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PUERTO RICO'S POLITICAL STATUS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

S. 712

APRIL 26, 1990

(Part 2 of 2)

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PUERTO RICO'S POLITICAL STATUS

THURSDAY, APRIL 26, 1990

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Moynihan, Bradley, Riegle, Chafee, Heinz, and Symms.

[The press release announcing the hearing follows:]

[Press Release No. H-26, Apr. 6, 1990]

FINANCE COMMITTEE PLANS THIRD HEARING ON PUERTO RICO'S STATUS; CHAIRMAN BENTSEN SAYS COMMITTEE TO FOCUS ON ECONOMIC IMPLICATIONS

WASHINGTON, DC—Senator Lloyd Bentsen, Chairman, announced Friday that the Senate Finance Committee will hold a hearing this month on the economic implications of changes in Puerto Rico's political status.

Bentsen (D., Texas) said the hearing will be at *10 a.m. on Thursday, April 26, 1990* in Room SD-215 of the Dirksen Senate Office Building.

Legislation pending in Congress provides for a referendum that would enable residents of Puerto Rico to choose among becoming a state, becoming an independent republic or remaining a commonwealth but with enhanced status. The bill, as referred to the Finance Committee, is self-executing, so that the option chosen by a majority of the voters would go into effect without further Congressional approval.

The bill, S. 712, also includes provisions that make the major changes in Federal law applicable to Puerto Rico that would be necessary to implement the voters' choice. This involves many provisions within the Finance Committee's legislative jurisdiction, including taxation, international trade and the social welfare programs established by the Social Security Act.

"Whatever course Puerto Rico voters select, there will be significant economic implications both for the island and for the U.S. Government. It is vital that members of the Finance Committee have a thorough understanding of those implications in order for us to consider whether changes to the bill may be appropriate," Bentsen said.

"The Congressional Budget Office has just issued a study on how these options would affect Puerto Rico's economy. We'll be looking at that report and we'll be listening to the observations and opinions of other experts for guidance as we consider the three status options provided for in the bill," Bentsen said.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. If you will please cease conversation, we can get underway. The legislation that we are considering today lays out three very different possible courses for Puerto Rico's future. I think the stakes are tremendously significant to both the island and to the United States.

My own personal relationship with the status of Puerto Rico 40 years ago is one that I remember with a great deal of sentiment. I was on the Interior Committee in the House at that time, when the Congress was considering the status of Puerto Rico and its future. I remember going down and addressing the legislature in Puerto Rico in about 1951 or 1952, at a time when Puerto Rico had a battalion of soldiers fighting in South Korea. They did a magnificent job for our country.

We have had referred to us S. 712. The bill was reported by the Energy Committee, which has primary jurisdiction here. It would allow Puerto Rican voters to choose between becoming a State, becoming an independent republic or remaining a Commonwealth.

S. 712 was referred to the Senate Finance Committee because many of its provisions fall within our jurisdiction—taxation, international trade, and the social welfare programs that were established by the Social Security Act. Whatever choice the people of Puerto Rico make—and I am certainly supportive of their being able to make that choice—could have far-reaching economic impacts on both Puerto Rico and the United States. There are a wide divergence of observations and opinions on what would occur under each of the three options, if enacted.

At my request, the Congressional Budget Office has prepared a study on how each option would affect Puerto Rico's economy. We will be taking a close look at the report's findings. We will also be hearing from other experts, including representatives of the administration and of Puerto Rico's political parties.

It is critical for this Committee, in crafting its part of this legislation, to sift through these competing views to develop an understanding of the economic issues involved.

I am looking forward to a full and a fair exchange of the issues by the experts today.

I would like to now defer to my colleague, the senior Senator of New York, who has long been interested in the concerns of Puerto Rico.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. I ask that you would, I guess, indulge me in a somewhat longer opening statement than is normal.

I wish to state my growing sense that by the close of this session, and accordingly of the 101st Congress itself, we will not have sent to the President a bill providing for a referendum on the status of Puerto Rico. I need not say that this is in no way the result of any delays on the Senate side, certainly not in this Committee as this hearing attests, noting this Chairman's very emphatic statement that you just heard. It is on the House side where this scenario will work out if indeed it does, as I fear it will.

This would not be my wish—to the contrary. Now what I am about to say is sensitive, and I have a limited, but I dare to hope sufficient sense of just how sensitive. I mean no offense to anyone and devoutly hope that in the end I shall not have given any offense.

But we recall with what great expectations this matter came before us at the outset of the first session of this Congress. On January 17 the Senate Majority Leader received a letter from the heads of the three principal political parties of Puerto Rico recording that they each had included in their platform for the previous November election, a call for a plebiscite and asking that there be one. On February 9 in an address to a joint session of Congress, President Bush said: "I have long believed the people of Puerto Rico should have the right to determine their own political future. Personally I strongly am for statehood, but I urge the Congress to take the necessary steps to allow the people to decide in a referendum."

First this was taken up by the Senate Energy Committee. Last June, Chairman Johnston and Senator McClure were kind enough to invite me to sit in on hearings in San Juan as an observer. I cannot doubt that a third of the population of the island watched the proceedings on television all day, and two-thirds during the reruns at night. You could not walk the streets of San Juan in the evening without people addressing you by name and commenting on some remark you may have made or question you may have asked.

And yet here we are in April and we have not advanced. On April 10, the Chairman of the House Insular and International Affairs Subcommittee, our friend Ron de Lugo, from the Virgin Islands as it happens, stated the House is still waiting for legislation from the Senate that was promised last year. At some point soon we will cross a point when it would become impossible to pass a bill in the House, he said.

I will make the point later that there is no reason for them to be waiting on us. We pass our bill, you pass yours, and we'll go to conference. But the question is: What happened?

I would offer several propositions. First, just a personal remark. Like the Chairman, I have been involved with Puerto Rico in a way for—well, if it must be known—from the day I walked into a pool room on 101st Street in Manhattan called Los Muchachos in the original area in Park Avenue where the tracks come up from the ground. In 14 years on the Finance Committee I have been much involved in Puerto Rican matters. I think my colleagues have generally assumed that this was the case because of a large Puerto Rican population in New York, which is true, in part.

But also, if I can say, I was at the United Nations in 1975 and 1976 and fought the fierce attacks from Cuba and the unaligned nations on the political status of Puerto Rico. As U.N. Ambassador spoke up for President Ford, emphasizing the absolute quality of our commitment to free choice for Puerto Rico between the three status options, a choice which I hope is not going to be lost through procedural difficulties.

And so I want to make two points. First of all, I should acknowledge that halfway through my experience in this Committee I came to assume that statehood was an inevitability. I saw things happening which would never happen were Puerto Rico a member of this body, represented in the Senate. We will remember that in 1984, in the first proposal for major reform of the Tax Code made by President Reagan, it was proposed that the Section 936 benefits to corporations be abolished. That was in Treasury I. We got it out of the final bill. But Treasury I was a product of the permanent government and we can assume that the idea is still around.

We continuously found ourselves dealing with these sudden assaults on economic interests, social welfare interests in Puerto Rico, where there were no Puerto Ricans represented. And so let me just say that part of this whole problem is that the basic dilemma which confronts those who would choose between statehood and commonwealth—I leave out independence as a wholly different consideration and would not involve any of these—and the dilemma is this: statehood automatically brings huge increases in social welfare benefits.

Supplementary security income payments, Mr. Chairman, in Puerto Rico today are $32 a month. Under statehood this rises to $386 a month—on order of magnitude ten fold. This arises from a change in American social welfare policy since the time when the Commonwealth arrangement was developed in the early 1950's. Then, the levels of benefits were very much pegged to States. More and more our policy, as in SSI, is to make them more uniform nationally.

So the impact of statehood on a large segment of the population of the island would be an instantaneous ten-fold increase in social welfare benefits. At the same time, Section 936 would be lost. There would be no possibility for that to continue. And by contrast, Commonwealth status retains the economic stimulus of 936 but also means a continued lower level of social welfare benefits.

I have a few three suggestions I would like to make to see if we can get through the procedural block that we face. The first is that the Executive Branch and Congress have got to undertake as much analysis as the remaining time allows. Mr. Chairman, the request for a study from the CBO, which we will hear about this morning, was a very good start. We have had good cooperation from Treasury. The rest of the Government acts as if this issue is not before us. The executive branch has got to show some energy here, particularly from the Department of Health and Human Services.

Second, I would hope that the parties in Puerto Rico could try to avoid taking positions that cause anxieties in Congress, and there are anxieties. The concern is that statehood would put the people of Puerto Rico, who are fellow citizens, in what is known as the welfare trap, and not without reason.

The Food Stamp Program began in 1975. By 1982 fully 60 percent of the Puerto Rican population was receiving food stamps. That is an abnormal and unnatural situation. Similarly, those supporting continued Commonwealth status should take care that the present seeming preference for statehood as reflected in opinion polls does not persuade them that the best course is to put off the plebiscite.

I take, for example, the fact that nothing is happening in the House is altogether unacceptable and needs explaining. The House writes its own bill in all these matters and meets us in conference. They have done nothing in a year and a half.

As for enhanced Commonwealth status, we can talk about it. I will offer some proposals in the bill that we will mark up. But finally, may I say that the great issues involved here are civic, not economic. Do the people of Puerto Rico wish to become Americans? For that is what statehood ineluctably implies. That is what statehood brings. Or, do they wish to retain a separate identity of, but not in, the American union? This could be a perfectly intelligent choice. And, of course, the option of eventual statehood or independence remains.

But so again Congress must act. It is almost a century now since William Graham Sumner composed his bitter essay in the aftermath of the Spanish-American War, which was entitled "The Conquest of the United States by Spain." His thesis was that the U.S. lost that war. He said having entered the colonials lists we would soon be acting like the other imperial nations. We would begin their decline and assume their attitudes.

One of their attitudes was never to let go of what was known in those days as a colony. Let us be clear that whereas Puerto Rico began as a colony, by a colonial war, it is much more than that today. We have to see that in the end we demonstrate that fact by providing them this referendum.

Mr. Chairman, that is a long statement. I thank you for your courtesy.

The CHAIRMAN. Gladly.

[The prepared statement of Senator Moynihan appears in the appendix.]

Senator BRADLEY. Mr. Chairman?

The CHAIRMAN. Senator Bradley?

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY

Senator BRADLEY. Thank you very much, Mr. Chairman.

Let me say that I am on the Energy Committee and I sat through many of the hearings and the markup that produced the Energy Committee bill. I think that we owe it to the people of Puerto Rico to fully air all of the issues, even those that are potentially difficult. Because what we are dealing with here is a self-executing document. Once Congress passes this, with the rights and responsibilities that attach to each option and the Puerto Rican people vote, that is it. It does not come back to the Congress and it does not require further review.

Now having sat through much of the work on the Energy Committee, I think that there are a couple of questions that everyone needs to focus on, and particularly the people of Puerto Rico, the administration and the Congress. One of the those, if statehood is the chosen route, is going to be a big increase in entitlements programs. Where is that money going to come from?

Is it going to be taken out of the welfare pots of every other State in the Union? Or, is there a commitment for additional revenue in an amount equal to the increase in Puerto Rico's share? We have not resolved that question. We have not heard from the administration on that question. That is an important issue.

The second question relates to Section 936. If Commonwealth is the chosen route, it seems to me that the assumption is that Section 936 is almost viewed as a right, not something to be changed by Congress whether it is for tax reform, revenue raising or whatever. We have not said that here. The Energy Committee did not say that. I think it is essential that we be clear for the people of Puerto Rico who have to make a decision what is our long-term intention with regard to Section 936. Because if they opt for a Commonwealth on the assumption Section 936 will be available and we subsequently change our minds, then they face quite a different circumstance.

Third, is the whole issue of the constitutionality under the uniformity clause of continuing Section 936 should Puerto Rico become a State. Now there is no way to determine this really short of a declaratory judgment of the Supreme Court. I, for one, if I were a citizen in Puerto Rico, would want to know with some certainty about the constitutionality of continuing Section 936 during the transition period.

The fourth point is in some ways the most difficult of all. Language. The Energy Committee was the artful dodger when it came to the language issue—very difficult, very divisive. But if the people of Puerto Rico opt for statehood and we then get into a major battle on bilingualism, you had better face this issue up front so that we and the people of Puerto Rico know whether Spanish or English or both will be the language of Puerto Rico.

And last, probably insignificant in the larger scheme of things, but something that Puerto Rican politicians seem to think is important in this debate, is the issue of the Puerto Rican Olympic team. Puerto Rico wants an Olympic team even if they opt for statehood. Well, let's at least face that issue before we act on legislation that would be basically self-executing, so no one has any illusions of misconceptions.

So, Mr. Chairman, having sat through the Energy Committee and having seen us not take up these issues, I think that it is incumbent upon the Senate to work them through and reach a clear decision on them before any legislation leaves the Senate and the people of Puerto Rico have to make a decision. Because, if they base their choice on certain assumptions and those assumptions do not turn out to be valid, it might create a more difficult situation for all of us 10 years down the road.

The CHAIRMAN. Thank you very much, Senator. I think those cautionary comments are well taken. It shows we are dealing with a very complex issue, with far-reaching consequences as I had stated earlier in my comments, for both Puerto Rico and this country.

I am delighted to recognize the Resident Commissioner, Hime Houstare, who is here today. We are pleased to have him.

Senator MOYNIHAN. Mr. Chairman, I would call to your attention that Mr. Sorono, the new member of the House from New York City is with us also, a native of Puerto Rico.

The CHAIRMAN. We are delighted to have them both.

I would like to now call the first panel. Mr. Philip Morrison who is the International Tax Counsel, Office of Tax Policy, U.S. Department of Treasury; and Mr. Martin Gerry, the Assistant Secretary of Planning and Evaluation for the U.S. Department of Health and Human Services. Gentlemen, if you will come forward, please.

Mr. Morrison, if you would proceed with your statement.

STATEMENT OF PHILIP D. MORRISON, INTERNATIONAL TAX COUNSEL, OFFICE OF TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. MORRISON. Thank you, Mr. Chairman and members of the Committee. It is a pleasure to be back at the Finance Committee. As some of you know, I am a former staffer. I hope the experience of sitting in front of you is as pleasant as the experience of sitting behind you was.

The CHAIRMAN. Well that remains to be seen. [Laughter.]

Mr. MORRISON. It is also a pleasure to be here today on behalf of the administration to reaffirm our support for Senate bill 712. The administration, as you mentioned, is also represented here today by Assistant Secretary Martin Gerry of HHS who can address the HHS expenditure issues raised by this bill.

As you know, Ken Gideon, Assistant Secretary of Treasury for Tax Policy, has already testified before this Committee last November regarding this bill. Treasury appreciates Senator Moynihan's observation that we have testified now three times on this bill and have spent considerable effort, we think, on both the tax legal analysis as well as the tax economic analysis, of this bill. We hope our testimony today will aid the latter.

To avoid repetition, as I mentioned, my written statement is designed to give some background to the revenue estimates which were presented in the prior testimony, particularly in light of the two new economic studies which have subsequently addressed this bill, one commissioned by the Governor of Puerto Rico and the other prepared by CBO. I would like to request that my full written statement be made part of the record.

The CHAIRMAN. That will be done.

Mr. MORRISON. As the Chairman has mentioned, S. 712 would provide for a popular referendum or a plebiscite on the political status of Puerto Rico to be held in the summer of 1991. Three options are provided: statehood, independence or commonwealth. The administration strongly supports the right of the people of Puerto Rico to decide for themselves the future status of their island.

As Senator Moynihan has mentioned, the President has noted a number of times that he personally favors the admission of Puerto Rico as a State.

We think S. 712 achieves, to the extent possible, the three important goals set for it by the Senate Committee on Energy and Natural Resources. First, an even playing field, politically speaking, among the three political parties in Puerto Rico. Second, a relatively smooth economic transition to any new status that is chosen. And third, an adjustment to any new status that is budget neutral over time.

It is important to know at the outset, however, that there are significant limitations on any attempt to quantify precisely the economic equivalence of the three status options. Economic projections out to the year 2000, through the transition period, are just that—projections, not guarantees.

In addition, the economic result under each of the options is obscured by intangible and unquantifiable factors, including most importantly the reaction of the Puerto Rico people and their government to the option chosen.

One of the chief issues for this Committee is the third policy point identified by the Energy Committee: the overall impact of the Puerto Rican status referendum on our Federal deficit. With respect to the Commonwealth option, as you know, the baseline budget, of course, already contains the cost of Section 936. Treasury's Office of Tax Analysis estimates that $2.1 billion in net tax benefits will be received by Section 936 corporations in fiscal year 1990 alone. This cost is projected to grow at about 10 percent per year.

Under statehood the administration estimates that while there is a net increase in the Federal deficit in earlier years, there is a substantial net decrease in the Federal deficit beginning in fiscal year 1996. This projection is illustrated in Appendix II at the back of my written statement. Even using the higher expenditure outlay estimates prepared by CBO in their report will not affect this eventual shift to deficit reduction. It merely shifts the crossover point when deficit decreases are achieved from fiscal year 1996 to fiscal year 1997.

Another question, quite apart from the deficit impact, is whether one of the options under S. 712 would create serious economic dislocation on the island itself. To the extent that quantifiable aspects of any dislocation might have an impact on our revenue estimates, they are addressed in my written statement.

There are two related points to summarize here. First, our major disagreement is with the Governor's report, not with CBO's; and that involves the revenue pickup from the phaseout of 936, not the impact on Puerto Rico's GNP growth.

Second, even if the economic impact to Puerto Rico were as serious as projected by CBO, the Federal revenue impact of such a slow-down would be very small. This is because the pickup from phasing out 936 is relatively insensitive to Puerto Rico's GNP. It is also shown by the fact that the Treasury projections of Federal revenue pickup from those items that are sensitive to Puerto Rican economic health are similar, if not smaller than, both the other studies.

Specific tax policy aspects of the bill that we support or suggest need changing are outlined in my written statement and have been outlined before in Mr. Gideon's testimony last November. A detailed discussion of our revenue estimates and projections is also provided in the written statement.

Allow me, please, however, to highlight for you a few of the points we make regarding the revenue pickup from phasing out 936 under the statehood option.

There are two points to make regarding the development of a revenue baseline for 936. First, the baseline used in the Governor's study seems to miss more than 25 percent of the Section 936 income that is actually reported to the IRS. Second, in developing a baseline it is important to divide Section 936 active business income from passive income. Even if a 936 company shifts its Puerto Rican operations to an overseas location after statehood, passive income will generally become taxable.

There are also a couple of points to make regarding the possible offshore shift of active 936 income if statehood is chosen. First, only where 936 company activities are shifted outside the United States will some portion of the active income not yield increased Federal revenue. In analyzing the possible offshore shift of 936 operations, it is important to consider both the amount of 936 income derived from intangible assets and the division of such intangible income between marketing intangibles, such as trademarks, and manufacturing intangibles, such as patents.

Most marketing intangibles used in 936 companies are for the U.S. market. Because of this, only manufacturing intangible income can even in part successfully be shifted offshore. This appears also to have been overlooked by the Governor's study.

Third, the transfer of intangibles to an overseas affiliate would require substantial royalties to be paid back to the U.S. transferor of those intangibles. If 936 companies do choose to move offshore, such royalties would reduce the benefits of the foreign location and offset much of the revenue loss. This, of course, would affect the initial decision of whether to move Puerto Rican operations offshore or not.

Admittedly, royalty payments could be somewhat offset by the U.S. owners' foreign tax credits. Thus, the frequency of excess foreign tax credit positions, by industry, was analyzed in our revenue estimate.

Finally, because of the liberal product definition rules under Section 936, if 936 operations were moved overseas some income currently allocated to Puerto Rico would not be able to follow and would shift to the United States automatically, quite apart from the effect of increased royalty payments.

As a result of examining all of these factors for each industry, Treasury has concluded that, in the long run, about 25 percent of the active 936 net income in Puerto Rico under the current law baseline—and remember, that is growing baseline—would move and remain offshore. Combined with the passive portion, which would become automatically taxable, this means that nearly 80 percent of the tax benefit cost of 936 would be picked up under statehood. This result is shown on the first line of Appendix I to my written statement.

This concludes my statement and I will be happy to take any questions after Mr. Gerry's statement.

[The prepared statement of Mr. Morrison appears in the appendix.]

The CHAIRMAN. We will proceed with Mr. Gerry. Would you go ahead with your statement, please.

STATEMENT OF MARTIN H. GERRY, ASSISTANT SECRETARY, PLANNING AND EVALUATION, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. GERRY. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Committee, it is a pleasure to be here today with Mr. Morrison on behalf of the Administration to reaffirm our support for Senate bill S. 712. Secretary Sullivan strongly supports the President's view that it is important to provide the people of Puerto Rico with an opportunity to choose their future relationship with the United States.

Our review of that legislation strongly indicates that it will provide the kind of equitable and workable approach to self-determination that we are seeking.

The Department of Health and Human Services provides approximately $2.7 billion per year to or on behalf of the residents of Puerto Rico. I would like to briefly summarize the principal effects of S. 712 on our programs.

Under the statehood option expenditure ceilings or caps on AFDC and Medicaid would be removed and a Federally administered Supplemental Security Income program would be extended to eligible persons in Puerto Rico. We estimate additional Federal expenditures under HHS programs will exceed $1.6 billion by fiscal year 1995 and $3 billion by fiscal year 2000. Most of this increase will be attributable to changes in Medicaid and SSI. HHS expenditure increases represent about 80 percent of the total Federal expenditure increases. The balance being with the Department of Agriculture's Food Stamp program.

In addition to direct program expenditure increases, the statehood provisions are likely to affect general economic conditions in Puerto Rico. On the one hand, there will be economic effects of the increases in Federal transfers to Puerto Rico for SSI, Medicaid and AFDC programs—and for the Agriculture Department's Food Stamp program. On the other hand, statehood would change how Puerto Rican corporations and individuals are taxed and the Department of the Treasury has addressed those changes in taxation. I would certainly defer to Mr. Morrison on them.

But I would only like to add that funding for a number of our programs will be influenced by macro-economic conditions. Because changes in personal income, employment, and unemployment do affect the amount of money that is received by any State. Therefore, actual Federal costs of statehood could be higher than the estimates I have cited. The interplay of taxes and program benefits are complex and we do not have an adequate model to estimate these effects at the present time.

I would like to mention one concern, however, with the statehood provisions and that relates to the Medicare program. S. 712 would change the way in which hospitals in Puerto Rico would be reimbursed under Medicare. Currently those hospitals are reimbursed at a blended rate—that is, based 25 percent on the U.S. national rate and 75 percent on the local rate in Puerto Rico. If Puerto Rican hospitals were paid on the same basis as hospitals in other States, those payments would be about 30-percent higher than current payments.

Because hospital costs in Puerto Rico are substantially lower than in the States, reliance on the national rate could result in overpayment of Puerto Rican hospitals. S. 712 would limit reimbursements in Puerto Rico to the actual costs of providing equivalent health care to the levels of care provided in several contiguous States.

However, this appears inconsistent with respect to the prospective payment approach which provides hospitals with incentives to control costs. We believe as a result of these questions that the

Medicare payment provision of S. 712 should be reexamined by the Committee to ensure that it achieves its intended purposes which are basically to provide fair and reasonable payments without resulting in unintended windfalls.

Commonwealth status as provided for in S. 712 would have little direct effect on HHS programs. The most significant change would be related to the bill's provision allowing Federal agencies to consolidate certain financial assistance programs. We have now had 10 years of experience applying the consolidation mechanism to other insular areas and we do not foresee any problems in this regard.

Finally, our primary concern with the independence option is to ensure an equitable and manageable transition to a Puerto Rican Social Security and Medicare systems. Currently, Puerto Rico employers and employees are covered by the Social Security and Medicare trust funds in the same manner as employers and employees in the 50 States. S. 712 recognizes the complexity of transition to Puerto Rican systems for both Social Security and Medicare and establishes a Commission to address this. We support this approach. In particular, we believe that a Social Security totalization agreement, similar to the ones we have with 11 other countries would be an effective approach.

Thank you very much for this opportunity, Mr. Chairman. I would be happy to answer any questions that the Committee might have.

[The prepared statement of Mr. Gerry appears in the appendix.]

The CHAIRMAN. Thank you.

The original commonwealth legislation used the term "compact" to refer to the relationship. I believe that has been a source of some misunderstanding. Thinking about Senator Bradley's comment, I would like to know what the administration thinks, assuming that the plebiscite chooses commonwealth status.

Does the administration view that as, in any way, legally binding future Congresses or future administrations to maintain any of the tax, welfare or trade provisions that we may incorporate in this legislation? That is a critical point for the people of Puerto Rico to understand. They are entitled to hear, as we are, the opinion of the administration.

Mr. MORRISON. Mr. Chairman, with respect to the tax benefits currently enjoyed by the Commonwealth of Puerto Rico, we have made clear in our previous testimony and we repeat today that it is important, we think, for Congress to make very clear that this bill enabling Puerto Rico to have a referendum provide no guarantee with respect to the tax benefits currently enjoyed by the island. And that they should, as Congress has in the past, be subject to continuing analysis to determine efficiency and to determine whether they should indeed be continued.

Therefore, we would strongly urge you to make it clear that you are in no way binding future Congresses at all with respect to tax initiatives.

Mr. GERRY. Let me just add, if I can, Mr. Chairman, I agree with everything Mr. Morrison just said. If I understand your question correctly, there was a constitutional law question involved in it, which is whether in effect this Congress can bind future Congresses with respect to the assumptions—I guess it would be assumptions—underlying this.

I cannot, obviously, from the Department of Health and Human Services respond to that question, although I think it is an important question to be resolved. But I can say that I think it is clear that we support the position of the Treasury Department as just articulated, that we do not think such a course would be advisable—that is for the Congress to try to make such an offer.

As you know, and this Committee knows better certainly than I do, these programs have evolved and changed in many ways and hopefully will continue to do so. The implication I got from your question would be that somehow the present status quo would be frozen. That is the only way that I could see——

The CHAIRMAN. That was not an implication. That is what I said.

Mr. GERRY. Okay. Well then I think that would have undesirable effects in terms of the changes that the Committee or future Committee would want to make.

The CHAIRMAN. I think Puerto Rico is entitled to know the viewpoint of the administration on that. I think Mr. Morrison has stated quite clearly what he thinks is the administration's viewpoint. That is what I wanted to determine.

Mr. Morrison, the Congressional Budget Office has released a report that indicates that, if the statehood option were chosen, reduced investment by Section 936 companies would lower Puerto Rico's GNP by 10 to 15 percent by the year 2000. Is that consistent with the administration's analysis? Would you tell the Committee what the administration believes the macro-economic impacts on Puerto Rico would be under the alternative status options provided for in the bill?

Mr. MORRISON. It is important to note, Mr. Chairman, that CBO's estimate of a 10 to 15 percent reduction in GNP by the year 2000 is a 10 to 15 percent reduction in the otherwise "grown" or increased GNP that Puerto Rico would have by the year 2000. Thus, they are not predicting recession for Puerto Rico from statehood, but predicting reduced growth. Their low-growth baseline is, as I understand it, about 2.5 percent growth; their high-growth baseline somewhere about 4 percent. They are only talking about a 1 or 2 percentage point per annum reduction in that rate of growth.

Second, it is important, and I am trying not to wiggle out of answering your question too much, it is important to note that the Treasury Department Office of Tax Policy is not in the business of predicting GNP affects for the island, either for the short term or, more importantly, for the long term.

The CHAIRMAN. Well, Mr. Morrison, we are entitled to your best judgment on that. We are talking about a very complex piece of legislation.

Mr. MORRISON. That is understood.

The CHAIRMAN. This Committee is entitled to have all the information it needs. We are trying to decide whether to make some adjustments in this particular bill.

Mr. MORRISON. Besides pointing out the fact that the GNP predictions of CBO are just a reduction in growth and not a reduction overall, I think it is important to note what CBO itself said it is not doing in its report, and defensibly not doing, because taking these factors into account is not a quantifiable task. Those are what we refer to as the intangible benefits from statehood.

These include such things as the perception of Puerto Rico as an integrated part of the United States both by foreign companies and foreign governments as well as our own people. The intangible benefit of the people of Puerto Rico themselves considering themselves more integrated with United States.

But most importantly what cannot be quantified, but has to be taken into account in reaching a judgment is, what will be the reaction of the Puerto Rican Government and the Puerto Rican people to the policy choice they make in the referendum. CBO cannot analyze that because it is nonquantifiable.

But we certainly could foresee that the government of a new State of Puerto Rico could decide radically to change its marginal tax rates, reducing some of the higher marginal rates, and therefore using its own State tax system to provide for economic incentives.

We could also foresee the State government of the new State of Puerto Rico radically changing its public expenditures policy. Today there are a number of public companies owned by the Government of the Commonwealth of Puerto Rico, including the telephone company and a sugar company. There may be economic efficiency gains that can be achieved through privatizing that sort of government-owned business.

So the bottom line, I think, is that it is most important to take into account the reaction that a new State government in Puerto Rico and its people may have to the choice of becoming a State.

The CHAIRMAN. Thank you, Mr. Morrison. I think that is helpful. My time has expired.

Senator MOYNIHAN?

Senator Moynihan. Mr. Chairman, I think we would all agree that Mr. Morrison and Mr. Gerry have given us good testimony, marked by openness and responsiveness.

Let me just pursue a few of these questions. On the statehood matter that Mr. Morrison was mentioning, Senator Inouye and our beloved deceased colleague, Senator Matsunaga, would speak with great emphasis of the difference in the economic conditions in Hawaii once statehood came about. It was a different place in terms of investment and so on.

But, Mr. Morrison, in my prepared statement I noted the fact that abolition of Section 936 appeared in Treasury I, which was very much a document of the permanent government. And that we could assume that sentiments to abolish Section 936 still exist at Treasury. Secretaries come and go. I see in your statement—and I think it is very important—that 936 benefits should continue to be reviewed.

Section 936 was originally put in place to encourage American investment in the Philippines, as I recall, in the 1920's. Is it the administration's view that under commonwealth status that the administration would not propose that the Congress change 936?

Mr. MORRISON. That is correct. We are not making any proposal to do that.

Senator MOYNIHAN. But to enjoy what is more a constitutional fact that Congress is bound by previous Congresses and this can change at any time?

Mr. MORRISON. That is correct.

Senator MOYNIHAN. Mr. Gerry, you suggest that we are going to have from just the Department of Health and Human Services that the outlays in Puerto Rico will have doubled by the year 2000 from $2.7 billion, an additional $3 billion by the year 2000.

Mr. GERRY. That is correct. Mr. Moynihan.

Senator MOYNIHAN. That comes from expenditures of your Department of $2,000 per capita if I can roughly divide. About 3 million people, about $6 billion. That is $2,000.

Could you give this Committee some notion about what by say the year 2000 what you expect the per capita outlay of social welfare benefits in Puerto Rico would be as against other States or do you have some notion now?

Mr. GERRY. I have a general notion.

Senator MOYNIHAN. Could you offer us that subject to revision?

Mr. GERRY. It would be substantially higher than in any of the other States, Senator Moynihan.

Senator MOYNIHAN. Twice as high?

Mr. GERRY. I think—let me see if I can find it. I had the material or at least some of the material that you want. I would be happy to provide it State by State.

Senator MOYNIHAN. I think we would be interested in that, yes. But give us an estimate now while we have you here, before something else interferes.

Mr. GERRY. Let me see if I can find that for a minute, Senator. I think what we did was we grouped the States that had the highest, somewhere between 7 and 10, and my understanding is that the expenditures would be about—there are a lot of variables, as I have indicated—but roughly twice as high.

Senator MOYNIHAN. Roughly twice as high.

Mr. GERRY. As in the 7 to 10 States, Senator.

Senator MOYNIHAN. We will ask you to go back and think about this. What would you say is the portion of the population that would be receiving various program benefits? Would we go back to 60 percent of the population receiving food stamps?

Mr. GERRY. My understanding——

Senator MOYNIHAN. That is not your——

Mr. GERRY. Well it is not, but I think we could say comfortably we would not, Senator. In fact, probably because of the current rates there would be the likelihood of something, even a decrease in the number of people receiving food stamps although there would be an increase in the value.

Senator MOYNIHAN. Fine. Could we get that?

Mr. GERRY. Certainly.

Senator MOYNIHAN. We would have to ask the Treasury, I guess, about earned income tax credits. Most of the population would be eligible, would they not? Offhand, wouldn't you think?

Mr. MORRISON. I think we have that figure. It is about half—a substantial percentage, yes.

Senator MOYNIHAN. About 40 percent or so?

Mr. MORRISON. More than half of all returns, but the per-taxpayer credit would average well below that on the mainland.

Senator MOYNIHAN. I guess if the administration could give us an estimate of the incidents of social welfare benefits, per capita, I mean in the island as against the other norms around the country.

Mr. GERRY. We would be happy to do that, Senator Moynihan.

[The information appears in the appendix.]

Senator MOYNIHAN. Could I just ask one other question. On the language issue, has the administration made a position?

Mr. MORRISON. Not from the tax perspective; no, sir. [Laughter.]

Senator MOYNIHAN. Mr. Morrison, you will go far. [Laughter.]

Mr. Gerry, let's see what your future holds. [Laughter.]

Mr. GERRY. I would repeat not from the tax perspective. But as far as I know, Senator Moynihan, the administration has not taken a position on that issue. I would be happy to try to find out.

The CHAIRMAN. It seems to me, Senator, it is a taxing issue. [Laughter.]

Senator MOYNIHAN. Thank you, Mr. Chairman.

Thank you, gentlemen.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you, Mr. Chairman. Some people would say tax talk is a separate language anyway.

If statehood is the option and you estimate that that will cost additional $2 to $3 billion a year, where will that money come from?

Mr. MORRISON. If I can first quibble with your predicate, Senator, the net deficit impact will not be $2 to $3 billion under our estimates.

Senator BRADLEY. Over the first 5 years.

Mr. MORRISON. Over the first 5 years the cumulative total would have been $2 to $3 billion, but the annual amount is a few hundred million.

Senator BRADLEY. So is it an increase in the deficit in the first 5 years by $2 to $3 billion?

Mr. MORRISON. The increase in the deficit from fiscal year 1992 through fiscal year 1995, cumulative, would be on the order of $3 billion.

Senator BRADLEY. So where does the money come from?

Mr. MORRISON. That is an expenditure—and Mr. Gerry can address this as well—that the administration is willing to accept. But in terms of "accepting" that means we are willing to work with the Congress in balancing expenditures in designing the fiscal year 1992 budget and the follow-on budgets to accommodate that.

We acknowledge that the expenditure is not negligible, but it is less than $1 billion a year; and that that is an item that can be addressed in the general balance of budget items. We do not shirk from the task.

Senator BRADLEY. So basically you are saying you take it from some place else?

Mr. MORRISON. I think it has to be——

Senator BRADLEY. Would you take it from another State?

Mr. MORRISON. It has to be part of the mix of designing the budget for each of those years.

Senator BRADLEY. Well I think it is important to be candid. I mean I sure do not want my people in New Jersey loosing out because there's a need for an extra $2 to $3 billion and the administration basically says we are going to take it from one State and give it to another State.

Mr. MORRISON. Would realize I am not saying it would come from the same line item. It can be part of a mix of the entire expenditure package.

Senator BRADLEY. So you won't give us anymore specific suggestions?

Mr. MORRISON. At the moment I understand the administration's position to be that when the plebiscite occurs and statehood is chosen we would immediately come and begin to discuss the issue.

Senator BRADLEY. Well let me say to you, as well as to the people of Puerto Rico, I would sure want to know where it would come from prior to my vote. If I vote for statehood and I have an administration that says, well, I might come up with the money but I am not sure where or how, I would want to know that. I would want to have the administration on the record as to where the money is going to come from so I could be sure I was going to get the money.

Mr. MORRISON. We are committed to finding the money. Deciding where it comes from needs to be a collegial process, I think.

Mr. GERRY. If I might add, Senator Bradley, it not only needs to be but it always is one. The administration's position is that the President will come forward with a budget that includes these costs and that it will be obviously up to the Congress and the administration collaboratively to decide on all the other items in the budget. I do not think we can necessarily trace arrows to other positions for precisely where each dollar will come from.

Senator BRADLEY. Okay.

Under the bill, if the people choose statehood they get the immediate benefits of statehood and the benefits of Section 936 are phased out. Is that correct?

Mr. MORRISON. That is correct.

Senator BRADLEY. Is that constitutional?

Mr. MORRISON. The Justice Department has testified at great length in November on the constitutionality of the phase out of 936 and the answer was yes.

Senator BRADLEY. So it is the Justice Department's opinion that you can provide a tax benefit to one State that does not go to other States?

Mr. MORRISON. Provided it is phased out over a short period of time.

Senator BRADLEY. You feel quite comfortable with that? You do not think you need declaratory judgment from the Supreme Court and you do not think you need anything else? You feel quite comfortable with the Assistant Solicitor's view?

Mr. MORRISON. I have to defer to the Justice Department. But Mrs. Peterson's testimony did make it clear that that was their position.

Senator BRADLEY. Now if I were the people in Puerto Rico I would sure want to know that with a little more authority than the view of a Justice Department lawyer. They have been wrong. There are a lot of dollars involved here. But I realize that is not a tax matter.

On the issue of the Puerto Rican Olympic team, can Puerto Rico have an Olympic team from the administration's standpoint if they opt for statehood? That is more in your area, Mr. Gerry? [Laughter.]

Mr. GERRY. That is the problem with the Department of Health and Human Services. If we cannot figure it fits anywhere else, it always ends up being one of our questions. [Laughter.]

I do not know that we have anything to do with Olympic team formation or the rules governing Olympic teams. So I cannot honestly answer your question, Senator Bradley.

Senator BRADLEY. Do you think New Jersey should have an Olympic team?

Mr. GERRY. I would not want to preempt the citizens of New Jersey from at least arriving at that conclusion probably first. But I honestly do not know the extent to which the Federal Government plays a role in deciding who has Olympic teams and under what rules they select them.

Senator BRADLEY. Well if the people of Puerto Rico are under the impression that they can have statehood and an Olympic team, which is a certain element of pride and a certain element of identity, it ought to be clear where Congress and the administration stand on that before they choose.

Mr. GERRY. I agree with you it ought to be clear, Senator. I do not know what the impression is. I know that our Department right now is not operating under any impression with respect to whether there will or there will not be an Olympic team in Puerto Rico after statehood.

The CHAIRMAN. Thank you, Senator.

Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman; and, gentlemen, thank you very much for your testimony.

All three of my colleagues have asked you questions that require a high degree of candidness to ensure there is no misunderstanding on the part of the people of Puerto Rico as to the possibilities regarding this issue. The prospect of a recession in Puerto Rico concerns me. I think, Mr. Gerry, you said in your testimony there may be a recession in Puerto Rico. Did you say that or who said that?

Mr. GERRY. No, not a recession.

Mr. MORRISON. I said that even under CBO's analysis they are not predicting a recession in Puerto Rico.

Senator SYMMS. Well if, in fact, some of the tax returns in the 936 companies, did you analyze those tax returns that would show an approximate 15-percent drop in profits in the 936 companies if statehood is enacted?

Mr. MORRISON. In developing our revenue estimates we would not normally take into account the GNP drop in Puerto Rico. But let me explain why that is not important here. First——

Senator SYMMS. Try to make the answer brief because I am trying to get to my question.

Mr. MORRISON. Okay. First, there is no impact on the revenue pickup from 936; and second, even assuming CBO's negative numbers, there is only a 5 percent total impact on the small portion of the pickup that is not relative to 936. That has an almost negligible effect on the total revenue impact.

Senator SYMMS. My question concerns Pete Marwick's indication of a possible 15-percent drop in profit. Thus, if they are making on the average 18 percent in that study, they could be down to 3 percent, while if you can borrow money at 10 percent and pick up and leave and go to Mexico or somewhere else, what happens to Puerto Rico if they lose employment and jobs?

Mr. MORRISON. The point is that we do not believe they can pick up and leave and go to Mexico. If they went to Mexico they would have to——

Senator SYMMS. Or Jamaica, say. Maybe they will make an arrangement for them.

Mr. MORRISON. If they went to any foreign jurisdiction a substantial portion of the income earned by 936 companies would have to be paid back to the mainland in the form of royalties. So from a revenue perspective we estimate, even if there is a significant hit to Puerto Rico's GNP, very little impact on the revenue pickup from 936 companies.

Senator SYMMS. So what is your basic reason from Treasury's point of view, what is the comparative business advantage for someone to be in Puerto Rico as a State as to say going to North Carolina or New Jersey or to go to some low tax jurisdiction like Jamaica or somewhere in the Far East? What is the advantage? What is the comparative advantage? How do you analyze it?

Mr. MORRISON. There is very little difference in your example between going to North Carolina or New Jersey versus staying on shore in Puerto Rico. Our revenue estimates with respect to the pickup from 936 are not sensitive to whether a 936 company moves from Puerto Rico back to the United States. If that happens we will still pick up the same amount of revenue.

The question as to whether or not 936 companies will move offshore is addressed in our testimony; and that is the only thing that has an impact on our revenue pickup.

Senator SYMMS. Well I guess what I am driving at here is if, in fact, statehood—let's hypothetically say that statehood is granted, which you are recommending, and then in fact after three or 4 years, if GNP is down and things have not turned out as well and people aren't quite as wealthy as they thought they would be and they feel disillusioned, and then they get a new election over there and elect a party slate of officers in the legislature and the Governor that are demanding independence, what is the Treasury's position going to be then?

Mr. MORRISON. Well the administration's position is that they have the right of self-determination at this time. It is the President's personal opinion that they ought to be a State.

Senator SYMMS. I hear you. I understand that. I am just looking down the road. Before I get too committed on this, I would like to be somewhat comfortable, and hope the people in Puerto Rico will realize that every possible decrease in income for those people needs to be addressed in advance.

Mr. MORRISON. We agree with that, Senator, absolutely, and think our estimates with respect to that——

Senator SYMMS. How high of a margin of the election of the plebiscite in Puerto Rico is required before statehood is granted by the Congress or by the U.S. Government—50.1 percent?

Mr. MORRISON. It is a simple majority.

Senator SYMMS. Is there any way that it could be increased to a higher majority, just so that we were confident that that's what they really want to do?

Mr. MORRISON. That would be up to the judgment of the Senate and the House.

Senator SYMMS. I do not know what the Constitution says about that.

Senator MOYNIHAN. Would my friend yield for comments?

Senator SYMMS. Certainly.

Senator MOYNIHAN. The Constitution does not say, but from the very beginning when the Northwest Territories were divided into States one by one the rule was a simple majority of the population which needed to be 60,000 or more.

Senator SYMMS. Well all I am asking is—and I guess what I am driving at is—I think the Chairman said at the beginning we had better be very candid about this and make sure that everyone understands it. If in fact there is a negative impact with respect to these 936 companies, employment, GNP, and income, and the people believe that they are going to be much wealthier if they become a state and then if they are not wealthier and if they have only voted for it by a very small majority in the first place, well in three or 4 years what happens when they reconsider the statehood status of Puerto Rico? That is the question I am asking.

Mr. MORRISON. Well, I think we have to look to the history of the 1860's to determine whether or not secession is appropriate.

Senator SYMMS. Well I hope you are not going to—I mean, I hope we can think that through. I think that is what we all have to think about.

Mr. Chairman, I know my time is up, but since Mr. Gerry is here could I ask one other question about the hospital costs? I think Treasury has said, if I understood their testimony right, that Treasury revenues would increase if statehood is granted; and you have said hospital costs will also increase. Is the hospital cost increase greater than its revenue increase?

Mr. GERRY. No, Senator Symms.

Senator SYMMS. I am asking the same question in a different way that Senator Bradley asked.

Mr. GERRY. Well let me see if I can separate the issues. If the bill as currently drafted is passed, we are not certain of which of two calculations we would use under the current wording. That is one of our problems with the wording of the bill. We would have to calculate the rate, the approved rate, for reimbursement of Medicare hospitals in one of 2 ways. Either of those two ways as we currently anticipate it would not be consistent with the prospective payment system now in effect in other jurisdictions.

And, based on our current understanding of actual costs in Puerto Rico the two approaches which would be the national hospital average or the actual costs, we have a blended formula right now for calculating the Medicare reimbursement rate. The question would be under the current language which one we would use.

Either of those two would produce a higher reimbursement rate than it would appear to be warranted by the actual costs of hospital care. However, if you take either of those approaches, the amount of money that it would cost from the Medicare trust fund would certainly not be as much as the revenue gained by the Treasury from statehood—for that is the total revenue gain by the Treasury Department from statehood would be larger than either of those calculations just on the Medicare trust fund amounts.

Senator SYMMS. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Gentlemen, one of the traditional views for determining when a jurisdiction qualifies for statehood is that it should reach a stage of economic development where it can hold its own in the national economy.

The CBO questioned whether Puerto Rico has reached that stage of development. Do you think that is a valid requirement for statehood? If you do, do you think Puerto Rico has reached that stage of development?

Mr. MORRISON. I think, of course, it is an important criteria for this Committee and the Congress to consider in considering the admission of Puerto Rico as a State should the people choose that option. I also think that from my reading the CBO's study, given the fact that even under the statehood option there would be economic growth rather than depression, I think it is fair to assume that Puerto Rico has reached such a stage of economic development.

The CHAIRMAN. Let me ask that again, because you put it back on us. I am trying to find out what the administration thinks. Do you think that is a valid qualification requirement for statehood, to reach a stage of economic development where it can hold its own in the national economy?

That is one of the traditional viewpoints. I want to know the administration's view.

Mr. MORRISON. From the Treasury's perspective, I think we would agree that it is a valid concern.

Mr. GERRY. I would have to say I think the President has endorsed the concept of self-determination as the first valid concern.

Mr. Chairman, being from the western part of the United States myself, and although understanding the point of your criterion, I do not know what the application of such a criterion would have meant to the Montana territories or to probably 10 or 15 of the Western States that were admitted if Congress had attempted at that point in time to calculate the precise ability of those territories as States to compete in the national economy.

I think it is relevant but I do not think it ought to take precedence over the principal of self-determination, which is the one that the President has very strongly supported. I think the administration continues to support it as the major concept governing the ability of people within this country to make decisions about their own future.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, the morning is going by and I am going to again thank these two distinguished members. They have helped us a lot and we are going to get more information from you.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you, Mr. Chairman.

Just one quick question. On the calculation of the net costs, over the period 1992 to 2000 what is your calculation of the net transfers?

Mr. MORRISON. Of the net transfers, Senator Bradley?

Senator BRADLEY. Yes. Spending less taxes.

Mr. MORRISON. I would have to do some quick addition, but through 1995 we show a net loss of over $3 billion; and from 1996 through 2000 we show a net gain on the order of $6 billion. So net between 1992 and 2000, we show a pickup on the order of $2 to $3 billion.

Senator BRADLEY. So the Treasury shows a pickup of $2 to $3 billion?

Mr. MORRISON. Between fiscal year 1992 and fiscal year 2000.

Senator BRADLEY. CBO has quite a different view? The CBO report states that net transfers, spending less taxes to Puerto Rico would be nearly $18 billion higher over the period 1992 to 2000.

What is the difference between a gain of $3 billion and a net transfer of $18 billion?

Mr. MORRISON. It is important not to take CBO's statement out of context. CBO, and they can address them themselves, is talking about net transfers to the island. They are not talking about the revenue pickup from phasing out Section 936, which is revenue picked up from the U.S. owners of the 936 companies.

We think if you take CBO's outlay estimates and add our pickup from Section 936, which we do not believe CBO is quibbling with, you still end up in a net positive figure.

Senator BRADLEY. So basically it is the Section 936 pickup?

Mr. MORRISON. That is right.

Mr. GERRY. Yes. I would just add that we agree. We think the CBO's outlay estimates are generally accurate. We have minor differences. So that would confirm the proposition that the difference is in the 936 treatment.

Senator BRADLEY. Thank you.

The CHAIRMAN. Thank you.

Senator Dole, the Minority Leader, also has some concerns and has some written questions that he will be submitting for the record.

[The questions appear in the appendix.]

The CHAIRMAN. I would like to now call Dr. Robert Reischauer, the Director of the Congressional Budget Office, to the witness stand.

I note that Fred Ribe will also be with Dr. Reischauer. Fred Ribe has done some of the work on the CBO report on Puerto Rico.

Gentlemen, we are pleased to have you. Dr. Reischauer, if you would proceed, please.

STATEMENT OF DR. ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY FREDERICK C. RIBE, ASSISTANT DIRECTOR FOR FISCAL ANALYSIS, CONGRESSIONAL BUDGET OFFICE

Dr. REISCHAUER. Mr. Chairman and Senator Moynihan, it is a pleasure to be here before the committee this morning. I am accompanied by Fred Ribe, CBO's Assistant Director for Fiscal Analysis, who returned yesterday from Puerto Rico where he discussed the contents of CBO's study with the island's economists.

I will submit my prepared statement for the record and briefly summarize CBO's analysis of the economic and budgetary impacts of the statehood and independence options as they are defined by S. 712.

At the outset, I want to emphasize that the analysis that the CBO undertook for this Committee was not able to incorporate all of the possible effects that a change in the island's political status could have. We concentrated on the quantifiable impacts that would result from changes in net government transfers and from the gradual elimination of Section 936 benefits.

A change in Puerto Rico's political status could affect many other things—tourism, the local sector's capacity to spend, how Puerto Ricans and outsiders perceive the island as a place to do business, work effort and saving patterns of the Puerto Rican population, and the island's trade, shipping, and international tax positions.

These dimensions could have important impacts on Puerto Rico's economy, but CBO had little basis for estimating their relative magnitudes.

Under statehood, Puerto Rico would become eligible for full Federal entitlements, and individuals and corporations on the island would become liable for Federal taxes. Because the former would outweigh the latter, net Federal transfers to Puerto Rico would increase by about $18 billion over the 1992 to 2000 period. By itself this net increase in Federal flows would increase the island's aggregate demand and stimulate the Puerto Rican economy. It also might affect the island's labor supply and the migration flows between the island and the mainland.

Statehood would also involve the gradual phaseout of Section 936 benefits. Affected firms would respond to this by reducing their investments in Puerto Rico. The reduced investment would decrease aggregate demand and over time would reduce the island's productive capacity.

At first the Puerto Rican economy would probably enjoy a temporary surge in response to the increase in net transfers, but this effect would be eventually offset by the loss of Section 936 activity. On balance these two repercussions of statehood would result in a reduction of 1 to 2 percentage points in Puerto Rico's economic growth rate over the balance of this century.

By the year 2000, the island's real gross national product (GNP) would be 10 percent to 15 percent lower than it would be under a continuation of commonwealth status. Employment growth would fall by about one-half to 1 percentage point, which translates into a reduction of 50,000 to 100,000 jobs by the year 2000. The lower economic growth and higher unemployment projected under statehood would act to increase Federal spending for such programs as unemployment insurance, food stamps, Aid to Families with Dependent Children, and Medicaid by somewhere between $300 million and $600 million by the year 2000.

Estimating the impact of independence on the Puerto Rican economy involves even more conjecture than does estimating the effects of statehood. On the one hand, independence could have positive economic effects if it led to expanded investment, increased labor supply, and reduced dependency. On the other hand, independence could be harmful if the progressive loss in Federal transfers that would occur under S. 712 proved to be too burdensome, and if Puerto Rico encountered difficulties obtaining capital from abroad.

Under independence, Federal transfers to Puerto Rico would fall progressively below the baseline levels and eventually would terminate. The excise tax on rum would no longer be remitted to Puerto Rico. The overall result would be a decline in net fiscal flows from the United States to Puerto Rico that would amount to about $7 billion over the balance of this century.

The decline in net fiscal flows from the United States would reduce aggregate demand and reduce the average growth of real GNP in Puerto Rico by somewhere between two-tenths and three-tenths of a percent per year over the balance of the century.

Independence could also affect Puerto Rico's ability to attract direct investment. Under S. 712, U.S. corporations in Puerto Rico would lose all of the benefits of Section 936. However, the independent nation could respond by offering other tax-related advantages that could transform it into a low-tax jurisdiction for U.S. firms and into a more attractive location for investment by third countries than is now the case. The net effect of this was impossible for CBO to estimate.

An independent Puerto Rico might encounter severe difficulties financing its balance-of-payment outflows. In the past this outflow has been financed by net transfers from the Federal Government; by Puerto Rican Government borrowing in the U.S. municipal bond market; and by direct investment by Section 936 firms. Under independence, U.S. Government transfers, as I have mentioned, would decline, and Puerto Rico would lose its access to the U.S. municipal bond market.

If these effects were not offset by an increase in direct investment from abroad, Puerto Rico would face a decline in funds from outside sources which would cause its economy to contract. Either the Government would have to reduce its borrowing to balance the shortfall, or real interest rates would have to rise. Either case would lead to reduced output, employment, and income at least in the short run.

Let me conclude by reiterating the caveats that must be kept in mind when discussing CBO's analysis. First, the effects of a change in Puerto Rico's status are extremely complex and very uncertain. Second, CBO could not quantify many of these effects. Third, those that we could quantify could not be stated with a great deal of precision.

What this suggests is that CBO's study, while useful in laying out the general pattern of likely effects, should not be regarded as the last word on this subject.

Finally, I think that it is important to reflect on Senator Bradley's opening comments and to note the limited scope of CBO's study. We examined the economic and budgetary impacts of a shift in Puerto Rico's political status. Such a shift would represent a major political change, and certainly there are numerous other factors that should be considered as you resolve this issue.

Thank you.

[The prepared statement of Dr. Reischauer appears in the appendix.]

The CHAIRMAN. Dr. Reischauer, you talked about an economy in Puerto Rico that has been built on Federal tax preferences and local tax preferences, and that their elimination would have a negative impact on Puerto Rico's investments.

As an economist, do you believe the Puerto Rican economy is built on tax incentives? Do you think it could sustain economic growth without those incentives?

Dr. REISCHAUER. I think it certainly can in the long run. There will be a difficult adjustment period.

The CHAIRMAN. In the long run, that is what the Congress is saying. In the long run we are all dead. But tell me again, what do you mean by long run? Measure it out for me.

Dr. REISCHAUER. Well, there will be an adjustment period. As the Puerto Rican economy adjusts to the withdrawal of the incentives provided by Section 936, that will act as a drag on economic growth and, by our calculations, a fairly serious drag. But by the year 2000, Section 936 credits will have been totally phased out for 2 years. The increased tax payments to the Federal Government will be phased in and readjustments will occur.

The CHAIRMAN. So you are saying by the year 2000 you think it could sustain economic growth without the Federal tax incentives?

Dr. REISCHAUER. Yes. We are not saying that there will not be economic growth between now and the year 2000.

I would like to correct a misimpression that might have been left by Mr. Morrison. We have made no forecast of what the Puerto Rican economy will do over the next decade. We have no ability really to forecast the ups and downs in the Puerto Rican economy the way we do the American economy for our work on the budget.

We have looked back at the track record of the Puerto Rican economy and have developed high-growth and low-growth scenarios that are consistent with past experience in Puerto Rico and then asked, what would happen, given statehood, assuming these two growth paths. So the answer to the question of whether we predicted a recession or not in Puerto Rico is that we did not predict one nor did we not predict one.

The CHAIRMAN. Gentlemen, I have another engagement I have to fulfill and so I am going to ask Senator Moynihan to continue to Chair the hearing.

Thank you.

Senator MOYNIHAN. Dr. Reischauer, in my opening remarks I offered the thought that the real issues we are dealing with here are civic and not economic. We have every reason properly to ask, you know, what will be the economic consequences and this is the Finance Committee and we deal with such matters. But as you look at this situation, and try to get beyond your modeling mode, wouldn't you be disposed to say that with all that we know that there are not going to be any economic consequences of any magnitude compared with the magnitude of the civic ones? Do the economic issues override the importance of the civic ones?

Do you want to be a citizen of the United States and a member of the union with representation in Congress? Do you want to be a citizen of the United States but not have representation in Congress through a Commissioner? Do you want to be independent?

Compared to the magnitude of those civic issues—maybe you do not want to answer this. You do not have to, obviously. What is the growth rate in the 1980's in Puerto Rico, about 2.5 percent, something like that?

Dr. REISCHAUER. It is between 2 percent and 3 percent.

Senator MOYNIHAN. Two to three. I said 2.5. In between 2 and 3 percent. Mr. Ribe—is it Mr. Ribe?

Dr. REISCHAUER. Yes, Mr. Ribe.

Senator MOYNIHAN. What does that do in a decade? That compounds to about 30 percent or so?

Dr. REISCHAUER. Probably a little over 30 percent.

Senator MOYNIHAN. Thirty-five?

Dr. REISCHAUER. Roughly.

Senator MOYNIHAN. Yes. So your GNP has gotten better than it was. We are accustomed to economic growth in a way that the species did not ever begin to experience until about 150 years ago. So the economic growth in the eyes of the island will be about 35 percent in this decade if it continued about what it was in that decade. That is a big increase, about a third or more. It would be about three-fold. No?

Dr. REISCHAUER. Roughly 28 percent.

Senator MOYNIHAN. Roughly 28.3 did you say?

Dr. REISCHAUER. No, 28 percent growth, roughly.

Senator MOYNIHAN. I would say a third. There are more people too, but you know physically better off.

So then between 28 and 24?

Dr. Reischauer. No. What you would be doing is reducing that growth rate of——

Senator MOYNIHAN. No, no.

Dr. REISCHAUER. If it were 2.5 percent per year and we said the impact of statehood would be to reduce that by 1 to 2 percentage points a year, we would then be talking about a growth rate that was between 0.5 percent and 1.5 percent per year; and that is a very substantial change in the circumstances.

Senator MOYNIHAN. At 1.5 percent, what is the increase?

Dr. REISCHAUER. It ends up reducing the level of GNP, as I said in my statement, by between 10 percent and 15 percent. The increase from what it would have it otherwise.

Senator MOYNIHAN. I understand these things. I have been 14 years here; I am beginning to get the hang of it.

So would I be within a range of saying that in your estimate things as they are, assuming there is no change in 936, the GNP of Puerto Rico will increase by about 30 percent in this decade; and that if we go to statehood instantly it will increase by about 15 percent? In those round figures.

That seems to me, if I may say—and this is a judgment other people will make, obviously—these seem to be derisory sums compared to the magnitude of the issue, what kind of a citizenship do you desire.

Dr. REISCHAUER. Well, let me agree with your final statement—I think that the citizenship or civic issue is the paramount issue. But I would mention that, as you noted, the population of Puerto Rico is growing, and, under a pessimistic scenario, the lower GNP growth rate might result in basically static per capita GNP over a decade. That is not a happy set of circumstances.

Senator MOYNIHAN. The median income in the United States in 1987, the median family income, finally got back to the level of 1973, right?

Dr. REISCHAUER. The answer is yes, in real terms.

Senator MOYNIHAN. Yes, in real terms.

Dr. REISCHAUER. And we are above that, yes.

Senator MOYNIHAN. So we went 15 years with no increase in the median family income and life went on. You know, World Series were held, and football games, hearings.

Dr. REISCHAUER. Real per capita GNP rose fairly substantially during that period, and some of the reasons why real family incomes did not regain their 1973 level had to do with demographic shifts that were going on and the restructuring of the American family. But this is a more complicated issue, which you and I have talked about before.

Senator MOYNIHAN. Yes, a more complicated issue than statehood or commonwealth.

Listen, could you tell the Committee—this is the Chairman. The Chairman asked me to ask you this question. Dr. Reischauer, you have testified that there are a number of potential effects of the various status options which CBO is unable to estimate in its analysis. I understand that putting a precise number on many of these effects is often difficult. Nevertheless, this Committee has to make tough and important decisions and we need to have the best possible advice and analysis.

Could you tell the Committee whether in your best professional judgment the unestimated effects are likely to override the negative consequences which CBO has predicted under the statehood and independence options?

Dr. REISCHAUER. The answer to that, simply put, is no. We omitted a number of important factors, because we did not have the capacity, the data, or the modeling ability. Some of those factors would act to slow down the Puerto Rican economy beyond the factors that we examined; others would act in the other way. We omitted the impact that would result from the elimination of the uncertainty over Puerto Rico's political status and political future that presumably would have a positive effect.

Senator MOYNIHAN. How are you going to, you know, put a number on that.

Dr. REISCHAUER. We also omitted the increased recognition—knowledge that Puerto Rico exists and that it is a place to do business—and the tourism impact. Those factors presumably would be positive.

On the negative side, we left out such things as the impact that would occur from increased marginal tax rates on individuals that could lead to a reduction in the labor supply; the increased tax burden on capital in Puerto Rico—local capital; the effects that a reduction in the Section 936 sector would have on local supplying firms; the possibility that the Puerto Rican state government might be strapped for funds and have to cut back its activity if the economy of Puerto Rico suffered poor growth.

So there were things on both sides. Whether on balance they would add up to a plus or minus, I am unsure—but I think the net effect of all these omitted factors would be relatively small compared with the large negative impact that the two dimensions we did examine would produce. So I am fairly confident about the direction of the effect, if not in the size.

Senator MOYNIHAN. We want to be as neutral here as we can and just present the alternatives—I think that is the view of the committee. I think it was the view of the Energy and Natural Resources Committee. Just present information and let people make their own choices.

It would be helpful, I think, and could I ask, would you try to work out a per capita GNP path over the next 10 years in terms of the two scenarios. Leave independence out. Independence is a judgment people can make that will have nothing to do with economics. If they want to do it, it will be for reasons that have nothing whatever to do with economics. But these other things you might, economics will tend to make a difference.

Could you do that for us?

Dr. REISCHAUER. We will be glad to do it. I want to add that this analysis will be as uncertain and difficult as the other analyses we have done because we have no way of estimating the effects on migration of changed economic situations. So we will assume, you know, a steady situation in that regard.

[The information appears in the appendix.]

Senator MOYNIHAN. Yes.

One of the economic issues that I would like to see you factor in is transfer payments. If statehood brings $2,000 per capita in transfer payments out of HHS that seems to me that—you know, a family of five has a $10,000—well, that median family of five, they are in the range where that would be the largest transfer payment in per capita terms than any place in the world; wouldn't it be? I mean you hear a lot about Sweden but I doubt it. You know, can you factor that in?

Dr. REISCHAUER. We have calculated in our report and in my testimony what we think those transfer payments will be, and we will be glad to work them out on a per capita basis for you and provide them.

[The information appears in the appendix.]

Senator MOYNIHAN. You have Mr. Gerry, so you have their judgment. You can use that.

Dr. REISCHAUER. Yes.

Senator MOYNIHAN. Would you tell us about it, too, you know, a little footnote.

Finally, can I ask you, sir, has the House of Representatives asked anything of you in this matter?

Dr. REISCHAUER. Apparently they have put in an analogous request to the General Accounting Office.

Senator MOYNIHAN. Recently, as far as you know?

Dr. REISCHAUER. A month ago.

Senator MOYNIHAN. A month ago. All right.

Because may I for the record say that we asked the Congressional Research Service a year ago, last summer, to give us an assessment of what the effects on social programs would be and transfer payments and so forth. We have been at this. I do not want to be difficult, but I have to say that if the House of Representatives does not get onto this job we are going to have a situation I described earlier. We will end this Congress without legislation to send to the President in accordance with his clear expectation and wish at the beginning of this Congress.

That would be a dereliction of a responsibility of a very high order, or so I think, and about which I do not ask you to comment on.

Gentlemen, thank you very much, Dr. Reischauer, Mr. Ribe. We appreciate it very much. We will hear from you. I guess you have nothing else to do right now, but could you get us these things as soon as you can because we have to proceed on this.

Dr. REISCHAUER. We should be able to get it to you in a couple days.

Senator MOYNIHAN. Good.

Well now, we now hear from a panel of distinguished citizens who are involved with these matters. We will stand in recess for 1 minute while we sort of reshuffle.

[Whereupon, the hearing was recessed for 1 minute.]

Senator MOYNIHAN. I will appreciate it if our guests will reshuffle. Our witnesses listened with great patience to the earlier witnesses now let's give them the same courtesy. There is no discourtesy. There is just a certain amount of shuffling going on in the back there. I am going to ask our guests who are standing if they wouldn't be kind enough to sit down. I really must ask that because we owe the courtesy. Very well.

We now have a panel which I am informed—I did not know, but that is just fine.

Wait a minute now. We are going to have order in this hearing room. There is a matter of courtesy and civility involved here. All right.

I am told that our panel is divided into three. It represents the three options that we are going to provide for—which is to say commonwealth, statehood and independence, or independence, commonwealth and statehood. You have to list them, but we treat them equal. We are going to have to be attentive to time under Senate rules. Therefore, each position will have 10 minutes to set forth and then we will have questions. Let's get on with it.

There is a pair of persons representing the different positions. The pair will divide its 10 minutes as it chooses. And with that not very complicated instruction, let me first ask Mr. Benny Frankie Cerezo, who is Presidential Delegate from the New Progressive Party and Mr. Michael J. McKee, a principal of Quick, Finan & Associates, in Washington.

Good morning, Mr. Cerezo.

Mr. CEREZO. Good morning, sir.

Senator MOYNIHAN. And Mr. McKee.

Proceed, please, sir.

STATEMENT OF BENNY FRANKIE CEREZO, ESQUIRE, PRESIDENTIAL DELEGATE, NEW PROGRESSIVE PARTY, SAN JUAN, PR

Mr. CEREZO. I am pleased to testify this morning on S. 712 on behalf of the Puerto Rico statehood movement and its political instrument, the New Progressive Party. I am accompanied by Mr. Michael McKee, an economist. With us is a group of well-respected Puerto Rican economists and tax experts—Gerardo Carlo, Nelson Soto and Carlos Diza-Olivo. They will be available to answer questions now and until markup.

To save time, I respectfully request that the full testimony be included in the record.

Senator MOYNIHAN. That will be done, sir; and it will be done for each of the witnesses.

Mr. CEREZO. I was unpleasantly surprised Tuesday morning when I read a Washington Post editorial declaring S. 712 dead for this Congress. Not since Dewey beats Truman has a newspaper been so premature in writing a political epitaph.

The Senate Energy Committee reported this complex bill in record time. The Agriculture Committee has conducted hearings and reportedly can report the bill quickly. With today's hearing, the Finance Committee completes a lengthy process and should be equipped to report S. 712 expeditiously. The House leadership has promised an expedited process this year on our self-determination issue.

The Post's opinion notwithstanding, there is time to enact S. 712 this year if the Finance Committee moves promptly. I suggest that the New York Times editorial of April 1, of which I have made a copy available, is better reasoned. Therefore, we urge you to mark up S. 712 quickly.

Today we examine the economics of S. 712. We were gratified when you appointed the Congressional Budget Office to work with other expert analysts within the Federal Government to produce an assessment of the economic impact of each status. For years, parties with a vested interest in retaining Section 936 have hired economists and accounting firms to turn out supposedly authoritative reports that predicted the downfall of Puerto Rico's economy, even under statehood, absent Section 936. These paid reports are inherently suspect, particularly when authored by former policy-making Treasury officials who opposed Section 936 while in office.

Before we discuss the CBO report, let me emphasize this: Economics matter but, fundamentally, this issue transcends economics. It is civics as Senator Moynihan has rightly stated today. Puerto Ricans—3.3 million American citizens—hunger for self-determination. All three political parties which rarely agree on anything stand united on this point. Never in our nation's history has self-determination been denied, when requested. Nor can the United States deny self-determination for its citizens when demanding it for citizens of other nations. Nor has the question of whether or not to admit a State been ever decided solely on the basis of economics.

Mr. Chairman, two points. First, we welcome the opportunity to work with the Committee to adjust the transition periods of S. 712 to prevent the brief economic downtown projected by CBO.

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Second, let me say that every objection to Puerto Rican statehood that will be raised this morning (1) that it is too expensive for the Federal Government; (2) that it will crush economic development; (3) that taxes would be too much of a burden on companies and citizens; (4) that our island can never be self-supporting—were raised identically during the debate over the admission of no fewer than 10 States. To wit, Alaska, Hawaii, California, New Mexico, Nevada, Oregon, Illinois, Oklahoma, Arizona, and Mississippi. Those objections were false in every one of those cases and they are equally wrong when raised about Puerto Rico.

History has proved once and again that the American Dream works.

Now I defer to Mr. McKee.

[The prepared statement of Mr. Cerezo appears in the appendix.]

Senator MOYNIHAN. We thank you, sir.

Mr. McKee?

STATEMENT OF MICHAEL J. McKEE, PRINCIPAL, QUICK, FINAN & ASSOCIATES, WASHINGTON, DC

Mr. McKEE. Thank you and good morning, Mr. Chairman.

I am Michael McKee, Managing Director of Quick, Finan & Associates, appearing again on behalf of the statehood party of Puerto Rico. I thank the committee for consenting to hear our views on the CBO report.

I am going to be brief in summarizing the report. You have the testimony, Mr. Chairman.

Senator MOYNIHAN. I do.

Mr. McKEE. So I will be brief in my summary because I have some extemporaneous remarks that I would like to make that seem to me to address some more serious and deeper issues here.

But first to summarize the testimony, I draw five conclusions from the study. They all stem from one threshold observation. CBO has expressly limited itself to what it regards as the three quantifiable aspects of S. 712—elimination of 936; imposition of Federal taxes; and introduction of full Federal benefits.

CBO has not analyzed what it calls unquantifiable benefits that statehood undoubtedly will bring. Thus, what CBO calls statehood is nothing more than commonwealth, minus 936, plus Federal taxes and benefits. Nothing more than commonwealth with full fiscal parity to the states. Using this as its foundation, CBO compares commonwealth with parity against commonwealth as it exists today, which it projected for purposes of the study to last forever.

Does the omission of statehood's tangible benefits matter? Consider one inescapable conclusion I know you will find unsustainable. It means Senators and Congressmen do not count and have no impact on their State's economies. I do not believe this. This and other quantifiable impacts of statehood matter greatly and are not in the study. Statehood is fundamentally different from a commonwealth with parity—politically, emotionally and economically. In the end I will return to this and let you be the judge.

Does it matter that Section 936 is assumed to last forever? In 1980 Section 936 caused a Federal revenue loss of $1 billion per year. In 1989 the revenue loss is more like $2 billion a year. During that time Puerto Rico's manufacturing sector, all of it, including non-936 companies, added just 1,000 jobs according to the island's employment survey of establishments. So each of those net new jobs is now costing the U.S. Treasury something like $1 million every year. Being generous in adjusting for inflation, each new job costs well over half a million dollars a year, every year.

Does it matter that CBO projects 936 to last forever? CBO assumes that in the 11 years after 1989 Section 936 will be responsible for adding between 90,000 and 160,000 936 jobs, well more than the 1,000 or so added during the last decade.

Now let me turn to the five conclusions I draw from CBO's study. Conclusion one, commonwealth is a subordinate status to statehood; yet, commonwealth has a free ride even the poorest States do not now enjoy. The commonwealth Governor has attempted to argue that S. 712 provides a tilt towards statehood. The Governor, when he asks for fiscal parity, does not really mean full fiscal parity. He wants the benefits and the benefits only. A truly balanced bill would, under commonwealth, phase out Section 936 and impose Federal income tax liability on Puerto Rico's citizens as it confers entitlement benefits. If anything, the bill currently tilts against statehood.

The second conclusion, the current statehood transition provisions in S. 712 need adjustment. Mr. Cerezo has already addressed that.

Conclusion three, the study puts a floor under the risks from statehood and the possible fall is a short one. I think that came clearly from the previous testimony. There may be some loss of GNP. It is a loss of growth, and the economy will grow more slowly. That will pass and the economy will resume growing as fast under statehood as it would have under commonwealth.

I compare that, however, to studies like Peat Marwick's and studies that have gone before, that have shown statehood to be an utter disaster, that show the economy sinking under the ocean. That is not what CBO says.

Why does CBO's statehood economy perform better than Peat Marwick or other studies that have gone before have shown? Basically it is because Puerto Rico is a different place than we have been led to believe. There are really three islands in Puerto Rico, three different Puerto Ricos. Puerto Rico has developed very rapidly.

Still on the island today there is the Puerto Rico of the old people, people who grew up in an underdeveloped, less developed country, a less developed economy. There is the Puerto Rico of the middle-aged, people who grew up during the development stage. And now there are the youth of today. They are growing up in a developed economy. That is the key difference.

Finally, turning to the question of whether this is a floor under statehood. I think the answer is inescapable that it is a bottom but not a top. Just ask yourself, Senator, would you rather be the Governor of the State of Puerto Rico, trying to develop that state, or would you rather be the Governor of a commonwealth with parity trying to develop that commonwealth. I think you will—when you think about it, think about the presentations you would have to make to investors—find clearly that statehood would make it easier for you.

It looks like my time is running out so I will have to examine the deeper question at a later time.

Senator MOYNIHAN. Wait until it rings.

Mr. MCKEE. Well let me address what I think is a deeper question, which is: Is Puerto Rico ready for statehood.

Senator MOYNIHAN. Finish your statement.

Mr. MCKEE. The real question, it seems to me, is whether Puerto Rico is part of the first world or whether Puerto Rico is part of the third world. If Puerto Rico is part of the first world, if it is a developed country, and it takes a shock—whether it is CBO's shock or Peat Marwick's shock—it will recover. We have a fundamental faith that economies in the first world have a resilience and that they may slow down, they may slow their growth, they may have a recession, but they will come out of it.

Senator Bentsen's Texas is a perfect example. We do not doubt that Texas will come back.

On the other hand, if Puerto Rico is fundamentally part of the third world, we think that it does not have the resilience and, therefore, any shock is going to be harmful and the economy cannot recover from it. The effects will multiply and make the situation worse. There is no recovery.

What is the difference? What is the fundamental, economic difference then between the first world and the third world? How do we judge? The commonwealth party will throw statistics. We can throw statistics. We will all make up numbers about the future of the economy but we cannot predict it. So the question is: How can we tell basically whether the resilience is there or whether it is not? What is the difference between the first world and the third world? The difference is education.

In the first world, universally in the first world, you have universal education for all children up through high school. In the third world that is not the case. In the third world you have to keep the children at the plow. There is not enough productivity to provide freedom for education for the children. In the first world you have education. And because you have education, people are masters of their own economic destiny, to the extent we can master the future and to the extent we can master destiny.

Senator MOYNIHAN. Fine. I think that is a very forcefully made point, Mr. McKee. We thank you very much.

Mr. MCKEE. If I may then just conclude by pointing to a chart in my testimony.

Senator MOYNIHAN. Yes.

Mr. MCKEE. Which shows that now, at least 10 years ago, in 1980, Puerto Rico had made that jump.

Senator MOYNIHAN. This is Chart number 1?

Mr. MCKEE. Chart number 1.

Puerto Rico now has universal education.

Senator MOYNIHAN. Yes.

Mr. MCKEE. And now it has that resilience.

Senator MOYNIHAN. Thank you.

[The prepared statement of Mr. McKee appears in the appendix.]

Senator MOYNIHAN. Very well, we are going to hear first of all—our next group is obviously the commonwealth group. Mr. Jose Berrocal, who is Counsellor to the Governor, the distinguished Governor, and we have his predecessor here today as well. Then Mr. Harvey Galper, who is formerly Director of the Office of Tax Analysis and who now works with Peat Marwick and I would assume was involved in the preparation of that report. It is nice to see you again, Mr. Galper. And Mr. Berrocal, good morning, sir. Would you proceed?

STATEMENT OF JOSE M. BERROCAL, ESQUIRE, COUNSELOR TO THE GOVERNOR OF THE COMMONWEALTH OF PUERTO RICO, SAN JUAN, PR

Mr. BERROCAL. Good morning, Mr. Chairman. I am pleased to appear before you to discuss the potential economic impact of S. 712 on Puerto Rico.

I am by training a lawyer and currently serve as Counselor to the Governor. I come to represent the views of those of us in Puerto Rico who believe that our commonwealth relationship is and should continue to be an instrument for assuring the continued dignity and progress of the Puerto Rican people. We seek to improve what has proved to be a practical and unequal creative solution to the problems of a developing society in its aspirations for progress.

During the first half of this century Puerto Rico was a stricken land, suffering from desperate poverty and destitution. Through commonwealth status in the 1950's Puerto Rico experienced a dramatic turnaround. A new political relationship gave Puerto Rico the opportunity to pull up its economy by its bootstraps and dramatically improve the socioeconomic condition on the island. It did so by maximizing the use of its fiscal autonomy, possible only under commonwealth in the span of just two generations. The poorhouse of the Caribbean emerged as a bustling and industrious society, and today Puerto Rico enjoys one of the highest standards of living in Latin America.

Commonwealth has proven to be a productive partnership through which the United States has helped Puerto Rico help itself. What we seek today is to enhance that partnership with policy tools that will bolster our self-sufficiency, contributing in our own way to the greatness of the United States as a small but hard-working society. What we seek is opportunity. What we aspire to are more jobs.

The CBO report confirms that under commonwealth Puerto Rico can continue to prosper on a road to greater growth. It also concludes that with the loss of Puerto Rico's fiscal autonomy—which necessarily is lost under statehood pursuant to the uniformity clause—statehood would severely and permanently affect the capacity for growth of the Puerto Rican economy. In essence, the report confirms that a change in status to statehood would entail substituting jobs for welfare.

My written testimony discusses in detail Puerto Rico's challenges as a developing society in an insular setting and I would ask that it be entered into the record.

Senator MOYNIHAN. Yes, of course. We would be happy to.

Mr. BERROCAL. I would like to focus my oral comments on the CBO's report. The current CBO report is the latest in a long series of serious studies with analogous results. It is not an aberration. The United States-Puerto Rico Status Commission reached similar conclusions. The Kreps (U.S. Department of Commerce) report, as well as private studies by the nation's leading independent firms—Booz Allen; ICF, Inc.; Robert Nathan & Associates; and now Peat Marwick Policy-economics—they all reach similar conclusions.

Without Puerto Rico's fiscal autonomy the prospects for economic growth and prosperity in Puerto Rico are compromised. The CBO report clearly and unequivocally demonstrates that statehood would entail a permanent loss for the Puerto Rican economy.

CBO shoes a loss of 10 to 15 percent GNP by the year 2000. I think it is important, Senator, to put that in perspective. That would be the equivalent of a permanent loss of between $550 to $825 billion for the U.S. economy. Or as if the combined economies of Texas, New Jersey, West Virginia, Minnesota and Arkansas permanently disappeared. Even larger effects are found in other indicators. Wages and salaries of Puerto Rican workers would decline by between 17 and 26 percent under the CBO study. That is equivalent to a loss of between $480 to $730 billion in current wages in the United States.

The CBO study also demonstrates that the statehood economy would lose the capacity for self-sustaining growth. By the year 2000, as you have indicated, Federal transfers would grow dramatically. According to the CBO study, by $11.8 billion. This is information contained in the Appendix to their study and it shows an increase of over 65 percent over commonwealth. And Federal transfers would fully constitute 37 percent of disposable income.

Senator, that is really not the kind of future I would like to aspire to for my children or their children.

Senator MOYNIHAN. Could I interrupt you, sir, to ask: Is that figure in your prepared statement?

Mr. BERROCAL. It is in my written statement.

Senator MOYNIHAN. Could you give me a page number? I just wanted to note it.

Mr. BERROCAL. Well I have my——

Senator MOYNIHAN. Don't worry. It is in your statement?

Mr. BERROCAL. Yes.

Senator MOYNIHAN. Would you say it again?

Mr. BERROCAL. Yes.

Federal transfers to individual would constitute fully 37 percent of disposable income in the Puerto Rican economy.

Senator MOYNIHAN. In the year 2000.

Mr. BERROCAL. And Federal transfers would increase to $11.8 billion in the year 2000. This is information contained in the Appendix to the CBO report.

Senator MOYNIHAN. For the persons at the press table, this is on page 15.

Mr. BERROCAL. Thank you, Senator.

There are a number of adverse economic impacts on Puerto Rico that are not explicitly addressed in the CBO report. As the CBO Director indicated they are smaller than the effects that were modeled and they are likely to be adverse to Puerto Rico, not positive. In particular, with respect to statehood, there are four effects that are adverse. The effect on the rest of our economy that are not Section 936-related. That was not fully captured and they face the added weight of Federal taxes. The effect on economic growth to our financial sector by the loss of the so-called 936 funds which account for more than a third of all bank deposits. The effect on the market for Puerto Rican securities and the effect on government finances.

Now the effect on government finances, Senator, is an important one because the Treasury spokesman suggested that this could actually be a positive effect. If Puerto Rico were to lower its taxes to the level of the higher tax states it would lose $1 billion in tax revenues. That would require cutting back our government sector by nearly 90,000 government workers.

Other alternatives that are suggested are equally available under commonwealth. Much has been said by statehood critics of the so-called unquantifiable benefits of statehood that are not modeled. On the political certainty angle I would simply submit to you a study prepared by those groups that evaluate political risk around the world. They analyze Puerto Rico from that certainty perspective and conclude that it is one of the safest locations to invest in the world.

Senator MOYNIHAN. Do you have a document, sir?

Mr. BERROCAL. Yes, sir.

Senator MOYNIHAN. That you want to submit for the record?

Mr. BERROCAL. Yes, I will submit it for the record.

Senator MOYNIHAN. Please. That is just fine.

Mr. BERROCAL. In summary, sir, neither statehood nor independence offer any coherent economic model so that the people of Puerto Rico can continue to prosper through their effort and ingenuity. Only through commonwealth can Puerto Rico continue to prosper. Its enhancement will make it better.

I would like to turn now to Mr. Galper who will address the issues in our Peat Marwick study.

[The prepared statement of Mr. Berrocal appears in the appendix.]

Senator MOYNIHAN. Mr. Galper, we welcome you to the Committee, sir.

STATEMENT OF HARVEY GALPER, PRINCIPAL, KPMG PEAT MARWICK, AND FORMER DIRECTOR, OFFICE OF TAX ANALYSIS, U.S. DEPARTMENT OF THE TREASURY

Mr. GALPER. Thank you, Mr. Chairman. I am Harvey Galper, a principal in the Policy Economics Group of KPMG Peat Marwick. PEG has been retained by the Governor of Puerto Rico to undertake a study of the economic effects of statehood for Puerto Rico. The effects we could quantify are almost exclusively the result of the loss of the tax benefits under Section 936 of the Internal Revenue Code which has been discussed at length here.

I should emphasize at the outset that neither I, nor Peat Marwick, take any position for or against statehood for Puerto Rico. My testimony today highlights the major points in our study which has been made available in its entirety to this Committee and we submit it for the record.

Senator MOYNIHAN. We will look at it for the record, but it may be a lot more to print than we want.

Mr. GALPER. That is fine. The executive summary is also available.

Senator MOYNIHAN. And that will be in the record.

Mr. GALPER. The study leads to three main conclusions: First, statehood would have several direct negative effects on the Puerto Rican economy, primarily because its corporations established under Section 936 of the Internal Revenue Code would be able to significantly increase their after-tax return by abandoning their existing operations and relocating in tax-favored locations elsewhere in the Caribbean, in Europe or in the Pacific Rim. In addition, expansion by current 936 companies and the formation of new 936 companies would be sharply curtailed, if not eliminated. We estimate that 72 percent or more of the operating income of 936 companies would be subject to relocation.

Second, as companies chose to move off the island, the Puerto Rican economy would be seriously affected because of the impact on non-936 firms that serve 936 corporations. We estimate that between 80,000 and 145,000 private sector jobs would be lost under statehood, increasing the unemployment rate to somewhere between 25 and 30 percent.

Senator MOYNIHAN. At what point in time do you estimate that?

Mr. GALPER. We estimate these at 1992 levels, but it is fully phased in at 1992 levels.

Third, under statehood Puerto Rico residents would be eligible to participate in all Federal outlay programs. But the extension of Federal transfer programs, although mitigating some of the negative impacts, would still lead to some small decline in aggregate demand in Puerto Rico when the other effects are taken into account.

The second major point is: The statehood option has major budgetary implications for the U.S. Government, affecting both revenues and expenditures. We estimate that over the period from 1992 through 2000 statehood would have a net cumulative cost to the U.S. Government of between $22 to $25 billion, a net cost of roughly $2 billion per year.

Senator MOYNIHAN. Is that at variance with the CBO estimate that we have?

Mr. GALPER. Well the $18 billion is not the equivalent figure for CBO. I think that was explained in the Treasury's statement.

Senator MOYNIHAN. Perhaps you could give us a note on that.

Mr. GALPER. All right.

[The information appears in the appendix.]

Third, statehood would cause a major budget dilemma for Puerto Rico. As was noted, if Puerto Rico were to lower their tax rates to be consistent with the highest taxed States in the mainland, that would result in a revenue loss of about $8 billion from 1992 to 2000, roughly $1 billion a year. Balancing the budget under those——

Senator MOYNIHAN. What proportion of the commonwealth tax—what is $1 billion?

Mr. GALPER. About 25 percent.

Senator MOYNIHAN. Twenty-five percent. A quarter?

Mr. GALPER. Right.

And balancing the budget under those circumstances could lead to severe retrenchment on the part of the government and other employment effects that we do not estimate directly in our measures of unemployment, but could also be potentially serious.

These results demonstrate that under statehood the Puerto Rican economy would experience a major economic transformation.

I would like to just make one comment comparing our results with the CBO study, if I may.

Senator MOYNIHAN. One more comment.

Mr. GALPER. Thank you.

Generally, we agree with the results of the CBO study. They estimate, for example, that by the year 2000 there will be a decline in the capital stock employed by 936 companies of between 37 and 47 percent—a decline in the capital stock employed by 936 companies.

We estimate under a least amount of relocation assumption a decline in the capital stock of 31 percent. So there are similarities in what we are saying and what they are saying.

The effects on employment, however, we think would be somewhat more substantial than those that they estimate. But I would also note that CBO does not make the statement that there would not be a recession in Puerto Rico. They say they are just projecting alternative growth scenarios. But if there is a shock of that order of magnitude that is imposed on the Puerto Rican economy, it is hard to see why there would just be a smooth rate of growth, or a smooth lower rate of growth in the face of that shock. So I think it is important to think of that.

Thank you very much.

[The prepared statement of Mr. Galper appears in the appendix.]

Senator MOYNIHAN. Thank you very much, sir.

And now the third triad here. We are going to hear from Hon. Fernando Martin-Garcia, who is Senator of the Legislative Assembly and Vice Chairman of the Puerto Rican Independence Party; and Professor Pedro Parrilla. Do I have that right, Professor Parrilla?

Dr. PARRILLA. Yes.

Senator MOYNIHAN. Oh, there you are down there. There is a fourth collection over in that section.

Dr. Parrilla who is an Economist at the University of Puerto Rico in San Juan. We welcome you both.

Senator, why don't you begin.

STATEMENT OF HON. FERNANDO MARTIN-GARCIA, SENATOR, LEGISLATIVE ASSEMBLY OF THE COMMONWEALTH OF PUERTO RICO, AND VICE CHAIRMAN, PUERTO RICAN INDEPENDENCE PARTY, SAN JUAN, PR

Senator MARTIN. Thank you, Mr. Chairman. Also with me today, although not sitting right here in front, is Mr. Eric Negron who would be available for questions that might require his special tax expertise. He is sitting right behind me.

Senator MOYNIHAN. Mr. Negron, we welcome you to the Committee.

Senator MARTIN. May I say, sir, that I hope this statement will help to correct the dangerous, and I believe erroneous, impression that you may have created a moment ago when you expressed that economic considerations were not important in people making up their minds as to independence.

Senator MOYNIHAN. That statement is hereby withdrawn.

Senator MARTIN. Very well.

Senator MOYNIHAN. Cancelled, and it will be struck from the record. No, it cannot be struck from the record.

Senator MARTIN. From the point of view in economics in trade, Senate bill S. 712 represents a welcome departure from the traditional attitudes concerning independence which have prevailed in official U.S. circles. The provisions of S. 712 are a giant step forward in the arduous process of rehabilitating the feasibility of the Independence alternative before the eyes of the Puerto Ricans. After almost a century in which U.S. policy was tantamount, the de facto and at times de jure to closing off the option of independence to the Puerto Rican people. Senate bill 712 represents a reversal of that policy and recognizes the need for a new policy of affirmative action that will counterbalance the fears and prejudices which have developed and have been promoted during these decades of dependence and political subordination.

This policy is made explicit in the legislative language of S. 712 when in Section 313, in reference to transition grants and Federal programs, the bill states, and I quote, "that these provisions are enacted in recognition of the unique relationship between the United States and Puerto Rico to affect a smooth and fair transition for the new Republic of Puerto Rico with a minimum of economic disruption, and to promote the development of a viable economy in the new Republic of Puerto Rico".

It is therefore with these enlightened criteria in mind that we must examine the CBO report on the potential impact of status changes contemplated in S. 712.

Inasmuch as the CBO identifies areas of concern that could adversely affect the stated objectives of a "fair and smooth transition" and the promotion of "the development of a viable economy in the new Republic of Puerto Rico," it is incumbent upon this Committee to introduce the necessary amendments that will better assure an adequate correspondence between the means provided by the bill and the aforementioned goals which I am sure you all share.

In contemplating amendments to the economic provisions of Title III, I wish to remind the Committee of three crucial considerations which must be kept in mind.

The first is that in designing the Independence alternative the Congress does not encounter constitutional limitations such as may be present in the other status options. Only issues of congressional policy are present here. What is put to a test is the extent of congressional good faith in fashioning a truly viable Independence option that will forever dispel from the minds of the Puerto Ricans and the international community the impression that Congress would react punitively to the possibility of Independence.

The second consideration is that no matter how fair and generous the provisions concerning Independence might turn out to be, they will always be less costly to the U.S. taxpayer than the statehood or commonwealth alternatives.

The third consideration is that the United States, after 92 years of exercising its sovereignty over its Puerto Rican possession has an obligation--moral and political—to make Independence a real choice and not merely an illusory one.

Having said this, I will now propose to you three modifications to S. 712 which we believe will better insure that the policy objectives of Title III are not inadvertently undermined by the existing provisions of the bill.

With regards to Section 936 of the Internal Revenue Code S. 712 provides that the benefits under this section would cease to apply to an independent Puerto Rico. The report from the Committee on Energy and Natural Resources made clear that it thought this matter should be ultimately left to the Finance Committee, although it expressed that the foreign tax credit in an Independent Puerto Rico would be available to what are now 936 corporations. The CBO report goes further to say that arrangements might be reached between the United States and Puerto Rico which could provide comparable benefits to those enjoyed today by these companies.

It should be obvious, however, that if stability and continuity are to be promoted during a transition period Section 936 benefits should continue to apply to an Independent Puerto Rico for at least a 10 year period. Treasury will not be worse off because of such an extension in view of what the consequences would be of using the foreign tax credit, while at the same time it would offer existing and potential investors the added incentive of continuity and certainty for a specified period of time.

The second modification concerns Puerto Rico's public debt. As S. 712 stands now interest payments on any new debt or on any refinancing of existing debt after Independence would no longer enjoy tax exemption in the United States when earned by U.S. residents. As the CBO report points out this would raise the cost of borrowing at the time when the emergent republic's credit rating in the international markets have not yet been established.

If the principle of a smooth and fair transition has been applied as much as possible across the board, there seems to be no valid reason why it should not be applied to the area of public debt financing. Here again, our proposal is that the existing structure of tax exemption for interest earned from bonds issued by the Government of Puerto Rico and its instrumentalities be kept in place for a period of no less than ten years after the proclamation of the Republic.

