make the program operate.

Today, at a very difficult time in Puerto Rico's history, we are faced with the prospect that the Senate proposal would virtually eliminate the mechanisms on the federal side that made our economic development program function.

Puerto Rico is not a rich island and we have not yet attained the living standard and per capita income levels in even the poorest state of the Union. Our per capita income is only one third of the national average, and only one half that of the lowest state.

Our economy has been plagued by a long term inability to create the number of jobs that our population requires. Unemployment is presently 23.5 percent, but is actually 30 percent when we add those who stopped looking for job. Our total number of employed persons has fallen by 5 percent during the last twelve months versus a static level of employment on the nation as a whole.

Tourism, construction and agriculture are dwelling in crisis.

Investment has declined sharply.

Manufacturing is the only sector of our economy that has resisted relatively the recessionary forces.

The proposed action by the Senate Finance Committee goes directly against our developmental stronghold-manufacturing. It would inhibit the continued expansion of our manufacturing employment, and could very possibly lead to an actual reduction in manufacturing employment over the next several years by placing into jeopardy jobs which we have today.

This result is obviously unintentional. The Congress of the U. S. would not intentionally pass legislation that would destroy Puerto Rico's ability to expand and ever maintain its current level of manufacturing employment.

There is a basic misconception prevalent in Washington that this provision simply requires one segment of the manufacturing sector to pay more taxes and has no other effect or implication for Puerto Rico. That is absolutely false.

The proposed legislation affects adversely all U. S. manufacturing firms presently in Puerto Rico, reduces the incentive for any further industrial expansions, and indirectly affects all of Puerto Rico's economy.

The Senate has simply over reacted to a problem and gone too far. The cure is worse than the disease. Puerto Rico's economy will be pushed even further into a greater dependence upon social welfare programs, and farther from our goal of a self sustaining full employment economy.

Among the adverse effects of these proposals, we can mention:

a. As local production may go down, it may provoke an increase in Federal expenditures close to $375 million during 1984.

b. Puerto Rico may loose $187.9 million in tax collections.

c. Local banking institutions may loose from $4 to $5 billion in deposits.

d. Such deposit loss will result in higher interest cost to the banking system which will be passed on to borrowers.

e. Said deposit loss will reduce the liquidity and profitability of our local banking system.

f. Said deposit loss will increase the cost of our public debt as it may even affect present ratings of government obligations.

The Federal and our local Treasury Departments should be allowed the opportunity to complete the revision of present 936 regulations to assure the use of 936 funds to economic development purposes.

In light of this situation, we recommend that the Senate's provisions on the Possessions System Corporations be revised: they are simply too harsh.

No action should be adopted that may affect Puerto Rico's ability to promote its economic development and general well-being of its people.

The Legislative Proposal

In a courageous effort to produce additional revenue that may assist in reducing the running budget deficit in the Federal Government, the Senate Finance Committee agreed on a package of revenue-making and spending reductions. The revenue bill which implements said agreement contains provisions which are extremely damaging and will have far reaching effects in Puerto Rico's economy.

The Senate Finance Committee version of the bill places stringent restrictions upon Possessions System Corporations (Section 936, U. S. Internal Revenue Code). Specifically, the bill provides that income of said corporations that qualifies for the possession credit would not include income allocable to intangibles. Such income would be allocated to the U. S. affiliates of the qualifying corporation. Intangibles include patents, processes, copyrights, trademarks, trade names, and brand names.

In addition, the current rule that permits a qualifying corporation to earn up to 50 percent passive income would be changed to permit only 10 percent passive income. This means that 936 corporations doing business in Puerto Rico would be required to derive at least 90 percent of their gross income from the active conduct of a trade or business in Puerto Rico. Thus, passive income could not exceed 10 percent of 936 corporation's gross income.

We recognize that we are living very difficult times. National and State budgets are being subjected to considerable pressures for comprehensive revisions- on the revenue as well as on the expenditure side. Thus, we understand the fact that Congress be naturally concerned with the accumulation of large tax free earnings by 936 corporations under the U. S. Internal Revenue Code when there is a national need of producing additional revenue to the Federal Treasury.