The cost in foreign income to the Treasury would be no larger than the one incurred in by a continuation of the present status, and then only for a 10-year period.

Our third proposal for modification concerns the transition grants provided for in Section 313, Subsection 3. The CBO report has expressed concern over the balance of payments outlook generated in part by the reduction in real terms of the transition grants since the formula is not based on the present value of Federal payments to Puerto Rico in the fiscal year prior to the proclamation of Independence but simply on its nominal value. The language of the bill should be clarified so that the yearly transition grants reflect the present value of the initial outlay during the 9 year transition period.

The incorporation of these three modifications still keeps Independence as by far the least costly alternative for the United States, while at the same time strengthening the viability of the Independence option and serving to ensure the success of the stated policy of the bill. The adoption of these amendments would be a resounding reaffirmation, by this Committee, of the Senate's commitment to the principle of affirmative action in the case of Independence.

A strong and viable Republic of Puerto Rico is not only in our best interest but I think also in yours. I am sure that this Committee will know how to combine justice with enlightened self-interest.

Thank you, sir.

Senator MOYNIHAN. I wished I was as sure as you are, Senator.

[The prepared statement of Senator Martin appears in the appendix.]

Dr. Parrilla?

Dr. PARRILLA. Dr. Parrilla will be available for questions if needed.

Senator MOYNIHAN. Well do not stop there. You have time. When I said I hoped I was as sure of that as it was very generous of you to say. It is just such an elusive result always.

Those are three very specific proposals and amendments. They are properly addressed to the Finance Committee. I want to thank you for them.

Dr. Parrilla, would you have any idea offhand what the public debt of the Commonwealth is now?

Dr. PARRILLA. Yes, it is maybe $12.5 to $13 billion.

Senator MOYNIHAN. Oh. So we are talking interest payments of about $100 million a year, in that range?

Dr. PARRILLA. Yes.

Senator MOYNIHAN. $100 to $125 million.

Dr. PARRILLA. Seven percent of that amount.

Senator MOYNIHAN. So we will call it $100 million and round it to that. Your proposal is that this debt—the interest on this debt—continue to be tax exempt for a 10-year period?

Dr. PARRILLA. Our proposal is that the new debt that is initiated in the first 10 years of the Republic will be tax exempt in the interest.

Senator MOYNIHAN. Right. And I should correct myself, it is $1 billion a year in round numbers.

And you are proposing what with respect to new debt, could I ask you that?

Dr. PARRILLA. Yes. I have to clarify that at present S. 712 specifies that the understanding that that interest is tax exempt.

Senator MOYNIHAN. Right.

Dr. PARRILLA. What we are saying is that there is a possibility that we would set down capital loss in the first debts, in the first let's say 5 or 10 years, after Republic. Those can amount to $200 to $300 million a year of new debt.

Senator MOYNIHAN. Right.

Dr. PARRILLA. Some of it, through financing go in debt and some of it to attract new capital. And in that we are asking that the present percentage of interest is maintained.

Senator MOYNIHAN. Gotcha.

Well now I would like to ask three questions each and have the group involved comment on them. First of all, let me say that we have had—I am going to address this question to you, Senator, and to Mr.—no, sir. We are going to address this to you, Mr. Berrocal and Mr. Galper.

Your colleagues who are in favor of statehood have testified before us that the 936 companies have added in the last decade—is that the point Mr. McKee?

Mr. MCKEE. 1980 to 1989.

Senator MOYNIHAN. A thousand jobs were added from 1980 to 1989. That is a decade. That is not many jobs. That would be what General Electric did in the United States, manufacturing employment did not grow. If there were only 1,000 jobs added in the last decade by vigorous industry—936 companies have been very active—why would we expect more than that in say the next decade? What would be the loss in employment?

Mr. BERROCAL. Senator, the number of 1,000 is not a number that I accept.

Senator MOYNIHAN. All right.

Mr. BERROCAL. The rate of growth in the manufacturing sector has increased dramatically over the past five years, particularly with the restoration of a policy of promoting manufacturing. You see in the period when a pro-statehood administration was in power, they in effect started phasing out 936. By raising the rate of taxation from Puerto Rico on these companies the effect of that was to reduce the annual promotion of jobs in half—from 15,000 to 7,000.

We have had a rate of growth in employment, over the past five years, in excess of the rate of growth of the United States, and particularly in manufacturing. It has reached the highest level manufacturing has ever achieved. In 1983 under Treasury's own numbers employment in 936 was 88,000; by 1989 it was 112,000. That is an increase of 24,000 or approximately 25 percent. So there has been significant growth in this sector.

Senator MOYNIHAN. All right. We will leave the record open for any response Mr. McKee might want to make.

Dr. Parrilla, Senator, would you like to comment on that?

Dr. PARRILLA. Yes, of course.

You want the question on Independence or on——

Senator MOYNIHAN. Is 936 producing a serious increase in employment or is it not?

Dr. PARRILLA. No. The 936 are creating, as they say, some employment. But for 10 years they have been fortunate in 936. They have brought very little employment. For 2 years in Puerto Rico, 936 clause, and we have more than 14 percent in unemployment in that same period. That 14 percent unemployment level is a pain because we have almost 1 percent integration per year of the total population. From 1980 to 1989, from that period, we have a net integration from the United States of about 40,000 Puerto Rican per year.

Senator MOYNIHAN. Forty thousand per year?

Dr. PARRILLA. Forty thousand per year.

Senator MOYNIHAN. All right. There is no need to argue. That is your point.

Let me ask then a question about the statehood proposition option. Let's see, who said this? I guess it was Mr. Berrocal said that Federal transfers to individuals under statehood would constitute fully 37 percent of disposable income. That is a large sum and suggests that there are behavioral consequences.

Mr. Cerezo, what would you say to that?

Mr. CEREZO. I defer to Mr. McKee.

Senator MOYNIHAN. Mr. McKee, what do you say to that?

Mr. MCKEE. I am not sure about the calculation of disposable income and the 37 percent. But if you look at the programs that are being implemented, the big hits are Medicaid.

Senator MOYNIHAN. All right.

Mr. MCKEE. Right now Puerto Rico supplies medical services to all the poor with State services. There is a State Public Health Service. It must rely, because of budget difficulties, in many cases on non-certified physicians, for example. So the Medicaid program is really going to replace the Public Health Service with private services or allow the Public Health Services to pay more and provide better services.

Senator MOYNIHAN. Yes.

Mr. MCKEE. Next, SSI. SSI is not really for those poor who have the potential to work.

Senator MOYNIHAN. No, that is out of the labor market. Yes.

Mr. MCKEE. But more importantly, the absence of SSI may even now keep people from the labor force. Remember, given the way this economy has developed, those who are aged are those less likely to have a support network. They are the people who grew up in an undeveloped economy, who had relatively little education, whose job history may have been spotty at best and probably not covered by Social Security. So it is now the old who suffer the most from poverty. They have to be supported by their families, which means that somebody has to stay home and take care of them, take care of the family, so then they cannot work.

Senator MOYNIHAN. So SSI would certainly change that.

Mr. MCKEE. It would certainly change that.

Senator MOYNIHAN. I would like to hear, if we can, if we can get any comments on the 37 percent number we would appreciate it. It is a very important number and we would like to see how you got it.

Mr. BERROCAL. Senator, it appears in the simulations that the CBO conducted.

Senator MOYNIHAN. Oh.

Mr. BERROCAL. The number is 37 percent for statehood and 19 percent for commonwealth. These simulations were made available by CBO to the three parties and they include the dynamic affects of the loss of jobs in the Puerto Rican economy.

Senator MOYNIHAN. Thank you very much. I will take that back to Dr. Reischauer.

Let me ask you a question about independence. Do you believe that the economy of the island would continue in anything like its present level should the relations of the United States be cut off completely? I will ask Mr. Berrocal first then Mr. Cerezo.

Mr. BERROCAL. Our view, senator, is that the CBO study was slightly optimistic with respect to the economic feasibility of an independent Puerto Rico, particularly in the area of the capital flows. The assumption that Puerto Rico could continue to access capital markets for needed private and public investment is very much in doubt and Puerto Rico would face a significant increase in the cost of capital.

Senator MOYNIHAN. But isn't there a—I will ask Mr. Cerezo. Isn't there a prospect of more general development in the Caribbean, the Caribbean Initiative, that some levels of economic union are out there on the horizon a bit that independence would just put—you know, Puerto Rico would be one of about 20 Caribbean countries?

Mr. MCKEE. It could happen. But right now the development of the Caribbean basin is dependent on Section 936. And as I understand it from Mr. Pickle's Oversight Committee hearing last week that is not working very well. What the prospects would be in the absence of that, I do not know.

Senator MOYNIHAN. Well let me hear from Senator Martin. You wrap up and rebut.

Senator MARTIN. Well, let me tell you, Senator, that I think that if we can contemplate the sort of independence that Senate bill 712 contemplates, I think that we are looking towards the option that I think has greatest potential for growth.

Senator MOYNIHAN. Fine.

Senator MARTIN. I think that the bill makes clear the willingness to negotiate a free trade agreement with the United States. I think independence makes possible the cheapening of imports of raw materials and intermediate goods. I think it opens Puerto Rico to the possibility of tax bearing agreements with third nations. And I think it provides the most flexibility for trying to deal with the problems of development in Puerto Rico in a sort of a nonuniform way as is happening today. I see it as the most flexible of the options and potentially the one with the greatest growth.

Senator MOYNIHAN. Fine. Whatever else we may say, there has been no question that these three panels know what they think. And even in summary, know where the numbers come from.

We thank you very much, gentlemen. We will have written questions. The Chairman will send them to you.

Did you want to comment?

Mr. CEREZO. Yes, sir. If I may, I would like to see if the record could be kept open because I notice that Senator Bradley had some questions with regard to an issue on Olympics which we do not think is an issue to be addressed by Congress. That is a private citizen affair, such as those beauty contests. And we would like to submit something in writing.

Senator MOYNIHAN. The record will remain open, remain open for any comments with respect to any kind.

Mr. BERROCAL. Senator, if I just could, this last comment requires a brief response. There is a Federal law called The Amateur Sports Act of 1978. It provides that the international representation of the 50 States and the District of Columbia, by Federal law, can only be pursued through the U.S. Olympic team. This was done in the times of the Moscow Olympics of 1980. That law would be binding on a State of Puerto Rico. That is, I think, the issue that the Senator raised, because there is a legal barrier to that representation under current law.

Mr. CEREZO. Senator, we must take exception to that because no one in Puerto Rico has the pretension of assuming the representation of the U.S. Olympic Committee. We will submit in writing.

Senator MOYNIHAN. We will welcome any comments on that and baseball and other matters.

Mr. CEREZO. Exactly.

Senator MOYNIHAN. Thank you, gentlemen, all. Thank you, gentlemen, for being there.

I am going to recess for 1 minute for a seventh inning stretch and then our final panel—two very distinguished persons.

[Whereupon, the hearing was recessed for 1 minute.]

Senator MOYNIHAN. The Chair is going to ask our guests that those who have to leave do; and those who are going to stay if they might resume their seats.

And now our final panel of the morning, two most distinguished public officials. There is a great, great history behind them. The Chair takes a special pleasure in welcoming the Honorable Teodoro Moscoso, a friend of 30 years from the Kennedy administration times. I will not even presume to read his resume. But to know that he ran the Alliance for Progress under President Kennedy and was later Ambassador under President Kennedy. And Professor Ramon Oyola, who is with the Department of Economics, also at the University of Puerto Rico and the head of the Puerto Rico—President, rather, of the Puerto Rico Government Development Bank.

Good morning, gentlemen. Ambassador, would you please proceed.

STATEMENT OF HON. TEODORO MOSCOSO, FORMER ADMINISTRATOR, PUERTO RICO ECONOMIC DEVELOPMENT ADMINISTRATION, FORMER U.S. AMBASSADOR TO VENEZUELA, AND FORMER U.S. COORDINATOR, ALLIANCE FOR PROGRESS, U.S. DEPARTMENT OF STATE, SAN JUAN, PR

Mr. Moscoso. Mr. Chairman, in the interest of saving time I would like to skip the reading of my statement.

Senator MOYNIHAN. It will go in the record as if read.

Mr. Moscoso. Pardon me?

Senator MOYNIHAN. It will be put in the record as if read. You are a privileged person.

Mr. Moscoso. Then I will proceed to make my brief comments.

Senator MOYNIHAN. Please do, sir.

Mr. Moscoso. The only reason I am here probably is because I had something to do with the creation of the program in the first instance and have continued to have an interest in its development over a period of many years—the Fomento Program as it is called.

Senator MOYNIHAN. Fomento.

Mr. MOSCOSO. It is sometimes attributed to be my child. That is wholly unjust because there was quite a number of people involved in that Program at various times.

But I do want to stress a few points that have not been mentioned sufficiently this morning here. For instance, when commenting on the effects of statehood both the Treasury testimony and CBO stress the fact that there will be a loss of investment and there will be a loss of jobs now present in Puerto Rico, or at least a substantial reduction of that investment.

My greatest fear is in the real commitments. I do really feel that without the tax attractions that we have today there will be great difficulty in being able to match conditions in other areas. Our weight structure is an extremely high one within the area where we live, in the Caribbean, and Latin America generally. It is much higher than most of the Pacific areas where some of these companies could move to.

But the process of bringing in additional increments of capital is going to be extremely difficult without offering tax benefits. I do not think that enough has been done to try to gauge the impact of that situation. New investments, to effect new investments, new promotions, how is that going to be affected by the elimination of 936 under statehood?

Now I think that my friend Professor Oyola is going to mention the fact that tourism is going to pick up the slack when statehood is the relationship between Puerto Rico and the United States and 936 is no longer available. Well in the first place I do not think that Mr. Oyola has had enough experience trying to get investment into Puerto Rico with or without 936.

Senator MOYNIHAN. You have been there, I take it.

Mr. MOSCOSO. I have. It is very different.

In the second place, tourism has a limited possibility in Puerto Rico. You are dealing with an entirely different situation than in the case of Hawaii or even in the case of the surrounding islands. We are a highly overpopulated area. We have close to 1,000 people per square mile; and it is even difficult to find appropriate sites for the construction of these facilities, let alone to build many Caribe Hiltons to take the slack created by the loss of industrial manufacturing jobs which might be lost without the 936 attraction.

I do not believe that the Congress is aware of the tremendous job that was done by Puerto Rico during the past two or three decades in economic development as compared to other areas. We have a notion here in the United States of instant everything—instant coffee—therefore, almost anything can be done instantly. That just simply does not happen, Mr. Chairman.

I remember sitting in front of a distinguished group in the Committee Room in this Congress back in 1961 and being belabored because we had not built under the Alliance for Progress an airport for Bolivia in about 9 months time.

Senator MOYNIHAN. Right. You were already 9 months in place.

Mr. MOSCOSO. Yes. I remember that the Chairman at that time was the distinguished gentleman from Missouri—no, from Louisiana—Mr. Pasman.

Senator MOYNIHAN. Yes, sir.

Mr. MOSCOSO. I have fond memories of Mr. Pasman.

I remember telling Mr. Pasman that the Dulles Airport had taken about 25 years and $40 billion. By that time it was not finished yet. Now what I do not think we are aware of is what it takes to develop a country economically. Perhaps it is because the United States has never deliberately tried to develop a country. In the case of Puerto Rico, it is a whole different plan of development. That is, what we obtained is acquiescence; we obtained assistance. But there was really no planned effort.

The best we ever did was to send a very intelligent wise person to be Governor of Puerto Rico at the time when the President of the United States selected our Governors—Mr. Rexford Guy Tugwell, who believed in planning. A word which is forbidden around these parts. And Mr. Tugwell tried to plan economic development for Puerto Rico. And some of the results we see today, are due to the plan done by Mr. Tugwell.

Of course, he was assisted by that political genius, Mr. Muñoz Marin, who eventually became Governor of the island. But the basic plan, the fundamental work, was done during the term of Mr. Tugwell as Governor, with Governor Muñoz Marin holding the fort at the legislature and backing him with all of the proposals that came forth to try to develop the infrastructure and then the economy of Puerto Rico.

Senator MOYNIHAN. That being the 1930's.

Mr. MOSCOSO. That is right.

Since the island of Puerto Rico has no resources to develop except its people, we have very little. We spend millions preparing geological maps, geophysical maps, and mineralogical maps, land use maps, et cetera, et cetera, and we have not been able to find any natural resources which will support this level of population.

It has been necessary to do something with what was available to us, and that was this relationship between Puerto Rico and the United States. We have made full use of it and I think good, constructive use of it. I do not think we have to be ashamed of it.

As a matter of fact, I have a piece of paper here that is my particular pride and joy. This is a paper written in 1961 by a person I think you know—Ken Boulding. Professor Boulding wrote this paper for a publication of the Center of Democratic Institutions.

Senator MOYNIHAN. Oh, indeed.

Mr. MOSCOSO. Bill Bancus is one of those who wrote in that particular issue of this publication. This issue is devoted to the United States and revolution. And Professor Boulding mentions the three most recognized revolutions, of course—the American, the French and the Russian.

Then he says, "But there is a fourth revolution. There is a fourth type of revolution which does not fit into any of the above categories and which may be the most important for all in the long run." It is called the Fomentarian Revolution in honor of a remarkable institution in Puerto Rico which is known as Fomento.

He analyzes the case for the Fomentarian development for circumstances such that it can be successful. It can also be fairly cheap. Socialist development is obtained at a terrible cost. Capitalist development, likewise, has a high cost in benefits foregone. We should look carefully at those social purposes aside from Puerto Rico, that seem to make the best of both worlds, both government and private enterprise, both domestic organizations and foreign investment. These are the kinds of revolution that one would like to see encouraged.

Senator MOYNIHAN. If I may, I would like to include that in the record. Could you provide us with a copy of that?

Mr. Moscoso. Yes, I think that would make good reading.

Senator MOYNIHAN. It was very eloquent.

Could we hear from Professor Oyola and see where you are going to put those 300 Caribe Hiltons. Is that what you said, Ambassador? One hundred Caribe Hiltons. I see.

I am sorry, Mr. Walter Davila is accompanying Mr. Oyola. We welcome you, sir, to this Committee. You are a good friend of our deliberations in so many ways over so many years.

[The prepared statement of Mr. Moscoso appears in the appendix.]

STATEMENT OF PROFESSOR JOSE RAMON OYOLA, PH.D., SCHOOL OF MANAGEMENT, UNIVERSITY OF PUERTO RICO AT MAYAGUEZ CAMPUS AND FORMER PRESIDENT, PUERTO RICO GOVERNMENT DEVELOPMENT BANK, TESTIFYING ON BEHALF OF PUERTO RICANS FOR CIVIC ACTION, MAYAGUEZ, PR, ACCOMPANIED BY WALTER J. DAVILA-BENAVENT, REPRESENTATIVE FOR PRCA

Mr. OYOLA. Thank you for the opportunity to express our views on the economic implications of statehood for Puerto Rico. I represent Puerto Ricans in Civic Action, (PRCA) a grassroots movement that has obtained 350,000 signed petitions of residents of Puerto Rico requesting statehood for the island.

I served in the Cabinet of the present Governor of Puerto Rico in 1985 and 1986 when I was President of the Government Development Bank. I have a Doctoral Degree in Economics from the University of California.

S. 712 provides for the referendum in 1991 to allow U.S. citizens in Puerto Rico to choose between three status formulas. We urge you to approve S. 712 with its present transition rules which we believe allow a smooth conversion of the commonwealth economy into the economy of a state.

The experience of previous U.S. territories has been that statehood creates a new economic environment in which the gains to the majority of the people are greater than the losses of a few in the territory. This Committee already asked the Congressional Budget Office to examine the economic implications of a change in the political status of Puerto Rico. The results have been widely discussed in previous testimony this morning.

I would like to make a point regarding the limitations of the model that was utilized to arrive at CBO's conclusions. CBO's model is what is called a "demand side" model. It does not have any supply side factors in it. Which means, for example, that if you ask the CBO to utilize that same model to determine whether the State of New York should be declared an independent republic, the model will conclude that the State of New York should secede from the Union.

The reason for this is that the U.S. Treasury collections in the State of New York are greater than the Federal expenditures in the same State. In other words, that model is not able to factor in the most important elements of statehood for Puerto Rico.

The CBO's first assumption is that only two events will happen under statehood—namely, the phase out of Section 936 benefits and the introduction of Federal tax entitlements. The CBO says nothing about the opportunities that will arise under statehood in the sectors of tourism, health, transportation, communications, education, and provision of retirement services, to name just only a few.

With our limited resources we were only able to quantify the effects of the tourism sector when statehood arises. Tourism will become a leading industry in Puerto Rico, like in the State of Hawaii. Tourism does not need Federal tax subsidies to attract investors to Puerto Rico; and it depends on the resources that Puerto Rico has in abundance—namely, its natural resources, tropical climate, outstanding scenery, a distinctive culture with hospitable people, and the fact that we are service oriented.

The main drawback of the current status to achieve a major increase in our tourism sector is that most U.S. tourists consider Puerto Rico as a foreign location, not as part of the United States. Under statehood there will be several factors on the supply side which will work together to increase the number of tourists in Puerto Rico.

The first one is the massive publicity surrounding Puerto Rico's entrance into the Union. The second is the infrastructure. The infrastructure that is necessary to achieve a tripling of the size of the tourism industry in Puerto Rico is already in place.

For example, our international airport is the Caribbean hub of American Airlines and is served by more than 20 airlines. Another element in the supply side that is already in place is current hotel investments. The States of Hawaii and Puerto Rico will share in common the Japanese investors who have specialized in financing, constructing and managing tourist resorts.

In the appendix to my testimony I provide evidence of the commitment of Japanese investors to develop hotels in Puerto Rico. For example, right now there is a $1 billion Costa Isabela project, which would be the largest hotel resort in the Caribbean. It is a 2500 acre complex with five golf courses, 36 tennis courts, 2,000 hotel rooms and 8,000 employees.

The first table in my testimony presents a conservative forecast for the tourism industry under statehood until the year 2000. This forecast was not obtained by applying mechanically the experience of Hawaii to Puerto Rico, but rather by adjusting the trends that already exist under commonwealth for the change in Puerto Rico status. Total jobs generated in the tourism industry will triple from 57,000 jobs in 1988 to 150,000 jobs in the year 2000. That is more than enough to compensate for any manufacturing job loss due to the phase out of Section 936. This new supply side development is not anywhere in the CBO report.

[The prepared statement of Mr. Oyola appears in the appendix.]

Senator MOYNIHAN. Dr. Oyola, I am afraid that the hour of 1:00 having been reached, under our rules we are going to have to close.

I will break the rules, if nobody tells the Sergeant at Arms, to say that you might want to finish up.

Mr. Davila, would you like to say something? Your point is about a supply side model. That was your specialty at the University of California. You took your dissertation in modeling, didn't you? It is beyond me, I assure you.

STATEMENT OF WALTER J. DAVILA-BENAVENT, REPRESENTATIVE FOR PRCA

Mr. DAVILA. Thank you for the opportunity, Senator. What I would like to do is just applaud your leadership, the leadership of Chairman Bentsen, Chairman Johnston, and Senator McClure on the Senate side, who have not been lost in the details but have kept a vision of what this means for the nation, for Puerto Rico, and for the international community.

The CBO report is full of caveats, possibly more caveats than any of the previous reports. And you were correct in pointing out that these are major issues of self-determination that are at stake. My major concern at this time is that the House is pointing its collective finger at the Senate to excuse its action awaiting the Senate's final action.

Senator MOYNIHAN. Inaction.

Mr. DAVILA. Inaction, yes.

I am also saddened to see the passing of the most vocal voice of the Senate that knew how it feels to be like on this side of the fence in trying to achieve statehood. I am talking about Senator Matsunaga, who in the meetings that we had was most emphatic saying that the biggest economic change of Hawaii came after statehood and he could not see why Puerto Rico did not recognize that.

So this is the only point that I wanted to bring to you today. And like I said, to applaud the leadership that the Senate has had. I am sorry to see that the House at this point still has time to act and Puerto Rico needs its action.

Senator MOYNIHAN. We thank you, sir.

Ambassador, would you like to close the morning?

Mr. MOSCOSO. Yes. I would like to find out from Dr. Oyola, who is right next to me here, whether he changed his views put down in a report prepared in 1984 in which he stated that statehood would result in the loss of at least 170,000 jobs in the private sector, given that more than half of the 936 corporations established in the island would leave with the imposition of Federal taxes, and also that the Puerto Rican Government had to dismiss more than 116,000 employees under statehood.

Now he wrote that in 1984. And today he is saying things which are slight contrary. Which statement is correct?

Senator MOYNIHAN. The Chair rules that economists have the right to change their minds. [Laughter.]

Dr. Oyola, would you like to, in a good natured way, respond to that?

Dr. OYOLA. Certainly, I believe in progress.

I would like to comment on that because it is important for the people of Puerto Rico to decide and to know what is the process, the decisionmaking process, that will lead us to make a final decision with respect to political status.

I made a change, as he mentioned, I was a commonwealth advocate in 1985 and I believe now that statehood is better for Puerto Rico economically. Why is that? Because I read carefully the S. 712 and all the studies that have been done regarding the economic impact of statehood for Puerto Rico. Many things have changed since 1985. Federal taxes have gone down. Federal transfer payments have gone up. The government sector in Puerto Rico is a drag on the economy that will never be resolved and unless there is a change in political status.

So there are many, many factors that once you think about it carefully will lead you to the conclusion that statehood is better for Puerto Rico and for the United States also.

Senator MOYNIHAN. Well, that is a perfectly coherent response.

May I just say that the Committee is much in the debt to our witnesses, especially those from the Commonwealth, the island, who have come here prepared, thoughtful, collegial, and deeply concerned about something which commands—you know, here is an issue worth being involved with. We would hope to do our work. We will be after you for more information. The record will remain open.

The Chair would like particularly to recognize Dr. Ferre's presence here. There has been no more law and affective exponent of that particular view in the history of the island.

With that, we thank our staff and all concerned; and this hearing comes to a close.

[Whereupon, the hearing was adjourned at 1:10 p.m.]

APPENDIX

Additional Material Submitted

Prepared Statement of Jose Berrocal

Mr. Chairman and Members of the Finance Committee, I am pleased to have the opportunity to speak with you today on the potential economic impact of S. 712 in Puerto Rico.

I am Jose Berrocal. I am by training a lawyer and currently serve as Counsellor to the Governor of the Commonwealth of Puerto Rico.

I come to represent the views of those of us in Puerto Rico who believe that our Commonwealth status is and should continue to be an instrument for assuring the continued dignity and progress of our people.

Throughout this debate, it is crucial to keep in perspective the fact that the issue of our political status essentially responds to the desires and aspirations of our people for stability, dignity and prosperity. For us Puerto Rico's political status is a means to an end.

As proponents for the enhancement of the present Commonwealth relationship, we seek to improve what has proved to be a practical and unequaled creative solution for the problems of a developing society in its aspirations for dignity and progress.

For almost a century, Puerto Rico has been a part of the United States. During the first half of the century, Puerto Rico was "a stricken land," suffering from desperate poverty and destitution, and frustrated by the unresponsiveness and insensitivity of a colonial system of government. Then, with the establishment of Commonwealth status in the early 1950's Puerto Rico experienced a dramatic turnaround. A new political relationship gave Puerto Rico the opportunity to pull its economy up by its bootstraps and dramatically improve socioeconomic conditions on the island. Spearheaded by an aggressive investment promotion campaign, and maximizing the use of its fiscal autonomy, in the span of just two generations, "the poorhouse of the Caribbean" emerged as a bustling and industrious society, and today Puerto Rico enjoys one of the highest standards of living in Latin America.

This dramatic improvement in living conditions was forged on the basis of a productive and dignified partnership, through which the United States helped Puerto Rico help itself.

What we seek today is to enhance that partnership with policy tools that will bolster our self-sufficiency, contributing in our own way to the greatness of the United States as a small but hardworking society. What we seek is opportunity. What we aspire to is more jobs.

The CBO report on the "Potential Economic Impact of Changes in Puerto Rico's Status under S. 712" confirms that under Commonwealth, Puerto Rico will continue on the road of greater economic progress and growth. It also concludes that with the loss of Puerto Rico's fiscal autonomy, statehood would severely affect the capacity for growth of the Puerto Rican economy, and would in fact lead to significant job loss. In essence, the report confirms that a change in status toward statehood would entail substituting jobs for welfare.

This testimony will comment further on the analysis and conclusions of the CBO report, while attempting to place some of the critical economic and fiscal issues in adequate perspective. More specifically, I will address the following points:

- Puerto Rico's challenges as a developing society in an insular setting with limited natural resources, and the role of fiscal autonomy in economic development.
- The general conclusions and specific estimates of the income and employment effects of a change in Puerto Rico's political status contained in the report.

• Certain areas not fully covered by the report, including:

—the impact on the non-manufacturing sectors of the economy
—the effects on the financial sector
—the effect on Puerto Rico's access to capital markets, and;
—the effect on the Puerto Rican government sector and its fiscal soundness.

POLITICAL STATUS, FISCAL AUTONOMY AND ECONOMIC DEVELOPMENT

Before reviewing the specifics of the CBO Report, one should examine basic background information that is only briefly alluded to in the Report: the history of modern economic development in Puerto Rico, its relationship to the island's political status and the role of its fiscal autonomy in attracting investments.

The dilemma of achieving sustained economic growth and development for an island society besieged by competitive disadvantages flowing from its exceedingly scarce natural resources, chronic labor surplus and relatively remote location vis-a-vis its natural export markets, has been at or near the center of political life in Puerto Rico for over a century. As the CBO Report makes clear, tax incentives for productive investment have been a successfully implemented policy option for Puerto Rico under the Commonwealth relationship and the fiscal autonomy which is an integral part of that relationship.

The Puerto Rican economy has undergone a remarkable transformation over the past forty years. The Commonwealth has developed from a poverty-stricken, primarily agricultural economy in the 1940's to one driven by export-led manufacturing. The manufacturing sector's share of total output increased from 17% in 1950 to 40% at present. This transformation was the result of an economic development strategy based on positioning Puerto Rico as a competitive, low-cost manufacturing site for labor-intensive commodity consumer goods, such as apparel and footwear, within the U.S. common market.

The key competitive factors that supported this strategy and made it consistently successful for over three decades included:

• The relatively low level of wages prevailing on the island in relation to the relatively high productivity of the Puerto Rican worker once he was trained for industrial work;

• The relatively low cost of energy in Puerto Rico visa-vis the U.S., since the island was outside the protectionist oil import arrangements of the U.S., and was thus able to source cheaper foreign oil; and

• The relatively weak international competition of the postwar years, combined with relatively high tariff protection in the U.S. for the consumer goods which Puerto Rico began manufacturing.

The most significant competitive disadvantage that Puerto Rico had to overcome was the inordinately high transportation costs associated with its particular location as an island 1600 miles away from its main supplier and export market, while at the same time being forced to ship on high-cost U.S. flag vessels under the provisions of the Jones Act. Puerto Rico began to overcome this disadvantage in 1948 through the passage of a comprehensive program of tax incentives for productive investment in manufacturing which, when combined with the predecessors of Section 936 of the U.S. Internal Revenue Code, provided a strong offset to the transportation cost disadvantage and allowed Puerto Rico to begin its transformation to an industrial society.

This powerful combination of Federal and Commonwealth tax incentives was, of course, rooted in Puerto Rico's traditional fiscal autonomy which dated back to the establishment of the island's first civilian government after the Spanish-American War. Fiscal autonomy and the policy alternatives it offered Puerto Rico, which only began to be exploited in the 1940's, would continue to be the cornerstone of successful economic development policies in Puerto Rico throughout its modern growth phase.

The foregoing strategy and combination of competitive factors served Puerto Rico well into the 1960's and early 1970's, although weaknesses started to appear over time by the mid-1970's.

The key factors which led to declining competitiveness were:

• Beginning in the late 1950's, but accelerating throughout the 1960's and 1970's, industries in Puerto Rico, mostly as a result of economic development it self, were experiencing rising wage rates in excess of productivity gains. Thus, Puerto Rico's labor cost advantage over other U.S. locations, and certainly over newly-industrializing foreign locations, was ending. This trend reached its climax in the late 1970's and early 1980's with the full applicability of U.S. minimum wage rates in Puerto Rico.

• The lowering of U.S. trade barriers beginning with the Kennedy Round of tariff reductions in the early 1960's, coupled with more intense foreign competition in the markets for Puerto Rico's traditional labor-intensive manufactured goods, dramatically heightened competition for Puerto Rico's industries. In later years, particularly the early and mid-1980's, this was further exacerbated by significant increases in the value of the dollar, which made the U.S. economy in general—and Puerto Rico's in particular, because of the relatively heavier weighting of manufacturing in its economy—less competitive with foreign countries.

• The reduction in the incentives provided under Puerto Rico's industrial incentives law enacted in 1978 by an ideologically motivated pro-statehood administration, the net effect of which was to cut in half the number of jobs promoted annually by our Economic Development Administration.

• The enormous increases in oil prices in 1973 and 1979 made energy costs in Puerto Rico, which is almost 100% dependent on foreign oil for its energy needs, much higher than in alternative U.S. or foreign locations.

• The high inflation/high interest rate scenario that characterized much of this period, particularly the mid-1970's and early 1980's, was an additional negative event for a developing economy like Puerto Rico's that is highly dependent on external financing sources for both private and public investment flows.

The combined result of these negative developments was that Puerto Rico, which had consistently outperformed the. U.S. economy as a whole for approximately two decades, began to suffer much lower rates of growth and higher unemployment, in general underperforming the U.S. economy from 1975 to 1985. In 1983 unemployment peaked at 25%, the highest level in recent decades.

From 1986 to the present, Puerto Rico has been able to mount a significant comeback for the following key reasons:

• Restoration of tax incentives for manufacturing and tourism, which contributed to a substantial recovery in these sectors.

• Beginning in 1986, oil prices began to collapse, leading to a dramatic improvement in the current account and energy cost competitiveness of the Puerto Rico economy. Although this trend has moderated in the last 12 to 18 months and in fact may have reversed, energy prices are still significantly below the peaks reached in the early 1980's.

• Beginning in late 1985, the dollar has generally weakened in relation to other currencies, with significant competitive benefits for U.S. industry in general, and Puerto Rico's in particular.

• Increases in labor costs moderated in relation to productivity increases, particularly after Puerto Rico absorbed the full implementation of U.S. minimum wages on the island by the early 1980's and this process was followed by a relatively long period of stable minimum wage levels in the U.S., which have only recently been revised.

• Interest rate levels and inflation have generally subsided since 1983, which has led to a stronger public and private sector financial posture in Puerto Rico and lower cost of capital for investment projects on the island.

• The one moderately negative factor during this period of time has been the relatively diminished value of, and uncertainty over, the tax incentives that Puerto Rico can offer, as a result of the lower corporate tax rates generally introduced in the Internal Revenue Code of 1988. Nevertheless, tax incentives continue to play a key role in Puerto Rico's development strategy and in preserving the island's competitiveness.

The foregoing factors have led Puerto Rico to a relatively strong economic performance over the last four years. In fact, as the U.S. itself knows all too well, we now live in an economically interdependent world characterized by dramatically heightened international competition in most industries, continuous change and volatile markets.

It is clearly not easy even for a large developed country like the U.S. to compete in this sort of market; it is much more difficult to cope with the stringencies of such a market for a much smaller, less well-endowed, developing society such as Puerto Rico's.

Nevertheless, Puerto Rico, with all its limitations, has excelled in the past in being able to design and implement an effective economic development strategy and has over the long-term succeeded where others in our region have failed. I have no doubt that we can again meet the challenge and continue our progress toward a better standard of living through our own effort and ingenuity. But I also have no doubt that an essential ingredient to continue Puerto Rico's development at this stage is a continuation of the fiscal autonomy we have enjoyed for the last 90 years and the valuable tax incentives that we can offer under such autonomy.

These tax incentives still provide Puerto Rico with a unique "equalizing" advantage to help it overcome the island's great locational disadvantages relative to alternative investment sites. Consequently, Puerto Rico still needs—to continue on its path to economic development—a political relationship with the U.S. like the current one, which affords it the flexibility and breadth of action required to craft a distinct economic development strategy, suited to its own needs and priorities, and rooted in its own resources and limitations. An essential component of such a relationship has historically been, and should continue to be, fiscal autonomy.

CBO REPORT

Every major study ever conducted of Puerto Rico's economic condition recognizes the paramount importance of our tax autonomy to our continued prosperity. The current *CBO Report* is the latest in a long line of serious studies with analogous results—the United States—Puerto Rico Status Commission, the Kreps Report, as well as private studies by the nation's leading independent firms—Booz Allen, ICF, Inc., Robert Nathan & Associates, Peat Marwick Policyeconomics, among others.

The CBO Report is, within the constraints imposed by time and data readily available for the analysis, and the limitations inherent in all econometric models, a careful, well-researched attempt at assessing the impact of a change in Puerto Rico's political status under S. 712. Of all the studies undertaken so far by Federal executive or legislative agencies, the CBO Report best conveys the severe economic dislocation that statehood would impose on the Puerto Rican people. Nevertheless, I believe there are several limitations in the analysis that make even these severe results a best case scenario for statehood or independence, significantly underestimating the magnitude of the effects.

Despite its limitations, the CBO Report clearly and unequivocally demonstrates, beyond any doubt, that statehood would entail a permanent and significant loss to the Puerto Rican economy at the same time that the U.S. Treasury is permanently and adversely affected. The CBO Report shows a loss of 10 to 15% of real GNP by the year 2000. To put in perspective, this would be equivalent to a permanent loss of between $550 and $825 billion for the U.S. economy, or if the combined economies of Texas, New Jersey, West Virginia, Minnesota, and Arkansas suddenly disappeared.

This loss in GNP is but the beginning of the story. The results of the CBO economic model, not published in the report, but submitted to all three parties demonstrate even larger effects in other indicators. For example, construction would decline from 27% to 33%. Instead of a source of jobs as statehood proponents are predicting, the construction industry would collapse. National income, which is the measure of the flow of earned income sources (wages and salaries, rents, interest) would decline from 18% to 26%. In particular, wages and salaries of the Puerto Rican workers would decline by 17% to 26%. If the same thing were to happen to the U.S. this would be equivalent to the loss of $480 to $730 billion in wages and salaries.

The CBO study also demonstrates that the statehood economy would lose its capacity for self-sustaining growth. By the year 2000 Federal transfers to persons would increase to $11.8 billion, an increase of 65% over Commonwealth status. *Federal transfers to individuals would constitute fully 37% of disposable income.* Under the state of Puerto Rico, Federal transfer would no longer be a safety net, but the primary economic base preventing a total economic collapse.

We believe the CBO report severely underestimates the impact of statehood on unemployment. ~~CBO~~ estimates the loss between 50,000 to 100,000 jobs. In the U.S. this would be equivalent to the loss of 6 to 12 million jobs. This result, while quite dramatic (a loss of 5 to 10% of the labor force), is not consistent with the CBO result that 25% of wages and salaries would be lost. The problem is a methodological one. While CBO's economic model carefully links investment, income, and output flows, employment is treated as an add-on to the model. Even if we account for the fact that under statehood a relatively high proportion of the higher paying jobs would be lost, a 25% decline in wages implies at least IS to 20% decline on the number of jobs.

Another significant result of the CBO study not included in the report, but submitted in the simulations given to all three parties, are the impacts on the U.S. Treasury. The CBO study estimates that the net additional Federal transfers under statehood would increase by $4.0 to $5.0 billion dollars annually by the year 2000.

Numerous studies have concluded that the investment process of 936 companies is highly tax sensitive, both for new and existing firms. Based on these studies, CBO's estimates of the reduction in productive investment and employment by 936 firms over time as a result of changes in the tax relationship between Puerto Rico and the United States are a best case scenario. That is, I would expect a *larger* effect to occur *faster* during the years subsequent to such changes.

The reason for the CBO's very significant, but less dramatic estimates of impact on private investment and employment stem, I believe, from a relatively benign assumption of the tax sensitivity of the investment process of industrial corporations in Puerto Rico.

There are a number of adverse economic impacts on Puerto Rico of a change in political status under S. 712 that are not explicitly addressed in the CBO Report. The CBO projections are in effect a best-case scenario for either alternate status. with respect to Statehood, CBO does not measure (1) the effect on the non-936 sector of the imposition of Federal taxes; (2) the effect on economic growth of the loss of the so-called 936 funds, which account for 40% of our bank deposits; (3) the effect on the market for Puerto Rico securities, and (4) the effect on governmental finances.

First, CBO did not fully *capture* the supplyside impact on the non-industrial, non-936 sectors of the economy, which account for approximately 40% of our economy. To understand this point, one must first understand the general composition of Puerto Rico's economy. There are only three fundamental, primary sectors in Puerto Rico's economy; manufacturing, tourism and agriculture. A "primary sector" for this purpose is one which generates incremental income, production and employment for Puerto Rico because it produces either: (a) an exportable good or service, or (b) a substitute for the import of a necessary good or service. All other sectors of the economy, such as construction, services, utilities, transportation and even government, in fact rely upon demand for their services from the primary sectors to generate their own income and employment.

In Puerto Rico's case, manufacturing is, and has been since the 1950's, the primary sector on which the rest of the economy has relied for overall economic growth. It currently accounts for approximately 40% of the island's gross domestic product, while the other two primary sectors, tourism and agriculture, together account for less than 10% of gross domestic product. Hence, non-primary sectors of the economy, which account for approximately 50% of gross domestic product in Puerto Rico, and which rely fundamentally on the secondary income and employment effects of manufacturing activity, would suffer dramatically from any reduction in the levels of investment and production in the industrial sector.

It is our policy for Puerto Rico to strive, as a long-term goal, to increase the contribution of both tourism and agriculture to gross domestic product. However, because of our limited land resources and relatively high labor costs, neither tourism nor agriculture can in the short-run nor even in the longer-term, make up the income and employment losses of the manufacturing sector to the overall economy under a change in political status.

Another important adverse impact of statehood would be a significant reduction in the employment and income of the financial sector, stemming from the fact that 936 deposits account for 40% of all deposits in Puerto Rico's financial system. A capital flight of such magnitude would dramatically increase interest rates, thus shrinking reducing consumption and investment in the economy.

The availability of low cost 936 funds has given Puerto Rico a significant impetus in the area of capital improvements for both public and private projects. Currently, 936 funds are generally available at 1.75 percentage points lower than LIBOR funds. It has become a crucial issue in the Caribbean Basin Initiative, as 936 funds have emerged as an important source of developmental funds for the Caribbean region as a whole.

With respect to the market for Puerto Rico securities, I would like to submit for the record the Statement of the Securities Industry Association of Puerto Rico (the "SIA") delivered to the U.S. Senate Committee on Energy and Natural Resources during public hearings on S. 712 in San Juan, Puerto Rico in June 1989, which establishes (1) that the loss of the so-called "triple tax exemption" of Puerto Rico municipal bonds, (2) the Federal taxation of non—exempt Puerto Rican debt, and (3) the virtual elimination of the market for certain types of mortgages and mortgage-backed securities related to housing in Puerto Rico, would result in a significant increase in the cost of capital for public and private sector economic development projects and infrastructure in Puerto Rico. It would therefore materially adversely affect the future growth of the Puerto Rican economy. This effect, however, is not directly taken into account in the CBO Report.

A final key area of analysis of the economic impact of a change in the political status of Puerto Rico that is not adequately covered by the CBO Report is the effect of a status change toward statehood on the finances of the public sector of Puerto Rico.

The critical effect that must be carefully evaluated is the revenue impact on the Commonwealth government of the imposition of Federal income taxes on corporate and individual residents of Puerto Rico. Specifically, such an imposition of Federal taxes would immediately tend to displace the Commonwealth's existing tax base and impair its ability to continue funding budgetary expenditures from traditional revenue sources.

This displacement of current tax base would force the Commonwealth to choose between retaining its present tax rates resulting in uncompetitively high levels of combined Federal and state taxes in an attempt to preserve current levels of expenditures or the implementation of severe cutbacks in such expenditures in public services in order to be able to live within more limited revenue sources. Our studies indicate that if Puerto Rico were to lower its taxes to the level of the higher-taxed states, the revenue loss would exceed $1 billion annually, and would require reducing government services, and laying off 90,000 government workers.

The fundamental reasons for this fiscal dilemma for the Commonwealth should not be lost sight of, for therein lies the basic reason for not incorporating Puerto Rico into the Federal tax system: with a per capita income that is only a third of the U.S. national average, Puerto Rico cannot be expected to carry a full Federal tax burden and still be realistically expected to sustain state government tax revenue levels necessary to pay the cost of basic public services expected in a developing industrial society. Hence, under statehood, the government of Puerto Rico could realistically only be expected to provide a standard of public services significantly lower than the current one, in line with its income per capita relationship to the rest of the nation, with likely adverse effects on the quality of life on the island and long-term increased labor migration prospects.

The second direct adverse effect on the public sector of Puerto Rico arises from the negative consequences of a status change on the cost of capital for essential public sector investment projects, notably infrastructure. These negative consequences arise from two main sources: the loss of Puerto Rico's current tax advantages with respect to its public sector borrowings, and the general deterioration of the credit quality of the Commonwealth under a status change.

The first of these relates to the fact that the borrowings of the Puerto Rican public sector currently rely heavily on various key tax advantages that we described earlier; specifically, the "triple tax exemption" of Puerto Rico bonds in the U S. tax exempt market, and the existence of a local tax exempt market to tap available local savings at a relatively low rate when the U.S. market is unavailable. The loss of these two advantages under a status change would lead to a narrower and costlier market for Puerto Rico bonds.

The second source of negative consequences of a status change on the Puerto Rican public sector's cost of capital relates to the general deterioration of creditworthiness of the Commonwealth as a result of the shrinkage of its tax base and the impairment of its revenues which was described above.

The combination of these two factors leads to sharply reduced availability of credit to Puerto Rico's public sector and a higher cost of capital and, consequently, lower public investment in growth-sustaining projects, particularly infrastructure necessary to support private sector investment, which itself would likely be constrained by inadequate infrastructure. This constraint, in turn, would negatively impact aggregate demand in the economy as a whole, with a resulting reduction in overall growth and employment in the economy vis-a-vis the CBO's baseline projections under Puerto Rico's current political status.

Much has been said by statehood critics of the CBO report that it unfairly omits the unquantifiable benefits of statehood. These so called benefits are quite trivial if at all existent. They argue that Statehood would change perceptions of the Island that would supposedly increase incentives to invest. I can assure you gentlemen that the vast majority of investors are sophisticated and would not be swayed by whether Puerto Rico appears or fails to appear in a AAA map of the U.S., as was previously testified. The American business system is motivated by profits. The competition for business investment is intense. Puerto Rico is an established, well known player in this business with nine promotional officers all over the U.S. and seven internationally. The KPMG Peat Marwick report clearly demonstrates that statehood would result in substantial loss of profitability compared not just to Commonwealth, but with respect to alternative foreign locations in Singapore, Ireland, Taiwan, Mexico and others.

I would not expect these negative effect on private investment and employment to be mitigated significantly by any sort of "political certainty" benefit accruing under statehood. Corporate investors in Puerto Rico are among the United States' most sophisticated transnational industrial corporations which are well accustomed to investing in foreign locations and assessing "political risk," and already operate numerous alter native cost-effective foreign locations for the investments they make in Puerto Rico.

Furthermore, such investors generally do not, in fact, view the Commonwealth as possessing any significant element of "political risk" at present and are, therefore, driven predominantly by financial and tax criteria in their locational evaluations of Puerto Rico vis-a-vis alternative U.S. or foreign locations.

In fact, political risk surveys consistently rank Puerto Rico under Commonwealth as one of the safest locations in the world, surpassing, in fact, many OECD countries.

Tourism has also been presented as the savior of the economy under statehood.

The so-called unquantified benefits under statehood for tourism are based on an extremely naive assessment of marketing and financial realities. Tourists do not flock to Hawaii because of statehood. Hawaiian tourism must be evaluated in terms of its limited competitors in the Pacific. Statehood did not prevent Miami Beach from losing its competitive position vis-a-vis the Caribbean and Mexico for visitors from the Eastern Seaboard.

Puerto Rico must compete with all other Caribbean islands, Central America, Southern Florida and Mexico for the U.S. tourist. These locations combined surpass the number of visitors to Hawaii. Puerto Rico is faced, because of its relatively high wages, with being a high cost location.

The statehood strategy for tourism was already tried and it was an utmost failure. When statehooders came into power—they eliminated tax incentives for tourist hotels. The loss of tax incentives for tourist hotels resulted in a collapse of tourist investment with a loss of almost half of the hotel rooms. The same loss would result under statehood. In 1985 tax incentives for tourist hotels were restored. This resulted in a boom of hotel investment, and a doubling of capacity and double-digit growth expenditures.

In summary, neither Statehood nor independence offers any coherent economic model so that the people of Puerto Rico can continue to prosper through their effort and ingenuity. Only through Commonwealth can the Puerto Rican people continue to prosper; through its enhancement it can work even better.

Prepared Statement of Benny Frankie Cerezo

Good morning Mr. Chairman. My name is Benny Frankie Cerezo, and I am here today in my capacity as Presidential Delegate of the Puerto Rican Statehood Movement. I am pleased to testify this morning before you and your colleagues on S. 712 on behalf of the Puerto Rico Statehood Movement and its political instrument, the New Progressive Party. I am accompanied by Mr. Michael McKee, an economist. With us is a group of well-respected Puerto Rican economists and tax experts, Gerardo Carlo, Nelson Soto, and Carlos Diaz-Olivo. They will be available to answer questions now and until mark-up.

I was unpleasantly surprised Tuesday morning when I read a *Washington Post* editorial declaring S. 712 dead for this Congress. Not since "*Dewey Beats Truman*" has a newspaper been so premature in writing a political epitaph.

The Senate Energy Committee reported this complex bill in record time. The Agriculture Committee has conducted hearings and reportedly can report a bill quickly. With today's hearing, the Finance Committee completes a lengthy process and should be equipped to report S. 712 expeditiously. The House leadership has promised an expedited process this year on our self-determination issue.

The Post's opinion notwithstanding, there is time to enact S. 712 this year *if* the Finance Committee moves promptly to markup. I suggest *The New York Times* editorial of April 1 (enclosed) is better reasoned. Therefore, we urge you to mark up S. 712 quickly.

Today we examine the economics of S. 712. We were gratified when you appointed the Congressional Budget Office to work with other expert analysts within the Federal Government to produce an assessment of the economic impact of each status option included within S. 712. For years, parties with a vested interest in retaining Section 936 have hired economists and accounting firms to turn out supposedly authoritative reports that predicted the downfall of Puerto Rico's economy, even under statehood, absent Section 936. These paid reports are inherently suspect, particularly when authored by former policy making Treasury officials who *opposed* Section 936.

Before I discuss the CBO report, let me emphasize this: Economics matter but, fundamentally, this issue transcends economics. Puerto Ricans—3.3 million American citizens—hunger for self-determination. All three Puerto Rican parties—which rarely agree on anything—stand united on this point. Never in our nation's history has self-determination been denied, when requested. Nor can the U.S. deny self-determination for its citizens when demanding it for citizens of other nations. Nor has the question of whether or not to admit a state been decided solely on the basis of economics.

We have serious misgivings about the CBO study, but it does settle some important issues for this Committee. One of our most serious concerns has to do with CBO's activity since the study was issued. As reported in the Puerto Rican press (enclosed), the study's author has travelled to Puerto Rico as the guest of Commonwealth economists and has issued statements unsupported by any substantive analysis. He professes now that CBO *omitted* information for the sake of preserving what he deems to be "a balance."

Why would CBO omit known beneficial facts or even negative information? Why would this CBO official place himself in such a compromising and presumptuous position? And finally, how in good conscience can CBO arbitrarily decide which information to include or exclude in its report and then claim its study is unbiased, scientific? The appearance created is objectionable. Presumptuous, selective omission of facts taints this report's validity. How can Congress comfortably rely on its objectivity?

Furthermore, the political impotence of Puerto Rico's territorial status was again demonstrated this week when said staffer, who served as project manager of the report, made several appearances in the island during which he, wearing the cloak of CBO, engaged in a sort of "search and destroy" operation, making statements that play up our opponents' antistatehood propaganda in aspects that were not even part of the CBO study and for which there was no objective data offered. I very much doubt that a functionary of a congressional office would be allowed or would dare to go to Senator Dole's Kansas or the Chairman's Texas and meddle in a sensitive local political issue.

Mr. Chairman. Two final points: First, as Mr. McKee will illustrate, the press occasionally has misreported CBO's findings. We have read the Commonwealth advocates' press packages—which I understand also have been circulated in this Committee. We lack the resources to conduct the type of preemptive public relations campaign—funded by Puerto Rican tax dollars—being waged by the other side. I urge the press and this Committee to seek our reactions to materials they receive so there will be a balanced record.

Second, we will welcome the opportunity to work with the Committee to adjust the transition provisions of S. 712 to prevent the brief economic downturn projected by CBO.

In closing, let me say that every objection to Puerto Rican statehood that will be raised this morning—that it is too expensive for the Federal government; that it will crush economic development; that taxes would be too much of a burden on companies and citizens; and that our island can never be selfsupporting—were raised during the debate over the admission of no fewer than ten states: Alaska, Hawaii, California, New Mexico, Nevada, Oregon, Illinois, Oklahoma, Arizona, and Mississippi. Those objections were false in every one of those cases and they are equally wrong when raised about Puerto Rico.

History has proven once and again that the American Dream works.

Thank you, Mr. Chairman.

Enclosures.

El Mundo, April 24, 1990.

"IMPARTIAL" THE REPORT

[By Agnes J. Montano]

The Deputy Director of the Congressional Budget Office (CBO), Frederick Ribe . . . While defending the report's impartiality . . . Ribe said that CBO omitted information that could be adverse to statehood for the sake of preserving "a balance."

Ribe admitted that there were certain factors about statehood that were intentionally omitted from the report, but indicated that, in totality, there were as many factors affecting as factors benefiting statehood that were excluded.

"Overall, the group of factors do not affect the results" said Ribe. "Moreover, on certain areas we omitted on purpose prejudicial factors (on statehood) in order to preserve the balance of the report." As an example, he said that one of the aspects not mentioned in the report was the diminution on the investment of local corporations that would have to pay Federal taxes.

Ribe . . . also challenged that his visit to Puerto Rico is being paid for by the Popular Party, as rumors have it.

The New York Times

Sunday, April 1, 1990

The 51st and 52d States

Let Puerto Ricans Decide Their Fate, but Fairly

Puerto Rico is not America's Lithuania, but it is unhappy with its status as a highly dependent commonwealth. An overwhelming majority of 3.3 million islanders are agreed that they want change. But as Congress is learning, agreement stops there. What adds to the perplexity is a parallel but unrelated campaign to grant statehood to the District of Columbia.

A Senate bill supported by the Bush Administration would offer Puerto Ricans a chance to choose, by a binding vote next year, statehood, improved commonwealth status or independence. The problem is to assure a fair choice. If one or another side has plausible reasons for charging bad faith, the referendum could prolong the argument it is meant to end.

Polls for the first time show a narrow majority of Puerto Ricans now favors statehood. As sentiment has shifted, so has the tone of a longstanding debate. Statehood supporters now join with advocates of independence in decrying colonialism. Those clamoring for enhanced commonwealth status contend that the Senate bill is frontloaded unfairly in favor of statehood.

The argument springs from a complicated history. The U.S. acquired Puerto Rico from Spain almost incidentally in 1900. In 1917, Puerto Ricans became U.S. citizens, but not until 1947 did they elect a Governor. Five years later, Congress approved an ingenious commonwealth arrangement, giving a Spanish-speaking island home rule and exemption from Federal taxes but no vote in Federal elections.

Economically, the plan made sense. Using an additional tax break known as Section 936 of the revenue code, Puerto Rico has provided generous incentives for mainland investors. But politically, the island has been virtually a ward of Congress, without the clout it would wield with two senators and six or seven representatives, plus a Presidential vote.

This sense of being second-class citizens has given potent impetus to the statehood campaign. As statehood sentiment has waxed, so has uncertainty about Puerto Rico's tax exemptions, causing investors to hold back. To end the debate once and for all, Gov. Rafael Hernandez Colon, a commonwealth advocate, proposed a binding referendum.

But he now faults the Senate bill as "terribly, dangerously unbalanced." It would phase in Federal taxes and phase out Section 936 over four years. Meanwhile, says the Congressional Budget Office, statehood could cost other U.S. taxpayers as much as $9.4 billion in additional Federal social spending; more than half the island's population remains below the national poverty line.

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A very different view is taken by former Gov. Carlos Romero Barceló, a statehood proponent. He persuasively cites similar preferential treatment granted other incoming states. Congress can redress the balance by rewording the commonwealth choice to give its proponents more of what they seek: an increased international role, an open port for air carriers, a voice in Federal appointments and jurisdiction over natural resources.

What is unarguable and fundamental is Puerto Rico's right to self-determination. The choice is primarily between two forms of association with the United States. Even the minority favoring independence relies on reason rather than passion. Congress can reciprocate by specifying clearly and fairly what Puerto Ricans can expect, whichever way they vote.

EL MUNDO ◻ MARTES 24 DE ABRIL DE 1990

'Imparcial' el informe

Por AGNES J. [illegible]

[illegible]

El director [illegible] de la Oficina de Presupuesto del Congreso (CBO, por sus siglas en inglés), Frederick Ribe, rechazó ayer categóricamente que el informe que preparó esa oficina sobre el efecto económico de las tres opciones de status, estuviese cargado en contra de la estadidad.

Al defender la imparcialidad del informe en una entrevista exclusiva con El Mundo, Ribe dijo que el CBO omitió en el mismo información que podría ser adversa a la fórmula estadista en aras de preservar "el balance del mismo".

El informe, comisionado por el Comité de Finanzas del Senado y dado a conocer el pasado 5 de abril, ha sido fuertemente criticado por el liderato estadista que entiende que el mismo es "incompleto e inexacto". El mismo concluye que como estado Puerto Rico sufriría una significativa reducción en su crecimiento económico porque mermaría la inversión y el empleo en el sector manufacturero ante la pérdida de la Sección 936.

Específicamente, el sector estadista alega que si el CBO hubiese cuantificado algunos de los beneficios que tendría la Isla como estado, la fórmula no hubiese salido tan desfavorecida.

"El informe trata de ser lo más explícito posible. De hecho menciona explícitamente en muchas ocasiones el hecho de que había una serie de factores que no eran cuantificables... y si hubiéramos intentado hacerlo se habría afectado la calidad profesional del informe", agregó.

Asimismo, dijo que discutió el borrador del informe en tres ocasiones con los representantes de la opción estadista y "estos nunca refutaron el hecho de que habían aspectos que eran no cuantificables".

Ribe admitió que sí hubo ciertos factores sobre la estadidad que fueron omitidos intencionalmente del informe, pero indicó que en total se excluyeron en igual grado factores que la afectaban como que la beneficiaban.

"En su totalidad el grupo de factores (omitidos) no tergiversa los resultados", dijo Ribe. "Es más, en ciertas ocasiones omitimos a propósito factores que eran perjudiciales (a la estadidad) para poder preservar el balance del informe", agregó. A modo de ejemplo dijo que uno de los aspectos que no se mencionó en el informe fue la disminución en la inversión por las corporaciones locales que habría al estas tener que pagar contribuciones federales.

Ribe - que a las 9:00 a.m. de hoy disertará sobre "El impacto económico de los cambios en el status de Puerto Rico", en el Recinto de Río Piedras de la Universidad de Puerto Rico - también rechazó que su visita esté siendo pagada por el Partido Popular Democrático, como se ha rumorado.

PREPARED STATEMENT OF HARVEY GALPER

THE ECONOMIC EFFECTS OF STATEHOOD FOR PUERTO RICO

Mr. Chairman and members of the Senate Finance Committee: I am Harvey Galper, a principal in the Policy Economics Group of KPMG Peat Marwick. The Policy Economics Group has been retained by the Governor of Puerto Rico to undertake a study of the economic effects of statehood for Puerto Rico. The effects we could quantify are almost exclusively the result of the loss of the tax benefits under Section 936 of the Internal Revenue Code. I should emphasize at the outset that neither I nor Peat Marwick takes any position for or against statehood for Puerto Rico. My testimony today highlights the major points in our study which has been made available in its entirety to this Committee. The Peat Marwick study leads to three main conclusions:

- *Statehood would have several direct negative effects on the Puerto Rican economy.*

First, corporations established under Section 936 of the Internal Revenue Code would be able to significantly increase their after-tax return by abandoning their existing operations and relocating in tax-favored locations in the Caribbean, Europe, or the Pacific rim. In addition, expansion by current 936 companies and the formation of new 936 companies would be sharply curtailed, if not eliminated. Seventy-two percent or more of the operating income of 936 companies would be subject to relocation.

Second, as companies choose to move off the Island, the Puerto Rican economy would be seriously affected. This would increase unemployment in Puerto Rico and reduce wages throughout the economy. Between 80,000 and 145,000 private sector jobs could be lost under statehood Increasing the unemployment rate to nearly 30 percent.

Third, under statehood Puerto Rico residents would be eligible to fully participate in all Federal outlay programs. The extension of Federal transfer programs would mitigate some of the negative economic impact of relocation and the imposition of Federal taxes, but aggregate demand in Puerto Rico in 2000 would decrease between $0.2 billion and $2.3 billion.

- *The Statehood option has major budgetary implications for the U.S. government, affecting both revenues and expenditures.*

The extension of Federal transfer programs would increase Federal outlays by about $36 billion from 1992 through 2000. This is accompanied by an increase in Federal revenues that would partially offset these costs. Depending on the extent of the relocation of companies, Puerto Rican Statehood would have a net cumulative cost to the U.S. Government of between $22 billion and $25 billion during the same period.

- *Statehood would cause a major budget dilemma for Puerto Rico.*

To balance expenditures for present services, Puerto Rico would not be able to lower its taxes despite the burden of full U.S. taxes. If Puerto Rico chose to reduce its individual income tax rates to align them with tax rates facing residents in the U.S., the cost to the Puerto Rican Government would be about $8 billion from 1992 through 2000. To place the deficit problem in perspective, balancing the budget after the transition period solely through a cut-back in public sector services would require a lay-off of about 90 thousand employees or about 40 percent of total government employment.

The results demonstrate that under statehood, the Puerto Rican economy would experience a major economic transformation. The economy would lose a significant component of its industrial base because of the relocation of 936 and foreign-owned corporations. The public sector would be forced to cut back services and employment to retain competitive levels of taxation. Industrial production, capital accumulation, and both private and public sector employment would be replaced, in part, by transfers from the Federal government.

SECTION 936 AND THE PUERTO RICAN BUSINESS SECTOR

It is clear that the most important effects of statehood on the Puerto Rican economy would result from the loss of the benefits of Section 936 of the Internal Revenue Code to U.S. corporations operating on the island. On balance, Section 936 provides Puerto Rico manufacturing operations a substantial tax advantage over operations in the United States. Moreover, these advantages make Puerto Rico competitive with foreign countries that provide their own tax incentive programs for the manufacturing operations of U.S. companies.

These incentives have clearly contributed to the growth in the Puerto Rican economy since 1976. By 1989 total direct employment by 936 corporations reached 112,000 jobs. In addition to the impact of Section 936 on the manufacturing sector, 936 corporations have greatly strengthened the financial sector, accounting for 40 of all bank deposits.

In addition to the effect on direct employment, 936 corporations are responsible for the creation of thousands of indirect jobs. These 936 corporations require a variety of raw materials and services. While some goods and services are provided by foreign suppliers and other 936 companies, local purchases have led to the establishment and growth of many new businesses in Puerto Rico with resulting increases in employment and the island's tax base.

Fundamental to reaching an understanding of the potential impact of statehood on the Puerto Rico economy is determining its impact on the 936 company sector on the island. The dominance of these 936 corporations in the economy is evident. As shown in Table 1 the nearly five hundred 936 corporations account for 94.4 percent of the operating income and 78.6 percent of the assets in the manufacturing sector. The operating income of four Industries: apparel and other textile products, pharmaceutical, machinery (including electrical & electronic equipment), and instruments, is almost entirely accounted for by 936 companies.

Table 1.—ESTIMATES OF SECTION 936 AND FOREIGN-OWNED MANUFACTURING CORPORATIONS IN 1992: MANUFACTURING INDUSTRY DISTRIBUTION AND FINANCIAL CHARACTERISTICS

[Dollar amounts in millions]

Industry	Corporations		Operating Income		Operating Assets	
	Number	Percent	Amount	Percent	Amount	Percent
Food & Kindred Products	29	12.2	708	86.8	838	50.5
Apparel & Other Textile Products	81	34.0	183	97.2	410	37.0
Pharmaceutical	59	75.6	3,546	98.4	5,336	96.7
Other Chemicals	30	29.7	261	81.7	2,799	89.9
Electrical & Electronic Eguip	118	62.1	1,199	97.9	2,849	98.3
Instruments	59	73.8	560	99.3	850	97.7
Other Manufacturing	121	20.1	488	76.3	1,410	43.2
TOTAL	497	32.5	6,945	94.4	14,490	78.6

Note: Percentages refer to 936 firms as a share of Puerto Rican firms in the industry.

The potential for the relocation of these companies can best be measured by determining the impact of the elimination of Section 936 on the after-tax rate of return of 936 corporations.[1] The after-tax rate of return for all manufacturing companies would decline by 9.8 percentage points, or 23.2 percent, under statehood.

These averages mask the variance in the effect on individual firms. Table 2 shows a distribution of firms by the size of their reduction in the after-tax rate of return. Sixty-five companies, accounting for 20.5 percent of net income, would experience a reduction of more than 30 percentage points. One hundred seventy-five companies, with a combined total of 62.6 percent of net income, would experience a reduction in their rate of return of more than 15 percentage points.

RELOCATION EFFECTS

International business location decisions depend upon several factors, including political stability, wage rates, availability of labor and raw materials, financing arrangements, and infrastructure, such as utility and transportation systems. In addition, a major consideration is taxes. This part of the report analyzes how statehood,

[1] The after-tax rate of return is computed using a methodology similar to the method the Treasury Department used to compute before-tax income in *The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report*, March 1989. The rate of return equals operating income divided by operating assets. Operating income is defined as gross sales less cost of foods sold and all other deductions except taxes, interest, and charitable contributions. Operating assets includes net property, plant, and equipment, inventories, and net accounts receivable. The after-tax rate of return computation reduces operating income by Puerto Rican and Federal income taxes paid.

including the repeal of Section 936, would affect the level of business activity in Puerto Rico.

This analysis is necessarily limited to the companies that are currently operating in Puerto Rico, but implicit in the analysis is that newly formed 936 companies and current 936 companies that are expanding their operations in Puerto Rico would be affected in the same way as the existing operations of current 936 companies. Existing 936 corporations will therefore be considered as representative of all potential 936 investment in Puerto Rico. If, for example, two thirds of the current level of 936 activity would relocate after statehood, then two thirds of the new investment (new 936 companies or expansion of existing companies) would also locate outside Puerto Rico.

There are two separate issues that need to be addressed. The first issue is the extent to which, in the long run, economic activity would be reduced in Puerto Rico as a result of statehood. The second issue is the time frame over which this reduction would occur. The adjustment process is clearly very complex. For simplicity, it is assumed that the adjustment would occur rateably over five years starting in 1994. For some operations, the adjustment would take longer, and for others the process would begin even before 1994.

It is not possible to replicate all of the factors which influence decisions concerning location, to enter, stay, or leave. It is possible, however, to analyze, in the case of Puerto Rico, the bottom-line effects of increased taxes resulting from a move to statehood and to compare the resulting bottom-line to the available in alternative sites.

Table 2.—VARIATION IN CHANGE IN AFTER-TAX RATE OF RETURN FOR 936 AND FOREIGN-OWNED CORPORATIONS IF STATEHOOD IS ADOPTED

[Dollar amounts in millions]

Reduction in rate of return	Number of Firms	Net income	
		Amount	Percent
Less than 3 percentage points	108	6	.1
3.0 to 4.9 percentage points	57	412	4.6
5.0 to 7.9 percentage points	90	591	6.7
8.0 to 9.9 percentage points	47	744	8.4
10.0 to 14.9 percentage points	87	1,571	17.7
15.0 to 19.9 percentage points	54	1,838	20.7
20.0 to 24.9 percentage points	34	1,522	17.1
25.0 to 29.9 percentage points	22	383	4.3
30.0 or more percentage points	65	1,820	20.5
TOTAL	564	8,886	100.0

Source: KPMG Peat Marwick estimate.

While it is not possible to know for each individual firm, the rate of return differential that would be required to induce the firm to relocate or invest elsewhere, this study analyzes two cases: A differential in the after-tax return of 5 percentage points, and 11 percentage points. The logical way to think about the results displayed is that those firms incurring the higher immediate reductions in ret-urns, particularly where the percentage reduction exceeds their cost of capital, would be the first to leave Puerto Rico and relocate in a more conducive tax atmosphere. Firms suffering a return reduction approximately equal to their cost of capital, for which the 11 percent case is thought to be a current surrogate, would have no economic rationale for remaining in Puerto Rico even in the short-run and, depending on the balance of other factors, would have motivation to leave.

The 5 percent reduction case is most relevant to the longer term and to potential new entrants to Puerto Rico. Few firms would choose Puerto Rico over a foreign location or perhaps a U.S. location when its after-tax return. would be reduced 5 percent to a level significantly less than what it could achieve in another foreign location. The practical judgment here would be that only those firms which would find offsetting advantages to location in Puerto Rico would decide to do so.

The estimates below show the effect on the Puerto Rican manufacturing sector at 1992 levels assuming the adjustment process is complete.

LONG RUN EFFECT OF STATEHOOD ON THE PUERTO RICAN MANUFACTURING SECTOR: 1992 LEVELS

[Percent of 936 and foreign owned company activity]

Relocation Threshold	Percent of Firms	Percent of Operating Assets	Percent of Operating Income
5 Percentage Points	−67	−72	−105
11 Percentage Points	−31	−31	−72

This loss in economic activity has a dramatic effect on employment and wages. As shown below, the job loss, taking account of both direct and first order indirect effects, is estimated to range between 79,500 and 145,000 jobs. The related aggregate wages range from $1.4 billion annually under the 11 percent case to $2.6 billion under the 5 percent case.

ESTIMATED EMPLOYMENT AND WAGE EFFECTS OF RELOCATION RESULTING FROM THE ADOPTION OF STATEHOOD UNDER ALTERNATIVE RATE OF RETURN THRESHOLDS: 1992 LEVELS

	Employment (thousands)	Wages (billions of dollars)
5% Relocation	−145	−2.6
11% Relocation	−80	−1.4

Source: KPMG Peat Marwick

COMPARISON TO CONGRESSIONAL BUDGET OFFICE STUDY

The results of the analysis by KPMG Peat Marwick may be compared to those estimated by the CBO in its recently released study, *Potential Economic Impacts of Changes in Puerto Rico's Status under S. 712,* (April 1990). At the most general level, the two analyses reach quite similar conclusions, despite different methodological approaches. The CBO also finds that statehood would cause serious economic dislocations on the island, primarily because of the loss of the tax benefits from Section 936. When full effects are accounted for, by the year 2000, the CBO estimates that GNP in Puerto Rico would be 10 to 15 percent below what it would be under current commonwealth status and that unemployment would be higher by 50,000 to 100,000.

Furthermore, the CBO study also estimates that after-tax rates of return on investment would fall substantially after statehood. They estimate a decline of about 9 percentage points for the average Section 936 manufacturer, very close to the decline of 9.113 percentage points in the Peat Marwick study. Any difference in the results of the two studies stems from two sources: (1) the effects of this decline in rates of return on new investment in the 936 sector and (2) indirect effects on economic activity in the non-936 sector that served as suppliers to 936 corporations.

By the year 2000, the CBO estimates a decline in investment of Section 936 companies of between 62 and 73 percent from baseline estimates and a decline in the capital stock employed by 936 companies of 37 to 47 percent. CBO did not separately estimate the resulting decline in income.

In the Peat Marwick study, the decline in the capital stock employed by 936 companies depends upon the threshold change in the rate of return before firms decide not to operate in Puerto Rico. With a threshold change of 5 percentage points, that is a change in the after-tax rate of return of 5 percentage points or more, 72 percent of capital and virtually 100 percent of the operating income employed by the 936 sector would leave the island. With a tougher test of a change of 11 percentage points in the after-tax rate of return, 31 percent of the capital currently employed and 72 percent of the income would leave the island.

A reduction in the rate of return of 5 percentage points compared to what may be earned in alternative locations appears a reasonable threshold for a longer-run analysis and an 11 percent threshold would be more appropriate for a shorter-run analysis. Thus, the Peat Marwick study finds that in the long-run, the decline in capital would be greater than that estimated by CBO.

Similarly, the Peat Marwick study finds that indirect effects can add about 70 percent to the loss of jobs and 35 percent to the loss in income to the direct effect of reduction in 936 activity. These effects also appear larger than those estimated by CBO. These indirect effects reflect the methodological differences in the two studies. The CBO estimated a macro-economic model for Puerto Rico and used this model to determine secondary effects on the Puerto Rican economy once the initial decline in investment due to the loss of benefits under Section 936 had been taken into account. The Peat Marwick study accounted directly for the linkages between the 936 sector and the non-936 sector by using an input-output approach.

Given these methodological differences, it is even more significant that both studies conclude that the economic dislocations to Puerto Rico under statehood would be severe.

THE EFFECT OF STATEHOOD ON U.S. GOVERNMENT RECEIPTS AND OUTLAYS

Under statehood, Puerto Rican residents would be subject to the full tax system facing U.S. residents and would be eligible for all U.S. outlay programs. Table 3 and table 4 show the effect of statehood on Federal tax revenues under the 11 percentage point and 5 percentage point assumptions, respectively. Under both scenarios, revenues increase dramatically in the first few years as the Section 936 credit is being phase-out. Over the nine year period, treasury revenues would increase by about $28.5 billion before accounting for the decline in economic activity induced by statehood. Under the 11 percentage point scenario slightly less than 30 percent of the "static" effect is offset by the reduction in economic activity for a net of about $20.2 billion. Under the 5 percentage point case, nearly 40 percent of the static effect is offset for a net gain of about $17 .4 billion.

Table 3.—THE EFFECT OF STATEHOOD ON U.S. GOVERNMENT REVENUES: 11 PERCENTAGE POINT RELOCATION SCENARIO

[Millions of dollars]

Source	Fiscal Year									Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Corporation Income Tax:										
Excluding Economic Effects			634	1377	1971	2672	3495	4053	4418	18,620
Economic Effects			-140	-400	-711	-1080	-1515	-1801	-1981	-7.628
Net			494	977	1260	1592	1980	2252	2437	10,992
Individual Income Tax:										
Excluding Economic Effects			651	962	1010	1061	1114	1169	1228	7,195
Economic Effects			-17	-43	-73	-105	-140	-155	-164	-697
Net			634	919	937	956	974	1014	1064	6,498
Excise Taxes:										
Excluding Economic Effects	174	268	281	295	310	325	342	359	377	2,731
Economic Effects										
Net	174	268	281	295	310	325	342	359	377	2,731
Grand Total:										
Excluding Economic Effects	174	268	1566	2634	3291	4058	4951	5581	6023	28,546
Economic Effects			-157	-443	-784	-1185	-1655	-1956	-2145	-8,325
Net	174	268	1409	2191	2507	2873	3296	3625	3878	20,221

Table 4.—THE EFFECT OF STATEHOOD ON U.S. GOVERNMENT REVENUES: 5 PERCENTAGE POINT RELOCATION SCENARIO

[Millions of dollars]

Source	Fiscal Year									Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Corporation Income Tax:										
Excluding Economic Effects			-634	1377	1971	2672	3495	4053	4418	18,620
Economic Effects			-187	-536	-951	-1445	-2026	-2410	-2649	-10,204
Net			-447	841	1020	1227	1469	1643	1769	8,416

Table 4.—THE EFFECT OF STATEHOOD ON U.S. GOVERNMENT REVENUES: 5 PERCENTAGE POINT RELOCATION SCENARIO—Continued

[Millions of dollars]

Source	Fiscal Year									Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Individual Income Tax:										
Excluding Economic Effects	....	....	651	962	1010	1061	1114	1169	1228	7,195
Economic Effects	....	....	−24	−62	−102	−147	−197	−219	−231	−982
Net	....	....	627	900	908	914	917	950	997	6,213
Excise Taxes:										
Excluding Economic Effects	174	268	281	295	310	325	342	359	377	2,731
Economic Effects	....	....	....	....	....	....	....	....	....	....
Net	174	268	281	295	310	325	342	359	377	2,731
Grand Total:										
Excluding Economic Effects	174	268	1566	2634	3291	4058	4951	5581	6023	28,546
Economic Effects	....	....	−211	−598	−1053	−1592	−2223	−2629	−2880	−11,186
Net	174	268	1355	2036	2238	2466	2728	2952	3143	17,360

Table 5 and table 6 show the effect on Federal outlays. The estimates are shown with and without the effect of the decline in economic activity and include the cover–over of tax revenues that would occur during the transition years. Total outlays during the period would be about $41.8 billion under the 11 percentage point case and $42.6 billion under the 5 percentage point case.

Table 7 summarizes the Federal budget implications under the two scenarios. The cumulative increase in the Federal deficit is $21.5 billion under the 11 percentage point case and $25.2 billion under the 5 percentage point case. Under either scenario, after the first partial fiscal year of 1992, the deficit to the Federal government would increase by over $2 billion each year.

THE EFFECT OF STATEHOOD ON THE PUERTO RICAN BUDGET

Statehood would have a very negative effect on Puerto Rico's fiscal situation. Statehood would reduce tax revenues in Puerto Rico in four ways. First, the tollgate tax that currently applies to repatriations to the U.S. from Section 936 companies would be repealed. Second, as corporations relocate, income, and therefore tax revenue paid under the current Puerto Rican income tax, would be reduced. Third, as corporations relocate and unemployment increases and wages and personal income decline, Puerto Rico would experience a reduction in tax revenues from the individual income tax. Finally, financial institutions which would be adversely affected would be downsized and pay much lower taxes.

Table 5.—THE EFFECT OF STATEHOOD ON U.S. GOVERNMENT OUTLAYS: 11 PERCENTAGE POINT RELOCATION SCENARIO

[Millions of dollars]

Item	Fiscal Year								2000	Total
	1992	1993	1994	1995	1996	1997	1998	1999		
Extension of Outlay Programs to Puerto Rico Residents:										
Food Stamps	615	858	729	706	741	779	817	858	901	7,004
Medicaid	946	1460	1577	1703	1839	1987	2145	2317	2502	16,476
Medicare	46	70	76	82	88	96	103	111	120	792
Supplemental Security Income (SSI)	0	0	600	900	944	992	1041	1093	1148	6,718
Aid to Families with Dependent Children (AFDC)	51	141	208	219	230	241	253	266	279	1,888
Foster Care	2	3	3	3	4	4	4	4	4	31
Earned Income Credit	0	0	12	243	255	268	281	295	310	1,664
Total, Excluding Economic Effects	1660	2532	3205	3856	4101	4367	4644	4944	5264	34,573

Table 5.—THE EFFECT OF STATEHOOD ON U.S. GOVERNMENT OUTLAYS: 11 PERCENTAGE POINT RELOCATION SCENARIO—Continued

[Millions of dollars]

Item	Fiscal Year								2000	Total
	1992	1993	1994	1995	1996	1997	1998	1999		
Economic Effects:										
Food Stamps	0	0	0	31	78	128	185	246	274	942
Medicaid	0	0	0	25	68	118	175	241	279	906
AFDC	0	0	0	7	19	32	47	63	72	240
Cover-Over of Tax Revenues in Transition Years	174	268	1290	1847	843	325	342	359	377	5,825
Total Outlays	1834	2800	4495	5766	5109	4970	5393	5853	6266	42,486

Table 6.—THE EFFECT OF STATEHOOD ON U.S. GOVERNMENT OUTLAYS: 5 PERCENTAGE POINT RELOCATION SCENARIO

[Millions of dollars]

Item	Fiscal Year									Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Extension of Outlay Programs to Puerto Rico Residents:										
Food Stamps	615	858	729	706	741	779	817	858	901	7,004
Medicaid	946	1460	1577	1703	1839	1987	2145	2317	2502	16,476
Medicare	46	70	76	82	88	96	103	111	120	792
Supplemental Security Income (SSI)	0	0	600	900	944	992	1041	1093	1148	6,718
Aid to Families with Dependent Children	51	141	208	219	230	241	253	266	279	1,888
Foster Care	2	3	3	3	4	4	4	4	4	31
Earned Income Credit	0	0	12	243	255	268	281	295	310	1,664
Total, Excluding Economic Effects	1660	2532	3205	3856	4101	4367	4644	4944	5264	34,573
Economic Effects:										
Food Stamps	0	0	0	45	113	181	267	355	396	1,357
Medicaid	0	0	0	37	98	171	252	347	402	1,307
AFDC	0	0	0	10	28	46	68	91	104	347
Cover-Over of Tax Revenues in Transition Years	174	268	1268	1794	823	325	342	359	377	5730
Total Outlays	1834	2800	4473	5742	5163	5090	5573	6096	6543	43314

Table 7.—SUMMARY OF THE EFFECT OF STATEHOOD ON U.S. TAX REVENUES AND OUTLAYS UNDER ALTERNATIVE RELOCATION SCENARIOS

[Millions of dollars]

	Fiscal Year									Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	
11 Percentage Point Case:										
Revenues	174	268	1409	2191	2507	2873	3296	3625	3878	20221
Outlays	1834	2800	4495	5766	5109	4970	5393	6266	42486	
Increase in Surplus (+) or Deficit (−)	−1660	−2532	−3086	−3575	−2602	−2097	−2097	−2228	−2388	−22265
5 Percentage Point Case:										
Revenues	174	268	1355	2036	2238	2466	2728	2952	3143	17360
Outlays	1834	2800	4473	5742	5163	5090	5573	6096	6543	43314
Increase in Surplus (+) or Deficit (−)	−1660	−2532	−3118	−3706	−2925	−2624	−2845	−3144	−3400	−25954

In addition to the loss in tax revenues from the loss in economic activity, Puerto Rico would face very difficult fiscal choices. The combined Federal and Puerto Rican tax rates would be much higher than those facing U.S. residents and there would be considerable pressure to lower their rates to be better aligned with other states. However, Puerto Rico would face long term deficits under statehood that may require increasing tax rates. Any tax rate reduction would further exacerbate the fiscal position and would necessarily require a significant increase in other tax revenues or massive reduction in government services and employment.

Table 8 and table 9 summarizes the effect of statehood on the Puerto Rican budget under the 11 percent point and 5 percentage point scenarios.

In total, over the nine years, Puerto Rican tax revenues would decline by about $5 billion. This would be partially offset by a reduction in outlays of $1.5 billion. The outlay reduction would result primarily in the health care area as Federal programs are substituted. This would result in a net deficit of about $3.6 billion. However, the $5.7 billion cover-over of Federal taxes during the transition period would more than offset the deficit, leaving Puerto Rico with a net surplus of $2.26 billion over the period. It is important to note, however that there would be a net deficit in each of the last four years of the period as the cover-over ends.

As indicated above, one important issue that Puerto Rico would face is the extremely high tax rates facing its residents. If Puerto Rico reduced its tax rates to the average state rates in the U.S., Puerto Rico would experience a net deficit in all but one year of the forecast period for a cumulative deficit of about $7 billion. Balancing the budget after the transition period solely through a cutback in public sector services would require a layoff of about 90 thousand employees or about 40 percent of total government employment.

Table 8.—SUMMARY OF THE EFFECT OF STATEHOOD ON PUERTO RICO TAX REVENUES AND OUTLAYS: 11 PERCENTAGE POINT RELOCATION SCENARIO

[Millions of dollars]

	Fiscal Year									Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Revenue (Excluding cover-over of taxes)	−94	−190	−248	−376	−514	−677	−865	−1001	−1071	−5036
Outlays	−81	−160	−166	−170	−173	−175	−177	−176	−186	−1464
Increase in Surplus or Deficit (Excluding cover-over of taxes)	−13	−30	−82	−206	−341	−502	−688	−825	−885	−3572
Cover-over of Taxes	117	265	1011	1836	1117	322	338	355	373	5734
Increase in Surplus (+) of Deficit (−) (Including cover-over of taxes)	104	235	929	1630	776	−180	−350	−470	−512	2162
Reduction in Individual Income Taxes	−392	−892	−936	−983	−1032	−1084	−1138	−1195	−1255	−8907
Net Effect	−288	−657	−7	−647	−256	−1264	−1488	−1665	−1767	−6745

Table 9.—SUMMARY OF THE EFFECT OF STATEHOOD ON PUERTO RICO TAX REVENUES AND OUTLAYS: 5 PERCENTAGE POINT RELOCATION SCENARIO

[Millions of dollars]

	Fiscal Year									Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Revenues (Excluding cover-over of taxes)	−94	−190	−277	−467	−632	−921	−1200	−1401	−1500	−6682
Outlays	−81	−160	−166	−166	−160	−150	−139	−125	−124	−1271
Increase in Surplus (+) or Deficit (−) (Excluding cover-over of taxes)	−13	−30	−111	−301	−472	−771	−1061	−1276	−1376	−5411
Cover-over of Taxes	−117	−265	−996	−1791	−1089	−322	−338	−355	−373	−5646

Table 9.—SUMMARY OF THE EFFECT OF STATEHOOD ON PUERTO RICO TAX REVENUES AND OUTLAYS: 5 PERCENTAGE POINT RELOCATION SCENARIO—Continued

[Millions of dollars]

	Fiscal Year									Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Increase in Surplus (+) of Deficit (−) (Including cover-over of taxes)	104	235	885	1490	617	−449	−723	−1276	−1376	235
Reduction in Individual Income Taxes	−344	−782	−821	−862	−906	−951	−998	−1048	−1101	−7813
Net Effect	−240	−547	64	628	−289	−1400	−1721	−2324	−2477	−7578

SUPPLEMENTAL STATEMENT OF HARVEY GALPER

The CBO report does not attempt to estimate the effect of statehood on the Federal budget. The estimates that CBO does report (Table 7 of the report) show only of the change in Federal net transfers to Puerto Rico as a result of statehood. This table does not include the increase in revenues to the Federal Government from the taxation of 936 corporations nor the increase in Spending from the cover-over of taxes, the earned income tax credit, and increased transfers to workers who are displaced because of relocation of 936 corporations (economic effects).

The KPMG Peat Marwick estimates of the effect of statehood on the Federal budget can be compared to the estimates included in S. 712 and the current U.S. Treasury (for revenues) and CBO (for expenditures) estimates. All these estimates are presented in Table 1. The U.S. Treasury estimates are included in Mr. Philip Morrison's testimony and CBO's estimates were presented on November 14, 1989 before the Senate Finance Committee. The expenditure estimates include Treasury's estimate of the cover-over of taxes.

On the revenue side, the main explanation for the discrepancy ($1.7 billion in 1998) is the estimate of the relocation of 936 companies to foreign locations. Treasury estimates that 35 percent of the income would relocate outside the U.S. while Peat Marwick estimates relocation between 65 percent and 81 percent of income.

The difference in the estimates of Federal spending is presented in Table 2 and explained in detail in Section II of the Peat Marwick report. The difference in total spending amounts to $1.2 billion in 1998. About two-thirds of the difference reflects different program assumptions and about one-third dynamic economic effects.

Table 1.—SUMMARY OF THE EFFECT OF PUERTO RICO STATEHOOD ON U.S. TAX REVENUES AND EXPENDITURES AS ESTIMATED BY CBO AND THE U.S. TREASURY DEPARTMENT

[Millions of dollars]

	Fiscal year						
	1992	1993	1994	1995	1996	1997	1998
Committee on Energy and Natural Report of S. 712:							
Revenues	0	0	458	1,171	3,120	4,063	5,027
Expenditures	431	453	1,337	1,404	1,474	1,548	1,626
Net Budget Effect	−431	−453	−879	−233	−1,646	−2,515	−3,401
Current CBO and U.S. Treasury:							
Revenues	258	423	1,741	2,632	3,385	4,178	4,969
Expenditures	1,882	2,108	3,503	4,571	4,038	3,918	4,156
Net Budget Effect	−1,624	−1,685	−1,762	−1,939	−653	260	813
KPMG Peat Marwick:							
Revenues	174	268	1,409	2,191	2,507	2,873	3,296

Table 1.—SUMMARY OF THE EFFECT OF PUERTO RICO STATEHOOD ON U.S. TAX REVENUES AND EXPENDITURES AS ESTIMATED BY CBO AND THE U.S. TREASURY DEPARTMENT—Continued

[Millions of dollars]

	Fiscal year						
	1992	1993	1994	1995	1996	1997	1998
Expenditures	1,834	2,800	4,495	5,766	5,109	4,970	5,393
Net Budget Effect	−1,660	−2,532	−3.086	−3,575	−2,602	−2,097	−2,097

Table 2.—KPMG PEAT MARWICK AND CONGRESSIONAL BUDGET OFFICE ESTIMATES OF THE EFFECT OF STATEHOOD ON U.S. GOVERNMENT OUTLAYS FOR FISCAL YEAR 1998

[Billion of dollars]

CBO Estimate	4.2
Difference excluding economic effects:	
Food Stamps	0.1
Medicaid	0.6
AFDC	0.2
Other	−0.1
Subtotal	0.8
Economic Effects	0.4
KPMG Peat Marwick	5.4

Prepared Statement of Martin H. Gerry

Mr. Chairman and Members of the Committee: It is a pleasure to be here today on behalf of the Administration to reaffirm our support for Senate bill S. 712. It is important to provide the people of Puerto Rico with an opportunity to choose their future relationship with the United States. We believe S. 712 does so in an equitable and workable manner.

Our Department provides approximately $2.7 billion per year to, or on behalf of, residents of Puerto Rico. I will briefly summarize the principal effects of S. 712 on our programs.

Under the *statehood* option, expenditure ceilings on AFDC and Medicaid would be removed and the Federally administered Supplemental Security Income program would be extended to eligible persons in Puerto Rico. We estimate *additional* Federal expenditures under HHS programs would exceed $1.6 billion by FY 1995, and $3 billion by FY 2000. Most of this increase is attributable to changes in Medicaid and SSI. HHS expenditure increases represent about 80 percent of the total Federal expenditure increases. The balance is for extension of Agriculture's Food Stamp program to Puerto Rico.

In addition to direct program expenditure increases, the statehood provisions are likely to affect general economic conditions in Puerto Rico. On the one hand there will be economic effects of the increases Federal transfers to Puerto Rico for SSI, Medicaid and AFDC programs—and for Agriculture's Food Stamp program. On the other hand, statehood would change how Puerto Rican corporations and individuals are taxed. The Department of the Treasury has addressed the changes in taxation. I would only like to add that funding for a number of our programs will be influenced by macro-economic conditions—changes in personal income, employment, and unemployment. Therefore, actual Federal costs of statehood could be higher than the estimates I have cited. The interplay of taxes and prod benefits is complex and we do not have an adequate model to estimate these effects.

I would like to mention one concern with the statehood provisions. S. 712 would change the way in which hospitals in Puerto Rico would be reimbursed under Medicare. Currently, they are reimbursed at a blended rate based 25% on the U.S. national rate and 75% on the local rate in Puerto Rico. If Puerto Rican hospitals were paid on the same basis as hospitals in the states, those payments would be about 30% higher than current payments. Because hospital costs in Puerto Rico are substantially lower than in the states, reliance on the national rate could result in overpayment of Puerto Rican hospitals. S. 712 would limit reimbursements in Puerto Rico to "actual costs of providing equivalent health care to the levels of care provided in the several contiguous states." However, this appears inconsistent with the prospective payment approach—which provides hospitals with incentives to control costs. We believe the Medicare payment provision of S. 712 should be re-examined to ensure it achieves its intended purposes.

Commonwealth status as provided for in S. 712 would have little direct effect on HHS programs. The most significant change is related to the bill's provision allowing Federal agencies to consolidate certain financial assistance programs. We ten years experience applying the consolidation mechanism to other insular areas and we do not foresee any problems in this regard.

Finally, our primary concern with the independence option is ensuring an equitable and manageable transition to Puerto Rican Social Security and Medicare systems. Currently, Puerto Rico employers and employees are covered by Social Security and Medicare in the same manner as employers and employees in the 50 states. S. 712 recognizes the complexity of transition to Puerto Rican systems for Social Security and Medicare, and establishes a Commission to address this. We support this approach. In particular, we believe a Social Security totalization agreement, similar to ones we have with eleven other countries, would be an effective approach.

Thank you for this opportunity. I will be happy to answer any questions.

Responses to Questions Submitted by Senator Moynihan

PER CAPITA BENEFITS

Question. Could the Administration give us an estimate of the incidence of social welfare benefits, per capita, in the Island as against the other norms around the country.

Answer. While Federal spending in Puerto Rico will increase in most programs over time due to inflation, the "statehood cost," per se, is due to six programs: Medicaid, Aid to Families with Dependent Children, Supplemental Security Income, the Social Services Block Grant, Foster Care, and Medicare. Our estimate of the cost of statehood reflects incremental costs for these programs. Statehood costs for Medicare cannot be estimated because of ambiguities in S. 712.

Under statehood, we estimate that Federal spending for the five programs would be $1.8 billion in 1995. This is over $1.6 billion higher than the $175 million in Federal spending for those programs under current law. FY 1995 per capita spending is estimated to be $53.00 under current law. Under statehood, it is estimated to be $541 in FY 1995 and $1,073 in FY 2000.

The attached table displays per capita Federal outlays in Puerto Rico for the five programs and compares this to the nation as a whole. We estimate that per capita spending for these programs will be 1.4 times the national per capita average in FY 1995 and twice the national per capita average by FY 2000. The higher per capita spending in Puerto Rico is attributable to the greater proportion of people living in poverty in Puerto Rico as compared to the rest of the nation. This does not mean that spending per beneficiary would be higher in Puerto Rico, but rather that there would be proportionately greater numbers of program beneficiaries there than in the rest of the states. Further, as the table shows, per capita Federal non-defense expenditures for Puerto Rico would still fall below the national rate.

PER CAPITA PROGRAM OUTLAYS FOR PUERTO RICO AND THE NATION FOR PROGRAMS AFFECTED BY STATEHOOD [1]

	1989		1990		2000	
	US	PR	US	PR	US	PR
Current Law [2]	$260	$52	$397	$53	$536	$53
Statehood [3]	260	NA	397	541	536	1,073
Total non-defense [4]	2,804	NA	3,595	2,478	4,450	3,162

[1] Includes HHS programs affected by S. 712 provisions: Medicaid, AFDC, AABD/SSI, SSBG, Foster Care. Does not include Medicare due to ambiguities in S. 712. 1989 population for Puerto Rico estimated at 3.3 million. National per capita figures based on U.S. resident population estimates and projections provided by the Bureau of the Census. Population for the territories and Puerto Rico are held constant in the outyears.

[2] Assumes current law program caps: Medicaid—$79 million for FY 1990 and beyond; AFDC, AABD, and Foster Care—$82 million for FY 1990 and beyond.

[3] Statehood program expenditures do not include administrative costs.

[4] Per capita 1989 Federal non-defense expenditures data provided by the Government Division of the Bureau of the Census. Out-year estimates are based on FY 1989 and five percent a year inflation. Puerto Rico Federal non-defense expenditures based on the 1989 data provided by the Census Bureau and projected per capita program increases for the five HHS programs.

RESPONSES TO QUESTIONS SUBMITTED BY SENATOR DOLE

HEALTH AND HUMAN SERVICES

Question. The Department of Treasury has estimated that about 35 percent of the active Section 936 income would move offshore from Puerto Rico due to statehood. The CBO estimates the phase-out of Section 936 would lead to a loss between 37 percent and 47 percent of the capital and production of Section 936 corporations in the year 2000 compared with what it would be in 2000 under the current status.

Does the static revenue analysis used by HHS to calculate the expenditure figure for statehood take the above into consideration?

In light of those economic consequences, would not a dynamic analysis of the effects of statehood be more accurate? Can you quantify the increased expenditure costs under statehood as a result of using a dynamic analysis?

Answer. Our analysis of HHS program outlays for Puerto Rico under statehood does not take into account estimates of the impact of the phase-out of Section 936 income on the Puerto Rican economy. We recognize that adverse economic conditions would increase Federal spending for our major programs—AFDC, Medicaid, and SSI—which are needs based and are affected by changes in unemployment or family income. Although a dynamic analysis of the effects of statehood would be more accurate, we do not now have a model of the Puerto Rican economy that allows us to estimate the magnitude of the economic effects of the change of tax status on program benefits.

PREPARED STATEMENT OF SENATOR FERNANDO MARTIN

Mr. Chairman, Members of the Committee, my name is Fernando Martin, I am the vice-President of the Puerto Rican Independence Party and I am a Senator in the Puerto Rican Legislature. With me is Professor Pedro A. Parrilla who has been advising my party in economic matters concerning the legislation under consideration by this Committee. Available also to answer your questions, particularly on tax related issues, is Mr. Eric Negron, Esq.

From the point of view of economics and trade S. 712 represents a welcome departure from the traditional attitudes concerning Independence which had prevailed in official United Stages circles. The provisions of S. 712 are a giant step forward in the arduous process of rehabilitating the feasibility of the Independence alternative before the eyes of the Puerto Ricans after almost a century in which United States policy was tantamount, de facto and at times de jure, to closing off the option of Independence to the Puerto Rican people. Senate bill 712 represents a reversal of that policy and recognizes the need for a new policy of affirmative action that will counterbalance the fears and prejudices which have developed—and have been promoted—during these decades of dependence and political subordination.

This policy is made explicit in the legislative language of S. 712 when in Section 313, in reference to transition grants and Federal programs, the bill states that these provisions "are enacted in recognition of the unique relationship between the United States and Puerto Rico, to affect a smooth and fair transition for the new Republic of Puerto Rico with a minimum of economic disruption, and to promote the development of a viable economy in the new Republic of Puerto Rico."

It is therefore, with these enlightened criteria in mind, that we must examine the Congressional Budget Office report on the potential impact of status changes contemplated in S. 712.

In as much as the CBO identifies areas of concern that could adversely affect the stated objectives of a "fair and smooth transition" and the promotion of "the development of a viable economy in the new Republic of Puerto Rico," it is incumbent upon this Committee to introduce the necessary amendments that will better assure an adequate correspondence between the means provided by the bill and the aforementioned goals which I am sure you all share.

In contemplating amendments to the economic provisions of Title III, I wish to remind the Committee of three crucial considerations which must be kept in mind.

The first is that in designing the Independence alternative the Congress does not encounter constitutional limitations such as may be present in the other status options. Only issues of Congressional policy are present here. What is put to a test is the extent of Congressional good faith in fashioning a truly viable Independence option that will forever dispel from the minds of the Puerto Ricans and the international community the impression that Congress would react punitively to the possibility of Independence.

The second consideration is that no matter how fair and generous the provisions concerning Independence might turn out to be, they will always be less costly to the US taxpayer than the statehood or commonwealth alternatives.

The third consideration is that the United States, after ninety two years of exercising its sovereignty over its Puerto Rican possession has an obligation—moral and political—to make Independence a real choice and not merely an illusory one.

Having said this I will now propose to you three modifications to S. 712 which we believe will better insure that the policy objectives of Title III are not inadvertently undermined by the existing provisions of the bill.

With regards to Section 936 of the Internal Revenue Code S. 712 provides that the benefits under this section would cease to apply to an independent Puerto Rico. The report from the Committee on Energy and Natural Resources made clear that it thought this matter should be ultimately left to the Finance Committee although it expressed that the foreign tax credit in an Independent Puerto Rico would be available to what are now 936 corporations. The CBO report goes further to say that arrangements might be reached between the Unites States and Puerto Rico which could provide comparable benefits to those enjoyed today by these companies.

It should be obvious however that if stability and continuity are to be promoted during a transition period Section 936 benefits should continue to apply to an Independent Puerto Rico for at least a ten year period. Treasury will not be worse off because of such an extension in view of what the consequences would be of using the foreign tax credit, while at the same time it would offer existing and potential investors the added incentive of continuity and certainty for a specified period of time.

The second modification concerns Puerto Rico's public debt. As S. 712 stands now interest payments on any new debt or on any refinancing of existing debt after Independence would no longer enjoy tax exemption in the United States when earned by US residents. As the CBO report points out this would raise the cost of borrowing at a time when the emergent republic's credit rating in the international market has not yet been established. If the principle of a smooth and fair transition has been applied as much as possible across the board, there seems to be no valid reason why it should not be applied to the area of public debt financing. Here again our proposal is that the existing structure of tax exemption for interest earned from bonds issued by the government of Puerto Rico and its instrumentalities be kept in place for a period of no less than ten years after the proclamation of the Republic. The cost in foregone income to the US Treasury would be no larger than the one incurred in by a continuation of the present status, and then only for a ten year period.

Our third proposal for modification concerns the transition grants provided for in section 313 subsection 3. The CBO report has expressed concern over the balance of payments outlook generated, in part, by the reduction in real terms of the transition grants since the formula is not based on the present value of Federal payments to Puerto Rico in the fiscal year prior to the proclamation of Independence but simply on its nominal value. The language of the bill should be clarified so that the yearly transition grants reflect the present value of the initial outlay during the 9 year transition period.

The incorporation of these three modifications still keeps Independence as by far the least costly alternative for the United States while at the same time strengthening the viability of the Independence option and serving to ensure the success of the stated policy of the bill. The adoption of these amendments would be a resounding reaffirmation, by this Committee, of the Senate's commitment to the principle of affirmative action in the case of Independence.

A strong and viable Republic of Puerto Rico is not only in our best interest but also in yours; I am sure that this Committee will know how to combine justice with enlightened self interest. Thank you.

PREPARED STATEMENT OF MICHAEL J. MCKEE

I am Michael McKee, a Principal and Managing Director of Quick, Finan & Associates, appearing again today on behalf of the Statehood Party of Puerto Rico. I thank the Senate Committee or, Finance for consenting to hear our views on the economic consequences of Statehood as projected by the Congressional Budget Office in its recent study.

Previously, I served as a senior staff economist for the President's Council of Economic Advisers and the U.S. Treasury's Office of Tax Analysis, as well as at the Organization for Economic Cooperation and Development in Paris. For more than a decade, I have specialized in analyzing structural adjustment issues—that is, how shifts in taxes, social programs, regulations, development policies and other actions that change the underlying structure of the economy affect economic growth and performance.

Before I begin, let me thank the Congressional Budget Office for having done their job under less-than-ideal circumstances. Although I do differ with them on a number of technical aspects of their work, I will not focus on those today. Rather, I shale talk about what their results mean for Statehood.

I draw five conclusions from the study. They all stem from one threshold observation: CBO has expressly limited itself to what it regards as the three *quantifiable* impacts of S. 712 elimination of 936, imposition of Federal taxes, and introduction of full Federal benefits. CBO has not analyzed what it calls "unquantifiable" benefits that Statehood undoubtedly will bring. Thus, what CBO calls "Statehood" is nothing more than Commonwealth, minus 936, plus Federal taxes and benefits: nothing more than Commonwealth with *full fiscal parity* to the states. Using this as its foundation, CBO compares "Commonwealth with parity" against Commonwealth as it exists today, which is projected, for purposes of the study, to last forever.

Does the omission of Statehood's intangible benefits matter? Consider one inescapable conclusion I know you will find unsustainable: It means Senators and Congressmen don't count, and have no impact on their states' economies. I don't believe this and I suspect you don't either. This and other "unquantifiable" impacts of Statehood matter greatly and are not in the study. Statehood is fundamentally different from a "Commonwealth with parity"—politically, emotionally, and economically. In the end I will return to this and let you judge.

Does it matter that Section 936 is assumed to last forever? In 1980, Section 936 caused a Federal revenue loss of $1 billion per year. In 1989, the revenue loss is more like $2 billion. During that time, Puerto Rico's manufacturing sector—*all* of it, including non-936 companies—added just 1,000 jobs, according to the island's employment survey of establishments. So each of these net new jobs is now costing the U.S. Treasury something like a million dollars every year. Being generous—adjusting for inflation—each new job costs well over half a million dollars per year.

Does it matter that CBO projects 936 to last forever? CBO assumes that, in the 11 years after 1989, Section 936 will be responsible for adding between *90,000 and 160,000 936* jobs—well. more than the 1,000 or so added during the last decade. But Section 936 is not adding that many jobs anymore. Its costs are way out of line. Thus CBO's assumption that the Federal government will permit Section 936 to last forever is a delusion.

Now let me turn to the five conclusions I draw from CBO's study.

CONCLUSION 1: COMMONWEALTH IS A SUBORDINATE STATUS TO STATEHOOD, YET COMMONWEALTH HAS A FREE RIDE EVEN THE POOREST STATES DO NOT NOW ENJOY

The Commonwealth Governor has attempted to argue that S. 712 provides a tilt toward Statehood. The Governor, when he asks for fiscal parity, doesn't really mean full fiscal parity. He wants the benefits—and the *benefits only.* A truly balanced bill would phase out Section 936 and impose Federal income tax liability upon Puerto Rico's citizens as it confers entitlement benefits. If anything, the bill currently tilts against Statehood.

Consider from a Federal perspective how unrealistic the Governor's suggestion is. CBO illustrates that Commonwealth, though a subordinate status to statehood, has a free ride at the expense of even the poorest states. Who can believe Congress will go the further step of enhancing the current generous system: granting full benefits, retaining Section 936, and imposing no Federal tax liability. Let's face it: Commonwealth is not Statehood. Congress won't treat Commonwealth better than it does now. It is more realistic to expect that, over time, confronted with the rising cost and incremental inefficiency of Section 936, Congress will reduce—not enhance—Commonwealth.

CONCLUSION 2: THE CURRENT STATEHOOD TRANSITION PROVISIONS IN S. 712 NEED ADJUSTMENT

What does CBO show about how Puerto Rican Statehood is treated under S. 712? The bill's transition is meant to smooth adjustment from the addiction to 936 to a more sustainable economy. By projecting a temporary downturn in Puerto Rico's economic growth late in the transition period, CBO suggests the current transition in S. 712 may be inadequate to achieve that goal. There are ways to rectify this—additional grants, a longer phase-out of 936, a longer phase-in of Federal taxation, or enterprise zones. Other ways include leveling the playing field by giving Commonwealth full parity treatment: by phasing out 936 and imposing Federal income taxes under the Commonwealth option, by implementing a 936 recapture provision for firms that leave the island, or by further limits on the retention of earnings in foreign tax havens. We would welcome the opportunity to work with the Committee to improve the transition. An adequate transition should eliminate the downturn in growth which CBO predicts late in the transition period.

CONCLUSION 3: THE STUDY PUTS A FLOOR UNDER THE RISKS FROM STATEHOOD, AND THE POSSIBLE FALL IS A SHORT ONE

Contrary to prior studies commissioned by Commonwealth advocates, CBO shows that "Statehood"—Commonwealth with full parity—doesn't look bad after all. The Commonwealth party has tried to suggest that the CBO study, like all the other studies that have gone before it, shows Statehood to be a disaster once Section 936 is taken away. But that is not the case in the CBO study. CBO shows merely that this "Commonwealth with parity" grows more slowly than current Commonwealth, but it grows. Indeed, using CBO's method for computing jobs, their results show Commonwealth with parity *adding between 40,000 and 70,000 936-like manufacturing jobs—and with no revenue loss.* And after the transition period, CBO concludes the state will return to the same growth rates as current Commonwealth. Hence, for those who fear Statehood, the result is reassuring. Even in a worst case scenario, the Statehood economy would add jobs. Whatever downturn occurs would be relatively small and temporary.

But it is easy to distort or misunderstand these results. Indeed some recent press reports have done precisely that.

Let me give you an example. *The New York Times* seriously misreported when it said CBO had predicted a loss of 100,000 of Puerto Rico's current 900,000 jobs. In fact, CBO projects no loss at all from the current 900,000. CBO's "high base path" projects an *increase* of 150,000 jobs under Statehood; 250,000 under Commonwealth. Neither status option would shrink the current employment base.

Of course, the real net increase in manufacturing employment since 1980—only 1,000 jobs—illustrates that both figures are wildly optimistic. The disparity between Statehood and Commonwealth is likely much smaller: probably small enough to be eliminated with modest changes in the bill's transition provisions.

What does this say about the earlier studies, typically sponsored by the Commonwealth and its beneficiaries, which have shown the Puerto Rican economy vanishing when 936 goes away? Well, let's not forget that $2 billion revenue loss—it isn't going into the pocket of Puerto Rico's workers and managers. The trick is to use lots of numbers to mask clever assumptions. Peat Marwick, for example, *assumes* certain kinds and numbers of firms will leave, it does *not* deduce this from its "model." Curiously, Peat Marwick assumes that the firms with the highest pretax profits will leave. In 1986, the same interests paid for a study by Booz Allen that came to the same bottom line, but assumed that the firms with *low* pretax profitability would leave.

Let me simply repeat the conclusion: For those who worry that Statehood is an economic disaster, stop worrying. Even in the worst of cases, employment rises and the economy grows.

CONCLUSION 4: CBO'S "STATEHOOD" PERFORMS WELL BECAUSE PUERTO RICO IS A BETTER PLACE THAN WE'VE BEEN LED TO BELIEVE

For many years, representatives of the Commonwealth have been telling us the island's economy couldn't survive without 936. CBO says that is not true. How can this be?

Well, in fact, it used to be true. Puerto Rico has developed in only forty years. Our perceptions lag behind this rapidly evolving dynamism. Remember that today's Puerto Rico is really three Puerto Ricos: the island of the old, the poorhouse of the Caribbean; the island of the middle-aged, a developing economy; and the island of the young, a developed economy. Statistics can be misleading because they show the average of the fading—but still present—past, confused with the economy of tomorrow. But Statehood is for the Puerto Rico of today's young—and tomorrow's.

For example, play is sometimes given to the fact that only 39.5 percent of those over age 24 have a high school diploma, well below the mainland figure. But this figure is from the 1980 census—ten years ago—and at that time, those over 24 were those born before 1956—when the island had just begun to develop. Thus, this statistic merely shows that people on the island back then didn't get the schooling of people today.

As you can see in Chart 1, the evolution in schooling since that time—even only up to 1980—has been remarkable. The island even in 1980 had a greater share of university-aged people in school than did the mainland. We can see the same evolution in English proficiency, in Chart 2, with one caveat—it stopped improving among the young in the 1970s.

Which brings us to the schizophrenia of Commonwealth advocates. They have chosen to deemphasize English in the schools as a political matter—even though their own economic future depends on bilingualism. Their advertising for investors emphasizes that the work force is fluent in English (see Attachment No. 1). This is just one case among many where Commonwealthers must accentuate the positives for investors, but the negative before the Congress.

What are the positives? A skilled and educated work force that is inexpensive by mainland standards; an attractive climate and beautiful beaches and mountains; fertile land for tropical agriculture; language and culture that make the island a natural economic bridge between the mainland United States and Latin America; a history of pro-development government; and a militarily strategic location in the Caribbean. It is these, together with the recognition of Statehood, that assure Puerto Rico's economic future.

CONCLUSION 5: CBO'S "STATEHOOD" PROVIDES NO CEILING BECAUSE STATEHOOD IS MORE THAN JUST A COMMONWEALTH WITH FISCAL PARITY

My last point is that there is a difference between Statehood and "Commonwealth with parity." CBO has given us a floor under Statehood, it has not given us a ceiling.

Why is that? First of all because CBO has given us only what it *chose* to quantify, and the intangible effects of Statehood require assumptions they were not willing to make in order to preserve their appearance of fairness. But let's be clear, CBO has assumed its conclusion about 936 departures—this also came from no model. The model only quantified the *effect* of this assumption. That the assumption is less biased than those of studies sponsored by Commonwealth shows in the results. Still, both are mere conjectures.

Likewise, to understand the effects of Statehood require assumptions based on history and judgment. They cannot be proven statistically (no more than can the departure of 936 companies) because statistical economic projections, such as they are, have to be based on historical data.

We do have a history of territories becoming states. And their success speaks volumes. But that is not enough for statistical analysis: 48 of those states became states before we had economic data that would permit such an analysis. The other two, Hawaii and Alaska, became states in modern times, and we have data for them. But two states aren't enough for statistical analysis. That is, with a sample of only two states, each observation can be met with some rebuttal. Sure, Hawaii grew a thriving economy based largely on tourism, agriculture, and military spending after Statehood; but after all, there was a military buildup; there was growth in Asia; there was more transPacific travel. Roosevelt Roads is one of the largest U.S. Navy bases outside the continental U.S. The same jets that fly to Hawaii do fly to Puerto Rico, yet Puerto Rico's tourist economy is less developed. There will be continuing growth in Latin America. All true, but these factors simply cannot be the basis for statistical extrapolation and therefore Statehood's potential must rest on judgment.

Next week we will be submitting a study that closely examines the prospects for the Statehood economy. It will quantify the potential gains from Statehood. It will show those gains easily to exceed the supposed losses of a Commonwealth with parity, with job gains of up to 150,000 over the decade.

Today, we introduce for the record the testimony of Mr. Nelson Soto, former President of the Puerto Rico Planning Board, demonstrating that under Statehood, increased foreign investment, increased access to Federal procurement, tourism development and customary Federal employment will produce between 94,000 and 150,000 new jobs by the year 2000.

We also introduce for the record the testimony of Professor Carlos Diaz-Oliva of the University of Puerto Rico School of Law, who shows conclusively that the danger of 936 companies relocating is marginal because the continued benefits of Puerto Rican operations in most cases outweigh the tax benefits of relocating.

Are the judgments sound? Is being a state better than being a Commonwealth with parity?

Each of you on this Committee is an experienced individual with a knowledge of business and a knowledge of the world. You are able politicians. The question that each of you must answer is a simple one: If you were responsible for the economic development of this island, would your job be easier as the governor of a territory with full fiscal parity, or would your job be easier as Governor of the 51st State?

• When you appeal to mainland investors, would you rather say "come to the 51st state," or would you rather have to explain the ins and outs of your peculiar relationship with the U.S.—that you are foreign soil, but not really? In being a state, you can appeal to investors not as a foreign country, not as a foreign location—as the Commonwealth must do today by attempting to offset its foreignness with tax benefits—but rather as a state.

• Would you rather appeal to foreign investors interested in putting a plant in the U.S. by saying "We're the 51st state; we've got educated people, inexpensive skilled labor, good infrastructure, good labor relations, and a government that will help you." Or would you rather try to explain what a Commonwealth is, and apologize for the fact that when foreign investments become a hot political item, your representation in Washington is, shall we say, thin, but promise that legions of lobbyists achieve the same results as two Senators and seven Congressmen.

• Would you rather appeal to tourists by saying, come and see the 51st state, or would you rather appeal to tourists as the Commonwealth must do now by saying, come and see our beautiful island in the Caribbean? Tourists today routinely ask: Do I need foreign currency, do I need shots, and do I have to bring my passport?

Is the answer as obvious to you as it is to me? Then where is the ceiling on this state's future?

To sum up, then, there is one basic fact about the CBO report. It estimates the consequences of "Commonwealth with parity" and calls that Statehood. It has five implications.

• The current Commonwealth is a more generous system than the states get: It won't be enhanced by Congress appreciably—and may ultimately be curtailed or eliminated.

• The current Statehood transition in S. 712 should be adjusted to prevent the brief economic downturn projected by CBO.

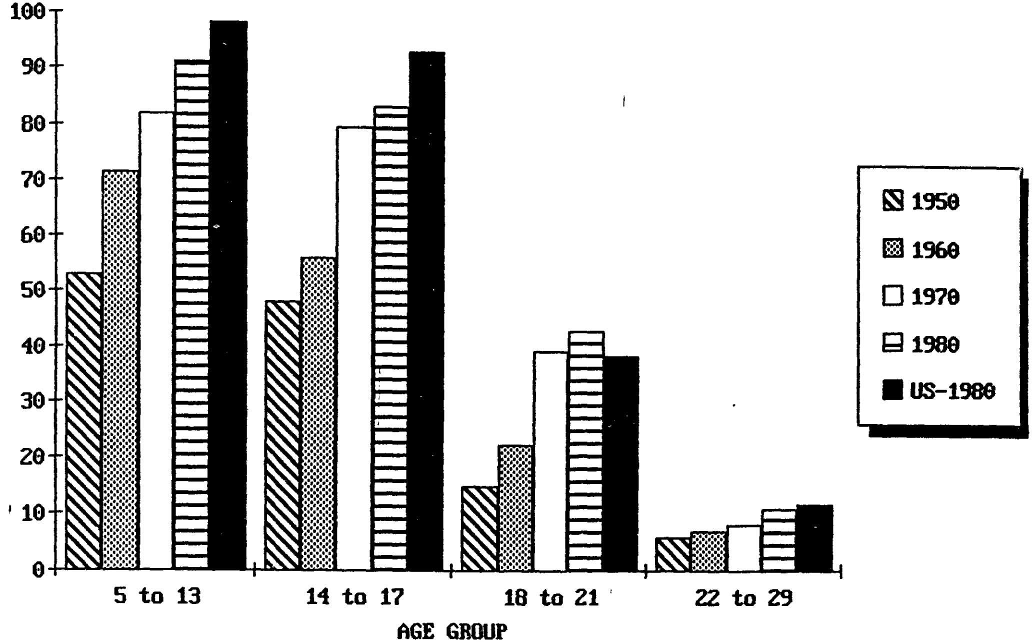
• Contrary to earlier dire predictions, even in the worst case the "Statehood" economy will keep on growing.

• Puerto Rico is a very different place today than it has been in the past. That explains why CBO's "Statehood" keeps on growing and why actual Statehood will be even better.

• Finally, for you to decide: To build an enduring economy, would you rather be Governor of the State or Governor of a Commonwealth? If you answer "the State," you yourselves will have recognized that the Congressional Budget Office study has put a floor under the future of the Puerto Rican economy as a state, but not a ceiling over it. Thank you very much.

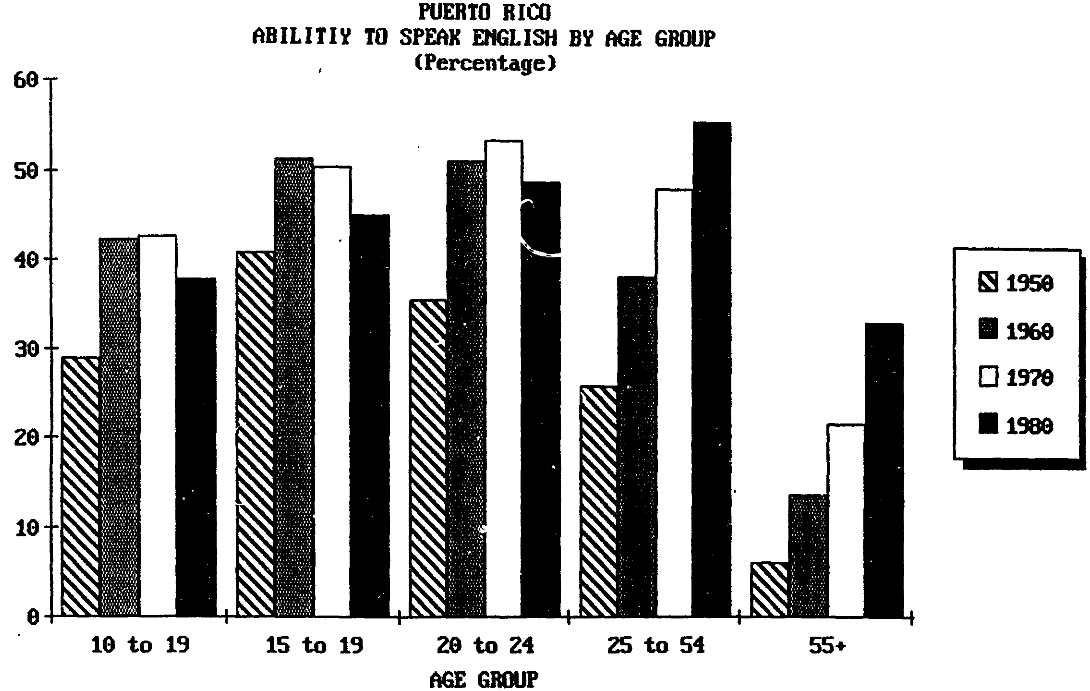
Chart 1

PUERTO RICO 1950-80 vs. U.S. 1980
PERSONS ENROLLED IN SCHOOL BY AGE GROUP
(Percentage)



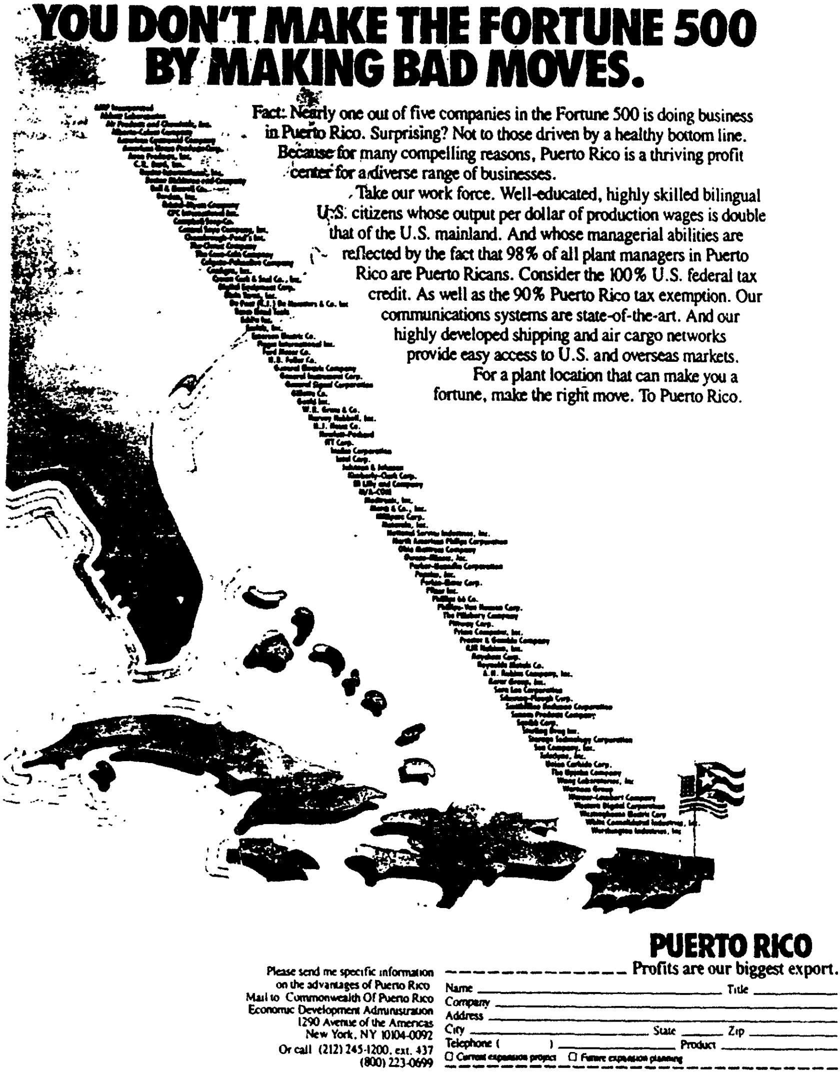
Source: United States Census

Chart 2



Note: 1980 10-24 Age Groups Adjusted by QFA
Source: United States Census

Attachment 1



PREPARED STATEMENT OF PHILIP D. MORRISON

Mr. Chairman and Members of the Committee: It is a pleasure to be here today on behalf of the Administration to reaffirm our support for Senate Bill 712, a bill "To Provide for a Referendum on the Political Status of Puerto Rico." The Administration is also represented today by Assistant Secretary Martin H. Gerry of the Department of Health and Human Services, who can address the HHS-related expenditure issues raised by this bill.

Senate Bill 712 would provide for a referendum, to be held in 1991, in which the Puerto Rican people could decide among the options of statehood, independence, or commonwealth status. Kenneth W. Gideon, Assistant Secretary for Tax Policy, testified before this Committee on November 14, 1989 regarding this bill. Today, I provide a more detailed analysis of the revenue effects which were presented in that prior testimony, particularly in light of new economic studies which have subsequently reviewed this matter. I also summarize the Administration's position on this bill, which was provided in more detail in the written statement submitted for the record at the November hearing.

I. INTRODUCTION

The Administration strongly supports the right of the people of Puerto Rico to decide for themselves the future status of their island. Further, as the President has noted a number of times, he favors the admission of Puerto Rico to the Union as a state, thereby assuring the people of Puerto Rico equal standing with other United States citizens.

The Administration believes that the Puerto Rican people should be given an opportunity to express their will in a manner that recognizes the historic and fundamentally political nature of their decision of self-determination. The decision they face as a people transcends narrow concerns about specific aspects of economic or fiscal structures. We recognize, however, that the significant economic features of the three options must be identified to allow an informed choice and to make the proposed referendum self-executing in its important features.

The Administration endorses the balance between these two concerns which was struck in Senate Bill 712 as reported by the Committee on Energy and Natural Resources. The bill informs the Puerto Rican people of the broad outline of the fiscal and economic structures applicable to each of the three status options. Yet it preserves this essentially political choice free from a welter of details, transitional rules, and administrative provisions best addressed by Congress after the political choice is made.

Our prior written statement covered a number of technical issues, not affecting the basic balance of the bill, that we believe require clarification or other attention in the drafting of this bill. In addition, for many of the bill's fiscal provisions, we anticipate that further legislation by Congress will be necessary after the referendum to cover particular details of the transition. We discussed in our prior written statement a number of issues that such legislation might cover.

The Administration also believes that the substance of the proposed tax and economic results under each of the three options in Senate Bill 712 represents a reasonable resolution of the difficult policy choices faced by the drafters of this legislation. We think the bill achieves, to the extent possible, the three goals set for it by the Committee on Energy and Natural Resources: (1) an even playing field, politically, for the three political parties, (2) a smooth economic transition, and (3) an adjustment that is budget neutral over a period of time.

It is important to note at the outset, however, that there are significant limitations in any attempt to quantify with precision the economic "equivalence" of the three status options. Economic forecasts out to the year 2000 are only projections, not guarantees. The prediction of the economic results under each of the options is further clouded by many intangible factors, including the reaction of the Puerto Rican people and their government to the option chosen, the response to that choice by the business community, and the possibility that Congress will amend the current tax treatment of Puerto Rico under commonwealth status. Each of these factors could significantly alter the comparative economic forecasts under each of the referendum options.

One of the primary issues for this Committee is the overall impact of Puerto Rican status on the Federal deficit. With respect to the commonwealth option, the baseline budget deficit, of course, already contains the cost of Internal Revenue Code section 936, which effectively exempts domestic corporations active in Puerto Rico from U.S. tax. Treasury's Office of Tax Analysis (hereinafter, "OTA") estimates that $2.1 billion in net tax benefits were received by section 936 corporations in fiscal year 1990, projected to grow at about 10 percent a year. Under statehood, the Administration estimates that while there is a net increase in the Federal deficit under statehood in early years, there is a substantial net decrease in the Federal deficit beginning in fiscal year 1996. Using expenditure estimates prepared by the Congressional Budget Office (hereinafter, "CBO") does not alter the conclusion of an eventual deficit reduction, but merely shifts the crossover point to fiscal year 1997. These projections are illustrated in Appendix II.

As an overall legislative package, the current bill reflects a good and defensible balance among the three status options. It is not, however, the only alternative that might have been adopted. For example, a uniform phase-out of section 936 under both the statehood and commonwealth options would eliminate what is perceived by some as a bias in the bill toward commonwealth. Nevertheless, we recognize that section 936 should not be viewed in isolation from the other costs and benefits affected by this referendum. Other provisions in the bill can reasonably be viewed as providing a rough balance to the phase-out of section 936. Accordingly, the Administration accepts the treatment of section 936 proposed in the current bill and the related Congressional judgment that the economic provisions set forth for the three alternatives are fairly equivalent.

Before turning to a review of our economic projections, let me briefly restate the Administration's position with respect to each of the bill's major provisions affecting tax policy.

II. SUMMARY OF ADMINISTRATION'S POSITION ON TAX PROVISIONS

A. Statehood Option

1. Deferred Application of Federal Taxes

We support the decision to defer until January 1, 1994 the application of Federal tax laws, other than those relating to excise taxes. This provision will give both U.S. and Puerto Rican tax authorities the necessary time to ensure a smooth transition to a new Puerto Rican state tax system. In addition, we believe that it will allow adequate time to develop detailed transitional rules for Congress to consider enacting before the January 1, 1994 changeover.

2. Phase-Out of Section 936

We also believe that the proposed phase-out under the statehood option of the section 936 credit during the period from 1994 through 1997 reflects a good and defensible balance among the different interests at stake. We defer to the Justice Department for the conclusion that continuation of section 936 after statehood for a limited transition period passes muster under the uniformity clause of the U.S. Constitution (Art. I, sec. 8, cl. 1), which broadly requires taxes to be uniform throughout the United States. As recommended in the Justice Department's prior testimony on this bill, we also strongly encourage specific fact findings by Congress to support a Congressional determination that providing transitional tax benefits to Puerto Rico is appropriate and that any section 936 transition adopted is well suited to achievement of Congressional goals.

3. Application of Excise Taxes

The bill would extend all Federal excise taxes to Puerto Rico as of its date of admission as a state. In general, we agree with this result, but recommend an effective date as of the first day of the calendar year following admission.

4. Statehood Grants and Assistance

The bill provides for transition assistance in the form of a transfer (or "cover-over") to the Puerto Rican Treasury of Federal excise taxes derived from Puerto Rico prior to October 1, 1998, as well as the tax collected from the extension of Federal internal revenue laws to the State of Puerto Rico in 1994 and 1995. We agree that Puerto Rico should receive sufficient assistance to ease its transition from commonwealth status. As discussed in our November written statement, however, the cover-over mechanism has presented complex administrative problems in the past. We therefore recommend that Congress preserve its flexibility to address in future legislation the appropriate procedures to be used in measuring and remitting the desired levels of such statehood grants, without restricting its choice to a direct cover-over of collected taxes.

B. Independence Option

1. Elimination of Section 936

The bill would eliminate the benefits of the section 936 credit for income from activity or investments in Puerto Rico upon the proclamation of independence. This automatic repeal is essential to avoid the difficulties that would otherwise arise with respect to a number of income tax treaty partners of the United States who have effectively been granted most favored nation status with regard to tax sparing incentives.

2. Negotiation of Tax Treaties

The bill provides for a Task Force on Taxation to facilitate the negotiation of appropriate tax treaties between the United States and an independent Puerto Rico, which would be approved by the two governments in accordance with their respective constitutional processes. Due to the economic integration between Puerto Rico and the United States, we strongly support this goal, although we understand that there may be technical legal difficulties with this section as drafted and defer to the Department of Justice on this issue.

3. Interest on Puerto Rican Government Obligations

The bill would continue the current Federal tax exemption for interest paid on Puerto Rican bonds outstanding upon proclamation of independence. We recommend clarification that this provision does not apply to either original issuances or refinancings on or after the date of independence and that the continued exemption is subject to the rules governing the exemption for U.S. municipal bonds, as amended from time to time.

C. Commonwealth Option

1. Continuation of Section 936 Benefits

Under the enhanced commonwealth option, the bill would not result in any changes to the substantive tax laws currently applicable with respect to Puerto Rico. Accordingly, the benefits of section 936 would not be phased-out (as under statehood) or eliminated (as under independence). We believe, however, that Congress should make it clear that such benefits cannot be regarded as guaranteed under commonwealth status but rather should continue to be viewed as incentives which Congress will, as it has in the past, review and revise as necessary.

2. Puerto Rican Review of Federal Laws and Regulations

The bill provides for expedited review procedures where the Puerto Rican government determines that Federal laws or regulations are inconsistent with the enhanced commonwealth relationship. As described in more detail in our written statement submitted in November, the Administration has serious concerns with respect to these provisions. In the context of legislation and regulations affecting the tax system, we believe such special review procedures would unreasonably complicate fair and efficient tax administration. The standard Constitutional and Congressional procedures governing tax legislation and the rules of the Administrative Procedure Act governing tax regulations provide reasonable and appropriate protections of Puerto Rico's interests.

3. International Agreements

The bill would permit the Governor of Puerto Rico to enter into international agreements to promote the international interests of Puerto Rico as authorized by the President of the United States and consistent with the laws and international obligations of the United States. Currently, Puerto Rico does not have the authority to negotiate or enter into international double taxation conventions or similar agreements in its own right. An outright grant of independent tax treaty authority to Puerto Rico would significantly complicate the negotiations of United States treaties and quite possibly undermine several existing conventions. We recommend that Congress explicitly deny independent tax treaty authority in the commonwealth option.

III. REVIEW OF REVENUE ESTIMATES AND PROJECTIONS

The revenue estimates and projections which were submitted by the Administration in November are updated and submitted as Appendix I to this written statement. As you are aware, two economic studies have been published subsequent to our testimony last Fall which raise questions with respect to some of our conclusions: *Potential Economic Impacts of Changes in Puerto Rico's status under S. 712*, prepared by the Congressional Budget Office, (April 1990) (hereinafter the "CBO

Study"), and *Economic and Fiscal Impacts of Puerto Rican Statehood*, prepared for the Governor of Puerto Rico by the Policy Economics Group, KPMG Peat Marwick (February 1990) (hereinafter the "Governor's Study"). In response to these studies, this testimony describes in greater detail the assumptions we made in developing our estimates and projections, and reviews how our conclusions relate to those reached in the new studies.

As I previously stated, the economic effects of each of the political options under the bill cannot be estimated with precision. Much would depend upon the decisions made by the government and people of Puerto Rico as they exercise their rights under each of the options, as well as the response of the business community with respect to current and future levels of investment on the island. The choices made would affect the Puerto Rican economy and to some extent Federal tax revenues and outlays. The conclusions to be drawn from the numbers must always be weighed together with the admittedly unquantifiable, though potentially beneficial, effects of the choice of either the statehood or independence options. Both of the new studies recognize this fact and the resulting danger of relying too heavily on those factors which can be quantified.

A. Federal Revenue Effects of Phase-Out or Elimination of Section 936

Both the statehood and independence options under S. 712 assume some form of reduction of the tax incentives currently provided under section 936. As noted, OTA estimates that $2.1 billion in net tax benefits were received by section 936 corporations in fiscal year 1990, and these benefits are projected to grow under existing commonwealth status. Under S. 712, if the statehood option were chosen by the Puerto Rican people, these benefits would be phased out during the period from 1994 to 1997. Under the independence option, the benefits would be eliminated upon proclamation of independence.

As the Governor's Study and the CBO Study agree, the extent to which the reduction of these benefits are actually translated into increased Federal tax receipts is the major factor in the determination of the impact of the bill on Federal receipts. The projected revenue gain from phasing out section 936 tax benefits represents considerably more than half of the total revenue gain projected under statehood, and over 90 percent of the gain projected under independence. The section 936 revenue figures are also the most controversial, since the Treasury projections of Federal gains from personal taxes and other non-section 936 revenue sources are similar to the projections in the other studies.

OTA's estimate of the revenue gains from phasing out section 936 required consideration of several factors. The following discussion reviews how each of these factors contributed to the estimates and projections noted in Appendix I.

1. Developing a Current Law Baseline

As an initial matter, it was necessary to determine a baseline of the Federal tax benefit currently derived from Code section 936. For this purpose, OTA used the most recent data available on the income of section 936 corporations in Puerto Rico, based on tabulations of 1985 tax returns filed with the Internal Revenue Service by the companies. In comparing the OTA analysis to the projections in the Governor's Study, it is important to note that the baseline used in the Governor's Study relied on Puerto Rican tax data and seems to miss more than 25 percent of the section 936 income actually reported to the IRS.

OTA divided the section 936 income into its two components: active business income and qualified possession source investment income (QPSII). In recent years QPSII has accounted for about 15 percent of total section 936 net income. Each of these components must be analyzed separately because the phase-out of section 936 would affect them differently. For example, even if a section 936 company attempted to shift its Puerto Rican operations to an overseas location after statehood, the financial component (QPSII) would generally become taxable by the United States. This is because passive earnings of a U.S.-controlled foreign subsidiary are generally deemed to be repatriated and taxed currently at the U.S. shareholder level under subpart F (Code sections 951-964).

Each of the components of section 936 income were projected forward to estimate the level of such income under current law to compare with the phase-out of these benefits under statehood and their elimination under independence. The active income component was projected from 1985 to 1988 using data in the Puerto Rican national accounts on the growth of non-wage income in manufacturing. A growth rate consistent with previous historical trends was used for the years following 1988. In addition, an adjustment was made for the impact of the Tax Reform Act of 1986 on section 936 income. In particular, the likely shift by many section 936 companies to the 50-50 profit split method as a result of the imposition of a royalty floor in the cost-sharing option was taken into account. The QPSII component was projected using recent trends in growth of financial assets.

2. Effect of Overseas Shift of Current Section 936 Activity

Under the statehood option, if the active business income of section 936 corporations currently shielded from Federal taxation by the section 936 credit were to continue to be earned either in Puerto Rico or in any other state,[1] the phase-out of section 936 tax benefits would generally be translated dollar-for-dollar into increased Federal tax receipts. If, however, the activities of these corporations were shifted outside of the United States, some portion of the income would not yield increased Federal revenue in the near term. This is because certain income earned by U.S.-controlled foreign subsidiaries may be deferred from Federal taxation until repatriated. Moreover, even when the income is distributed to the U.S. shareholder, Federal tax on such earnings could be offset by foreign tax credits. Accordingly, Federal receipts under the statehood option could increase by some figure that is less than the full amount of the current law section 936 baseline.

The possibility of section 936 operations moving to non-U.S. locations is therefore one of the most important issues in projecting the revenue gain from phasing out section 936. Estimating the extent of such movement, however, is also the most difficult step in making this projection.

3. Factors Considered in Estimating Overseas Shift

OTA's estimate of the extent to which section 936 operations would move abroad under the statehood option was based on several considerations. One was the determination for each industry of the extent to which section 936 income was derived from intangible assets. A further consideration was the division of such intangible income between that attributable to marketing intangibles (such as trademarks) and manufacturing intangibles (such as patents).

The above distinctions are relevant since they affect the potential for shifting income-producing activity outside of the U.S. tax jurisdiction. Under current law, the transfer of either manufacturing or marketing intangibles to an overseas affiliate would require substantial royalties to be paid to the U.S. transferor. These royalties must be "arm's length" and commensurate with the income attributable to the intangible. Where the output of the offshore affiliate was primarily sold in the United States (which is currently the case for most section 936 activity), the affiliate would contribute little additional marketing to the overall income produced and the required royalty payments would thus offset a substantial portion of the affiliate's income. With respect to marketing intangibles, the royalties required would leave very little income offshore. If section 936 companies do choose to move offshore, such royalties would reduce the benefits of a low-cost location and increase the Federal revenue pick-up. This, of course, will affect the decision whether or not to move offshore.

U.S. taxation associated with the repatriation, through royalty payments, of the income that can be moved overseas could, however, be somewhat reduced by the U.S. owner's foreign tax credits. If the section 936 company's parent corporation is in an overall excess foreign tax credit position, then royalties paid with respect to intangibles used overseas would generate foreign source income and could be sheltered from U.S. tax by the recipient's foreign tax credits. For this reason, the frequency of excess foreign tax credit positions by industry was also examined.

This foreign tax credit protection would generally not be available, however, with respect to income derived from marketing intangibles related to the U.S. domestic market. Royalties paid with respect to income derived from such marketing intangibles, even after their transfer overseas, would retain their character as U.S. source income and would be fully subject to Federal tax. This important factor was overlooked by the Governor's Study.

Further, for some industries, an offshore location would offer lower profitability than Puerto Rico quite apart from the effect of increased royalty payments. This is because the income allocation rules under section 936(h) often permit section 936 companies to claim a return on intangible assets associated with a broader "product" than the product actually produced in Puerto Rico. For example, the section 936 affiliate can often claim all or a part of the return attributable to an intangible

[1] For the purpose of estimating Federal revenues, it is generally unnecessary to determine how much of the section 936 income would stay in Puerto Rico rather than move back to the mainland. As long as the state tax and operating costs on the mainland were comparable to those in Puerto Rico, the Federal revenue pickup would be the same since, either on the mainland or in Puerto Rico, such income would be subject to Federal tax.

even though the highly technical part of the process is still performed by the parent in its U.S. plant. These rules thus permit a greater portion of income to be attributed to the section 936 corporation than would be the case for an affiliate operating in alternative offshore locations. As a result, if such Puerto Rican operations were moved overseas, some income currently allocated to the section 936 company would not be able to follow and would shift to the U.S., even before the imposition of an increased royalty on the overseas income.

The very high rates of return earned by section 936 corporations in the aggregate suggest that intangible assets account for 75 percent or more of total income. A review of 1985 tax return data also indicates that marketing intangibles were significant for a substantial portion of the section 936 corporations. Under Code section 936(h), a section 936 corporation is allowed no return on its intangible income unless it elects either the cost-sharing method or the 50–50 profit split method. Prior to changes introduced by the 1986 Tax Reform Act, the cost-sharing method was generally a more beneficial choice for companies relying on manufacturing intangibles. The significant role of marketing intangibles to section 936 operations, therefore, can be seen from the fact that, as of 1985 (before the 1986 changes took effect), 40 percent of section 936 income was received by companies which had elected the 50–50 profit split option rather than cost-sharing.

Information on the present location of U.S.-controlled operations supplying the U.S. market was also consulted. For example, the electronics industry has demonstrated that substitutes for Puerto Rico appear to be available in the low-tax countries of the Pacific rim. Finally, the availability of low-tax alternatives for particular activities such as pharmaceutical manufacturing was evaluated. In this connection, OTA consulted with foreign government and other experts to gauge the extent to which foreign jurisdictions would offer incentives to section 936 operations.

4. Conclusion

As a result of examining these factors for each industry, OTA concluded that, in the long run, about 35 percent of the active section 936 income in Puerto Rico under the current law baseline would move offshore to non-U.S. locations. As noted, some of this income would have to be repaid to the United States in the form of royalties. Based on the likely royalties that would have to be paid and the excess foreign tax credit positions of the parent corporations in each industry, about 25 percent of active section 936 income would remain offshore. Stated another way, the phase-out of section 936 would result in an addition to the U.S. tax base of 75 percent of the active section 936 income. Adding to this the portion of section 936 income that is passive (the QPSII component) and, as described above, would also not escape U.S. tax, nearly 80 percent of total section 936 income would become subject to U.S. tax after the phase-out.

I would like to stress that projecting the amount of income that would shift to low-tax locations cannot be a simple mechanical process, but must take a number of factors into consideration. For example, the Governor's Study assumed that any operation that can increase its after-tax return by 5 percentage points by moving offshore would necessarily do so. Applying the same logic to operations on the U.S. mainland would lead to the conclusion that virtually no highly-profitable manufacturing would currently take place in the United States. A low mechanical threshold of this type ignores the benefits now available in Puerto Rico that would be difficult to replicate in a foreign location, such as the use of the dollar as the local currency, protection from expropriation and political uncertainty, and the ability to obtain legal protection in a U.S. court. Furthermore, very few (if any) of the foreign locations considered to be potential alternatives to Puerto Rico can offer both the skilled labor force and the proximity to U.S.-based marketing and R&D personnel that are provided by Puerto Rico.

B. The Role of Macroeconomic Considerations in the Revenue Estimates

1. Reliance on Independent GNP Predictions

In estimating the revenue impact of any change in domestic tax policy, OTA revenue analysts hold various macroeconomic variables, such as GNP, employment, total investment, etc., fixed at those values set by representatives from the Council of Economic Advisors, the Office of Management and Budget, and the Economic Policy Office at Treasury. Similarly, the Joint Committee on Taxation staff makes their estimates consistent with CBO's macroeconomic projections.

This convention serves several useful functions. First, although a change in tax policy can affect these macroeconomic variables, the specific impact will generally depend upon the reaction of the Federal Reserve Board and other agencies whose policies may also have macroeconomic effects, and different analysts may have differing views about the magnitude of both the direct effect and the response. Second, without maintaining some overall constraints, it is easy to overstate the effects of a tax policy change. Thus, standard revenue estimating policy calls for assuming that the reduced employment (or investment) in an adversely affected industry will be offset by increased employment (or investment) elsewhere.

This convention has in general been followed in OTA's analysis of the revenue effects of S. 712. The Administration's forecasts for U.S. GNP, which might be expected to be relevant for projecting the growth of section 936 operations, was available only for 5 years, through fiscal year 1995. However, other than the brief interruption after 1982 caused by restrictions in section 936 benefits enacted under TEFRA, P.L. 97-248, the real growth of section 936 income has been relatively stable over a long period of time. This long-term historical growth of section 936 income was thus used to project section 936 income under the current law baseline into the late 1990's.

The representatives of the Council of Economic Advisors, OMB and Treasury, mentioned above, do not project Puerto Rican GNP and income. The OTA projection of increased Federal collection of personal and non-section 936 corporate taxes under statehood assumed continued real growth in Puerto Rico, but at a very conservative rate of about 2 percent per year. Following standard revenue estimating conventions, no attempt was made to predict the impact of phasing out section 936 benefits on the growth of the Puerto Rican economy.

2. Impact on Puerto Rico's GNP

Employment in section 936 corporations now accounts for 12 percent of total Puerto Rican employment, or about 100,000 to 110,000 jobs, and the income earned by employees of section 936 corporations represents about 16 percent of total Puerto Rican labor income. Thus, any reduction in the activity of section 936 corporations and their local suppliers of goods and services could potentially reduce the personal income of the residents of Puerto Rico (although, to the extent the activities were transferred to the mainland, the personal income of the residents of other States might increase). Nevertheless, the assumption made in the Governor's Study that those workers displaced by the relocation of section 936 activities would remain unemployed, apparently forever, seems far too pessimistic, since such workers are among the most skilled. They can be expected eventually to find jobs in other activities, although possibly at lower wage rates.

Estimating the impact on Puerto Rican employment of the potential relocation of section 936 activities not only requires determination of the extent to which such relocation would occur, but is also complicated by the other economic changes which would accompany statehood. Federal transfer payments to the residents of the state would grow significantly, increasing demand in Puerto Rico. Thus, the overall impact of statehood upon the gross national product of the State of Puerto Rico is not readily estimated.

The CBO Study utilizes a macroeconomic model of the Puerto Rican economy in order to estimate the impact of statehood and independence. The model attempts to capture the impact of the activities of the section 936 companies on the economy of Puerto Rico. The CBO Study projects that under statehood the Puerto Rican economy would continue to grow, but that the rate of growth may be one to two percentage points slower per year than under the current commonwealth status. These projections reflect only the impact of phasing out section 936 and extending Federal expenditure programs to Puerto Rico, which are the only consequences of statehood that CBO could quantify. As the CBO Study concedes at page 1, its analysis

> cannot take into account the unquantifiable gains from statehood, such as the effect of reduced uncertainty about Puerto Rico's future status and increased awareness of the opportunities that it offers. These effects, which generally would work to improve the economic outlook under statehood, may be significant, though CBO can give no estimate of their size.

The impact of phasing out of section 936 benefits will depend on the response of the Puerto Rican state government. One possible response is a development incentive to replace section 936. Treasury's reports to the Congress on the possessions corporation system of taxation have indicated that section 936 is a very expensive incentive when measured by the jobs created in Puerto Rico. The most recent estimates, those determined for 1983 in the Sixth Report (March 1989), show a revenue cost of about $18,500 per job, or about 125 percent of average compensation. In pharmaceutical manufacturing, which accounts for half of the revenue cost of section 936, the average cost per job was about $58,000. The trend in section 936 income and the growth of manufacturing employment since 1985 suggest that the cost per job is at least as high today, despite the post-1987 drop in the U.S. statutory corporate tax rate to 34 percent. Accordingly, the Puerto Rican state government may well be able to reproduce the job-creating effects of section 936 by designing a much more efficient program.

The difficulty in predicting the impact of statehood on the Puerto Rican economy is further evidenced by the fact that the Governor's Study, which predicts a much greater reduction in section 936 activities within Puerto Rico than does the CBO Study, estimates only a 5 percent reduction in GNP by the year 2000 (although its projection of a 14 percent reduction in reported personal income is more in line with CBO's projection of a 10 to 15 percent reduction). The Governor's Study also does not attempt to quantify the potential indirect benefits resulting from statehood, nor to examine how these non-quantifiable benefits may be enhanced by the subsequent decisions of the government and people of Puerto Rico.

I stated earlier that the OTA forecasts of the increased Federal tax collections of section 936 income under statehood did not depend to a significant degree on whether those operations not moving overseas remained in Puerto Rico or moved back to the mainland. This difference would, however, have an impact on Puerto Rico's GNP, although the reduction in section 936 activities on the island does not necessarily translate into a commensurate reduction in GNP.

Predicting how many U.S.-based operations would move back to the mainland is very difficult. It is true that the tax benefits that attracted most of the section 936 companies in the first place would be phased out. Nevertheless, many of the companies now have a substantial investment in physical plant and have developed a highly competent and cost-effective labor force. In view of the relatively long phase-out period for section 936 benefits under statehood contemplated in S. 712, it appears that any actual decline of section 936 operations in Puerto Rico would take place over a long period of time.

3. Impact of Puerto Rico's Change in GNP on Revenue Estimates

As I indicated earlier, the OTA projections of increased Federal collections of personal and non-section 936 corporate taxes under statehood assumed continued real growth (albeit at a modest level). The assumed rate of growth was only slightly lower than the average growth rate projected by CBO using its low-growth baseline. A reduction in the Puerto Rican growth rate of the magnitude projected by CBO would change the estimated total Federal revenue increase by only a modest amount. Even in fiscal year 2000, by which time the cumulative shortfall in GNP projected by CBO would be 10 to 15 percent, OTA's projected increase in Federal revenues would be reduced by less than 5 percent. This is because a reduction in the Puerto Rican growth rate affects only the increased Federal revenues from personal taxes and non-section 936 corporate taxes, which constitute a relatively small portion of the overall projected increase in Federal revenues.

Furthermore, the increase in individual income taxes projected by OTA is even less than that projected by the Governor's Study. For example, for fiscal year 1997, the Governor's Study projects an increase of individual income tax collections of $914 million in their high relocation scenario in contrast to OTA's projected increase of only $739 million. OTA's projection of increased non-section 936 corporate collections is lower than the Governor's study estimate as well. These results confirm the fact that the projections of increased Federal tax from income now benefiting from section 936, which is not sensitive to the state of the Puerto Rican economy, is the only important area of disagreement on revenues.

C. Net Impact of Puerto Rican Status Referendum on the Federal Deficit

A major question to be faced by this Committee is whether S. 712 creates an economic balance for any of the three status options that is likely to increase the Federal budget deficit, decrease it, or keep it roughly the same. The baseline budget deficit, of course, already contains the cost of section 936; thus there would be neither an addition nor a reduction to the deficit in the commonwealth option. As stated above, however, OTA estimates that $2.1 billion in net tax benefits were received by section 936 corporations in fiscal year 1990 and these benefits are projected to grow at about 10 percent per year under the existing commonwealth status.

The statehood option, on the other hand, changes the status quo. It increases both revenues and outlays. While the net effect in the early years is a net increase in the deficit under anyone's estimates, in later years there is a substantial net decrease, whether the outlay figures used are the expenditure estimates prepared by CBO or by the Departments of Health and Human Services and Agriculture. The only difference produced by using these alternative estimates, resulting from CBO's higher outlay figures, is the year in which the net figure turns positive (*i.e.*, the year there is no longer an increase in the Federal deficit due to Puerto Rican statehood and is, instead, a deficit reduction). Using the expenditure estimates of the Departments of Health and Human Services and Agriculture, this "crossover point" occurs in fiscal year 1996; using the CBO estimates, it occurs in fiscal year 1997. This crossover point for the Administration's estimates is illustrated in Appendix II.

It is important not to misinterpret the conclusions in the CBO Study which refer to an $18 billion "net transfer" to Puerto Rico over the nine-year period between 1992 and 2000. The CBO Study states at page 27 that this "net fiscal benefit from statehood would likely be permanent." These figures are based on Table 7 in that study, which describes the Federal expenditures to Puerto Rico net of new Federal taxes derived from the island. As stated in a footnote to that Table 7, however, the increase in Federal taxes does *not* include the additional Federal revenues from the phase-out of section 936. Rather, the reference to "net transfers" in the CBO Study's conclusion is limited to the payments to and from Puerto Rico (which do not include increased Federal taxes paid by domestic corporations formerly benefiting from section 936). The focus of this Committee, however, must cover the full effects of statehood on the Federal deficit, including the very significant revenues to be derived from the section 936 phase-out. The effect of the section 936 phase-out thus accounts for the crossover point illustrated in Appendix II and an eventual net deficit reduction from statehood, even where "net transfers" to Puerto Rico continue beyond the crossover year.

D. Effects of Statehood on Federal Tax Revenues: A Detailed Analysis

1. Phase-out of Section 936 Benefits

The revenue effects of S. 712 under the statehood option over the fiscal year period 1992-2000, are presented in Appendix I. This table indicates that the revenue effects of the phase-out of the section 936 benefits, described in detail above, is the largest component during and after the phase-out period (changes in the Federal income taxes under statehood are scheduled to become effective on January 1, 1994). By fiscal year 2000, the revenue pick-up from this source is estimated to be nearly $4 billion.

2. Federal Excise Taxes

Puerto Rican residents do not currently pay Federal excise taxes, but would be subject to these taxes under statehood. This would result in an increase in annual revenues of $200 million to $400 million, which, under S. 712, would be rebated to the Puerto Rican government as a statehood grant at least through October 1, 1998.

3. Federal Income Taxes

The extension of the Federal income tax to individuals and corporations in Puerto Rico would result in additional Federal revenues. Net of the earned income credit, the individual income tax is estimated to annually raise between $650 million and $850 million during the period between fiscal years 1994 and 2000. Under statehood, Federal corporate taxes would also be collected from Puerto Rican businesses that do not now fully benefit from section 936. This includes locally incorporated as well as foreign corporations. As shown in Appendix I, these annual revenues are estimated to range from $250 million to $550 million between fiscal years 1994 and 2000. As noted in Appendix I, under S. 712, a portion of these taxes are scheduled to be "covered-over" to the government of Puerto Rico.

4. Other Federal Revenues

As noted in Appendix I, about $100 million to $175 million per year in customs duties would continue to be collected between fiscal years 1994 and 2000. Beginning in 1994 through at least October 1, 1998, these revenues would be covered-over to the government of Puerto Rico. Rum excise taxes, of about $250 million per year, would also continue to be covered-over to the government of Puerto Rico until 1998.

5. Interaction of the Federal and Puerto Rican Tax Systems

The government of Puerto Rico collected approximately $900 million in individual income taxes in their 1989 fiscal year, which is about 5 percent of reported personal income. Puerto Rico also collects about $1 billion annually in business taxes, which represent about 10 percent of business income. Together with the Federal taxes to which they would be subject, the total tax burden on Puerto Rican residents would thus be quite high. As a state, Puerto Rico could design a tax system which would maintain current tax revenues. It might also choose to follow other states in relying more heavily on sales taxes. Or alternatively, Puerto Rico can modify both its tax system and the level of its expenditures, as well as modify the role of government enterprises in the economy.

E. Revenue Implications of Independence

Under the independence option, the elimination of the section 936 benefits would also result in increased Federal revenues, as shown in Appendix I. Some section 936 activities (for example, those engaged in apparel manufacturing or food processing) might choose to reincorporate as Puerto Rican corporations, permitting deferral of the Federal tax on a portion of such income until repatriated to the U.S. owners. In addition, Puerto Rican taxes paid with respect to U.S. corporations that retain their Puerto Rican activity would generate a foreign tax credit (rather than a state tax deduction as under the statehood option). For these reasons, the Federal revenue gain from the elimination of the section 936 benefit is not expected to be as great in later years as under the statehood option.

As an independent country, Federal excise taxes (primarily that on rum) and customs duties would apply only on goods imported into the United States; the Federal Government would not collect any customs duties on goods imported into Puerto Rico. Federal income taxes would apply only to the extent income earned in Puerto Rico were repatriated to the United States (or deemed to be repatriated under Subpart F rules), and some Federal withholding taxes might be collected on the payment of income earned in the United States to Puerto Rican residents.

APPENDIX I.—ESTIMATED AND PROJECTED FEDERAL REVENUE INCREASES UNDER S. 712

The following chart shows the Federal revenue collections that are estimated to result from implementation of either the statehood or the independence option under S. 712 through fiscal year 1995 and projections of revenues for the five fiscal years thereafter. Because economic projections are not made by the Treasury, Council of Economic Advisors, or the Office of Management and Budget for years after 1995, the projections shown for 1996-2000 are based on a continuation of the fiscal year 1995 economic forecast in later years. The section 936 projections, however, are based on the historic patterns of section 936 tax expenditure growth which have been significantly in excess of U.S. economic growth.

Except in the case of customs duties and rum excise taxes, these figures reflect projected increases in Federal revenue collections over existing law. As indicated below, many of these amounts would be subject to a cover-over to the State of Puerto Rico until either fiscal year 1996 or 1998. Except as otherwise indicated, these figures reflect an effective date of 1/1/94 for Federal tax law changes. These figures do not assume any change in Puerto Rican tax law.

[In millions of dollars]

	Estimates (Fiscal years)				Projections (Fiscal years)				
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Statehood									
Phase-Out Sec. 936	45	128	538	1204	1889	2610	3325	3741	3994
New Excise Taxes [1]	[2] 213	[2] 295	[2] 309	[2] 325	[2] 341	[2] 358	[2] 376	395	414
Personal Tax									
Gross U.S. Collections (Net of EIC)			645	676	707	739	773	809	846
Cover-Over to P.R.			[2] 482	[2] 666	[2] 168				
Net U.S. Collections			163	10	539	739	773	809	846
Corporate Tax									
Gross U.S. Collections			249	427	448	471	495	519	545
Cover-Over to P.R.			[2] 249	[2] 427	[2] 174				
Net U.S. Collections			0	0	274	471	495	519	545
Customs Duties			[2] 97	[2] 134	[2] 141	[2] 148	[2] 155	163	171
Rum Excise Tax		[2] 188	[2] 252	[2] 255	[2] 257	[2] 260	[2] 262	265	268
Independence									
Eliminate Sec. 936 [3]	45	1501	2579	2738	2876	3095	3327	3555	3816
Rum Excise Tax [3]		188	252	255	257	260	262	265	268

[1] Reflects 1/1/92 extension of Federal excise taxes to Puerto Rico (other than the rum excise tax which already applies).
[2] Taxes subject to cover-over to Puerto Rico in years
[3] Assuming proclamation of independence occurs on 1/1/93.

Appendix II.—EFFECT OF THE STATEHOOD OPTION ON THE FEDERAL BUDGET BASED ON ADMINISTRATION'S ESTIMATES AND PROJECTIONS OF FEDERAL TAX REVENUE GAINS AND OUTLAY INCREASES

[Fiscal year in billions of dollars]

	1992	993	994	995	996	997	998	999	2000
Tax Revenue Gains [2]	([1])	.1	.7	1.2	2.7	3.8	4.6	5.1	5.4
Outlay Increases [3]	.8	.9	1.4	2.2	2.6	3.0	3.3	3.7	4.1
Increases in Surplus (+) or Deficit (−)	−.7	−.8	−.7	−1.0	+.1	+.8	+1.3	+1.4	+1.3

[1] Less than $50 million gain.
[2] Revenue gains estimated by Office of Tax Analysis, Department of the Treasury.
[3] Outlay increases estimated by Departments of Health and Human Services and Agriculture.

Responses to Questions Submitted by Senator Roth

Question 1. Has the Treasury Department considered the impact of statehood for Puerto Rico on Puerto Rican companies (companies established under Puerto Rican laws) which are owned by shareholders resident in neither Puerto Rico nor the U.S., but which have negotiated grants of partial tax exemption under the Puerto Rican Tax Incentives Act? Such incentives are analogous to those currently obtainable by I.R.C. section 936 companies and are subject to similar conditions regarding the creation of employment, but are not section 936 companies for purposes of the Code. As currently drafted, S. 712 does not address this issue, and I would like to know how the Treasury would propose addressing this problem so that both Puerto Rico and the United States' best interests are protected.

Answer. Under current law, U.S. mainland corporations operating in Puerto Rico are generally protected from Federal income tax by the section 936 credit. Corporations organized under Puerto Rican law with business operations on the island are not eligible for section 936 benefits; however, such corporations are classified under U.S. tax law as "foreign" corporations not engaged in the conduct of a U.S. trade or business. Puerto Rican corporations thus generally pay no Federal corporate income tax.

The structure of transition rules for the imposition of Federal corporate income tax under the statehood option must take into account both types of corporations. S. 712 provides clear transition benefits to mainland corporations by phasing out the section 936 credit over four years. The Committee on Energy and Natural Resources stated that this phase-out constituted "a reasonable transition to permit firms to adjust to the new tax situation." However, the Committee also indicated that additional transition relief may be necessary for other companies that would experience significant tax changes under statehood:

> There are firms in Puerto Rico which enjoy certain tax benefits under Puerto Rico's laws and which may have structured their investments and operations in response to these local tax laws. In these cases, some period of transition may be warranted.

S. Rep. 101-120, p. 36. We generally agree with the Committee's conclusion that some form of transition relief may be warranted for Puerto Rican corporations that would undergo an abrupt change of tax status under statehood. However, any such transition provisions must be carefully crafted to avoid unintended results.

We would propose that the bill state that the 1994-1997 phase-out of section 936 would apply solely to mainland corporations which are eligible under current law to receive the credit:. In addition, the bill or its legislative history could state that the transition legislation contemplated in section 213(d) of the bill will provide roughly comparable relief for certain Puerto Rican corporations but only in appropriate cases.

We would expect that the rules to be adopted under that legislation would address the case of a Puerto Rican corporation benefiting from partial tax exemptions granted by the Commonwealth government that would be subject to a significant increase in its overall tax burden under statehood. This result would be consistent with our revenue estimates and projections for statehood, in which we assumed, with respect to corporations organized in Puerto Rico, that only those which are eligible for exemption under the Puerto Rico Tax Incentives Act would receive transition benefits equivalent to the section 936 phase-out for mainland corporations.

Question 2. The Congressional Budget Office has estimated the effect of the statehood option on the operation of 936 companies, as well as the likely effect on the

Puerto Rican economy. Has any similar analysis been made of the effects on the operations of foreign companies? If so, what conclusions were reached regarding the behavior of such investors and potential investors under the possibility of statehood?

Answer. In making its revenue estimates and projections under the statehood option, Treasury did not make any detailed analysis of the effects of statehood on foreign-owned Puerto Rican companies, because at present such operations are a relatively small component of total tax-exempt activity on the island. Our presumption, however, is that the percentage of such foreign-owned Puerto Rican companies which would choose to relocate after statehood would be greater than for U.S.-owned operations. This is because, due to the nature of their intangible income, U.S.-owned companies would be less able to achieve overall reduction of tax through relocation.

Question 3. What would the approximate cost of including transitional relief for foreign owned companies be if the Puerto Rican Tax Incentives Act were extended after statehood?

Answer. If the form of the transitional relief were simply to extend the partial exemption from Puerto Rican tax after statehood, this proposal would have a negligible effect on Federal revenues. Of course, the extent to which incentive programs which are now available under Puerto Rican law would be modified after statehood would be a question for the Puerto Rican government to decide as part of its overall transition to a new state tax system.

On, the other hand, if this question contemplates that corporations currently enjoying a Puerto Rican tax incentive would be given an equivalent exemption from Federal corporate income tax following statehood, this would involve a significant revenue loss. Under such a proposal, corporations would receive a 90 percent exemption from Federal tax which, in some cases, would extend 25 years into the future. Moreover, this substantial loss of Federal revenues would be based solely on commitments made by the government of Puerto Rico. As such, it would abrogate Congressional discretion to structure and review an overall transition package. Consequently, this proposal would constitute a substantial increase in the transition benefits over those contemplated by S. 712 and we would oppose its adoption.

Question 4. What would the approximate cost of giving transitional relief for foreign owned companies be if it were tied to the same transitional relief given to 936 companies under S. 712?

Answer. In making its revenue estimates and projections under the statehood option, Treasury assumed that the transitional relief of the phase-out of section 936 would apply in a roughly equivalent form to those companies incorporated in Puerto Rico (whether or not foreign-owned) which now enjoy substantial tax exemptions under the Puerto Rican Tax Incentives Act. The cost, at least for those foreign-owned companies that qualify for such tax exemptions in Puerto Rico, is therefore included in the revenue figures presented in our testimony. If the final version of S. 712 specifies that these Puerto Rican companies will *not* receive transitional relief, the Federal revenue gain would be about $100 million higher over the phase-out period.

RESPONSES TO QUESTIONS SUBMITTED BY SENATOR DOLE

Question 1. Did you explicitly take into account CBO's estimate of relocation of Section 936 assets and exports in your estimate of Section 936 revenues recovered under statehood? If the answer is no, please explain the rationale behind Treasury's different assumptions.

Answer. In making its estimates and projections of Federal revenue increases from the phase-out of section 936, Treasury's Office of Tax Analysis ("OTA") did not rely on CBO's estimate of relocation of section 936 assets. Rather, OTA performed its own analysis of the effect such relocation would have on these revenue increases. The assumptions underlying Treasury's analysis of this issue are explained in greater detail in part 111(A) of the written statement submitted by International Tax Counsel Philip Morrison to the Senate Finance Committee on April 26, 1990.

It should first be recognized that the relocation of section 936 activities will not necessarily result in the income from such activities being any less subject to U.S. taxation under the statehood option. The OTA analysis concluded that nearly 80 percent of the income which section 936 essentially exempts under the current law baseline would become subject to U.S. tax after the phase-out. In summary, OTA's analysis included the following factors:

(i) Section 936 income attributable to passive investments (currently about 15 percent of total section 936 income) would generally become subject to U.S. tax under statehood even if the investment income were shifted offshore (since pasgive earnings of U.S.-controlled foreign subsidiaries are generally subject to current tax under subpart F of the Code).

(ii) Regardless of whether the activities generating non-passive section 936 income were continued in Puerto Rico or shifted back to the mainland, they would become subject to U.S. tax under statehood.

(iii) The amount by which section 936 companies could shift the income from their non-passive activities outside of Puerto Rico and the U.S. is affected by the extent such income is attributable to intangibles (much of which would be returned to the U.S. in the form of taxable royalties).

(iv) The foreign tax credit position of the company involved will affect the amount of residual U.S. tax imposed when royalties are paid back to the U.S. for the use of manufacturing intangibles offshore.

(v) Less offshore shifting of income is possible in the case of marketing intangibles (such as trademarks) than in the case of manufacturing intangibles (such as patents).

(vi) Current allocation rules under section 936 permit greater amounts of income to be attributed to the Puerto Rican operations than would be permitted in the case of a foreign subsidiary; thus even if the activity were moved to an offshore entity, a portion of the income now reported by the section 936 company would remain within the U.S. tax jurisdiction.

(vii) OTA reviewed the effects of the above factors on an industry-by-industry basis for the companies now benefiting from section 936.

(viii) In order to evaluate the potential for offshore relocation, OTA also considered potential substitute locations for section 936 operations on an industry-by-industry basis.

Question 2. CBO estimates that GNP would decrease 10 to 15 percent under Statehood and wages and salaries would decrease 26 percent. Bow do these figures affect Treasury's estimates of individual income taxes, corporate non-936 taxes and social security taxes? By what amount would the dynamic analysis affect Treasury estimates of the fiscal effects of statehood.

Answer. It is important to note at the outset that the CBO estimate does not constitute a "decrease" in current Puerto Rican GNP. Rather, CBO estimates a 10 to 15 percent shortfall in *projected GNP growth.* Moreover, this projection is a cumulative amount, representing a 1 to 1.5 percentage point reduction in the annual growth rate of GNP over a 10 year period. A reduction in the Puerto Rican projected growth rate of this magnitude would change the estimated total Federal revenue increase by only a modest amount. Even in fiscal year 2000 when the cumulative shortfall in GNP growth reached 10 to 15 percent, OTA's projected increase in Federal revenues for that year would be reduced by less than 5 percent. This is because a reduction in the Puerto Rican growth rate affects only the increased Federal revenues from personal taxes and non-section 936 corporate taxes, which constitute a relatively small portion of the overall projected increase in Federal revenues.

Question 3. Do the estimates of Federal outlays under statehood include the full dynamic effect of increased unemployment and decreased wages? By what amount would Treasury's estimates change if the full dynamic impact is included?

Answer. Treasury did not make its own estimates of Federal outlays under statehood. To describe the effects of the bill on the Federal deficit, Treasury compared its estimates and projections of Federal revenue changes to the outlay figures prepared by the Departments of Health and Human Services and Agriculture. See section 111(C) and Appendix II of the April 26, 1990 written statement submitted by Philip Morrison. The outlay estimates do not reflect the dynamic effect of any possible increase in unemployment or decreased wages.

Question 4. What increases in real and nominal GNP and GDP of the Puerto Rican economy under Commonwealth are implicit in Treasury's estimates of the growth of section 936 revenues?

Answer. The growth of section 936 revenues is basically unrelated to the growth of the Puerto Rican economy because almost all section 936 products are sold on the U.S. mainland. In developing a current law baseline for the revenue costs of section 936, OTA used the most recent data available on the income of section 936 corporations in Puerto Rico (1985 U.S. tax returns), and then divided such income into its two components: active business income and passive income. Each of these components was projected forward to estimate the level of such income under current law.

The active income component was projected from 1985 to 1988 using data in the Puerto Rican national accounts on the growth of non-wage income in manufacturing. A growth rate consistent with previous historical trends (10 percent) was used for the years following 1988. The passive income component was projected using recent trends in growth of financial assets (5 percent).

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Question 5. In your testimony you implicitly assume that only 28.6% (10 of 35 percentage points) of taxable income is recovered from Section 936 companies that relocate to other non-U.S. locations because of increased super royalty payments. If the remaining 71.% of taxable income can be saved by foreign relocations, what competitive advantage exists for these firms to remain in Puerto Rico or to relocate to the United States?

Answer. The 71.4 percent reduction in the amount of income which would be subject to U.S. tax for companies who would relocate does not represent the potential tax savings of the average 936 corporations. Rather, it represents the tax benefits which would be derived only by those companies which would gain the most by moving due to both tax and non-tax factors. As explained in greater detail in Treasury's written statement of April 26, 1990, many factors could reduce the potential tax benefits to be derived from relocation. For example, the large number of 936 corporations that depend heavily on marketing intangibles (such as trademarks) would save virtually nothing by moving offshore. The benefits of moving offshore may also be reduced because of distance from the marketing and R&D establishment on the mainland, currency risk and other non-tax factors. As indicated above, the Treasury attempted to consider the special role of marketing intangibles as well as the important role of non-tax determinants of costs in projecting the relocation of 936 corporations offshore.

Question 6. What proportion of the Section 936 firms in Puerto Rico under Commonwealth locate or relocate in the United States under statehood? Bow would this affect estimates of individual income tax collections, corporate non-936 taxes, social security taxes, and increased outlays?

Answer. The Federal revenue results are essentially the same whether section 936 companies remain in Puerto Rico or relocate to the U.S. mainland. Treasury did not, therefore, specifically project the proportion of section 936 firms that would relocate to the mainland under statehood. The main issue in projecting the section 936 revenue gain is how many 936 companies would move offshore to non-U.S. locations. As indicated above, Treasury assumed modest nominal Puerto Rican GNP growth in projecting non-section 936 tax collections. Due to this conservative approach, the revenue gain from personal and non-section 936 corporate taxes projected by Treasury was actually lower than in some studies which predicted serious consequences of phasing out section 936.

Prepared Statement of Teodoro Moscoso

Mr. Chairman and Members of the Finance Committee, I am pleased to speak today about the issue of statehood in Puerto Rico and economic development under commonwealth.

The United States acquired Puerto Rico in 1898. And ever since it has periodically been trying to decide what to do with us. During occasional attacks of bad conscience or by sheer accident it has tried to deliberately develop a policy. Intentions are usually the best as befits a great and generous nation endowed with large but limited resources. And with a political system born in revolution and able in its moments of greatness to correct its course usually without much bloodshed. As we grow older we have learned to use persuasion rather than violence to undo injustices domestically. We still have to learn this lesson in our international relations, particularly when we come to dealing with Latin America. But that is another subject. We are here to discuss Puerto Rico; an integral part of the United States, as a fact of life, no matter what hair-splitting lawyers or nostalgic nationalists may say.

In 1976 Congress amended the Internal Revenue Act to allow Puerto Rico's job creating tax incentive law to work more efficiently. Wilbur Mills, Al Ullman and the Ways & Means Committee saw the correctness of our request and endorsed Section 936 which Congress later approved.

The judicious use of this tax advantage has done much to allow an "economic miracle" to take place in our island. The London *Economist* has described it as "one century of economic development accomplished in a decade." Tax law experts will appear before you and tell you that this is sheer perversion of an equitable tax system. They will claim there is no logic in allowing a few manufacturers in Puerto Rico to make near-tax free millions in order to create jobs in this over-populated resource-starved island 1,500 miles from here. Perhaps, Mr. Chairman, but there is also no logic in Texas having oil, and Puerto Rico having none. We arrived late at the table when the banquet of world resources was being served. But even the most obdurate of tax experts at Harvard Law School, agree that the Puerto Rican program accounts for a substantial increase in the per capita income there. Of course, the reason why it has not worked as well elsewhere in the developing world is that ultranationalism—some call it local pride—has mitigated against these countries promoting their incentives to outsiders, who have the capital, manufacturing know how and marketing knowledge, and who might have been able to assist their people in achieving a better standard of living.

I grant you that our program is based on a frank appeal to cupidity, and as such it has been effective. As President Reagan might have put it: "What's wrong with that?" And if he outlives his bureaucratic opposition, Mr. Gorbachev would also agree, I hope.

There is now before the Congress a well-intentioned attempt to resolve what is known in Puerto Rico as the "status problem." Good intentions can mitigate but can not change realities. Independence ceased to be a valid alternative as far back as the first decade of the 19th century. If it had been able to think this far ahead, Puerto Rico could have then adopted a Chinese type population policy which would have stabilized the population of the island at about 250,000. If that had been the case, today, even with its meager resources, but a much smaller population, the island could have developed into a small nation of well-off farmers with many tropical tourists attractions. That the latter can mean, in terms of economic diversification, modernization and development—a sort of Barbados or Bermuda—with a modern agricultural export sector to fall back on. Inordinate population growth resulted from the very quick reduction in the death rate due to improvement in public health measures following the U.S. annexation of the island in 1898, without a countervailing reduction in the high birth rate. This lack of balance between population and resources made independence economically impossible. With independence we would not drop down to the level of the poorest country of the Caribbean, but eventually we would be down to the level of the next poorest and perhaps worse.

Statehood is not in the cards. Nor will it be for the foreseeable future in my estimation. Perhaps in some distant future science and technology will have been able to compensate for our non-contiguous disadvantage, being fifteen hundred miles away from our principal source of raw materials and food, and from the principal market for the things that we produce. Expanded tourism is no substitute for manufacturing. Not to downgrade our many attractions, but unlike Hawaii, we face competition from many nearby islands with many beaches.

Other very important factors mitigate against statehood. We are still very much a Latin American people. We think speak, feel, pray and die in Spanish. The lack of contiguity does not help here either. In the West and Southwest United States, large chunks of Latin America were made a part of the United States by force in a manner which would not be tried today. The population that came with this land was slowly absorbed, at least partly, into the mainstream of America, and the melting pot is doing the rest. Easy interchange of population due to contiguity has hastened the process and made it less painful. This would not be the case of Puerto Rico.

When statehooders are asked what they have in mind as a substitute gainful occupation for the hundred of thousand direct and indirect jobs that will be lost if Puerto Rico became a state, their fast answer is that mainland curious, will increase tourism. It happened in Hawaii, they say, so why not in Puerto Rico. Ironically, proponents of statehood who now offer expanded tourism development as a job-creating substitute for 936 manufacturing corporations, when these flee Puerto Rico under their formula, did everything in their power to undercut the travel industry of the island during their eight-year tenure in the 1980's. We lost about half of our tourist hotel rooms through inattention and hostility.

Hawaii was thoroughly Americanized even to the point of paying Federal taxes decades before it became a State. When it entered the Union, Hawaii, which has twice the land area of Puerto Rico, had one sixth of the population. One tenth of its population was Armed Forces personnel; the entire archipelago population, with a few exceptions, though, felt and spoke in English. The few thousand who communicated in a minor aboriginal tongue were very quickly overwhelmed, economically, socially and culturally, by the strong, hard working New England missionaries. By 1959, Hawaii was truly ready for statehood.

Conditions in Puerto Rico are different. When the United States established its sovereignty there, its four hundred years of Spanish history had created a Hispanic culture; habits-including religious ones—were purely Spanish. It laws, administrative practices, business mores, its intellectual, moral and aesthetic values were Spanish. You were born, lived and died in a Spanish milieu. The strongest of cultural influences—the language—is Spanish. A language which gave the world a rich literature, a language in which a Cervantes was to write the universally acclaimed first novel of Western civilization, Don Quijote; a language spoken by more persons on earth than any other except English. This is not a dialect used by a few thousand aborigines, with no literature worth mentioning, easily swamped by the English tongue and American culture.

If to four hundred years of cultural heritage from Spain, you add the lack of contiguity and a population six times larger, you are faced with a problem of assimilation quite different from Hawaii.

Now let us take a look at the Commonwealth status which defines the present relationship between Puerto Rico and the mainland. This status was tailor-made for the circumstances which prevailed in Puerto Rico almost a century ago and still largely do today. Too many people, too few natural resources, lack of proximity to the mainland, a different culture and language. And yet over the years of association, a rapport has developed between these two culturally different groups, one wealthy, large in land area and in numbers; the other small, but with a population density approaching one thousand per square mile. Ortega y Gasset would agree when he defined nationhood in his classic "Rebellion of the Masses": The most disparate people action together on matters of great import over time will eventually blend into dynamic nationhood. In our near-century of association, we have participated with the United States in the trials of great wars and in the joys of as yet unfinished peaceful revolutions.

Since planning is a much disliked word in the American Zeitgeist, the United States has, when the spirit moved it, considered Puerto Rico an integral part for many Federal programs but not for others in a most unplanned and haphazard fashion. Back in the early fifties, President Eisenhower agreed to correct, in part, our lack of natural resources by giving us a special dispensation for the importation of foreign crude oil. Mr. Chairman, at one time Puerto Rico enjoyed an oil import quota larger than almost any state in the Union. That particular bubble was pricked by OPEC pricing policy. Our hopes for thousands of jobs to be created by downstream development of petrochemicals went largely down the drain. Our unique status as a Commonwealth and as the poorest part of the United States was the principal reason behind President Eisenhower's decision. The changes made in Section 936 in 1976 helped to pick up the slack. Economic growth continues today. Not only do the 936 companies provide the bulk of our manufacturing jobs and wages, but also the bulk of our bank credit resources.

Early in the '80's, President Reagan proposed the Caribbean Basin Initiative, but failed to fund the program adequately. Goals were set but the strategy and money to make these goals a reality were largely absent. Puerto Rico offered to assist in the implementation and funding of the creditworthy projects of the initiative. Those who downgrade the Commonwealth status as a valid alternative tend to forget that if statehood became Puerto Rico's relationship with the U.S., Section 936 would soon disappear as would the funds now generated by 936 companies. Those companies not only are the mainstay of the Puerto Rican economy, but which will increasingly become an important source for development credits for all the Caribbean countries included in the CBI.

To sum up: Only under Commonwealth status, with its fiscal autonomy, can a strong, rapid economic development program flourish in Puerto Rico and the Caribbean. Only under Commonwealth can Section 936 exist and do its pump-priming job for Puerto Rico, as well as for the rest of the Caribbean Basin Initiative countries. CBI is the only positive, long-term American policy effort for assisting our nearest, and poorest Latin American neighbors that has come out of Washington in the past thirty years. It won't do the job if we don't allow it to do the job. If stimulated by the Congress and the Administration, it may be able to do what Puerto Rico's Operation Bootstrap did. I repeat the words of The London's Economist: one century of development in a decade. Bootstrap, or the Fomento program as it is generally called in Puerto Rico, has obtained world-wide acclaim. Back in 1973, the Taiwan Government gave me a copy of a dog-eared translation into Chinese of a 1958 study of the Fomento program done by the National Planning Association and used in the Taiwan development effort.

Initially, the industrialization program of Puerto Rico began as a state-run effort. This happened during World War II. It obtained the bipartisan blessing of both Senator Robert A. Taft and President Franklin D. Roosevelt, as the accompanying 1943 letters to the War Production Board attest. In 1949 when the end of the war permitted private industry to do the job Puerto Rico, anticipating "Perestroika" by almost forty years, privatized the plants the government was operating. It then embarked on a program of private industry promotion which served as the starting point for many of the Alliance for Progress efforts as well as for President Reagan's CBI. An essay by Dr. Kenneth Boulding, analyzing the Fomento program, appeared exactly

30 years ago in a publication of the Center for the Study of Democratic Institutions. I beg the members of this committee and its staff to read this brief paper and then ask yourself; if under Commonwealth such things can be accomplished, why change it? Why take the motor away from the tractor? Why not just install an improved or more powerful engine?

As I approach my eightieth birth, I feel even more strongly that the pace of history and technology are accelerating so rapidly that the political relationships most attuned to the needs of my grandchildren and their children are difficult to predict, and in any event, are decisions that should be made by a younger generation which will have to live with the consequences of their choice and make it work. Commonwealth's flexibility and dynamism is a significant virtue in this rapidly changing world. Perhaps in the next century that time your successors in Congress will also have other matters of great importance to consider: the creation of a United States of North Central and South America plus Canada; for short, it may then be called "the United America."

Back on a winter afternoon in 1961, in his apartment in Paris, Jean Monnet, father of the unification of Europe and no mean global planner, suggested this hemispheric approach to me, as a goal of the Alliance for Progress. I only wish I were fifty years younger to see it happen. What a magnificent role tiny, under-estimated Puerto Rico could play in furthering this stupendous objective.

Thank you.