The purpose of this statement is not necessarily to defend the accumulation of profits as such by the 936 corporations. This statement intends to defend the 936 mechanism as a source of funds to be directed to the attainment of a much needed economic and social development of our people.

Although we are cognizant of the Senate purpose, yet we are of the opinion that the measures provided in the Senate Finance Committee report have gone too far and constitute an over reaction to 936 corporations earnings tax treatment.

<u>Puerto Rico's Unanimous Opposition</u>

In this particular subject, may I emphasize, there is a practically unanimous position among Puerto Ricans. As you may know, I am a member of the Popular Democratic Party which presently controls the House and the Senate in Puerto Rico -vis-a-vis the New Progressive Party, which controls the Executive branch of government.

In spite of this fact, in this particular issue, we are vigorously -and I mean both parties- opposing the present Senate Finance Committee revenue measure which alters radically the 936 corporations tax treatment. In this endeavor, not only the two leading political parties in Puerto Rico join forces, but the leading business, banking, and financial institutions are defending the same cause. The Puerto Rico Bankers Association, the Savings and Loan League, the Puerto Rico Chamber of Commerce, the Puerto Rico Manufacturers Association share our deep concern.

We must not forget that 936 Section of the U. S. Internal Revenue Code was legislated at the urging of former Governor Rafael Hernández Colón and was meant to constitute an important development tool for Puerto Rico's economy. Successive administrations of the NPP, the opposing political party, have depended increasingly on this provision to foster economic development and as a source of funds for government loans and income.

As a matter of fact, Puerto Rico is still at a stage of adapting of the kind of regulations that will allow for the most effective use of 936 funds. In due time, I have no doubt that 936 funds, under present legislation, will prove to be the most important single tool for Puerto Rico's development and well-being.

We are therefore unanimously and vigorously opposing the proposed amendments to Section 936 because the Senate language threatens to destroy a means by which Puerto Rico and the Puerto Rican people will be able to further pulling themselves out of the abject poverty that prevailed in many decades past to a much improved standard of living. The amendments under congressional consideration gravely menace our most effective tool to attract industries to Puerto Rico to assure a continued growth in production, employment and higher income in our local economy. We are badly in need of moving ahead; we are desperately concerned with the possibility of moving backwards.

Modern Puerto Rico: a successful joint venture

Modern Puerto Rico is the culmination of a joint and successful effort of Government and the private sector of the last three and a half decades. We called it "Operation Bootstrap". Under it, we have been able to create a badly needed new infrastructure at a considerable expense that has facilitated the attraction of manufacturing enterprises to set up plants in Puerto Rico. We pioneered in Latin

America a tax preference treatment to these new plants for limited periods. Section 936, and its inmediate predecessor, complemented this effort and made this program work. As of June, 1981, there were a total 1730 manufacturing concerns established under this program which employed over 130,000 people and paid an annual payroll of close to one billion dollars.

There has been a joint legislative backing from the Puerto Rican Legislature and the U. S. Congress to assure the success of this program.

Today, we are faced with the prospect that the Senate proposal would virtually eliminate the mechanisms on the federal side that made our economic development program function.

The ABC of Puerto Rico's Economy

Allow me to bring to your consideration some of the basic facts of today's Puerto Rican economy.

Puerto Rico, contrary to what its name implies (rich port) is not a rich island. The economy of Puerto Rico is very weak.

Population wise -there are 3.2 million residents in the island. There are around two million Puerto Ricans living in the U. S. The Puerto Rican populations in the mainland as well as that in the Island, move back and forth to and from Puerto Rico. Our people move to the States to pursue college or graduate studies, to obtain specialized medical services, to enjoy recreational and cultural experiences. A considerable number of our people move to the Eastern seaboard, to the Middle west or as far west as California and Washington seeking better living and working conditions. Depending on the economic prospects in the Island, we may have annual net in-or-out-migration in numbers as high as 30 to 50,000. A migratory movement of this magnitude transfers population of varying educational levels, age groups, and economic needs. A part of these fellow citizens become clients of States' social programs.

Our gross national product is over 11.5 billion in current dollars. Real GNP for fiscal year 1982 is estimated to decline by 5 percent; it is expected that 1983 will be another year of negative growth.

Moreover, the level of real gross fixed domestic investment in Puerto Rico declined throughout the 1970's, so that the prospects for expanding GNP in the near future are poor.

Our per capita income is only one third of the national average, and one half that of the lowest state.

Our economy has been plagued by a long term inability to create the number of jobs that our population requires as the agricultural sector collapses leaving unemployed groups of workers which may not be transferable to the newly created manufacturing jobs.

Unemployment is presently 23.5 percent, 241,000 unemployed but it has been forecasted that it may go further down to over 25 percent. If we add those who have stopped looking for jobs, the unemployment situation becomes gloomier as the rate may be close to 30 percent.

Unemployment prevails among all the age groups of people. In Oct. 1981, 61 percent of our very young male workers and 51 percent of young women workers were unemployed.

Unemployment is not limited to a particular sector or an industry. It permeates throughout the economy.

Our total number of employed persons has fallen by 5 percent during the last twelve months versus a static level of employment on the nation as a whole.

The employment-population ratio has declined sharply. Since 1970, there has been a drop of 8 percentage points. In Oct. 1981 it was 33.8.

Our hotel and tourism industry has been going through crisis. The number of non-residents registered in the hotels have gone down as well as their expenditures.

The construction industry has gone to bottom levels.

Agriculture, in spite of the heavy subsidies from the government, has been unable to recuperate. The sugar cane industry is draining government resources as its operational annual deficit grows.

Investment has declined sharply -from around 30 percent of GNP which it used to be a few years ago, it has come down to 13.7 percent in 1981.

Manufacturing: the bright spot

The manufacturing sector of the economy of Puerto Rico has been the most dynamic and most important sector during the past thirty years. This sector now contributes 46 percent of our net income. It continues to provide one job of every five jobs in Puerto Rico. These jobs pay better salaries and wages as compared to the rest of the economy.

This sector is also responsible for a predominant part of our exports. It is the major force in our future economic development. This sector has been a direct beneficiary of 936 funds as this resource has become an "in place" source of savings in our banking and other financial institutions which are channeled to much needed investment activities in Puerto Rico. They are a source of investment for housing, commercial and industrial construction; they have helped plant expansions; they are a source of low cost deposits to our banks and a source of revenue to the Puerto Rican treasury.

936 funds have had and have an overall impact on the Puerto Rican economy.

Senate's Proposal Endangers prospective development

The proposed action by the Senate Finance Committee goes directly against our development stronghold - the manufacturing sector. It would inhibit the continued expansion of our manufacturing employment, and could very possibly lead to an actual reduction in manufacturing employment over the next several years by placing into jeropardy jobs which we have today.

This result is obviously unintentional. The Congress of the U. S. would not intentionally pass-legislation that would destroy Puerto Rico's ability to expand and even maintain its current level of manufacturing employment.

There is a basic misconception prevalent in Washington that this provision simply requires one segment of the manufacturing sector to pay more taxes and has no other effect or implication for Puerto Rico. That is absolutely false.

The Senate's provisions strike a mortal blow at Puerto Rico's entire economic development program and the aspirations and hopes of the Puerto Rican working man.

The proposed legislation affects adversely all U. S. manufacturing firms presently in Puerto Rico, reduces the incentive for any further industrial expansions, and indirectly affects all of Puerto Rico's economy.

The Senate has simply over reacted to a problem and gone too far. The cure is worse than the disease.

Puerto Rico's economy will be pushed éven further into a greater dependence upon Federal social welfare programs, and farther from our goal of a self sustaining full employment economy. And this may occur when the President is committed to restore the economic health of the Nation and extend the benefits of economic development to the Caribbean Basin.

Even the hope for a better future, now held by our Puerto Rican citizens, will be extinguished.

The Adverse Impact of the Senate Proposals

Although there are considerable shortcomings in any effort to quantify the impact of this legislation, the Governor's Office, our Secretary of the Treasury and the Bankers Association, among others, have attempted to offer such specific data. I shall relie on those presented in the "Puerto Rico Treasury Department position paper on the effects of Legislative Amendments to Section 936" as well as in the bankers evaluation.