Attachment.

THE U.S. AND REVOLUTION

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abril 1961

An Occasional Paper on the Free Society published by the Center for the Study of Democratic Institutions

THE American attitude toward revolution has all the ambivalence, so beloved of the psychologist, of our attitude toward our mothers. This, of course, is because the United States as a nation was born in a revolution, which one might describe, I suppose, as an adolescent revolt. Consequently, we feel a certain obligation to like revolution on principle, having been born in one ourselves. On the other hand, we are also afraid and suspicious of revolutions. This, no doubt, can be traced back to a suppressed guilt feeling about the treachery to a parent culture which any revolution implies. Our attitude toward revolution, therefore, is a compound feeling of both love and hate, affectionate regard for the infants toddling in our early footsteps and unresolved guilt about our own breakaway.[1]

The explanation of this ambivalence does not, of course, necessarily have to be psychoanalytic, for there are perfectly sober, rational reasons both for welcoming revolutions and for fearing them. Revolutions may get out of hand and they may turn out to be the wrong revolution. The world is haunted today by the specters of past revolutions, like past noises echoing through the corridors of the present. The French Revolution, which (1) consists essentially in the dispossession of large landowners and the division of land among small peasants, and which, in one of its aspects at least, has been called the "green revolution," continues to explode in countries which have not yet relieved themselves of the feudal landlord and the large estate. The American Revolution, (2) which represents the breakaway of the colonies from a metropolitan power, continues its interesting, if erratic, course, and is at the moment exploding in Africa. The Russian Revolution, which represents the dispossession of *all* capitalists and the seizure of political and economic power by a small and determined group of Communists, continued to roll pretty vigorously just after the end of the second World War, and although it has been temporarily checked it remains a constant threat.

Reforma agraria

Peru Ecuador

The tendency for one kind of revolution to pass into another is at least great enough to make it hard to select the precise revolution which one wants. Under these circumstances, there is a tendency to shore up the *status quo* and to prevent *any* revolution on the grounds that no revolution is better than the wrong revolution. This, however, is a rearguard action, almost certain to lead to ultimate defeat. Once revolutions are on the march, they have to be dealt with one way or another. And in one sense the only answer to the wrong revolution is the right revolution.

A further source of confusion is that it is not always easy to tell when a real revolution has occurred. Revolution is a "system change"; a social system with certain dynamic processes of its own reaches a boundary at some date and a new social system with new laws and a new dynamic takes over. Sometimes these boundaries are dramatic and visible. The French, American, and Russian revolutions are examples of such. Sometimes, however, the boundaries are not observable. The revolution, like the turn of the tide, is unnoticed at the moment but carries with it a profound reversal of the great tide of history. The industrial and technical revolution in which we are now living was one such. It is practically impossible to put a date on it. It was inaugurated by no violence and no fanfare. We can trace its origins perhaps as far back as the Benedictines of the sixth century A.D. The movement is slow and uncertain, however, until the seventeenth and eighteenth centuries. Then it becomes clear that man is caught up in a new tide which is carrying him he knows not whither. The three types of political revolution may perhaps ultimately be seen as mere eddies in this vast tide. Nevertheless, they are still important in the small time perspective in which most human decisions have to be made.

WE can neither perceive nor judge change in systems unless we have some theory about the dynamics of social systems. There are a good many such theories around, some of them explicit, some of them largely implicit and unformulated. Two such implicit theories guide a good deal of American thinking.

The first of these might be the cowboy theory. This is the theory that people are divided into good guys and bad guys, and that the business of a revolution is to get the bad guys out and the good guys in. It is not always easy to tell the good guys from the bad guys, but, of course, if any guys happen to be on Our Side, they are obviously good, and any guys that happen to be on the Other Side are obviously bad. A good revolution is one in which the good guys beat up the bad guys and a bad revolution is one in which the bad guys beat up the good guys. If there is a good deal of shouting, shooting, and running around going on, preferably on horses, the scenario is regarded as all the more satisfactory.

A somewhat more sophisticated version of the cowboy theory is the Liberty Bell or Independence Hall theory. This is the theory that the dynamics of a society depends upon its political constitution and that if only the right political constitution can be established all will be well. Societies are divided into those which have good constitutions (like ours) and those which have bad constitutions (unlike ours). A good revolution, then, is one that substitutes a good constitution for a bad one and a bad revolution is the reverse. Unfortunately for this theory, the slavish copying of the American constitution, especially by South American republics, does not seem to have resulted in uniformly satisfactory development either economic or political. And one suspects that more variables in the social system have to be taken into account.

At the level of sophisticated, explicit social theory, we seem to have two main contenders. On the one hand, there is the Malthusian theory of the classical economics which Baumol has described as the "magnificent dynamics." This states, in effect, that in the long run the only revolution that is really worth having is one that nobody has yet succeeded in accomplishing. This is establishment of a genuine population control. In the absence of this all revolutions will lead ultimately to the same ruin and the "dismal theorem" casts its long shadow over history. The dismal theorem is the proposition that if the only thing that can prevent the indefinite expansion of population is starvation and misery then all populations will expand until they are miserable and starve. A corollary is what I have called "the utterly dismal theorem." This is the proposition that if misery is the only ultimate check on the growth of population, any improvement in man's capacities, whether in the form of technological inventors or in the form of social inventions, merely has the ultimate result of enabling a larger population than before to live in misery. Improvement, therefore, leads to more misery not to less. We should not be deluded by temporary food surpluses into thinking that the Malthusian specter has been allayed. At present rates of increase it only takes about 700 years before we have standing-room only. Long before this time either the Malthusian revolution will have been accomplished or mankind will have sunk into a world of inconceivably teeming poverty.

The other system of explicit social dynamics is that of Marx, which perhaps we should designate out of respect for its New Testament as Marxism-Leninism. The theory is elaborate and fairly familiar and I will not outline it here. It contemplates the establishment of a rich and classless society by the expropriation of the capitalist and socialization of all property in the means of production. The actual predictions of Marx have, of course, been largely falsified by subsequent events, but this does not destroy the power of the theory. It has a peculiar fascination for poor countries which see in it a dream of controlling their own economic destiny. Its political and human costs, however, are high. It involves a gross centralization of power and is constantly exposed to the danger of tyranny. Cuba Nicaragua

BUT there is a type of revolution which does not fit comfortably into any of the above categories and which may be the most important of all in the long run. I call it the "Fomentarian revolution" in honor of a * remarkable institution in Puerto Rico which embodies it, known as "Fomento." The Fomentarian revolution has four aspects. Its prerequisite is some kind of political consensus in the society. It cannot develop if a society is wracked with internal conflicts and factional fights, whether these are between races, cultures, classes, or political groups. There must be some widely shared vision of the future and an image of the way in which the society can move towards its future. This usually has to be the work of a charismatic leader who can inspire large numbers of people with a vision of the future. Sometimes a succession of leadership is required. The charismatic but unrealistic leader may awake the people out of their apathy and give them a sense of identity and purpose. For the revolution to be accomplished, however, a new type of leadership may be necessary—more sober, less dramatic, and with a clearer and more realistic vision.

The second pillar of the Fomentarian revolution is the stress that it lays on education and the development of human resources. If necessary, a society must be prepared to accept some sacrifice of quality in education in the interests of quantity. The developing society not only requires literacy of the mass of the people, it requires a certain type of moral education in inculcating a favorable attitude toward work and austerity and it requires technical education appropriate to the modern world. Higher education of the right kind occupies a key position in this process.

The third pillar of the Fomentarian revolution is the skill to strike clever bargains with foreign capitalists. Genuinely bootstrap development is possible, as the history of Japan showed. The development of Japan came almost wholly from internal reorganization and by the acquisition of knowledge rather than capital from abroad. For this recipe to be successful, however, a fairly authoritarian social structure seems to be necessary. Whether this is feudal as in the case of Japan, or Communist as in the case of China, bootstrap development means holding down consumption, holding down real wages, and squeezing the farmer as hard as he can be squeezed in order to extract every last ounce of subsistence for capital accumulation. In looser and more democratic societies this is hard to achieve. It is hard to resist the clamor of the people for a present share of future benefits. Under these circumstances it is hard to keep real wages from rising, which means it is hard to keep consumption from rising, which means it is hard to keep production ahead of consumption, which means it is hard to accumulate. Under these circumstances a

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careful use of foreign investment seems almost necessary. If the investor can be rewarded with friendly attitudes and with long-term security, the recipient society will not have to pay so much hard cash. With an unfriendly and querulous attitude, on the other hand, foreign investment can only be attracted at a high price. The ability to make good bargains with foreign investors is a very important element in the success of the Fomentarian society.

The fourth pillar of Fomentarianism is the most difficult of all to establish. This is the ability to effect a sufficient cultural change at the level of the individual, the family, the neighborhood, and the small group so that the gains of development can be reasonably permanent and acceptable to the society. This brings us back to Malthus, for unless the revolution encompasses some kind of control of the population the revolution is doomed to failure. The control may simply be the ability to emigrate in the case of Puerto Rico. This, however, is a solution which is not open to the world at large, and it cannot be regarded as permanent. Nevertheless, the ability to emigrate from an already over-populated area may be the key, paradoxically enough, to a process of development which will eventually enable it to support a much larger population.

If a society is to enter the modern world, there must also be changes in the attitudes toward the family, toward work, and toward income and saving. All these changes, perhaps, may be summed up by saying that the transition from the traditional culture to what we call an "economic culture" will have to be made. In this process something inevitably is lost. One hopes that the gains are worth the cost.

WHEN we ask where is the Great Revolution taking us, the revolution that is science and technology, the answer may emerge that the end product of this revolution does not depend as much as we thought on the means which are used or the road which is followed. If one presses the Communists on what they mean by communism—that is, that ideal st.te of society toward which they hope they are moving, and which they do not now claim to have—the pat answer is, of course, that communism is a society in which we have "from each according to his ability and to each according to his needs." If they are pressed further on who is to be the judge of need and ability, the answer seems to be that, subject to the socializing forces of the society, the individual is to be his own judge. Certainly no dictator can judge either the need or the ability of the innumerable variety of men. This means, therefore, that in this ideal world people will decide what standard of life they wish to adopt and then go out and earn the kind of income which enables them to support it. We are getting closer and closer to this in the United States. What the Communists mean by communism, therefore, turns out to be surprisingly like that affluent society which is also the end of capitalist development.

The situation is somewhat confused at the moment by the fact that while we have examples of both successful and unsuccessful capitalist development, there are, as yet, no clearly unsuccessful examples of socialist development. This, I suspect, is because socialism is young. Given time, it will have no lack of failure. The crucial long-run question, therefore, for any community may not be whether it takes the capitalist or the socialist road to development. The question is whether its development is successful or unsuccessful in either system. The good revolution, whatever it is, is that which leads to a successful process of development. The bad revolution is that which does not. It may be, therefore, that we should be more relaxed about the political form under which development takes place, and more concerned that, under any form, the development should be successful.

This was written in April 1961

The great case for Fomentarian development where circumstances are such that it can be successful is that it can also be fairly cheap. Socialist development is obtained at a terrible cost. Capitalist non-development likewise has a high cost in benefits foregone. We should look carefully at those social processes, as exemplified in Puerto Rico, that seem to make the best of both worlds, that use both government and private enterprise, both domestic reorganization and foreign investment, and that foment rather than whip. These are the kinds of revolution that one would like to see us encourage.

Prepared Statement of Senator Daniel Patrick Moynihan

I wish to state my growing sense that by the close of this session of Congress, and accordingly, of the 101st Congress itself, we will not have sent to the President a bill providing for a plebiscite on the status of Puerto Rico.

This would not be my wish. To the contrary. What I am about to say is sensitive. I have a limited, but I dare to hope, sufficient sense of just how sensitive. I mean no offense to anyone and devoutly hope that in the end I shall not have given any offense.

We recall with what great expectations this matter came before us at the outset of the first session of this Congress. On January 17 the Majority Leader received a letter from the heads of the three principle political parties of Puerto Rico (identical letters having been addressed to the Speaker of the House and to the President) asking for a "resolution of the status issue" through a vote of the people of the Commonwealth. The text is as follows:

> In the past election held on November 8, 1988, all three political parties, which represent the three alternatives for the ultimate political status of the People of Puerto Rico, included the need for the resolution of the status issue in the platforms they presented to the electorate.
>
> In accordance with the platform of the Popular Democratic Party, the Governor of Puerto Rico announced in his Inauguration the intention of the Government of Puerto Rico to pursue the resolution of the status question with the Government of the United States of America and convened a meeting of the leadership of the three political parties that represent the three formulas.
>
> As a result of this meeting we, the Presidents—of the Popular Democratic Party, representing Commonwealth, the New Progressive Party, representing Statehood, and the Independence Party, representing Independence—have agreed to express to the President and to the Congress of the United States of America, that the People of Puerto Rico wish to be consulted as to their preference with regards to their ultimate political status and the consultation should have the guarantee that the will of the People once expressed shall be implemented through an act of Congress which would establish the appropriate mechanisms and procedures to that effect.
>
> Towards the formulation of such an act of Congress and related policies, we request to meet with you at your earliest convenience.
>
> Conscious that since Puerto Rico came under the sovereignty of the United States of America through the Treaty of Paris in 1898, the People of Puerto Rico have not been formally consulted by the United States of

America as to their choice of their ultimate political status, and in the understanding that we are taking a momentous decision in Puerto Rican history and confident of the commitment of the United States of America and of the People of Puerto Rico to the principles of self-determination and government by the consent of the governed, we remain,

Cordially yours,

BALTASAR CORRADA DEL RIO, *President, New Progressive Party.*
RAFAEL HERNANDEZ COLON, *President, Popular Democratic Party.*
RUBEN BERRIOS MARTINEZ, *President, Puerto Rican Independence Party.*

Some weeks thereafter, in an address to a Joint Session of the Congress on February 9, 1989, President Bush endorsed this proposal. He said:

> There's another issue that I've decided to mention here tonight. I've long believed that the people of Puerto Rico should have the right to determine their own political future. Personally, I strongly favor statehood. But I urge the Congress to take the necessary steps to allow the people to decide in a referendum.

The response in Puerto Rico was one of great satisfaction and even greater interest. In June a year ago I accepted the kind invitation of the Committee on Energy and Natural Resources to take part in a hearing on the issue held in San Juan. I think it likely that a third of the population of the island watched our televised hearings all day long, and two-thirds watched the reruns during the evening. That same evening, I could not walk anywhere in town without being greeted by name, usually with some apt comment on the (few) questions which I had asked that day. The Energy Committee went forward with deliberate dispatch, and on August 2nd reported out the bill which is now before the Finance Committee.

That was three quarters of a year ago. Nothing much has happened. It begins to look as if nothing might. On April 10, the chairman of the House Insular and International Affairs Subcommittee, Ron de Lugo, stated:

> The House is still waiting for legislation from the Senate that was promised last year. At some time soon, we will cross a point when it will become impossible to pass a bill in the House.

What happened?

Here I must declare, indeed assert, the limits of my knowledge, still more my understanding. I am no stranger to Puerto Rico. I first was there in the Navy near to half a century ago. (And, come to think, before that had spent more time than my mother knew in a pool hall called Los Muchachos in the original Manhattan barrio just north of 96th Street where the tracks come above ground on Park Avenue.) In the Kennedy years I came to know and to admire Luis Munoz Marin, and, indeed, worked with many of his lieutenants and associates. I did not fail to note that for them the English term "Commonwealth" was rendered "Estado Libre Asociado" with the further provision in one of the party conferences that the latter never be translated back into English.

At the United Nations I came upon the fierce accusations from Cuba and other elements of the so-called nonaligned nations that Puerto Rico was held in colonial captivity. On behalf of President Ford I answered back with, I hope, equal fierceness that it was the fixed policy of the United States that the people of Puerto Rico were free to choose any relationship with the United States that they wished: commonwealth, statehood, independence.

Shortly thereafter I came to the Senate and am, now in my fourteenth year on the Finance Committee. During this time I have recurrently found myself dealing with matters affecting Puerto Rico in the most direct and important ways. I think it fair to say that my colleagues have assumed my interest in these matters reflects the large number of Puerto Rican residents in New York State, which it surely does. But it also reflects my experience at the United Nations and generally with the process of colonialization and decolonialization. For make no mistake: in the first instance Puerto Rico was the spoil of a colonial war. It became an American colony. It has since evolved into much more than that, yet no one should doubt the explosive nature of the original relationship.

Moreover, I began to sense how precarious the situation of Puerto Rico was in the Congress. Puerto Rico had friends; it had no fully empowered member. A nonvoting resident commissioner in the House; no one at all in the Senate. Thus, in November

1984 the Reagan administration announced a wholesale revision of the Internal Revenue Code. The first version, known as Treasury I, simply abolished Section 936 of the Code, the economic cornerstone of the whole development policy conceived by Munoz and those of his time. We managed to block this; but only just. Treasury I was the work of the permanent government; it would be back.

This experience only confirmed my view that statehood would come sooner than anyone seemed to think. I had presented this view in a speech on the Senate floor the previous August.

> Having known Luis Munoz Marin, and being a friend and admirer of so many Puerto Rican leaders who carry on in his tradition, I must say that I have always assumed that this tradition views Commonwealth status as interim, as transitional.
>
> Temporary economic advantages can help prepare a society for statehood but can never indefinitely outweigh the civil advantage of full citizenship, which only statehood can confirm.
>
> I look to a Puerto Rico that appears at our portals asserting that the obligation of citizenship can never be fully met by a citizenship that is incomplete. In a word, I look to the day when a Puerto Rican sense of equality will animate a sense of the shared responsibility of equals.
>
> What I dread is a Puerto Rico coming to us in frustration and resentment at what it considers unequal treatment, looking to statehood as a remedy for grievances rather than a call to duty. Do these terms seem archaic, idealized? Perhaps. Yet I believe they would be recognized by the founders of this Republic, who have nothing to apologize for as regards to the realism of their ideals.

I might add that on that occasion I was defending the right of Puerto Rico to receive back excise taxes paid on liquor produced there. Nothing new in this. The second bill enacted by the first Congress imposed a tariff on Caribbean rum. I concluded:

> I urge the Senate to give consideration to this measure, and especially hope that it will come to the attention of our distinguished majority and minority leaders, who will one day, they or their successors, stand on the floor of this Senate and deal with the application by the Commonwealth of Puerto Rico for entry into the American union, asking that a pledge repeatedly made to the people of Puerto Rico be honored.

In the course of the years my views have not changed. They are known in Puerto Rico, and ought to be made known in the present debate. But I would make an important point in this regard. I have no quarrel with commonwealth status. To the contrary I have come to sense that to many of Munoz's time, and those who follow him, commonwealth was not a way station, an interim period prior to statehood. It was, to the contrary, the closest economically viable option to independence. Or at least, it was something this side of absorption into the union of the mainland.

I respect that. Just as I respect those for whom independence is the only acceptable outcome. My concern is that the process of making a viable choice should continue.

Leaving aside independence, where neither consideration arises, those who would choose between statehood and commonwealth status face a basic dilemma.

It is this.

Statehood automatically brings a huge increase in social welfare benefits. By an order of magnitude! Consider Supplementary Security Income. The current benefit in the commonwealth is about $32 a month for the blind, disabled, and aged who have insufficient Social Security or other benefits. The day statehood becomes effective, this benefit rises to $386, a tenfold increase, thereafter automatically indexed to inflation. Similar results occur across what is now a very wide range of programs. In the 1950s and later these benefits in the United States either did not exist or varied greatly from state to state. In the past 30 years, however, we have more and more tended to national benefit standards.

The impact of statehood on perhaps half the population of the island would be instantaneous and profound. And yet, at the same time, statehood means the loss of Section 936 benefits to industry, such that the economy loses a stimulus which has been absolutely central to economic growth in the past two generations. (Section 936, incidentally, was a program begun in the 1920s to encourage investment in the Philippines.)

By contrast, commonwealth status retains—for a period at least—the economic stimulus of Section 936. But it probably means a continued low level of social welfare benefits. And the absence of a considerable range of Federal taxes. Given those perplexities, I would offer a number of suggestions.

First of all, the executive branch and the Congress have got to undertake as much analysis as the remaining time allows. With no intent to criticize, I must state that some of the departments of the executive branch have been fair to mute on this subject. The Treasury, at least, has come before us and "endorsed" S. 712 as reported out by the Energy Committee, and offered a number of suggestions and reservations. Other departments with programs affected have simply come up here with no views and less data.

Second, the parties in Puerto Rico should try to avoid taking positions that cause anxieties here in the Congress. Those supporting statehood should be most careful about advertising its welfare attractions. Members of Congress altogether friendly to the people of Puerto Rico—they are, after all, our fellow citizens—could very well not wish them to fall into the "welfare trap," as it is called, and not without reason. Take the Food Stamp program, as an example. This began in early 1975. By 1982 fully 60 percent of the Puerto Rican population was receiving food stamps. This cost the Federal Government some $.9 billion a year. But what did it cost the people of Puerto Rico? I have to report that my impression from travels in the interior that it virtually destroyed Puerto Rican agriculture. As is well known, the Congress thereupon cut back on the program.

Similarly, those supporting continued commonwealth status should take great care that the present seeming preference for statehood, as reflected in opinion polls, not persuade them that the best course is to put off a plebiscite. It is now common to read of this in the Puerto Rican press. I would presume to suggest, for example, that there is no reason the House of Representatives should be waiting on the Senate for a bill.

Let them write their own bill, and we will go to conference with them. This is the normal way in which we do business. One could wish that voices were heard in San Juan asking why the House seems to be running out the clock. For there will be no winners in such an eventuality, or at all events, that is my view. As for "enhanced" commonwealth status, that is surely a matter the Finance Committee will want to consider. I will make proposals. I hope others will do so as well. "But time presses.

In the end, the great issues involved here are civic, not economic. Do the people of Puerto Rico wish to become Americans? For that is what statehood ineluctably implies. That is what statehood brings. Or do they wish to retain a separate identity? Of, but not in, the American union. This could be a perfectly intelligent choice, and of course, the option of eventual statehood or independence remains.

But to say again, the Congress must act. It is almost a century now since William Graham Sumner composed his bitter epitaph on the Spanish American War entitled, "The Conquest of the United States by Spain." His thesis, of course, was that by entering the colonial lists, we would become like other imperial nations, and suffer all their decadence and decline. Well, that hasn't happened. But we won't know until it is made perfectly clear that our offer to Puerto Rico of choice is in fact a fair-minded and efficacious offer. Which is to say, an offer which will shortly issue in an actual choice being made.

I ask that two important editorials, one from *The New York Times*, the other from *The Washington Post*, be appended to this statement.

16 E THE NEW YORK TIMES, SUNDAY, APRIL 1, 1990

The New York Times

Founded in 1851

ADOLPH S. OCHS, Publisher 1896-1935
ARTHUR HAYS SULZBERGER, Publisher 1935-1961
ORVIL E. DRYFOOS, Publisher 1961-1963

The 51st and 52d States

Let Puerto Ricans Decide Their Fate, but Fairly

Puerto Rico is not America's Lithuania, but it is unhappy with its status as a highly dependent commonwealth. An overwhelming majority of 3.3 million islanders are agreed that they want change. But as Congress is learning, agreement stops there. What adds to the perplexity is a parallel but unrelated campaign to grant statehood to the District of Columbia.

A Senate bill supported by the Bush Administration would offer Puerto Ricans a chance to choose, by a binding vote next year, statehood, improved commonwealth status or independence. The problem is to assure a fair choice. If one or another side has plausible reasons for charging bad faith, the referendum could prolong the argument it is meant to end.

Polls for the first time show a narrow majority of Puerto Ricans now favors statehood. As sentiment has shifted, so has the tone of a longstanding debate. Statehood supporters now join with advocates of independence in decrying colonialism. Those clamoring for enhanced commonwealth status contend that the Senate bill is frontloaded unfairly in favor of statehood.

The argument springs from a complicated history. The U.S. acquired Puerto Rico from Spain almost incidentally in 1900. In 1917, Puerto Ricans became U.S. citizens, but not until 1947 did they elect a Governor. Five years later, Congress approved an ingenious commonwealth arrangement, giving a Spanish-speaking island home rule and exemption from Federal taxes but no vote in Federal elections.

Economically, the plan made sense. Using an additional tax break known as Section 936 of the revenue code, Puerto Rico has provided generous incentives for mainland investors. But politically, the island has been virtually a ward of Congress, without the clout it would wield with two senators and six or seven representatives, plus a Presidential vote.

This sense of being second-class citizens has given potent impetus to the statehood campaign. As statehood sentiment has waxed, so has uncertainty about Puerto Rico's tax exemptions, causing investors to hold back. To end the debate once and for all, Gov. Rafael Hernandez Colon, a commonwealth advocate, proposed a binding referendum.

But he now faults the Senate bill as "terribly, dangerously unbalanced." It would phase in Federal taxes and phase out Section 936 over four years. Meanwhile, says the Congressional Budget Office, statehood could cost other U.S. taxpayers as much as $9.4 billion in additional Federal social spending; more than half the island's population remains below the national poverty line.

•

A very different view is taken by former Gov. Carlos Romero Barceló, a statehood proponent. He persuasively cites similar preferential treatment granted other incoming states. Congress can redress the balance by rewording the commonwealth choice to give its proponents more of what they seek: an increased international role, an open port for air carriers, a voice in Federal appointments and jurisdiction over natural resources.

What is unarguable and fundamental is Puerto Rico's right to self-determination. The choice is primarily between two forms of association with the United States. Even the minority favoring independence relies on reason rather than passion. Congress can reciprocate by specifying clearly and fairly what Puerto Ricans can expect, whichever way they vote.

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A24 TUESDAY, APRIL 24, 1990 THE WASHINGTON POST

The Washington Post

AN INDEPENDENT NEWSPAPER

Puerto Rican Statehood

A GAME IS being played in a mostly indifferent Congress with the people and the future of Puerto Rico. The issue is the recurrent one in island politics of statehood or independence versus the present mixed status of commonwealth.

The last election on the island in 1988 was won by the commonwealth party, but it was close. In hopes of taking the distracting status issue away from the statehood advocates nipping at their heels, the commonwealthers decided to ask Congress to authorize a binding referendum. Puerto Ricans would choose among the three broad relationships with the United States, and Congress would agree in advance to give effect to the result.

The other Puerto Rican parties also supported the idea, as did the administration, on record as favoring statehood. Then came the problem, which persists, of defining the alternatives that would be voted on. The administration wanted to leave them vague. The Senate Energy and Natural Resources Committee rightly resisted, on grounds that the voters should know what they were voting for. But the committee then produced a seriously misshapen bill, tilted sharply in favor of statehood. The legislation front-loaded the statehood option by providing that benefits would go up right away and taxes only later. Opinion polls on the island picked up an instant pro-statehood shift.

Now the Congressional Budget Office has done a study of the likely economic effects of statehood as outlined in the committee bill. From what might be called a welfare standpoint the island would gain (and the Treasury lose). Benefits would rise not just earlier than taxes, but as much as $2 billion to $3 billion a year more. But the Puerto Rican economy is dependent on a special provision in the U.S. tax code exempting from tax part of the income of U.S. companies that invest there. As a condition of statehood the exemption would be phased out. CBO says that would mean loss of jobs and calculates that within 10 years this loss on the job side would be greater than the gain in benefits. Puerto Rico would be both more dependent and worse off.

The bill has now gone to the Finance Committee, whose chairman ordered the CBO study. Finance, which has jurisdiction over taxes and many benefit programs, is scheduled to hold a hearing this week. The Agriculture Committee, which has jurisdiction over the food stamp program, an island mainstay, must also be heard from before the legislation can go to the floor. Then the whole process would have to be repeated in the House. There isn't time, and therefore there isn't likely to be a bill. The way the idea has been abused and mangled thus far, that would be a merciful result. But in the meantime the people of Puerto Rico have been badly jerked around.

PREPARED STATEMENT OF JOSE R. OYOLA

INTRODUCTION

The experience of previous U.S. territories has been that statehood creates a new economic environment in which the sizable gains to the majority of the people are greater than I he losses of a few in the territory. Thus, statehood should not be viewed solely as a budget neutral option in which the takes collected from a few tag-subsidized 936 corporations would be at least equal to the Federal entitlements to the poor residents of Puerto Rico.

The private sector of the economy would be a major beneficiary of a change in the political status. Profitable opportunities would arise to make the new State of Puerto Rico a preferred location for entrepreneurs and investors who have shunned the island as a commonwealth. The resulting Federal revenues from the booming private economy under statehood are hard to quantify but are not less certain than the numbers that would be presented to the members of this Committee as "quantifiable estimates."

TOURISM

Tourism would become a leading industry in Puerto Rico, like in the state of Hawaii. Unlike manufacturing, tourism does not need Federal tax subsidies to attract investors to Puerto Rico. Also, tourism does not generate tonic wastes and depends primarily upon indigenous, non-exhausting resources: a year-round warm climate, outstanding natural scenery, a hospitable people with a distinctive culture, and a well-developed communications & transportation infrastructure.

Tourism is a big industry in Hawaii and a minor industry in Puerto Rico. According to the *1986 Data Book* published by the Department of Planning of Hawaii there are thirteen times more hotel units and four times more hotel employees in Hawaii than in Puerto Rico. In 1986 there were 8,913 hotel employees in Puerto Rico, and 33,067 employees in Hawaii. Also, Hawaii had 66,000 hotel units in 1986, of which 12,000 units have been constructed since 1980. In Puerto Rico the number of tourist hotel rooms fluctuated around 5,000 units during the 1980-1989 decade.

Why would the tourism industry achieve a quantum leap under statehood The current commonwealth status has two drawbacks: first, most potential U.S. tourists consider Puerto Rico as a foreign location, not as part of the United States. Also, most U.S. tourists to the commonwealth come from a limited number of northeastern states in which direct air service is available.

Under statehood two factors would work together to increase the number of tourists from all of the United States: the massive publicity surrounding Puerto Rico's entrance into the Union would change in a fundamental way the perception of the island as a tourism site for 200 million U.S. citizens. This would be coupled with additional direct flights to Puerto Rico from the other mainland states.

The infrastructure necessary to achieve a tripling of the size of the tourism industry during the first. ten years of statehood is already in place. Our international airport is the hub of the Caribbean of American Airlines, and serves more than 20 airlines (see appendix 1). The former Ramsey Air Force base in the northwest corner can accommodate the largest jet aircrafts and would serve as the main tourist entry to the western part of the island.

Another critical element already in place is current hotel investments. The states of Hawaii and Puerto Rico would share in common the Japanese investors who have specialized in financing, constructing and managing megahotels. Two ongoing projects show the existing commitment of Japanese investors to developing hotels in Puerto Rico. First, the $1 billion Costa Isabela, which will be the largest hotel resort in the Caribbean. This is a 2,500-acre complex, with five golf courses, 36 tennis courts, 2,000 hotel rooms and 8,000 employees (see appendix 1).

Another current hotel project has been started by Kumagai Gumi Company Ltd. The former Conquistador Hotel in the eastern town of Fajardo will be transformed into a tourist and residential complex with a 750-room hotel, 200 condominiums, a recreation club, a golf course, spa, and 10,000-square-feet of swimming pools and fountains at a cost of $162 million.

The following table contains a forecast for the tourism industry under statehood until the year 2000. Total jobs generated by the tourism industry would triple from 57,000 in 1988 to 150,000 in the year 2000. This increase would be sustained by a three-fold increase in the number of rooms from 7,580 to 20,000 in the same period. The 150,000 jobs generated by the tourism industry would be enough to compensate the lack of growth in manufacturing jobs caused by the phaseout of Section 936 tax benefits.

	Commonwealth					Statehood	
	1960	1970	1980	1935	1988	1995	2000
Demographics							
Total population	2,340,000	2,710,000	3,184,000	3,280,000	3,297,000	3,485,308	3,614,002
Population, 16 years and over	1,383,000	1,718,000	2,094,000	2,283,000	2,321 ,088	2,519,878	2,649,063
In labor force	625,000	765,000	907,000	964,000	1,058,416	1,259,939	1,404,004
Employed	543,000	686,000	753,000	758,000	899,654	1,108,746	1,263,603
Unemployed	82,000	79,000	154,000	206,000	158,762	151,193	140,400
Outside labor force	758,000	953,000	1,187,000	1,319,000	1,262,672	1,259,939	1,245,060
16 years and over, percent of population	59. 1	63.4	65.8	69.6	70.4	72.3	73.3
Participation rate	45.2%	44.5%	43.3%	42.2%	45.6%	50.0%	53.0%
Unemployment rate	13.1%	10.3%	17.0%	21.4%	15.0%	12.0%	10.0%
Tourism Sector							
Jobs (thousands):							
In hotels			9	8	9	18	25
In tourism industry			43	42	57	113	150
Total number of jobs			753	758	899	1108	1263
Tourism/Total			5.7%	5.5%	6.3%	10.2%	11.9%
Visitors (thousands)	348	1 ,088	1,627	1,545	2,077	3,673	5,269

	Commonwealth					Statehood	
	1960	1970	1980	1935	1988	1995	2000
Expenditures ($ million)	58.1	235.4	615.0	722.7	1,035.0	2,197.6	3,416.0
Expenditures/visitor ($)	$167	$216	$378	$468	$498	$598	$648
Rooms	2,309	7,116	9,619	7,702	7,580	15,000	20,000
Hotels (tourist & others)	2,309	7,116	9,415	7,420	7,079	14,000	19,500
Country inns ("paradores")	0	0	204	282	501	1,000	1,500

Source of historical statistics. Planning Board Commonwealth of Puerto Rico.

POPULATION

Statehood would change the fortunes of thousands in and out of Puerto Rico, leading to big population movements. A look at what happened with the population of Hawaii will help us to discern what could happen if we become a state.

Current population estimates show that mainland Puerto Ricans now number 2.3 million and in Puerto Rico there are 3.3 million inhabitants. What would be their fate if Puerto Rico becomes the 51st state? How many mainland residents would come back and how many would leave the island? These are crucial questions that can change the estimates of Federal costs and benefits from statehood. Statehood brings economic progress, and progress attracts people. The population of Hawaii increased 52 percent since it became a state, while Puerto Rico's population increased 36 percent in the same period.

	Hawaii	Puerto Rico
Population change,	+332,000	+485,000
from 1960 to 1980	(+52%)	(+36%)
Total persons, 1980	965,000	3,197,000
Born in state of residence	58%	90%
Born in different state	26%	6%
Born in Asia	11%	0.1%
Born elsewhere	5%	3.9%

As a result of the influx of people from Asia and the thousands of military personnel stationed in its bases, only 58 percent of Hawaii's residents in 980 were born there. By contrast, 90 percent of Puerto Rico's population in 1980 was born here.

People born in the other states comprised 26% of the population of Hawaii and only 6% of Puerto Rico's population. People born in foreign countries represented 11% of Hawaii's population and only 4% in Puerto Rico.

Migration and independence. The CBO Report dated April, 1990 contains a frightful list of negative developments in the Republic of Puerto Rico, including wage deflation, skyrocketing interest rates and balance-of-payments difficulties. Under this scenario it is probable that thousands of U.S. citizens who live in Puerto Rico would choose to leave the island, and that there would be a massive migration to New York, New Jersey, Massachusetts and other states with large Puerto Rican communities. In this case, *the U.S. Treasury would end up paying entitlement benefits to the low-income families who migrate, but it would not be able to collect Federal taxes in the Republic of Puerto Rico.*

ESTIMATES OF FEDERAL OUTLAYS

This report shows the Federal revenues and spending under each status. These estimates are preliminary and subject to high variances. S. 712 is not the usual spending or tax bill amenable to simple estimation rules. A whole territory with 3.3 million individuals would be incorporated as a new state, and many unquantifiable factors would determine the final impact of S. 712 on future Federal budgets.

What is the appropriate length of time to make revenue and expenditure projections in S. 712? One decade would seem to be an appropriate length of time to allow adjustments in population and in the economic sectors to the new tax environment under statehood or independence.

The Congressional Budget Office already provided estimates of the Federal outlays for each option in a memo dated September 6, 1989. Two points are worth mentioning about these estimates: first, the estimates are incremental costs, with the existing commonwealth status used as the baseline. An unwary reader could conclude wrongly that the enhanced commonwealth status is costless. In fact, according to the U.S. Bureau of Census, Federal expenditures under the commonwealth status were $6.2 billion in Fiscal Year 1988.

In addition to $6.2 billion in direct Federal expenditures the commonwealth status costs $2.1 billion in tax expenditures, according to the 1991 U.S. Budget's list of tax expenditures. These foregone taxes represent the Federal tax savings of U.S. corporations in Puerto Rico that operate under I.R.C. Section 936.

The commonwealth status, therefore, entails more than $8 billion in Federal expenditures and foregone Federal taxes per year. This permanent financial drain, which the members of Congress need to be aware of in order to assess the total budgetary impact of the three status options, must be taken into consideration when analyzing the incremental cost provided in the CBO Report.

The second weakness of the CBO report is that the time period allowed is only four years, from 1992 to 1995. The total impact on the Federal budget of S. 712 is highly sensitive to the length of period because the U.S. Treasury would not receive any revenues under statehood until 1995. Also, it would be unwise to make a decision to incorporate a territory forever into the union based on the budgetary impact during the first four years of statehood.

COST TO THE FEDERAL GOVERNMENT OF THE COMMONWEALTH STATUS—FISCAL YEAR 1988

	Thousands of dollars
Total	6,231,000
Grants to Commonwealth Government	2,389,811
Direct Federal Payments to Individuals	2,906,940
Federal Government Procurement Contracts	382,909
Federal Salaries & Wages	489,740
Other Expenditure Programs	61,600
Loan and Insurance Programs	703,263

Source: *Federal Expenditures by State for Fiscal Year 1988*, Bureau of Census, U.S. Department of Commerce, March, 1989.

Revenue and Expenditure Estimates from 1991 to 2000. The next table provides estimates of Federal revenues and outlays for the three status options. *These estimates do not include Federal spending common to all status options.* The table shows:

(a) Federal expenditures under commonwealth status from 1991 to 2000. In 1988 Federal expenditures in the commonwealth were $6.2 billion. This figure is adjusted by subtracting Federal spending common to all the status options, and applying a 5 percent annual inflation factor. Estimates for 1992 are $3.7 billion, increasing to $5.5 billion in the year 2000;

(b) Federal expenditures under statehood, which would increase from $5.4 billion in 1992 to $8.6 billion in the year 2000. These estimates were obtained by adding the incremental costs derived by CBO to the costs of the enhanced commonwealth status.

(c) Revenue estimates for each option. Only under statehood would the U.S. Treasury collect significant revenues in Puerto Rico. The estimate of Federal income taxes in Puerto Rico for 1987 is $582 million. A 5 percent annual compounding factor would raise individual income taxes to $948 million in 1991 and to $1.2 billion in year 2000.

This is a reasonable estimate, since more than $1 billion is now legally excluded from taxes under commonwealth law, but would be taxable under statehood.

Corporate income taxes would bring in $2.4 billion in 1996 and $4.5 billion in the year 2000. These estimates increase rapidly due to the 5-year phaseout of Section 936.

The cumulative cost of the commonwealth status from 1992 to 2000 would be $40.7 billion in net expenditures plus $26.8 billion in tax expenditures due to Section 936. Statehood, on the other hand, would represent $41.7 billion in outlays from 1992 to the year 2000, or $1 billion more than commonwealth. The U.S. Treasury, however, would be able to reduce its tax expenditures due to Section 936 from $26.8 billion to $12.6 billion.

The cost of the Statehood status, including savings on tax expenditures is $13.3 billion less than enhanced commonwealth.

Puerto Rico Status Referendum Act
Federal Revenues, Outlays and Tax Expenditures, 1992-2000

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Cumulative 92-2000
STATEHOOD											
Estimated Outlays ****	---	5,400	5,693	6,627	7,520	7,644	7,868	8,103	8,350	8,610	65,816
Total Revenue	---	0	0	0	0	3,376	4,274	5,262	5,475	5,726	24,112
Individual income tax	---	0	0	0	0	948	995	1,045	1,108	1,185	5,282
Corporate income tax											
Phaseout of Section 936	---	0	0	0	0	1,806	2,488	3,210	3,310	3,410	14,224
Tax on Puerto Rican firms	---	0	0	0	0	622	790	1,006	1,057	1,131	4,606
Other taxes	---	**	**	**	**	**	**	**	**	**	**
Net Revenues	---	-5400	-5693	-6627	-7520	-4267	-3594	-2842	-2876	-2884	-41704
936 tax expenditure	---	-2510	-2610	-2710	-2910	-1204	-622	0	0	0	-12566
Net Revenue + Tax Expenditure		-7910	-8303	-9337	-10430	-5471	-4216	-2842	-2876	-2884	-54270
INDEPENDENCE											
Estimated Outlays*****	---	3,524	3,373	3,267	3,170	**	**	**	**	**	**
Total Revenue	---	*	*	*	*	*	*	*	*	*	*
Net Revenues	---	-3524	-3373	-3267	-3170	**	**	**	**	**	-13335
ENHANCED COMMONWEALTH											
Estimated Outlays***		3,724	3,873	4,067	4,270	4,484	4,708	4,943	5,190	5,450	40,710
Total Revenue		*	*	*	*	*	*	*	*	*	*
Net Revenues		-3724	-3873	-4067	-4270	-4484	-4708	-4943	-5190	-5450	-40710
936 tax expenditure		-2510	-2610	-2710	-2910	-3010	-3110	-3210	-3310	-3410	-26790
Net Revenue + Tax Expenditure		-6234	-6483	-6777	-7180	-7494	-7818	-8153	-8500	-8860	-67500

* Amount less than $5 million.
** Unknown.
*** Excludes Social Security ($1,852 million), Veterans payments ($268 million), Federal Retirement and Disability ($145 million), Federal salaries & wages ($490 million), and Procurement ($383 million). Figures in ( ) are 1988 outlays.
**** Statehood = Enhanced commonwealth status + CBO incremental costs
***** Independence = Enhanced commonwealth status + CBO incremental costs

Costa Isabela developers hope to start building by May

By BARBARA LE BLANC
Of The STAR Staff

Developers of Puerto Rico's largest-ever resort, the $1 billion Costa Isabela, said Wednesday they want to start construction by May and inaugurate the first two hotels on Oct. 12, 1992.

Plans for the five-hotel resort were announced at a press conference presided over by Gov. Rafael Hernández Colón.

It was the first official revelation of the project, which has been the topic of wide, but informal discussion for several weeks. If completed, it will be the largest resort in the Caribbean. The projected inauguration date is the 500th anniversary of the discovery of America.

The 2,500-acre complex, located on two and a half miles of beach, will have five golf courses, 36 tennis courts and a hotel school. With a total of 2,000 hotel rooms, it will employ 8,000 people.

It also will require five electrical substations, a water filtration system, asmall hospital and a fire and police station.

The first phase will include two hotels —a 650-room Conrad International and a 350-room Four Seasons — and two golf courses.

Conrad International is the international division of Hilton Hotels, which is a company separate from Hilton International that runs the Caribe Hilton Hotel.

TSC International, of Honolulu, Hawaii, will control 75 percent of Costa Isabela. Takeshi Sekigushi, the company's Japanese head, is providing equity and arranging financing with banks and investors in Japan.

IDG Development Corp., a hotel development company in Los Angeles, Calif., has a 25 percent financial involvement, said Albert T. DeVaul, IDG chairman.

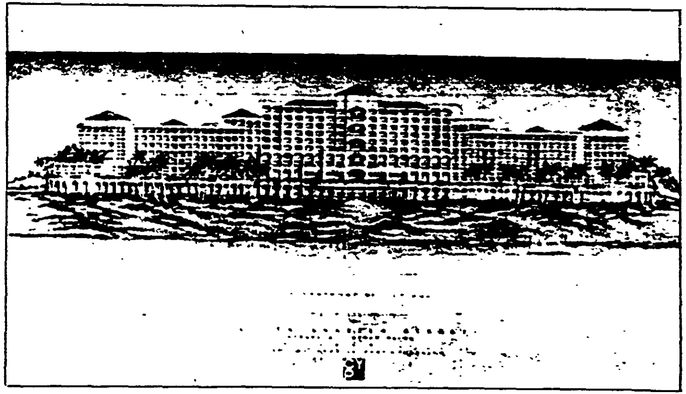
Arnold Benus, owner of the Regency Hotel in San Juan, and Pedro Feliciano, owner of Las Piedras Construction Corp., are local investors involved with IDG, DeVaul said.

Land acquisition will cost $40 million, Benus said at the press conference. All the required land is under option and being purchased, he said.

Sekigushi is providing the money for the land. Typically, Japanese developers buy land in cash and then use it as equity for financing, explained John Bralower, vice president of Sonnenblick-Goldman Corp., the New York financial consultant on the project.

Japanese developers also usually bring Japanese contractors to oversee projects, he said.

DeVaul said he was not certain if Sekigushi intends to do so, but, in any case, local firms and workers will remain involved in the construction. Lebrón Associates, a San Juan engineering firm, designed the project. Desarollos Metropolitanos will be the general contractor.



Conrad International plans to build this 650-room hotel at the Costa Isabela resort. Four Seasons Hotels plans to have a 350-room hotel; Marbella Club, of Spain, a 120-room hotel; and World Leisure, of Great Britain, a 350-room hotel. A fifth hotel operator has not been named.

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CAGUAS CENTRAL Federal Savings Bank

CARIBBEAN BUSINESS

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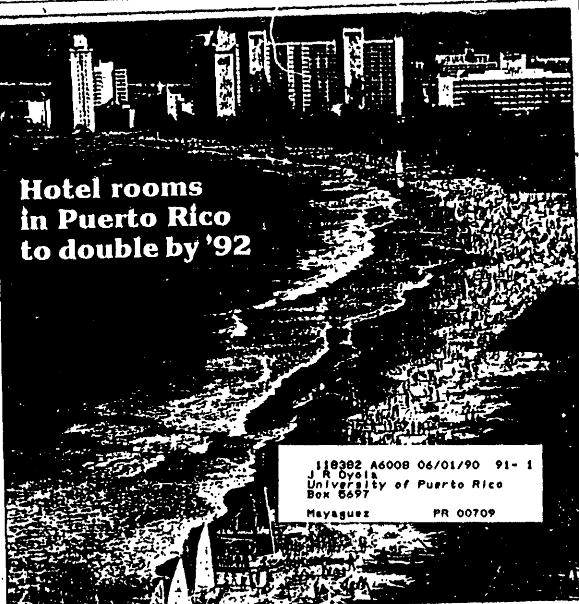

Hotel rooms in Puerto Rico to double by '92

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By ELIZABETH ROMAN
CARIBBEAN BUSINESS Reporter

CB EXCLUSIVE

The number of hotel rooms in Puerto Rico is projected to double by 1992, according to information obtained by CARIBBEAN BUSINESS. An estimated investment of nearly $2 billion will add as many as 7,000 hotel rooms by 1992, increasing the number of rooms in Puerto Rico from 7,793 available at present, to a record high of almost 15,000.

(Continued on page 8)

PAGE 1 STORY

A list of nearly 20 projects currently under development and targeted for completion by 1992 was obtained from the Commonwealth's Tourism Company. Included in the documents is a new mega-resort planned for the northeast town of Rio Grande which has not yet been announced. The resort, known as Bahia Beach Plantation, is estimated to cost almost $400 million and will have 1,100 rooms.

The list of tourism projects which will give rise to a major hotel construction boom on the island, includes the reopening of the El Conquistador with 750 rooms, for an estimated investment of $170 million. Also in the planning stages to reopen are the Dorado del Mar Hotel with 600 rooms and the Palm Hotel (formerly the Dupont Plaza) with 450 rooms. No major hotel has added new rooms in Puerto Rico since the Caribe Hilton inaugurated its 259 room tower in 1973.

New projects include the billion-dollar Costa Isabela resort, Bahia Beach Plantation, and the $128 million Ritz Carlton planned for Palmas del Mar in Humacao. Also listed are the new Holiday Inn Hotels in Isla Verde and Mayaguez.

"The projects currently under development are expected to double the number of hotel rooms in Puerto Rico by 1992," says Miguel Domenech, executive director of the island's Tourism Company. "Right now, Puerto Rico is a seller's market because it lacks sufficient rooms, keeping hotel rates higher than other Caribbean islands. This is expected to change during the 1990s as more rooms help spur competitive rates," he added.

Bahia Beach Plantation

In addition to the huge Costa Isabela project (see CARIBBEAN BUSINESS of Nov 30, 1989), which is expected to have 1,500 rooms at the completion of its first phase in 1992, the second largest project currently planned for Puerto Rico is Bahia Beach Plantation Resort, located only 20 minutes from Luis Muñoz Marin International Airport, and reportedly costing $400 million.

Bahia Beach has been under development for nearly two years, according to project insiders. "Not only has the land for this resort been purchased, most of it has already been cleared away, the infrastructure nearly fully developed, with construction of a golf course underway and scheduled for completion by the summer," said Jack Shehab, president of Jack Shehab Realty, the project's broker.

The mega-resort is being developed by a California group which does not want its name made public yet. It will reportedly feature two 550-room hotels along with residential villas and condominiums which could be rented by the resort's hotel management if the owners choose to do so, according to Shehab.

The Bahia Beach project will be developed in different stages and includes 250 marina villas with boat slips that will sell for an estimated $380,000 to $400,000 per unit, 46 golf villas, and 44 tennis villas ranging in price from $300,000 to $350,000 each. Another 300 beachfront condos have also been proposed for the Bahia Beach resort. "The owners of Bahia Beach are currently negotiating with various hotel groups and developers to invest in the project," said Shehab.

One source, however, told CARIBBEAN BUSINESS that, unlike the Costa Isabela resort, where the land has already been purchased for $41 million and major financing has been made available from Japanese investors, the owners of Bahia Beach Plantation were looking for companies who would not only build the hotels, but would finance and manage them as well. "They're looking for an equity partner for the project and these are not easy to find," said the source. "However, because of its excellent location and beautiful beach, several world-class investors are said to be interested," he added.

More new hotels

Another two hotels are planned on the site of the proposed World Trade Center in Isla Verde near the Luis Muñoz Marin International Airport. These will be the Embassy Suites with 250 rooms, and the Windham Hotel with 300.

Embassy Suites, based in Dallas, has 100 hotels on the mainland and recently signalled its intent to enter international markets by appointing a corporate director to handle resorts and international marketing. Embassy Suites is scheduled to break ground on its proposed all-suite hotel in March of 1990, according to information obtained by CARIBBEAN BUSINESS.

La Guancha Hotel, to be constructed in Ponce, will have an anticipated 250 rooms, a convention center, casino, restaurants, tennis courts and swimming pool. This project has an estimated price tag of $31 million.

In addition, plans for a small hotel in the town of Hatillo have also been approved by the Tourism Company. This hotel will be located directly in front of the Cuevas de Camuy project, confirmed Carlos Garcia, a Tourism Company architect. "The Hatillo hotel was originally approved for 50 rooms but the developers requested that it be expanded to 100," said Garcia.

Several other proposed tourism projects which did not appear on the Tourism Company's projections for 1992, but that CARIBBEAN BUSINESS knows are in advanced planning stages, are the 350-room hotel planned for Puerto del Rey in Fajardo, Rio Mar's proposed 500-room hotel which will reportedly be managed by Westin Hotels, and the recently announced Compri Hotel in Isla Verde.

The Compri Hotel is being developed by Jorge Colon Nevares, owner of the local Wendy's fast-food franchise. The proposed hotel will have 252 rooms and is expected to break ground as early as next August. It will be built on land purchased from the Puerto Rico Industrial Development Company. The land had originally been set aside in anticipation of the need for a centrally located major convention center larger than the one currently owned by the government in the Condado area.

Newfound enthusiasm

"There appears to be a newfound enthusiasm among developers towards tourism investments in Puerto Rico," said Jag Mehta, managing director of the Radisson Normandie. Mehta and other hotel managers in Puerto Rico agree that the island's success in attracting multi-million-dollar tourism investments has helped put Puerto Rico on the map. "I have no doubt Puerto Rico will become another well-known tourist destination like Hawaii and Mexico," added Mehta.

Domenech hopes this interest will help attract investment from local banks for tourism projects. "We're paying for the mistakes of the past," said Domenech, "when hotels on the island went bankrupt, owing local banks huge sums in outstanding loans."

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Ports Authority accelerates airport's expansion

By BARBARA LeBLANC
[illegible] STAR Staff

The Ports Authority is speeding up its expansion of the airport in part because American Airlines has accelerated its plans for turning San Juan into its international hub.

The Ports Authority will begin by year end its previously announced $100 million improvement program that will change the face of the Luis Muñoz Marín International Airport.

If the program is completed by 1993 as planned the airport will have a new flight control tower, a parking garage for 4,000 cars, an elevated taxi way running over the airport's entrance and a new five gate international terminal.

A combination of private, federal and Commonwealth Ports Authority money will pay for the projects. A $[illegible] million, *five gate international terminal will have* to wait for the sale of the Puerto Rico Telephone Company. It will be financed with the $1 billion infrastructure fund to be created with proceeds of the sale, said José Buitrago, executive director of the Ports Authority.

Buitrago said he decided to undertake all the work at once to limit inconvenience to airport users.

And American Airlines' ambitious plans for the Caribbean accelerated after Eastern Airlines was struck by employees 13 months ago, has forced the Ports Authority to put its expansion into fast forward.

The elevated taxi way, for example, originally was scheduled for 1997 or 1998. He said the carrier needs the work done for its own $150 million expansion plans at the airport.

American is responsible for much of the growth at the airport. After announcing plans in 1985 to make Puerto Rico its Caribbean hub, the airline's traffic has grown fivefold to 2.35 million passengers in 1989, equal to 56 percent of the airport's total traffic.

In June, American plans to spread its wings at the airport, with plans to take over 25 gates and more than half the terminal space at the airport.

Ports Authority will begin its work this year by widening the road through the airport, a $10 million project that was

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Airport

From Page B 1

designed by American.

The parking garage, which would double the parking space now available, is to be built over the current parking lot. The Ports Authority soon will be asking for proposals from private companies, one of which will be selected to build and operate the $28 million project, Buitrago said.

The Ports Authority would lease the land to the company for an undisclosed number of years, after which the garage will revert to public ownership.

In the same parking area, H I Development Corp will build a $13 million hotel. The project originally was planned with 230 rooms, but it has been modified by the Federal Aviation Administration, Buitrago said.

Buitrago said the company already has the financing.

Buitrago said the construction program will start shortly after American agrees to purchase Eastern's assets in San Juan.

Eastern has agreed to pay for the $3 million remodeling of its 11 gate terminal, so it can accommodate several carriers. It also agreed to help move the carriers to the terminal.

But Art Torno, American general manager, said last week that the agreement was not final and that the two airlines still were in financial negotiations.

American reportedly was offering Eastern nearly $25 million for the assets and for an agreement to turn its $34 million terminal back to the Ports Authority.

"That's was the figure that was rumored," said Arnaldo Deleo, Eastern's director of sales and service. "But that's not right anymore."

Once the deal is negotiated, international carriers will be located from their current terminal, which is located beside American's current terminal and is part of the carrier's expansion plan.

Torno said American wants to start the work by June, so the carrier can start operating an international hub next year.

It eventually would involve 100 flights a day, with jets landing in San Juan from 18 South and Central American cities, picking up additional passengers, and flying on to as many as five European cities, including London, Paris, Frankfurt, Madrid and Rome.

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Prepared Statement of Robert D. Reischauer

Mr. Chairman, I am pleased to appear before the Committee to discuss the Congressional Budget Office's (CBO's) analysis of the possible impact of S. 712 on the Puerto Rican economy and the Federal budget. The bill provides for a referendum in which the citizens of Puerto Rico would choose between three options: an enhanced version of commonwealth; statehood; or independence.

The economic impact of the enhanced commonwealth option seems relatively uncontroversial: the enhancements that are contained in S. 712 are likely to benefit the island, but perhaps by only a small amount. The economic effects of the other options—statehood and independence—are likely to be far more significant, but are also complicated, uncertain, and quite controversial.

If Puerto Rico's political status was changed to that of a state or an independent republic, the island could experience significant economic changes. These possible changes could involve the amounts of funds flowing between the island and the Federal government; the tax treatment of firms in Puerto Rico; the way Puerto Rico is perceived by outsiders and its own citizens; and seemingly small, but nevertheless consequential, changes in legal provisions governing such matters as trade, shipping, and international tax relations.

In developing quantitative assessments of the likely economic impact of changes in Puerto Rico's status, CBO has been able to estimate only some of these possible effects. CBO's approach has been to quantify those effects that it can, given the state of economics, while noting the unquantifiable possibilities of which it is aware.

My statement today will cover the following topics:

- The role of tax preferences in the Puerto Rican economy;
- The potential economic effects of statehood; and
- The potential economic effects of independence.

THE ROLE OF TAX PREFERENCES IN THE PUERTO RICAN ECONOMY

Much of Puerto Rico's postwar development reflects the complementary roles of Federal and Puerto Rican tax preferences. This is especially true of the manufacturing sector. Since 1948, Puerto Rico has largely exempted the profits of all manufacturers from tax. Since 1921, Federal tax provisions have, in effect, fully or partially exempted from tax the profits of qualified U.S. corporations operating in U.S. territorial possessions. This provision is known today, in amended form, as Section 936 of the Internal Revenue Code. In order to qualify for the tax advantage, "Section 936 firms" are usually organized as wholly owned U.S. subsidiaries of mainland parents.

The Puerto Rican economy has undergone a dramatic change under the Federal and local tax preferences. The economy has been transformed from one based on agriculture to one based on manufacturing as well as on government, construction, and services. Today, manufacturing concerns employ about 17 percent of Puerto Rico's work force, compared with about 7 percent in 1950. Section 936 firms employ over 10 percent of the work force.

Initially, labor-intensive industries, such as textiles, apparel, and leather goods, dominated the manufacturing sector. But such industries have been leaving the island for countries with lower wages. The pattern of expansion has shifted to such high-technology, capital-intensive industries as pharmaceuticals, electronics, and scientific instruments.

This concentration of industries reflects the incentives of Section 936. As a profit subsidy, Section 936 is more attractive to capital-intensive than to labor-intensive firms. Even more, however, Section 936 offers a unique tax opportunity for corporations that generate income from intangible assets, such as patents or trademarks. To the extent that the tax code allows, firms seek to transfer intangible assets to subsidiaries in low-tax jurisdictions like Puerto Rico. The cost of the intangible appears on the parent's books on the U.S. mainland, where the tax deduction is valuable; the income of the intangible appears on the subsidiary's books, where the tax rate is low.

Some types of corporations are well suited to take advantage of such opportunities to shield income from tax. These firms usually have developed intangible assets through expenditures for marketing or research and development. These companies produce a product that is easily transported and requires a mass-production stage in light industry. These considerations explain why Section 936 activity in Puerto Rico is dominated by such industries as pharmaceuticals, electronics, and scientific instruments—industries whose firms often have subsidiaries in several foreign locations. Most of their output is exported to the mainland.

Potential Effects of Losing Section 936 Tax Benefits

CBO concluded that Puerto Rico would grow more slowly under statehood because statehood would imply the loss of Section 936 tax benefits. CBO assumed that Section 936 benefits would continue under commonwealth status. Losing that tax advantage would leave Puerto Rico at a cost disadvantage relative to other locations. The after-tax rate of return on existing investments on the island would fall. Firms that found themselves earning less than a normal after-tax rate of return would be likely to curtail investment there or relocate their production.

CBO's calculations suggest that, under statehood, the reported after-tax rate of return would fall by about nine percentage points for the average Section 936 manufacturer. It would fall by about eleven percentage points for firms in the chemicals, electronics, and instruments industries, that together represent about three-quarters of all Section 936 capital. These are substantial reductions; they are close to the overall operating rates of return that corporations earn on the U.S. mainland.

For many firms, location in a low-tax foreign location could offer a significant tax advantage over Puerto Rico under statehood. By some estimates, over half the tax loss that statehood would imply might be recouped by relocating in a low-tax foreign jurisdiction. This possibility arises because deferral of U.S. tax on foreign-source profits reduces the effective tax rate on such profits. In principle, deferral applies only to tangible income, but U.S. firms operating abroad generally can use legal and accounting arrangements to shield significant amounts of intangible income from current U.S. tax.

CBO expects that Section 936 firms would be sensitive to loss of tax benefits. Section 936 firms must file commitments with the Puerto Rican government to create jobs in order to qualify their investment projects for exemption from Puerto Rican taxes. In the past, such job commitments have fallen sharply when news of possible changes in Section 936 provisions has been announced. These declines have occurred even when commitments by local firms have changed little. Section 936 commitments have once again fallen sharply during the current discussion of changing Puerto Rico's status. An actual change in status would probably reduce commitments and investment even further. In addition, Section 936 firms have demonstrated their sensitivity to tax and cost conditions by their initial decision to locate in Puerto Rico, by their many overseas operations, and by their tendency to leave Puerto Rico when costs become unfavorable.

Firms are more likely to reduce investment than to relocate. Moving existing assets and production to a new location involves costs that do not apply when considering possible locations for expanded production. Beyond their investment in fixed capital, going concerns in Puerto Rico have already trained their staff, organized their supply and distribution networks, and developed relations with local unions and government organizations. The costs of such efforts would have to be incurred again if a firm moved to a new location.

Arguments Suggesting that Investment Would Remain Strong Under Statehood. Several arguments have been advanced that Section 936 firms might not reduce their investment significantly if Puerto Rico were to become a state. But CBO did not incorporate these arguments into its analysis. In some cases CBO was unconvinced by the logic or evidence; in other cases, CBO did not have the time or resources to undertake the required analysis.

The first argument states that Section 936 corporations would remain profitable even after additional tax was imposed because they have such high before-tax profit margins. But these high reported profits are more apparent than real because they reflect the incentives provided by Section 936 firms to make their costs appear on the U.S. parent's books and their income (especially intangible income) appear on the Puerto Rican subsidiary's books. These returns to intangibles would accrue wherever production takes place, so they would not affect the decision on location in the absence of tax considerations.

The second argument states that new job commitments do not appear to have slowed when rules about the reporting of intangible income were tightened in 1982 and 1986. But the tightened rules merely reduced, and did not eliminate, the unique tax advantage provided by Section 936. They left Puerto Rico with a significant tax advantage over alternative locations. Moreover, it is difficult to separate the effect of these rules changes from the effect of the general business cycle.

The third argument states that Puerto Rico might still offer cost advantages under statehood compared with other locations. For some—but not all—firms and operations, this would be true. But a full comparison of the costs of each firm calculated for each feasible location is well beyond CBO's capabilities.

POTENTIAL ECONOMIC EFFECTS OF STATEHOOD

Proponents of statehood argue that the dominant effects would be positive. Admission to the Union would bring with it greater visibility and reduced uncertainty over Puerto Rico's status. As a result, outsiders would be more aware of the opportunities the island offers for tourism, investment, and trade with the remainder of Latin America. Proponents also argue that the increase in Federal transfer payments (less new taxes) that the island would receive under statehood would stimulate its economy. At the same time, all observers acknowledge that statehood would bring with it serious economic impediments, such as loss of Federal tax benefits for investment on the island, imposition of Federal taxes on Puerto Ricans, and potentially restrictive fiscal policies by the Puerto Rican government.

While many economic consequences of statehood could be significant, CBO has quantified only two: the change in net Federal transfers; and the reduction in investment by Section 936 corporations. Other effects discussed earlier may be significant, but there is little basis for estimating their magnitude.

The features of statehood that CBO can quantify suggest, on balance, reduced growth prospects for the rest of the century. Overall, from 1992 to 2000, average annual growth in Puerto Rico's real (inflation-adjusted) gross product (GNP) might be slower by about one to two percentage points than under current status. This translates into real GNP that would be 10 percent to 15 percent lower by 2000 than it might otherwise have been. The decline in real GNP would reduce Federal tax revenues and increase Federal spending in Puerto Rico. CBO does not have an estimate of the response of Federal tax revenues to lower GNP. The Joint Committee on Taxation is responsible for estimating the revenue effects of S. 712. As discussed later, Federal spending in Puerto Rico would increase by an estimated $0.3 billion to $0.6 billion in 2000 as a result of the economic changes. This is in addition to the estimated $3.6 billion increase in 2000 that statehood would imply in the absence of economic changes. A good deal of uncertainty surrounds all these estimates, suggesting that they should be regarded only as rough guides to the magnitudes involved.

Changes in Net Federal Transfers to Puerto Rico

Under statehood, net Federal transfers to Puerto Rico would increase. Individuals would become eligible for full Federal entitlements on the date of Puerto Rico's admission to the Union, assumed to be October 1, 1992. Puerto Rican individuals and corporations would become liable for Federal taxes beginning in 1994, but these taxes would be remitted to the Puerto Rican Treasury in 1994 and 1995. All Federal excise taxes would be imposed, but the taxes collected would be remitted to Puerto Rico through 1998. After 1998, the U.S. Treasury would not remit any tax collections to Puerto Rico.

In the absence of economic effects, these changes would increase net Federal flows to the island by about $18 billion over the 1992-2000 period (see Table 1). Other things being equal, tax collections from Section 936 firms would also increase, but they are not included in this estimate. Those taxes reduce the income of mainlanders, rather than islanders. Therefore, they do not affect Puerto Rican aggregate demand.

These changes might have two types of effect. First, the net increase in Federal flows would increase aggregate demand on the island and stimulate the Puerto Rican economy. Second, they might affect the supply of labor on the island and migration between the island and the mainland. CBO is unable to quantify the second effect, but believes that its inclusion would not significantly alter the results.

Reduced Investment by Section 936 Firms

Section 936 benefits would be phased out under statehood. In 1994, a Section 936 firm would receive only 80 percent of the credit it would otherwise receive, 60 percent in 1995, 40 percent in 1996, 20 percent in 1997, and no credit thereafter.

Table 1.—ASSUMED STATIC CHANGES IN FEDERAL EXPENDITURES AND REVENUES FROM LOCAL SOURCES AS A RESULT OF STATEHOOD

[In millions of dollars, by United States fiscal year]

Change	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total 1992–2000
Change in total spending	1,666	1,810	2,550	2,950	3,068	3,191	3,318	3,451	3,589	25,593
Change in Revenues from Local Sources: [1]										
New excise taxes	0	0	0	0	0	0	0	395	414	809
Customs duties	0	0	0	0	0	0	0	163	171	334
Rum excise tax	0	0	0	0	0	0	0	265	268	533
Personal tax	0	0	163	10	539	739	773	809	846	3,879
Tax on local corporations	0	0	0	0	274	471	495	519	545	2,304
Total change in local source revenues [1]	0	0	163	10	813	1,210	1,268	2,151	2,244	7,859
Change in net transfers to Puerto Rico [1]	1,666	1,810	2,387	2,940	2,255	1,981	2,050	1,300	1,345	17,734

[1] Excluding increased tax collections from Section 936 corporations.
Sources: Congressional Budget Office; Department of the Treasury.
Note: Revenue figures are expressed as net of remission of Federal collections to the Puerto Rican Treasury. The earned income tax credit is netted from personal tax, rather than appearing separately in expenditures. Beyond 1995, expenditure figures were assumed to grow at 4 percent a year. For more detail, see Congressional Budget Office, "Background Materials on the Costs of the Puerto Rico Status Referendum Act" (Nov. 5, 1989, processed); and Testimony of Kenneth Gideon, Assistant Secretary of the Treasury, before the Senate Committee on Finance, Nov. 14, 1989.

As I have already suggested, firms would probably reduce their investment in Puerto Rico substantially in response to losing Section 936 benefits. The reduced investment would directly reduce aggregate demand on the island and would ultimately reduce the island's capacity to produce.

CBO can make only a crude estimate of the extent to which Section 936 firms would reduce their scale of operations under statehood. As was noted earlier, loss of Section 936 benefits is more likely to discourage new investment than it is to lead firms to leave outright. But some firms would leave Puerto Rico even under current commonwealth status. Such attrition is normally more than offset by expansion of existing firms and entrance of new firms. CBO assumed that attrition would continue at its historical rate, but that the remaining firms would invest only enough to maintain their real stock of capital. This allows the possibility that more firms might exit while others entered or expanded, but supposes that the effects would balance.

The investment path described would reduce the capital and output of Section 936 firms. By the year 2000, their capital would fall below baseline levels by 37 percent to 47 percent (see Table 2). Investment would fall below the baseline by even more. CBO assumed that the output and exports of Section 936 firms would fall below baseline in proportion to the previous year's fall in capital.

Table 2.—ASSUMED CHANGES IN SECTION 936 GROSS INVESTMENT, CAPITAL, AND EXPORTS

[In percentages of baseline levels, by Puerto Rican fiscal year]

Item changed	1991	1992	1993	1994	1995	2000
High-Growth Baseline						
Section 936 Gross Investment	0	−26	−30	−56	−59	−73
Section 936 Capital	0	−4	−8	−15	−21	−47
Section 936 Exports	0	0	−4	−8	−15	−43
Low-Growth Baseline						
Section 936 Gross Investment	0	−26	−30	−47	−49	−62
Section 936 Capital	0	−3	−7	−12	−17	−37
Section 936 Exports	0	0	−3	−7	−12	−33

Source: Congressional Budget Office. Note: Puerto Rican fiscal years start on July 1 of the preceding calendar years.

Estimating the Overall Economic Implications of these Changes

CBO's analysis of the quantifiable effects of statehood consisted of two steps:

• Developing high- and low-growth baseline projections assuming Puerto Rico's current commonwealth status; and

• Estimating the net effects of the increase in net Federal transfers and the decrease in investment by Section 936 firms relative to these baseline projections by using an economic model of Puerto Rico.

The Baseline Projections. CBO developed two baseline economic projections for Puerto Rico. These are not forecasts; CBO does not have the expertise to develop forecasts of the Puerto Rican economy. Instead, the projections are mechanical extrapolations based on historical performance. They maintain consistent relationships among economic variables—such as income, output, investment and exports—and serve as benchmarks against which alternative status options can be measured.

The baselines represent the best and worst growth possibilities that can be considered likely based strictly on historical experience. Real gross domestic product (GDP) grows at 4.4 percent a year on the high-growth path and 2.4 percent a year on the low-growth path. In each case, output of the Section 936 sector grows 1.2 percentage points faster than the economy as a whole.

Estimating the Net Effects Using an Economic Model. CBO developed a model of the Puerto Rican economy that it used to determine the net effects of changed Federal flows and reduced investment by Section 936 firms. This model makes it possible to take into account many of the important indirect economic effects of the change in Federal transfers, as well as the loss in Section 936 investment. For example, the model implicitly takes account of any change in investment by local Puerto Rican firms that supply goods to Section 936 firms. The model also makes it possible to estimate the amount by which Puerto Rican consumers would increase their spending in response to increased Federal transfers, and how much this increase would be offset by the losses in income that they would experience when Section 936 corporations and others reduced their employment on the island.

On balance, statehood would reduce average Puerto Rican growth over the rest of the decade, given the quantifiable assumptions considered here. The economy would probably enjoy a temporary surge in response to increased net transfers, but this would eventually be offset by the loss of Section 936 activity. CBO's assumptions imply that the average annual growth rate would fall by one to two percentage points through 2000 (see Table 3). This growth shortfall translates into ten to fifteen percentage points lower real GNP than would otherwise have occurred by 2000 (see Figure 1). Employment growth would fall by one-half to one percentage point, which translates into 50,000 to 100,000 fewer jobs by 2000. In the absence of changes in labor supply or migration, these figures would roughly translate into an unemployment rate four to seven percentage points higher than otherwise by 2000.

The simulations do not take account of some other economic effects that might occur. First, Puerto Rico might have to reduce public spending to keep its budget balanced if tax collections fell either with slower growth or action to reduce a high combined Federal and state income tax rate. These reductions in spending would further act to slow growth. Second, local firms, like Section 936 firms, would face higher taxes and might reduce their investment or go out of business. Third, Puerto Rico's financial sector would contract because tax incentives that now induce Sec. 936 firms to make financial investments on the island would no longer apply.

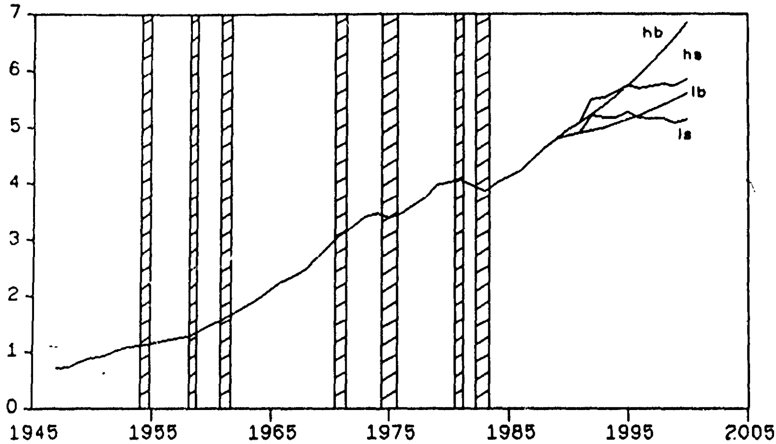
Table 3.—ILLUSTRATIVE EFFECTS OF STATEHOOD ON THE PUERTO RICAN ECONOMY

[Difference from baseline of average annual growth rate, in percentage points]

	1992-1995	1996-2000	1992-2000
High-Growth Baseline			
Real GNP	0.1	−3.3	−1.8
Real GDP	−0.4	−3.0	−1.9
Employment	0.1	−1.9	−1.0
Real Exports	−2.4	−4.5	−3.6
Low-Growth Baseline			
Real GNP	0.7	−2.3	−1.0
Real GDP	0.1	−2.2	−1.2
Employment	0.5	−1.4	−0.6
Real Exports	−1.8	−3.0	−2.5

Source: Congressional Budget Office.

FIGURE 1. ESTIMATED LEVELS OF REAL GNP UNDER STATEHOOD COMPARED WITH ALTERNATIVE BASELINE ASSUMPTIONS UNDER COMMONWEALTH STATUS (In billions of 1954 dollars)



SOURCE: Congressional Budget Office.

NOTES: Shaded areas represent recessions in the United States.
Puerto Rican fiscal years start on July 1 of the preceding calendar years.

hs = statehood with high growth.
ls = statehood with low growth.
hb = baseline with high growth.
lb = baseline with low growth.

Impact on Federal Spending of Slower Economic Growth in Puerto Rico

Lower economic growth and higher unemployment in Puerto Rico would work to increase Federal spending. Spending for unemployment insurance, food stamps, Aid for Families with Dependent Children (AFDC), and Medicaid would all increase as additional people and families became eligible for benefits. All of the additional benefit payments in unemployment insurance and food stamps would affect the Federal budget, and an estimated 83 percent of additional AFDC and Medicaid costs would fall on the Federal budget.

It is difficult to estimate accurately the size of these spending increases, since only one of these programs—unemployment insurance—is currently an open-ended entitlement program in Puerto Rico, while all would be so under statehood. CBO made its estimates on the basis of the Puerto Rican data for unemployment insurance, supplemented with U.S. experience for food stamps, AFDC, and Medicaid. Using these data, CBO estimates that the economic changes implied by statehood, coupled with the static impacts described in Table 1, might increase Federal spending by between $3.9 billion and $4.2 billion in 2000. This contrasts with the $3.6 billion Federal spending change in 2000 that would result from statehood alone, without any induced economic changes.

POTENTIAL ECONOMIC EFFECTS OF INDEPENDENCE

As I suggested earlier, Puerto Rico's economic prospects under independence are even more speculative than under statehood. Independence could help the island if it expanded investment and if Puerto Ricans responded with renewed energies. In addition, it would reduce what some observers view as an excessive economic dependence on the mainland United States. However, independence could be harmful if the progressive loss in Federal transfers that would occur under S. 712 proved too burdensome, and if obtaining capital from abroad proved as difficult as it has for many developing countries.

CBO has focused on three of the many issues that are relevant to independence: net Federal transfers to Puerto Rico; capacity to attract direct investment from abroad; and capacity to finance Puerto Rico's balance of payments.

Changes in Net Federal Transfers to Puerto Rico

Under independence, Federal transfers to Puerto Rico would fall and Federal revenues from local sources would rise. An annual block grant would replace current entitlement programs, such as Food Stamps and Aid for Families with Dependent Children. This grant would equal the 1993 level of spending on such programs and would extend through the year 2000, when it would expire. It would not provide the same funds as the entitlement programs would have, because it would not allow for inflation or for the increased participation that would have occurred. The U.S. Treasury would no longer remit collections from the excise tax on rum as it does now. The overall result would be a decline in net fiscal flows from the United States to Puerto Rico. As Table 4 shows, this would amount to about $7 billion from 1992 through 2000 in the absence of any economic effects. (As in the case of statehood, these estimates exclude increased tax collections from U.S. corporations operating in Puerto Rico.)

Table 4.—ASSUMED STATIC CHANGES IN FEDERAL EXPENDITURES AND REVENUES FROM LOCAL SOURCES AS A RESULT OF INDEPENDENCE

[In millions of dollars, by U S fiscal year]

	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total 1992-2000
Change in Total Spending	0	0	−100	−300	−500	−600	−800	−1,000	−1,200	4,500
Change in Revenues from Local Sources (Rum excise tax) [1]	0	188	252	255	257	260	262	265	268	2,007
Change in Net Transfers to Puerto Rico	0	188	−352	−555	−757	−860	−1,062	−1,265	−1,468	6,507

[1] Excluding increased tax collections from U.S corporations operating in Puerto Rico

Sources: Congressional Budget Office, Department of the Treasury.

Note. Independence is assumed to occur on January 1, 1993. For more detail, see Congressional Budget Office, "Background Materials on the Costs of the Puerto Rico Status Referendum Act" (November 5, 1989, processed); and Testimony of Kenneth Gideon, Assistant Secretary of the Treasury, before the Senate Committee on Finance, November 14, 1989.

The decline in net fiscal flows from the United States would have two effects. First, Puerto Rican aggregate demand would fall. Second, Puerto Rico would have more difficulty in financing its balance of payments.

CBO has estimated the economic effects of the reduction in net Federal transfers using its model of the Puerto Rican economy. The exercise isolates the effect of such transfers by assuming that no other outside change affects the economy. Compared with the same high- and low-growth baselines used in analyzing statehood, average growth in real GNP would fall by 0.2 to 0.3 percentage point per year between 1992 and 2000.

Capacity to Attract Direct Investment from Abroad

Several issues arise in assessing an independent Puerto Rico's potential to attract direct investment. Under S. 712, U.S. corporations in Puerto Rico would lose all benefits of Section 936 upon the proclamation of independence. Puerto Rico might, however, offer several tax-related advantages. First, by maintaining its current tax treatment, the republic could serve as a low-tax foreign jurisdiction for U.S. firms. Second, the republic could negotiate treaties with third countries that would make their investment in Puerto Rico more attractive than it is now. Third, the republic could institute a tax-subsidy policy as described by independence advocates that would be designed, in effect, to replace the benefits of Section 936.

The net effect of the possible outcomes cannot be quantified. Therefore, CBO provides no estimate of the extent to which an independent Puerto Rico might, on balance, gain or lose investment from abroad.

Capacity to Finance Puerto Rico's Balance of Payments

An independent Puerto Rico might have severe difficulty financing its balance of payments. The problem arises because outsiders (mostly section 936 firms) provide substantial funds for investment in Puerto Rico. The profits they repatriate represent an outflow in the balance of payments accounts. In the past, this outflow has apparently been financed by three principal sources: net transfers from the Federal government; Puerto Rican government borrowing in the United States, generally through the tax-exempt municipal bond market; and direct investment by Section 936 firms.

At least two of these sources would become more restricted under independence, and possibly all three would. U.S. government transfers would decline under independence from the levels that CBO projects under continued commonwealth status. Puerto Rico would lose access to U.S. tax-exempt bond markets. It would have to pay interest rates on new bonds at least two percentage points higher than now. In fact, like many Latin American countries, it might have difficulty borrowing abroad at any reasonable rate. Finally, direct investment from abroad might either rise or fall from levels that would occur under commonwealth status.

Any decline in funds from outside sources would cause the Puerto Rican economy to contract. Either the government would have to reduce its borrowing to balance the shortfall, or real interest rates would rise in Puerto Rico. Either case would lead to reduced output, employment, and income in the short run. Flexible wages and prices would mitigate the contraction, but, if the minimum wage was retained, it would largely forestall their operation.

Other Issues Under Independence

Other factors would also affect Puerto Rico's development as a republic. First, Puerto Rican exports to the United States would no longer automatically be duty-free. Although S. 712 states the desire of the United States to enter a free-trade association with an independent Puerto Rico, it makes no actual commitment to reduce or eliminate its tariffs. At a minimum, Puerto Rico would qualify for most-favored-nation status. Favorable U.S. tariff provisions would provide a significant cost advantage to Puerto Rico relative to other foreign locations. Second, an independent Puerto Rico would enjoy a cost advantage relative to U.S. locations for firms that make intracoastal shipments. Shipments from an independent Puerto Rico to the mainland would no longer have to be carried on U.S. vessels with U.S. crews. Finally, the greatest imponderable might be the response of Puerto Ricans themselves. They might respond positively by increasing work and saving in Puerto Rico, or they might respond negatively by emigrating or sending their savings abroad.

CONCLUSION

The effects of a change in Puerto Rico's status are extremely uncertain. CBO cannot quantify all these effects, and those that it can quantify cannot be stated with much precision. Therefore, while CBO's analysis may advance the debate, it cannot be regarded as definitive. Furthermore, as with any major political event, a change in Puerto Rico's status would require consideration of many factors beyond the limited realm of economics.

APPENDIX

At Senator Moynihan's request, the Congressional Budget Office (CBO) has estimated both per capita federal transfers to Puerto Ricans and growth rates of per capita real gross national product (GNP) under either commonwealth or statehood status as specified in S. 712. In doing so, CBO assumed that the Puerto Rican population would grow at 0.3 percent per year—roughly its most recent rate of growth. This rate appears to be very close to more authoritative projections that have been made available to CBO since the publication of its report. Under statehood, the rate of population growth could differ from the rate under commonwealth status because of a different rate of net migration from the island. CBO has not, however, tried to account for any differences in migration that would occur under the two status options.

CBO estimated Federal transfers in 1995, as specified in S. 712, for four entitlement programs—Food Stamps, Aid to Families with Dependent Children, Medicaid, and Supplemental Security Income (Aid to the Aged, Blind, and Disabled under commonwealth status). These are the major Federal entitlement programs funded by general revenues. CBO estimates that per capita Federal spending for these programs under commonwealth status would be about $400. Under statehood, this figure would rise to about $1,250. These figures compare with estimated per capita Federal spending of $475 for these programs on the mainland in 1995.

As the accompanying table shows, CBO estimates that real GNP per capita would initially grow more rapidly under statehood, as it is defined in S. 712, than under commonwealth status. But growth under statehood is likely to slow to a standstill or to turn negative from about 1995 to 2000. Over the entire 1992-2000 period, the quantifiable effects of statehood are estimated to reduce the average annual growth rate from between 1.3 percent and 3.1 percent to between 0.2 percent and 1.2 percent. These are not precise estimates, but are rough indications of the magnitudes involved.

Table. ESTIMATED AVERAGE ANNUAL GROW RATES OF REAL GNP PER CAPITA IN PUERTO RICO UNDER ALTERNATIVE STATUS OPTIONS

[In percent]

	1992-1995	1996-2000	1992-2000
High-Growth Case			
Commonwealth	2.7	3.3	3.1
Statehood	2.8	0.0	1.3
Low-Growth Case			
Commonwealth	0.8	1.5	1.2
Statehood	1.5	−0.8	0.2

Source: Congressional Budget Office.

Responses to Questions Submitted by Senator Dole

Question. According to the results of the econometric model used in your study, what would be the effect of statehood on Net Income, Wages and Salaries, Fixed Investment, and Investment in Construction?

Answer. The ranges of percentage reductions under statehood from baseline levels for the variables that you mention are as follows:

Wage and salary disbursements	17 percent to 25 percent
Private fixed investment	25 percent to 35 percent
Private investment in construction	25 percent to 35 percent
Net national product	13 percent to 21 percent

While we are not sure what is referred to by "net income," we assumed you meant net Puerto Rican product, which in our report is referred to as "net national product." As shown above, the range of percentage reduction in this variable is 13 percent to 21 percent.

Question. The back-up information on the CBO study provided to the three parties shows that wages and salary disbursements decrease under statehood from 17 to 25%. How is this figure reconciled with a much smaller proportional decrease in unemployment (from 50,000 to 100,000 workers compared to an employed labor force of approximately 1,000,000 in the year 2000).

Answer. One reason for sharper reductions in wages and salaries than in employment is that "losses in employment under statehood as defined under S. 712 are concentrated in relatively high-wage jobs in the Section 936 sector of the economy. Even at that, however, the two estimates may not be entirely consistent. CBO believes its estimate of the decline in employment is probably more reliable than its figures on the fall in wages and salaries. The potential overstatement of the decline in wages "should not have a significant effect on CBO's economic analysis, however. Any impact of the excessively high decline in wages on the analysis would be offset by the excessively *low* decline in profits of domestic firms that it implies, leaving unaffected the change in total income of local firms and individuals.

Question. What are the results provided in your model on the net fiscal costs of statehood, exclusive of Section 936 revenues? What results does your model provide for the dynamic impact on personal and corporate non-936 taxes, excise taxes, and social security taxes? What is the net deficit on the U.S. Treasury if CBO's estimate of net fiscal costs is combined with Treasury's estimate of recovery of Section 936 revenues under statehood?

Answer. CBO has not made estimates of the net fiscal costs of Puerto Rican statehood to the U.S. government. Such estimates must await input from other agencies. Crude figures on some of these magnitudes were developed in CBO's economic model as inputs to its purely economic analysis, but these estimates cannot be used in other contexts as CBO's budget estimates.

Question. Is Treasury's analysis of recovery of Section 936 revenues under statehood consistent with CBO's estimates of relocation of Section 936 assets, exports and income? Why, or why not? Explain any inconsistencies between Treasury's analysis and CBO's relocation estimates.

Answer. While Treasury has provided no description of the analysis underlying its estimated losses in Section 936 capital and tax revenue, they appear to be roughly consistent with CBO's estimates. Treasury estimates that at least 35 percent of Section 936 capital income would leave Puerto Rico under statehood. This estimate clearly seems consistent with CBO's estimated range of 37 percent to 47 percent.

Question. What proportion of disposable income is contributed by federal transfers to individuals under Commonwealth and under statehood? Please provide figures for the year 2000.

Answer. CBO's calculations suggest that federal transfers could rise as a proportion of disposable income from projected levels of between 20 percent and 25 percent in the year 2000 in the baseline case to levels of perhaps 35 percent to 40 percent in the same year under statehood as it is defined in S. 712.

Question. Is the gap of 10 to 15% of GNP between statehood and Commonwealth permanent? Would relocation of Section 936 assets continue beyond the year 2000? Could the GNP gap widen?

Answer. The decline in GNP relative to baseline levels would be permanent as long as the underlying assumptions about economic policies were maintained. While CBO has made no projections beyond 2000, it does not anticipate significant further reductions in Puerto Rican GNP relative to the levels that would otherwise have occurred.

Question. Statehood advocates have testified that statehood would bring an additional 100,000 direct and indirect jobs to replace the jobs lost in the Section 936 sector. Is this increase in jobs likely under statehood, over and above any additional tourist job increases under Commonwealth? How does the imposition of Federal taxes under statehood affect investment and job creation opportunities in the tourist industry?

Answer. CBO cannot judge how likely it is that statehood would lead to increases in employment as a result of factors beyond the tax and fiscal changes that are analyzed in CBO's report. It is not possible to analyze such factors using well-accepted economic methods. The imposition of Federal taxes under statehood could increase the costs of providing tourist services, because some tourist facilities currently qualify for Section 936 tax benefits.

COMMUNICATIONS

STATEMENT OF FRANCISCO CEPERO

IN THE UNITED STATES OF AMERICA

TO : THE HON. US. CONGRESS, HON. LAURA WILCOX, HON.ED MIHALSKI, HON. FED., INS., MUN. GOV'T., HON. NISSAN MOTOR CO., LTD.; MR. PEDRO CEPERO & SON, HON. DISCHARGED VETERAN SON; Respondents

FROM : JEANETTE CENTENO 584-21-9090, TOMASA MALDONADO 581-03-6508A, FRANCISCO CEPERO 580-24-6325, Petitioners, BOX 30204, 65 INF. RIO PIEDRAS, P.R., 00929.

PURPOSE :: PRAYED INDEMNITIES FOR SCANDALOUS CONTROLLED FEDERAL RIGHTS.

DATE : APRIL 9, 1990.

""

GRIEVANCES

Cepero herein, former Secretary and bona-fide member of the Nice Popular Democratic Party, respectfully comes now, alleges, prays:

1. That our Honorable Authorities enjoy Perfect, Historical Morality although without neither advanced fair hearing nor Legal Assistance it arranged for Insular General Elections, Plebiscite of Exhibit "A" and Plebiscite S. 712 supported by Administrative Duties of scandalous matter subverted in the Orderly Administration of the Federal, Insular Laws, Constitutions, Rulings, Democracy, Loyalty and the petitioners' Compensations moral, legally provided by the Rulings in the Case Cortés v. Industrial Commission, 85 D.P.R. 241. Our beloved Popular Democratic Party did criminally denied us the EXCELLENT help sent by our NICE USA for the poor Citizens of Puerto Rico..... We were starving, while our Popular Democratic Party did keep under its unlawful Custody our salaries and Social Security Taxes... afterwards, we enjoyed EXCELLENT LIVING when our Famous USA sent us our monies.... I pray our LORD to Assist the Permanent UNCONDITIONAL ASSOCIATION TO THE POWERFUL U.S.A. that such a HUMAN, NICE TREATMENT extends to our Island. The fabricated Popular Democratic Party's Deceitful Plebiscite may be Denied. The Exhibits B through F arose from our Popular Democratic Party's scandals. My honorably discharged Veteran son; Mr. Pedro Cepero & Son misrepresent my properties, monies, reputation. The Honorable Police Department's Grievance No. 0S-1-6-692 refers to the Competent Chauffeur that badly destroyed my automobile and hurt my body and misrepresent our Promise, may be asked to pay liquidated damages for its misrepresented Promise.

THEREFORE, our Meritful Popular Democratic Party may be Ordered to cease and Desist its entrapment of Cepero's employment, wages, Social Security Taxes, and liquidated damages amounting to five hundred fifty thousand dollars and equal amount for my wife's fraudulent discharge. The sham, false Popular Democratic Party Plebiscite may be set aside.

Respectfully Submitted.

Congress of the United States
Committee on the Judiciary
House of Representatives
Washington, D.C. 20515

Telephone: 202-225-3951

April 21, 1976

Mr. Francisco Cepero Alers
959 Malvis Street
Country Club
Rio Piedras, Puerto Rico 00924

Dear Mr. Cepero:

Thank you for your recent letter regarding the implementation of the provisions of H.R. 11200, which would institute a new compact between the Commonwealth of Puerto Rico and the United States. I appreciate your concern in this matter, however, the bill has not yet been enacted into law and is under study by the House Committee on Interior and Insular Affairs. It is my understanding that the Subcommittee on Territorial and Insular Affairs, chaired by Congressman Phillip Burton has already commenced hearings on H.R. 11200, and plans to hold public meetings in Puerto Rico on the impact of the bill.

I have referred your letter to the Subcommittee for their review. If I can be of any further assistance, I hope you will contact me.

Sincerely,

Peter W. Rodino

PETER W. RODINO, JR.
CHAIRMAN

PWR:vo

EXHIBIT "A"

PUERTO RICO'S ADMINISTRATIVE
SCANDALOUS OFFICIAL DUTIES
MAY BE ORDERED STRICKEN HEREIN

ESTADO LIBRE ASOCIADO DE PUERTO RICO
DEPARTAMENTO DEL TRABAJO
Negociado de Conciliación y Arbitraje
SAN JUAN, P. R.

4 de febrero de 1960

Sr. Francisco Cepero
Calle Las Palmas #1051
SANTURCE, Puerto Rico

Estimado señor Cepero:

Después de mi visita a usted el día 14 del pasado mes de enero, me comuniqué personalmente con el Ingeniero señor Luis A. Brignoni, Subdirector de Obras Públicas de la Capital.

De la información ofrecida por el señor Brignoni se desprende que usted tiene derecho a unos 60 días de vacaciones, el importe de los cuales puede recibir a su conveniencia pasando por el municipio. En cuanto a la licencia por enfermedad, por no recordar de momento el señor Brignoni lo que dispone el convenio con la Unión no pudó darnos detalles, pero usted tiene derecho a que se le paguen los días en que ha estado enfermo según lo disponga dicho convenio.

Como usted nos informó, además, que tenía horas extras que no le habían sido recompensadas, le aconsejamos pase por la oficina del Negociado de Normas en el Edificio Scharneco en la parada 26-1/2 de Santurce, donde le radicarán y tramitarán su reclamación.

Esperando haberle complacido en su solicitud, me suscribo

Cordialmente,

SALVADOR VAZQUEZ VARGAS
Conciliador

EXHIBIT "B"

SCANDALOUS DEPRIVATION OF SALARIES
KEEP UNDER PUERTO RICO'S UNLAWFUL
CUSTODY

DR. JULIO E. LERGIER, M.D.
Consultorio: 2203 Ave. Borinquen Esq. Martinó, Bo Obrero
Santurce, Puerto Rico

Horas de Oficina:
Lunes a viernes
8:30 a 5:00 P.M.
Sábado
8:30 a 12:30 P.M.

Teléfono:
726-8980
Lic. No. 560

NOMBRE Francisco Cepero Alers EDAD 73

DIRECCION Calle Infanta 959 [illegible] FECHA 8/3/79

℞ To whom it may concern
The patient, Mr. Francisco Cepero Alers, suffers from chronic arteriosclerotic heart disease.

He has been unable since January, 1979 to come for medical checkup and treatment because of financial difficulty.

He should be medically followed at least once a month.

... [signature] ... M.D.

DEA -AL 4214982 DM-01232-8

Medicare Patient 580-24-6325-A

EXHIBIT "C"

NISSAN MOTOR CO., LTD.

[illegible], Ginza [illegible], Chuo-ku,
Tokyo 104, Japan
Telephone: (03) 543-5523
Telex: NISMO J22503, J24474
Cable. "NISMO" Tokyo

YOUR REF:

OUR REF: D11-0154-85

March 28, 1985

EXHIBIT "D"

FABRICATED DECISION UPON A DECEITFUL SALE OF ONE MOTOR CAR FACTORY DEFECTIVE.

Mr. Francisco Cepero Alers
959 Malvis Street
Country Club
Rio Piedras
PUERTO RICO 00924

Dear Mr. Cepero:

We are in receipt of your letter of December 21, 1984, directed to both Motorambar Inc. and us.

Our records shows, however, that any pendency is not left concerning the matter indicated in your letters. Therefore, the case is considered to be closed.

We regret that we cannot be of further assistance to you.

Sincerely yours,

K. Fukunaga

K. Fukunaga
Manager
Latin America & Caribbean
Export Service Department

AKS/jt

c.c.: Mr. Samuel Otero
Service Manager
Motorambar, Inc.

Form No. 100-002

CRUV-AG-48
Rev. Octubre-78

Estado Libre Asociado de Puerto Rico
Departamento de la Vivienda
Corporación de Renovación Urbana y Vivienda de Puerto Rico
Apartado W, Río Piedras, Puerto Rico 00928

Num. 21957

RECIBO OFICIAL

Fondo PCA PR-R-33

Cuenta de Banco R-12

31 de noviembre de 1978

$ 175.00

Hemos recibido de Loreto Alers Miralles

la cantidad de ciento setenta y cinco dólares con 00/100

por concepto de saldo del solar C-5 en proyecto Aguadilla

CORPORACION DE RENOVACION URBANA Y VIVIENDA DE PUERTO RICO

REFRENDADO ______ Contralor

POR [illegible signature]

TITULO Recaudador

☐ Giro
☐ Cheque
☑ Efectivo

NO SERA VALIDO SI NO ESTA REFRENDADO

TC	PSEUDO CODIGO	SUBSIDIARIO	PROYECTO	CANTIDAD

CRUV-AG-68
Rev. Marzo 72

Corporación de Renovación Urbana y Vivienda de Puerto Rico
Apartado W. Río Piedras. Puerto Rico 00928

Nº 15577

Fondo PCA PR-R-33

RECIBO OFICIAL

Número 34-7

CRUV

$ 3,500.00

28 de enero de 1974

Hemos recibido de Loreto Alers Miralles

la cantidad de tres mil quinientos dólares

por concepto de depósito para garantizar la adquisición del solar Núm. C-5 PR-R-33

REFRENDADO [illegible signature] Contralor

CORPORACION DE RENOVACION URBANA Y VIVIENDA DE PUERTO RICO

☐ Giro
☐ Cheque 6702
☐ Efectivo

EXHIBIT E

POR [illegible signature]

TITULO Recaudador

NO SERA VALIDO SI NO ESTA REFRENDADO

Fondo CRUV o Persona que Remite	DEBITOS Banco	DEBITOS Cantidad	CREDITOS Cuenta Núm.	CREDITOS Cantidad

Departamento de la Vivienda
CORPORACION DE RENOVACION URBANA Y VIVIENDA
DE PUERTO RICO
AVENIDA BARBOSA 606 · APARTADO W — RIO PIEDRAS, PUERTO RICO 00928

A QUIEN PUEDA INTERESAR

CERTIFICO: Que esta Corporación se proponía vender a la señora Loreta Alers Miralles el solar C-5 del proyecto PRR-23-Moropó, Aguada.

QUE los terrenos no vendidos del referido proyecto serán transferidos al Gobierno Municipal de Aguada, conforme a disposición de Leyes Estatal y Federal aprobadas al efecto.

QUE el Gobierno Municipal de Aguada será responsable de la disposición final de dichos terrenos y viene obligado a honrar los compromisos contraídos por esta Corporación con anterioridad a la transferencia de los mismos.

QUE habiendo fallecido la señora Loreta Alers Miralles, el solar C-5 será vendido a la Sucesión por el Gobierno Municipal.

QUE esa Sucesión deberá someter Declaratoria de Herederos a fin de que el Gobierno Municipal de Aguada tramite la transacción tan pronto se le transfieran los terrenos.

EXHIBIT "F"
WILFULLY FABRICATED DECISION
UPON PUERTO RICO'S SCANDALOUS
ADMINISTRATIVE OFFICIAL DUTY.

Juan E. Martínez, Jefe
División Disposición Solares

METROPOLITAN MEDICAL SERVICE
VISITAS A DOMICILIO 24 HORAS AL DIA
Teléfono [illegible]
JULIO E. LERCIER, M. D.
Lic. No. 560 — Ave. Borinquen 2007 - Altos — Reg. Fed. [illegible]

PARA ....

RESIDENCIA .... FECHA 10/3/58

I hereby certify that Mr. Francisco Cepero, father of Francisco Cepero Jr. is under my treatment for hypertension and severe vertigo. He is unable to walk and has been in this condition since he was struck on the skull on September 16, 1957.

[signature]

Refill .... Times

.... M. D.

EXHIBIT "G"

STATEMENT OF HARDING S. FRANCO

Mr. Chairman: It is a great privilege for me to appear before this Finance Committee. I am doing it in my personal capacity as a regular citizen interested in the well being of my Country the United States of America, Puerto Rico included in the term the United States of America. I am not an economist but merely a student willing to do my part, my contribution to the best relationship between Puerto Rico and the mainland United States.

I respectfully request my presentation be made part of the Record at this Hearing.

I also respectfully request the attached document addressed to but not published by the San Juan Star Newspaper also be made part of this Hearing.

I do hereby further request the attached presentations before the Senate Energy Commission submitted at the Hearings at Washington on June 2, 1989 and the other presentation at the Senate Energy Commission on June 16, 1989 at San Juan, Puerto Rico, both on Senate Bill 710, 711 and 712 in re Plebiscite for Puerto Rico, PRESENTATIONS that were not made part of such Hearings and I do hereby request them to be included as part of the present hearings of today's Senate Finance Committee Hearings on Puerto Rico.

I am prompted to appear because all Puerto Ricans are tired of being governed without just representation in the Congress.

The grudge against England was taxation without representation is tyranny. In Puerto Rico is IMPOSITION without representation is also a type of tyranny which we hate and abhor.

We must grab this problem in the American way and solve it in the American way. Plebiscite is not the American way. A referendum to vote for Statehood YES OR NO is in the American way. And having exerted self and free determination first by accepting the U.S. citizenship as our identity and later by voting for a United States Commonwealth back in 1952 it is Congress turn to act by passing an enabling act for statehood for Puerto Rico or by allowing a representation of Democrats to sit in the Senate and at the House, this would be fairness in the American way.

If the United States Federal Government has a commitment to all the United States citizens of Puerto Rico to help provide for the welfare of the island commonwealth and our economic development, then the provisions of U.S. Internal Revenue Code Section 936 are not the required tool and certainly not an economic tool for job creation as claimed by the Washington Office of the State of Florida because several years have passed and job creation under Section 936 have been disappointing, nevertheless we agree in that Puerto Rico should be a key part of United States efforts in the Caribbean and in Central America, however, the existence of Section 936 serves to prove to our Caribbean NEIGHBORS that United States commitment to its citizens of the region has been merely a complete failure.

The Congress is not optimistic about the role of the Commonwealth in handling the Section 936 business in that which relates the Caribbean Basin policies and employment in Puerto Rico and there have not come to sight the expected changes in these areas and Puerto Rico remains a low standard of living community in a high cost of living area.

IRS CODE Section 936 provides the equivalent of a tax credit for earnings of qualified corporations operating in Puerto Rico. To qualify for effective tax exemption a U.S. Corporation must derive at least 50% or more of its gross income from the active conduct of a trade or business within a U.S. possession. Also 80% or more of its gross income must be from possession's sources.

As expressed by the U.S. Department of the Treasury in Washington this credit attractiveness is directly related to the amount of income the corporation can generate in Puerto Rico and there is no link to the amount of economic activity carried on in Puerto Rico.

Increasing employment in Puerto Rico has always been and remains the principal goal of Section 936, therefore a proposed wage credit may be used to offset U.S. taxes on any income from Puerto Rico and might work better than the income credit.

I honestly believe that we in Puerto Rico could have made better use of the funds derived from Section 936 funds deposited in local banks and totalling in excess of 20 billion dollars like in helping the Iowa farmers fight the drought problems and helping Massachusetts and many other states solve their crime problems.

I believe the Commonwealth thru incompetence have failed to take advantage of the vast opportunities created by Section 936 for the Commonwealth leaders, objectionably, have been working openly to constitutionally separate the Commonwealth from the United States in their quest for a Commonwealth by itself. Proof of this was the stand taken by the Governor of Puerto Rico during the Senate Bill 711 and 712 and S. 710 HEARINGS on June 1989 held by the Senate Energy Commission chaired by the Hon. Senator Bennett Johnston at which time the Governor of Puerto Rico was rebuked on 17 of his 20 proposals for a so called enhancement of the Commonwealth, which reminds me of the telltale of the dog biting the hands of his master who feeds the dog.

I have mentioned the vast opportunities created by Section 936 however the incentives granted by Section 936 are too mild and too inadequate to solve the catastrophic crisis in the economy created by the U.S. Government in misgoverning a disfranchised community of American citizens for over 90 years.

The switch from income credit to wage credit will fall short of our expectations and it is highly recommended that instead of enacting changes in Section 936 we support the total elimination of the entire 936 concept and therefore the Congress must take the necessary steps to pass an enabling act for the admission of the U.S. Commonwealth of Puerto Rico as the 51st state of the Union for such step alone will offset the legerdemain of 936 corporation earnings which fatten bank deposits in Puerto Rico without producing the expected financing; and the industrial and commercial and economic growth nor the expected employment en masse.

Statehood is the only answer to our economic and political debacle for we do not enjoy civil liberty in the Commonwealth of Puerto Rico since we do not share in the making of the congressional laws under which we are governed—and let us face it—time has come for both the government and the people of Puerto Rico and the United States to clear the way so we can practice and exert the full duties and rights as American citizens under our United States Constitution.

The proposed legislation under S. 710, 711 and 712 for the offering of a plebiscite on political status to a community of United States citizens is totally unconstitutional for there is no precedent in U.S. History whereby a choice to secede has ever been offered a community of American citizens whose only goal is equality under the U.S. Constitution. And we cannot establish a precedent for the citizens of any state to secede. The jurisprudence was established by the results of the U.S. Civil War: Once in Union, forever in the Union.

Self determination was already exerted by the Puerto Ricans when we embraced the American citizenship in 1917 and thru the Nationality Act as amended which declared citizens born in Puerto Rico after 1940 are deemed to be United States citizens by Jus Soli, by being born in U.S. soil. And further when we voted for the establishment of the Commonwealth Constitution, thru Public Law 600 within the body politic of the United States at which time we voted for self government in local matters only while the U.S. Government retained all the sovereignty and authority in the Federal sphere, so democratically and fairly we voted and exerted self and free determination when we voted in 1952 for a United States Commonwealth, not for a Commonwealth by itself.

The Hearings on S. 710, 711 and 712 where the Governor of Puerto Rico joined the independence advocates in his adventure and romance with an autonomous Puerto Rico not within the full authority of the U.S. Constitution, is enough proof that under the Commonwealth status there is no political nor economic stability. We must become a state to assure the investors stability will protect their investments firmly with U.S. constitutional guarantees

And should statehood comes to Puerto Rico only a few corporations will be willing to remove investments in Puerto Rico and transfer Commonwealth related intangibles and property to foreign jurisdiction just to avoid payment of Federal corporate taxes. The truth is that the majority of existing active corporations will remain operating in Puerto Rico and statehood alone will serve to attract high caliber corporations and to increase labor intensive industries besides high tech industries.

It is claimed that the manufacturing companies are directly responsible for 53% of Puerto Rico's net income. It is claimed that 30% of Puerto Rico's commercial Bank liabilities are the deposits and repurchase agreements of 936 companies. It is further claimed that 150,000 manufacturing workers represent some 19% of employment in Puerto Rico. These claims are perplexing since Puerto Rico remains in a state of political and economic bondage where more than 160,000 families depend on welfare payments from the United States. Under the Commonwealth government the agricultural products of Puerto Rico that once were the bulwark of our economy like the sugar industry, the tobacco plantations, the needlework industry, all have been replaced by high tech industries like the electronic and pharmaceutical who yield great earnings but fail to yield high employment especially the pharmaceutical.

To sum it up the truth is that Puerto Rico has been struggling in side a poverty stricken trap since 1898 as a result of oppressive laws that installed and instituted a political disfranchisement of a community of United States citizens so Puerto Rico has been thrown by the United States into a permanent political crisis and it is up now for the United States to liberate 3 million American citizens by opening the doors of political equality under full statehood.

If the United States has a commitment to all the United States citizens of Puerto Rico to help provide for those high aims stated in the preamble of our United States CONSTITUTION then it is duty of the Congress of the United States to follow the command of the Constitution and sit two Senators from Puerto Rico and sit 5 Congressmen NOW.

[The San Juan Star and other media]

FROM HARDING M. FRANCO REPROVING PAT BUCHANAN'S COLUMN IN THE WASHINGTON TIMES, FEB. 26, 1990 "P.R. AS OUR 51ST?"

Only a few-days ago a column by Patrick Buchanan a journalist wrote a pusillanimous political diatribe against statehood for Puerto Rico. His bamboozling harangue reminds us of the ugly American who fails to realize that American citizens regardless of race are entitled to the spirit of justice and fairness embodied in our great charters; our Declaration of Independence and our United States Constitution. His arguments are similar to those Commonwealth advocates and paid lobbyists who express the similar silent voices of corporations placidly enjoying tax incentives in Puerto Rico that have moved their factories from mainland cities to avoid full Federal taxation while relaxing in our tropical haven of Puerto Rico without having the least concern for our crushed civil liberties nor for their former community sites stateside, while not providing the high expectations of massive employment under Section 936 of the IRS Code. It is suspected that these 936 Corporations because of their tax privileges granted by the Commonwealth would be generously supporting the Anti-Statehood Commonwealth government its open drive to split away from United States constitutional ties either by the strengthening of an enhanced commonwealth by itself or thru the so called associated Republic which amounts to quasi total autonomy or independence. Pat Buchanan claims there is nothing wrong with the Commonwealth for he closes his eyes to the disfranchisement of near three million American citizens of Puerto Rico whose only goal is statehood on equal footing with the 50 states of the Union. It is no surprise for us here in Puerto Rico to witness the intolerance that is reflected by Mr. Patrick Buchanan's opinions and it is history that many states of the Union were haunted by bigots who delayed and postponed the admission to the Union of such territories squirting mud and injustice to so many fine Americans in the past. Pat Buchanan is entitled to his opinion however the statehood forces have many loyal friends in America and, like in Hawaii, Arizona, New Mexico and Alaska, we shall overcome.

We apologize for what some nationalists did at Blair House and at the visitors gallery of the U.S. House of Representatives for they do not represent the true ideals of peace and justice of the Puerto Rican people and we apologize too for the twenty anti-U.S. citizens civil right proposals expounded by the Governor of Puerto Rico during the Hearings at Washington in re Senate Bills 710-711 and S712 recently in his quest for a too-far reaching enhanced Commonwealth by itself at which time he was adamantly rebuked by Senator Bennett Johnston whose Senate Energy and Natural Resources Committee rejected seventeen of the twenty proposals and approved the remaining three subject to the sovereignty of the United States. The truth is that many of those independence advocates will be satisfied when statehood is granted to Puerto Rico because what makes them angry is the neglect of past Congresses in making needful rules for the territory under its jurisdiction. Should Mr. Pat Buchanan have given some time to study for himself the U.S. territorial and Constitutional tradition and given additional thought to our struggle for statehood before writing his unwarranted column in the Washington Times he could have saved Face and ridicule especially when so many Presidents of the United States and Congressmen have expressed their predilection for statehood without being concerned with an Ulster-type of reaction among localists.

Yes Mr. Pat Buchanan, there sure is an overwhelming clamor for statehood in Puerto Rico only that we do not shoot anybody nor set up bombs to kill innocent people. Our tools are democratic and never recourse to innuendoes, bigotry nor derogatory statements.

Plebicite legislation is now being considered by the body that represents 240 million Americans, the Congress of the United States, and such bills would allow 3.5 million United States citizens of Puerto Rico to choose either statehood on equal footing with the 50 states, an enhanced commonwealth which calls for splitting away from the Constitution of the United States and surely abridges the rights of all United States citizens who have a legal and natural interest in Puerto Rico, and finally independence. This kind of plebiscite which the Congress is about to offer a community of United States citizens is in fact unconstitutional just because you cannot risk the just acquired rights of American citizens should any option other than statehood wins at the poll sand further because it will establish a bad precedent for one or many states of the Union to follow suite requesting a referendum Puerto Rican style plebiscite doing away with the great achievements by the Union at the Civil War.

Pat Buchanan is frightened that Puerto Rico becomes a welfare state but he is not reading the right history books which show that Puerto Rican civil liberties have been held captive by the United States for over ninety years of U.S. rule without representation at the U.S. House of Representatives and at the United States Senate and as Samuel Johnson once said there is no civil liberty when we do not share in the making of the laws under which we are governed. Thus Mr. Patrick Buchanan Puerto Rico is the end product of 90 YEARS of United States regime and rule. Here you have an island under the American Flag whose citizens were granted the American citizenship in 1917 but were left adrift in the middle of the Atlantic Ocean and the Caribbean Sea to be practically governed by American corporations who never cared about the civics of fur people and who never were reminded about their social function and responsibility towards this community of second class Americans who were neglected by the Congress and by the different political administrations who established a colonial apparatus even worse than the Spanish or the British for the Spaniards at least cared for the spiritual life of the people thru the Catholic Church and the British taught their English language to their colonies. So Puerto Rico was abandoned to local politicians who were not interested in the improvement of education but rather used the Spanish language as a vehicle of nationalism so as to create a foreign atmosphere in order to be despised and rejected as equals to the American people to prevent the Americanization and the assimilation of American ways of life, so that later they could claim we are different to the mainland Americans, with a different language and a culture with the idea that we should be left alone by Uncle Sam so as to enjoy a paradise without the duties and responsibilities of citizenship but with the right to live on Uncle Sams' welfare. These people however forgot that while they planned their strategy, many changes were occurring like the birth of civic minded people who learned the American way of life stateside and locally and who became familiar with the rights of U.S. citizens under the Constitution of the United States and just overnight Puerto Rico became an integral part of the United States, a permanent part of the United States, while many mainland Americans became residents of Puerto Rico people who love this island as a very dear and permanent part of the United States. So Puerto Rico became the second market for U.S. manufactures in the Western Hemisphere and the fifth market far U.S. manufactures in the world.

It is time for the Congress to understand that our citizenship is not negotiable in a plebiscite, and that as Americans we demand to be treated as such; that me need not any sort of plebiscites and that all that is required is a referendum to vote YES or NO for Statehood, in the absence of an enabling act by the Congress to admit Puerto Rico to the Union since self determination was exersiced when we accepted our U.S. citizenship as our identification in political matters and since we already voted for a U.S. Commonwealth in 1952 at the time we were granted the Commonwealth Constitution giving us the right to self-government in local matters only while we delegated thru the Federal Relations Act those responsibilities pertaining to the FEDERAL sphere of government.

Patrick Buchanan you argue there are 300,000 embittered Hispanics who yet dream of an independent Country yet I never hear about Pat Buchanan counting the embittered Americans stateside who dream of a communist revolution in America about embittered Republicans or Democrats when they lose an election. Pat Buchanan we must learn, you and I to have respect for the polls no matter how embittered we feel when we do not get what we dream about. Patrick Buchanan you are out of reality when you talk about other countries chauvinism but you forget to mention that the Civil War did not put an end to racial antagonism which is a form of chauvinism and one day you will be surprised with the unstoppable march of democracy aid equality before the law in this country of ours, the United States of America. You speak that we are divided in Puerto Rico, well America is and has been divided since our Declaration of Independence and our nation is divided between Republicans and Democrats and there is nothing wrong with that. And you Pat Buchanan is concerned and frightened to see the Liberal State of Puerto Rico joining hands with the Democrats to help Ted Kennedy overturn the Reagan Revolution and there is nothing wrong with that EITHER for as a matter of factual politics of checks and balances it might be the alternative to switch just for a change and for a chance to the forgotten man on the streets of America. In this respect let me add that Senator Edward (TED) Kennedy regardless of Camelot and Chappaquidick has widely paid all his debts to American society and is now on the green ready to serve his country like his brother did and by the way Pat Buchanan must say I had admiration for a truly great President like Ronald Reagan however we must open the nation's justice to the veterans of this country, to the poor, to the elders and to our children who need education and guidance. After all we live in a pluralistic nation where fairness to all must be the magic touch. And to refresh your mind according to Time Magazine a state task force recently found out that Puerto Ricans have been subjected to an educational oppression along with other ethnic groups. But I do not put the blame only on the Congress or the presidency but on our local politicians like Munoz Marin and others who relegated the English language to an obscure place in our history subjecting the illiterate Puerto Ricans to live in ghettos in mainland cities to be cast away by progressive American communities.

Pat Buchanan the only item you failed to talk about was the proposed sale by the Commonwealth Government of the local Puerto Rico Telephone Company and the positive angry reaction by the labor unions. Let us make some history. In 1974 the local Commonwealth purchased the Telephone Company from ITT for an unknown number of millions of dollars and up to this time we the people do not know if a commission of several million dollars were paid to the sale agent or agents and if that was so, who else shared in the commission if any was paid. It seems that what lies beyond the sales of the Telephone Co. and the Educational Reform is a mere subterfuge to hide the defeat suffered by the Governor at the plebiscite hearings at Washington on June of last year 1989. And the governor adamantly wants to remain in power as Governor so as to continue defying the loyal Americans of Puerto Rico and the USA. After his Waterloo at the hands of Senator Bennett Johnston he needs money and power to challenge the Louisiana Senator. TELCO is his weapon.

We are also interested if these moneys were accounted for by the Commonwealth government or by the Federal Government in case this was an interstate transaction; and if there was a commission paid on the sales and purchase whether this commission was subject to payment of Federal and local income taxes. Because the citizenry is interested in these disclosure I have requested the Federal Communications Commission at Washington to hold approval of the present deal of sale in connection with the Puerto Rico Telephone Company AND IN ADDITION I have requested information about any commissions to agents responsible for the transaction as a public service. Because this has been a hasty transaction by the Executive Level where even the Legislature and the opposition were ignored all the way I feel it would be interesting to know what pieces of real estate are to be included in the sales transaction and the status of remaining property.

I really object to the sales of public services to foreigners but mainly I do object to the sales of public service units like the Puerto Rico Telephone Company that has been operating with supereminent economy in favor of the people of Puerto Rico and I resent that the Commonwealth has failed to look for other options like the following:

1. IRS 936 Corporations having more than 20 billion dollars deposited in local banks should invest in the education and health of this community as PART of their social responsibility.
2. The tollgate tax for earnings repatriated to their Corporation Headquarters without payment of Federal taxes should be increase from the present 5% to 10%.
3. Any Corporation who fails to pay the tollgate tax must be investigated and if failure to comply with this obligation the tollgate-tax must be increased by 10%.
4. The excise taxes on foreign made cars should be increased from 26% to 50%.
5. An extra excise tax in the amount of $1.50 per bottle of Rum whether locally produced or imported and including spirits of over 35% alcohol per volume; and an additional excise tax on wines irrespective of alcoholic content not to exceed $1.00 per one fifth of a gallon.
6. An additional gasoline tax of 10 cents per gallon.
7. An additional tax on persons travelling to any part of the world in the amount of ONE DOLLAR per ticket-airfare.

8. An additional excise tax on all imports from Korea, Taiwan, Japan and Israel equivalent of 20% as reflected on the Invoice Value of the imported merchandise.
9. An additional tax on such areas as determined by the local Treasury Department on imports that are having excessive earnings and should contribute to the welfare of the island.

I have objected to the sales of the Puerto Rico Telephone Company because once in private hands there is no guarantee the consumers will not be burdened with higher tariffs and there is no protection for employee rights.

To resume I must inform Mr. Pat Buchanan he has rendered a disservice to quality journalism to the Republican Party and to the Honorable President of the United States Mr. George Bush whose statehood support for Puerto Rico is in the best American tradition of justice and fairness. He deserves our support and our gratitude. Pat Buchanan has stabbed in the back the whole community of loyal Americans of the U.S. Commonwealth of Puerto Rico for he says we should keep quite under the present state of benevolent slavery or political disfranchisement.

HARDING FRANCO SOTO,
PO Box 12034 San Juan, PR 00914.

STATEMENT OF JOSÉ R. GONZÁLES

Mr. Chairman and Members of the Finance Committee, I am pleased to have the opportunity to speak with you today about the potential economic impact of S. 712 in Puerto Rico.

I am José R. González and I am currently the President of First Boston (Puerto Rico), Inc., an investment banking subsidiary of The First Boston Corporation with offices in San Juan. I speak to you today as a former President and Chief Executive Officer of the Government Development Bank for Puerto Rico (GDB). GDB is the statutory fiscal agent and financial adviser for the Commonwealth of Puerto Rico and a major financial institution with assets of over $6 billion.

I represent the point of view that our political status is, and should continue to be, an instrument for assuring the continued progress and economic well-being of our people.

Throughout this debate, it is crucial to keep in perspective the fact that the issue of our political status essentially responds to the desires and aspirations of our people for stability, dignity and prosperity. Status politics is a means to an end, not an end in itself.

As a proponent of the enhancement of the present Commonwealth relationship, I would seek to improve, not replace, what has proved to be a practical and unequaled creative solution for the problems of a developing society in its aspirations for dignity and progress.

For almost a century, Puerto Rico has been a part of the United States. During the first half of the century, Puerto Rico was "a stricken land," suffering from desperate poverty and destitution, and frustrated by the unresponsiveness and insensitivity of an unrepresentative system of government. Then, with the establishment of Commonwealth status in the early 1950's Puerto Rico experienced a dramatic turnaround. A new political relationship gave Puerto Rico the opportunity to pull its economy by its bootstraps and dramatically improve socioeconomic conditions on the island. Spearheaded by an aggressive investment promotion campaign and the effective use of its local resources, in the span of just two generations, "the poorhouse of the Caribbean" emerged as a bustling and industrious society, which today enjoys one of the highest standards of living in Latin America.

This dramatic improvement in living conditions was forged on the basis of a productive and dignified partnership, through which the United States helped Puerto Rico help itself.

What we seek today is to enhance that partnership with policy tools that will bolster our self-sufficiency, contributing in our own way to the greatness of the United States as a small but hardworking developing society. What we seek is opportunity, not handouts. bat we aspire to is more jobs, not more dependency.

The CBO report on the "Potential Economic Impact of Changes in Puerto Rico's Status under S. 712" (the "Report") confirms that under Commonwealth Puerto Rico will continue on the path of greater economic progress and growth. It also concludes that with the loss of Puerto Rico's fiscal autonomy, statehood would severely affect the capacity for growth of the Puerto Rican economy, and would in fact lead to significant job loss. In essence, the report confirms that a change in status toward statehood would entail substituting jobs for welfare, making Puerto Rico both poorer and more dependent.

This testimony will comment further on the analysis and conclusions of the CBO Report, while attempting to place some of the critical economic and fiscal issues in adequate perspective. More specifically, I will address the following points:

- Puerto Rico's challenge as a developing society in an insular setting with limited natural resources, and the role of fiscal autonomy in economic development.
- The general conclusions and specific estimates of the income and employment effects of a change in Puerto Rico's political status contained in the report.
- Certain areas not fully covered by the report, including:

—the effect on Puerto Rico's access to capital markets, and;
—the effect on the Puerto Rican government sector and its financial soundness.

POLITICAL STATUS, TAX INCENTIVES AND ECONOMIC DEVELOPMENT

Before reviewing the specifics of the CBO Report, however, one should spend some time reviewing basic background information that is only briefly alluded to in the Report· the history of modern economic development in Puerto Rico, its relationship to the island's political status and the role of tax incentives.

The dilemma of achieving sustained economic growth and development for an island society besieged by competitive disadvantages flowing from its exceedingly scarce natural resources, chronic labor surplus and relatively remote location vis-a-vis its natural export markets, has been at or near the center of political life in Puerto Rico for over a century. During most of the time, however, this dilemma has often been displaced from the top of the public debate agenda by, and almost always has been confused with, the issue of Puerto Rico's political status.

The "resolution" of Puerto Rico's status questions does not predetermine the solution of all our problems, including our economic development challenge, because the various alternative political statuses are not in and of themselves, economic development programs or strategies. Alternative political statuses do provide, however, differing ranges of public policy options and instruments which, properly utilized, may support a variety of economic development strategies. As the CBO Report makes clear, the use of tax incentives for promotion of productive investment has been a successfully implemented policy option of this sort for Puerto Rico under the Commonwealth relationship and the fiscal autonomy which is an integral part of that relationship.

The Puerto Rican economy has undergone a remarkable transformation over the past forty years. The Commonwealth has developed from a poverty-stricken, primarily agricultural economy in 1950 to one driven by export-led manufacturing. The manufacturing sector's share of total output increased from 17% in 1950 to 40% at present. This transformation was the result of an economic development strategy based on positioning Puerto Rico as a competitive, low-cost manufacturing site for labor-intensive commodity consumer goods, such as apparel and footwear, within the U.S. common market.

The key competitive factors which supported this strategy and made it consistently successful for over two decades included:

—The relatively low level of wages prevailing on the island in relation to the relatively high productivity of the Puerto Rican worker once he was trained for industrial work;
—The relatively low cost of energy in Puerto Rico vis-a-vis the U.S., since the island was outside the protectionist oil import arrangements of the U.S., and was thus able to source cheaper foreign oil; and
—The relatively weak international competitive situation of the postwar years, combined with relatively high tariff protection in the U.S. for the consumer goods which Puerto Rico began manufacturing.
—The most significant competitive disadvantage that Puerto Rico had to overcome was the inordinately high transportation costs associated with its particular location as an island 1600 miles away from its main supplier and export market, while at the same time being forced to ship on high-cost U.S. flag vessels under the provisions of the Jones Act. Puerto Rico began to overcome this disadvantage in 1948 through the passage of a comprehensive program of tax incentives for productive investment in manufacturing which, when combined with the predecessors of Section 936 of the U.S. Internal Revenue Code, provided a strong offset to the transportation cost disadvantage and allowed Puerto Rico to begin its transformation to an industrial society.

This powerful combination of Federal and Commonwealth tax incentives was, of course, rooted in Puerto Rico's traditional fiscal autonomy which dated back to the establishment of the island's first civilian government after the Spanish-American War. Fiscal autonomy and the policy alternatives it offered Puerto Rico, which only began to be exploited in the 1940's, would continue to be the cornerstone of successful economic development policies in Puerto Rico throughout its modern growth phase.

The foregoing strategy and combination of competitive factors served Puerto Rico well into the 1960's and early 1970's, although weaknesses started to appear over time which by the mid-1970's led to a clear phase of maturity and stagnation for Puerto Rico.

The key factors which led to declining competitiveness were:

—Beginning in the late 1950's, but accelerating throughout the 1960's and 1970's, industries in Puerto Rico, mostly as a result of economic development itself, were experiencing rising wage rates in excess of productivity gains. Thus, Puerto Rico's labor cost advantage over other U.S. locations, and certainly over newly-industrializing foreign locations, was ending. This trend reached its climax in the late 1970's and early 1980's with the full applicability of U.S. minimum wage rates in Puerto Rico.

—The secular lowering of U.S. trade barriers beginning with the Kennedy Round of tariff reductions in the early 1960's, coupled with more intense foreign competition in the markets for Puerto Rico's traditional labor-intensive manufactured goods, dramatically heightened competition for Puerto Rico's industries. In latter years, particularly the early and mid-1980's, this was further exacerbated by significant increases in the value of the dollar, which made the U.S. economy in general, and Puerto Rico's in particular because of the relatively heavier weighting of manufacturing in its economy, less competitive with foreign countries.

—The enormous increases in oil prices in 1973 and 1979 made energy costs in Puerto Rico, which is almost 100% dependent on foreign oil for its energy needs, much higher than in alternative U.S. or foreign locations.

—The high inflation/high interest rate scenario that characterized much of this period, particularly the mid-1970's and early 1980's, was an additional negative event for a developing economy like Puerto Rico's which is highly dependent on external financing sources for both private and public investment flows.

The combined result of these negative developments was that Puerto Rico, which had consistently outperformed the U.S. economy as a whole for approximately two decades, began to suffer much lower rates of growth and higher unemployment, in general underperforming the U.S. economy from 1975 to 1985. In 1983, for example, unemployment peaked at 25, the highest level in recent decades.

From 1986 to the present, Puerto Rico has been able to mount a significant comeback for the following key reasons:

—Beginning in 1986, oil prices began to collapse, leading to a dramatic improvement in the current account and energy cost competitiveness of the Puerto Rico economy. Although this trend has moderated in the last 12 to 18 months and in fact may have reversed, energy prices are still significantly below the peaks reached in the early 1980's.

—Beginning in late 1985, the dollar has generally weakened in relation to other currencies, with significant competitive benefits for U.S. industry in general, and Puerto Rico's in particular.

—Labor costs increased more moderately in relation to productivity improvements, particularly after Puerto Rico absorbed the full implementation of U.S. minimum wages on the island by the early 1980's and this process was followed by a relatively long period of stable minimum wage levels in the U.S., which have only recently been revised.

—Interest rate levels and inflation have generally subsided since 1983, which has led to a stronger public and private sector financial posture in Puerto Rico and lower cost of capital for investment projects on the island.

—The one moderately negative factor during this period of time has been the relatively diminished value of tax incentives that Puerto Rico can offer. These have declined both as a result of the introduction in 1982 and in 1986 of new statutory constraints on benefits available under Section 936 of the U.S. Internal Revenue Code and the generally lower corporate tax rates prevailing in recent years.

Nevertheless, tax incentives continued to play during this period a key role in Puerto Rico's development strategy and in preserving the island's cost competitiveness.

The foregoing factors have led Puerto Rico to a relatively strong economic performance over the last four years, but this is not to say that all is well and that the island has returned to its stellar performance of the 1950's and 1960's. In fact, as the U.S. itself knows all too well, we now live in an economically interdependent world characterized by dramatically heightened international competition in most industries, continuous change and volatile markets.

It is clearly not easy even for a large developed country like the U.S. to compete in this sort of market; it is much more difficult to cope with the stringencies of such a market for a much smaller, less well-endowed, developing society such as Puerto Rico's.

Nevertheless, Puerto Rico, with all its limitations, has excelled in the past in being able to design and implement an effective economic development strategy and has over the long-term succeeded where others in our region have failed. I have no doubt that we can again meet the challenge and continue our progress toward a better standard of living through our own effort and ingenuity. But I also have no doubt that an essential ingredient to continue Puerto Rico's development at this stage is a continuation of the fiscal autonomy we have enjoyed for the last 90 years and the valuable tax incentives that we can offer under such autonomy.

Even in light of their reduced value in a world of generally lower corporate tax rates, such tax incentives still provide Puerto Rico with a unique "equalizing" advantage to help it overcome the island's great locational disadvantages relative to alternative investment sites. Consequently Puerto Rico still needs, to continue on its path to economic development, a political relationship with the U.S., like the current one, which affords it the flexibility and breadth of action required to craft a distinct economic development strategy, suited to its own needs and priorities, and rooted in its own resources and limitations. An essential component of such a relationship has historically been, and should continue to be, fiscal autonomy. The salient conclusions of the CBO Report, and its assessment of the potential economic impact of changing Puerto Rico's current political relationship with the U.S., in fact confirm the importance of fiscal autonomy in Puerto Rico's past, present and future economic development.

CBO REPORT

The CBO Report is, within the constraints imposed by time and data readily available for the analysis, and the limitations inherent in all econometric models, a generally good attempt at assessing the impact of a change in Puerto Rico's political status under S. 712. Nevertheless I believe several points may be made with respect to areas that the Report addresses directly that would tend to indicate that its conclusions present, if anything, a "best case" in terms of the economic costs of a change in Puerto Rico's status.

First, my experience in both public and private sector financial management leads me to conclude that the investment process of 936 companies is highly tax sensitive, both for new and existing firms. Hence, I would conclude that the CBO's estimates of the reduction in productive investment and employment by 936 firms over time as a result of changes in the tax relationship between Puerto Rico and the United States are if anything, too *low* and too *slow*. That is, I would expect a *larger* effect to occur *faster* during the years subsequent to such changes.

The reason for the CBO's very significant, but less dramatic estimates of impact on private investment and employment stem, I believe, from a relatively benign assumption of the tax sensitivity of the investment process of industrial corporations in Puerto Rico.

I would not expect this negative effect on private investment and employment to be mitigated significantly by any sort of "political certainty" benefit accruing under statehood. Corporate investors in Puerto Rico are among the United States' most sophisticated transnational industrial corporations which are well accustomed to investing in foreign locations and assessing "political risk," and already operate in numerous cost-effective foreign locations which may serve as alternatives for the investments they make in Puerto Rico.

Furthermore, such investors generally do not, in fact, view the Commonwealth as possessing any significant element of "political risk" at present and are, therefore, driven predominantly by financial and tax criteria in their locational evaluation of Puerto Rico vis-a-vis alternative U.S. or foreign locations. In fact, independent political risk surveys consistently rank the Commonwealth of Puerto Rico as one of the safest locations in the world, surpassing, in fact, many OECD countries.

Second, the general negative trend in Puerto Rico's economic growth and unemployment through the year 2000 identified by the CBO as a consequence of a change in Puerto Rico's political status, although correct as to general direction, probably significantly underestimates the potential adverse impact on the island's economy because it appears that the CBO did not fully consider the impact on the non-industrial, non-936 sectors of the economy.

To understand this point, one must first understand the general composition of Puerto Rico's economy. There are only three fundamental, primary sectors in Puerto Rico's economy: manufacturing, tourism and agriculture. A "primary sector" for this purpose is one which generates incremental income, production and employment for Puerto Rico because it produces either: (a) an exportable good or service, or (b) a substitute for the import of a necessary good or service. All other sectors of the economy, such as construction, services, utilities, transportation and even government, in fact rely upon demand for their services from the primary sectors to generate their own income and employment.

In Puerto Rico's case, manufacturing is, and has been since the 1950's, the primary sector on which the rest of the economy has relied for overall economic growth. It currently accounts for approximately 40% of the island's gross domestic product, while the other two primary sectors, tourism and agriculture, together account for less than 10% of gross domestic product. Hence, non-primary sectors of the economy, which account for approximately 50% of gross domestic product in Puerto Rico, and which rely fundamentally on the secondary income and employment effects of manufacturing activity, would suffer dramatically from any reduction in the levels of investment and production in the industrial sector.

It is my view, furthermore, that although, in fact, Puerto Rico should strive, as a long-term goal, to increase the contribution of both tourism and agriculture to gross domestic product, for competitive reasons related to the island's limited land resources and relatively high labor costs, neither tourism nor agriculture can in the short-run, nor even in the longer-term, make up the income and employment losses of the manufacturing sector to the overall economy under a change in political status.

In sum, for the reasons stated above I believe the income and employment losses estimated by the CBO underestimate potential economic losses to be suffered by Puerto Rico as a result of status changes under S. 712.

Third, with respect to the analysis of the economic effects of a status change to independence, I find the CBO Report to be surprisingly shallow in its analysis and optimistic in its assumptions. For purposes of this statement I would concentrate on only one element of such analysis: the external finance problems of Puerto Rico under independence.

I believe Puerto Rico's current account "financing gap" under independence is highly likely to be a very sizable and chronic problem because of Puerto Rico's traditionally low internal savings rate relative to our public and private investment needs.

The Government of Puerto Rico would have to manage this current account deficit in a difficult international financial marketplace which would require interest rates approximately 200 to 300 basis points higher than the Commonwealth's current cost of capital in the U.S. tax exempt market, on money loaned for much shorter terms (7 to 10 years maximum versus the 20 to 30 years available in the U.S. tax exempt market) and with much restricted availability (because of an increased political and credit risk profile and because of the lenders' current concerns about this kind of financing).

The combined result of these adverse changes in capital flows to Puerto Rico under independence is likely to be a severe financial constraint on Puerto Rico's growth potential vis-a-vis the CBO's baseline projections under the current political status.

SPECIFIC COMMENTS ABOUT AREAS NOT COVERED IN DETAIL IN THE CBO REPORT

There are a number of areas of economic impact on Puerto Rico of a change in political status under S. 712 that are not explicitly addressed in detail in the CBO Report. I would like to comment on two: the effect on the market for Puerto Rico securities and the effect on governmental finances.

THE MARKET FOR PUERTO RICO SECURITIES

As recognized by the Securities Industry Association of Puerto Rico (the "SIA") in a Supplementary Statement delivered to the U.S. Senate Committee on Energy and Natural Resources during public hearings on S. 712 in San Juan, Puerto Rico in

June 1989, there are several types of Puerto Rico securities which would be adversely affected by a change in political status.

First, Puerto Rico municipal bonds that qualify under Section 103 of the U.S. Internal Revenue Code are, by virtue of the Puerto Rico Federal Relations Act and predecessor legislation, exempt from Federal, state and local taxation. This allows the Commonwealth of Puerto Rico to market its bonds to U.S. investors on a nationwide basis and to price those bonds at rates significantly lower than would otherwise be achievable, given Puerto Rico's credit rating. The SIA estimated that any change to the Puerto Rico Federal Relations Act that adversely altered the so-called "triple tax exemption" of Puerto Rico municipal bonds by, for example, eliminating the state and local tax exemption that is generally not a feature of U.S. municipal bonds except within the issuing jurisdiction, would materially reduce the value of these securities between 4% to 5% of the outstanding principal amount. This would represent a loss in value to U.S. mainland holders of these securities of between $400 to $500 million of the face value of the Commonwealth's outstanding public debt as of December 31, 1988, and a corresponding potential loss to the U.S. Treasury through the capital loss provisions.

Second, in addition to issuing municipal bonds that qualify under Section 10? of the U.S. Internal Revenue Code for Federal tax exemption, Puerto Rico also issues other types of obligations exempt from Puerto Rico income taxation for sale exclusively to residents of Puerto Rico, the proceeds of which are used for the funding of the capital improvement programs of public corporations such as the Puerto Rico Industrial Development Company and the Puerto Rico Tourism Company, and other public and private sector economic development projects, which for various technical reasons do not qualify for Federal tax exemption under Section 103 of the Code. These bonds were sold on the basis of the Puerto Rico tax exemption and the current tax status of Puerto Rico residents under Federal law, which provides that residents of Puerto Rico are generally exempt from U.S. income taxation on their income from Puerto Rico sources. The SIA estimated that the imposition of Federal income taxation upon residents of Puerto Rico who have invested in good faith in these securities could devalue by approximately 10, or $100 million, these securities.

Third, the Commonwealth has for years provided support for the housing market by providing Puerto Rico tax exemption for certain types of mortgages and mortgage-backed securities related to housing in Puerto Rico. This has allowed the Puerto Rico housing market to remain strong when other markets have faltered, and has reduced the effective cost of housing programs sponsored by the Commonwealth. This favorable tax treatment, once again, has been based on the fact that under the current relationship between the U.S. and Puerto Rico residents of the Commonwealth are not subject to Federal income taxation on their Puerto Rico source income. In this case the SIA estimated that the imposition of Federal income taxation upon residents of Puerto Rico could result in a market devaluation of these securities equal to approximately 8% of the outstanding face value of these securities, or approximately $150 to $180 million.

Beyond the potentially negative effects on investors' financial assets described above, the elimination or curtailment of the current tax attributes of Puerto Rico securities would result in a significant increase in the cost of capital for public and private sector economic development projects and infrastructure in Puerto Rico, and would therefore materially adversely affect the future growth of the Puerto Rican economy. This effect, however, is not directly taken into account in the CBO Report.

GOVERNMENTAL FINANCES

A second key area of analysis of the economic impact of a change in the political status of Puerto Rico that is not, in my opinion, adequately covered in the CBO Report is the effect of a status change toward statehood on the finances of the public sector of Puerto Rico.

The first critical effect that must be carefully evaluated with respect to Puerto Rico's public sector finances is the revenue impact on the Commonwealth government of the imposition of Federal income taxes on corporate and individual residents of Puerto Rico. Specifically, such an imposition of Federal taxes would immediately tend to displace the Commonwealth's existing tax base and impair its ability to continue funding budgetary expenditures from traditional revenue sources.

This displacement of current tax base would force the Commonwealth to choose between increasing its tax rates to uncompetitively high levels in an attempt to preserve current levels of expenditures in public services, or the implementation of severe cutbacks in such expenditures in public services in order to be able to live within more limited revenue sources.

Other alternatives are not likely to provide permanent solutions to this problem. Running a budget deficit, as an adjustment measure is not an option under Puerto Rico's Constitution, which mandates a balanced budget and, in any case, is highly unlikely to be an option given the stringent constraints of the credit markets on the Commonwealth's debt management policy. Selling assets, as an alternative "stop-gap" measure, is unlikely to generate funds over the long-term sufficient to meet the revenue shortfalls that might be experienced under a status change, and, in any case, the financial soundness of a policy of non-recurring asset sales to fund recurring budgetary expenditures would be highly questionable and would probably lead to an adverse re-evaluation of Puerto Rico's creditworthiness in the financial markets.

The fundamental reasons for this fiscal dilemma for the Commonwealth should not be lost sight of, for therein lies the basic reason for not incorporating Puerto Rico into the Federal tax system: with a per capita income that is only a third of the U.S. national average, Puerto Rico cannot be expected to carry a full Federal tax burden and still be realistically expected to sustain state government tax revenue levels necessary to pay the cost of basic public services expected in a developing industrial society. Hence, under statehood, the government of Puerto Rico could realistically only be expected to provide a standard of public services significantly lower than the current one, in line with its income per capita relationship to the rest of the nation, with likely adverse effects on the quality of life on the island and long-term increased labor migration prospects.

The second direct adverse effect on the public sector of Puerto Rico arises from the negative consequences of a status change on the cost of capital for essential public sector investment projects, notably infrastructure. These negative consequences arise from two main sources: the loss of Puerto Rico's current tax advantages with respect to its public sector borrowings, and the general deterioration of the credit quality of the Commonwealth under a status change.

The first of these relates to the fact that the borrowings of the Puerto Rican public sector currently rely heavily on various key tax advantages that we described earlier; specifically, the "triple tax exemption" of Puerto Rico bonds in the U.S. tax exempt market, and the existence of a local tax exempt market to tap available local savings at a relatively low rate when the U.S. market is unavailable. The loss of these two advantages under a status change would lead to a narrower and costlier market for Puerto Rico bonds.

The second source of negative consequences of a status change on the Puerto Rican public sector's cost of capital relates to the general deterioration of creditworthiness of the Commonwealth as a result of the shrinkage of its tax base and the impairment of its revenues which was described above.

The combination of these two factors leads to sharply reduced availability of credit to Puerto Rico's public sector and a higher cost of capital and, consequently, lower public investment in growth-sustaining projects, particularly infrastructure necessary to support private sector investment,, which itself would likely be constrained by inadequate infrastructure. This constraint, in turn, would negatively impact aggregate demand in the economy as a whole, with a resulting reduction in overall growth and employment in the economy vis-a-vis the CBO's baseline projections under Puerto Rico's current political status.

STATEMENT OF HEX, INC.

PUERTO RICAN STATEHOOD: A PRECONDITION TO SOUND ECONOMIC GROWTH

[By J. Tomas Hexner, Glenn Jenkins, Helen F. Ladd, and K. Russell LaMotte [1]]

The recent Congressional Budget Office report [2] focused attention on the potentially adverse effects that eliminating section 936 of the internal revenue code

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[1] This memorandum provides the essence of a report under preparation by Hex, Inc. of Cambridge, Massachusetts. J. Tomas Hexner is the Chairman of Hex, Inc. Glenn Jenkins is the Director of the International Tax Program at Harvard Law School and Fellow, Harvard Institute for International Development. Helen F. Ladd is Professor of Public Policy Studies at Duke University and Senior Fellow, Lincoln Institute of Land Policy. K. Russell LaMotte is a research assistant at the Lincoln Institute and will attend Harvard Law School this fall.

[2] Congressional Budget Office, "Potential Impacts of Changes in Puerto Rico's Status under S. 712," April, 1990.

might have on the Puerto Rican economy. Because the shift from Commonwealth status to statehood would require that section 936 be ended, many people have concluded from the CBO study that statehood would be harmful to the Puerto Rican economy. The CBO report notwithstanding, we believe that the long run economic growth of the island represents a much broader problem and that statehood is a necessary condition for its solution.

The main points of our argument are as follows.

1. Future economic growth for Puerto Rico requires a development strategy that is private sector oriented, that is gimmick free, that deals with the realities and dynamics of the 1990s and the 21st century, and that does not languish on the static rhetoric of the mid-twentieth century.
2. Statehood is the best path to this required development strategy. By resolving the status issue once and for all, statehood will reduce the uncertainty faced by potential investors. More importantly, statehood requires the elimination of section 936 of the tax code, a subsidy that is grossly inefficient and costly to the U.S. taxpayer, increasingly ineffective in providing jobs in Puerto Rico, and inconsistent with the island's future long run growth. In addition, statehood will produce a more efficient and streamlined public sector that can turn its attention to investment in basic infrastructure and education.
3. S. 712 is basically a solid bill. It appropriately gives Puerto Ricans the right to choose their own destiny and is sensitive to the fiscal constraints on the U.S. budget imposed by large deficits and the Gramm-Rudman-Hollings process. However, certain changes in the timing of the transition and the nature of the statehood grant are desirable and would help assure that statehood leads to the desired goal of promoting a more effective long run development strategy for the island.

THE NEED FOR A NEW PRIVATE SECTOR ORIENTED DEVELOPMENT STRATEGY

Puerto Rico's economy is *not* a case of "if it works, don't fix it." Although the economy experienced strong economic growth during the 1950s and the 1960s as it was transformed from an agricultural to a manufacturing economy, development in recent years has atrophied. Currently the island is experiencing high unemployment (15 percent), low labor force participation (45 percent), and high migration to the mainland in search of jobs (hovering around 1 percent per year). Moreover, a 1990 snapshot of Puerto Rico bears a close and uncomfortable resemblance to the stagnation and frustration of many developing countries with the following features: a high degree of centralization, a capital city mentality, a decaying infrastructure, and an apparently bloated public sector, some of which is suitable for privatization.

The problem is that Puerto Rico continues to rely on an outdated development model based on government assistance and tax incentives to attract investment. This approach is inapplicable in today's economic and financial climate, particularly considering the budgetary problems of both the U.S. and Puerto Rican governments. Future economic growth in Puerto Rico should not be dependent on a tax code provision that is as inefficient, expensive, and uncertain as section 936, that benefits special interest groups at the expense of the U.S. taxpayer, and that depends on the caprice of Congress in a period of fiscal retrenchment. Fine tuning of the status quo represents a wholly inadequate response and provides an inadequate stimulus and insufficient base for Puerto Rico's long-term economic health.

Sustainable growth in Puerto Rico demands much more. Government's role is to provide a conducive policy setting and a sound financial foundation, not heavy-handed controls and regulations. Successful and sustainable economic growth in both the U.S. and throughout the world must be fueled by the response of the private sector to the forces of the market place.

Fortunately, Puerto Rico has the assets needed for such private sector growth. Labor is one such asset: it is relatively inexpensive (the average hourly manufacturing wage is just over half of the mainland's and $2.29 lower than Mississippi's), highly skilled, productive, and plentiful. Puerto Rico's excess supply of labor should be particularly attractive to U.S. firms facing increasingly tight labor markets on the mainland. Well developed financial, communication and transportation networks are other crucial assets. A bicultural heritage and strategic location make the island a natural conduit between. North and South America in a period of rapid regional economic integration. These attractions, plus an ideal climate and natural environment, have already begun to attract major investments in the island's tourism sector. Given its affiliation with the U.S., Puerto Rico also offers advantages that similar locations competing for investment simply cannot match, including exemption from U.S. tariffs, use of the U.S. dollar, and protection under the U.S. legal system.

None of these assets depends on an inefficient tax subsidy or Congressional generosity. The potential exists for strong economic growth based on stability and private sector initiative. We believe that statehood, with its emphasis on self-reliance, its resolution of the status issue, and its stability, is a precondition of that growth.

ECONOMIC GROWTH AND SECTION 936

Section 936 has outlived its usefulness. While clearly helpful for promoting the growth of Puerto Rico's manufacturing sector in past decades, section 936 is no longer an appropriate economic development tool. Hence, opposition to statehood should not be based on concern about the loss of 936. To the contrary, eliminating 936 will provide the stimulus needed to modernize the island's development strategy.

Recent years have witnessed a dramatic change in the composition of section 936 corporations. As Puerto Rican wages have risen above those in competing Caribbean and Asian countries (while still remaining well below those on the mainland), the share of section 936 activity in labor intensive industries such as textiles has diminished significantly while the share in capital intensive electronics and pharmaceuticals industries has increased commensurately. In 1960, chemicals and machinery made up 22 percent of the net manufacturing income in Puerto Rico; by 1989 that share had increased to over 73 percent.[3] Increasingly a subsidy for capital intensive firms, section 936 represents a perverse economic development tool for the labor surplus economy of Puerto Rico.

As a subsidy to labor, section 936 is grossly inefficient. Section 936 now primarily transfers income to mainland parent corporations and serves as a subsidy to the parent corporations for tax planning rather than as a stimulus for job creation in Puerto Rico. The tax subsidy to wages is astounding. In 1983 (the latest year for which complete data is available [4]), the tax benefits received by 936 corporations averaged 125 percent of employee compensation; for the pharmaceutical industry, tax benefits were 265 percent of employee compensation. The bankruptcy of section 936 as an incentive to hire labor also emerges from outcome data: while manufacturing's share of Puerto Rico's gross domestic product increased from 29 percent to 40 percent between 1975 and 1988, the share of manufacturing income accruing to labor declined precipitously from 48 percent to 27 percent.[5]

Moreover, the 936 incentive will become increasingly ineffective in the future as firms respond to the 1986 reduction in the U.S. corporate tax rate, to proposals outlined in the Treasury's White Paper on intercompany pricing,[6] and to the uncertainty associated with the inevitable periodic attempts by the U.S. to get rid of this inefficient and costly subsidy.

At a time of severe budget pressure in the U.S., American taxpayers should not be asked to give up large amounts of tax revenues for such an inefficient subsidy. On April 26, 1990 Philip D. Morrison, the International Tax Counsel of the Department of the Treasury testified that the 936 corporations received $2.1 billion in net tax benefits in 1990 and that these benefits are predicted to grow at 10 percent per year. Estimating that 75 to 80 percent could be recovered by the Treasury if 936 were phased out as proposed under the statehood option of S. 712, he predicted that an additional $2.7 to $2.9 billion (in 1990 dollars) would be available to the U.S. Treasury by 1997.

It is time for both Congress and Puerto Ricans to acknowledge the need for change. The U.S. needs cost effective programs and Puerto Rico needs investment in people and facilities that effectively promote private sector development and income for Puerto Ricans. Whether or not statehood is adopted, section 936 should be eliminated. The statehood option is desirable in that it forces an immediate change in the island's development strategy while at the same time providing the preconditions for an alternative economic vision.

A BRIEF DIGRESSION ON FEDERAL GRANT PROGRAMS AND ECONOMIC DEVELOPMENT

Statehood also calls for the extension of full Federal entitlement programs to Puerto Rico. How might this extension affect the island's long term economic growth? Critics claim that expanded welfare would cause over-dependence to the

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[3] April, 1990 CBO Report, Table 3.

[4] Data on section 936 corporations is from the Department of Treasury, "The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report," March 1989.

[5] Puerto Rico Planning Board, "Economic Report to the Governor 1988," Tables 9 and 11.

[6] Treasury Department, Office of International Tax Counsel, Office of Tax Analysis, *A Study of Intercompany Pricing*, October 18, 1988.

detriment of productive work and real economic expansion. Proponents of statehood point to the stimulation of aggregate demand associated with the inflow of Federal funds and draw attention to the national trend of combining skill development and training with welfare programs. Neither argument is without merit, but both miss the main point. The real issue is not what increased entitlements will do to stimulate demand or reduce work effort, but rather whether the economy can generate jobs. Without more jobs and sustained economic growth, Puerto Ricans will continue to be poor, to be dependent on Federal welfare, and to migrate to the mainland to find work. Solving the job problem calls for a shift to statehood. Statehood both builds the foundation for economic growth and also assures a more adequate safety net of fair social welfare programs.

PRESSURE TO RESTRUCTURE THE PUBLIC SECTOR

A political fact of life: without statehood, the size and efficiency of the Puerto Rican public sector will not change. Casting no aspersions on the multitude of sincere and dedicated government officials, the Puerto Rican public sector, when viewed from a macro perspective, appears beset by problems including a bloated payroll, a centralized bureaucracy, a history of balancing the budget with one-time windfalls and gimmicks, a lack of accountability, and poor planning and insufficient investment in infrastructure and public works.

Between 1975 and 1988 the average annual growth rate of public sector employment was 2.6 percent, substantially higher than the 1.4 percent growth rate of non-government employment.[7] A 1985 prominent citizens' report commissioned (and seemingly ignored) by the current Governor recommended a vast overhaul of the Commonwealth's governmental structure on the grounds that this bureaucratic growth was an ad hoc response to employment crises on the island and did not represent improved service delivery.[8] A more recent May 6, 1990 article in the San Juan Star echoed this diagnosis, attributing the growth to the "Twin traditions of political patronage and government expansion to reduce unemployment." The 1985 report goes on to argue that the expansion of government has harmed Puerto Rico's private sector: "The government has assumed responsibilities and direct operations in the country's economic sector in which private capital enjoys a comparative advantage in providing more efficient service." [9] The reference here is to public sector involvement in traditionally private sector activities such as shipping, commercial banking and other enterprises.

Statehood will force changes in the way the Puerto Rican government operates. On the one hand, additional Federal funds for entitlement programs will free up some locally generated funds for other purposes. On the other hand, Puerto Rican taxpayers newly subject to Federal taxes will demand lower Puerto Rican income taxes, a more streamlined public sector, and possibly some decentralization of taxes and spending to the municipal level. A combination of privatization of various activities, spending cuts, and alternative revenue sources would provide space for the imposition of the new Federal income taxes with no increase in the (already high) tax burdens on Puerto Ricans. An overhaul of the ineffective collections process would (with the assistance of the Internal Revenue Service) also yield substantial revenues: a 1987 report on tax reform in Puerto Rico prepared by Booz, Allen & Hamilton estimated that $1.5 billion in personal income is currently untaxed because of non-filing and under-reporting and that an additional $135 million could be collected by improving the administration, enforcement, and compliance incentives.

No economy seeking investment and reinvestment can afford a bloated and reputedly ineffective and overcentralized public sector. Long run growth is possible only with meaningful and painful public sector cuts to generate some of the funds necessary for refurbishing the infrastructure and for reducing the island's tax burden. Only statehood will force these painful but essential decisions.

THE STATEHOOD PROVISIONS OF S. 712: NEEDED ADJUSTMENTS

With minor changes to the current version of S. 712, the transition to statehood can be accomplished with minimal disruption and in compliance with the discipline of the Gramm-Rudman-Hollings legislation. Under a slightly modified transition plan, between 1992 and 2000 statehood would generate over $2.5 billion (in net

[7] Treasury Department, "Sixth Report," Table 3.3.

[8] See "A Study on the Organization and Function of the Executive Branch of the Puerto Rican Government," prepared by the Committee for the Economic Development of Puerto Rico, 1985.

[9] Committee for the Economic Development of Puerto Rico, p. 32.

present value) to the U.S. Treasury, which if desired could be considered a source of funds to smooth the transition to statehood.

The statehood provisions of S. 712 stipulate the immediate extension of most U.S. social welfare programs,[10] a gradual phase-out of the section 936 tax credit, a delayed imposition of Federal income taxes for Puerto Rican citizens and corporations until 1994, and contain certain assumptions about the form and content of a "statehood grant." By extending the entitlement programs immediately while delaying the implementation of taxes, S. 712's transition program frontloads the Federal costs. This frontloading is undesirable in that it aggravates the U.S. budgetary problems during the initial years of statehood, understandably produces U.S. opposition to statehood, and focuses the statehood debate in Puerto Rico too heavily on the extension of entitlements.

Hence, the transition assumptions of S. 712 should be adjusted to treat the expenditure and revenue sides of the transition comparably. According to historical precedent, the Constitution imposes few constraints on the transition package, and grants Congress broad powers to make economic adjustments to minimize disruptions and dislocations associated with the transition to statehood. The flexibility to design an appropriate transition applies both to the tax side and to entitlement programs. From the U.S. perspective, extending full health and social welfare programs to Puerto Ricans before they are required to pay Federal taxes seems inappropriate. Delaying the expansion of welfare benefits can also be justified in terms of the adjustments required in Puerto Rico: a delay would provide more time to plan for the expansion of these Federal programs and to begin to make the necessary adjustments in locally financed health and welfare programs.

Table 1 reflects our modified transition assumptions. Specifically, the table assumes that Puerto Ricans will not begin to pay Federal excise and income taxes until 1994 and, to bring taxes and transfers into line, that none of the health and welfare programs are extended until that same year. S. 712's assumption about the phase out of section 936 (a five year period beginning in 1994) is retained to assuage any potential disruptions and to render fair treatment to corporations who made section 936 a significant element of their locational investment decisions. Table 1 does not include a statehood grant because that is a separate issue to be considered in light of these financial flows.

IMPACT OF STATEHOOD ON THE U.S. TREASURY

Table 1 shows that, excluding any special statehood grants, the shift to statehood would have a beneficial effect on the U.S. Treasury over the 1992 to 2000 period, the time period used in the April CBO report. In particular the shift to statehood would reduce the present value of net Federal outlays for Puerto Rico over the period by $2.5 billion. Thus, Puerto Rican statehood could reasonably free up Federal budgetary resources relative to what would occur under continued Commonwealth status. Even under the assumption of Federal budget neutrality, substantial Federal revenue could be available for a special statehood grant to Puerto Rico should Congress deem that desirable.

Table 1.—FINANCIAL BENEFITS AND COSTS OF STATEHOOD RELATIVE TO COMMONWEALTH, NO STATEHOOD GRANTS

[In millions of dollars]

	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
From Perspective of U.S. Treasury:										
Additional Outlays										
Entitlements [1]	0	0	2,550	2,950	3,068	3,191	3,318	3,451	3,589	....
Additional Revenues										
936 Phase Out [2]	45	128	538	1,204	1,889	2,610	3,325	3,491	3,666	....
Non-936 Corp. Taxes [3]	....	....	249	427	448	471	495	519	545	....
Indiv. Income Taxes [4]	....	....	645	676	707	739	773	809	846	....
New Excise Taxes [5]	....	....	309	325	341	358	376	395	414	....
Net Outlays	(45)	(128)	809	318	(317)	(987)	(1,651)	(1,763)	(1,882)	....

[10] The exception is the Supplemental Security Income program (SSI), the introduction of which would be delayed until 1994 to provide for the required administrative adjustments.

Table 1.—FINANCIAL BENEFITS AND COSTS OF STATEHOOD RELATIVE TO COMMONWEALTH, NO STATEHOOD GRANTS—Continued

[In millions of dollars]

	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Present Value of Net Outlays (10% discount rate)	(41)	(106)	608	217	(197)	(557)	(847)	(823)	(798)	(2,544)
From Perspective off Puerto Rico: [6]										
Net Inflow to Puerto Rico	0	0	1,347	1,522	1,572	1,623	1,674	1,728	1,784	....
Present Value of Net Inflow (10% discount rate)	0	0	1,012	1,040	976	916	859	806	757	6,366

All entries represent estimates of the additional costs or revenues associated with statehood compared to Commonwealth status. Additional outlays for entitlements are set equal to zero in 1992 and 1993 based on the authors' proposal that the expansion of entitlements be delayed until 1994. Similarly, excise taxes would not be imposed until 1994. The phase out of section 936 complies with the terms of S. 712. The table includes no statehood grant. Specifically, the cover over (transfer to the Puerto Rico Treasury) of Federal taxes paid by Puerto Ricans included in S. 712 is excluded.

[1] Entitlement figures from April CBO Report, Table 7.

[2] 936 phase out figures from November, 1989 Treasury testimony; post-1998 figures are calculated from an arbitrarily assigned 5% growth rate.

[3] Non-936 corporate taxes from November Treasury testimony; post-1996 figures from April CBO, Table 7.

[4] Individual income taxes from November Treasury testimony; post-1996 figures from April CBO, Table 7 They are net of the Earned Income Tax Credit.

[5] New excise taxes from November Treasury testimony; post-1998 figures from April CBO, Table 7. (Customs duties and rum excise taxes are excluded because their treatment would not change under statehood)

[6] Calculations not shown. The entries can be derived from the top panel by considering Federal outlays as inflows and Federal revenues (minus 936 revenues) as outlays.

Before discussing such a grant, the net financial flow from the perspective of Puerto Rico should be noted.

IMPACT OF STATEHOOD ON THE NET FLOW OF FUNDS TO PUERTO RICO

Not only does Puerto Rican statehood impose no additional costs on the U.S. Treasury, but it also substantially increases the flow of funds to Puerto Rico. The explanation for this apparent paradox is that the additional revenue to the U.S. Treasury generated from the elimination of section 936 will be paid not by Puerto Ricans but rather by the mainland corporate parents of the section 936 corporations.

Under the transition assumptions advocated above—and without providing for any form of statehood grant—the net inflow of Federal transfers by the year 2000 is estimated to be $1.8 billion dollars and the present value (in 1991) of the total inflow through the year 2000 is $6.4 billion. In terms of net financial flow, statehood is clearly beneficial for Puerto Rico. However, these financial flows should be scrutinized in the context of their economic effects as projected fully and carefully in the April CBO report which predicted a lower growth rate under statehood due to reduced investment caused by the elimination of the section 936 tax provisions. The CBO scenario needs to be addressed and provides a strong argument for designing a statehood grant that could stimulate and partially fuel Puerto Rico's economic growth in the short run to provide breathing room until the full long term positive effects on the economy of the move to statehood as discussed in this memorandum take hold.

PREPARING A STATEHOOD GRANT

Every state that has entered the Union since 1803 has received some form of statehood grant. Examples of these grants range from natural resource transfers to monetary aids. Historically Congress has recognized the desirability of enacting special assistance measures for new states and has shown remarkable flexibility in tailoring the statehood grants to their particular needs.

S. 712 includes a statehood grant in the form of a cover over of Federal taxes paid by Puerto Ricans. The Federal Government would turn over to the Puerto Rican Treasury all the proceeds from the Federal tax on individuals and corporations in 1994 and 1995 and all the revenue from the new Federal excise taxes at least through 1998.[11] The present value (as of 1991) of this statehood grant is $2.8 billion

[11] In addition, the United States would continue to rebate to Puerto Rico customs duties and excise taxes on rum. We have not include these rebates as part of the statehood grant because they would be provided under enhanced Commonwealth status as well as under statehood.

which is slightly above the $2.5 billion that would be consistent with U.S. budget neutrality over the ten-year period.

This approach to the statehood grant deserves serious rethinking based on two considerations. First, this cover over approach may reduce incentives for the Puerto Rican public sector to adjust to statehood. Second, the statehood grant should be used to offset more directly the economic disruptions that may accompany the elimination of 936 and to help Puerto Rico restructure its economy to move into the 21st century.[12]

Statehood will require significant changes in the operation of the Puerto Rican public sector. Although difficult, the number of public sector employees will have to be reduced and government operations will have to be streamlined and made more efficient. Because the new Federal taxes will not be paid until 1994, the transition period itself provides over two years for the Puerto Rican government to prepare for the change. No reason exists to delay the pressure for these changes by providing the Puerto Rican Treasury with a full cover over of the new Federal taxes paid by Puerto Ricans. Even if some cover over is deemed desirable to ease the government's adjustment to statehood, it should at most be partial.

Another compelling argument for a creative approach to the statehood grant is the need to help Puerto Rico restructure its economy to provide growth in private, not public, jobs. As we have argued throughout this memorandum, eliminating the 936 tax provisions is in the long run interest of the Puerto Rican economy. Even with the tax provision, unemployment has been high in recent years and will continue to be high in the future, unless new initiatives are undertaken. The elimination of the tax provision simply focuses attention on some basic structural problems in the Puerto Rican economy and the need to develop a new approach to economic development.

Following the lead of mainland states, Puerto Rico should deemphasize tax breaks and other gimmicks in favor of investment in basic infrastructure. Investments in physical infrastructure and in education would do more for the long term economic development of the island than any set of tax breaks. In this light, then, it is hoped that the Finance Committee will consider an alternative statehood grant which would be specifically designed to promote the conditions for strong private sector economic growth in Puerto Rico.

GREGORIO IGARTÚA,
Aguadilla, P.R., April 20, 1990.

Senator LLOYD BENTSEN, *Chairman,*
Committee of Finance,
U.S. Senate,
Washington, DC.

Dear Senator Bentsen: Your Committee will hold hearings next week in relation to the financial aspects of the three proposed political status formulas for Puerto Rico, to be included in a plebiscite bill. The "Briefing Report--Puerto Rico—Information for status Deliberations" of March, 1990, published by the U.S. General Accounting Office, contains information in pages thirty one and thirty two—"Federal Relations of Tax Laws," which in my view, is incorrect, misleading and unfair to the American citizens of Puerto Rico. I am sending to your Committee copies of two papers wrote, which reflect opposing views to the G.A.O. Briefing Report on those pages. (See Appendix A and B). Please make this information part of the official record of the Committee Hearings.

In summary, my papers are for the following propositions:

—That the American citizens of Puerto Rico are legally forced under the present political status to comply and participate in Federal tax programs in an equal footing as those citizens of the fifty states, with some exceptions.

—That the American citizens of Puerto Rico are compelled to pay different Federal taxes without political representation in Congress, without consent.

—That the actual Federal tax policy applicability to the American citizens of the territory of Puerto Rico without political representation is contrary to the moral principles which inspired the Founding Fathers of the Nation, and defended by everybody under the American flag ever since. Within this perspec-

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[12] A third concern has been expressed by the Treasury Department, which has testified that the cover over approach poses significant administrative difficulties.

tive, the actual applicability of tax policies to Puerto Rico represents an ever increasing embarrassing situation to the U.S. Government.

—That the Federal tax policy issue (the fact of the many millions of dollars contributed to the different tax programs by the American citizens of Puerto Rico) cannot be ignored, as the GAO Report did. It presently constitutes per se a main catalytic agent within the economic analysis, forcing not only in one direction the American citizens of Puerto Rico to attain a final decision on the political status of Puerto Rico by pressuring their analysis of their actual Federal tax policy rights and obligations without consent; but also, from the other direction, forcing with a certain pressure at this date, or with much more pressure at a future date, the American citizens of the fifty states to question Federal tax policies such as

—That the actual Federal tax policy applicability to the American citizens of the territory of Puerto Rico without political representation is contrary to the moral principles which inspired the Founding Fathers of the Nation, and defended by everybody under the American flag ever since. Within this perspective, the actual applicability of tax policies to Puerto Rico represents an ever increasing embarrassing situation to the U.S. Government.

—That the Federal tax policy issue (the fact of the many millions of dollars contributed to the different tax programs by the American citizens of Puerto Rico) cannot be ignored, as the GAO Report did. It presently constitutes per se a main catalytic agent within the economic analysis, forcing not only in one direction the American citizens of Puerto Rico to attain a final decision on the political status of Puerto Rico by pressuring their analysis of their actual Federal tax policy rights and obligations without consent; but also, from the other direction, forcing with a certain pressure at this date, or with much more pressure at a future date, the American citizens of the fifty states to question Federal tax policies such as that of IRC 936 and Federal grants applicable to the American citizens of Puerto Rico within the context of their tax policy rights and obligations as full American citizens. (See Appendix A, footnote 115; Appendix B, pgs. 41, 42, and Appendix C).

—The IRC 936 tax policy applicable to Puerto Rico within the context of cost-benefit effects constitutes in the one hand a mathematic constant in terms of the creation of jobs within the local economy; and, on the other hand, it constitutes a mathematic variable increasing disproportionately in terms of tax free income for the 936 Corporations. Within the tax policy context, these two conflicting situations are provoking a political embarrassing situation to Congress. The American press is questioning the tax benevolence of the policy. Congress is in the difficult position of deciding whether to continue with the 936 tax policy, or whether to eliminate the policy with the consequence of taxing income "from sources within Puerto Rico—a territory," which equals to "taxation without representation," something the Founding Fathers of the Nation fought against.

Finally, I would like to point out to your Committee certain factors within the Puerto Rico status deliberative process, which should be considered and defined more effectively, particularly within the economic context:

—How does independence for Puerto Rico, that is separation or economic disintegration from the U.S. market, can be realistically justified within the context of the current tendency of Nations to integrate into regional economic markets?

—How can the United States and Puerto Rico justify that the latter should not be granted statehood or independence, within the context of the international policy, as adopted by a United Nations resolution calling for the decolonization of all territories by the year 2000.

—How is an independent Puerto Rico going to solve the following situations:

—Elimination of permanent accessibility to the U.S. market, with all the benefits it represents.

—Elimination of the U.S. billionaire aid to Puerto Rico, which is actually received, and would also be received as a State even more, not by mere grants from Congress, but by the local payments to the U.S. Treasury through the various tax policies applicable to Puerto Rico.

—Negative effects in the balance of payments due to the payment of royalties for imported patented technology, necessary for the local economic infrastructure.

—Environmental policies diametrically different than those supported actually by the independence movement, defending presently the non exploitation of natural resources in Puerto Rico. In fact, one pro-independence commentator proposed that " . . . . Puerto Ricans could as well decide that a country that is much poorer than the U.S. does better by sacrificing some of its ecological concerns to more immediate economic needs of its people." (47-2 P.R. Bar Journal 172-1986)

—Migration to the U.S. has been called the "escape valve" of the economic problems of Puerto Rico. Once eliminated or controlled under independence, how can unemployment be diminished under a society with a highly increasing population.

—How strong or influential would be the participation of the Republic of Puerto Rico in international organizations or in its negotiating process with other countries?

—Would the local labor force be more or equally efficient or satisfied with lower economic benefits in the Republic of Puerto Rico?—(See, Negron, 47-2 P.R. Bar Journal 172 at footnote 156—" . . . Puerto Ricans should not dream about being able to develop a larger labor intensive sector without lowering their legal minimum wage relative to the U.S. level—something which as an independent country Puerto Rico could probably achieve . . . .)—If independent Puerto Rico taxes U.S. corporations doing business locally, that is IRC 936 eliminated and a foreign U.S. tax credit applicable, what new or more creative economic policies can be proposed or adopted, even through subsidies, that have not been implemented in other countries, in order to make it more attractive and competitive for foreign manufacturers or businesses, particularly from the U.S. Some economist favoring independence for Puerto Rico are proposing that under the Republic the 936 tax benefits could be substituted "evenly by taxing U.S. corporations in Puerto Rico, for which taxes these would in turn get a foreign tax credit in the U.S., and channeling back to the corporations the taxes imposed locally through subsidies. In fact, these are claiming the latest GAO and Congressional Report on Puerto Rico "sanctifies" this proposal. (See Appendix D).

—How will independent Puerto Rico solve the problem of the present public debt which amounted to $11,236.9 millions for fiscal year 1988, for a per capital debt of three times that of Mexico, one of the most highly indebted countries in the world. (See Appendix E).

—How will independent Puerto Rico control the massive outflow of capital the new status will generate. (See Appendix E)

—What is the mathematical certainty of the economic inference that Puerto Rico would be under statehood, at least in an economic position equal to that of the state in the lowest economic category?

—It has been suggested by some politicians that there are some variables that need to be clarified; of particular worriness—whether the 936 corporations will stay or leave the Island under statehood or independence. These have inclusively proposed that the 936 corporations should be consulted on the political status issue so they can confess whether they will continue local operations under the different alternatives. Obviously, the 936 corporations will promote that political alternative which represents the best potential for continuity of their tax benefits, and in this respect their position on what is the better political status for Puerto Rico, would be misleading and incorrect. Withing the alternative of statehood there are certain factors which serve as evidence that these will continue operations in Puerto Rico. First, they originally established operations in Puerto Rico with full knowledge of the political status change possibility, 95% of the population preferring for many years statehood and permanent association. Secondly, most 936 corporations have very high capital investments in their plants in Puerto Rico, to the extent that as a State there is no economic reason to move operations from the State of Puerto Rico to any other of the Nation. Moreso, once the IRC 936 tax policy is eliminated, there is no tax justification to move, operations from the State of Puerto Rico to another country, with political uncertainty, where taxes will have to be paid anyway (Even if they get a U.S. foreign tax credit). Also, the efficiency of the local labor force, wheather conditions and other factors favor permanency of operations in the State of Puerto Rico.

The political status deliberative process of Puerto Rico is complicated. It demands responsibility from all the parties involved, and respect for the American citizens of Puerto Rico. Many factors need to be pointed out, but ultimately there are certain variables which cannot be defined with mathematic precision or certainty under all of the three proposed political status formulas. Within this perspective, we will always have to rely on our instinct and prayers to our Lord.

Sincerely ours,

GREGORIO IGARTÚA, *Attorney at Law.*

APPENDIX A

REVISTA
DEL COLEGIO DE ABOGADOS DE PUERTO RICO

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EL PODER INVESTIGATIVO DE LA ASAMBLEA LEGISLATIVA
Francisco Aponte Pérez

FEDERAL COURT CERTIFICATION REVISITED
Mario Arroyo Dávila

LA JURISDICCIONALIZACION DEL SECTOR PENITENCIARIO.
Olga Elena Resumil de Sanfilippo y Angelo P. Sanfilippo

LA ELEVACION DEL CASO DE PUERTO RICO ANTE LA ASAMBLEA GENERAL DE LAS NACIONES UNIDAS EN LA DECADA ACTUAL
Carmen Gautier Mayoral

PROPUESTA PARA UN CURSO SOBRE LOS DERECHOS DE LA MUJER, ESQUEMA DE ESTUDIO Y GUIA BIBLIOGRAFICA
Carmelo Delgado Cintrón

U. S. IRC SECTION 936 A TAX POLICY ANALYSIS WITHIN THE P. R. PERSPECTIVE – TAX EXPENDITURES V. GOVERNMENT DIRECT EXPENDITURES
Gregorio Igartua

LA AMERICANIZACION DE FILIPINAS – LA JUSTICIA – LA IMPOSICION DEL IDIOMA INGLES EN LOS TRIBUNALES EN EL PERIODO 1898 - 1906
Alfonso L. García Martínez

CARTA DEL LICENCIADO ENRIQUE GONZALEZ AL GOBERNADOR DE PUERTO RICO

U.S. IRC SECTION 936: A TAX POLICY ANALYSIS WITHIN THE P.R. PERSPECTIVE — TAX EXPENDITURES v. GOVERNMENT DIRECT EXPENDITURES

GREGORIO IGARTUA

"...Fashioning a tax structure requires an intimate knowledge of, and sensitivity to, the society in which it is to function..." [1b]

I. Introduction

Our government tends to encourage the creation of capital in almost every sector of the economy by resorting to different policies. Usually, it will decide for justified economic reasons to favor an activity or group through monetary assistance which may be channeled or delivered by electing from a wide range of options —e.g., direct grants, loans, etc. In addition, it may attempt to pursue this goal by dealing with the tax system, particularly by the implementation of a tax policy — e.g., permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, special rates, other — with the expectation that a desired result will be achieved.[2]

A typical case of a tax policy applied with the expectation of achieving a desired result is the one covered by section 936 of the U.S. Internal Revenue Code (as amended) and some other related provisions which applies to Puerto Rico. Under this section, the so popularly known "possessions corporations" (companies incorporated in the United Sta-

1a. Excerpts of this paper were published in "The San Juan Star" B6 (July 24, 1983).

1b. J. T. Sneed, *The Criteria Of Federal Income Tax Policy*, 17 Stanford L. R. 567 (April, 1965), [hereinafter cited as Sneed (1965)].

2. *See generally*, Surrey & McDaniel, *The Tax Expenditure Concept: Current Developments And Emerging Issues, XX:* 2 Boston College L.R. 225 (1979) [hereinafter cited as Surrey & McDaniel (1979)]

tes) are fully exempted from federal tax on income from their operations in Puerto Rico. It is the purpose of this paper to examine and analyze: the effects of this tax policy on the economy of Puerto Rico and on the Federal Treasury; whether the expected results by its adoption, have been achieved; its tax expenditures considerations vis a vis a government direct expenditures alternative approach; and, to suggest some possible changes. No deep analysis is made of any of the constituent elements of section 936, since many good articles have already covered this subject. Since in the case of Puerto Rico we are dealing with a social macro-structure that has its own dynamics and institutional peculiarities, it is proper to start the present analysis by setting forth below a legal, political, and economic background.

II. Legal, Political and Economic Background

—Puerto Rico

Puerto Rico is a highly populated 3,500 square miles island, in the Caribbean, with limited natural resources. It became a territory of the United States in 1898 as a result of the Spanish-American War. Ever since that year its people have been politically divided into three main possible status formulas —independence, commomwealth, and statehood. The resulting state of uncertainty and political suspense affects P.R. negatively by obstaculizing what the people ultimately want, where P.R. is going, and how it will proceed. Moreover, newly proposed public policies affecting Puerto Rico will be subject to scrutiny by politicians, who will favor them depending on convenience within the context of their preferred status formulas. (Section 936 has not been the exception to this rule). In addition, the local legal, political, and economic system is continuously exposed to the ambiguity of being considered by the Federal Government as a state for some purposes, and differently for others.

The rights of the residents of Puerto Rico, who were granted American citizenship in 1917, have changed in a way parallel to the gradual transfers of powers of the U.S. Government to them. From an American military establishment during the first years P.R. changed to a republican form of government similar to the one of the fifty states of the Union at present, with the difference that it is ruled under the territorial clause of the Constitution of the U.S. Federal Statutes generally apply to Puerto Rico. In addition, P.R. shares a common currency, citizenship and open borders with the United States. The Merchant Marine Act applies to Puerto Rico, therefore, only United States flagships can be used for the transportation of merchandise to and from the mainland.[3] Notwithstan-

3. 46 U.S.C. 883. The present administration has requested Congress to make some changes relating to this policy (liberalization allowing foreign flag passenger service between Puerto Rico and the Mainland) with negative response. In addition, there is common defense with the U.S. An analysis of local military participation in conflicts where the U.S. has been involved can be found in: J.A. Ramos & López, *2,285 boricuas han muerto en los conflictos bélicos de E. U.*, El Mundo SA (March 5, 1983)

ding, the island has a separate fiscal structure, enjoying primary jurisdiction to tax Puerto Rican source income, while the United States has secondary jurisdiction to tax the Puerto Rican source income of U.S. citizens, residents and corporations.[4] Puerto Rico's authority to enact its own tax system derives from the Foraker Act of 1900. Nevertheless, there is a close relationship between the local tax rules and the federal tax rules, to the extent that in 1954 the legislature adopted its present income tax laws based on the U.S. Internal Revenue Code of 1939 (As amended in 1954).

At the turn of the century the main local industry was the sugar industry. Immediately thereafter, great quantities of American capital were invested in this industry to the extent that it experimented an extraordinary growth during the next 40 years, from 335,750 tons per year to nearly 1,300,000 tons.[5] During the 1940's Puerto Rico started its popularly known economic development program "Operation Bootstrap". The keystone of this industrial incentive program was the tax exemption policy adopted by the "Industrial Tax Exemption Act of 1948" providing qualified firms an exemption from income, property, and municipal taxes, for substantial periods of time depending on the selected location in the island.[6] Other legislation exempted from excise tax all raw materials, machinery, and equipment used in manufacturing for export or sold to other manufacturers in Puerto Rico; and provided incentives for government financing, availability of buildings under low rent agreements, and training for employees.[7] A government agency was established for the administration of this program — Fomento. As a result of this incentive policy, and particularly to benefit from the tax holiday, many firms established plants in Puerto Rico in the early 1950's. From 1947 to 1972, Puerto Rico achieved an average annual growth rate of 6% in real terms.[8]

The rapid expansion of the industrial sector during the 1950's was accompanied by an extremely large migration of citizens of Puerto Rico to the mainland. So many people left that migration was named the

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4. *The Operation And Effect Of The Possessions Corporation System Of Taxation*, 6, Third Annual Report, Dept. of the Treasury (June, 1980) [hereinafter cited as Treasury Report (1980)]. *See also*, *The Operation and Effect Of the Possessions Corporation System of Taxation* 26, Fourth Annual Report, Dept of the Treasury (Feb. 1983) [hereinafter cited as Treasury Report (1983)].

5. J. Simon, *La Amarga Trayectoria de la Industria del Azúcar en Puerto Rico*, 56-57, El Nuevo Día (November 8, 1981), [hereinafter cited as J. Simon (1981)].

6. *See generally:* Treasury Report (1980), *supra* note 4, at 12; Treasury Report (1983), *supra* note 4, at 1, 23 & 42; Luis P. Costas Elena, *I.R.C. Section 936 And Fomento Income Tax Exemptions In Puerto Rico (Primera Parte)*, Vol. 40 Num. 4 Rev. Col Abog. P.R. 563, at 569 (Nov. 1979) [hereinafter cited as Costas (Nov., 1979)]; D.N. Keifer, *Treating Puerto Rico As A State Under Federal Tax And Expenditure Programs: A Preliminary Economic Analysis*, Vol. 39:4 Rev. Col. Abog. P.R. 657, *at* 663 (Nov.,1978) [hereinafter cited as Keifer (1978)]; 1948 P.R. Laws 482.

7. *Id.*

8. *Id.*, Treasury Report (1980); and Treasury Report (1983) at 3. Honorable Luis Muñoz Marin was Governor of Puerto Rico during these years.

"escape valve" of the economic problems of the island.[9] Many economists underestimate the effectiveness of the incentives policy by arguing that the real economic growth experimented from 1950 through 1970 was primarily due to this migration. They espouse the proposition that, notwithstanding the abilities of the leaders guiding an economy, it is hardly difficult to find a country that would not experience economic growth by exporting large percentage of its citizens in a 20 year period.[10]

The economic picture of the island at present and during the past ten years has turned negative due to various factors, including the adverse effects caused by the recession of the U.S. economy and the high US interest rates. Real GNP grew by 2.3% in 1980, and .7% in 1981.[10A] Many believe that rather than looking for solutions through the adoption of economic policies, the real answer lies within the issue of the political status of Puerto Rico. Several factors serve to make this a strong argument. As mentioned before, although Puerto Rico is not a state, it is subject to the applicability of most U.S. policies. These are adopted by the U.S. Government taking into consideration a set of political, legal, and economic variables partly different from the local ones —e.g., different political relation, wages, fiscal structure, etc. As a result, the local political, legal, and economic system is continiously exposed to contradictory forces after policies are applied. In addition, policies for local applicability can be adopted, revised, or derogated unilaterally by the U.S. Government, subject of course to constitutional limitations, creating an atmosphere of uncertainty in some instances that can be negative particularly to the economic environment — e.g., uncertainty in the minds of potential outside investors because of possible changes in minimum wage policies, in IRC 936 policy or others. Moreso, the actual political relation serves as an additional ingredient for judicial interpretation relating to the legality of local applicable policies, which may be negative and limitative in some cases within the perspective of Puerto Rico. Past experiences with the maritime laws (note 3), fiscal structure, the local applicability of federal minimum wages, federal aid, and tariffs are evidence of the above statements.[10B]

The fact that the island has a separate fiscal structure with the peculiarity that local tax policies apply in most cases, that federal tax policies apply in others, and both tax policies in still other cases, makes the economic game completely different. With appropiate tax planning the citizens of Puerto Rico can legally avoid (even completely) paying annual income taxes both to the local & Federal Treasury. In addition, a citizen of Puerto Rico, who pays local and also federal taxes because of his income from sources within the U.S., will be contributing to a treasury that will treat him differently for purposes of federal aid pro-

9. J.A. Herrero, *La Economía de Puerto Rico: El Presente Crítico*, Vol. XLV: 3 & 4 Rev. Jur. Univ. P.R. 197, at 201 (1976), [hereinafter cited as Herrero (1976).] *See also:* W. Rodríguez, *Regresan a E. U. los puertorriqueños*, El Nuevo Día 6, (March 6, 1983); Treasury Report (1983), *supra* note 4, at 33 - 35.