1. The Senate proposals would provoke an increase in Federal expenditures of around $375 million during 1984 due to legally mandated transfer payments to Island residents (unemployment benefits and social secutiry payments) and increased welfare payments on the mainland according to our Secretary of the Treasury. "This latter category would be due to decreased imports of mainland goods to Puerto Rico which would cause decreased production on the mainland, leading in turn to more unemployment and the loss of Federal tax revenues". This calculation is based on a hypothetical 10 percent drop in Puerto Rico industrial production resulting from the proposed amendments.

2. According to our Secretary of the Treasury Puerto Rico will loose local revenue amounting to $187.9 million, as shown bellow:

a.	Toll gate tax	$ 66.2 million
b.	Corporate tax	43.7
c.	Banking franchise tax	30.0
d.	Personal income tax	48.0

This loss represents a 9 percent reduction of the Government of Puerto Rico's total operating budget for 1983, a most serious blow to an already stringent budget.

3. It will cause a massive withdrawal of 936 deposits ranging between 4 and 5 billion dollars now in deposit with Puerto Rican banks or placed with Puerto Rican brokers or investment bankers, with its attendant results in the availability of funds for continued investment. According to the Bankers Association, as the total funds deposited with Puerto Rican banks amount to $6.0 billion, and because a significant part of those amounts have a maturity of over a year, the market for section 936 funds would disappear.

4. Banking institutions will have to substitute the present low cost service of 936 funds by regular funds accquired in the Eurodollar or U. S. financial markets. This will result in higher interest cost to the financial institutions which must be passed on to the local borrowers. As the new regulations of the Puerto Rican Treasury Department have gone into effect, section 936 funds have reduced the cost of borrowing to our commercial and industrial borrowers, the Government of Puerto Rico, the Government Development Bank and the Savings and Loan Associations. Bankers estimate combined interest savings at the tune of $200 to $250 million per year. This is a most valuable contribution to our local economy when interest rates have been skyrocketing.

5. Our local bankers claim with reasonable data that a loss of 4 to 5 billion dollars in bank deposits will

substantially reduce the liquidity and profitability of the Puerto Rican banking system. I am certain that it will hurt deeply our already weakened Savings and Loan Associations.

6. The withdrawal of $4 to $5 billion from the banking system will have a direct negative effect on the cost of our public debt.

Present local regulations require that each eligible depository institution must own and hold not less than 30 percent of its total eligible deposits invested in obligations of the Commonwealth of Puerto Rico. At least one third of that investment requirement must be held in obligations of the Government Development Bank. Thus around $1.2 to $1.5 billion out of the $4 to $5 billion will be reduced from such government obligations: government bonds and notes as well as government and municipal financings for different projects and situations, with such massive withdrawal.

Those reductions would, in turn, have to be financed either by increased borrowing from other sources, or, through a reduction of liquid assets in the case of the Government Development Bank. As the Government Development Bank obtains these 936 funds at around 9 percent per annum, it will have to pay higher interest rates for substitute funds while loosing income. The combined effect could be of a magnitude estimated by the Bankers Association beween $70 to $90 million annually. Such loss could affect the present rating of the government obligations, which again may produce an increase in interest expense.

<u>Treasury Regulations should assure development</u>

Our Department of the Treasury has been working closely with the Federal Department of the Treasury in revising the applicable regulations in order to eliminate any tax loophole and thus, to assure that 936 funds be aggresively and consistently geared to foster the desired economic and social development of our Commonwealth. Such action is of mutual benefit to us in Puerto Rico and to the Federal taxpayer. An effective channeling of 936 funds may assure a locally sustained economic growth which should reduce dependency on the Federal resources to solve our fundamental developmental shortcomings.

We firmly believe that the Senate proposal acts contrary to the mutually agreed developmental policy which has been tied to 936 funds.

In light of this situation, we recommend that the Senate's provisions on the Possession System Corporations be revised; they are simply too harsh.

The price for error is too high. The pain of frustrated dreams, long term unemployment and economic deprivation can be greatly reduced by taking time to understand the implications of the Senate's proposal and to then recognize the need to adopt an alternative measure.

It is my convinced judgment that no agreement or action should be adopted that may affect Puerto Rico's ability to promote its economic development and general well being of its people through increassed working opportunities and decreased dependence on welfare assistance programs.