10. *Id.*

10A. *Id.*, Treasury Report (1983), at 36.

10B. *Id.*, at 32 & 33, and 56.

grams because of the political status of the jurisdiction in which he resides.

Another conflicting area is the one dealing with wages. On the one hand, Federal minimum wages have been established in Puerto Rico sistematically without consideration being given to the fact that the economic variables (including those affecting the forces of supply & demand of labor) within the present "commonwealth political status" are different from those in the mainland (fiscal, etc.)[11] On the other hand, this policy serves as an inducement to an industrial structure that is not labor intensive while P.R. faces at the same time a problem of high levels of unemployment.[12] Thus, for purposes of wages, local employers are forced to meet the obligations of stateside employers. Puerto Rican Distribution of Employment in 1950, 1970, 1979, and 1981 changed as follows in selected sectors:[13]

	Agriculture	Manufacturing	Home Needlework	Services	Government
1950	214,000	55,000	51,000	77,000	45,000
1970	68,000	132,000	less 2,000	116,000	106,000
1979	38,000	160,000	less 2,000	142,000	190,000
1981	41,000	155,000	less 2,000	150,000	203,000

The increase in employment in the government sector was primarily due to an increase in federal aid to the island from 290 million in 1968 to 2.057 billion in 1979, and 3.035 billion in 1982.[14] In addition, the island received nearly 734 million under the food stamps program,[15] which some analysts say has served as an incentive for some people to leave the employment sector to join the unemployment ranks.[16] One other factor which led to an increase in employment in the manufacturing and servi-

11. R. Alonso.,*Criterios para la Forjación de una Nueva Política de Desarrollo Económico para Puerto Rico,* 43 Rev.Jur Univ. P.R. 667, (1974) [hereinafter cited as Alonso (1974)]. *See generally,* Treasury Report (1983), *supra* note 4, at 43. Notwithstanding, average wages within Puerto Rican manufacturing industries are lower than those of Stateside firms. *Id.* at 63.

12. *Id.;* and, Treasury Report (1983), at 4, 32 & 52.

13. Treasury Report (1980), *supra* note 4, at 21; Treasury Report (1983), *supra* note 4, at 37. *See also "Serie Histórica del Empleo, de Desempleo y Grupo Trabajador en Puerto Rico 1979",* Junta de Planificación, Manufacturing employment in 1982 was 149, 300. Government employment was 220, 800 in 1982.

14. *Id.,* (1980) at 29. $2,791 millions with food stamps. Hon. Luis A. Ferre Governor of P.R. during the period of 1969-72 deserves special credit for these federal aid increases, together with the Resident Commissioners of P.R. in Washington. The food stamp program in 1981 reached $860 million. *Id.,* Treasury Report, at 47.

15. *Id.*

16. *Id.,* See generally Herrero (1976), *supra* note 9, at 200.

ces sectors was the change in federal tax policy of IRS section 931 to 936 (in 1976) which resulted in the inflow of more than six billion dollars into the Puerto Rican money markets during the years hence.[17]

Federal assistance programs and policies may have lessened to some extent the local economic problems, but at the same time these have not been enough and the issue of the political status cannot be ignored. (In fact, because of its political status, Puerto Rico is not treated as a state for purposes of all federal aid programs). The total outstanding public debt in fiscal 1981 was around 7.51 billion.[18] Unemployment is well above 23.5%.[19] The situation may worsen if one considers the fact that assistance to P.R. in some of the federal programs was reduced by the recent budget cuts adopted by Congress. (This will reduce local government employment and personal disposable income —e.g. Termination of the CETA program alone cost Puerto Rico 26,000 jobs).[20] Moreover, the Island has not achieved parity with the rest of the Nation in per capita income levels or general standards of living.[21] However, this comparison may be judged as pretentious. On the other hand, the Island has achieved economic growth and "ambiance" far superior to any Latin American Nation.

Some analysts argue that the real problem of unemployment in Puerto Rico is the result of mismanagement at Fomento, the government agency primarily in charge of administrating the industrial incentives program. These critics argue that Fomento is a beggar policy institution, that it has never fulfilled its promised employment goals, that it has violated its exemption contracts with favoritism for outside investors, that it has deluded itself with the fallacy of extraordinarily large projects, and that the tax exemption policy has cost and continues to cost too

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17. *See* J. Baird, *The Flap Over Puerto Rico's Tax Bonanza*, Inst. Investor 121 (May, 1980) [hereinafter cited as Baird (1980). *See* note 80, infra.

18. *See generally*, J. Pietrantoni, President, Govt. Dev. Bank, "Addres Banco Popular Seminar, March 3, 1982, Wash, D.C. Around $4 billion in 1975; *see also*, L.P. Costas, *I.R.C. Section 936 And Fomento Income Tax Exemptions in Puerto Rico (Segunda Parte)*, 14:1 Rev. Col. Abog. P.R. 101 at 111, (Feb., 1980) [hereinafter cited as Costas (Feb., 1980)]. The public debt of P.R., as of Sept. 1982 amounted to $7.9 billion- M. Bhatia, *A Toast to Keynes, P.R.'s economic hero*, The San Juan Star B6 (June 5, 1983).

19. *See, P.R. Unemployment Rate Hits All-Time High, 23.5%*, The San Juan Star, July 17, 1982. *See also* B.P. Finn and J. Meszaros *Reaganomics For Puerto Rico*, P.R. Buss. Review 1 (Special Supplement — July — August 1981) [hereinafter cited as Finn (1981)] *See also* Treasury Report (1980), *supra* note 4, at 21. *See also*, La tasa desocupación local se encuentra a un 24.1 %, El Mundo 5A (Sept.21, 1983); *Feeling the pulse of P.R.'s economy*, The San Juan Star B2 (June 5, 1983); J. Oyola, *An advance look at the* Carrion Report, The San Juan Star B2 (Oct. 9, 1983).

20. *Id.*, Finn. Total Federal Aid to Puerto Rico is expected to increase nominally during the next few years. However, P.R. will experience reductions in important areas such as nutrition and job creation programs. *See* J. Simon, *E.U. enviará fondos por $5000*, El Nuevo Día 4 (April 10, 1983). *See also* Appendix D.

21. *See*, B. Finn. *"New Federal Year, The Bucks stop Here"* The San Juan Star B-9, Oct. 4, 1981.

much.[22] But still the problems of P.R. are not just the result of an "alleged" mismanagement of a government agency. Rather, the problems are the result of a more complex set of variables, which when analyzed ultimately will always lead to the issue of the political status situation.

Another example which makes the political argument evident is the one dealing with the balance of payments situation in Puerto Rico. Under the present status. P.R. does not have any voting representative in Congress (just a Resident Commissioner). The United States has sole power to establish the tariffs against foreign goods, thus native export industries are completely dependents upon these policies which are adopted mainly within the U.S. political & economic perspective.[23] As a result, their competitiveness may be reduced. In 1978, imports of goods and services equaled 87% of gross national product.[24] During fiscal year 1981 total imports were $3,594,149,146.[25] Imports of crude oil rose from $200 million in 1972 to $1 billion in 1982[26], our purchases abroad.[27] For example, for businesses and individuals in the United States these imports meant more than 153,000 jobs.[28]

Imports are affecting the Puertorican economy badly. In order to balance the trade deficit P.R. needs to increase its exports. But these were just $1,003,320,214 during 1980-81,[29] which leaves a negative balance of $2,590,828,932 for that year.[30] Thus, the outflow of money is more than twice the inflow of money, leaving as a result a financial deficit or burden that must be covered. The 1983 Budget Request Report of the Puerto

22. *See generally* L.P. Costas, *IRC Section 936 And Fomento Income Tax Exemption In Puerto Rico (Part III)*, 41:2 Rev. Col. Abog. P.R. 225 (May, 1980) [hereinafter cited as Costas (May, 1980)]; Costas (Nov., 1979), *supra* note 6. *But see*, J. Simon, *Fomento prefiere el transistor en vez*, Nuevo Día 4, 31 enero, 1982.

23. 48 U.S.C.S. 734, 739, 821. *See:* J. Collins, *Intense lobbying efforts surround CBI rum issue*, Caribbean Bus. (May 11, 1983); Treasury Report (1983), *supra* note 4, at 49 & 56.

24. *See* Treasury Report (1980), *supra* note 4, at 58.

25. *Peticiones Presupuestarias*, Depto. de Comercio 2, Año Fiscal 1983 [hereinafter cited as Presupuesto (1983)].

26. *See* Treasury Report (1980), *supra* note 4, at 21. *Also*, J. Oyola, An advance Look at the Carrion report, The San Juan Star B2 (Oct. 9, 1983).

27. *See generally*, *Puerto Rico's Purchases From the United States - Fiscal Year 1977*, Economic Development Administration 1, (June, 1978); or, 7:6 Bus. Rev. 8, Govt. Dev. Bank, June 1982. *See also*, Treasury Report (1983), *supra* note 4, at 129.

28. *Id. See also*, *Puerto Rico As A Distribution And Trade Center*, Economic Development Administration 1, Office of Economic Research (July, 15, 1981); *and*, *Economic Study Of Puerto Rico*, Vol I, ch. 3, U.S. Dept. of Comm. (Dec., 1979).

29. Presupuesto (1983), *supra* note 25, at 2.

30. *Id.* Other figures appear in: *Island's GNP Growth Rate Poorest in 4 Years*, 3, The San Juan Star, Jan. 20, 1982; H. Ledesma, Banco Popular Seminar, Wash., D. C., March 3, 1982. Notwithstanding, the Commerce Department has made some recent claims of surplus in balance of payments for 1981-82 (*P.R. logra primer superávit comercial en 22 años*, El Mundo 5A (Oct. 27, 1982) & (Feb. 2, 1983), but these have been questioned by local analysts as exagerated because of the way it includes 936 transfers of goods back to the U. S. *See also*, O. Carrasco Amadeo, *Comercio Exterior: un potencial, una esperanza*, El Mundo 8A, Nov. 8, 1982. "By the end of fiscal year 1981-82 Puerto Rico

Rico Department of Commerce states the following external and internal reasons affecting exports:[31]

- lack of knowledge of export techniques in the industrial and commercial sectors
- lack of interest from the manufacturers in the export commerce, due principally to lack of knowledge of its advantages
- lack of additional experienced and trained personnel in the Department
- lack of adequate resources to increase promotional activities outside

Other factors which have adversely affected the balance of payments situation of Puerto Rico are: that the industries that have moved to Puerto Rico traditionally have as their principal purpose exportation and not the substitution of local imports; the propensity of Puerto Ricans to save, which appears to be extremely small; the bankruptcy of some of the main export industries —e.g. in the agricultural sector the sugar industry; the relatively small number of, and conservative commercial attitude of local investors; and, a negative effect on local money supply caused by the continuous deficit in the balance of payments.[32]

The economy of Puerto Rico is really affected by four primary factors: the world economy; the national economy; the political status of the Island; and the locally adopted policies. The first two factors it can only influence minimally. The third factor can only be solved in the long run and not within the next two years. The last factor is within local control and is the one that can be used to implement necessary corrective steps in the short run. But, is there any real solution to the economic problems of Puerto Rico for the near future? It may be necessary that the government, in order to cover for the commercial deficit, sells its national wealth or increase the emission of public debt.[33]

Even higher interest rates makes it harder to obtain public funds. In addition there cannot be unlimited growth in the public debt without

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registered for the first time in 22 years a positive balance of payments. Exports ($8,795.3 millions) exceeded imports ($8,490.5 millions) by $304.8 millions. These figures include the volume of comercial exchange between U. S. parent-corporations and their island subsidiaries. Since there are no statistical figures available allocating the main source of the commercial activity it is difficult to verify effectively the volume of exports which corresponds to these subsidiaries and which to efforts from the native industrial sector", P. R. Latortue, *La balanza comercial de Puerto Rico,* 11 El Reportero (May 17, 1983).

31. *See,* Presupuesto (1983), *supra* note 25, at 51.

32. *See generally;* Treasury Report (1980), *supra* note 4, at 58, A. Asmar, *Análisis Breve del Informe Tobin* 2, Ensayo 1, Temas sobre Economía de P. R., Facultad de Ciencias Sociales, Depto. Econ., Univ. de P. R. (Junio, 1976) [hereinafter cited as Asmar (1976)]; L. Smith, *Notas sobre la Política de Inversión y sus efectos sobre el control de capital en Puerto Rico,* 43 Rev. Jor. Un. P. R. 601, at 603 (1974) [hereinafter cited at Smith (1974)]; Herrero (1976), *supra* note 9, at 200. For the purpose of this paper "trade deficit" includes a negative balance of payments between P. R. and the U. S. mainland.

33. *See* Herrero (1976), *supra* note 9 at 203.

reaching the day when a final account will have to be rendered.[34] The reality is that under present circumstances Puerto Rico may be facing harder times because of the economy. An economic debacle was postponed in 1972 by the extraordinary increase in federal aid, and, in part in 1976 by the federal implementation of IRC section 936. Notwithstanding, there are two facts that must be kept in mind when planning to change the economic picture of Puerto Rico. First, Puerto Rico cannot depend totally on public debt and federal aid to finance public investment or expenditures.[35] Secondly, any economic development policy to be adopted must take into consideration P.R.'s own peculiar characteristics. It must be viable and realistic.[36]

III. Adoption of IRS Section 936

1) Constituent Elements

One of the major changes of the Tax Reform Act of 1976 was the adoption by Congress of I.R.C. section 936, effective since taxable years beginning after December 31, 1975. Section 936 replaced I.R.C. section 931, the statute that was applicable previously to U.S. companies operating in Puerto Rico. Under previous law, if possessions corporations decided to repatriate profits on a current basis, these were subject to full U.S. corporate income tax. But, if the corporation elected to accumulate its profits until the end of the tax exemption grant, it could then liquidate the subsidiary company into the parent corporation with profits free of any taxes in Puerto Rico or the United States. This had the result of great accumulation of funds which were invested outside of Puerto Rico or the United States until liquidation. (Particularly, in the Eurodollar market)

Since the adoption of section 936, possessions corporations can repatriate profits to their U.S. parents on a current basis free of any U.S. tax.[37] This repatriation policy had been long sought by Puerto Rico. Thus, an electing possession corporation is granted a credit against its federal income-tax return commensurate with the ratio that its qualifying taxable income bears to its total taxable income. As a result, if all of the

34. *See,* Asmar (1976), *supra* note 32, at 10.

35. *Id.* at 4.

36. *See generally,* Alonso (1974), *supra* note 11, at 670.

37. *See generally,* R. Hudson, *Tax-Exempt Possessions Corporations In Puerto Rico — An Overlooked Oportunity,* Vol. XXXI Univ. Of Fla. L. Rev. 42 (1978) [hereinafter cited as R. Hudson (1978)]; *Tax Reform Highlights — Section 936,* Econ. Dev. Adm. (Dec., 1978); Treasury Report (1980); *supra* note 4; Costas (Nov., 1979), *supra* note 6; Costas (Feb., 1980), *supra* note 18; Costas (May, 1980), *supra* note 22; *Puerto Rico,* 1980 Tax Management Portfolios, BNA Núm. 139 — 3rd.; R. Griggs, *Operating In Puerto Rico In The Section 936 Era,* 32 Tax L. R. 239 (1977); R. Sierra, *El Nuevo Trato Contributivo Federal de las Corporaciones Norteamericanas en P. R.* 38:2 Rev. Col. Abog. P. R. 235 (May 11, 1977). The main elements of the possessions corporation tax exemption became part of U. S. law as section 262 of the Revenue Act of 1921, and were added for the purpose of promoting the competitiveness of U. S. business operating in the possessions. *See,* Treasury Report (1983) *supra* note 4, at 1 & 9.

taxable income of the corporations qualifies, no federal income tax is due. Notwithstanding, liquidation of a possessions corporation benefits are still tax free under section 332.

The tax credit of 936 is given in lieu of the ordinary foreign tax credit provided by section 901 of the Code. It is applicable to qualified possession source investment income, which includes only income from sources within a possession in which the corporation actively conducts a trade or business, regardless of whether or not such business produces taxable income in a taxable year,[38] with income earned elsewhere subject to the normal U.S. tax rates. The credit is not allowed against taxes imposed by: section 56 (relating to corporate minimum tax); section 531 (relating to the tax on accumulated earnings); section 541 (relating to personal holding company tax); or section 1351 (relating to recoveries of foreign expropiation losses)[39]. Losses from other sources are to be taken into account, in determining the amount of tax attributable to the income from the active conduct of a possession trade or business or from qualified possession investment income.

In order for a possession corporation to qualify for the 936 benefits (as amended by the "1982 Tax Equity & Fiscal Responsibility Act") it must meet the following staturory requirements:[40]

- it must have domestic corporate status.[41]
- it must elect to use the 936 benefits for a period of 10 years[42]. In order to avoid double benefits while an election is in effect, the corporation cannot file consolidated returns.[43]
- Eighty (80) percent of its gross income must be from sources within a possession of the United States[44].

38. I. R. C. section 936 (d) (2). *See*, Treasury Report (1983), *supra* note 4, 9, 12. The Tax Reform Act of 1976 left intact the exemption for income derived by U. S. corporations from operations in a possession, but eliminated the exemption for income derived from foreign countries. *(See*, IRC 936 (c) — Gross income received in the U. S., regardless of source, may not be taken into account as income from sources without the U. S. (IRC Section 936 (b). Thus, the exemption is limited to: income from the active conduct of a trade or business in a possession, or from the sale or exchange of substantially all of the assets used by the corporation in the active conduct of such trade or business; and to Qualified Possession Source Investment Income (QPSII), which is non-business income derived from the possession in which the corporation has its trade or business and which is attributable to the investment of funds derived from such trade or business. "For U.S. parent companies, the QPSII exemption makes Puerto Rico a very advantageous location for financial investments compared to the United States... or lowtax foreign countries". *Id.* at 58. There are three requirements for investment income to qualify as QPSII. *Id.* at 70. In relation to recapture of overall foreign losses, *see*, IRC 904 (f).

39. IRC Section 936 (a) (3). *See also*, IRC Section 47, 50A (c), & 1378.

40. *See generally*, R. Hudson (1978), *supra* note 37, at 43; Treasury Report (1980), *supra* note 4; Costas (Nov., 1979), *supra* note 6; Costas (Feb, 1980), *supra* note 18; Costas (May, 1980), *supra* note 22.

41. I.R.C. section 936 (a) (1).

42. I.R.C. section 936 (e) (1).

43. I.R.C. section 1504 (b) (4).

44. I.R.C. section 936 (a) (2) (A).

This test must be met also for the 3 year period immediately preceding the close of the taxable year when the ten year benefit period starts to run.

—Sixty-five percent or more of its gross income must be derived from the active conduct of a trade or business within a possession of the United States after calendar year 1984.[45] Taxpayer must establish to the satisfaction of the Secretary that the funds invested were obtained from the active conduct of a trade or business within the same possession and were actually invested in assets in that possession. In the case of intermediaries (e.g. — banks) it must be shown that these didn't reinvest the funds outside of the possession.

— The corporation must be neither a Domestic International Sales Corporation (DISC), nor a former DISC.[46]

— Greater benefits can be obtained if: the corporation applies for the Puerto Rico's tax exempt program; if profits are reinvested in Puerto Rico; and, if with a significant business presence in a possession, the corporation elects out of the new rules on intangible income.[47]

As of June 1982, 807 corporations had filed a section 936 election form, including about 600 which were in operation under the predecessor 931 exemption.[48] Most of these firms are also enjoying tax exemption

45. I.R.C. section 936 (a) (2) (B). Until 1982 the test was 50%, but was amended to 65% after 1984. Subsection (a) (2) (C) provides for a transitional rule with respect to taxable years beginning after December 31, 1982, and before January 1, 1985, as follows: 1983 — 55%; 1984 — 60%. See also: IRC sections 861 — 63; Treasury Report (1983), *supra* note 4, at 14 & 23. "The greater level of required active business income will mean that less passive investment income can be earned by a corporation still wishing to qualify for effective tax exemptions under section 936".

46. I.R.C. section 936 (f).

47. *See*, I.R.C. Section 936 (h) (5). Recently enacted subsection (h) states that the intangible property of a 936 corporation for any taxable year shall be included on a pro rata basis in the gross income of all shareholders of such corporations and shall be excluded from its (corp.) gross income. The term "intangible property" covers — patent, invention, formula, process, design, pattern, know-how; copyright, literary, musical or artistic composition; trademark, trade name, or brand name; franchise, license, or contract; method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or any similar item — which has substantial value independent of the services of any individual (936 (h) (3)). Intangible income excluded as received by the possessions shareholders is: (a) gross income from intangible property licensed to the corporation since 1948 and currently in use; and, (b) gross income derived from the disposition of any product or the performance of any service that the IRS determines to be a reasonable profit on direct and indirect costs allocable to the income (936 (h) (3) (A) & (C)).

Notwithstanding, a 936 corporation may elect out of the rules on intangible income (936 (h) (5)) —If it does, it must compute its taxable income from its possession operations under one of two methods: the cost sharing method, or the profit split method. In addition, any transfer of intangible property to a foreign person by a possession corp. or a U. S. affiliate of a possession corp. after August 14, 1982, is treated as tax avoidance transfer. *See generally*, Treasury Report (1983), *supra* note, 4, at 14-23.

48. Treasury Report (1980), *supra* note 4, at 65; Treasury Report (1983), *supra* note 4, at 131-32.

benefits under the Industrial Incentive Act of Puerto Rico.

Notwithstanding, local policies and recent amendments by Congress may undermine to some extent the attractive economic peculiarity of section 936 to U.S. firms. On the one hand, Puerto Rico imposes a "tollgate" tax on dividends paid by possessions corporations to their stateside parent company (less than 10%).[49] Although the tax is attacked on grounds that it reduces to a certain extent the 936 net benefits, its effects are really minimal, both to the firm and to the local Treasury.[50] On the other hand, Congress and the Federal Treasury Department are constantly reviewing the section 936 policy and may at any time be expected to come up with some changes.[51] The most recent ones were those covered in the "Tax Equity and Fiscal Responsibility Act of 1982. For several years, the U.S. Treasury Department felt that mainland companies had been receiving unintended tax benefits by transfering the intangibles to their subsidiaries.[52] To lessen this abuse, the provision was therefore modified,[53] with the expectation that it will raise $1.2 billion in federal taxes from the 936 corporations over the next three years.[54] It is estimated that the new policy besides costing industries in Puerto Rico more millions a year, may also stall efforts to attract more high technology and pharmaceutical plants since they will be hardest hit. Notwithstanding, the amendments have added a degree of certainty to the statutory computation of income subject to the 936 tax credit. In addition, the Administration has decided to extend to Puerto Rico two United States business tax breaks —investment tax credits and an accelerated depreciation write-off on plant and machinery.

2.) Legislative Purpose

Before 1976, under the policy of IRS section 931, most possessions corporations earnings were invested mainly in the Eurodollar market, where they continued to enjoy United States tax exemption. Congress was concerned because these investments did not benefit the possessions economies, while at the same time they resulted in a revenue loss to the United States. Moreso, these corporations could repatriate earnings free of tax on liquidation. To help Puerto Rico attract more job-creating investment, and particularly, to encourage the corporations to repatriate earnings on a current basis back to the United States, Congress legislated

49. *See generally*, R. Sierra, *The Puerto Rico Tollgate Tax*, Int. Tax J. 824 (Feb., 1978). New local Treasury regulations provide for special treatment on this matter.

50. *See*, R. Hudson (1978), *supra* note 37, at 44.

51. *See* letter of Senator Dole to Treasury Secretary Regan of October 20, 1982 affirming more possible analysis of Section 936, notwithstanding the 1982 amendments.

52. *See*, H. Turner, "*New 936 Tax Rules Give Firms A Choice On 'Safe* Harbor"', The San Juan Star B1, April 25, 1982.

53. *See*, Conference Report Accompanying H. R. 4961 related to I.R.C. Section 936. *See* note 47, *infra*.

54. *See*, H. Turner, *House Oks. Tax Bill With 936 Agreement*, The San Juan Star 1, August 20, 1982.

to adopt section 936. That these were the main objectives can be clearly understood by reviewing the reports of the Congressional Committees. Specifically, the report of the "Joint Committee On Taxation" states in pertinent part:[55]

> ... *Under prior law no tax was paid to the United States as long as no dividends were paid to the parent corporation.*
>
> Because no current U.S. tax was imposed on the earnings if they were not repatriated, the amount of income which accumulated over the years from these business activities could be substantial. The amounts allowed to accumulate were often beyond what could be profitably invested within the possession where the business was conducted. As a result, corporations generally invested this income in other possessions or in foreign countries either directly or through possessions banks or other financial institutions. In this way possessions corporations not only avoided U.S. tax on their earnings from businesses conducted in a possession, but also avoided U.S. tax on the income obtained from reinvesting their business earnings abroad.
>
> After studying the problem, Congress concluded that *it is inappropriated to disturb the existing relationship between the possessions investment incentives and the U. S. tax laws* because of the important role it is believed they play in keeping investment in the possessions competitive with investment in neighboring countries. The U. S. Government imposes upon the possessions various requirements, such as minimum wage requirements and requirements to use U. S. flagships in transporting goods between the United States and various possessions, which substantially increase the labor, transportation and other costs of establishing business operations in Puerto Rico. Thus, without significant local tax incentives that are not nullified by U. S. taxes, the possessions would find it quite difficult to attract investments by U. S. corporations.
>
> However, investing the business earnings of these possessions corporations outside of the possession where the business is being conducted does not contribute significantly to the economy of that possession either by creating new jobs or by providing

55. *General Explanation Of The Tax Reform Act Of 1976*, H. R. 10612 94th. Congress, Public Law 94-455, Joint Commitee on Taxation 273-74, (December 29, 1976), [hereinafter cited as Explanation Report (1976)]. *See also:* H. R. 10612, 94th. Congress, lst. Sess. Rep. 94-658, at 254 (Nov. 12, 1975); H. R. 10612, 94th. Congress, lst. Sess, J.C.S. 12-76 (April 14, 1976); H.R. 10612, 94th. Congress, 2d. Sess., Rep. 94-938, at 277-82 (June 3, 1976); Treasury Report (1980), *supra* note 4. For over two thirds of a century Congress has repeatedly recognized the need, in order to foster industrial & economic growth in P. R., to provide incentives for United States industries, to establish manufacturing facilities here. As early as 1921 Congress enacted the predecessor of IRC section 931 which completely exempted from U. S. tax, income of domestic corporations deriving most of their income from the active conduct of trade or business in Puerto Rico and other possessions.

capital to others to acquire new plant and equipment. Accordingly, while Congress believes it is appropriate to continue to exempt trade or business income derived in a possession and investment income earned in that possession, it does not believe it is appropriate to provide a tax exemption for income from investments outside of the possession.

In addition, Congress recognized that the provision of prior law denying a dividends received deduction to the U. S. parent corporation forced a possessions corporation to invest its income abroad until it was liquidated (usually upon the termination of the local tax exemption) when it could be returned to the United States tax free. *These accumulated business profits were thus not available for investment within the United States,* and the income produced was (under prior law) not subject to U. S. tax. Congress believed that while it is appropriate to tax the foreign source investment income from possession business earnings, *possessions corporations should at the same time be given the alternative of returning the business income to the United States prior to liquidation without paying U. S. tax.* Permitting taxfree repatriation of the accumulated earnings only upon the liquidation of the possessions corporation, while taxing the foreign source investment income derived from the accumulated earnings would lessen to a significant extent the tax incentive of making the initial investment.

To accomplish these two major changes, the Act revises prior law to provide for a more efficient system for exemption of possessions corporations. Under the Act, these corporations are generally to be taxed on worldwide income in a manner similar to that applicable to any other U. S. corporation, but a full credit is to be given for the U. S. tax on the business and qualified investment income from possessions regardless of whether or not any tax is paid to the government of the possession. The effect of this revised treatment is to exempt from tax the income from business activities and qualified investments in the possessions to allow a dividens received deduction for dividends from a possessions corporation to its U. S. parent corporation, and to tax currently all other foreign source income of possessions corporations (with allowance for the usual foreign tax credits for foreign taxes paid with respect to that other income). *Congress believes that this revised treatment will assist the U. S. possessions in obtaining employment-producing investments by U. S. corporations while at the same time encouraging those corporations to bring back to the United States the earnings from these investments to the extent they cannot be reinvested productively in the possession...*

The Government of Puerto Rico expected then with great optimism that 936 would effectively work as an incentive for U. S. investments in Puerto Rico, which would result in the creation of many new jobs. Also, it was believe that the new policy would result in more foreign funds being transferred to P. R., particularly with local commercial banks as recipients.[56] Moreover, the increment of 936 corporation deposits should have expectedly initiated an increment in the credit supply for construction, commerce, and industry; and, a reduction in the finance costs for the benefited areas, since this measure should increase supply without reducing demand[57]. An improvement in the credit conditions should also result in a reduction in interest rates[58].

In order to analyze currently the operation and effect of the possessions corporation system of taxation, Congress ordered the Treasury to submit an annual report to the committee including revenue effects of the provision as well as effects on investment and employment in the possessions[59]. It was pursuant to this annual analysis that section 936 was amended partially last year; as previously mentioned[60], particularly to lessen the abuse caused by taxpayers claiming tax free income generated by intangibles developed outside Puerto Rico.

IV. Tax Policy Consideration

A) Tax Expenditures - In General

Direct expenditures such as - direct grants, loans, interest subsidies, guarantees of loan repayment or interest payments, insurance on investments, and others - are viewed by Government as useful to implement social and economic policies[61]. Another mechanism available to government in achieving these goals is the tax system with its different impositions. Within this context one approach to view taxation is as if it is part of the general budget policy which has as its end the maximization of general welfare by pushing public expenditures to the point where the marginal return of satisfaction from them equals the satisfaction lost because of the resulting inability to make private expenditures[62]. From this perspective, the particularized ends sought to be accomplished through the tax system are tremendously numerous. Even dominant political forces frequently employ it to satisfy their more immediate

56. *See generally* Costas (Feb., 1980), *supra* note 18, at 115 & 132; Treasury Report (1983), *supra* note 4, at 68.

57. *See generally* E. Ason, *Comentarios Sobre las Recomendaciones del Uso de los Fondos de las Corporaciones 936*, Conferencia Núm. 7 Pág. 3, Fac. Ciencias Soc., Depto. Econ., Univ. P. R., (Mayo, 1977) [hereinafter cited as Ason (1977)].

58. *Id.*

59. *See*, Explanation Report (1976), *supra* note 55, at 282.

60. *See* notes 47 & 53 *infra*. The U. S. Treasury most recent Report is the one cited in note 4 (1983).

61. *See* D. Surrey, *Tax Incentives As A Device For Implementing Government Policy: A Comparison With Direct Government Expenditures*, 86:4 Harv. L. Rev. 705 (1970) [hereinafter cited as Surrey (1970)].

62. *See*, Sneed (1965), *supra* note 1, at 575.

wants and aspirations[63]. But mainly, taxation has a tremendous impact upon economic stability, thus the government should adopt those fiscal measures that are best suited to achieve its economic objectives[64]. In designing systems related to fiscal measures desired, the following guidelines should be considered[65]: to achieve a dependable tax yield the base upon which a particular level is assessed should consist of stable and easily identifiable features of the social and economic order; the design of the structure, considering both the tax base and the applicable rates, should impose a burden sufficiently light and compatible to prevent substantial distortion of those features which constitute the base; the pain of paying taxes should neither be maximized nor eliminated; the use of the taxing power to encourage or discourage specific conduct requires both intelligence and restraint; the allocation of the tax burden should reflect the political, social, and ethical aspirations of dominant groups.

Once the above guidelines have been observed, fiscal policies can be implemented as possible solution to national or state problems, particularly through income tax incentives[66]. The present federal income tax contains many tax incentives provisions which have been adopted to assist particular industries, business activities, financial transactions, and others[67]. These special provisions of the federal income tax system which represent government expenditures made to achieve various social and economic objectives are known as "tax expenditures", and provide deductions, credits, exclusions, exemptions, deferrals, preferential rates and others, to serve ends similar in nature to those served by direct government expenditures or loan programs[68]. These are also used as tax incentives to induce certain voluntary activities or behavior in response to the monetary benefit available[69].

63. *Id.*, at 596.
64. *Id.*, at 591.
65. *Id.*, at 567.
66. *Contra*, S. Surrey (1970), *supra* note 61, *at* 705: "Professor Surrey argues that the tax incentive is generally inferior to the direct subsidy as a means of achieving social goals: that incentives are usually less equitable, since they benefit persons in high tax brackets most, and more difficult to develop and administrate, since they are handled by tax committees and administrative agencies which have little expertise in non-tax social policy. He suggested then a strong presumption against their use". *See also*, Surrey & McDaniel (1979), *supra* note 2.
67. *Id.*
68. *Id.*, at 706. "Essentially, the tax expenditure concept, as applied to an income tax, regards such a tax as composed of two distinct elements. The first element contains the structural provisions necessary for implementation of a normal income tax. These structural provisions include the definitions of net income; the specification of accounting periods; the determination of the entities subject to tax; and, the specification of the rate schedule and exemption levels. These provisions compose the revenue raising aspects of the tax. The second element consists of the special preferences found in every income tax system. These special preferences, often called tax incentives or tax subsidies, are departures from the normal tax structure, designed to favor a particular industry, activity or class of persons. Tax subsidies partake of many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates". Surrey & McDaniel, *supra* note lA, 227-28, 232-33; & 246.
69. *Id.* at 711-712.

Since "tax expenditures" constitute a revenue loss to the U.S. Treasury, the Congressional Budget Act of 1974 requires a listing of all these implemented in the United States budget[70]. The Act defines tax expenditures as:

> "...those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability;...[71]

A 1978 Senate Budget Committee Report explains the intent of listing and measuring federal tax expenditures, as follows[72]:

> "The listing of a provision as a tax expenditure in no way implies any judgement about its desirability or effectiveness relative to other tax or nontax provisions that provide benefits to specific classes of individuals and corporations. Rather, the listing of tax expenditures, taken in conjuction with the listing of direct spending programs, is intended to allow Congress to scrutinize all federal programs – both nontax and tax – when it develops its annual budget. Only if tax expenditures are included will Congressional budget decisions take into account the full spectrum of federal programs. Because any qualified taxpayer may reduce tax liability through use of a tax expenditure, such provisions are comparable to entitlement programs under which benefits are paid to all eligible persons. Since tax expenditures are generally enacted as permanent legislation, it is important that, as entitlement programs, they be given thorough periodic consideration to see whether they are efficiently meeting the national needs and goals that were the reasons for their initial establishment".

Section 936 clearly comes within the definition of a "tax expenditure". In this sense, it refers to the tax an exempt local subsidiary would pay if it were producing the same output but taxed at the full U.S. rate.

"Tax expenditures" such as the section 936 policy have been defended by public and private interests on various grounds. Some favor the point

70. Tresury Report (1980), *supra* note 4, at 32. *See also* Surrey (1970), *supra* note 61, at note 2; Surrey & Mc. Daniel, *The Tax Expenditure Concept And The Budget Reform Act of 1974*, XVII:5 Boston College Ind. & Comm. L. R. 679 (June, 1976); P.R. McDaniel, *Tax Expenditures In The Second Stage: Federal Tax Subsidies For Farm Operations*, 49 So:Cal L:R 1277, (1976)... The primary task with respect to these tax expenditures is no longer identification in a conceptual framework. Attention must turn instead to evaluation of tax expenditures, both in terms of their effieciency and equity and in terms of their relationship to direct expenditures programs. That is, Congress in its regular legislative process must recast these tax expenditure programs as direct spending programs and evaluated them just as it does direct spending programs.

71. *Id.*, Treasury Report.

72. *Id.* An excellent table analyzing tax expenditures as a direct revenue loss appears in Surrey (1970), *supra* note 61, at 709-11. *See also*, Surrey & McDaniel (1979), *supra* note 2, 226-27.

that they achieve a particular purpose, claimed to be desirable, other than the measurement of net income under an income tax[73]. Other sponsors simply assume that if the benefit sought is helpful to them in reaching a desired result, the incentive is in the public interest[74]. Supply-side theorists affirm that tax [incentives] for business and individuals also cause changes in relative prices and consequently affect the allocation of resources, the alternative of economic units, and real economic activity[75]. Some other advantages of tax incentives (or expenditures) are: tax incentives encourage the private sector to participate in social programs; tax incentives are simple and involve far less Governmental supervision and detail; tax incentives promote private decisionmaking rather than government-centered decisionmaking[76]. Some asserted disadvantages of tax incentives (or expenditures) are: tax incentives permit windfalls by paying taxpayers for doing what they would do anyway; tax incentives are inequitable...; tax incentives distort the choices of the marketplace and produce unneutralities in the allocation of resources; tax incentives keep tax rates high by constricting the tax base and thereby reducing revenues; tax expenditures complicate enormously the task of tax administration; and, others[77].

Notwithstanding the different attitudes toward tax incentives (or expenditures) as means to achieving desired results, the adoption of any such policy must be delivered in harmony with the purposes which have shaped throughout the years the rates and structure of the federal income tax. These are: to supply adequate revenue; to achieve practical and workable income tax system; to impose equal taxes upon those who enjoy equal incomes; to assist in achieving economic stability; to reduce economic inequality; to avoid impairment of the operation of the market oriented economy; to acomplish a high degree of harmony between the income tax and the sought-for political order; and economic growth[78]. Finally, tax exemption techniques must be devised as to assure a proper balance between taxes paid and benefits received, that is, within the fields of cost-benefit and cost-effectiveness analysis, so that the objective can be accomplished without disturbing the forces of supply and demand in the market no more than necessary[79]. It is within the above contex that the section 936 policy will be analyzed below.

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73. *Id.* Surrey, (1970) at 707.
74. *Id.* at 713.
75. *Supply-Side Economics: Reality and Outlook*, Economic Bulletin, Puerto Rico Planning Board (March 1981), reproduced in P. R. Buss. Review 19 (July-August, 1981).
76. S. Surrey (1970), *supra* note 61, *at* 715-19; *See also* M. Ramírez, *Exención Contributiva Industrial de Puerto Rico — Réplica*, 38:4 Rev. Col. Abog. P. R. 486, at 487 (Nov., 1977).
77. *Id.* Surrey, at 715-26; *See generally*, Surrey & McDaniel (1979) *supra* note 2, at 253-80.
78. Sneed (1965), *supra* note 1, *at* 568.
79. *Id.*, 568. *See also* Surrey (1970), *supra* note 61, at 714.

B) Section 936 — Cost-Benefit Effects

As stated before, Congress's two main objectives in adopting section 936 were to permit repatriation of profits of local subsidiaries back to U.S. parent corporations prior to termination of their respective tax exemption periods; and, of relevant importance to Puerto Rico, to induce U.S. corporate investment in active trades and business locally. The new provision exempted income generated by 936 business operations in Puerto Rico and it went so far as to treat as tax exempt income the profits made from retained earnings reinvested in P.R. giving the government the opportunity to stimulate investmen of 936 funds locally. In 1976, the costs of this policy in general terms were the foregone tax revenues for the U.S. Government, and the local Treasury's lost revenue for not taxing the 936's corporate income fully. The then expected benefits were primarily: additional employment generated by these corporations; multiplier impacts of 936 corporate expenditures (employment, savings, local purchases); increase in local Treasury's revenues via personal income tax paid by new employees; and, investments by 936's in local public works, mortages, commercial paper and loans. Seven years have passed since the enactment of section 936, from which an analysis can be made to determine whether Congress objectives have materialized and how good of a tax policy is section 936.

More than $7 billion have been invested in Puerto Rico since the enactment of section 936 in 1976[80]. For local banks this figure means more than one third of their deposits[81]. But, more than fifty five percent of all those deposits have gone to the three larger banks —Banco Popular, Chase and Citibank[82]. Thus, most native banks (except for Banco Popular) are not having much access to direct deposits of 936 money, and are unlikely to receive much more than currently[83]. Some analysts propose that the problem with this tendency is that some of these larger banks may be conservative by nature in their policies, and therefore, may tend not to channelize these resources toward productives ends[84].

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80. Treasury Report (1983), *supra* note 4, at 59, & 69. *See generally* Treasury Report (1980), *supra* note 4, at 69 *et seq.* Treasury Secretary Carmen A. Culpeper, *Culpeper Defends 936, Wages, Fewer Reports,* The San Juan Star B2 (Dec. 26, 1982). *See:* Appendix A Distribution of 936 Deposits Among The Banks In P. R. as of Dec. 31, 1982; Appendix B — 936 Funds in P. R. Banking Industry Resources & Deposits.

81. *Id.,* Treasury Report (1980) *See* Table showing where investment goes. Currently the 936 poll contains about 36 billion-funds available for productive investment in Puerto Rico, $4.9 billion of which are placed in the commercial banking sector. *Id.,* Culpeper. *See also,* C. Beardsley, *Fondos 936 en Sistema Banca Comercial de la Isla Ascienden a $5.200.* millones, El Mundo 7B (may 31, 1982). *See also,* Treasury Report (1983), supra note 4, chapter 4.
Appendix A; Treasury Report (1983), *supra* note 4, 89-91.

82. *See also:* L. Costas (Feb., 1980); *supra* note 18, at 132-34, Baird (1980), *supra* note 16, at 122-23; J.P. Rice, *Chase should benefit from loans, rates,* The San Juan Star Ba (July 24, 1983).

83. *Id.,* Costas, at 134.

84. *See* Ason, (1977), *supra* note 58, at 8. *See also,* Treasury Report (1983), *supra* note 4, at 89.

The increment in deposits from 936 corporations should have consequently reflected an increment in the credit supply for construction, commerce and industry[85]. Additionally, it should have reflected a noted improvement in the general credit conditions through a reduction in interests rates or other credit terms, and a reduction in the existing limited credit available to the residents of Puerto Rico[86]. Unfortunately, the inflow of funds from these 936 corporation into Puerto Rico is having to some extent rather a depresing influence due to limited investment opportunities on the island[87]. The real fact is that the Puertorican economy cannot provide sufficient investment opportunities to absorb the earnings of all the possessions corporations operating in Puerto Rico[88]. As a result, more 936's earnings are being repatriated earlier than otherwise, notwithstanding the tollgate tax imposed on these by the local government[89]. Moreover, the earnings that are invested in Puerto Rico have three basic characteristics which have precluded that these have a more direct impact on the economic development of Puerto Rico: low risk, liquidity, and short term maturity[90]. As a result banks are not having too much long-term transactions, while investing funds deposited with

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85. *Id.*, at 3.
86. *Id.*, at 1&3.
87. *See*, Costas (Nov., 1978), *supra* note 6, at 668: *See also*, B. Klingman, *The '76 Act Hits The Tropics: The Improved Investment Climate In Puerto Rico*, Tax Adviser 12, at 17 (Jan., 1977) [hereinafter cited as Klingman (1977)]; *las 936*, El Nuevo Día; primer plano 7 (June 20, 1982). *But see*, Culpeper, *supra* note 80: "In addition, the existence of such a large pool of funds tends to lower the cost of borrowing locally. The differential between the Puerto Rico CD rate and the Eurodollar rate has increased since the imposition of our new regulations on the use of 936 funds last February. Of course that differential appears smaller in absolute terms at lower interest levels, but in proportional terms it is still increasing. In November 1982, when the Eurodollar rate averaged 9.7 percent and the 936 rate averaged 5.7 percent, the differential was 400 basis points — a significant advantage for investor in Puerto Rico.

The all-important liquidity afforded the Puerto Rico financial system by this pool of funds has uses beyond direct lending. However, in recent months the existence of 936 funds and the consequent availability of low-cost financing has made possible the solution of a significant number of banking problems and has reduced to a minimum the failures of financial institutions in Puerto Rico. Thus the benefits of 936 funds to banking transcend the local economy and are of significant import to Federal bank regulation agencies such as the FDIC and FSLIC. They have been able to solve problem bank situations without actual deposit payments from their insurance funds.

88. *Id.* Klingman; A. Patureau, *936 mortage rules "too stiff"*, The San Juan Star B1 (Jan 16, 1983). Notwithstanding, more investment opportunities through government planning are being offered presently by the local Administration. *But see*, Treasury Report (1983), *supra* note 4, at 6-7, 69, & 106.
89. *Id.*, Report (1983), at 130. *See* Costas (Nov., 1978), *supra* note 6, at 668. *See also*, J. Oyola, *How to lower P.R. interest rates to 5%*, The San Juan Star B3 (July 17, 1983), proposing some ideas to succesfully channeling 936 funds into long term investments in P.R.; A. Patereau, *Treasury probing "936" deals*, The San Juan Star B1 (Sept. 18, 1983). 936 corps. repatriated a record $2 billion to the U.S. in the fiscal year ended June 30.
90. C. Figueroa, *936 Financial Intermediation And The Development Of The Service Industries*, P.R. Buss. Rev. 16, at 17 (Special Supp. July-August 1981). *See* comments by M. Mier, Beardsley, *supra* note 81.

them outside Puerto Rico through some technical mechanisms they have discovered. The U.S. Treasury Department admits that "there is little evidence that the increase in funds has had any significant effect on the total availability of credit, or long-term interest rates, in Puerto Rico"[91]. Therefore, the prevailing economic environment shows a situation of unbalance with an excessive supply of funds available for short term investment, great need for local long term investment, and no actual adequate institutional mechanism available to channel effectively the 936 funds in order to get the most benefits for the local economy[92].

One other area where the effectiveness of section 936 policy has been questioned by some competent authorities is the one related to employment. The 936 corporations in Puerto Rico have failed to resolve the problem of chronically high employment in Puerto Rico[93]. This is due to several factors. First, most of the 936 corporations that establish a subsidiary in Puerto Rico are not labor intensive, maybe because of the federal minimum wages which apply locally, although this can be overcome easily by the tax exemptions. Also, some of these industries bring top personnel from outside Puerto Rico. In addition, in most of the cases the operations of the industries that relocate in P.R. are specific segments of a larger process of production. As one specialist noted:[94]

> "What the aforesaid studies of Fomento have failed to realize or take into account is that possession corporations mostly are

91. *The Operation And Effect Of The Possessions Corporation System Of Taxation*, Second Annual Report, Department of the Treasury (June, 1979), *But see*, M. Escobar, *Problems of channeling 936 funds*, The San Juan Star B 6 (Feb 20, 1983). Probably, the fact that Congress has shown a tendency to supervise continously the 936 policy and make changes to it, has affected also the determination by 936 corporations to make long term investments locally because of the degree of uncertainess involved.

92. One institution that could assist in the investment of 936 funds properly is the Government Development Bank. *But see*, J. O'Neill, *Is GDB investing 936 funds properly*, The San Juan Star Bl (Oct, 24, 1982). *See* A. L. Seda, *Creativity, consensus needed on 936*, The San Juan Star B4, March 13, 1983. The local Treasury has taken some regulatory steps to improve this situation —e.g.: R. Arrieta, *Fondos 936 para la construcción de viviendas*, El Nuevo Día, primer plano 4 (Dec. 1, 1982) In addition, the Banking Regulations which became effective February, 1982 were intended to help with this problem although long term effect is somewhat less certain. *See generally*, Treasury Report (1983), *supra* note 4, 78-87. *But see*, T. Sella, *P.R. rated safe for investors over short term 2*, The San Juan Star (May 19, 1983); A. Patereau, 936 incentive urged affecting mortgages, The San Juan Star 32 (Sept. 2, 1983). An economist proposed a new 936 incentive that would reduce or eliminate the tollgate tax on repatriated profits in exchange for the 936 corps making a substantial investment in P.R. mortgage instruments.

93. *See generally*, Costas (Nov., 1979), *supra* note 6; Costas (Feb. 1980), *supra* note 18, *at* 131. Notwithstanding 936 corporations now provide 40% of all local manufacturing jobs according to a study by the island Treasury Department. *See also* J. Omang, *P.R. Views Tax Bill As Spoiler of Island's Economy*, The Washington Post Al, (August 2, 1982). Of course, most of these corporations were established in Puerto Rico before 1976.

The Fourth Treasury Report estimates 936 employment in P.R. in 1980 at 72,000. *Id.*, Treasury Report (89-83) at 7. *Id.*, at 118-119 for Estimate on Forward & Backward Linkages.

94. Costas, (May, 1980), *supra* note 22, at 266-7.

> subsidiaries of multinational parent companies and that their operations in Puerto Rico are only specific segments of a larger process of production performed by the total corporate family. For the Puerto Rican operations the multinational parents select a discrete portion of such process, incorporate that portion and thereinto shift much of the familial profit. In the case of pharmaceutical companies that discrete portion involves mixing to produce patented drugs and in the case of electrical and electronic equipment businesses it involves assembling, or sub-assembling to produce patented equipment. Such mixing or assembling requires only a specific pre-determined plant. Its original size has been chosen for economic optimality and psychological credibility —to perform the desired portion most efficiently and not tie down the possession corporation to Puerto Rico, thereby presenting a credible threat to leave Puerto Rico in negotiating from the Puerto Rican government additional exemption decrees and other concessions. Accordingly, beyond the initial plant construction and purchase of the original equipment, the Fomento exempt possession corporations have little need or desire for concrete expansion".

Tax expenditures costs in a ratio compared to employees hired by 936 corporations can also seem to demonstrate the previous assertions. In 1978, nine companies for which the federal tax expenditure represented more than $100,000 per Puerto Rican employee, accounted as a result for 11.4 percent of the total tax expenditures but only 1.3 percent of the employment of the companies for which employment data were available[95]. Thus the mechanics of the 936 policy presently allow an exagerated balance in cost-benefits for different corporations.

One other negative consideration is that the cost of the 936 policy as a tax expenditure has been too high as compared to its local effects. The 936 policy is among the ten highest corporate tax expenditures in the Internal Revenue Code[96]. In 1977, the 936 tax expenditures estimate was $641 million[97]. In 1978 it was estimated at $840 million[98]. In fiscal 1981 these were $1,278 million, and are estimated at $1,373 million for fiscal

95. Treasury Report (1980), *supra* note 4, at 51. The U.S. Treasury estimated that the revenue loss for each job created is so high that the federal government would save money if it simply paid the workers' wages directly instead. In the case of drug companies, the Treasury is losing more than $3 in taxes for each $1 in wages paid to a worker. But all these benefits have been decreased since the 1982 amendments to 936. A. Patureau, *936 revamp will hit drug firms hardest*, The San Juan Star B1 (August 1, 1982).

96. Costas (Nov., 1979), *supra* note 6, *at* 564. *See also* R. Sierra, *Possessions Corporations: Critique of Treasury Report*, Int. Tax J. 14, at 18 (1980). In 1980, Federal tax benefits per Puerto Rican employee averaged $17,186. Treasury Report (1983), *supra* note 4, at 113.

97. Treasury Report (1980), *supra* note 4, *at* 10, n. 6.

98. *Id.*, at 34.

1982[99]. For several reasons, some argue that section 936 constitutes a misguided and ineffective expenditure of federal funds[100]. Mainly, the fact that this is an exemption on corporations that have easy ability to pay taxes, most of which are listed in Fortune 500[101].

The above analysis demonstrates that the local and U.S. Government expectations with the adoption of section 936 were high within the context of employment and other benefits to Puerto Rico, although not from the point of view of increase in money supply to the mainland due to the now allowable annual repatriation of profits[102]. In fact some companies are taking back annually as much as $43,000 in profit per island job. [103] Possibly one reason for experiencing incongruent results may be the fact that no matter what economic policy is adopted to assist the local economy, the different economic variables afecting the forces of supply and demand in the Commonwealth of Puerto Rico are different than those in the mainland. But this argument leads ultimately to other considerations which relate in turn to the different political status alternatives for Puerto Rico. Thus, within this reality the best advantages must be presently sought to improve the economic condition of the island. Notwithstanding, 936 policy has had some favorable effects locally, to the extent that its derogation would be negative to the economy within the present political status. Currently, one third of income tax colections, and a significant fraction of local gross product are directly traceable to the 936 corporations. The following excerpt from Treasury Secretary Carmen Ana Culppeper's testimony, December 15 on section 936 before a U.S. House subcomittee on banking, finance and urban affairs, is quite revelant:[104]

> Though 936 firms are effectively exempt from U.S. taxes on their Puerto Rico source earnings they are not fully exempt from Puerto Rico taxes, and of course personal income resulting from their operations has always been fully taxable.
>
> The result is that the Puerto Rico Treasury now depends to a great extent on revenues stemming directly from 936 operations. In fiscal year 1982, about 15 percent of our General Fund revenues resulted from such direct operations, not counting secondary effects such as tax revenues from local suppliers of 936 firms and other multiplier effects.

99. Treasury Report (1983), *supra* note 4, at 101. Costas (Nov., 1979), *supra* note 6, at 564.
100. *Id.*, at 587.
101. *Id.*, at 563. *See also*, T. Doulan, *Tax Headache Strikes*, Barron's 11 (April 13, 1981).
102. *See*, *The 1982 Amendment to IRC Section 936*, P.R. Bus. Rev. 1 (Sept., 1982).
103. J. Omang, *supra* note 93. *But see*, H.L. Friedman, *Travenol reveals 936 impact*, The San Juan Star B1, (May 1, 1983) —"During 25 years, $256 million in taxes were waived while $630 million was pumped into P.R. economy."
104. Culpeper, *supra* note 75. *See also*, J.R. Madera, *The Impact Of The Possessions Corporation System Of Taxation On The Economic Development of P. R.*, 1983 Court of P.R., Econ. Development Administration.

Another revenue source stemming directly from the 936 system is the so-called "tollgate tax", paid on 936 earnings as they are repatriated to the U.S. This tax operates as a postponed income tax and can be adjusted depending on prior uses of funds and the length of time they remain in Puerto Rico.

Obviously such a tax is useful for more than revenue generation, serving as a control for the use of 936 funds while on the island and a valve for their flow from the island. Currently we receive about $80 million per year in revenues from this source, about 4 percent of our General Fund.

The uses of these funds and their effect on the cost of capital in Puerto Rico are impressive. Our own Industrial Incentives Act, in conjuction with Puerto Rico Treasury regulations issued last February, strictly regulates the uses to which 936 funds must be put in order to qualify for favorable "tollgate tax" treatment. Generally they must be invested locally in elegible activities, which include productive assets, public financial instruments, or qualifying mortages, directly or through local financial intermediaries.

Nearly half the $6.9 billion in total eligible activity —$3.2 billion— is in commercial loans, about one quarter is in government obligations, another 16 percent is in mortages, and the remainder is in other development— related investments. Much of this activity would not exist without Section 936 and without conscious regulation by the Puerto Rico Treasury.

Even more important as a revenue source is the personal income tax resulting from 936 payrolls. During 1982 we expect to receive $240 million in personal income taxes from employees of 936 corporations, about 11 percent of our General Fund revenues and more than one third of our total personal income tax.

Most economists estimate the employment multiplier of 936 firms at 2.5 or higher. Thus the effect on our fiscal system is very significant, probably accounting for more than two thirds of our personal income tax collections.

These figures indicate more than just the importance of Section 936 to the Puerto Rico Treasury. They should show you an increasingly efficient fiscal system — a Treasury increasing its 936 — based revenues even though the economy is in recession and is adjusting to production under the corporate income tax. Neither of these developments would be possible without the stable and favorable climate of the Possessions Corporation Taxation System.

One other issue that may affect the local 936 investment because of the uncertainty and instability it creates is the continuous supervision of the section by Congress. A clear example of this is the fact that notwithstanding the Summer 1982 Amendments to 936, a few months thereafter we were hearing again some warnings by congressmen[105]. It is acceptable that the policy has to be evaluated periodically by the U.S. Treasury Department as other tax policies are. But there must be a feeling of stability and credibility for the policy to work effectively.

Althoug it is "not impossible" that section 936 be repealed, it is improbable. On the one hand, the tax expenditures of 936 may not be viewed as a Federal expenditure. Rather, if such corparations were fully taxed in Puerto Rico or elsewhere, the United States would anyway allow a foreign tax credit for income taxes paid to these countries. (Thus, these would be foregone taxes to the U.S. Treasury anyway). In addition, the U.S. money supply in a way is more solid today under 936 than under section 931 because of the current repatriation of earnings, a policy that the U.S. will undoubtedly change. Possession Corporations in Puerto Rico will not move their operations to other foreign countries because of the earnings, reinvestment, and repatriation benefits of 936. Nor will they move back to the mainland to pay full income taxes[106]. Notwithstanding, the applicability of a tax policy similar to U.S. IRC 936 would be different under each of the three possible political status alternatives for Puerto Rico. [106A]

105. *Dole: 936 compromise "too generous"*, The San Juan Star 1 (Aug. 5, 1982); P. Serralles, *Drugs stocks affected by Section 936 threat*, The San Juan Star B8 (Dec. 5, 1982); J. Simon, *Aplazan un gigante projecto 936*, El Nuevo Día 3 (Dec. 3, 1982); A. Patureau, *Dole letter stirs hope, doubt at 936 meet*, The San Juan Star B1, (Nov. 21, 1982); *See*, Senator Dole letter to Treasury Secretary Regan of October 20, 1982 — "...there is continuing Congressional concern that even the revised section 936 may not be adequately targeted..." This Congressional attitude towards the 936 policy has been critized by U.S. and P.R. Treasury officials which have stated the need for certainty of tax treatment as essential for U.S. investment in Puerto Rico. A. Patureau, *Treasury official urges Congress to delay any planned 936 changes*, The San Juan Star 3 (Nov. 20, 1982); *See*, Culpeper, *supra* note 75. *Also*, K. Wagenheim, Budget Office takes 936 off its "hit list", Caribbean Business 5 (March 9, 1983).

106. *See*, Treasury Report (1980), *supra* note 3, at 61-2. In fact, after the 1982 amendments 40 plants in P.R. announced plans of expansion: R. Merino, *40 Empresas Planean Expandirse*, El Mundo 1 (agosto 17, 82). It is improbable that Congress will attempt to review the amended version of 936 before the 1984 Presidential election. Next Congressional Review may not reppeal the section but may introduce amendments that will relate the 936 credit to the creation of direct employment, and to regulate the qualified Possession Source Investment Income. *See also*, Treasury Report(1983), *supra* note 125-129, & 50; F. M. Andic, *936 has subtle advantages for U.S.*; The San Juan Star B3 (June 19, 1983).

106A Independence —

Under this political status, section 936 would not apply to Puerto Rico. The income taxes paid to the local government by foreign investors —*e.g.*, U.S. Corps. doing business in P.R.—could get a tax credit in their respective countries.

Commonwealth —

Under this political status, the continual applicability of section 936 is not guaranteed absolutely. However, it is improbable that it be repealed because it constitutes anyway foregone tax revenues to the U.S. Treasury. If repealed, the U.S. corps. doing business locally would get a tax credit for income taxes paid to P.R. Also, legal constitucional

Finally, although it is favorably argued that tax incentives (as 936) are basic to the economic development policies of Puerto Rico, it is also argued that these have not placed the island in a competitive level with southern states in relation to: market access; good transportation system; availability of raw materials; low cost of energy; excess labor demand at lower wages; lower state taxes; and favorable industrial climate (relating to labor laws and labor tendency to unionize). [107] Notwithstanding, departing from the fact that we have to consider demand and supply variables within our present political status, the United States Government should also consider implementing additional policies (e.g.- considering that the people of Puerto Rico are American citizens, an increase in direct expenditures to Puerto Rico in a way equal to the 50 states) to offset the above disadvantages. These would further contribute to the solution of local problems and make the island a more competitive site for outside investment.

C. Government Direct Expenditures — An Alternative

As previously mentioned, Government may use "direct expenditures" such as grants, interest subsidies, direct federal loans, federal insurance or guarantee of private loans, and others to accomplish the purposes and objectives which the special tax provisions seeks to achieve or encourage[108]. Authorities seem to be divided in proposing which policy may be more effective and appropiate for Government to adopt in its social and economic pursuits — some argue tax expenditures are more effective than Government direct expenditures and vice versa[109]. It is argued by supporters of Government direct expenditures that... "the cause of informed and efficient government is advanced by eschewing tax concessions in favor of direct goals"...[110] In this sense, it is suggested that the administration of tax concessions is normally a less exact process than exists when the program is one related to governmental funds because they

issues could arise because of the applicability of Federal taxes to income from sources within P.R.

Statehood—

Section 936 would not be repealed automatically because P. R. becomes a states of the Union. The agreement of incorporation between the U. S. and P. R. could provide for its continuity for many years. In addition, P. R. would benefit from: increased participation in federal programs; political stability; perpetual accesibility to the U. S. market; and, others. Many of the local capital intensive industries would not leave the island overnight to other countries with doubtfull political stability, or to the mainland, where variable costs may be higher.

107. *See* Costas (May 1980), *supra* note 22; Treasury Report (1983), *supra* note 4, at 44; M. Bhatia, Effects of recession: P. R. vs. Southern States, The San Juan Star B2 (June 19, 1983).

108. Note 61 *infra*. On the other hand, tax expenditures represent use of the tax system to provide financial assistence.

109. *Compare* Surrey (1970), *supra* note 61, *with*, *Sneed* (1965), *supra* note 1, at 602-04. *See also*, Surrey and McDaniel (1979), *supra* note 2.

110. *Id.*, Sneed at 602.

involve less negotiation of the arrangements, less suspension, less red tape, no new bureaucracy and so on. Two local tax expenditures that have been critized by some on grounds of supervision are: the administration by the U.S. Treasury Department of section 936 possessions corporations which some say can liberally decide when, where, to what extent, and in what way they want to enjoy the benefits of the section; and the administration by Fomento of the exempted industries in Puerto Rico with its lack of appropiate records[111]. To the contrary, tax expenditures are supported by those who critized the government intervention as expensive and bureaucratic[112].

Moreso, it is also argued that the administration of tax expenditures programs involve a certain degree of waste, carelessness, and even dishonesty, otherwise inconceivable in direct expenditure programs[113]. Some are for the proposition that these programs allowed undeserved deductions and tax credits, affording greater benefits to the rich[114]. Senator Kennedy has opposed vigorously the section 936 policy, precisely on these similar arguments. He once said in relevant part as follows[115]:

> "In anticipations of the enactment of Section 936 many possessions corporations are placing as much as possible of their earnings in a liquid state so as to cash in on the benefit of immediate tax-free distribution if Section 936 is enacted. Many are motivated by a widespread belief that any enacted Section 936 will not last very long, but would be repealed when Congress woke up to its real effects. They want therefore, to be ready to take advantage of the new Section 936 gift while they can. In fact, lurking beneath the desire to cash in on a new Section 936 is the worry that when its generous benefits combined with the exemption benefits of Section 931 become fully known and the financial reports of the beneficiaries of this moneymaking machine are scrutinized —really for the first time — the whole scheme will crash down. They thus are hoping they can obtain Section 936 without Congress looking into Pandora's Box that contains the Section 931 exemption. For that Pandora's Box would disclose the tax windfalls that U.S. multinationals are obtaining under even the present tax exemption."

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111. *See* Costas (Nov. 79), *supra* note 6, at 566-7; and, Costas (Feb. 80), *supra* note 18, at 104-5. Notwithstanding, the 1982 amendments to section 936 may invalidate this claim.

112. *See* Sneed, *supra* note 1, at 603. For a comparison of tax expenditures & government direct expenditures in the United States *see* Surrey (1970), *supra* note 61, at 711; of course, they are also favored by those benefiting from them. *See also:* Surrey & McDaniel (1979) *supra* note 2; H. Fridman, *Main cry to Cof C: "Push Tax Reorm"*, The San Juan Star B1 (june 12, 1983).

113. *See* Sneed (1965), *supra* note 1, at 602.

114. *Id.* A deeper analysis about the real affects can be found in: Surrey & McDaniel (1976), *supra* note 70. Also the tax expenditure policies may raise constitutional issues. (pg. 707). Surrey & McDaniel (1979), *supra* note 2.

115. Reprinted in Sierra (1978), *supra* note 49, at 840.

Notwithstanding, the effects of the above statements can be positively reduce if such tax expenditures are effectively scrutinized by the legislative and executive branches, or are subject to annual budgetary review processes[116]. Finally, it is argued against tax incentives that these greatly decrease the ability of the Government to maintain control over the management of its priorities[117].

In relation to section 936 policy and within the above context, the determination of whether it is more effective or appropiate than a federal government policy of direct expenditures depends on various factors. First, one has to question whether the governmental goal which led to the adoption of the policy is an appropiate one (Evidently in the case of section 936 this has to be answered in the affirmative)[118]. Then comes the question of — to what extent will the tax approach or the direct approach achieve the desired objective[119]. Next, comes the analysis of determining that if both approaches are viable, which is more effective[120]. In this respect, it is important to know, whether there is money available to apply alternatively a direct expenditure policy. Another important issue is whether the government is interested in more direct supervision to solve the problems of Puerto Rico (as through with direct assistance) or if it is willing to have the private sector participate by providing solutions with economic ventures. Other considerations involve the possibility that the problems caused in the legislative process and in tax administration would be present under either approach[121]. But also, in the case of Puerto Rico, with its own peculiar economic and political status situation, a joint policy approach, both of tax and direct expenditures right prove to be more effective, if implemented with maximum considerations to the local reality. In summary, any change in policy to ward tax expenditures or government expenditures or to both, has to be as a result of a prior

116. Compare Sneed (1965), *supra* note 1, at 602 *with* Surrey (1970), *supra* 61, at 730.
117. *Id.*, Surrey, *at* 730.
118. *See generally*, Surrey & Mc Daniel, *supra* note 2, at 251.
119. *Id.* To what extent the tax approach has achieved the desired objective or result has been analyzed in this paper. To what extent the direct approach can achieve the desired result as an alternative to the 936 policy can be determined analogaly by examining how effectively other direct investment policies have worked in Puerto Rico, or elsewhere. Promotion of certain economic sectors, as the one of employment, is much better handle in a free enterprise system as ours, by channeling policies through the private sector. In this case with a policy equal or similar to section 936. A report on how much the Federal government is spending now in Puerto Rico, and on what programs, can be found in: K. Wagenheim, *What the Feds spend to aid Puerto Rico*, Caribbean Buss. 2, (March 9, 1983). ..."Federal expenditures in Puerto Rico can be sub-divided into four major categories: 1) grants to state and local governments; 2) salaries and wages paid to Federal employees; 3) direct payments to individuals; 4) procurement... Comparisons of per capita Federal expenditures by state and territory show that P.R. received only $1,422 per capita in Federal aid during Fiscal 1982, compared with a nationwide average of $2,591. *See also*, K. Wagenheim, Caribbean Buss. 2 (March 9, 1983). *See* Appendix D.
120. *Id.*
121. *Id.*

cost-benefit cost-effect analysis of each of the alternatives proposed. This is the real test.

V. Conclusion

Seven years of experience with the 936 policy have served to measure to some extent how certain were the expectations of Congress in its adoption. Unquestionably, the change in policy from section 931 to 936, providing for current repatriation of profits rather than at liquidation of the possessions corporation, helped increase the money supply of the U.S. economy. Although, it has been argued that section 936 is too costly as a tax expenditure for the Federal Treasury, it can be questioned whether this may be exaggerated for several reasons. On the one hand, such corporations if fully taxed in Puerto Rico or elsewhere would be entitled anyway to a tax credit for such paid income taxes. On the other hand, the direct benefits to mainland corporations because of the credit (and the indirect benefits to other sectors of the economy) are of tremendous magnitude to the U.S. economy when compared to the policy as an expenditure[122]. Thus, by adopting the 936 policy, the Federal Government has successfully device a scheme that induces American Corporations to confine operations within U.S. borders (in this case P.R.) with all the direct and indirect economic benefits this represents, and which avoids outflow of funds to the treasuries of foreign countries to the extent that the income from 936 corporations would constitute otherwise foregone tax revenues. Although the 936 foregone tax revenues are not received by foreign treasuries nor by the U.S. Treasury (since it is received as income to the 936 corps), it constitutes funds within the U.S. money supply which serves in turn as a positive catalytic agent within the American economy in different ways. Moreso, this tax expenditure argument may not be as strong as before the 1982 amendment to section 936 was implemented, since the tax credit has been reduced.

From the local point of view, it would be unfair and unrealistic to say that the 936 policy has not worked effectively at all. In fact, the policy and the increase in federal aid served as a catalytic agent to postpone an economic debacle in Puerto Rico. Notwithstanding, local unemployment continues to rise and 936 corporations cannot be expected to aid with the problem much more since most are not labor intensive industries. Within this view, in its periodic revisions of the policy, Congress and the Federal Treasury Department should consider the possibility of adding to the 936 credit a variable that would relate the credit more directly to job creations by the possessions corporations.

Althoug presently section 936 needs no major changes (other than regulations for QPSII) the practical reality is that it needs to be scrutinized periodically (as any other tax policy) by the corresponding compe-

122. The Department of the Treasury of Puerto Rico should keep annual figures in relation to this matter for comparative purposes.

tent agencies to avoid abuses by elected corporations. The 1982 amendments under the "Tax and Fiscal Responsibility Act", limiting income from intangibles, is a clear example of this need. This reviews should carefully analyze for each specific period of time, the advantages and disadvantages of the policy within the contex of cost-benefit and cost-effect variables so that any suggested changes can be implemented without disturbing local supply and demand resulting from its present applicability more than necessary. But, one important factor that must also be considered by the competent authorities is that periodical scrutiny must be carried out within the perspective that the policy (as any other tax exempt policy) needs stability and credibility in order to be attractive and reliable to investors. Thus, there must be a general feeling that only minor changes (not major changes) may result in the short run (within the next few years from these)[123]. The Government of Puerto Rico should consider the preparation of a 936 Counter Report to each of the 936 U. S. Treasury Annual Report (e.g., 90 days after the publication of the Federal Report). This would offer the local Government the opportunity to respond competently and effectively to the Treasury Report. In addition, interesting parties would be much better informed.

Within the local economic perspective, in the short run and considering the actual political reality, various corrective steps can be attempted. The primary goal should be the maximum posible reduction of imports and the maximization of exports to decrease the possibility of a deficit in the balance of payments. To this end, the sector of production is important because it may reduce imports to the extent that these are produced locally in as much as possible. Also, it generates exports and thus inflow of funds. In addition, exports can be largely increased if the Government appropriates more funds to this purposes: employs adequate personnel; concentrate more effort in commercial missions and participation in international commercial activities; and, educates the people of Puerto Rico to be more economically oriented. The fact is that local people need to be aware of the potential benefits they can get in international commercial ventures[124]. The government cannot rely endlessly in only indus-

123. A reasonable strategy was the one adopted by the U.S. Treasury Department in its response to Senator's Dole letter of October, 1982. In addition, the U.S. Treasury should be very carefull in preparing the 936 Reports as required by Congress. Statements should avoid contradictions that could embarass either the U.S. Government or P.R. *See, e.g.*, Treasury Report (1983), *supra* note 4, at: 4 compared to 63; 20 — conclusive statements with evidence from a recessionary period; 32 compared to 33; 57 & 58 too hypothetical; 74; others. *See also*, K. Wagenheim, *936 corporations lukewarm toward 4th. Treasury Report*, Caribbean Bus. 7 (April 13, 1983); H. Turner, *Corrada 936 Report shouldn't alarm P.R.*, The San Juan Star 3 (May 3, 1983); A. Patereau, *Feds snipe at 936 again in new report... and Fomento chief roars a reply*, The San Juan Star B2-3 (May 1m 1983).

124. *See*, A. Patureau, *Corrada: isle trade can triple in decade*, San Juan Star 18 (May 20, 1983); C.R. Jimenez, *An Export strategy mapped for P. R. business*, The San Juan Star B6 (june 12, 1983).

124A. *See*, A. Patureau, A report about the 1983 winter season, The San Juan Star B1 — 8 (March 6, 1983). *Also*, H. Fridman, *$5 million tourism drive only so-so*, The San Juan Star B1 (July 24, 1983); H. Fridman, *Arraras vous to fight irreal tourism policies*, The San Juan Star B4 (July 23, 1983); P.

tries from the mainland to go and resolve the economic problems of P.R. The explotation of local resources should be maximized. Local investors should try to get a share of the U.S. market. Also, tourism should be heavily promoted abroad[124A], while protecting it at home by pursuing a reasonable and competitive market. Another area where the government can attempt to reduce imports with positive results is that related to energy — e.g. effective policies can be implemented to reduce the consumption of electricity, which in turn accounts heavily for the import of crude oil to Puerto Rico. In addition, (notwithstanding possible conflicting political views) considering the fact that the people of P.R. are American citizens, the Government should pursue the goal of increased participation in federal direct expenditures programs, in a manner similar to that of the 50 states. Another consideration is the one that proposes that the Government dispose of "losing businesses" such as the Navieras Shipping Line, The Telephone Co. and the Electric Power Authority[124B]

Finally, notwithstanding the possible solution and alternatives that may be brought to the aid of local problems, one must seriously consider the fact that the local political status issue will in most of the cases affect their implementation. Still, something has to be done to change the present situation and avoid an economic debacle. Within this perspective, it is time for the policy makers to realize that the variables of supply and demand are different in Puerto Rico than in the mainland. That, while the present political status continues, policies must be adopted that are viable and realistic given the peculiar characteristic of Puerto Rico. Moreso, in the case of a tax policy (as section 936) the fact that "... fashioning a tax structure requires an intimate knowledge of, and sensitivity to, the society in which it is to function..."[125].

Hernández & J. de Córdova, *Who gets what from the new tourism incentives*. The San Juan Star B9 (June 26, 1983); A. Patereau, *Big hotels outlook bleak without more incentives*, The San Juan Star B1 (June 19, 1983); C. Morales, *Tourism still a stepchild despite new law 52*, The San Juan Star B3, (June 12, 1983); H. Fridman, *Incentives Act: new day dawns for small hotel*, The San Juan Star 131 (June 5, 1983).

124B. A Patereau, *Laffel urges P. R. to adopt rest of his policies*, The San Juan Star B4 (June 12, 1983).

125. Sneed, note 1 *infra*.

APPENDIX A

ESTIMATED DISTRIBUTION OF 936 DEPOSITS AMONG BANKS AND TRUST COMPANIES WITH BANKING POWERS IN PUERTO RICO
JUNE 30, 1983 — $ THOUSANDS
SOURCE — DEPT. OF THE TREASURY

			936 DEPOSITS	
LOCAL BANKS	936 DEPOSITS	TOTAL DEPOSITS	AS A % OF TLT DEPS	AS A % OF TLT 936 DEPS
BANCO POPULAR DE P.R.	380450	2048557	18.57	7.91
BANCO DE PONCE	151102	1160159	13.02	3.14
BANCO ROIG	33111	141266	23.44	0.69
BANCO DE CAGUAS	14515	35374	41.03	0.30
BANCO COOPERATIVO	0	39149	0.00	0.00
BANCO FINANCIERO DE P.R.	0	47405	0.00	0.00
SUBTOTAL-LOCAL BANKS	579178	3471910	16.68	12.4
FOREIGN BANKS				
CITIBANK	1331296	2170583	61.33	27.67
CHASE MANHATTAN BK	1044022	2220798	47.01	21.70
BANK OF AMERICA	594583	628287	94.64	12.36
CONTINENTAL ILLINOIS	181838	328812	55.30	3.78
ROYAL BANK OF CANADA	311703	645801	48.27	6.48
BANCO DE SAN JUAN	44835	329795	13.59	0.93
BANK OF NOVA SCOTIA	168281	178805	94.11	3.50
SCOTIA BANK DE P.R.	84840	343706	24.68	1.76
BANCO DE SANTANDER P.R.	171693	737592	23.28	3.57
BANCO CENTRAL CORP.	149102	694468	21.47	3.10
BANCO COMERCIAL DE MAYAGUEZ	49724	208962	23.80	1.03
BANK OF BOSTON	96459	129315	74.59	2.00
SUBTOTAL-FOREIGN BANKS	4228376	8616924	49.07	87.87
TOTAL-ALL COMMERCIAL BANKS	4807554	12088834	39.77	99.91

TRUST CO.'S WITH BKG POWERS				
UNIVERSAL TRUST COMPANY	0	53	0.00	0.00
ESPAÑOLA DE FINANZAS TRUST	0	557	0.00	0.00
GIROD TRUST COMPANY	4549	216263	2.10	0.09
LAS AMERICAS TRUST COMPANY	0	22213	0.00	0.00
UNION TRUST COMPANY	0	27221	0.00	0.00
TOTAL TRUST COMPANIES	4549	266307	1.71	0.09
GRAND TOTAL	4812103	12355141	38.95	100.00

APPENDIX B
936 FUNDS IN PUERTO RICO
6/30/82

(Source: P.R. Treasury Dept.)

Type of Asset	*Dollar Value (Billions)*	*Percent of Total*
P.R. Bank Deposits	$ 4.7	54.0%
Invested with Brokers	1.4	16.1
P.R. Mortgages (GNMA Pools)	1.5	17.2
P.R. Government Bonds	.3	3.4
Other P.R. Assets (Mortgages, Direct Loans, etc.)	.3	3.4
P.R. Subtotal	8.2	94.3
Outside Puerto Rico	.5	5.7
TOTAL	$ 8.7	100.0%

APPENDIX C

P.R. Banking Industry Resources and Deposits
(In Millions, as of April, 1982)

(Source: P.R. Treasury Dept.)

	1978	1979	1980	1981	1982
Total Resources	$8,428.7	$8,982.8	$10,521.5	$11,757.4	$13,526.3
Total Deposits	6,762.9	7,526.0	8,637.7	9,676.4	11,324.1
936 Deposits	1,450.0	2,298.8	3,023.2	3,550.2	4,668.1
936 Deposits as a Percentage of Total Resources	17.2%*	25.6%	28.7%	30.2%	34.5%
936 Deposits as a Percentage of Total Deposits	21.4%*	30.5%	35.0%	36.7%	41.2%

*Estimate

APPENDIX D

(El Nuevo Día 4, April 10, 1983)
FEDERAL FUNDS TO PUERTO RICO
U.S. FISCAL YEAR (Millions of Dollars)
Actual

	1981	1982	1983	1984
TRANSFER OF FUNDS	2,858.2	3,035.0	3,078.0	3,186.6
EXPENSES BY FEDERAL AGENCIES	545.7	605.5	693.7	777.8
EXCISE/CUSTOMS	316.7	293.6	331.0	465.0
DESIGNATED AID	1,104.6	991.8	990.6	1,021.8
OTHERS	45.8	41.1	41.4	42.4
TOTAL FEDERAL FUNDS	$4,871.0	$4,977.0	$5,134.7	$5,493.6
PAYMENTS — P.R. to U.S.	949.0	961.0	997.6	1,046.5
NET FEDERAL FUNDS	$3,922.0	$4,016.0	$4,137.1	$4,447.1

APPENDIX B

"TAX CONTRADICTIONS WITHIN THE ACTUAL POLITICAL STATUS OF PUERTO RICO --U.S. TAXATION WITHOUT REPRESENTATION"

I. INTRODUCTION

Government tends to encourage the creation of capital in almost every sector of the economy by resorting to different policies. Usually, it will decide for justified economic reasons to favor an activity or group through monetary assistance which may be channeled or delivered by electing from a wide range of options -- e.g. direct grants, loans, etc.[1] In addition, it may attempt to pursue this goal by dealing with the tax system, particularly by the implementation of a tax policy -- e.g., permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, special rates, other -- with the expectation that a desired result will be achieved. Thus, taxing is an institutional arrangement to cover financial expenses of government, that is, tax measures are formulated in order to finance new or expanding government activities. Within the context of taxation, its traditional objective is to raise revenues. Other objectives of taxation are:

- --alter the distribution of income among individuals
- -- influence consumer buying habits and investment practices
- -- curb inflation
- -- to stimulate private investment in plant and equipment through selective tax reductions

The above objectives have very important effects in the economy as a whole and individually in citizens. For example, heavy taxation of large incomes and modest taxation of small incomes tend to equalize the distribution of income among persons; taxing a particular commodity may have the effect of discouraging purchases from consumers, etc. In addition, the tax system may encourage or dampen incentives to produce efficiently, or may worsen or prevent serious hardships caused by fluctuations in the economy. Increases in unemployment and production exceeds in demand may be changed by lowering taxes leaving more money in the hands of consumers. Thus, the government influences the economic climate through various means, but particularly through its tax authority, which on the other hand, requires Congressional approval, within the federal context, U.S. Congressional approval.

The above analysis is important within the perspective that within the broad range of considerations the political status of Puerto Rico debate presents, the financial consideration is one of the most important. The people of Puerto Rico aspire to a way of living equal or better to that of the american citizens of the states with whom they have been related since 1898. Over the years the relationship between Puerto Rico and the U.S. has fostered the integral role of the Federal Government in the Island, influencing the public and private financial and socioeconomic development, in some cases with complex arrangements.[2] The economic and legal variables affecting rights and obligations of american citizens from the different states and from Puerto Rico are almost identical. If match each against the other, the gap comes very near to that difference of the political issue of no representation in Congress, and no participation in the electoral process of voting for the President. This political gap makes the government in relation to citizens of Puerto Rico one not of full consent by the people, since there is no real equality in national political and legislative matters.[3]

Defining the legal, political and economic differences that still exist is important in order to determine whether there is any rational basis from keeping Puerto Rico politically differently than any of the other states of the United States. Within this context, it is the purpose of this paper to analyze some existing tax policy contradictions within the actual political status of the Island which have unequal political and economic effects on the citizens of Puerto Rico, when compared to those of the states.

The Island has a separate fiscal structure, enjoying primary jurisdiction to tax Puerto Rican source income, while the United

States has secondary jurisdiction to tax the Puerto Rican source income of U.S. citizens, residents and corporations. Puerto Rico's authority to enact its own system derives from the Foraker Act of 1900. Nevertheless, there is a close relationship between the local tax rules and the federal tax rules, to the extent that in 1954 the Legislature adopted its present income tax laws based on the U.S. Internal Revenue Code of 1939.[4] The fact that the island has a separate fiscal structure with the peculiarity that local tax policies apply in most cases , that federal tax policies apply in others, and both tax policies in still other cases, makes the economic game completely different. With appropriate tax planning the citizens of Puerto Rico can legally avoid (even completely) paying annual income taxes both to the local and federal treasury.[5] In addittion, a citizen of Puerto Rico, who pays local and also federal taxes because of his income from sources within the U.S., will be contributing to a treasury that will treat him differently for purposes of federal aid programs because of the political status of the jurisdiction in which he resides.[6] Differences in economic aid, or in tax policies may disrupt an economy.[7] The continuity of the Puerto Rico political status uncertainty provokes in the decisional mental process of the residents of the Island many contradictory thoughts and feelings; for example, in those who favor statehood for Puerto Rico that as the one of desiring on the one hand statehood, and on the other hand, the acceptance of the reality that there is to some extent local federal taxation "without equal access or rights to federal congressional representation" within the Nation which they feel a part of and which they want to join. Ironically the issue of taxation without representation led the colonies to form a union and a nation, and constitutes presently one of the hot finnancial issues within the debate of the political status of Puerto Rico in its relation with that same Nation, the United States of America.

11. Taxation Without Representation-The British Colonial System

Democracy has a context in every sphere of life. Some have found its essence in the relation between government and the people. Within this perspective other political notions include:

--it is equal share in power

--it is extension of privileges since limitation is not justifiable that is, exclusion from privilege is exclusion from benefit,

Thus the notion of equality points the way to the essence of the democratic idea-the effort of men to affirm their own essence and to remove all barriers to that affirmation.[8]

As previously mentioned, there are differences between the american citizens of Puerto Rico, and those of the other states. Is there a rational basis for those differences within the above context of democratic equality? To give those differences the protection of the legal order is to prevent demand for equality from the citizens of Puerto Rico, and to promote for a system or a status erected upon differences and not upon similarities. In this case we are refering particularly to the tax discrepancies mentioned above, the applicability of federal taxes in Puerto Rico without Congressional representation. In this respect, it is pertinent to analyze briefly by analogy some thoughts which reflected the situation in the colonies; the disadvantages of the British colonial system were pressing heavily upon them, particularly economic causes (The 1765 Stamp Act and others taxes). Set forth below are some the objections to tax drew up by Thomas Fitch, from Connecticut, and which show how the people of the colonies felt about the issue of being tax without representation:

> "As the chief excellency of the British constitution consists in the subjects' being bound only by such laws to which they themselves consent, as aforesaid, and as, in order to their enjoying that right, they are (agreeable to the constitution) necessarily vested with the power of electing their representatives, so this right or power is a fundamental privilege and so essential a part of the constitution that without it the subject cannot be said to be free. Therefore, if he be hindered from voting in such election or obstructed in the lawful use of that real right or privilege, a suit will lie for him at common law.
>
> None of the privileges included in those general rights

> (which in a special manner denominate the British subjects a free people) is maintained with greater care and circumspection, and of which they are more jealous, than this particular, known, approved, and fixed one, that no tax, loan, or benevolence can be imposed on them but with their own consent by their representatives in Parliament. This privilege is of ancient date, and whenever it has been encroached upon has been claimed, struggled for, and recovered as being essential for the preservation of the liberty property, and freedom of the subject. For if the privilege of not being taxed without their consent be once taken from them, liberty and freedom are certainly gone with it. That power which can tax as it shall think proper may govern as it pleases; and those subjected to such taxations and government must be far, very far from being a free people. They cannot, indeed, be said to enjoy even so much as the shadow of English liberties.[9]

Also, set forth below is a -- Resolution Proposed by Patrick Henry-1765

> ..."Resolved, that the taxation of the people by themselves, or by persons chosen by themselves to represent them, who can only know what taxes the people are able to bear, or the easiest method of raising them, and must themselves be affected by every tax laid on the people, is the only security against a burdensome taxation, and the distinguishing characteristic of British freedom, without wich the ancient constitution cannot exist..."[10]

It is partly, within the above considerations which we have to consider the political and economic contradictions of whether it is reasonable to be liable for federal taxes in certain cases as american citizens of Puerto Rico while not having the right to vote for a representative in Congress, as equally as american citizens of other states, this is taxation without representation, without consent.

III. Federal Taxes in Puerto Rico

The U. S. Congress has the constitutional authority to collect taxes under the Sixteenth Amendment. Any tax policies that may be adopted by Congress will consider certain factors such as: whether it is justified, equitable, uniform in respect to the amount of tax, convenient in relation to payment and viable and economical in its administration those factors are considered by congressman representing citizens or their constituents. Thus, citizens participate in these decisions through their votes for candidates, and by influencing their elected representatives. Once tax policies are adopted, taxes have to be paid. There is no possible analysis of the merits of the tax, if not paid, property is confiscated and the liable citizen goes to jail.

Puerto Ricans don't have representation in the U.S. Congress, as equally as the states of the Union. Notwithstanding, Portoricans have to pay income taxes on U.S. source income (if not exempted) and other federal taxes---Federal social security, unemployment taxation, custom duties, excise taxes.[11] Is there a rational basis for this fiscal arrangement? The fact that the Island has a separate fiscal structure with the peculiarity that local tax policies apply in most cases, that federal tax policies apply in others, and both tax policies in still other cases, makes the economic game completely different. With appropriate tax planning the citizens of Puerto Rico can legally avoid (in some cases even completely) paying annual income taxes both to the local and Federal treasury, thereby affecting the Puerto Rico money supply, and the disposition of government for goods and services. The tables in Appendix A of this paper reflect vital information related to the Federal Internal Revenue collections from Puerto Rico, and its relation to other regions and districts, states and other areas within the United States for the year 1988, most important:[12]

a. Puerto Rico total internal revenue collections--
   $1,474,558,000.00
   ---This amount is higher than the total internal revenue collections of the following districts in the Nation.
   - Burlington-Vermont
   - Aberdeen-South Dakota
   - Fargo-North Dakota
   - Cheyenne-Wyoming

b. Puerto Rico Corporate Income taxes
   ---$87,085,000.00-This amount was higher than that of three IRS Districts in the Nation-In this case income from P.R. based corporations is not included nor the 936 tax credits of many U.S. based corporations doing business in Puerto Rico.

c. Total individual and employment taxes total was $1,367,211,000.00, which was higher than that of other four Districts in the Nation.

d. Total individual income tax not witheld amounted to $80,492,000.00

e. Total income tax withheld and FICA was $1,259,488,000.00, which was higher than that of six other Districts in the Nation.

f. Total taxes on unemployment insurance were $27,233,000.00, which was higher than that of 17 other Districts in the Nation.

g. Table 4 of Appendix A of this paper shows IRS refunds for Puerto Rico as follows.
---Total internal revenue refunds- $68,835,000.00
---Corporate income refunds - $ 8,191,000.00
---Individual income refund - $46,997,000.00
---Employment taxes refunds - $13,082,000.00

h. Table 6 of Appendix A of this paper shows the number of returns filed from Puerto Rico, as follows:
---Total tax returns -338,646
---Individual income tax returns - 94,135
---Corporate income tax -896
---Employment taxes -178,676
(higher than 16 Districts in the Nation)

The numbers shown above are clear evidence of applicability of Federal tax policies to Puerto Rico. They constitute taxation without representation, without consent of the people of Puerto Rico, a showing that the gap between Puerto Rico in its actual political status and that of the other states is diminishing It is pertinent to inquire again, whether there is any rational basis for this political situation based on unequality not on similarities.

In the case of statehood for Puerto Rico, the Office of the Comptroller General has prepared various "Reports to Congress" related to Puerto Rico and analyzing the tax liabilities within that status.: It mentions in pertinent part:[13]

> Although the Federal individual income tax liability will increase (for examples, it was estimated in 1980 as an increase of $248 million) the Island individual liability would have been less than any state, because of Puerto Rico's low per capita income. In addition, more than 60% of Puerto Rican returns could be eligible for the earned income credits. Excluding the corporate tax liability, the island total liability in 1980 would have increased by aproximately 17%. (Updated Statistics on Puerto Rico Income Taxes are included as Appendix B of this paper).

Under statehood, Federal corporate income tax liability would increase, but due mostly to the substantial profits of U.S. mainland based firms operating in Puerto Rico under tax exemptions.

Appendix B is included as an Estimate of FederalTaxes in 1980 if Puerto Rico would be a State.

IV. U.S. Social Security Taxes in Puerto Rico

Puerto Rico residents are subject to Federal Social Security taxes. The system works by taxing income at its base, on wages. As shown before on page six of this paper .: (e) total federal income tax withheld and FICA taxes along amounted in Puerto Rico in 1988 to $1,259,448,000.00, an amount which was higher than that of six other IRS Districts in the Nation. Thus, this is not only another U.S. taxpolicy applicable in Puerto Rico, which has been paid locally for many years, but it is a policy aplicable to all Portorican workers and employers; a tax policy applicable to Puerto Rico without representation in Congress. Is there a rational basis for this political and economic contradiction?

The payment of social security taxes by citizens of Puerto Rico within the Federal economy is of great importance, considering the impact of these taxes for the U.S. Budget, as Senator Patrick Moyniham proposes.[14] In his view-

> "Federal taxes overall have not been cut for the past years. What happened was the burden of taxation was shifted from the income tax to the Social Security tax. Counting their employers' share, nearly three-quarters of all Americans now pay more in Social Security taxes than they do in income taxes.
>
> One result is that the expenses of Government are financed more by tax on the poor and the middle class and less by a tax on the wealthy. Another result is that surplus revenues in the Social Security system are being used to mask the deficit in the Government's operating budget instead of being used as they were intended, to guarantee pension benefits for today's workers when they retire.

Economist agree that if employers did not have to contribute their share of social security taxes for their employees, workers could demand and generally receive most if not all of that money in higher wages.[15] In the meantime, they claim that the payroll tax rate now is effectively 15.3 percent. In the case of Puerto Rico higher wages would increase the money supply of the local economy. The effects of these tax burden are shown in the Tables of Appendix C of this paper. For Puerto Rico it also means that the poor and the middle class are financing together with workers in other states the expenses of the U.S. Government, the operating budget, with the difference that Portoricans are being taxed without representation. Evidently this is another tax contradiction within the actual political status of Puerto Rico which needs to be consider in the present political status debate.

V. IRC-Section 936-Tax Credit at any Price

One of the major changes of the Tax Reform Act of 1976 was the adoption by Congress of I.R.C. section 936, effective since taxable years beginning after December 31, 1975.[16] Section 936 replaced I.R.C. section 931, the statute that was applicable previously to U.S. companies operating in Puerto Rico. Since the adoption of section 936, possessions corporations can repatriate profits to their U.S. parents on a currents basis free of any U.S. tax. Thus, an electing possession corporation is granted a credit against its federal income-tax return commensurate with the ratio that its qualifying taxable income bears to its total taxable income. As a result, if all of the taxable income of the corporations, qualifies, no federal income tax is due. Notwithstanding, liquidation of a possessions corporation benefits are still tax free under section 332.

The tax credit of 936 is given in lieu of the ordinary foreign tax credit provided by section 901 of the Code. It is applicable to qualified possession source investment income, which includes only income from sources within a possession in which the corporation actively conducts a trade or business, regardless of whether or not such business produces taxable income in a taxable year, with income earned elsewhere subject to the normal U.S. tax rates. Losses from other sources are to be taken into account, in determining the amount of tax attributable to the income from the active conduct of a possession trade or business or from qualified possession investment income. As of June 1982, 807 corporations had filed a section 936 election form, including about 600 which were in operation under the predecessor 931 exemption. Most of these firms are also enjoying tax exemption benefits under the Industrial Incentive Act of P.R..

To help Puerto Rico attract more job-creating investment, and particularly, to encourage the corporations to repatriate earnings on a current basis back to the United States, Congress legislated to adopt section 936. It was stated:

> "The U.S. Government imposes upon the possessions various requirements, such as minimum wage requirements and requirements to use U.S. flagships in transporting goods between the United States and various possessions, which substantially increase the labor, transportation and other costs of establishing business operations in Puerto Rico. Thus, without significant local tax incentives that are not nullified by U.S. taxes, the possessions would find it quite difficult to attract investments by U.S. corporations."

Although, it has been argued that section 936 is too costly as a tax expenditure for the Federal Treasury, it can be questioned whether this may be exaggerated for several reasons. On the one hand, such corporations if fully taxed in Puerto Rico or elsewhere would be entitled anyway to a tax credit for such paid income taxes. On the other hand, the direct benefits to mainland corporations because of the credit (and the indirect benefits to other sectors of the economy) are of tremendous magnitud to the U.S. economy when compared to the policy as an expenditure. Thus, by adopting the 936 policy, the Federal Government successfully deviced a scheme that induces American Corporations to confine operations within U.S. borders (in this case P.R.) with all the direct and indirect economic benefits this represents, and which avoids outflow of funds to the treasuries of foreign countries to the extent that the income from 936 corporations would constitute otherwise foregone tax revenues. Although the 936 foregone tax revenues are not received by foreign treasuries nor by the U.S. Treasury (since it is received as income to the 936 corps), it constitutes funds within the U.S. money supply which serves in turn as a positive catalytic agent within the American economy in different ways.

It is pertinent to mention that the adoption of 936 encounter opposition in Congress. Some were for the proposition that this program allowed undeserved tax credits, affording greater benefits to the rich. Senator Kennedy opposed vigorously the section 936 policy, precisely on those similar arguments. He once said in relevant part as follows.

> "In anticipations of the enactment of Section 936 many possessions corporations are placing as much as possible of their earnings in a liquid state so as to cash in on the benefit of immediate tax-free distribution if Section 936 is enacted. Many are motivated by a widespread belief that any enacted Section 936 will not last very long, but would be repealed when Congress wake up to its real effects. They want therefore, to be ready to take advantage of the new Section 936 gift while they can. In fact, lurking beneath the desire to cash in on a new Section 936 is the worry that when its generous benefits combined with the exemption benefits of Section 931 become fully known and the financial reports of the beneficiaries of this moneymaking machine are scrutinized--really for the first time--the whole scheme will crash down. They thus are hoping they can obtain Section 936 without Congress looking into Pandora's Box that contains the Section 931 exemption. For that Pandora's Box would disclose the tax windfalls that U.S. multinationals are obtaining under even the present tax exemption."

The various years of experience with the 936 policy have served to measure to some extent how certain were the expectations of Congress in its adoption. In 1976, the costs of this policy in general terms were the foregone tax revenues for the U.S. Government, and the local Treasury's lost revenue for not taxing the 936's corporate income fully. Puerto Rican Distribution of Employment in 1950, 1970, 1979, and 1981 changed as follows in selected sectors:

	AGRICULTURE	MANUFACTURING	HOME NEEDLEWORK	SERVICES	GOVERNMENT
1950	214,000	55,000	51,000	77,000	45,000
1970	68,000	132,000	less 2,000	116,000	100,000
1979	38,000	160,000	less 2,000	142,000	190,000
1981	41,000	155,000	less 2,000	170,000	201,000

The increase in employment in the government sector was primarily due to an increase in federal aid to the island from 290 million in 1968 to 2.057 billion in 1979, and 3.035 billion in 1982. As can be seen from the above numbers Puerto Rico's employment in the manufacturing sector has been almost constant during the past fifteen years, even with the existence of 936.[17] Employment in all possessions corporation in manufacturing industries was estimated to be 88,579 persons in 1983, which represented 12% of total employment in Puerto Rico and 62% of employees in the Puerto Rico manufacturing sector.[18] Nowithstanding, the unemployment rate reached an all time annual high of 23.4% in the year ending June 1983, but declined slightly from 1983 to 1986, and in 1988, it stood at 14.4 %.[19] The high levels of unemployment and low labor force participation rates explain most of the poverty in Puerto Rico. Estimates indicate that one-half of Puerto Rican families lived below the federal poverty level in 1983.[20]

More than 1% of the residents of Puerto Rico migrate annually to States of the Union, where they assume full american citizen's rights and obligations.[21]

On the other hand, the tax credits are very lucrative for the 936 corporations. Notwithstanding unemployment and migration, net income originating in Puerto Rican manufacturing industries has been climbing with speed from $957.6 millions in 1970 to $9,432.5 millions in 1988.[22] In 1983, there were 527 possessions corporations engaged in manufacturing; they earned net income of $4.1 billion and derived tax benefits of $1.6 billion.[23] Over all manufacturing industries, possessions corporation's tax benefits averaged $18,523 per employee, or 125% of the average compensation per employee.[24] In fact some companies are taking back annually as much as $43,000 in profit per island job. In 1983, 936 companies reported $14.0 billion of retained earnings.[25]

Section 936 permanency is not guaranteed. Congress and the Federal Treasury Department are constantly reviewing the section 936 policy and may at any time be expected to come up with somo changes. The local government and backers of the present political status have been trying continously to justify its existence and to avoid a total phaseout have come up with different proposals and financial schemes within this pursuits, the last being the proposal for the use of 936 funds for the CBI countries.[26] But Congress and the Federal Government are in a very embarassing situation with this tax policy. On the one hand, as shown above, the benefits in income to these corporations in proportion to the benefits of employment to Puerto Rico are too great. They expose the situation that Congress is willing to pay any price to keep the 936 policy. Moreso, if the 936 tax credit is compared to the foreign tax credit claim from U.S. citizens and corporations in other countries the situation is alarming. If Congress decides, on the other hand, to eliminate the 936 credit, it will be taxing Puerto Rico source income. This is turn will add more fuel to the proposition that there is taxation without representation for Puerto Rico from the Federal Government. In fact, one can speculate that 936 has not been phaseout totally by the U.S. Congress for this as one of the reasons.

Finally, the pressure to eliminate the 936 tax credit is starting to increase from the citizens of the different states.

As "Jeffrey Hart", a reporter, expressed disrespectfully a few months ago in a newspaper article --"Who Could Possibly Want Puerto Rico . . . . U.S. taxpayers are subsidizing this economic bag woman with that annual $6 billion".[27]

VI. FINAL COMMENTS

In conclusion, from the above analysis it is evident that the three million American residents of Puerto Rico are being denied the fundamental right of representation, even through a significant proportion of them are being taxed by the Federal government. Is there a rational basis within these tax contradictions to continue the political situation as it is. (Compare the above with the reasoning of the highest Court in the case of Harris v. Rosario, 64 L Ed. 2d. 587, 588 - 1980, establishing that Congress was empowered under the territorial clause of the Constitution to treat Puerto Rico differently from the States so long as there was a rational basis for doing so, and it held that Puerto Rico could receive less assistance than the States under the Aid to Dependent Children program, 42 USC 601 et.seq.).

The citizens of Puerto Rico are being denied the right to participate, through congressional representation, in the decision making process of all federal tax policies applicable, either fully or partially, to them. Within the tax policy context, the actual political status is growing over the years upon differences not similarities of fundamental rights of a democratic society, that is upon inequalities.

Taxation without representation was condemned by the founding fathers of the United States of America, and it is as unnacceptable today. "Every man having evidence of attachment to and permanent common interest with the Society ought to share in all its rights and privileges."[28]

FOOTNOTES

1. G. Igartúa, U.S-IRC Section 936-A Tax Policy Analysis Within The P.R. Perspective-Tax Expenditures V. Govt. Direct Expenditures 45 PR Bar J 109 (1984) [Hereinafter Igartúa 936]

2. See, Report to Congress, By the Comptroller General of the United States, P.R. Political Future: A Divisive Issue with Many Dimensions, March 2, 1981, GGD 81-48 [Hereinafter cited as Report 1981], at 51

3. Id., 53,

4. Infra 1, at 111

5. Id., 112

6. Id.

7. Report 1981, Infra 2, at 52

8. See, Bishop & Hendel, Basic Issues of American Democracy, 10, 5th ed. 1965.

9. Annals of America, 1755-1783 Resistance and Revolution, Vol 2 Encyclopedia Británica 1976

10. Id., ar 148

11. Report 1981, Infra note 2, at 57 & 128 – , Customs duty + excise tax minus adm expenses are returned to P.R.

12. See Appendix A

13. Report 1981, Infra note 2, at 57, 58, 128, 129

14. See Appendix C. D. E. Rosenbaum, The Nation, Prof Moynihan Wakes the Class With Thruth About Taxes, the New York Times, Sunday, January 21, 1990-E-4; P. Passell, Economic Watch, Oratory Over Social Security May Lead to a Cold Security, New York Times National, Sunday, February 4, 1990, 1, Column 3 and 19 Column 3.

15. Id.

16. Igartúa 936, supra note 1.

17. See Appendix D. Also. See generally, The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report, Dept of the Treasury, March 1989, at 21 [hereinafter cited as Treasury Report 1989]

18. Id at 3.

19. Id. at 2

20. Id. at 22

21. Id., at 20. See Tables Appendix D.

22. Id., at 28.

23. Id, at 2. See Tables Appendix D.

24. Id, at 3.

25. Id, at 39

26. D. Hemlock, 936 firms seek to raise $100 million, C.B.I., Business Today, The San Juan Star, February 20/1990., and Appendix F.

27. See Appendix C.

28. Bishop, supra note, at 51.

Table 1. — Internal revenue collections by sources and by internal revenue regions and districts, states and other areas (*in thousands of dollars*)

Internal revenue regions and districts, states and other areas (States represented by revenue single districts indicated in parentheses; totals for other states shown at bottom of table)[1]	Total internal revenue collections[1] (1)	Corporation income tax[2,3] (2)	Individual income and employment taxes: Total (3)	Income tax not withheld and SECA[4,5,6] (4)	Income tax withheld and FICA[4,7] (5)	Railroad retirement[8] (6)	Unemployment insurance[9] (7)	Estate tax[10] (8)	Gift tax[10] (9)	Excise taxes[11] (10)
United States, total	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
North Atlantic Region	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Albany (See (d) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Augusta (Maine)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Boston (Massachusetts)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Brooklyn (See (d) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Buffalo (See (d) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Burlington (Vermont)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Hartford (Connecticut)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Manhattan (See (d) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Portsmouth (New Hampshire)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Providence (Rhode Island)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Mid-Atlantic Region	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Baltimore (Maryland & D C)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Newark (New Jersey)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Philadelphia (See (f) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Pittsburgh (See (f) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Richmond (Virginia)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Wilmington (Delaware)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Southeast Region	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Atlanta (Georgia)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Birmingham (Alabama)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Columbia (South Carolina)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Fort Lauderdale (See (b) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Greensboro (North Carolina)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Jackson (Mississippi)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Jacksonville (See (b) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Little Rock (Arkansas)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Nashville (Tennessee)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
New Orleans (Louisiana)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Central Region	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Cincinnati (See (e) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Cleveland (See (e) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Detroit (Michigan)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Indianapolis (Indiana)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Louisville (Kentucky)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Parkersburg (West Virginia)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Midwest Region	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Aberdeen (South Dakota)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Chicago (See (c) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Des Moines (Iowa)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Fargo (North Dakota)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Helena (Montana)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Milwaukee (Wisconsin)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Omaha (Nebraska)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
St Louis (Missouri)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
St Paul (Minnesota)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Springfield (See (c) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Southwest Region	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Albuquerque (New Mexico)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Austin (See (g) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Cheyenne (Wyoming)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Dallas (See (g) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Denver (Colorado)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Houston (See (g) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Oklahoma City (Oklahoma)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Phoenix (Arizona)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Salt Lake City (Utah)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Wichita (Kansas)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Western Region	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Anchorage (Alaska)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Boise (Idaho)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Honolulu (Hawaii)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Laguna Niguel (See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Las Vegas (Nevada)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Los Angeles (See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Portland (Oregon)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Sacramento (See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
San Francisco (See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
San Jose (See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Seattle (Washington)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
International	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Puerto Rico	1 474 558	87 085	1 367 711	80 492	1 259 480	(1)	27 233	323	20	19 719
Other	3 634 704	1 001 358	2 556 727	701 180	1 870 009	9 990	24 660	37 245	604	38 769
Undistributed										
Federal tax deposits[12]	3 859 486	613 263	3 117 019		2 983 505	39 514	94 000	–	–	129 204
Gasoline, lubricating oil and excess FICA credits[13]	973 147	98 043	875 104	875 104	–	–	–	–	–	–
Clearing account for excise taxes—aviation fuel and oil—Air Force and Navy	176	–	–	–	–	–	–	–	–	176
Presidential election campaign fund[14]	33 422	–	33 422		33 422	–	–	–	–	–
Earned income credits[15]	118 990	–	118 990		118 990	–	–	–	–	–
Other[16]	(383 245)	-	(597 373)	(695 438)	(840 699)	-	938 764	214 128	–	–
Totals for states not shown above										
(a) California	108 332 486	12 228 874	92 090 778	21 831 879	69 801 061	333 608	573 482	1 209 164	98 486	2 705 185
(b) Florida	38 905 963	2 360 070	33 160 093	9 065 716	22 477 672	641 872	175 867	375 524	29 875	962 672
(c) Illinois	57 783 661	9 340 742	46 452 795	8 210 081	37 629 328	292 708	320 926	524 043	23 267	1 643 314
(d) New York	101 363 532	14 839 995	84 709 794	15 920 810	68 060 792	710 176	507 448	929 380	13 350	919 627
(e) Ohio	42 533 053	5 449 784	35 442 847	5 271 800	29 983 698	28 183	186 183	240 287	25 480	1 374 548
(f) Pennsylvania	45 732 077	5 441 921	38 867 575	6 767 900	31 083 155	460 579	553 861	328 860	29 877	1 064 138
(g) Texas	57 579 171	6 058 172	45 040 428	9 565 486	35 197 507	48 386	264 764	444 349	39 137	5 957 085

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Table 4. — Amount of internal revenue refunds including interest (*in thousands of dollars*)

Internal revenue regions and districts, states and other areas. (States represented by single districts indicated in parentheses; totals for other states shown at bottom of table.)		Total[1] (1)	Corporation income (2)	Individual income[2] (3)	Employment taxes[3] (4)	Estate tax (5)	Gift tax (6)	Excise taxes[4] (7)
United States, total		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
North-Atlantic Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	(See [illegible] below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Mid-Atlantic Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	(Maryland & D.C.)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Southeast Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Central Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Midwest Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Southwest Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Western Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
International		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Puerto Rico		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other miscellaneous refunds		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Totals for states not shown above								
	(a) California	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(b) Florida	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(c) Illinois	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(d) New York	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(e) Ohio	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(f) Pennsylvania	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(g) Texas	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

[1] [illegible]
[2] [illegible]
[3] [illegible]
[4] [illegible]
[5] [illegible]
[6] [illegible]
[7] [illegible]

Table 5. — Number of internal revenue refunds issued

Internal revenue regions and districts, states and other areas (states represented by single districts indicated in parentheses; totals for other states shown at bottom of table)		Total (1)	Corporation income (2)	Individual income (3)	Employment taxes (4)	Estate tax (5)	Gift tax (6)	Excise taxes (7)
United States, total		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
North-Atlantic Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Albany	(See (d) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Augusta	(Maine)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Boston	(Massachusetts)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Brooklyn	(See (d) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Buffalo	(See (d) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Burlington	(Vermont)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Hartford	(Connecticut)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Manhattan	(See (d) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Portsmouth	(New Hampshire)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Providence	(Rhode Island)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Mid-Atlantic Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Baltimore	(Maryland & D.C.)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Newark	(New Jersey)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Philadelphia	(See (f) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Pittsburgh	(See (f) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Richmond	(Virginia)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Wilmington	(Delaware)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Southeast Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Atlanta	(Georgia)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Birmingham	(Alabama)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Columbia	(South Carolina)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Fort Lauderdale	(See (b) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Greensboro	(North Carolina)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Jackson	(Mississippi)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Jacksonville	(See (b) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Little Rock	(Arkansas)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Nashville	(Tennessee)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
New Orleans	(Louisiana)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Central Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Cincinnati	(See (e) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Cleveland	(See (e) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Detroit	(Michigan)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Indianapolis	(Indiana)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Louisville	(Kentucky)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Parkersburg	(West Virginia)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Midwest Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Aberdeen	(South Dakota)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Chicago	(See (c) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Des Moines	(Iowa)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Fargo	(North Dakota)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Helena	(Montana)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Milwaukee	(Wisconsin)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Omaha	(Nebraska)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
St. Louis	(Missouri)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
St. Paul	(Minnesota)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Springfield	(See (c) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Southwest Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Albuquerque	(New Mexico)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Austin	(See (g) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Cheyenne	(Wyoming)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Dallas	(See (g) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Denver	(Colorado)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Houston	(See (g) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Oklahoma City	(Oklahoma)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Phoenix	(Arizona)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Salt Lake City	(Utah)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Wichita	(Kansas)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Western Region		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Anchorage	(Alaska)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Boise	(Idaho)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Honolulu	(Hawaii)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Laguna Niguel	(See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Las Vegas	(Nevada)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Los Angeles	(See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Portland	(Oregon)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Sacramento	(See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
San Francisco	(See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
San Jose	(See (a) below)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Seattle	(Washington)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
International		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Puerto Rico		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other		[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Other miscellaneous refunds		[illegible]	–	[illegible]	–	–	–	–
Gasoline and excess FICA credits		–	–	–	–	–	–	–
U.S. Customs Service		–	–	–	–	–	–	–
Earned income credit offsets[2]		–	–	–	–	–	–	–
Refund reversals unclassified[3]		(85,463)	–	(85,463)	–	–	–	–
Totals for states not shown above								
	(a) California	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(b) Florida	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(c) Illinois	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(d) New York	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(e) Ohio	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(f) Pennsylvania	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	(g) Texas	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Column Contents
[1] Includes 225,184 refunds issued to fiduciaries and partnerships.
[2] In Table 6 "Amount of Internal Revenue Refunds including interest," refund amounts are given for these credits.
[3] Includes refunds issued in September 1988 minus refund reversals received in September 1988 that were not classified by District before September 30, 1988 (the end of the fiscal year). For accounting and comparative purposes, the data included in this table must agree with the actual transactions affecting the refund and interest appropriation accounts for the fiscal year.

Table 6. — Number of returns filed

Internal revenue regions and districts, states and other areas (States represented by single districts indicated in parentheses, totals for other states shown at bottom of table)		Total tax returns (1)	Individual income tax (2)	Individual estimated tax (3)	Fiduciary (4)	Fiduciary estimated tax (5)	Partnership (6)	Corporation income tax (7)	Estate tax (8)	Gift tax (9)
United States, total		194 305 425	106 993 675	35 448 541	2 713 005	1 055 242	1 814 470	3 960 250	52 364	102 500
North Atlantic Region		29 662 001	14 190 357	5 021 707	477 795	217 100	217 001	667 563	9 277	18 778
Albany	(See (d) below)	1 733 764	999 235	317 742	18 050	4 682	12 415	34 708	474	1 255
Augusta	(Maine)	990 083	539 315	181 685	13 520	5 187	6 401	18 523	223	575
Boston	(Massachusetts)	5 336 640	2 907 704	1 035 170	19 405	63 521	34 219	113 750	1 975	4 036
Brooklyn	(See (d) below)	5 455 494	3 026 410	1 030 423	36 945	7 752	40 143	163 030	1 607	2 504
Buffalo	(See (d) below)	3 362 540	1 907 706	600 852	53 554	16 770	24 031	53 347	724	2 747
Burlington	(Vermont)	504 342	251 461	97 003	7 321	2 002	3 934	12 001	109	274
Hartford	(Connecticut)	3 130 205	1 642 635	634 900	61 116	22 206	30 692	66 008	1 359	2 715
Manhattan	(See (d) below)	4 348 369	1 863 754	770 001	142 965	77 512	52 720	164 975	2 298	3 695
Portsmouth	(New Hampshire)	984 008	531 054	181 671	12 143	4 408	7 222	19 641	371	530
Providence	(Rhode Island)	838 560	480 995	147 574	14 768	8 080	5 814	21 513	237	439
Mid-Atlantic Region		20 475 410	14 765 502	4 962 867	460 323	154 451	233 812	534 030	7 082	12 253
Baltimore	(Maryland & D C)	4 545 397	2 537 220	775 872	105 121	33 080	41 474	90 186	1 237	2 220
Newark	(New Jersey)	7 201 361	3 938 276	1 366 318	73 394	25 773	69 946	199 994	2 318	3 158
Philadelphia	(See (f) below)	6 178 872	3 420 477	1 279 394	158 434	44 232	52 315	101 790	1 512	2 703
Pittsburgh	(See (f) below)	3 277 646	1 872 814	667 471	57 437	15 818	26 867	41 778	574	1 233
Richmond	(Virginia)	4 657 551	2 692 408	775 430	60 664	24 115	36 887	86 441	1 103	2 492
Wilmington	(Delaware)	724 811	304 171	94 632	13 273	11 413	4 329	14 844	160	357
Southeast Region		34 741 310	18 440 651	6 004 060	313 027	134 237	261 005	777 102	8 590	18 551
Atlanta	(Georgia)	4 476 861	2 657 476	590 179	19 254	16 112	11 613	91 431	865	2 154
Birmingham	(Alabama)	2 610 010	1 581 604	502 610	18 176	8 826	18 956	41 900	475	1 291
Columbia	(South Carolina)	2 374 316	1 418 064	111 171	19 519	8 946	18 746	44 418	400	1 274
Fort Lauderdale	(See (b) below)	5 456 929	2 445 740	1 405 540	72 162	25 470	34 923	192 929	2 151	4 919
Greensboro	(North Carolina)	4 790 015	2 815 909	733 193	65 136	21 309	38 609	86 543	1 013	2 537
Jackson	(Mississippi)	1 577 041	940 524	218 037	11 757	3 754	17 094	27 048	367	842
Jacksonville	(See (b) below)	5 099 181	3 065 758	1 157 904	14 676	23 772	37 415	136 166	1 363	2 576
Little Rock	(Arkansas)	1 611 846	901 908	276 070	15 075	5 309	13 715	30 019	296	758
Nashville	(Tennessee)	3 305 920	2 033 040	500 764	14 794	14 614	32 229	51 013	613	1 375
New Orleans	(Louisiana)	2 801 164	1 602 010	471 310	21 018	7 863	20 702	73 617	495	1 057
Central Region		22 009 164	13 279 307	3 960 070	330 710	112 333	177 660	410 730	4 259	9 009
Cincinnati	(See (e) below)	3 504 794	2 067 695	617 251	72 590	21 630	29 458	54 730	801	1 715
Cleveland	(See (e) below)	4 683 598	2 708 131	860 644	70 697	28 396	35 475	87 745	897	2 160
Detroit	(Michigan)	8 755 968	3 981 654	1 151 249	80 921	10 766	56 841	135 371	1 154	2 841
Indianapolis	(Indiana)	4 054 406	2 376 409	730 374	66 606	15 405	25 228	75 431	740	1 850
Louisville	(Kentucky)	2 455 657	1 475 708	475 199	13 527	12 034	20 609	44 043	447	1 135
Parkersburg	(West Virginia)	1 150 646	670 765	206 363	14 378	4 522	10 127	18 910	216	407
Midwest Region		29 021 364	14 189 295	5 037 600	444 759	108 290	234 847	491 169	9 873	15 880
Aberdeen	(South Dakota)	565 857	293 658	110 512	9 198	1 793	5 936	9 103	98	466
Chicago	(See (c) below)	6 811 945	3 790 845	1 275 253	131 891	73 442	63 916	148 185	1 990	3 321
Des Moines	(Iowa)	2 308 275	1 198 409	514 897	48 014	9 796	21 712	42 322	599	1 203
Fargo	(North Dakota)	555 346	279 891	109 116	7 913	1 441	6 031	9 787	202	524
Helena	(Montana)	684 446	315 309	126 876	7 198	1 668	8 654	14 858	176	649
Milwaukee	(Wisconsin)	3 819 377	2 118 002	731 486	70 847	24 374	31 267	66 094	695	2 952
Omaha	(Nebraska)	1 320 467	692 675	253 112	20 782	7 079	11 648	27 579	373	906
St. Louis	(Missouri)	4 002 114	2 185 165	812 017	69 211	22 315	32 278	74 587	939	1 801
St. Paul	(Minnesota)	3 490 438	1 940 043	617 596	44 631	16 055	34 364	69 519	697	2 007
Springfield	(See (c) below)	2 272 609	1 267 468	486 795	15 052	8 775	17 031	29 611	744	1 017
Southwest Region		20 511 045	13 300 521	4 042 210	318 760	132 073	319 029	510 603	9 247	13 856
Albuquerque	(New Mexico)	1 053 918	606 154	168 784	8 759	3 262	11 234	18 569	229	509
Austin	(See (g) below)	3 778 372	2 189 629	460 964	47 431	20 704	47 317	62 433	996	2 505
Cheyenne	(Wyoming)	307 346	195 790	66 511	4 357	1 479	5 565	8 780	77	335
Dallas	(See (g) below)	5 412 656	2 915 227	890 510	73 750	39 153	81 090	110 473	1 474	2 881
Denver	(Colorado)	2 739 480	1 458 548	451 306	35 077	13 575	39 250	70 399	683	1 609
Houston	(See (g) below)	3 013 957	1 666 102	434 165	40 862	20 025	36 379	70 451	730	1 410
Oklahoma City	(Oklahoma)	2 327 657	1 240 637	419 258	29 854	10 569	25 940	51 110	608	1 311
Phoenix	(Arizona)	2 695 030	1 450 394	517 530	35 507	11 131	30 831	57 324	748	1 302
Salt Lake City	(Utah)	1 068 677	618 749	143 754	16 462	4 422	10 068	24 256	179	448
Wichita	(Kansas)	2 039 757	1 061 703	479 476	20 917	8 553	18 947	38 859	575	1 185
Western Region		32 475 015	17 336 467	6 232 644	362 787	137 061	377 094	875 070	9 857	13 540
Anchorage	(Alaska)	508 657	328 204	42 711	1 743	605	6 499	8 673	70	145
Boise	(Idaho)	705 629	376 622	173 242	7 844	2 359	9 543	14 345	123	278
Honolulu	(Hawaii)	909 109	503 855	155 716	10 852	4 389	7 880	21 180	210	879
Laguna Niguel	(See (a) below)	6 552 754	3 595 280	1 304 679	54 476	13 253	75 048	114 587	1 889	1 909
Las Vegas	(Nevada)	850 433	490 570	137 568	8 073	3 149	8 551	19 990	180	465
Los Angeles	(See (a) below)	5 867 788	3 131 541	1 019 646	79 308	29 346	77 004	170 159	2 267	2 086
Portland	(Oregon)	2 301 977	1 197 876	457 064	29 146	5 123	22 330	47 642	486	1 429
Sacramento	(See (a) below)	3 067 033	1 907 033	857 976	33 960	8 854	44 209	51 323	1 172	1 445
San Francisco	(See (a) below)	2 734 950	1 372 232	570 179	54 996	36 355	31 594	42 107	1 421	1 405
San Jose	(See (a) below)	4 270 031	2 308 655	830 062	39 982	11 547	53 149	63 644	1 397	1 845
Seattle	(Washington)	3 027 914	2 042 788	731 249	42 379	18 901	41 999	68 340	792	1 600
International		1 093 232	525 340	199 249	858	163	1 304	19 889	457	271
Puerto Rico		338 648	94 135	59 941	241	26	178	896	24	20
Other		754 586	431 205	139 308	617	137	1 126	18 993	433	251
	(a) California	23 313 356	12 393 552	4 590 612	262 730	99 355	261 084	399 900	8 096	8 750
	(b) Florida	11 158 110	5 511 506	2 564 444	138 784	49 200	72 338	329 085	3 714	7 515
	(c) Illinois	9 084 554	5 058 313	1 762 048	166 943	82 217	80 947	177 796	2 734	4 338
	(d) New York	14 900 191	7 877 113	2 743 018	249 514	106 724	120 809	416 127	5 103	10 201
	(e) Ohio	8 188 392	4 775 826	1 477 935	143 283	50 026	64 883	138 983	1 698	3 876
	(f) Pennsylvania	9 456 268	5 293 286	1 946 815	215 871	60 050	79 182	142 574	2 086	4 016
	(g) Texas	12 204 985	6 750 958	1 845 649	157 043	79 882	160 194	243 307	3 150	6 076

Column Contents:
(2) Includes Forms 1040, 1040A, 1040EZ, 1040NR, 1040SS PR and 1040C
(3) Form 1040ES
(4) Form 1041
(5) Form 1041ES
(6) Form 1065
(7) Includes Forms 1120, 1120A, 1120L, 1120M, 1120S, 1120POL, 1120F, 1120H, 1120ND, 1120RIC, 1120REIT, 1120FSC and 1120PC
(8) Forms 706 and 706NA
(9) Form 709

Table 6. — Continued

Internal revenue regions and districts, states and other areas (States represented by single districts indicated in parentheses, totals for other states shown at bottom of table.)		Employment taxes (10)	Exempt organizations (11)	Employee plans (12)	Excise taxes (13)	Supplemental documents (14)	Non master file returns (15)
United States, total		78 235 144	489 957	1 619 455	956 079	10 523,211	4 060
North Atlantic Region		3 964 737	78 903	247 899	97 132	1,457,463	1,161
Albany	(See (d) below)	242 436	4 263	10 649	8 223	81 534	44
Augusta	(Maine)	150 807	3 715	4 380	7 984	47 758	22
Boston	(Massachusetts)	732 311	17 549	43 680	18 648	266 175	267
Brooklyn	(See (d) below)	764 475	6 936	47 709	15 965	300,456	120
Buffalo	(See (d) below)	438 010	9 377	22 501	14 628	130 188	152
Burlington	(Vermont)	94 801	1 910	3 700	3 224	26 950	22
Hartford	(Connecticut)	438 404	9 586	28 250	10 714	178 799	225
Manhattan	(See (d) below)	878 737	21 384	71 231	10 860	330 567	190
Portsmouth	(New Hampshire)	155 008	2 674	5 970	5 727	37 865	63
Providence	(Rhode Island)	130 747	2 192	5 879	2 961	37 371	46
Mid Atlantic Region		3 858 210	65 799	225 018	108 800	1,238,643	418
Baltimore	(Maryland & D C)	647 858	14 023	49 158	15 068	233 024	27
Newark	(New Jersey)	1 020 878	13 060	60 604	26 751	400 862	231
Philadelphia	(See (f) below)	791 294	16 404	48 109	28 791	225 436	50
Pittsburgh	(See (f) below)	429 229	9 303	28 836	19 377	107,384	85
Richmond	(Virginia)	678 917	11 064	35 294	16 116	234 527	18
Wilmington	(Delaware)	81 934	1 945	3 010	2 887	27 008	19
Southeast Region		5,338 839	88 000	237 273	188,530	1,981,380	383
Atlanta	(Georgia)	718 194	8 817	33 189	21 587	281 884	78
Birmingham	(Alabama)	413 515	5 018	13 019	17 684	115 093	12
Columbia	(South Carolina)	368 747	4 837	13 380	10 181	97 048	10
Fort Lauderdale	(See (b) below)	818 078	8 346	47 196	13 816	384 375	–
Greensboro	(North Carolina)	748 123	11 057	31 659	22 766	219 992	15
Jackson	(Mississippi)	265 267	3 470	8 573	13 198	72 053	3
Jacksonville	(See (b) below)	791 270	10 583	36 379	20 253	348 988	150
Little Rock	(Arkansas)	254 514	3 914	8 958	14 087	87 213	–
Nashville	(Tennessee)	517 890	7 550	22 207	18 753	150 829	37
New Orleans	(Louisiana)	443 743	5 598	21 865	17 111	163 817	–
Central Region		3 093 491	60 743	200 234	109 333	878,838	292
Cincinnati	(See (e) below)	456 027	9 897	33 574	41 072	133 794	81
Cleveland	(See (e) below)	626 363	12 639	50 521	19 238	185 439	67
Detroit	(Michigan)	976 843	15 978	64 751	29 570	277 658	89
Indianapolis	(Indiana)	544 083	13 564	30 439	26 204	140 088	21
Louisville	(Kentucky)	368 640	5 405	14 343	16 132	88 832	3
Parkersburg	(West Virginia)	171 531	3 056	6 606	8 117	38 147	1
Midwest Region		3 717 587	80 387	333 818	181,862	998,783	646
Aberdeen	(South Dakota)	97 598	2 147	8 731	7 292	21 313	13
Chicago	(See (c) below)	884 560	17 423	98 425	21 478	293 088	152
Des Moines	(Iowa)	341 588	8 213	38 578	19 360	88 074	12
Fargo	(North Dakota)	90 219	2 617	11 119	8 060	21 113	1
Helena	(Montana)	123 868	2 466	7 066	8 896	47 141	3
Milwaukee	(Wisconsin)	356 658	11 491	44 145	25 372	125 983	94
Omaha	(Nebraska)	213 156	4 396	18 094	21 382	49 204	21
St Louis	(Missouri)	587 727	12 433	25 411	23 889	143 998	71
St Paul	(Minnesota)	493 893	12 306	51 815	41 934	164 747	151
Springfield	(See (c) below)	320 312	6 810	26 534	14 213	58 174	63
Southwest Region		3,857 938	57 805	185 563	132,778	1,758,752	108
Albuquerque	(New Mexico)	180 879	2 488	6 151	8 072	60 830	–
Austin	(See (g) below)	555 527	8 523	19 790	17 958	274 511	2
Cheyenne	(Wyoming)	68 508	1 389	2 531	4 135	22 885	–
Dallas	(See (g) below)	830 810	12 207	40 861	32 831	421 272	1
Denver	(Colorado)	479 342	7 674	25 881	13 108	192 078	71
Houston	(See (g) below)	473 478	5 559	26 587	12 771	275 488	–
Oklahoma City	(Oklahoma)	348 083	5 744	14 946	16 798	163 320	1
Phoenix	(Arizona)	371 173	5 348	21 803	8 456	175 467	18
Salt Lake City	(Utah)	158 529	2 513	9 184	6 451	80 648	9
Wichita	(Kansas)	313 678	6 367	17 879	14 898	101 253	5
Western Region		4 543 579	73 676	391 883	145 336	2,172,176	119
Anchorage	(Alaska)	62 752	1 359	4 020	2 570	49 801	–
Boise	(Idaho)	118 995	1 870	6 037	8 865	35 500	3
Honolulu	(Hawaii)	121 489	1 948	10 916	1 789	60 038	–
Laguna Niguel	(See (a) below)	860 451	11 595	78 685	18 653	424 231	–
Las Vegas	(Nevada)	116 039	1 520	6 323	6 148	56 842	7
Los Angeles	(See (a) below)	883 152	13 218	90 556	14 118	417 144	–
Portland	(Oregon)	350 935	6 112	22 562	17 077	150 107	31
Sacramento	(See (a) below)	539 078	9 207	44 927	18 351	299 508	2
San Francisco	(See (a) below)	375 327	8 340	40 496	5 253	195 212	3
San Jose	(See (a) below)	602 959	10 277	57 769	19 993	267 752	–
Seattle	(Washington)	562 477	10 272	34 592	34 519	230 038	73
International		201 371	709	1 866	3,982	136 610	1,163
Puerto Rico		178 676	120	755	90	3 543	1
Other		22 695	589	1 111	3 892	133 067	1 162
	(a) California	3 260 967	52 637	307 433	74 368	1 573 847	5
	(b) Florida	1 609 346	18 929	83 575	34 169	733 341	150
	(c) Illinois	1 204 872	24 293	124 939	35 689	351 190	215
	(d) New York	2 273 658	41 907	152 090	49 676	845 745	506
	(e) Ohio	1 082 290	22 736	84 095	38 310	319 203	148
	(f) Pennsylvania	1 220 623	25 707	76 945	48 168	342 830	115
	(g) Texas	1 859 765	26 294	87 238	63 360	971 271	3

Column Contents

(10) Includes Forms 940, 940PR, 941, 941PR and SS, 941E, 942, 942PR, 943, 943PR and SS, CT-1 and 1042

(11) Includes Forms 990, 990PF, 990T, 990C, 5227 and 4720

(12) Includes Forms 5500, 5500C, 5500 Z, 5500R and 5500M

(13) Includes Forms 720, 730, 2290 and 11C

(14) Includes Forms 1040X, 1120X, 2688, 4868, 7004 and 1041A

(15) Includes Forms 941M, 941 NMI, CT 2, 990BL, 1042, 1120 DISC, 1120 IC DISC, 1120 FSC and 8404

APPENDIX B

Estimated 1979 Federal Individual Income Taxes In Puerto Rico

Adjusted Gross Income	Number Of Returns	Estimated Federal Taxes (see note a)	Total Earned Income Credit	Earned Income Payments To Taxpayers	Earned Income Credit Used To Offset Taxes
Under $2,000	19,458	$ 0	$ 421,525	$ 421,525	$ 0
2,000 under 4,000	33,341	0	3,730,943	3,730,943	0
4,000 under 6,000	60,210	2,813,877	14,495,500	14,106,271	389,229
6,000 under 8,000	66,468	3,858,545	13,382,406	11,642,927	1,739,479
8,000 under 10,000	49,441	10,395,086	4,007,872	1,316,630	2,691,242
10,000 under 15,000	72,216	48,482,902	-	-	-
15,000 under 20,000	37,888	54,496,300	-	-	-
20,000 under 25,000	17,125	40,415,732	-	-	-
25,000 under 30,000	8,003	27,567,295	-	-	-
30,000 under 50,000	7,854	45,131,421	-	-	-
50,000 under 100,000	1,691	26,307,972	-	-	-
100,000 under 500,000	206	11,174,955	-	-	-
Subtotal	373,901	$276,144,085	$36,038,246	$31,218,296	$4,819,950
Less: Federal Internal Revenue Service estimate of individual taxes actually paid by residents of Puerto Rico on income from sources outside Puerto Rico (see note b)		28,117,000	-	-	-
Total		$248,027,085	$36,038,246	$31,218,296	$4,819,950

a/Net of earned income credit used to offset taxes due.

b/Latest available data was for 1978.

APPENDIX B_2

Estimated 1979 Federal Individual Income Taxes In Puerto Rico

Adjusted Gross Income	Number Of Returns	Estimated Federal Taxes (see note a)	Total Earned Income Credit	Earned Income Payments To Taxpayers	Earned Income Credit Used To Offset Taxes
Under $2,000	19,458	$ 0	$ 421,525	$ 421,525	$ 0
2,000 under 4,000	33,341	0	3,730,943	3,730,943	0
4,000 under 6,000	60,210	2,813,377	14,495,500	14,106,271	389,229
6,000 under 8,000	66,468	5,858,545	13,382,406	11,642,927	1,739,479
8,000 under 10,000	49,441	10,395,086	4,007,872	1,316,630	2,691,242
10,000 under 15,000	72,216	46,482,902	-	-	-
15,000 under 20,000	37,838	54,496,300	-	-	-
20,000 under 25,000	17,125	40,415,732	-	-	-
25,000 under 30,000	8,003	27,567,295	-	-	-
30,000 under 50,000	7,854	45,131,421	-	-	-
50,000 under 100,000	1,691	26,307,972	-	-	-
100,000 under 500,000	206	11,174,955	-	-	-
Subtotal	373,901	$276,144,085	$36,038,246	$31,218,296	$4,819,950
Less: Federal Internal Revenue Service estimate of individual taxes actually paid by residents of Puerto Rico on income from sources outside Puerto Rico (see note b)		28,117,000	-	-	-
Total		$248,027,085	$36,038,246	$31,218,296	$4,819,950

a/Net of earned income credit used to offset taxes due.

b/Latest available data was for 1978.

DATOS BASICOS DE PLANILLAS
AÑO FISCAL 1988
AÑO NATURAL 1987

JIAEPL01 TABULACION DE LA CINTA PLANILLAS CUADRADAS 3/16/89 PAG. 1

TOTAL PLANILLAS LEIDAS	542,431
CONT RETENIDA NO RESIDENTES	368,690.56
CONT TOTAL RETENIDA	702,634,885.64
TOTAL SALARIOS Y COMISIONES	6,920,523,547.56
TOTAL GASTOS DEDUC EN SALARIOS	594,728,451.59
INGRESO BRUTO AJUSTADO	7,599,468,509.61
DEDUCCIONES Y CREDITOS	3,852,684,633.81
ING NETO SUJETO CONTRIBUCION	3,822,874,285.56
TOTAL CONT DETERMINADA	796,024,625.69
TOTAL CONT DECLARADA	770,511,603.47
PAGOS SOBRE CONT ESTIMADA	74,692,827.99
CONT DETERMINADA BALANCE A PAGAR	372,023,948.36
CONT DECLARADA BALANCE A PAGAR	366,900,961.71
CANT QUE SE ACOMPAÑA CON PLANILLA	306,106,430.32
CONT DETER BAL PEND PAGO O PAG E	98,442,839.94-
CONT DECLA BAL PEND PAGO O PAG E	83,443,424.22
DEDUCCION FIJA	403,654,173.12
SISTEMA RETIRO	125,526,598.88
INTERESES PAGADOS	1,068,684,440.91
TABLILLAS DEL AUTO	36,884,313.72
CONT SOBRE PROPIEDAD	32,584,324.18
PERDIDA DE LA RESIDENCIA	2,763,676.61
DONACIONES	25,699,742.59
CONT ALTERNATIVA ANTES CREDITOS	15,482,681.74
DEDUCCION CALENTADOR SOLAR	1,952,999.57
DIFERENCIA ENTRE CONTRIBUCION DECLARADA Y ALTERNATIVA	
DIFERENCIA ENTRE CREDITOS Y CONTRIBUCION DECLARADA	323,715.59

GASTOS ASISTENCIA MEDICA	14,219,360.81
DEDUCCION A VETERANOS	30,498,500.00
EXENCION PERSONAL	1,952,599.57
TOTAL DE CREDITOS	1,761,934,221.75
INGRESO DE INTERESES	68,315,598.01
BENEFICIOS DE SOCIEDADES	2,355,842.07
DIVIDENDOS	4,742,212.69
GANANCIA O PERDIDA NEGOCIOS	194,702,462.72
GANANCIA O PERDIDA AGRICULTURA	3,066,756.05-
GANANCIA O PERDIDA PROFESIONES	288,260,545.79
PERDIDA NETA OPERACIONES	12,770,027.82
GAN O PERD VENTA O PERM. ACT CAP	76,688,429.40
GAN O PERD VENTA O PERM OTROS AC	6,713,415.21
ING ANUALIDADES O PENSIONES	85,601,815.38
ING RENTAS O CANONES	78,021,027.56
ING MISCELANEOS	84,929,127.43
CREDITO CONT PAGADA AL EXTRANJERO	
PERDIDA DE BIENES INMUEBLES POR CAUSAS FORTUITAS	3,262,461.54
JORNALES NO SUJETOS A RETENCION	352,252,738.56
GANANCIA O PERDIDA COMISIONES	50,408,837.65
GASTO CUIDO DE HIJOS	47,457,223.54
RENTA PAGADA	13,416,321.76
CREDITO DE ESTIMADA ORIGINAL	
PROP DEDUCIBLE CONT PAGADA EU	7,429,470.93
NUMERO DE CASOS	0
NUMERO DE CASOS	249

APPENDIX B5

BAL PEND PAGO O PAG EX DETERM (EXENTOS)	5,503.31	NUMERO DE CASOS	32,782
BAL PEND PAGO O PAG EX DETERM, REG (OBLIGADOS)	9,503,450.44-	NUMERO DE CASOS	30,288
BAL PEND PAGO O PAG EX DETERM, REG (NO OBLIGA)	1,305,775.69-	NUMERO DE CASOS	6,233

492918 RCDS. ESCRITOS EN CINTA 49513 RCDS. CUADRADOS

CANT. PAGADA EN EXCESO PARA ACREDITAR A ESTIMADA DECLARADO 10,003,569.26

CANT. ACREDITADA A ESTIMADA CON PL. EXENTA 962,271.28 NUMERO DE CASOS 731

CANTIDAD SOLICITADA PARA BONO .00

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C M E 3

DEPARTAMENTO DE HACIENDA
OFICINA DE ESTUDIOS ECONOMICOS Y FINANCIEROS
SAN JUAN, PUERTO RICO

APPENDIX B6

DATOS BASICOS DE PLANILLAS DE INDIVIDUOS TOTALES POR CATEGORIA DE INGRESO BRUTO AJUSTADO
AÑO FISCAL 1987

PLANILLAS TRIBUTABLES

ING. BRUTO SOBRE	AJUS. HASTA	NUMERO PLANS.	ING. BRUTO AJUSTADO	DEDUCCION FIJA	DEDUCCIONES ESPECIALES	EXENCION PERSONAL	CREDITO POR DEPENDIENTES	INGRESO NETO TRIBUTABLE	CONT. DECL. DESP. CREDS.	# DEPENDIENTES HIJOS	OTROS
	2,000	4,851	7,133,357	713,310	394,352	3,882,000	14,401	2,129,127	217,824	3	15
2,000	3,000	7,334	18,707,899	1,870,910	1,458,015	8,536,000	235,200	6,607,605	676,563	97	181
3,000	4,000	10,571	37,188,698	3,719,035	3,467,958	14,759,200	1,632,600	13,607,303	1,416,263	1,082	879
4,000	5,000	13,451	60,987,414	6,098,846	6,869,892	20,845,600	5,123,001	22,045,891	2,360,251	3,968	2,198
5,000	6,000	20,086	111,267,935	11,127,134	14,327,858	33,310,400	12,965,800	39,529,920	4,329,714	10,355	5,268
6,000	8,000	66,410	466,049,278	46,605,842	69,105,031	115,891,600	65,925,603	168,494,833	19,225,420	52,762	26,748
8,000	10,000	62,058	557,554,865	55,755,906	94,135,661	110,212,800	76,069,401	221,352,922	26,833,855	62,275	29,456
10,000	12,500	67,524	757,371,905	67,524,009	145,373,722	123,025,200	96,552,606	324,864,322	42,332,266	80,868	34,824
12,500	15,000	46,581	637,920,807	51,033,690	122,694,810	86,703,600	76,877,005	300,589,498	42,639,256	64,300	27,687
15,000	20,000	67,335	1165,791,397	93,263,354	233,586,341	127,292,400	126,352,402	585,264,593	92,855,237	107,023	46,017
20,000	25,000	41,244	919,100,815	73,528-218	188,995,924	78,871,200	84,826,000	492,859,726	89,965,510	72,921	27,972
25,000	30,000	23,564	643,010,653	47,128,002	131,565,628	45,173,200	49,155,200	369,976,984	77,357,683	42,424	15,753
30,000	33,333	10,516	332,252,090	21,032,901	69,134,284	20,250,800	22,247,200	199,582,703	46,063,186	19,260	8,982
33,333	40,000	12,982	471,281,344	28,277,016	97,350,106	25,019,600	26,450,000	294,178,440	74,637,195	23,200	7,788
40,000	50,000	9,217	408,177,484	24,490,740	86,535,178	17,765,600	18,496,000	260,885,717	74,329,836	16,689	4,903
50,000	60,000	3,979	216,322,771	12,979,388	46,016,552	7,739,600	7,735,400	141,850,032	45,185,959	7,162	1,843
60,000	75,000	2,626	174,494,772	10,464,297	36,454,149	5,110,400	4,887,000	117,487,731	41,040,068	4,593	1,059
75,000	90,000	1,174	90,318,769	5,332,510	19,667,931	2,284,400	2,149,600	66,583,789	25,759,962	2,091	379
90,000	100,000	427	40,262,249	2,013,110	8,001,906	834,800	799,000	28,613,250	11,227,427	811	111
100,000	150,000	761	90,663,117	4,583,159	25,868,836	1,470,400	1,284,000	68,456,409	28,504,551	1,287	193
150,000		459	109,656,089	6,032,817	16,181,409	874,800	650,600	86,916,312	37,529,392	661	83
TOTALES		473,150	7321,123,708	573,573,444	1407,185,543	849,853,602	680,428,019	3811,877,107	784,467,418	573,892	238,318

T-C37IBA

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APPENDIX B-1

[illegible]PARTAMENTO DE HACIENDA
[illegible]FICINA DE [illegible]STUDIOS [illegible]CONOMICOS Y FINANCIEROS
SAN JUAN, PUERTO RICO

INGRESO BRUTO AJUSTADO DE PLANILLAS DE INDIVIDUOS
POR FUENTE DE INGRESOS Y POR CATEGORIA DE INGRESO BRUTO AJUSTADO
*1987

PLANILLAS TRIBUTABLES

INGRESO BRUTO AJUSTADO SOBRE	HASTA	SALARIOS # PLS. CANT.	DIVIDENDOS # PLS. CANT.	BENEFICIOS DE SOCIEDADES # PLS. CANT.	INTERESES # PLS. CANT.	INGRESOS DE INDUST.,COM. Y NEGOCIOS # PLS. CANT.	INGRESOS DE AGRICULTURA # PLS. CANT.
50,000	60,000	2,302 153,889,793	512 2,590,791	20 55,334-	52 251,907	194 3,842,718	47 289,334-
60,000	75,000	2,096 115,027,460	510 2,599,[illegible]	16 1[illegible],276	72 238,014	133 3,013,840	30 50,509-
75,000	90,000	986 56,565,542	223 1,621,853	20 265,139	38 125,558	64 1,971,576	20 203,346-
90,000	100,000	326 22,373,[illegible]	145 65[illegible],1[illegible]	11 126,698-	18 65,852	27 809,910	5 42,944-
100,000	150,000	588 49,258,347	323 1,952,714	18 7,690	37 312,025	36 1,669,253	23 80,826
150,000		346 46,626,[illegible]	271 [illegible]	25 913,587	25 291,907	18 917,930	7 74,124-
TOTAL		410,623 6,123,536,1[illegible]6	16,412 61,229,[illegible]14	352 2,091,933	1,349 4,465,904	23,920 175,887,455	2,737 690,19[illegible]

NEW YORK TIMES NATIONAL SUNDAY, FEBRUARY 4, 1990

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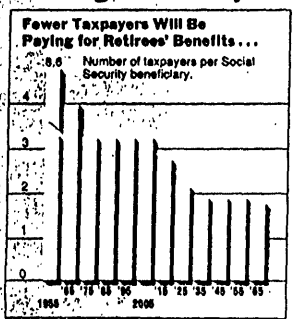
Appendix (

Planning for the Baby Boom's Retirement

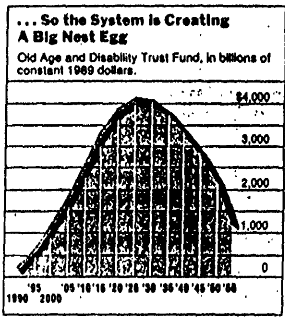
Fewer Taxpayers Will Be Paying for Retirees' Benefits . . .

Number of taxpayers per Social Security beneficiary.



. . . So the System Is Creating A Big Nest Egg

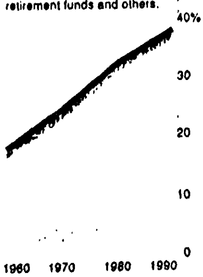
Old Age and Disability Trust Fund, in billions of constant 1989 dollars.



Source: Social Security Board of Trustees Report 1989, Alternative IIA

Growing dependence

Percentage of Federal revenues from payroll taxes including Social Security, Medicare, disability insurance, Federal employee retirement funds and others.



Source: Congressional Budget Office

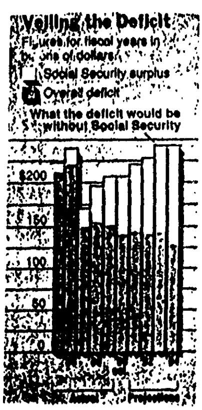
A dent in the paycheck

If employer contributions are included, most people pay more in Social Security and payroll taxes than they do in income tax. Here are relative 1990 tax burdens at different income levels for a married couple with two children. Figures assume both partners work and have equal earnings, all in wages; itemized deductions equal 20 percent of income, and no claim is made for child-care credit.

	Social Security taxes*		
Yearly wages	Employee share	Employee share plus employer share	Income tax
$20,000	$1,530	$3,060	$926
30,000	2,295	4,590	2,370
40,000	3,060	6,120	3,570
50,000	3,825	7,650	4,770
60,000	4,590	9,180	6,925
70,000	5,355	10,710	9,165
80,000	6,120	12,240	11,405
90,000	6,885	13,770	13,645
100,000	7,650	15,300	15,885
110,000	7,849	15,698	18,195
120,000	7,849	15,698	20,835

* Payroll taxes including Social Security and Medicare.

Source: Congressional Budget Office calculations



A crutch for the budget

The surplus funds collected by *Social Security* are being used to offset a significant share of the budget deficit. Figures in billions of dollars.

	Projected deficit without Social Security surplus	(minus)	Projected Social Security surplus	(equals)	Projected final deficit
1990	$206		$65		$141
1991	219		75		144
1992	227		86		141
1993	242		99		143
1994	241		113		128

Source: Congressional Budget Office

APPENDIX C2

Forma **1040-PR**
Department of the Treasury
Internal Revenue Service

PLANILLA PARA LA DECLARACIÓN DE LA CONTRIBUCIÓN FEDERAL SOBRE EL TRABAJO POR CUENTA PROPIA — PUERTO RICO

Para el año natural (calendario) 1989 u otro año contributivo comenzado el .... de 1989 y terminado el .... de 19.....

OMB No 1545-0090

1989

Escriba a máquina o con letra de molde

Nombre e inicial	Apellido	Número de seguro social
Dirección actual (calle, número o ruta rural)		Naturaleza del negocio
Ciudad, pueblo u oficina postal y zona postal "ZIP"		

A Si usted es ministro, miembro de una orden religiosa o practicante de la Ciencia Cristiana Y usted radicó la Forma 4361, pero obtuvo otras ganancias ascendentes a $400 ó más sujetas a la contribución sobre el trabajo por cuenta propia, continue en la Parte I y marque este encasillado ... ▶ ☐

B Si su unico ingreso sujeto a la contribución federal sobre el trabajo por cuenta propia fue de salarios procedentes de una iglesia u organización controlada por una iglesia que está exenta del pago de la contribución patronal al seguro social, y usted no es sacerdote, ministro, pastor o miembro de una orden religiosa, haga caso omiso a las líneas de la 1 a la 3b Anote cero en la línea 3c Continue en la línea 5a

Parte I — Compute la contribución federal al seguro social sobre el trabajo por cuenta propia

1	Ganancia (o pérdida) neta procedente de un negocio agropecuario, la cantidad de la línea 36, Parte III, más la parte recibida por usted de la ganancia neta de una sociedad agropecuaria. (Vea las instrucciones en la página 4)		1	
2	Ganancia (o pérdida) neta procedente de un negocio no agropecuario, la cantidad de la línea 28, Parte IV, más la parte recibida por usted de la ganancia neta de una sociedad no agropecuaria Los empleados de una iglesia o de una organización controlada por una iglesia que eligió exención de la contribución NO deberán anotar en esta línea los salarios que aparecen en su Forma 499R-2/W-2PR (Vea las instrucciones en la página 5)		2	
3a	Anote aquí la cantidad de la línea 1 (o, si eligió el método opcional (negocio agropecuario), de la línea 2, Parte II) ..		3a	
b	Anote aquí la cantidad de la línea 2 (o, si eligió el método opcional (negocio no agropecuario), de la línea 4, Parte II)		3b	
c	Sume las líneas 3a y 3b Si el total de esta suma es menos de $400, no radique esta planilla, usted no adeuda la contribución federal sobre el trabajo por cuenta propia (Excepción: Si usted era empleado de una iglesia u organización controlada por una iglesia exenta del pago de la contribución, y el total de las líneas 3a y 3b es menos de $400, anote cero y complete el resto de esta planilla)		3c	
4	Máximo combinado de salarios y ganancia neta del trabajo por cuenta propia sujetos a la contribución al seguro social en 1989		4	$48,000 00
5a	Total de salarios y propinas sujetos a la contribución al seguro social, segun aparecen en la Forma 499R-2/W-2PR o en la Forma W-2 Importante: Los empleados del gobierno sujetos solamente a la contribución del 1.45% al Medicare y los empleados de ciertas iglesias u organizaciones controladas por una iglesia NO deberán anotar sus salarios en esta línea Vea las instrucciones ...	5a		
b	Propinas que usted no informó a su patrono y que están sujetas a la contribución al seguro social, línea 9 de la Forma 4137	5b		
c	Sume las líneas 5a y 5b Anote el total aquí		5c	
6a	Reste la línea 5c de la línea 4 Anote el total aquí Si el resultado es cero o menos, anote cero y no continue, usted no adeuda la contribución federal sobre el trabajo por cuenta propia ...... ▶		6a	
b	Anote sus salarios gubernamentales calificados sujetos al Medicare Vea las instrucciones para determinar si usted debe usar el borrador que viene con las mismas para computar su contribución sobre el trabajo por cuenta propia ..	6b		
c	Anote los salarios ascendentes a $100 ó más que aparecen en su Forma 499R-2/W-2PR o en su Forma W-2 recibidos de una iglesia u organización controlada por una iglesia que eligió exención de la contribución	6c		
d	Sume las líneas 3c y 6c. Anote el total aquí ..... ▶		6d	
7	Anote la menor de las cantidades que aparecen en las líneas 6a y 6d		7	
8	Tipo de contribución		8	x .1302
9	Contribución sobre el trabajo por cuenta propia. Si la línea 7 es $48,000, anote $6,249 60 De lo contrario, multiplique la línea 7 por el numero decimal indicado en la línea 8 y anote el resultado. (Vea las instrucciones para la línea 9) ..		9	
10	Pagos hechos mediante declaración de contribución estimada del año 1989		10	
11	Si la línea 10 es mayor que la línea 9, anote aquí la cantidad PAGADA EN EXCESO .... ▶		11	
12	Cantidad de la línea 11 que desea que se le REINTEGRE .... ▶		12	
13	Cantidad de la línea 11 que desea que se le ACREDITE A LA CONTRIBUCION ESTIMADA DE 1990 ▶	13		
14	Si la línea 9 es mayor que la línea 10, anote aquí el MONTO NO PAGADO DE LA CONTRIBUCIÓN. Acompañe cheque o giro por la totalidad de la contribución adeudada a la orden del *Internal Revenue Service*. Escriba en el mismo su numero de seguro social y "Forma 1040-PR, 1989" ..... ▶		14	

Sírvase firmar aquí

Declaro bajo las penalidades de perjurio que esta planilla, incluyendo los anexos y demás documentos que se acompañan, ha sido examinada por mí y que segun mi mejor conocimiento y creencia es cierta correcta y completa La declaración del agente o preparador (que no es el contribuyente) está basada en toda la información sobre la cual el agente o preparador tenía conocimiento

▶ ______________________ Su firma ▶ ______________________ Fecha

Para uso del agente o preparador remunerado solamente

Firma del agente o preparador ▶	Fecha	Marque aquí si el agente o preparador trabaja por cuenta propia ▶ ☐	Número de seguro social
Nombre del negocio (o del agente o preparador, si trabaja por cuenta propia) y dirección ▶		Número de identificación patronal ▶	
		Zona postal "ZIP" ▶	

Vea en la página cuatro el Aviso sobre la Ley de Reducción de Trámites.

Sección C.—Ingreso de negocio agropecuario—Método de contabilidad a base de lo devengado
No incluya en las líneas de abajo la venta de animales usados para tiro, cría, entretenimiento o lechería.

37	Venta de animales, productos agrícolas (vegetales, frutas, etc.), granos y otros productos durante el año	37	
38a	Total de distribuciones de cooperativas (Forma(s) 1099-PATR) 38a ______ 38b Cantidad tributable	38b	
39	Pagos recibidos del programa de agricultura	39	
40	Préstamos por crédito sobre productos bajo elección (o decomiso)	40	
41	Ingreso de servicios prestados con equipo agrícola	41	
42	Otros ingresos de negocio agropecuario (especifique)	42	
43	Sume las líneas de la columna derecha desde la 37 hasta a la 42, ambas inclusive	43	
44	Inventario de animales, productos agrícolas (vegetales, frutas, etc.), granos y otros productos al comienzo del año	44	
45	Costo de animales, productos agrícolas (vegetales, frutas, etc.), granos y otros productos comprados durante el año	45	
46	Sume las líneas 44 y 45	46	
47	Inventario de animales, productos agrícolas (vegetales, frutas, etc.), granos y otros productos al final del año	47	
48	Costo de animales, productos agrícolas (vegetales, frutas, etc.), granos y otros productos agrícolas vendidos Reste la línea 47 de la línea 46*	48	
49	Ingreso bruto agropecuario. Reste la línea 48 de la línea 43. Anote la diferencia aquí y en la página 2, línea 11, Parte III ►	49	

*Si usted usa el método de precio por unidad para los animales, o el método de precio de finca para valorar su inventario y la cantidad que aparece en la línea 47 es mayor que la de la línea 46, reste la línea 46 de la línea 47 y anote el resultado en la línea 48. Después sume las líneas 43 y 48, y anote en la línea 49 el total obtenido.

Parte IV Ganancia o pérdida de negocio (por cuenta propia)

Sección A.—Ingresos

1	Total de ingresos $______ menos devoluciones y descuentos $______ Balance ►	1	
2a	Inventario al comenzar el año	2a	
b	Mercancías compradas (menos el costo de los artículos retirados del negocio para uso personal)	2b	
c	Costo de mano de obra (no incluya el sueldo pagado a usted mismo)	2c	
d	Materiales y suministros	2d	
e	Otros costos (junte una explicación)	2e	
f	Sume las líneas de la 2a a la 2e	2f	
g	Inventario al final del año	2g	
h	Costo de mercancías vendidas. Reste la línea 2g de la línea 2f	2h	
3	Ganancia bruta. Reste la línea 2h de la línea 1	3	
4	Otros ingresos	4	
5	Ingreso bruto. Sume las líneas 3 y 4 ►	5	

Sección B.—Gastos

6	Anuncios	6		20	Reparaciones	20
7	Deudas incobrables de ventas y servicios	7		21	Materiales (no incluidos en la Sección A)	21
8	Gastos de vehículos de motor	8		22	Contribuciones	22
9	Comisiones	9		23	Gastos de viaje, comidas y entretenimiento:	
10	Agotamiento	10		a	Viajes	23a
11	Depreciación y deducciones de acuerdo a la sección 179 del Código, de la Forma 4562 (no incluida en la Sección A)	11		b	Total de comidas y entretenimiento	
12	Programas para el beneficio de los empleados (excepto los incluidos en la línea 18)	12		c	Anote el 20% de la cantidad de la línea 23b sujeta a la limitación	
13	Fletes (no incluidos en la Sección A)	13		d	Reste la línea 23c de la línea 23b	23d
14	Seguros (excepto de salud)	14		24	Servicios públicos (agua, electricidad, gas, etc.) y teléfono	24
15	Intereses sobre deudas del negocio	15		25	Sueldos no incluidos en la línea 2c	25
16	Servicios legales y profesionales	16		26	Otros gastos (indique tipo de gasto y cantidad)	
17	Gastos de oficina	17				
18	Planes de pensión y de participación en las ganancias	18				
19	Renta o alquiler:					
a	Maquinaria y equipo	19a				
b	Otra propiedad comercial	19b				26

27	Total de gastos. Sume las líneas de la 6 a la 26 ►	27	
28	Ganancia o pérdida neta. Reste la línea 27 de la línea 5. Anótela aquí y en la página 1, línea 2	28	

BEST AVAILABLE COPY

The Operation and Effect of the Possessions Corporation System of Taxation

Sixth Report

Department of the Treasury
March 1989

TABLE 3-2

NET MIGRATION OF RESIDENTS OF PUERTO RICO

Fiscal year	Net migration of residents of Puerto Rico	Annual rate per mid-period population
1950-1960	-493,000	-2.19%
1960-1970	-201,000	- .79
1970-1977	- 43,640	- .22
1978	- 20,282	- .65
1979	- 6,078	- .19
1980	- 16,101	- .51
1981	- 10,460	- .32
1982	- 33,297	-1.02
1983	- 44,433	-1.36
1984	- 34,484	-1.06
1985	- 28,609	- .87
1986	- 46,619	-1.42
1987	- 22,325	- .68

Department of the Treasury
Office of Tax Analysis

SOURCE: Puerto Rico Planning Board, Economic Report to the Governor (various issues); U.S. Bureau of the Census, Current Population Reports, Series P-25, Nos. 80, 336, and Puerto Rico Department of Labor and Human Resources.

TABLE 3-3

PUERTO RICAN UNEMPLOYMENT RATE AND DISTRIBUTION OF EMPLOYMENT IN SELECTED YEARS, 1950 - 1988
(thousands of workers)

Fiscal Year	Unemployment rate	Total employment[a]	Government[b]	Total non-government employment	Agriculture	Manufacturing	Home needlework	Construction	Wholesale and retail trade	Finance, insurance, real estate	Transportation and utilities	Other services
1950	12.9%	596	45	551	214	55	51	27	90	3	20	77
1955	14.3	539	50	489	164	66	29	34	89	n.a.	n.a.	69
1960	13.1	543	62	481	124	81	10	45	97	6	39	75
1965	11.7	617	82	535	107	106	6	56	109	n.a.	n.a.	103
1970	10.7	686	106	580	68	132	*	76	120	13	45	116
1971	11.2	699	111	588	61	132	*	81	134	15	47	117
1972	11.9	738	131	607	58	142	*	80	135	16	49	126
1973	11.7	745	141	604	49	139	*	78	144	18	49	125
1974	12.2	744	140	604	52	141	*	77	141	17	51	123
1975	15.3	699	143	556	47	130	*	65	134	17	49	114
1976	19.4	678	149	529	44	126	*	50	132	17	44	114
1977	20.0	691	157	534	40	135	*	40	136	18	46	119
1978	18.7	722	167	555	36	145	*	41	139	19	46	128
1979	17.5	735	173	562	36	146	*	44	141	19	46	130
1980	17.0	753	184	569	38	143	*	44	138	21	47	135
1981	17.9	759	185	574	37	141	*	44	142	23	49	137
1982	21.7	719	171	548	34	134	*	36	141	21	48	132
1983	23.4	703	170	533	36	131	*	30	136	22	45	132
1984	22.0	743	177	562	40	142	*	34	145	22	41	140
1985	21.4	758	180	578	38	138	*	36	147	23	43	151
1986	20.5	777	180	597	40	140	*	36	149	26	49	157
1987	17.7	834	197	637	35	152	*	41	159	30	52	167
1988p	15.9	873	201	672	31	157	*	48	173	30	50	182
Average annual growth rate												
1950-1960		-0.9%	3.3%	-1.3%	-5.3%	3.9%	-15.0%	5.2%	0.8%	7.2%	3.4%	-0.3%
1960-1970		2.4	5.5	1.9	-5.8	5.0	—	5.4	2.0	8.0	1.4	4.5
1970-1980		0.9	5.7	-0.2	-5.2	0.8	—	-5.3	0.0	4.9	0.4	1.5
1980-1986		0.4	-0.3	0.7	0.7	-0.3	—	-2.0	1.1	3.1	0.6	2.2
1985-1986		2.5	0.0	3.3	5.3	1.4	—	0.0	1.4	13.0	14.0	4.0
1986-1987		7.3	9.4	6.7	-12.5	8.6	—	13.9	4.7	15.4	6.1	6.4
1987-1988p		4.7	2.0	5.8	-11.4	3.3	—	17.1	8.8	0.0	-3.8	9.0

Department of the Treasury
Office of Tax Analysis

SOURCES: Puerto Rico Planning Board, Economic Report to the Governor (various issues); Puerto Rico Development Administration, Economic Analysis of the Industrial Incentive Program of Puerto Rico, 1978; Institute of International Law and Economic Development, Puerto Rico Industrial Sector Study, Draft Report for the U.S. Department of Commerce, April 1978.

NOTE: Figures for 1971 through 1981 were revised in the Economic Report to the Governor, 1982-1983.

[a] Figures may not add to total due to rounding errors.

[b] Includes only public administration.

* Less than 2,000

n.a. not available

p Preliminary figures

TABLE 3-6

NET INCOME ORIGINATING IN PUERTO RICAN MANUFACTURING FISCAL YEARS 1960, 1970, 1980, 1983, AND 1988
($ million)

	1960		1970		1980		1983		1988p	
	Amount of net income	Percent of total	Amount of net income	Percent of total	Amount of net income	Percent of total	Amount of net income	Percent of total[a]	Amount of net income	Percent of total
All manufacturing industries	288.8	100.0%	957.6	100.0%	4,808.7	100.3%	5,734.9	100.0%	9,432.5	100.0%
Food and kindred products	66.7	23.1	161.3	16.8	548.5	11.4	564.8	9.8	1,152.0	12.2
Tobacco products	10.4	3.6	36.4	3.8	46.3	1.0	55.2	1.0	84.8	0.9
Textile mill products	13.9	4.8	41.1	4.3	39.6	0.7	31.7	0.6	48.3	0.5
Apparel	50.7	17.6	172.0	18.0	360.7	7.5	408.2	7.1	458.7	4.9
Furniture and wood products	8.8	3.0	26.2	2.7	29.6	0.6	27.3	0.5	36.2	0.4
Printing and publishing	11.2	3.9	22.6	2.4	58.8	1.2	69.5	1.2	104.5	1.1
Chemicals	9.8	3.4	109.3	11.4	1,583.2	32.9	2,268.9	39.6	4,180.8	44.3
Stone, clay, and glass products	18.8	6.5	49.1	5.1	95.4	2.0	77.3	1.3	138.9	1.5
Machinery and metal products	54.7	18.9	191.5	19.4	1,453.7	30.2	1,752.5	30.6	2,744.8	29.1
Other manufacturing	43.7	15.1	148.0	15.5	597.0	12.4	479.4	8.4	483.6	5.1

Department of the Treasury
Office of Tax Analysis

SOURCE: Puerto Rico Planning Board, Economic Report to the Governor, Table 7 (various years).

[a] Percentages do not add to 100 due to rounding errors.

p Preliminary figures

APPENDIX D_5 36

TABLE 4-5

NET INCOME, POSSESSIONS TAX CREDITS CLAIMED AND ESTIMATED TAX BENEFITS BY INDUSTRY, 1983
($ million)

	625 companies; 527 manufacturing		
	Net income	Credit claimed	Tax benefit
All manufacturing industries	$4,131	$1,895	$1,641
Food and kindred products	279	128	113
Textile mill products	6	3	3
Apparel	123	56	51
Chemicals	2,013	925	809
Pharmaceuticals	1,888	867	760
Other chemicals	125	58	49
Rubber and plastic products	29	13	12
Leather	40	18	17
Fabricated metal products	52	24	21
Machinery, except electrical	41	19	17
Electrical and electronic equipment	1,008	461	382
Instruments and related products	286	131	115
All other manufacturing	254	117	101
Nonmanufacturing	157	71	0
Total	$4,228	$1,966	$1,641

Department of the Treasury
Office of Tax Analysis

APPENDIX D6

TABLE 4-11

FEDERAL REVENUE COST ESTIMATES, POSSESSIONS CORPORATION PROVISIONS, 1973-1983

(millions of dollars)

Year	Calendar Year Receipts Foregone*	Fiscal Year Receipts Foregone*
1973	269	254
1974	393	325
1975	473	429
1976	692	572
1977	763	724
1978	988	864
1979	1,156	1,121
1980	1,233	1,195
1981	1,694	1,463
1982	1,643	1,668
1983	1,619	1,633

Department of the Treasury
Office of Tax Analysis

* Estimates for 1973 through 1975 are based on the original possessions corporation provisions enacted in the Revenue Act of 1921. Estimates for 1976 to 1982 are based on the section 936 provisions of the Tax Reform Act of 1976. Estimates for 1983 are based on the provision of TEFRA.

Source: The 1973 through 1975 figures are based on book income data taken primarily from 936 election forms filed for 1976 (Form 5712). The 1976 and 1977 estimates are based on net income data taken primarily from Federal income tax forms (Form 1120). The figures for 1978-1983 are based on qualified possession taxable income taken from possessions credit computation forms (Form 5735).

APPENDIX E

Figure J

Current-year Foreign Taxes and Foreign Branch Taxable Income as Percentages of Foreign-source Taxable Income, by Selected Country, 1982 1/

[Money amounts are in millions of dollars]

Country	Current-year foreign taxes as a percentage of foreign-source taxable income			Foreign-source taxable income	Foreign branch taxable income as a percentage of foreign-source taxable income		
	Rank	Percent	Taxes		Rank	Percent	Foreign branch taxable income
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
All countries	-	38.6%	$21,998	$57,059	-	25.4%	$14,475
Nigeria	1	85.9	858	999	7	44.9	448
Norway	2	70.6	1,794	2,540	8	41.4	1,052
United Arab Emirates	3	69.7	591	848	2	73.2	621
Libya	4	69.4	467	674	5	51.4	346
Brazil	5	68.1	831	1,219	15	20.6	251
Saudi Arabia	6	65.0	733	1,127	9	41.2	465
Indonesia	7	56.0	2,148	3,838	10	39.1	1,501
Netherlands	8	51.0	863	1,693	23	2.2	38
Peru	9	49.3	257	521	22	2.8	15
Mexico	10	49.1	768	1,564	17	14.6	228
Australia	11	48.2	680	1,411	6	45.3	639
Venezuela	12	45.6	277	609	13	21.4	130
West Germany	13	45.6	927	2,035	2/	2/	-86
Egypt	14	42.6	490	1,151	21	4.3	50
Japan	15	42.3	837	1,978	2/	2/	-109
Canada	16	38.4	2,470	6,438	20	7.1	455
Spain	17	31.0	163	526	18	12.0	63
Switzerland	18	28.3	221	781	2/	2/	-29
Italy	19	28.2	256	907	16	17.8	161
United Kingdom	20	28.0	2,871	10,244	11	32.7	3,354
France	21	27.3	431	1,578	14	21.0	332
Argentina	22	21.5	176	818	3	62.4	511
Panama	23	19.0	239	1,259	19	11.3	142
Netherlands Antilles	24	17.0	196	1,152	12	31.5	362
Bahamas	25	1.8	40	2,222	1	74.9	1,664
Bermuda	26	0.6	3	552	24	0.4	2
Cayman Islands	27	0.6	4	769	4	58.5	450

1/Includes countries with more than $500 million of foreign source taxable income.
2/Not calculated due to foreign branch loss.

APPENDIX E2

Source:
Statistics of Income – SOI Bulletin,
Vol 6–2 – Dept of The Treasury – Fall 1986

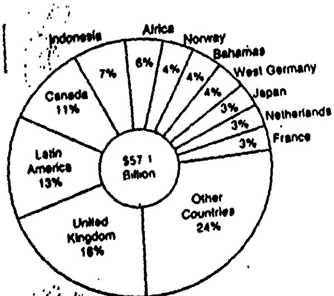
Figure A.--Foreign-Source Taxable Income, by Selected Country, 1980 and 1982

[Millions of dollars]

Country	1980	1982	Change
	(1)	(2)	(3)
All countries.....	$70,541	$57,059	-19.1%
Netherlands Antilles	587	1,152	96.2
Brazil..............	862	1,219	41.4
Panama..............	939	1,259	34.1
Bahamas.............	1,934	2,222	14.9
Mexico..............	1,522	1,564	2.8
Saudi Arabia........	1,114	1,127	1.2
Egypt...............	1,182	1,151	-2.6
Canada..............	6,610	6,438	-2.6
France..............	1,626	1,578	-3.0
United Kingdom......	11,347	10,244	-9.7
Indonesia...........	4,293	3,838	-10.6
Italy...............	1,123	907	-19.2
Australia...........	1,877	1,411	-24.8
Norway..............	3,532	2,540	-28.1
Japan...............	2,942	1,978	-32.8
Switzerland.........	1,172	781	-33.4
Netherlands.........	2,635	1,693	-35.7
West Germany........	3,579	2,035	-43.1
United Arab Emirates	1,677	848	-49.4
Nigeria.............	2,730	999	-63.4
Libya...............	2,266	674	-70.3

21

Percent of Total Foreign-Source Taxable Income, by Country or Area, 1982



APPENDIX F 40

Fund in works for modest projects

936 firms seek to raise $100 million

By DOREEN HEMLOCK
Of The STAR Staff

A group of 936 beneficiary firms, including many pharmaceutical companies, are working to develop a multimillion-dollar fund to finance small- and medium-sized projects in the Caribbean Basin.

Preparations are "in the late stages," and a draft proposal should be submitted to the U.S. Internal Revenue Service for a ruling in the next few weeks, said Karl Nordberg, executive director of the Puerto Rico-USA Foundation and counsel to the fund's organizers.

Nordberg said he could not provide details because organizers were still designing the plans.

But financial sources said the project seeks to raise $100 million in 936 funds and would set a cap on loans, probably at less than $10 million each.

Some sources voiced skepticism, however, that the venture could get off the ground. They cited the nagging problems of loan guarantees for small projects in the Caribbean, plus a reluctance by some 936 beneficiary companies to contribute.

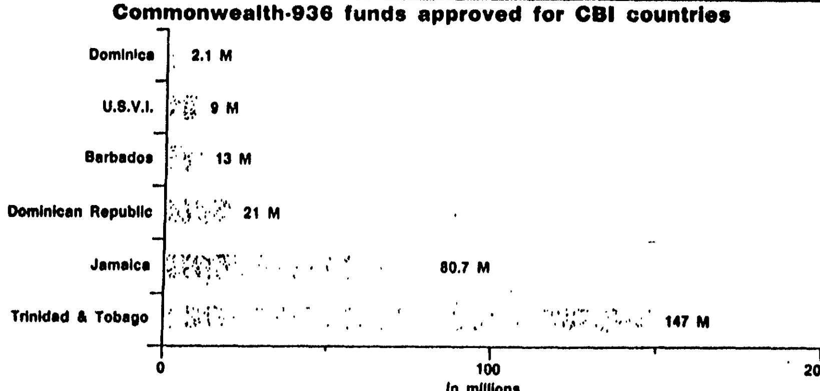
"I'll believe it when I see it," said one executive involved in CBI financing. "It's still not clear who's putting in and how much."

The proposed new 936 fund would help Puerto Rico fulfill its pledge to Congress to finance Caribbean Basin projects — a commitment made in 1985 as part of an effort to save Section 936 tax breaks from a proposed phaseout.

It would supplement efforts by Commonwealth and private banks, which have provided only large 936 loans to the Caribbean region so far.

See CBI, Page B-2

Commonwealth-936 funds approved for CBI countries



Source: Economic Development Administration (Fomento)

APPENDIX G

THE AUGUSTA CHRONICLE --
July 27, 1989

"Jeffrey Hart"

WHO COULD POSSIBLY WANT PUERTO RICO?

ASTOUNDINGLY, Congress appears to be in the mood to allow Puerto Ricans in a 1991 referendum to decide whether they wish to be independent, remain a U.S. commonwealth or become our 51st state. Some senators and oven. The New York Times appear to think that such a referendum in Puerto Rico would be "morally binding" upon the United States.

This is farcical. Puerto Rico is a Caribbean entity in language, politics and culture.

It has a much higher percentage of its population living on U.S. food stamps than any state in the union. In absolute numbers, it has more food-stampers than New York State. Its federal assistance programs amount to some $6 billion annually. Puerto Ricans pay no U.S. federal taxes.

UNDER ITS present post-1952 commonwealth status, Puerto Rico cannot negotiate trade agreements with other nations. The principal beneficiaries of this arrangement are U.S. corporations that use the island as an off-shore workshop staffed by cheap labor. For the benefit of these corporations, U.S. taxpayers are subsidizing this economic bag woman with that annual $6 billion.

The Bush administration, and I hate to say it, characteristically has not got its mind around this one. Recently an assistant secretary of State, Kenneth Gideon, announced that "the selection among the possible status options should be made by the people of Puerto Rico unaffected by the bias which specific costs and benefits could bring to the process."

Is Assistant Secretary Gideon joking?

Apparently not. Senators have been asking the Bush administration for serious economic projections about the likely results of the three Puerto Rico options. So far, zero response from the Bush administration.

IF WE ARE to continue, however tenuously, to be a "self-governing" people, we can hardly consign our nation and its shape to a confused vote in Puerto Rico.

Do we really wish to engage ourselves in a statehood proyect that would have two senators and three or four congressmen from Puerto Rico, and 3 million Spanish-speaking Puerto Ricans voting for the U.S. president?

Puerto Rico, on that arrangement, would be the first American state in which the majority of the residents are on welfare.

Though many Puerto Ricans in the educated and professional classes do speak English, a great many more do not. Of what sort of participation in the American political process are they really capable?

In no sense that one can easily think of is Puerto a reasonable candidate for statehood.

ONE KNOWS instinctively on this one that the bush administration is hiding out--say it isn't so, George--to avoid offending Hispanic voters in the crucial Sun Belt States. But even assuming that he lost some of those voters by doing the right thing, he would more than make up the loss among other voters who do grasp the issues.

Rather than wait upon the whim of voters in Puerto Rico, it is time for a second American Declaration of Independence--independence from Puerto Rico.

KING FEATURES SYNDICATE

APPENDIX 2

"The Augusta Chronicle"
8/6/84

SUPPORTS PUERTO RICANS AND THEIR RIGHTS

Editor, The Chronicle:

This letter is in answer to a column by Jeffrey Hart, which appeared in the July 27 edition of The Chronicle.

Puerto Rico was ceded to the United States after the Spanish American War in 1898. Congress granted citizenship to Puerto Ricans in 1917. Fewer than 1,000 Puerto Ricans declined American citizenship in 1917. Since then, relations between the United States and Puerto Rico have grown closer, to the benefit of both, I believe.

All three branches of our government have allowed and sometimes encouraged relations to grow, with full knowledge of cultural, ethnic and economic differences.

Hart ignored the fact that since 1917, and beginning with the First World War, thousands of Puerto Ricans have served in the armed forces of the United States. In addition, major military installations in the island have been used for operations and training activities. The "state" tax in Puerto Rico is as high as the federal income tax.

In addition, many residents of Puerto Rico, by virtue of their employment status or of their investments in the United States or ownership of federal securities, also pay federal income tax. All working Puerto Ricans contribute to the Federal Income Contribution Act tax (Social Security).

There are several states that receive more from the federal treasury than what they contribute. In addition, several other wealthy states benefit from the presence of large military installations within their borders.

The welfare money generates jobs, and Puerto Rico, taken separately, is one of the best customers in the whole world for goods manufactured in the United States.

If a majority of Puerto Ricans request the same rights that all other American citizens enjoy, and if they are willing to bear the burdens--such as federal taxation--that it entails, then it would be less than American to deny them those rights.

RAFAEL JUAN ICARIUA, M.D.
EVANS

APPENDIX C

EL NUEVO DIA-MARTES 17 DE ABRIL DE 1990 5

Repetido ataque a la estadidad

Por JOHN T. SKELLY
De El Nuevo Día

WASHINGTON - Otra importante columnista sindicada ha advertido a los norteamericanos y al Congreso en particular, sobre las consecuencias espantosas que sobrevendrían a raíz de que Puerto Rico se convirtiera en estado.

Georgie Ann Geyer, cuya columna aparece tres veces por semana en más de ciento cincuenta periódicos en los Estados Unidos, dijo en su columna en el Washington Times que la estadidad "seguramente sólo traería la desintegración económica a Puerto Rico, y a Washington problemas económicos y políticos jamás soñados".

El mes pasado, el columnista sindicado nacionalmente, Pat Buchanan, quien fue director de comunicaciones en la Casa Blanca durante la mayor parte de los años de lucha de la administración Reagan, también advirtió sobre la posibilidad de que Puerto Rico se convierta en estado.

A diferencia de Buchanan, Geyer no tiene una poderosa influencia entre los Republicanos conservadores en la Cámara y el Senado. Sin embargo, Geyer es muy respetada y es la principal columnista femenina, sindicada a nivel nacional, dedicada a escribir sobre política nacional e internacional actualmente.

Geyer ha visitado Puerto Rico en varias ocasiones durante los últimos 20 años. Geyer depende, en su ataque a la estadidad, de las conclusiones de dos recientes estudios: el estudio de la Oficina de Presupuesto Congresional, dado a conocer hace dos semanas, y el estudio hecho para el PPD por la firma de consultoría económica - con base en Washington - Peat Marwick y Co.

GEYER dice que para el año 2000 la mitad de las compañías 936 habrían salido de Puerto Rico, lo que resultaría en una baja de entre 33 a 43 por ciento en las exportaciones de Puerto Rico y una pérdida de aproximadamente 70,185 empleos.

Geyer dijo que el Partido Nuevo Progresista tiene un estudio en camino para balancear los estudios del PPD y de la Oficina de Presupuesto Congresional, pero hasta ahora no hay ninguno a la vista.

"El dato simple es que el asunto de la estadidad no se ha discutido con claridad. Bajo la estadidad, Puerto Rico perdería la independencia relativa, pero real, que tiene bajo el estatus de Estado Libre Asociado por un empobrecimiento económico y quién sabe qué resultados producto de la agitación política. Puerto Rico pasaría de ocupar su envidiada posición actual como la maravilla económica y tecnológica del Caribe -esta pequeña isla le compra a Estados Unidos más que Brasil, Colombia, Argentina y Chile combinados- a ocupar nuevamente la posición que tenía en la década de 1940 cuando era la "casa de los pobres del Caribe".

Concluye Geyer: "...nuestro esfuerzo debería ser tratar de asegurar la notable prosperidad de una hermosa isla como Puerto Rico, otorgándole, también, tanta independencia de acción como sea posible".

Que hablen ahora las 936

Las corporaciones 936 están escuchando al Partido Independentista Puertorriqueño sobre su presencia en Puerto Rico después de la independencia o en la libre asociación. Esa es la mayor sorpresa en los quince meses de negociación y consulta entre los Estados Unidos y Puerto Rico sobre el status político. Ambas partes lo podrán negar, pero el hecho es un hecho.

En mi análisis del pasado domingo del Informe del Congressional Budget Office sobre los aspectos económicos de un cambio de status, signifiqué el hecho de que –no una, sino cuatro veces– los técnicos del Congreso indicaron que el silencio de las corporaciones 936 les hacía difícil radicar un informe mas preciso. Dije entonces, y repito ahora, que el principal testigo de las vistas de la Comisión de Finanzas del Senado a celebrarse en Washington el 26 de abril deben ser las corporaciones 936. Su honradez en indicar sus intenciones sobre cada una de las alternativas de status político, *en el récord*, es vital para que sigan teniendo una imagen positiva en Puerto Rico.

Las corporaciones 936 deben hablar ahora o nunca.

El dato sobre este tema es la nota al calce 18 en la página 24 del Informe del CBO sobre los aspectos económicos de las tres fórmulas de status. La nota dice muy escuetamente: "See Erick Negrón, 'S. 712) Manufacturing Incentives Made Possible by the Foreign Tax Credit', unpublished memorandum, February 6, 1990". ¿Qué importancia tiene esta nota al calce? ¿Por qué cita y oficializa el CBO un memorando hasta ahora secreto? Veamos.

La oferta del PIP a las corporaciones 936 está contenida en el Informe del CBO en los términos siguientes: "Varios issues se plantean al evaluar el potencial de un Puerto Rico independiente para atraer inversión extranjera. Bajo el S. 712 los beneficios de la Sección 936 no seguirían estando disponibles a las corporaciones norteamericanas. Sin embargo, Puerto Rico podría ofrecer varias ventajas relacionadas con impuestos que podrían reemplazar efectivamente las que existen bajo el status actual. Primero, la República podría ofrecer las ventajas de una jurisdicción foránea con impuestos bajos a las firmas norteamericanas. Además, la nueva nación tendría la oportunidad, que no está disponible al status actual, de negociar tratados de exención contributiva, que harían la inversión de otros países más atractiva. Finalmente (y aquí salió el conejo del sombrero), el Partido Independentista Puertorriqueño *ha propuesto* un nuevo grupo de medidas con la intención de duplicar los efectos de la Sección 936."

"De acuerdo a la descripción del PIP, *el acuerdo* envolvería imponerle una contribución puertorriqueña a las ganancias corporativas igual a las impuestas en los Estados Unidos y luego devolverle lo pagado en impuestos a las corporaciones manufactureras y otras firmas en forma de subsidios. Ya que las corporaciones norteamericanas afectadas verían su obligación contributiva norteamericana reducida a cero mediante el crédito contributivo extranjero, y ya que todo el impuesto puertorriqueño le sería devuelto en subsidios, las compañías terminarían con una pequeña o ninguna obligación contributiva".

Tan sencillo como todo eso. Un nuevo desarrollo crucial.

Esta no es una propuesta salida del sombrero. Erick Negron es un abogado graduado de Harvard cuya tesis de graduación fue dedicada al estudio de sustitutos efectivos a la exención de las 936 en el caso de la independencia. La publicación de su tesis en la Revista del Colegio de Abogados de Puerto Rico no fue comprendida por uno de los grandes bufetes de la Isla dedicados a los intereses de las 936. No se imaginaban qué su propuesta resultaría atractiva para las mismísimas corporaciones 936. Y que sería santificada por el Congressional Budget Office en su informe oficial sobre la economía del status.

En una reunión privada entre altos funcionarios de las corporaciones 936 y dos miembros del Comité de Diálogo sobre el Status, el senador Fernando Martín y Erick Negrón develaron la propuesta del PIP a las 936. La recepción fue entusiasta.

Esa reunión, a la que no se permitió el acceso a la Prensa, se celebró en el Hotel Dorado Beach el 2 de febrero de 1990. La Cámara de Comercio de Puerto Rico en los Estados Unidos, una organización que agrupa a muchos de los ejecutivos de las 936 en la Nación, resumió la reunión como una actividad "principal" de su reunión anual en Puerto Rico. Su revista destaca el momento en que Erick Negrón presentaba la propuesta del PIP en el panel con los economistas y políticos de los tres sectores ideológicos. Y dice: "El senador Martín y el Sr. Negrón presentaron un plan económico preparado por el Sr. Negrón, un economista, donde los beneficios de la Sección 936 se mantendrían como un crédito contributivo si la Isla se hiciese independiente". Ese es el verdadero origen del texto contenido en el Informe del CBO.

Hay *que saber ahora cómo responden las 936. Para reciprocar, en el evento del Dorado Beach, los representantes de las corporaciones 936 evidenciaron varias preocupaciones sobre cada una de las* alternativas de status y sus interrogantes *merecen* respuesta. También *en el récord* de las próximas vistas, si el proceso de negociación y consulta va a seguir siendo uno abierto y disponible para su evaluación por el pueblo de Puerto Rico.

Sobre el *Estado Libre Asociado* plantearon lo siguiente:

* Si la plataforma del Partido Popular sobre el status comenzaba o no a parecerse a la de los independentistas;
* Si el Estado Libre Asociado podría desaparecer en *el futuro*;
* Si las 936 *bajo* el ELA son temporeras, qué está haciendo el Gobierno para que no sean necesarias en el futuro.
* *Qué medidas toma el Gobierno para defenderse de las presiones del Departamento del Tesoro para la eliminación de la exención a las corporaciones 936;*
* *Si es razonable esperar que ese crédito contributivo sea permanente bajo el ELA.*

Sobre la *estadidad*, las *interrogantes* fueron éstas:

* Como compensaría la estadidad la eliminación de la exención a las corporaciones 936 y los empleados en ellas;
* Como se compensaría la perdida de los empleos indirectos generados por la presencia en la Isla de esas corporaciones;
* Si es realista esperar que el Congreso deje viva la exención a las 936 por los tres años de la transición a la estadidad;
* Cómo se mantendría la clasificación de esas corporaciones si Puerto Rico deja de ser una "posesión" de los Estados Unidos como requiere la ley actual.

Sobre la *independencia*, las preguntas fueron éstas:

* Qué está haciendo el PIP para demostrarle a las corporaciones que es la mejor alternativa de status;
* Cómo tratarían los Estados Unidos el subsidio provisto por la República a las corporaciones para crear empleos, si como ingreso o como parte del crédito contributivo;
* Cómo competiría Puerto Rico con otras jurisdicciones que ofrecen ventajas contributivas;
* Por qué darían los Estados Unidos beneficio alguno a un Puerto Rico *independiente*, aparte de como pago por las bases militares;
* Cómo puede *asegurársele a Puerto Rico* el apoyo económico de los Estados Unidos si se *recrudecen* los problemas fiscales de esa nación.

Todas son buenas preguntas. Estemos pendientes a la vista del Comité de Finanzas el 26 de abril. Debe haber respuestas.

X.ND

ARTICULO
El Nuevo Día
4/12/90
GARCIA

La independencia con un balance en rojo

APPENDIX E

Por LISETTE NUÑEZ
De El Nuevo Día

EL ESTUDIO congresional sobre las implicaciones económicas de las tres alternativas de status para la Isla es muy superficial, según varios economistas consultados.

Una de las omisiones más graves del estudio es el impacto que tendría la independencia sobre la deuda pública, señaló un economista, quien no quiso ser identificado.

La deuda pública per cápita en Puerto Rico es tres veces mayor que la de México, uno de los países más endeudados del mundo.

La deuda en la Isla ascendió a $11,236.9 millones para el año fiscal 1988, según el último informe al Gobernador de la Junta de Planificación. Por habitante, la deuda pública en Puerto Rico es de $3,500. Mientras que en México es de poco menos de $1,000 por habitante.

"Aparentemente se les acabó la gasolina cuando llegaron a la independencia", dijo el economista. El estudio también ignora el problema de la deuda hipotecaria. El economista dijo dudar que el gobierno de Estados Unidos continúe garantizando las hipotecas bajo la independencia. Para 1986 había $2,500 millones en deuda hipotecaria.

Tampoco habría una demanda grande en los mercados financieros para refinanciar la deuda pública de países en desarrollo como Puerto Rico. El gobierno de un Puerto Rico independiente podría tener que incurrir en un costo monumental para refinanciar la deuda.

El estudio preparado por la Oficina de Presupuesto Congresional (CBO) toca someramente el problema que tendría un Puerto Rico independiente en obtener capital. Señala que "al igual que otros países en desarrollo de América Latina y en otras partes, la Isla podría sufrir de una escasez de capital externo".

LA INDEPENDENCIA agravaría un serio problema de fuga de capital que ya existe en la economía, dijo Elías Gutiérrez, vicepresidente de Corplan, compañía de asesoramiento empresarial y económico.

De 1976 a 1984 las inversiones de Puerto Rico en el exterior aumentaron en 312 por ciento de 2,900 millones a $12,300 millones. El ritmo de crecimiento para 1992 debe aguantarse, pero aun así, Gutiérrez estima que habrá una fuga de $27,600 millones. La fuga de capital continuará aun sin un cambio en el status. Además del problema de la fuga, la relación de la deuda de Puerto Rico comparado con el valor del patrimonio del país ha ido empeorando. "Hay más endeudamiento", dijo Gutiérrez.

El Estado Libre Asociado es el "punto de compromiso [illegible] más cierto de todos. Sin embargo, también ha tenido períodos de grandes problemas y tiene un problema fundamental que es la canalización de su capital", apuntó el economista. Muy poco del capital está destinado a inversiones en maquinarias y equipo, elementos que pudieran aumentar la capacidad productiva del país.

Bajo la estadidad la fuga de capital también es de esperarse, según Gutiérrez. La estadidad, según el modelo econométrico utilizado por el estudio, redundaría en la fuga del capital de las corporaciones 936. El estudio anticipa que bajo la estadidad se perdería entre 37 a 47 por ciento del capital y la producción de las corporaciones 936 para el año 2,000.

Gutiérrez alabó el análisis hecho por CBO por entender la importancia fundamental que ha tenido el flujo de capital en la economía.

El análisis del CBO prácticamente ni toca las implicaciones económicas de continuar bajo el ELA. Pero señala que la continuación de la Sección 936 no está asegurada bajo ese status. Y si la sección desaparece, el ELA estaría sujeto a las mismas penurias que sufriría la estadidad. En ese caso *el ELA* contaría con el agravante que no habría un aumento marcado en las transferencias federales, según apuntó Augusto Amato, vicepresidente senior a cargo de estudios económicos del *Banco Popular.*

AMATO dijo que el ELA es el equivalente a un jibarito que tiene una finca *en el centro de la isla.* "El gobierno le presta un tractor para aumentar la producción con la única condición que comparta *con sus vecinos que son pobres* al igual que él. Pero todos los años el gobierno viene a amenazar con que se va a llevar el tractor", dijo.

El tractor es la Sección 936 del Código de Rentas Internas Federal. La sección permite la exención contributiva a las corporaciones estadounidenses y multinacionales que se establecen en la Isla cuando *repatrían las ganancias* a Estados Unidos.

Ese ha sido el instrumento que ha permitido que Puerto Rico cuente con *medios* de producción, según explicó el economista.

Bajo la estadidad, el gobierno se llevaría el tractor y en su lugar traería una hamaquita y una fiambrerita, según Amato. Bajo la *independencia* ocurriría lo mismo, dijo. Sólo que la hamaquita y la fiambrerita las concedería *por* un período corto de tiempo, dijo Amato.

"Yo encuentro que el Congreso de Estados Unidos es inflexible en cuanto a nosotros decidir nuestro status. Nos tiene pegados a la pared", dijo. Bajo las tres *fórmulas,* Puerto Rico está *vulnerable* a los vaivenes del Congreso.

El economista que no quiso identificarse dijo que el modelo supone que las corporaciones 936 se marcharán todas de Puerto Rico *al poco tiempo de surgir un cambio* en el status. Ese supuesto no necesariamente se sostiene, dijo. *La* conversión a estado podría redundar a la larga en una "bonanza económica para el Tesoro de Estados Unidos", si una cantidad significativa de las empresas 936 optan por quedarse.

Statement of Puerto Ricans in Civic Action

STATEHOOD FOR PUERTO RICO & I.R.C. SEC. 936*

Thank you for the opportunity to express our views on Statehood for Puerto Rico and on Section 936 of the Federal, Internal Revenue Code. Puerto Ricans in Civic Action is a grass roots movement that with the force of more than 350,000 individually signed petitions of individual United States citizens [1] living in Puerto Rico has essentially petitioned Congress for a redress of our grievances and requested Statehood for Puerto Rico, pursuant to Article IX of the Treaty of Paris of 1898,[2] to end the present colonial status of Puerto Rico.

Because of the truncated time allowed me, I commence with the following highlights: (1) that Federal, Internal Revenue Code sec. 936 is a scandalous waste of Federal funds,[3] which the United States can and should terminate soon, even now, under the present so-called Commonwealth status; (2) that any person concerned with revenue neutrality or equality among the political status formulas in the coming plebiscite must logically at least require the so-called Commonwealth to pay the $500 million every year which the so-called Commonwealth repeatedly promised to pay annually by 1985, to the Federal Treasury in lieu of Federal taxation upon Puerto Rico; [4] and (3) that Statehood is the only status formula that (a) categorically accepts both the rights and responsibilities of United States citizenship, and (b) that can relieve the taxpayers and votes of each of the States that you represent from the heavy and ever—increasing burden of the so-called Commonwealth of Puerto Rico. If you aid or tolerate that so-called Commonwealth in any way, you in effect crucify the taxpayers of your States, your constituents, on the cross of that Commonwealth and particularly with the nails of 936.

I now point out some of my ideas to handle I.R.C. section 936 or make adjustments after Statehood, even for those who still have some desire to maintain that Federal tax expenditure:

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[1] Persons born in Puerto Rico are automatically United States citizens, since Article 5 of the Jones Act of 1917; Act of March 2, 1917, ch. 145, 39 Stat. 951, 953. See also Nationality Code of 1940; Act of Oct. 14, 1940, ch. 876, sec. 202, 54 Stat. 1139: "*All persons born in Puerto Rico on or after April 11, 1899,* subject to the jurisdiction of the United States, residing on the effective date of this act in Puerto Rico or other territory over which the United States exercises rights of sovereignty and not citizens of the United States under any other Act, *are hereby declared to be citizens of the United States.*" (emphasis added)

[2] 30 Stat. 1759: "The civil rights and political status of the native inhabitants of the territories hereby ceded to the United States shall be determined by the Congress."

[3] See, e.g., U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report (March 1989); U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Fifth Report (July 1985); U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Second Annual Report (June 1979); U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, First Annual Report (June 1978).

[4] See, e.g., Luis Muñoz Marín, Governor of Puerto Rico, in Hearings On S. 2023 and Proposed Substitute S. 2708 before the Senate Comm. on Interior and Insular Affairs, 86th Cong., 1st Sess., Proposed Amendments to the Puerto Rican Federal Relations Act 37 44 (1959) : "The Commonwealth propose . . . through this modification to begin sharing in the common burdens of the Union. . . . This year the Legislature of Puerto Rico, feeling that our economic progress had made it feasible to begin acting on that principle, included a proposal to the effect. . . ."; "Are we proposing in this bill to share in the burdens of the Union? Yes; we are proposing to *begin sharing and sharing increasingly* as the economy of our government permits us to. This would also make Puerto Rico resemble a federated state more, not less." (emphasis added); Governor Luis Muñoz Marín in 3 United States—Puerto Rico Commission on the Status of Puerto Rico, Hearings on the Status of Puerto Rico—Econonic Factors in Relation to the Status of Puerto Rico, S. Doc. No. 108, 89th Cong., 2d Sess. 25, 231 (1966) : "You recollect a resolution of the Puerto Rican Legislature, of December 1962 that a formula be worked out whereby *Puerto Rico will begin contributing* a part of its increased wealth, increased production from year to year, *to support the common burdens of the American union . . . .*; "*that return from Puerto Rico could be about as much as the Federal tax* at that time would be." (emphasis added) "Now, on the tax question, of course, you know that *we, upholders of the Commonwealth are proposing that Puerto Rico begin to contribute,* not in the form of taxes, *to the common burdens of all parts of the American Union.* It is our belief that we can make that contribution, and that if we can make it grow until it gets to whatever size it has to get according to a fair formula, it can be as much as taxes at a given time;" (emphasis added); Dr. Alvin Mayne, the economist for Commonwealth, in id. at 749: "I believe that *by 1985 the contribution of $500 million to the United States might be possible*—now, this is not an official statement, but it is a computation." (emphasis added).

(1) You can terminate I.R.C. sec. 936 now and substitute it with a direct Federal employment program for Puerto Rico, funded with amounts below bat previously escaped the Federal treasury because of I.R.C. sec. 936.

(2) You can cap or segmentize I.R.C. sec. 936 and thereby stop or reduce its hemorrhage of Federal funds, for example, (a) by prohibiting the use of the tax sparing credit of I.R.C. sec. 936 after a certain cut-off date, (b) by phasing-out I.R.C. sec. 936 as you phased out Western Hemisphere Trade Corporations [5] and China Trade Act Corporations,[6] (c) by excluding pharmaceutical mixing operations and electrical machinery assemblage from the definition of corporations that can use the tax sparing credit of I.R.C. sec. 936.

(3) You can eliminate 936 and substitute it with a national program of enterprise zones for all States whose statewide rate of unemployment is, for example, 14% or higher, which program would remain in place for the State until it lowered said unemployment to say 9% and maintained that lowered rate for a consecutive period of say 5 years.

(4) You can arguably prolong I.R.C. Sec. 936 intact for a short period of time after Statehood for Puerto Rico.

The above segmentation or cap approach takes into account, for example, that although pharmaceutical section 936 operations obtain 46.3% of the total Federal cost of I.R.C. sec. 936, such pharmaceuticals provide only 14.8% of the employment in Puerto Rico's manufacturing sector.[7] In 1987, according to the Puerto Rico Planning Board, the chemicals and related products sector, basically pharmaceuticals, had $3,757,600,000 of the $8,661,300,000 total net income of all the manufacturing sector in Puerto Rico,[8] but chemicals and related products only had 18,000 employees of the total 148,900 employed in manufacturing in Puerto Rico.[9] The shocking fact is that the "top sixteen possession corporations accounted for 24.2 percent of the tax benefits but provided only 3.6 percent of the employment of the 378" section 936 corporations in the Sixth Annual Report of the U.S. Treasury Department on I.R.C. sec. 936.[10] Sixteen section 936 corporations obtained $100,000 or more of the Federal tax expenditures of I.R.C. sec. 936 for each person they employed. [11]

You and I should wholly agree with the late Professor Stanley Surrey of the Harvard Law School:

> "(A) tax incentive does involve the expenditure of government funds."
>
> "*A dollar is a dollar*—both for the person who receives it and the government that pays it, *whether the dollar tax credit label or a direct expenditure label.*"
>
> "(M)any incentives look, and are, highly irrational when phrased as direct expenditure programs structured the same way."
>
> "(A) resort to tax incentives greatly decreases the ability of the Government to maintain control over the management of its priorities."
>
> "*(T)ax incentives do involve expenditures—'back-door expenditures'. . . and . . . a legislator concerned with expenditure levels and expenditure control should not, while holding the front door shut, let hidden expenditures in through the back door." (emphasis added).*[12]

I.R.C. section 936 is one immense price that the United States continues to pay so as to prop up the so-called "Commonwealth" status of Puerto Rico. Not only has the "Commonwealth of Puerto Rico never paid to the United States the annual contributions in lieu of Federal taxes that Governor Luis Muñoz Marín promised in

[5] I.R.C. secs. 921, 922 (1987).

[6] I.R.C. sec. 941 (1987).

[7] U.S. Department of the Treasury, The operation and Effect of the Possessions Corporation System of Taxation, Sixth Report, 51, 46 (Mar. 1989).

[8] Puerto Rico Planning Board, Informe Económico al Gohernador, 1987, at A-12, Table 12 (Feb. 12, 1988). See attached Exhibit A.

[9] Ibid. at IV-12. See attached Exhibit B.

[10] U.S. Department of the Treasury, Sixth Annual Report, supra. note 7, at 48.

[11] Idem. See attached Exhibits C and D.

[12] Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harvard L. Rev. 705, 717, 721-722, 732 (1970).

1959 [13] and reiterated in 1965 [14] and that for 1985 should have been $500 million [15] but the United States via I.R.C. section 936 suffers tax expenditures that amounted to 1.167 billion in 1979: 1.326 billion in 1980; 1.711. billion in 1981; 1.678 billion in 1982; [16] and $1.641 billion in 1983.[17] Accordingly, in only these two Federal tax expenditure programs,[18] the cost to the United States of the present "Commonwealth" status exceeds $2 billion each year.

There is no need for further study or vacillation on I.R.C. section 936. Its utter failure to achieve its stated purpose of creating employment in Puerto Rico has been and is evident to all who wish to see. I.R.C. section 936 has not and cannot provide Puerto Rico with its desired opportunities for employment. In 1940 unemployment in Puerto Rico was 15%,[19] hovered around 20% from 1976 to 1986 and was 17.7% in 1987.[20] The sorry fact is that, as reported by the former Chief Justice of Puerto Rico's Supreme Court, in 1899 unemployment in Puerto Rico was 17%.[21]

In fiscal year 1986 the number of persons employed in the entire manufacturing sector of Puerto Rico was 148,800; and in fiscal year 1987 incremented by only 100 persons to 148,900 [22] which is less than the 156,000 so employed in 1980.[23] However. net interest and profits in manufacturing rose from $5.331 billion in 1986 to $6.276 billion in 1987.[24]

Since 1970 the proportion of net income paid to Puerto Rican manufacturing employees has declined from 64% to 27.5% in 1987.[25] The reason is that more and bore the greatest component of net income in the exempt manufacturing sector corresponds to the low employment—high profit pharmaceutical and electrical machinery operations. In 1987 the entire number of employees in basically pharmaceutical operations was 18,000 and in electrical machinery 20,000;[26] but their respective net incomes were $3.758 billion and $1.330 billion.[27]

The aforegoing evidences grave, fundamental, mistakes in the C.B.O. Report. *Whereas employment in the manufacturing sector in Puerto Rico has essentially remained stable for the past 22 years, fluctuating between 128,000 employees in 1976 to 156,000 in 1980 and 153,000 in 1988 whereas GNP has continued growing because of the exempt profit shifting of the 936 corporations,* the C.B.O. Report bases its calculations on the following false presumption (p.18): "The behavior of Puerto Rican employment is predicted chiefly on the basis of the evolution of overall GNP." *The C.B.O. Report* thus *begins with a false basis, contradicted by the Puerto Rican Government's own historical factual data and heaps computerized assumptions and calculations onto that false basis.*

The reality is that the revenue costs of I.R.C. section 936 (and its predecessor I.R.C. section 931) have continued to increase but to maintain under Commonwealth about the same number of persons employed in so-called manufacturing. [28] The C.B.O. Report seems to have either not noticed, or purposely overlooked important pertinent observations of the Tobin Report.

> "It might be thought that "direct investment" is all physical investment and has built up in Puerto Rico over $5 billion of plant, machinery and equipment. Nothing could be farther from the truth. 'Direct investment' in-

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[13] E.g., Testimony of Governor Luis Muñoz Marín, in hearings on. S. 2023 and Proposed Substitute of S. 2708 before the Senate Comm. on Interior and Insular Affairs, 86th Cong. 1st Sess. Proposed Amendments to the Puerto Rican Federal Relations Act 37 (1959).

[14] Statement of Luis Muñoz Marin, 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, 89th Cong., 2d Sess. 233 (1966).

[15] Statement of the economist representing the position of Commonwealth in id. at 751: "We could probably make a contribution of $500 million by 1985."

[16] Department of the Treasury, the Operation and Effect of the Possession Corporation System of Taxation, Fifth Report 53, Table 4-9 (July 1985).

[17] Department of the Treasury, Sixth Annual Report, supra note 7, at 44, 45.

[18] The nonpayment of the in lieu taxes, or I.R.C. section 933, and I.R.C. section 936.

[19] Junta de Planificación de Puerto Rico, Informe Económico al Gobernador—1977, at A-26 (Jan. 25, 1978).

[20] Junta de Planificación de Puerto Rico, Informe Económico al Gobernador—1987, at A-33, Table 29 (Feb. 12, 1988).

[21] José Trías Monge, 1 Historia Constitucional de Puerto Rico 7 (1st ed. 1980) (University of Puerto Rico Press).

[22] Informe Económico al Gobernador, 1987, at IV-4.

[23] Informe Económico al Gobernador, 1987, at A-35, Table 31.

[24] Ibid., at A-11, Table 11.

[25] Ibid., at IV-10.

[26] Ibid., at IV-12.

[27] Ibid., at IV-7.

[28] See Puerto Rico Planning Board tables Exhibit E and compare with Exhibits A, D, and F.

cludes all increases in the net worth of external firms, including paper assets such as Commonwealth bonds. Puerto Rican mortgages, CD's in Puerto Rican banks or CD's in Guam, as well as real assets, such as factories and machinery. Although the facts are not readily ascertainable, perhaps half of the $5 billion represents financial rather than real assets.*"

"Even when direct investment does represent real physical investment, it does not necessarily imply an increase in Puerto Rican welfare. Although investment by subsidiaries of Mainland firms does provide new output and employment, it also entails new subsidies and real infrastructure investment by the Puerto Rican government and the greater remission of profit to the Mainland. The net *benefit* to Puerto Rico is not automatically positive; it *must be carefully estimated case by case.*"

"It should be remembered that the statistic 'direct investment' does not represent a net flow of new resources into Puerto Rico. Mainland investments earn profits, which can be freely remitted from Puerto Rico. Remittances have in fact been relatively small because unremitted profits are exempt from Federal corporate income tax, and accumulated profits can eventually be 'repatriated' 'tax-free'. Puerto Rican macroeconomic accounts count unremitted profits twice, once as an outflow as if they were remitted and once as an inflow of new direct investment. *Probably something like 80% of recorded direct investment in Puerto Rico is simply the accumulation of profits on past direct investments.*

"Direct investments placed in financial instruments may not represent a new flow of new resources to Puerto Rico. They may do no more than replace other funds that would otherwise have flowed into Puerto Rico into the same financial instrument. Or they may represent financial investments that are not really in Puerto Rico at all."[29] (Emphasis added.)

The C.B.O. Report furthermore gives credence to statistics that are not even believed by the people at Fomento, contrary to common sense that treats statistics of promised employment by prospective 936 corporate suitors of tax exemption in Puerto Rico for what they are—either numbers designed to influence the rapidity that governmental officials provide them with tax exemptions and other benefits, or propagandistic numbers specifically designed to influence public policy, such as elections in Puerto Rico, proposed changes in I.R.C. sec. 936, and in the present case the plebiscite and C.B.O.'s own Report. The C.B.O. Report overlooks hard, still pertinent data, for example, my own S.J.D. thesis for the Harvard Law School that 46.13% of the exempt manufacturing companies have never fulfilled their own promised employment and have violated their exemption contracts.[30]

The worst C.B.O. fault is, however, its complete inability or unwillingness to compare or analyze the status of Commonwealth, even of Enhanced Commonwealth, to the extreme of neglecting the holes and immense costs of sought Commonwealth enhancements to the United States, for example, Puerto Rican tax sparing treaties with foreign countries, the ability of the Japanese to escape via Puerto Rico the U.S. quotas on Japanese made vehicles,[31] the conversion of Puerto Rico into a haven for polluters, etc. Obviously, any report that omits to analyze or compare Commonwealth status is no comparison at all but a sham, easily twisted into Commonwealth propaganda.

About a decade ago I discovered and wrote in my S.J.D. thesis for Harvard Law School this still valid point:

"I.R.C. Section 936 is not working. I.R.C. section 936 will never work. What maintains I.R.C. section 936 and Fomento tax exemptions are not benefits to Puerto Ricans since historically 'little of the profit earned by

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[29] The Committee to Study Puerto Rico's Finances, Report to the Governor 44, 44n. (December 11, 1975) (Chairman James Tobin of Yale University).

[30] Costas Elena, I.R.C. section 936 and Fomento Income Tax Exemption in Puerto Rico, published in 40 Revista del Colegio de Abogados de Puerto Rico (Puerto Rico Bar Association Law Review) 563-602 (1979) (derived from my company by company comparison, exemption decree by exemption decree, with each company's own reported employment over the years to the P.R. Labor Department). See also the other portions of this Harvard Law School thesis published in 41 Revista del Colegio de Abogados de Puerto Rico 101-148 (1980); 41 Revista del Colegio de Abogados de Puerto Rico 225-277 (1980); 42 Revista del Colegio de Abogados de Puerto Rico 611-668 (1981). See also my L.L.M. thesis for Harvard Law School, History of Federal Income Taxation in Puerto Rico—Analysis of the Possession Corporation in Comparison with Other Modes of Business Operation in Puerto Rico: An Insight into Tax Exemption, published in 36 Revista del Colegio de Abogados de Puerto Rico 477-582 (1975).

[31] See e.g., Exhibit G., San Juan Star, April 1, 1990 on the diversion of Japanese made cars via Puerto Rico to the United States.

> U.S. owners of Puerto Rican subsidiaries has been invested in the Puerto Rican economy'. . . but the vested interests that benefit from those privileges."

Commonwealth assuredly repudiates the basic economic premise of permanent union, *Baldwin* v. *G.A.F. Seelig*:[32]

> *"The Constitution . . . was framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division."*

States Saint Augustine, *On Free Choice of the Will*:[33]

> "Our freedom then consists in submission to the truth. It is our God Himself who frees us from death, that is, from the state of sin. Truth itself, when it speaks as a man, says to those who believe in Him, 'If you remain in My word, you shall be My disciples indeed, and you shall know the truth and the truth will make you free'. The soul enjoys nothing with freedom, unless it enjoys it securely."

And such a truth is that such prosperity and security for Puerto Rico exists, and will exist, for Puerto Rico, only in the permanent union that is solely Statehood.

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[32] 294 U.S. 511, 523 (1934) (J. Cardozo) (emphasis added).

[33] Saint Augustine, On Free Choice of the Will 69 (translated by A. Benjamin & L. Hackstaff) (published 1964).

TABLA 12 - INGRESO NETO DE LA MANUFACTURA: AÑOS FISCALES
TABLE 12 - NET MANUFACTURING INCOME: FISCAL YEARS

-A-

(En millones de dólares - In millions of dollars)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987p	
TOTAL	1,868.9	1,987.4	2,474.0	2,841.4	3,398.5	3,995.8	4,808.7	5,220.3	5,405.9	5,734.9	6,484.9	6,984.0	7,630.9	8,661.3	TOTAL
Alimentos y productos relacionados	245.3	285.1	326.0	381.6	442.8	496.6	548.5	644.8	681.6	564.8	753.8	833.8	896.0	981.3	Food and kindred products
Productos de tabaco	34.1	36.1	53.2	47.3	54.8	51.0	46.3	54.0	60.4	55.2	51.6	58.2	64.1	84.7	Tobacco products
Productos textiles	55.6	45.4	40.1	34.7	38.1	35.5	35.6	32.1	34.3	31.7	33.8	38.9	41.7	39.3	Textile mill products
Ropa y productos relacionados	215.8	205.5	261.6	268.2	302.4	329.3	360.7	373.7	375.1	408.2	451.3	406.4	410.1	422.2	Apparel and related products
Muebles y artículos de madera	28.5	30.1	29.8	28.5	24.3	28.7	29.6	30.0	27.2	27.3	29.1	31.1	32.4	35.5	Furniture and wood products
Impreso y publicaciones	35.6	42.6	41.2	39.9	47.3	53.1	58.8	62.5	65.7	69.5	77.1	79.9	91.8	107.7	Printing and publishing
Productos químicos y derivados	453.7	560.5	884.2	943.3	1,173.7	1,287.8	1,583.2	1,786.1	1,907.5	2,268.9	2,340.9	2,686.0	2,957.8	3,757.6	Chemical and allied products
Productos de piedra, arcilla y cristal	76.7	71.2	67.9	77.4	93.9	96.1	95.4	90.4	78.6	77.3	77.8	89.8	111.7	130.7	Stone, clay and glass products
Maquinaria y productos metálicos	445.5	484.0	607.9	778.7	922.0	1,197.8	1,453.7	1,721.4	1,828.3	1,752.5	2,164.3	2,293.9	2,543.8	2,607.3	Machinery and metal products
Productos de papel	15.6	19.4	18.5	19.3	21.9	24.3	26.5	28.1	31.0	32.7	38.1	49.2	48.0	46.9	Paper and allied products
Productos de cuero	34.8	33.9	32.5	34.3	42.5	51.2	64.9	73.8	68.5	82.2	89.1	85.9	95.5	92.0	Leather and leather products
Otra manufactura	227.7	173.6	111.1	188.2	234.8	344.3	505.6	323.3	247.7	364.5	378.0	331.0	338.0	356.1	Other manufacturing

p - Cifras preliminares.

p - Preliminary figures.

Fuente: Junta de Planificación, Area de Planificación Económica y Social, Negociado de Análisis Económico.

Source: Puerto Rico Planning Board, Area of Economic and Social Planning, Bureau of Economic Analysis.

-B-

NUMERO DE EMPLEOS EN LA MANUFACTURA POR GRUPO INDUSTRIAL
(En miles de personas-Años fiscales)

SIC	Grupo Industrial	1970	1980	1985	1986	1987	Cambio Absoluto 1986/1985	Cambio Absoluto 1987/1986	Cambio Porcentual 1986/1985	Cambio Porcentual 1987/1986
	TOTAL	136.2	155.5	148.8	148.8	148.9	0.0	0.1	0.0	0.1
20	Alimentos y relacionados	21.7	23.3	22.3	22.3	22.6	0.0	0.3	0.0	1.3
21	Tabaco y productos de tabaco	6.1	2.1	0.8	0.8	1.3	0.0	0.5	0.0	62.5
22	Productos textiles	8.1	4.0	2.8	3.3	3.4	0.5	0.1	17.9	3.0
23	Ropa y productos análogos	38.1	34.3	30.9	31.1	30.5	0.2	-0.6	0.6	-1.9
24	Madera y productos de madera	0.7	1.1	0.8	0.9	1.1	0.1	0.2	12.5	22.2
25	Muebles	4.1	2.8	2.3	2.4	2.5	0.1	0.1	4.3	4.2
26	Papel y relacionados	1.4	1.6	1.7	1.7	1.7	0.0	0.0	0.0	0.0
27	Imprenta y publicaciones	2.5	3.2	3.0	3.2	3.4	0.2	0.2	6.7	6.2
28	Químicos y relacionados	4.9	16.4	16.9	17.5	18.0	0.6	0.5	3.6	2.9
29	Refinerías de petróleo y relacionados	2.6	2.6	1.6	1.5	1.4	-0.1	-0.1	-6.3	-6.7
30	Productos plásticos y de goma	4.2	4.5	5.0	4.6	4.8	-0.4	0.2	-8.0	4.3
31	Cuero y productos de cuero	8.9	6.0	5.3	5.6	5.4	0.3	-0.2	5.7	-3.6
32	Productos de piedra, barro y cristal	6.5	5.1	3.9	4.1	4.4	0.2	0.3	5.1	7.3
33	Productos primarios de metal	1.0	1.0	0.6	0.6	0.6	0.0	0.0	0.0	0.0
34	Productos fabricados de metal	4.5	4.7	3.7	3.6	3.7	-0.1	0.1	-2.7	2.8
35	Maquinaria, excepto eléctrica	1.3	6.9	7.6	5.9	5.5	-1.7	-0.4	-22.4	-6.8
36	Maquinaria y equipo eléctrico	9.9	17.6	22.5	21.4	20.0	-1.1	-1.4	-4.9	-6.5
37	Equipo de transportación	0.6	0.5	0.6	0.7	0.7	0.1	0.0	16.7	0.0
38	Instrumentos profesionales y									
39	Industrias manufactureras misceláneas	4.2	4.0	3.0	3.3	3.5	0.3	0.2	10.0	6.1

Fuente: Departamento del Trabajo y Recursos Humanos, Encuesta de Establecimientos; y Junta de Planificación, Area de Planificación Económica y Social, Negociado de Análisis Económico.

-C-

TABLE 4-8

TAX BENEFITS, EMPLOYMENT, AND COMPENSATION OF EMPLOYEES BY SIZE OF TAX BENEFITS PER EMPLOYEE, 1983

	Number of returns	Qualified possession net income ($ thousand)[a]	Tax benefits		Employees	
			Amount ($ thousand)	Percent of total	Number	Percent of total
ALL FIRMS						
All manufacturing corporations	378	4,059,624	1,406,406	100.0	75,966	100.0
$100,000 or more	16	951,128	340,417	24.2	2,319	3.1
$ 50,000 under $100,000	23	967,573	343,204	24.4	5,018	6.6
$ 10,000 under $ 50,000	142	1,673,172	562,671	40.0	25,955	34.2
$ 5,000 under $ 10,000	57	283,731	103,338	4.3	15,511	20.4
$ 1,000 under $ 5,000	91	167,147	55,229	3.9	19,327	25.4
$ 500 under $ 1,000	11	2,983	1,126	*	1,599	2.1
$ 1 under $ 500	13	1,365	421	*	1,206	1.6
No tax benefits	25	12,525	0	0	5,031	6.6
FIRMS ELIGIBLE FOR TEFRA REQUIREMENTS						
All manufacturing corporations	292	2,959,327	1,010,705	100.0	58,877	100.0
$100,000 or more	10	550,004	198,553	19.6	1,354	2.3
$ 50,000 under $100,000	17	688,492	245,305	24.2	3,488	5.9
$ 10,000 under $ 50,000	115	1,364,772	449,380	44.5	21,638	36.8
$ 5,000 under $ 10,000	45	195,452	69,759	6.9	9,979	16.9
$ 1,000 under $ 5,000	71	144,819	46,578	4.6	15,902	27.0
$ 500 under $ 1,000	8	2,226	810	*	1,227	2.1
$ 1 under $ 500	9	1,037	320	*	923	1.6
No tax benefits	17	12,525	0	0	4,366	7.4

Department of the Treasury
Office of Tax Analysis

* Less than 0.5 percent

[a] Equals net income from the active conduct of a trade or business in a possession plus net qualified possession source investment income.

-D-

TABLE 4-7

DISTRIBUTION OF TAX BENEFITS AND EMPLOYMENT, BY INDUSTRY, 1983

	Percentage of tax benefits	Percentage of employees
All manufacturing industries	100%	100%
Food and kindred products	6.9	9.1
Textile mill products	0.2	1.1
Apparel	3.1	17.6
Chemicals	49.3	17.2
Pharmaceuticals	46.3	14.8
Other	3.0	2.6
Rubber and plastic products	0.7	1.3
Leather	1.0	5.3
Fabricated metal products	1.3	2.2
Machinery, except electrical	1.1	1.0
Electrical and electronic equipment	23.3	28.7
Instruments and related products	7.0	14.3
Other manufacturing	6.1	2.2

Department of the Treasury
Office of Tax Analysis

SOURCE: The amount of tax benefits is from Table 4-5, column 3. The number of employees is from Table 4-6, column 3.

TABLA 26 - PERSONAS EMPLEADAS POR INDUSTRIAS: AÑOS ECONOMICOS
TABLE 26 - EMPLOYED PERSONS BY INDUSTRY: FISCAL YEARS

(En miles - In thousands)

Partida	1940	1950	1960	1965	1966	1967	1968	1969	1970	1971	1972	1973	Item
TOTAL	512	596	543	657	(2) 677	(2) 684	701	722	738	755	783	810	TOTAL
Agricultura	229	214	124	119	105	93	91	84	74	65	60	53	Agriculture
Caña	124	87	45	36	34	30	24	23	19	14	12	11	Sugar cane
Café	26	22	23	23	19	19	20	17	13	13	10	9	Coffee
Tabaco	18	20	9	13	7	4	4	3	2	2	3	2	Tobacco
Otras fincas	61	85	47	47	45	40	42	41	40	37	36	29	Other farms
Silvicultura y pesca	(1)	2	(1)	(1)	(a)	(a)	1	1	1	1	2	1	Forestry and fisheries
Manufactura, excepto aguja en el hogar	56	55	81	114	123	128	136	143	141	142	149	$\boxed{151}$	Manufacturing, except home needlework
Azúcar	20	11	8	7	7	7	6	7	8	6	7	8	Sugar
Productos de tabaco	6	6	6	9	10	8	8	7	6	8	6	6	Tobacco products
Textiles y aguja en talleres	17	12	22	30	31	33	36	39	39	37	37	39	Textiles and apparel
Licores y cerveza	(1)	(1)	2	3	3	3	3	3	3	4	4	3	Alcoholic beverages and breweries
Otras industrias manufactureras	13	24	43	65	71	77	82	87	85	90	95	97	Other
Trabajo de aguja en el hogar	45	51	10	7	4	(a)	2	1	1	---	---	---	Home needlework
Minería	(1)	(1)	(1)	2	(a)	(a)	1	1	1	1	2	2	Mining
Construcción	16	27	45	62	62	67	70	73	83	88	85	86	Construction
Comercio	54	90	97	119	124	126	128	132	138	145	144	157	Trade
Al por mayor	6	7	9	14	14	14	14	14	14	18	21	20	Wholesale
Al detal	48	82	88	105	110	112	114	118	124	127	123	137	Retail
Finanzas, seguros y bienes raíces	2	3	6	10	10	11	12	13	14	16	17	19	Finance, insurance and real estate
Transportación	17	23	27	28	28	29	29	30	29	30	31	32	Transportation
Comunicación	1	(1)	4	5	5	5	6	6	7	7	7	7	Communication
Otros servicios públicos	2	5	8	11	11	12	13	13	13	14	14	15	Public utilities
Servicios	73	77	75	97	107	111	112	116	123	126	133	135	Services
Servicio doméstico	43	31	18	18	18	18	17	16	16	16	14	12	Domestic services
Otros	30	46	57	79	90	93	95	100	107	110	120	123	Other
Gobierno	13	45	62	83	94	95	100	108	113	119	138	153	Government

Nota: Promedio de 4 meses, julio, octubre, enero y abril para los años de 1940 a 1964. Para los otros años, promedio de 12 meses.

(1) Información no está disponible.

(2) El desglose no suma al total debido al redondeo.

(a) Menos de 2,000.

Fuente: Departamento del Trabajo, Negociado de Estadísticas, excepto para 1940 que se obtuvo del Censo de Población de 1940.

Note: Four month-rate, July, October, January and April from 1940 to 1964. For the other years, 12 month rate.

(1) Data not available.

(2) Figures may not add to total due to rounding.

(a) Less than 2,000.

Source: Department of Labor, Bureau of Labor Statistics, except for 1940 obtained from U.S. Census of Population.

EXHIBIT E (ii)

TABLA 31- NUMERO DE PERSONAS EMPLEADAS EN ESTABLECIMIENTOS POR SECTOR INDUSTRIAL PRINCIPAL: AÑOS FISCALES
TABLE 31- NUMBER OF EMPLOYED PERSONS IN ESTABLISHMENTS BY MAJOR INDUSTRIAL SECTOR: FISCAL YEARS

(En miles de personas - In thousands of persons)

	1980	1981	1982	1983	1984	1985	1986	1987	1988p	
TOTAL 1/	687	691	660	635	665	693	701	742	781	TOTAL 1/
Manufactura	$\boxed{156}$	154	140	141	148	149	149	148	153	Manufacturing ✓
Minería	a/	a/	a/	a/	a/	a/	a/	a/	a/	Mining
Construcción	38	38	29	23	25	28	26	32	36	Construction
Comercio	114	115	110	107	112	119	123	132	138	Trade
Al por mayor	31	31	31	29	30	31	30	32	33	Wholesale
Al detal	83	83	79	77	83	89	93	100	105	Retail
Finanzas, seguros y bienes raíces	27	28	29	28	29	30	32	34	36	Finance, insurance and real estate
Transportación, y otras utilidades públicas	17	16	15	15	16	16	16	17	16	Transportation, and other public utilities
Servicios	84	87	86	85	88	96	100	107	112	Services
Administración pública	250	252	239	236	246	257	261	272	290	Public administration

p- Cifras preliminares.
1/ El desglose puede no sumar debido al redondeo.
a/ Menos de 2,000.

Fuente: Departamento del Trabajo y Recursos Humanos, Negociado de Estadísticas del Trabajo, Encuesta de Establecimientos (Empleo no Agrícola).

p- Preliminary figures.
1/ Figures may not add to total due to rounding.
a/ Less than 2,000.

Source: Department of Labor and Human Resources, Bureau of Labor Statistics, Establishments Survey (Non agricultural employment).

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EXHIBIT F (1)

TABLE A.

	A	B	C	D
1	Item	Drugs	Drugs	Drugs
2		All	Cost sharing	Others
3		85-86	85-86	85-86
4	Number of returns	73	22	51
5	Total assets	8,921,844	3,507,634	5,414,210
6	Cash	1,717,851	623,249	1,094,602
7	Notes &A/R	1,337,999	786,751	551,248
8	Less: BDAllowance	2,177	1,530	647
9	Inventories	475,179	219,077	256,102
10	Investment in GOs	488,874	340,570	148,304
11	Other current assets	313,005	99,073	213,932
12	Loans to stockholders	38,910	0	38,910
13	Mortgage and real estate loans	4,165	0	4,165
14	Other investments	3,229,602	1,006,823	2,222,779
15	Depreciable assets	1,449,793	548,233	901,560
16	Less: Acc. depreciation	474,400	180,629	293,771
17	Depletable assets	69	0	69
18	Less: Acc. depletion	0	0	0
19	Land	28,910	5,959	22,951
20	Intangible assets	128,911	7,292	121,619
21	Less: Acc. amortization	86,267	2,916	83,351
22	Other assets	271,419	55,682	215,737
23	Total: L + S. Equity	8,921,844	3,507,634	5,414,210
24	A/P	275,606	183,085	92,521
25	Current portion: LTD	151,311	48,780	102,531
26	Other current liabilities	237,113	83,472	153,641
27	Loans from stockholders	33,052	9,002	24,050
28	Mortages, notes & bonds	247,960	14,502	233,458
29	Other liabilities	86,012	13,884	72,128
30	Capital stock	132,902	18,098	114,804
31	Paid-in or capital surplus	320,990	119,972	201,018
32	Retained earnings, approp.	0	0	0
33	Retained earnings, unapprop.	7,506,376	3,016,839	4,489,537
34	Less: cost of treasury stock	44	0	44

Source: U.S. Treasury Department

EXHIBIT F (ii).

	A	B	C	D
1	Item	Drugs	Drugs	Drugs
2		All	Cost sharing	Others
3		85-86	85-86	85-86
35	Total receipts	4,094,212	1,781,646	2,312,566
36	Business receipts	2,778,388	1,676,252	1,102,136
37	Interest on Non-Munis	324,755	87,634	237,121
38	Interest on Munis	23,619	11,029	12,590
39	Rents	119	55	64
40	Royalties	2,695	0	2,695
41	Net ST C.G.	2,561	0	2,561
42	Net LT C.G.	1,285	102	1,183
43	Net gain, concapital assets	12	0	12
44	Dividends from dm &frgn corps.	20,887	1,561	19,326
45	Other receipts (net)	939,892	5,013	934,879
46	Total deductions	1,654,828	943,806	711,022
47	Cost of sales and operations	863,924	512,696	351,228
48	Compensation of officers	1,931	973	958
49	Salaries & wages	51,198	22,071	29,127
50	Repairs	14,142	5,676	8,466
51	Bad debts	596	265	331
52	Rents paid	3,007	2,069	938
53	Taxes paid	13,433	5,770	7,663
54	Interest paid	12,497	5,983	6,514
55	Contributions	657	318	339
56	Amortization	989	375	614
57	Depreciation	57,979	30,278	27,701
58	Depletion	0	0	0
59	Advertising	15,963	10,247	5,716
60	Pension, stock bonus plans	3,695	2,510	1,185
61	Employee benefit programs	14,332	7,775	6,557
62	Net loss, noncapital assets	968	737	231
63	Other deductions	599,515	336,064	263,451
64	Total receipts - total deductions	2,439,385	837,840	1,601,545
65	Net income (less deficit)	2,415,766	826,811	1,588,955
66	Net income	242,117	826,811	-584,694
67	Deficit	-5,351	0	-5,351
68	NI - D per books	2,395,964	860,482	1,535,482
69	Inc. subject to tax	2,403,154	825,484	1,577,670
70	Inc. tax before creds: total	1,107,001	379,813	727,188
71	Inc. tax before creds: reg. & altern.	1,105,199	379,704	725,495
72	**U.S. possessions tax credit**	**1,093,244**	**378,885**	**714,359**
73	Foreign tax credit	65	65	0
74	Investment credit	0	0	0
75	Research activities credit	0	0	0
76	General business credit	54	13	41
77	Jobs credit	0	0	0
78	Other credits	0	0	0
79	Income tax after credits	13,679	850	12,829
80	Reduction in tax liability	973,844	342,865	630,979
81	Dist. to stockholders, not own stock	1,410,215	362,815	1,047,400

San Juan Star

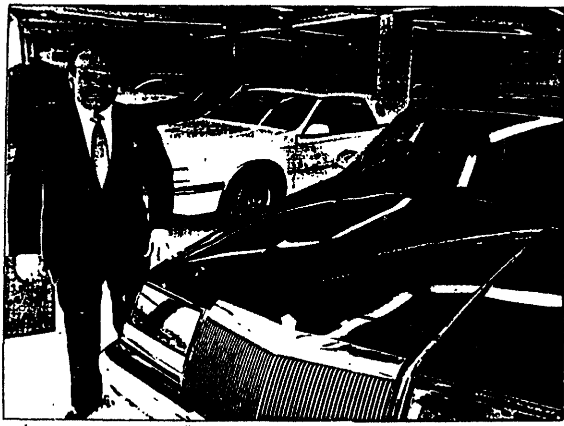
Business Sunday

Sunday, April 1, 1990.

EXHIBIT G.

Estrada expands in rough times

The price of an auto empire



STAR photo by Farah Rivera

Emérito Estrada Rivera shows off his top of the line Chrysler Imperial, priced at $38,000. The lot above is packed with hundreds of cars and Jeeps that Estrada must try to sell in a very slow market.

By MARIA T. PADILLA
STAR Business Editor

Emérito Estrada Rivera is known around town as the man who is buying everything.

Recently, one wag asked Estrada if he planned to buy the Puerto Rico Telephone Co. as well. The dimunitive Estrada replied, "I'm not buying it because it doesn't include Navieras," the island's government-owned shipping company.

Even without PRTC and Navieras, Estrada, 50, has done quite well for himself.

In the last several years, he has enlarged his auto distribution business making it the island's No 2. Such makes as Chrysler, Plymouth, Dodge, Jeep, Jeep Eagle, Alfa Romeo, Isuzu and Daihatsu fall under the Estrada banner. That's not including a car leasing subsidiary, a parts and accessories business and an agricultural equipment unit.

All told, Estrada's empire brings in between $140 million and $150 million annually, enough to place it among the top native companies.

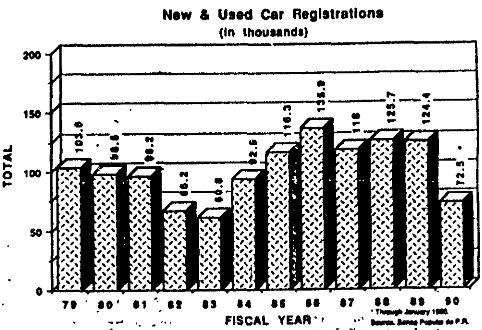
If Estrada has his druthers, he may be on his way to pushing sales higher. He is negotiating the purchase of the Thrifty car rental/leasing franchise. And is eyeing Toyota, the best-selling car make in Puerto Rico, and possibly Ford and General Motors as well.

Estrada may be either a madman or a genius. After all, this activity comes at a time when car sales aren't exactly sanguine. The best year for car sales was 1986, when nearly 136,000 new and used units were sold. As Ronald Flecha, General Motors Overseas Corp. district manager said, "It's all been downhill ever since."

The auto distributor doesn't appear overly concerned about the current downturn. "We will continue to widen our horizon independent of how the market is behaving," Estrada said.

So how does Estrada make his empire grow?

See ESTRADA, Page B-2



Since 1986, the industry's best sales year ever, car unit sales haven't been quite the same.

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Estrada

From Page B-1

Corporate records show that Estrada likes to expand when the going is tough, because that's when assets can be bought cheaply. When the upturn arrives, he is ready. He is a big participant in government car bids, selling about 10 percent of his cars this way annually. And during the Japanese car import quota period, he was not above diverting vehicles destined for Puerto Rico to the U.S. market instead, earning a tidy profit.

In fact, Estrada created a Panamanian subsidiary to handle Japanese car sales to the United States, and there's a distinct possibility the Panamanian company's main purpose was to avoid paying Puerto Rico and U.S. taxes.

"It's a classic scheme, one of the oldest in the book," said a U.S. Justice Department official.

If nothing else, Estrada's strategies indicate a business acumen not unlike his father's before him.

Don Mero Estrada started a used car firm in San Sebastián in 1943, when the United States was in the throes of World War II. Don Mero adapted used cars and other vehicles for agricultural use and sold them to the area's cane, coffee and orange growers.

"My father was the architect of all this. He taught us much and gave us good advice," said younger brother Sergio, who has his own auto dealer/distribution company.

Estrada, meantime, was learning the car business working with other dealers. By the time he and Sergio joined his father's firm in 1964, the company had expanded into Aguadilla and was grossing between $5 million and $6 million annually — a substantial amount at the time.

Eventually the Estradas expanded into Mayaguez and San Germán, where they distributed Chevrolets in western Puerto Rico. Later they added Japanese-made Datsun, which now is known as Nissan.

The really big move, however, came in 1982 when the Estradas transferred the main business to San Juan on the Kennedy Avenue marginal road.

That was not a very good year for auto dealers. A bad recession hit the United States and Puerto Rico in 1982, depressing car unit sales by 31 percent to 66,200 units. The following year was even worse. Unit sales, which includes used cars as well, fell to 60,000 in 1983, according to Banco Popular de Puerto Rico figures.

But the Estradas were expanding. They gave up the Datsun dealership to distribute Isuzus, which at the time was an unknown make in Puerto Rico. Estrada, in particular, is widely admired for establishing the Isuzu line out of nothing.

"He got Isuzu and made it into a very good line. He sells thousands now, and it's not easy to do something like that," said one competitor.

In quick succession came such subsidiaries as Emérito Estrada Rivera Isuzu de Mayaguez; Emérito Estrada Rivera Enterprises, which is a real estate and investment company; and Emérito Estrada Rivera Auto Parts & Services, established in 1986.

That year, Estrada's Isuzu de Puerto Rico firm bought 15 acres off Kennedy Avenue for $2.2 million. That was on top of the six acres, three-story building and warehouse Estrada already owned on Kennedy Avenue, and for which Emérito Estrada Enterprises Inc. had paid $2.37 million in 1986.

The year 1986 was an even more important year for Estrada for several reasons.

First, Estrada and Sergio parted ways after the death of Don Mero. Estrada paid $9 million for Sergio's stock in Isuzu and an undisclosed amount for his mother's Isuzu participation as well.

The brothers maintain there was no disagreement. Sergio simply wanted to go his own way. "We get along well. I just became independent," Sergio says.

Indeed, today Sergio, who distributes Yugo and Aro Hunter vehicles, is Estrada's largest retail dealer out of a network of more than 40 islandwide, the two brothers confirmed.

But 1986 also was a key year because Estrada started selling cars to the United States, funneling funds through the Panamanian firm, Importadora Simla, S.A.

At the time quotas on Japanese cars imported to the United States was a new development. But Japanese cars sold to Puerto Rico and diverted to the United States fell outside the quota system.

The transaction is not illegal, but highly unusual if only because Puerto Rico doesn't manufacture cars and, therefore, is not in the business of selling cars to the U.S. market. Knowledgeable sources say that every Japanese car distributor on the island was doing the same, selling tens of thousands of units to the United States during a two-year period.

Estrada acknowledges he created Simla, a wholly owned subsidiary, to sell Japanese cars to the United States. But beyond that he isn't saying much else.

Corporate records indicate that Emérito Estrada Rivera Isuzu de Puerto Rico Inc. "owed" Simla $11 million in 1986 and $9.57 million in 1987 for a total of $20.6 million.

It's unclear why Estrada registered Simla in Panama, but experts say this is a classic way to evade taxes. The scheme works like this: Funds are channeled to the Panamanian firm and then "loaned" to the parent. The funds, of course, aren't repaid.

"It's a very cutesy way to hide money you haven't declared," said the Justice Department official.

Knowledgeable sources also say that during the 1988 tax amnesty, between $75 million and $100 million of the total $296 million in back taxes collected, found its way back to Puerto Rico from Panama, where similar companies had been set up.

Since Puerto Ricans also are U.S. citizens, funds deposited in Panama are taxable by Uncle Sam as well. It's possible that most, if not all, the Panamanian amnesty funds may owe U.S. taxes, because sources at the Internal Revenue Service say the agency did not participate in Puerto Rico's tax amnesty.

In either case, Estrada says he "deactivated" Simla in 1987. He didn't elaborate further, saying the information was not "at hand." When pressed further about Simla, Estrada asked the STAR to put questions in writing and fax them to him. The STAR complied, but failed to receive answers to these questions by late Friday evening.

Since then, Estrada bought Boricua Motors Corp, which held the Dodge franchise in Puerto Rico. Boricua, which entered bankruptcy in 1988, was losing money, accumulating more than $2 million in operating loss carryforwards.

This is a tax credit that can be applied to profits and has the effect of boosting reported earnings. In this case, Estrada can apply these tax credits to his company's earnings in annual installments through 1992.

To Boricua, now a car leasing and rental firm, Estrada plans to add the Thrifty car leasing and rental franchise. Negotiations are nearly complete for Estrada to buy the logo and service mark, which now is held by Velasco Rental & Leasing Co. of Puerto Rico Inc. This company, which lists the Thrifty franchise as a $25,000 asset on its books, is in the midst of a dispute with Thrifty.

Similarly, Estrada bought in 1989 the "income producing assets" of Kennedy Motors, which represented the Jeep/Jeep Eagle line.

This company also was experiencing problems and Estrada paid only about $300,000 for the assets, while the liabilities were liquidated, records show. The purchase added another $95,313 of tax credits that can be applied to profits through 1996.

Now, Estrada has set his eyes on the Toyota franchise, which is owned by Gómez Hmnos. Inc.

Gómez Hmnos. controls more than 20 percent of the car market and as the No. 1 car distributor on the island is Estrada's main competitor. If Estrada bought Toyota it would make his life easier. After all, he must sell about seven different car lines to maintain his No. 2 position, while Toyota is only Toyota.

If the two joined forces, Estrada could create an auto monopoly. The thought has occurred to Estrada and he concedes, "I can't represent everything because then I'd come into conflicts with the law."

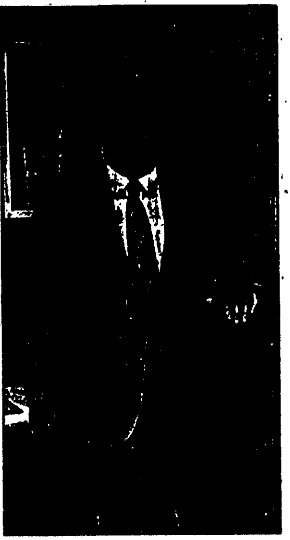
But the law is not the only thing Estrada has to worry about. Toyota would want to look him over too, since Japan's largest automaker must approve the deal. Estrada may have an inside track, though, because his Daihatsu line is co-manufactured by Toyota.

Meanwhile, Gómez Hmnos. officials acknowledge the two have talked, but "there's nothing concrete," said Victor M. Gómez, general manager. Further, the Gómez family hasn't put the company up for sale, he said.

Of course, that is not to say that Gómez Hmnos wouldn't sell to Estrada at the right price.

The following are either subsidiaries, business units or affiliates of Emérito Estrada Rivera's growing enterprise.

- Emérito Estrada Rivera Enterprises Inc.
- Emérito Estrada Rivera Isuzu de P.R. Inc.
- Emérito Estrada Rivera de Mayaguez Inc.
- Emérito Estrada Rivera Auto Parts & Serv. Inc.
- Uni-Serv Inc.
- ETA Commercial Enterprises Inc.
- Isuzu del Caribe Inc.
- Daihatsu of Puerto Rico Inc.
- Boricua Motors Inc.
- EER Agricultural Equipment Inc.
- Emérito Estrada Rivera Inc.
- EER Realty Corp.
- Chrysler Jeep
- Jeep Eagle
- Alfa Romeo



Sergio Estrada Rivera, younger brother of Emérito Estrada Rivera, says his father was the "architect" of their auto businesses.

Corporate records show that Estrada likes to expand when the going is tough, because that's when assets can be bought cheaply. When the upturn arrives, he is ready. He is a big participant in government car bids, selling about 10 percent of his cars this way annually.

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Statement of Ex-Senator Ruben Rivera Ramos

Mr. Chairman. I appreciate the opportunity given me by this Committee to present in writing my statement and I hereby pray this Committee to make it as part of the record.

Mr. Chairman, the Puerto Rican people must be told the truth. Sad to say but truth is not coming from Congress. The Congress Budget Office Report is based on "HEARSAY" rather than on economic facts, good for lobbyist, but squalid for United State Senators. They have taken the view of protecting the 936 Corporations, while ours is above all a problem of freedom within the Union or out of the Union as a Republic. How could C.B.O. miss the point that if Puerto Rico, becomes a Republic, United States will have to pay yearly *from five to eight billions dollars* for the naval and military installations in Puerto Rico? This will be then, an International Issue, while now Ceiba Naval Base it is not negotiable for U.S.A.

How could C.B.O. Congress Budget Office fail to see that Puerto Rico is a piece of Real Estate owned by the United States as an exclusive market to sell the U.S.A., farming and industrial products here and that, Puerto Rico is the 4th U.S. most important market out of the mainland?

How could the C.B.O. people fail to see that if the Puerto Rican poor and indigent receives over two Billion dollars in Statehood, that money will go back to the heart of the American economy through the Arteries of the economy; which is not likely to happen under Independence.

How could C.B.O. technicians fail to see that 936 Corporations can remain in Puerto Rico, if Puerto Rico becomes a state until Puerto Ricans raise their income "PER CAPITA" similar to that of the state of Mississippi. Why they close this door to walk in darkness?

The C.B.O. Report is cruel in its nature, and fails to show that Commonwealth is no longer an option, because of an ambivalence that cries for self determination, for a final definition and the ending of a third class citizenship based on a privilege called tax exemption, which is a crime against the poor and indigent and for the benefit of the rich and mighty exploiter of the mainland. Simple Common sense makes it imperative for a reasonable man to tell. C.B.O. people "sad to say shame on you."

For the C.B.O. technicians, Statehood is a trial and error adventure unknown to mankind and something beyond human experience and the report is fog to shadow available scientific economic facts real to our integrated economy, and they are failing to show truth to members of Congress.

The C.B.O. Report seems to convey the message that Statehood means starvation! UNBELIEVABLE! The report is biased.

Mr. Chairman sad to say, but the plebiscite proceeding in the House of Representative of the United States and the C.B.O. Report are lacking seriousness and we pray for seriousness as measured and considered in S. 712.

We also pray for legislation to guarantee one man, one vote; because in Puerto Rico dozens of thousands of voters never appear on the voting list, and Computers counting votes are one sided. Under the American Flag that vote, and the right to vote must be protected, but that justice is choked in Congress and in Puerto Rico, if our self determination proceeding is a battle among the 936 Corporations interest and those on Welfare in the Island.

Mr. Chairman, please consider S. 712.

Statement of the Securities Industry Association of Puerto Rico

The Securities Industry Association of Puerto Rico believes that any considerations to modify Puerto Rico's existing political status should take into account the tax attributes at time of issuance of Puerto Rico securities and other types of financings, so that significant economic value is not needlessly destroyed and Puerto Rico's ability to finance its future economic development is not impaired.

There are several types of securities which could be adversely affected by a change in political status and should be considered separately:

—Puerto Rico municipal bonds that qualify under Section 103 of the U.S. Internal Revenue Code are, by virtue of the Puerto Rico Federal Relations Act and predecessor legislation, exempt from Federal, state and local taxation. This allows the Commonwealth of Puerto Rico to market its bonds to U.S. investors on a nationwide basis and to price those bonds at rates significantly lower than would otherwise be achievable, given Puerto Rico's credit rating. Any change to the Puerto Rico Federal Relations Act that adversely altered the so-called "triple tax exemption" of Puerto Rico municipal bonds by, for example, eliminating the state and local tax exemption that is generally not a feature of U.S. municipal bonds except within the issuing jurisdiction, would. materially reduce the value of these securities by between 4 to 5% of the outstanding principal amount. This would represent a loss in value to U.S. mainland holders of these securities of between $400 to $500 million of the face value of the Commonwealth's outstanding public debt as of December 31, 1988, and a corresponding loss to the I.R.S. through the capital loss provisions.

—In addition to issuing municipal bonds that qualify under Section 103 of the U.S. Internal Revenue Code for Federal tax exemption, Puerto Rico also issues other types of obligations exempt from Puerto Rico income taxation for sale exclusively to residents of Puerto Rico, the proceeds of which are used for the funding of the capital improvement programs of public corporations such as the Puerto Rico Telephone Authority and the Puerto Rico Industrial Development Company or other public and private sector economic development projects, which for various technical reasons do not qualify for Federal tax exemption under Section 103 of the Code. These bonds were sold on the basis of the Puerto Rico tax exemption and the current tax status of Puerto Rico residents under Federal law, which provides that residents of Puerto Rico are generally exempt from U.S. income taxation on their income from Puerto Rico sources. The imposition of Federal income taxation upon residents of Puerto Rico who have invested in good faith in these securities could devalue approximately 10%, or $100 million, of the outstanding value of these securities.

—Finally, the Commonwealth has for years provided support for the housing market by providing Puerto Rico tax exemption for certain types of mortgages and mortgage-backed securities related to housing in Puerto Rico. This has allowed the Puerto Rico housing market to remain strong when other markets have faltered, and has reduced the effective cost of housing in Puerto Rico, allowing for affordable housing programs sponsored by the Commonwealth. This favorable tax treatment, once again, has been based on the fact that under the current relationship between the U.S. and Puerto Rico residents of the Commonwealth are not subject to Federal income taxation on their Puerto Rico source income. In this case, the imposition of Federal income taxation upon residents of Puerto Rico could result in a market devaluation of these securities equal to approximately 8% of the outstanding face value of these securities, or approximately $150 to $185 million.

For the reasons stated above, The Securities Industry Association of Puerto Rico strongly feels that irrespective of political status considerations, the particular tax status applicable on the date of issuance to any Puerto Rico securities or other types of financings should be effectively "grandfathered." Failure to do so would destroy significant investor wealth both in Puerto Rico and in the United States, without achieving any meaningful objective for either jurisdiction.

Beyond the potentially negative retrospective effects on investors' assets described above, The Securities Industry Association of Puerto Rico would also like to point out that the elimination or curtailment of the current tax attributes of Puerto Rico securities would result in a significant increase in the cost of capital for public and private sector economic development projects and infrastructure in Puerto Rico, and would therefore materially adversely affect the future growth of the local economy.

Attachment.

S. Hrg. 101-198 (Pt. 2)

POLITICAL STATUS OF PUERTO RICO

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STATEMENT OF MIGUEL A. FERRER, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, PUERTO RICO, ACCOMPANIED BY JOSE GONZALEZ, SECURITIES INDUSTRY ASSOCIATION; AND JORE MIRANDA, SECURITIES INDUSTRY ASSOCIATION

Mr. Ferrer. Mr. Chairman, Senators, my name is Miguel Antonio Ferrer. I am here representing the Securities Industry Association of Puerto Rico, which is composed of the many securities firms with presence in Puerto Rico.

With me to help with questions that may arise is Mr. Jose Ramon Gonzalez.

We welcome having this opportunity to focus your attention on two matters of economic significance that have not been offered sufficient attention up to now. Please allow me to briefly read from the statement previously submitted to you.

The Securities Industry Association of Puerto Rico maintains that, irrespective of political status considerations, section 936 of the U.S. Internal Revenue Code should be preserved as long as possible, since the corporations operating under this section are of fundamental importance to Puerto Rico's present and future economic well-being. Section 936, coupled with the Puerto Rico Industrial Incentives Acts, constitute the most cost-effective economic development benefit the United States currently provides Puerto Rico.

The Securities Industry Association of Puerto Rico believes that any alteration of section 936 would cause severe dislocations in the existing economic structure of Puerto Rico, and as such should be rejected. It should be noted that this section has already been altered twice, once in 1982 through the TEFRA Act, and later in 1985. In both instances the uncertainty caused by revisions in the section proved damaging to investment in Puerto Rico and raised the costs of locating in Puerto Rico for 936 corporations. The Association believes that the limitations placed on income due to intangibles by TEFRA and the trimming of benefits from investment income effected in 1985 were sufficient to address the concerns of the U.S. Treasury and the Congress, and that preservation of this section as presently established is essential.

The operation of section 936 has been the subject of much analysis, almost since the section's enactment in 1976. This presentation makes use of previous studies on the impact of section 936, particularly the recently finished study commissioned by the Puerto Rico Bankers Association.

The purpose of this presentation is to elaborate on the following points:

One. Since the enactment of the section in 1976, 936 manufacturing and financial activities have given life to local industry and capital markets, which currently are the backbone of investment activities benefiting Puerto Rico and the Caribbean Basin.

Two. Section 936 accelerated the development in Puerto Rico of high-technology manufacturing precisely at the time when rising labor costs and other factors were eroding Puerto Rico's competitive edge in light, labor-intensive manufacturing.

Three. Approximately $15 billion that 936 companies keep invested in Puerto Rico are the island's most valuable source of capital and have played a crucial role in the development of a modern and sophisticated financial system.

Four. Funds invested by 936 companies in Puerto Rico have also been crucial in supporting socially-stabilizing public sector programs and have provided a relatively low-cost source of financing for government investment in development oriented projects.

Five. The cost-benefit analyses of the operation of section 936 indicate that the benefits to Puerto Rico are substantially higher than the costs to the U.S. Treasury, so that the section is a cost-effective instrument for promoting economic development in the island.

Puerto Rico's present and future level of economic development depends critically on the preservation of section 936.

I will also touch now on the second matter on hand, which is a supplementary statement made in our statement to you.

The Securities Industry Association of Puerto Rico believes strongly that any consideration to modify Puerto Rico's existing political status should take into account the tax attributes at the time of issuance of Puerto Rico's securities and other types of financings so that significant economic value is not needlessly destroyed, and Puerto Rico's ability to finance its future economic development is not impaired.

There are several types of securities which would be adversely affected by change in political status and should be considered separately.

First, Puerto Rico municipal bonds that qualify under section 103 of the U.S. Internal Revenue code are by virtue of the Puerto Rico federal relationship and predecessor legislation exempt from federal, state and local taxation. This allows the commonwealth of Puerto Rico to market the bonds to U.S. investors on a nationwide basis and to price these bonds at rates significantly lower than would otherwise be achievable, given Puerto Rico's credit rating.

Any change to the Puerto Rico federal relationship that adversely alters the so-called triple tax exemption of Puerto Rico municipal bonds—for example, eliminating the state and local tax exemption that is generally not a feature of the U.S. municipal bonds, except within the issuing jurisdiction, would materially reduce the value of these securities of between 4 to 5 percent of the outstanding principal amount.

This would represent a loss in value to U.S. mainland holders of these securities of between $400-$500 million of face value of the commonwealth's outstanding public debt as of December 31, 1988, and a corresponding loss to the IRS through the capital loss provisions.

In addition to issuing municipal bonds that qualify under section 103 of the U.S. Internal Revenue Code for federal tax exemption, Puerto Rico also issues other types of obligations exempt from Puerto Rico income taxation for sales exclusively to residents of Puerto Rico, the proceeds of which are used for the funding of the capital improvement programs of public corporations such as Puerto Rico Telephone Authority, the Puerto Rican Industrial Development Company, and other public and private sector economic development projects which for various technical reasons do not qualify for federal tax exemption under section 103 of the code.

These bonds are sold on the basis of Puerto Rico tax exemption, and the current tax status of Puerto Rico residents under federal law which provides that residents of Puerto Rico are generally exempt from U.S. income taxation on their income from Puerto Rico sources.

The imposition of federal income taxation upon residents of Puerto Rico who have invested in good faith in these securities could devalue approximately 10 percent or about $100 million of the outstanding value of these securities.

Finally, the commonwealth of Puerto Rico has for years provided support for the housing market by providing Puerto Rico tax exemption for certain types of mortgages and mortgage backed securities relating to housing in Puerto Rico. This has allowed Puerto

Rico housing markets to remain strong when other markets have faltered and has reduced the effective cost of housing in Puerto Rico, allowing for affordable housing programs sponsored by the commonwealth.

This favorable tax treatment once again has been based on the fact that under the current relationship between the U.S. and Puerto Rico, residents of the commonwealth are not subject to federal income taxation on their Puerto Rico source income.

In this case, the imposition of federal income taxation upon residents of Puerto Rico could result in a market devaluation of these securities equal to approximately 8 percent of the outstanding face amount of the securities or somewhere approximately $150–$185 million.

For the reasons stated above, the Securities Industry Association of Puerto Rico strongly feels that irrespective of political status considerations, the particular tax status applicable of the date of issuance to any Puerto Rico securities or any other type of financing should be effectively grandfathered. Failure to do so would destroy significant investor wealth both in Puerto Rico and in the United States without achieving any meaningful objective for either jurisdiction.

Beyond the potentially negative retrospective effects on investor assets described above, the Security Industry Association of Puerto Rico would like to point out that the elimination or curtailment of the current tax attributes of Puerto Rico securities would result in a significant increase in the cost of capital for public and private sector economic development projects and infrastructure in Puerto Rico and would, therefore, materially adversely affect the future growth of the local economy.

Thank you very much.

[The prepared statement of Mr. Ferrer follows:]

Statement by the Securities Industry Association of Puerto Rico Before the U.S. Senate Committee on Energy and Natural Resources on S. 710, S. 711 and S.712

San Juan, Puerto Rico June 16 - 19th, 1989

The Securities Industry Association of Puerto Rico maintains that, irrespective of political status considerations, Section 936 of the U.S. Internal Revenue Code should be preserved as long as possible, since the corporations operating under this Section are of fundamental importance to Puerto Rico's present and future economic well being. Section 936, coupled with the Puerto Rico Industrial Incentives Acts, constitute the most cost-effective economic development benefit the United States currently provides Puerto Rico.

The Securities Industry Association of Puerto Rico believes that any alteration of Section 936 would cause severe dislocations in the existing economic structure of Puerto Rico, and as such should be rejected. It should be noted that the Section has already been altered twice, once in 1982 through TEFRA (the Tax Equity and Fiscal Responsibility Act), and later in 1985. In both instances the uncertainty caused by revisions in the Section proved damaging to investment in Puerto Rico and raised the costs of locating in Puerto Rico for 936 corporations. The Association believes that the limitations placed on income due to intangibles by TEFRA and the trimming of benefits from investment income effected in 1985 were sufficient to address the concerns of the U.S. Treasury and the Congress, and that preservation of the Section as presently established is essential.

The operation of Section 936 has been the subject of much analysis almost since the section's enactment in 1976. This presentation makes use of previous studies on the impact of Section 936, particularly the recently finished study commissioned by the Puerto Rico Bankers Association.

The purpose of the presentation is to elaborate on the following points:

- Since the enactment of the Section in 1976, 936 manufacturing and financial activities have given life to local industry and capital markets, which currently are the backbone of investment activities benefiting Puerto Rico and the Caribbean Basin.

- Section 936 accelerated the development in Puerto Rico of high-technology manufacturing precisely at a time when rising labor costs and other factors were eroding Puerto Rico's competitive edge in light, labor-intensive manufacturing.

- The approximately $15 billion that 936 companies keep invested in Puerto Rico are the Island's most valuable source of capital and have played a crucial role in the development of a modern and sophisticated financial system.

- Funds invested by 936 companies in Puerto Rico have also been crucial in supporting socially-stabilizing public sector programs and have provided a relatively low-cost source of financing for government investment in development oriented projects.

- Cost-benefit analyses of the operation of Section 936 indicate that the benefits to Puerto Rico are substantially higher than the costs to the U.S. Treasury, so that the Section is a cost-effective instrument for promoting economic development on the Island.

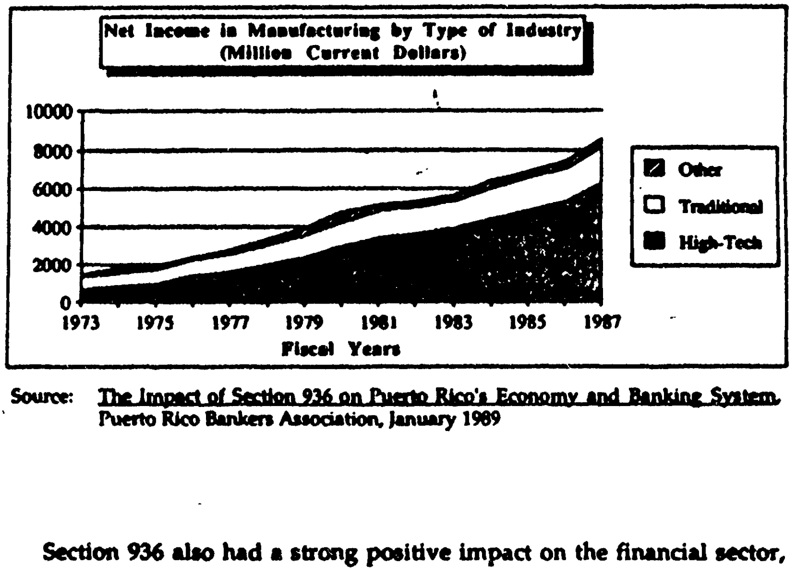
- Puerto Rico's present and future level of economic development depends critically on the preservation of Section 936.

The Economic Impact of Section 936

The enactment of Section 936 in 1976 had a strong immediate impact on Puerto Rico's economy, but it also had a more pervasive longer-term effect. The immediate impact consisted in buffering the Island's severe economic crisis of the mid 1970s, the first in Puerto Rico's modern economic history. More important, however, is the longer-term contribution of Section 936 to facilitating the transition away from light, labor-intensive manufacturing to an industrial structure characterized by the application of advanced technologies, of which the pharmaceutical and electronics industries are the foremost examples.

The movement away from traditional, labor-intensive industries to high technology manufacturing processes was necessary because Puerto Rico has experienced a loss of its competitive advantage as a low labor cost site. Section 936 has been an important factor in facilitating this transition, together with the Commonwealth's own tax incentives. It is unlikely that any of the firms operating under Section 936 in Puerto Rico would have located here had it not been for the existence of the Section.

The unsatisfactory trends in employment and investment since the mid-1970s would have been much worse without the growth of high-technology manufacturing spurred by Section 936. It should be pointed out that in 1988 manufacturing was responsible for 56% of total Gross Product and 40% of Gross Domestic Product. Of net manufacturing income, 73% was produced by high-technology industries in 1988. It is also important to mention that investment in machinery and equipment, most of which was in the 936 manufacturing sector, in the period between 1976 and 1988 grew in every year except one. The experience with construction, however, was quite different, with decreases in five of those years.



Source: The Impact of Section 936 on Puerto Rico's Economy and Banking System, Puerto Rico Bankers Association, January 1989

Section 936 also had a strong positive impact on the financial sector, as the inflow of 936 deposits provided much-needed liquidity at a critical moment. Commercial banks were under great pressure in the early 1970s owing to the crisis in the construction industry and the overall weakness of the local economy. More recently, in the early 1980s, federal savings banks were endangered by the sharp rise in interest rates that affected the entire industry in the United States. In both cases, 936 funds were instrumental in facilitating adjustment and recovery for local financial institutions.

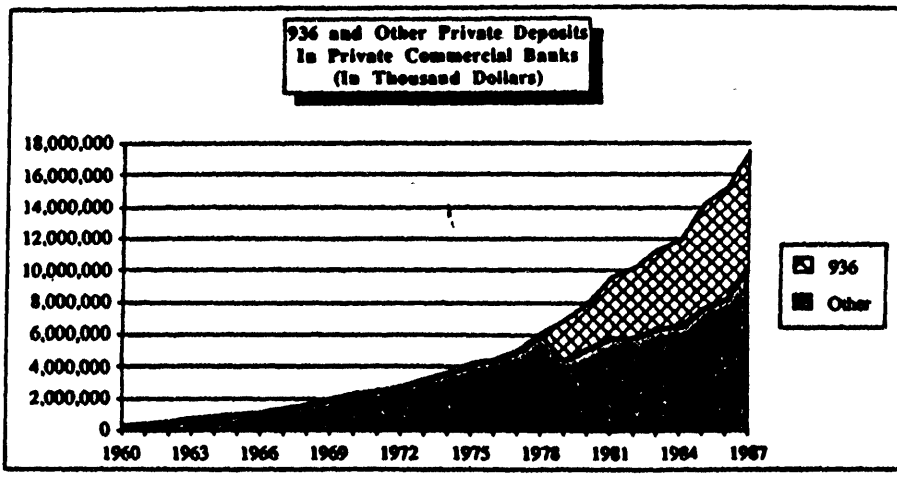
The liquidity and soundness made possible by 936 deposits have also shielded local savings and loans associations from the crisis that besets the industry on the mainland. While the federal government estimates that as much as $200 billion will be needed to bail out ailing savings and loans on the mainland, no such bail-out effort will be required in Puerto Rico. The reason is that, on average, local savings and loans are on a sounder footing than their U.S. counterparts, owing largely to the healthy effects of 936 deposits. For example, in the third quarter of 1988, the five local thrifts with publicly-traded stock, which together account for 75% of deposits in the industry, had a return on average equity of 12.16%, more than double the U.S. average of 5.38%. Similarly, these institutions had a ratio of net income to average assets of 3.22% compared with a national average of 2.01%.

936 Deposits and Puerto Rico's Financial System

Since the 1960s, Puerto Rico's commercial banks had been facing a declining growth rate of deposits which eventually would have affected their lending capacity. After 1976, the inflow of 936 deposits helped to maintain the growth of total deposits at close to historical rates, which in itself represents a substantial contribution of these funds to the local economy.

In the 27 years since 1960, deposits at commercial banks grew at an average annual rate of 14%, but the growth was not even during the period. In fact, the expansion of private deposits--the bulk of the total--decelerated significantly during 1960-1977. From an average annual growth of 16.1% in 1963-1976, the growth of these deposits slowed to 12.6% annually in 1973-1977.

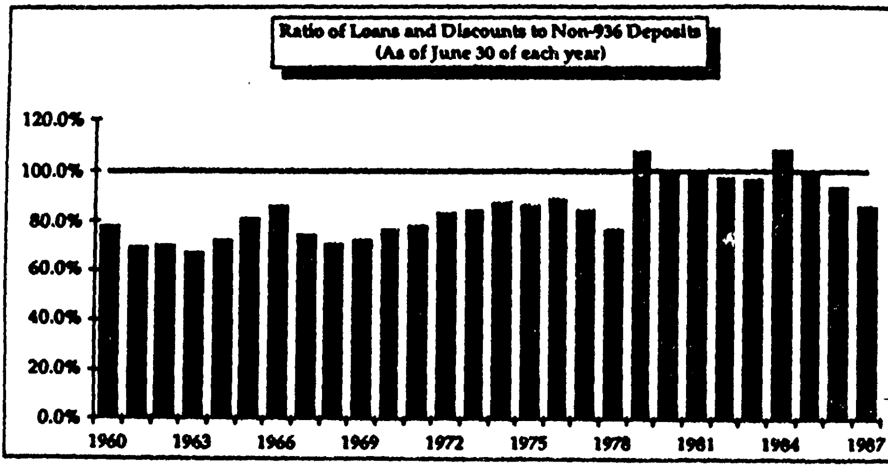
Following the enactment of Section 936, the growth of deposits picked up again during 1978-1982, although it still remained below the rates observed in the early 1960s.



Source: Estudios Técnicos, Inc., based on data from the Commissioner of Financial Institutions

As of the end of fiscal year 1987, private commercial banks had $18.3 billion in deposits, of which 96% were private deposits. Funds deposited by 936 corporations amounted to $6.9 billion, representing 38% of all deposits and 39% of private deposits.

In the absence of 936 funds it would have been difficult for private commercial banks to extend credit in the amounts actually observed since the mid-1970s, given the slowdown in the growth of non-936 deposits. The ratio of total loans and discounts to non-936 deposits exceeded 100% in four of the eleven years after 1976, and in another four years during that period the ratio was over 90%. This is a clear indication that non-936 funds alone could not have sustained the growth in the banks' loan portfolio observed since 1977



Source: The Impact of Section 936 on Puerto Rico's Economy and Banking System, Puerto Rico Bankers Association, January 1989

Financial institutions authorized to receive 936 deposits in Puerto Rico are subject to regulations governing the use of such funds. The Commonwealth's Commissioner of Financial Institutions is responsible for enacting and enforcing the applicable rules, currently embodied in Regulation 3582, which replaced the previous Regulation 3087 on March 1, 1988. The crux of the regulations is the definition of eligible activities to which funds may be channeled and the establishment of minimum and additional eligible-activity generation requirements. Eligible activities are defined in Regulation 3582 as those lending and investment activities that constitute utilization within Puerto Rico of eligible funds and which tend directly to increase production, income and employment. Regulation 3582 includes a list of such activities and explicitly excludes some uses of funds from eligibility. For example, consumer loans do not qualify for the use of 936 deposits.

These regulations stimulate financial institutions to assume an activist position in seeking qualified borrowers and in keeping the cost of 936 funds low. They also encourage the pass-through of low deposit costs to final borrowers by forcing the institutions to compete for eligible activity. And if local demand for financing is weak--as may happen during a slow period in the Island's economy--institutions will tend to offer unattractive rates to 936 depositors, thus encouraging repatriation of earnings to the mainland. Therefore, the rules are consonant with Congress' dual intent of promoting productive investment in the possessions and fostering repatriation of earnings not absorbed productively by the possession economy.

A 1985 study by the Government Development Bank (GDB) points out that \$3,731 million of direct 936 funds received by commercial banks up to March 1985 went into commercial, industrial and agricultural loans, representing 86% of total commercial bank loans in that category and 45% of eligible activity. The remainder went into mortgage loans(14.4%), government obligations(22.8%) and other eligible activities (17.9%). As of February 1988, the share of commercial loans in total eligible activity was 51% and the outstanding balance amounted to \$4.5 billion. Total financing of eligible activity as of February 1988 amounted to \$9.4 billion, 56% higher than the \$6 billion in direct 936 deposits at commercial banks.

It should be noted that the creation in 1977 of the Puerto Rico Industrial, Medical, Educational and Environmental Control Facilities Financing Authority (AFICA), an affiliate of the Government Development Bank, offered another channel for the use of 936 funds in productive investment. AFICA offers medium- and long-term financing through the issuing of tax-exempt industrial revenue bonds at rates below conventional lending rates. As of fiscal year 1986, AFICA had financed 99 projects for a total of about $2.1 billion, of which more than two-thirds went into industrial projects.

Another important effect of 936 funds has been to reduce the cost of credit in Puerto Rico. According to data reported by commercial banks to the Commissioner of Financial Institutions, the average rate charged on commercial loans originated in August 1988 was 12 basis points under the U.S. prime rate, which suggests that credit to local productive activities is relatively inexpensive thanks to the availability of 936 deposits. GDB's 1985 study had already found that in March 1985 the four largest commercial banks on the Island were charging 59 basis points less than the prime rate on commercial, industrial, agricultural and construction loans, a sharp contrast with the rate of 346 basis points over the prime rate charged on the same loan categories in March 1975, before Section 936 was enacted.

Studies of Puerto Rico's economic structure show that commercial bank financing is an important input in many productive sectors, particularly in trade, services, government, and in some areas of manufacturing. Input-output data for 1984 show that financial intermediation has strong linkages to service-sector activities with a substantial representation of local capital that have a significant impact on employment and income on the Island. A reduction in bank lending such as would result from the loss of 936 deposits would therefore have strong negative effects on important sectors of local economic activity.

More than 90% of the banks' commercial and industrial loans are small loans, that is, loans of less than $100,000, which support the operations of small and medium-size businesses. In fact, more than 65% of these loans do not exceed $25,000. Other items of interest include the fact that four Puerto Rico banks were listed recently among the 300 leading U.S. banks in commercial loans. Similarly, one local bank ranks second in the United States in the issuing of Small Business Administration loans and another ranks 67th among the top 100 banks in granting agricultural loans. To put the significance of these rankings in the proper perspective, it should be noted that there are 14,000 commercial banks in the United States.

Although 936 deposits in commercial banks constitute the single largest investment of such funds by 936 corporations, substantial amounts have also been intermediated through other segments of the local financial system, such as savings and loans banks and brokerage houses. In addition, 936 corporations also invest a significant amount of funds directly in local financial instruments, such as GNMA issues to finance mortgages originated in Puerto Rico. The spreading of these funds through the financial system, and the direct investment by the corporations have extended the benefits of 936 funds through the local economy, sustaining the development of a wide array of financial activities and allowing for a broader scale of operations in financial institutions.

As of May 1988, the local financial system had $10.6 billion of 936 funds, of which $6.4 billion were deposited in commercial banks, $1.9 billion were in savings and loans banks and $2.4 billion were held by brokerage houses. In addition, it is estimated that corporations had invested about $2 billion directly, without recourse to financial intermediaries. By contrast, in 1983 the funds were much more concentrated in commercial banks. At the end of that year, banks held $4.9 billion in deposits out of a total of $5.7 billion, while brokers held the remaining $800 million and savings and loans banks had no participation in the market. This trend towards a better distribution of deposits across the financial system has amplified the positive effects of 936 funds on the local economy.

The growth and diversification of the 936 funds market has led to the development of innovative ways of financing productive activity in Puerto Rico. One recent example is the creation of a special fund for agricultural loans which has channeled about $250 million to farmers in Puerto Rico through the Farm Credit Bank of Baltimore. The Bank sold notes to 936 companies to fund its credit activities in Puerto Rico, and passed through the relatively low cost of the funds to the borrowers. This is also the first known instance of a federal government agency directly tapping the local 936 market.

Costs and Benefits of Section 936

A cause for much concern in Puerto Rico has been the assertion in various U.S. Treasury reports that Section 936 is cost-ineffective, that is, that costs to Treasury from the Section's operation outweigh the benefits to Puerto Rico's economy. This assertion has been effectively contested in several public- and private-sector studies in Puerto Rico, which have shown the opposite to be true: the cost-benefit balance in effect argues for the Section's permanence.

The essence of Treasury's approach has been to regard the tax credits claimed by 936 corporations as the cost of the Section's operation and to consider as benefits only the compensation to workers employed directly by 936 corporations. Thus, in the Treasury's Sixth Report on the operation of Section 936, it is pointed out that in tax year 1983 all manufacturing 936 companies received $18,523 in tax benefits per employee, while the average compensation per employee was $14,836.

This approach has been effectively challenged on the following grounds:

- Treasury overestimates the costs of the Section's operation in assuming that tax benefits obtained by 936 corporations would become tax revenues, dollar by dollar, in the absence of Section 936. In effect, many 936 corporations would reincorporate in Puerto Rico or relocate elsewhere outside the United States, such that the anticipated tax revenues to the U.S. Treasury would not materialize. If companies reincorporate in Puerto Rico, the Island would be the primary tax jurisdiction, and the U.S. Treasury would only be able to tax dividends repatriated to the United States after fulfilling Puerto Rico's tax obligations. A similar situation would arise if companies were to relocate elsewhere outside the United States.

- Treasury underestimates the benefits of Section 936 to Puerto Rico by looking only at direct employment and compensation in 936 corporations. The indirect employment and compensation effects of 936 manufacturing companies are substantial, and should not be ignored in the cost-benefit evaluation.

In a study by the Economic Development Administration of Puerto Rico (EDA), which evaluated Treasury's cost-benefit analysis in the Fifth Report, it is argued that Treasury overestimated the cost per employee by "*...at least $11,274 and underestimated the average benefit per employee by $34,675.*" EDA concluded that "*...Section 936 generates more than $4.50 in benefits for every $1.00 of cost.*" (EDA, Analysis of the Treasury Proposal to Repeal Section 936, March 1985, p. 26) Other studies have found similar favorable ratios of benefits to costs by extending Treasury's analysis to include indirect benefits and to incorporate more realistic estimates of the Section's cost.

As mentioned earlier, Section 936 underwent significant modifications in 1982 and in 1985, which limited tax benefits by placing constraints on income from intangibles and from financial investments.

Effects of Repeal of Section 936

Should Section 936 be repealed, the assumption made by Treasury in estimating a tax gain of approximately $1.6 billion is that all manufacturing activity presently in Puerto Rico would relocate to the United States. This is a highly questionable assumption, and it would be more correct to assume that the largest share would move to other locations outside the U.S. In this case, tax payments would be substantially below those paid by a U.S. based corporation under present tax legislation. Some firms would opt to remain in Puerto Rico, as Puerto Rican corporations. In this case, Puerto Rico would be the primary tax jurisdiction and federal taxes would be paid only on that portion of profits sent as dividends to U.S. firms or individuals.

Thus, the benefits to the U.S. Treasury from repeal of Section 936 are questionable at best. On the other hand, the damage to Puerto Rico's economy would be substantial and certain. The direct loss to Puerto Rico in manufacturing output and employment would be significant, but the indirect effects could be even more damaging. Many other domestic sectors of economic activity are linked to 936 corporations through the effects these corporations have on overall employment and on the aggregate demand for goods and services on the Island. In addition, negative effects would spread to other activities through the financial ramifications of the 936 sector, which currently provides a major portion of the supply of capital resources at relatively low cost. Moreover, the indispensable transition to high-technology manufacturing could be halted, endangering the Island's development prospects in the medium and long terms.

Finally, it should be pointed out that Section 936 also provides benefits to the United States economy, since local economic activity generates a demand for U.S. products that creates and sustains jobs on the mainland. A study by the WEFA Group of Philadelphia for the Puerto Rico Bankers Association found that repeal of Section 936 could result in the loss of as much as 80,000 jobs in the United States over a five-year period. Although this is not a dramatic impact, given the size of the U.S. labor market, it is by no means negligible.

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