

PUERTO RICO, U. S. A. FOUNDATION

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CONFIDENTIAL

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April 26, 1991

MEMORANDUM TO PRUSA MEMBERSHIP

Re: Price Waterhouse Section 936 Studies

Enclosed for your information is a confidential advance copy of the now-completed Price Waterhouse study on Section 936. The study is in two volumes. Volume I analyzes the costs and benefits of Section 936 from a mainland, Puerto Rico and Caribbean perspective. Volume II, utilizing a macroeconomic model of the Puerto Rican economy developed by the Congressional Budget Office and incorporating information obtained from a survey of PRUSA member-companies, analyzes the effects of a hypothetical repeal of Section 936.

Also enclosed are (1) a brief PRUSA summary of the highlights of the Price Waterhouse findings and (2) a public information brochure on Section 936 which incorporates the Price Waterhouse findings.

We are asking the PRUSA membership to hold all of these materials on a confidential, for in-house use only basis until we notify you otherwise. We do so until such time as we are able to complete certain advance confidential briefings of key Members of Congress, as well as Puerto Rican government officials. Once these briefings have been completed we will make the documents available to the public.

Copies of the Price Waterhouse Volumes I and II will be limited in number. Copies of the PRUSA highlights summary and the public information brochure will be in substantial supply and made available to the membership upon request. It should be noted that a Spanish-language version of the public information brochure will also be made available to the membership for use in Puerto Rico.

If you have any questions about the enclosed materials, please do not hesitate to contact me at 202/857-0620.


Peter E. Holmes

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Price Waterhouse Studies
on
Benefits of Section 936 and Effects of Repeal

At the request of members of the Puerto Rico USA Foundation^{2/}, the independent accounting firm of Price Waterhouse has prepared two new studies on Section 936 of the Internal Revenue Code: "Benefits and Costs of Section 936" and "Section 936 and the Puerto Rican Economy: An Analysis of the Effects of a Repeal of Section 936 Under Puerto Rico's Present Commonwealth Status."

These new studies have been prepared in an effort to improve public understanding of the important benefits Section 936 provides to the U.S. mainland, Puerto Rico and the Caribbean. In addition, the studies correct certain misassumptions about the effects of a repeal of Section 936, particularly on Federal Government revenues, on the continuation on the island of 936 manufacturing operations and on the Puerto Rican economy as a whole.

Highlights

VOLUME I - "Benefits and Costs of Section 936"

The Mainland Perspective

o Section 936 is the only tax advantage available to U.S. multinationals comparable to "tax-sparing" agreements which virtually every other major industrialized nation has with developing countries and which enable foreign-based companies to operate with much lower costs than U.S. firms.

o By increasing companies' cash flow, the tax benefits of Section 936 have permitted the investment of additional resources in research and development, critical to America's competitive industries in maintaining world leadership in science and technology and expanding exports. Seventy-four (74) percent of the 936 credit is claimed by the instruments, electrical and electronic equipment and pharmaceutical industries, three of the most research intensive in the U.S. It is estimated, for example, that each \$100 increase in after-tax cash flow results in an additional \$37.48 of R & D expenditures in the pharmaceutical industry.

o By maintaining competitiveness and encouraging repatriation of manufacturing profits from Puerto Rico to the mainland, Section 936 enhances employment opportunities in the states.

^{2/} The Puerto Rico USA Foundation (PRUSA) is a non-profit membership organization of approximately 70 mainland manufacturing companies, financial institutions and other firms with operations in Puerto Rico related to Section 936. Membership includes companies representing food, apparel, electronic, instrument, electrical machinery, medical devices and pharmaceutical industries.

- o Six major military facilities covering 49,000 acres and deploying 6,000 troops in Puerto Rico save the U.S. Government an estimated \$350 million annually in base rights costs.
- o Puerto Rico ranks as the 10th largest purchaser of U.S. mainland exports, buying over \$9 billion of goods in fiscal 1989, including \$2.1 billion of consumer goods. These purchases have a significant positive impact on jobs in the states. In 1988, Puerto Rico ranked as the world's eighth largest exporter to the U.S. mainland.
- o Maritime trade between U.S. mainland ports and Puerto Rico is covered by the Jones Act and represents nearly 25% of the value of all international shipments carried by U.S. flag vessels, so crucial to the American merchant marine fleet in times of international conflict such as the recent Desert Storm operations in the Middle East.
- o The loss of Section 936 would result in increased unemployment in Puerto Rico and migration to the mainland, increasing Federal transfer payments by about \$337 million a year in 1995.

The Puerto Rico Perspective

- o As intended by the Congress, Section 936 has worked effectively in promoting the creation of jobs through new economic development, principally in manufacturing. In 1989, U.S. mainland companies operating in Puerto Rico directly employed 113,000 workers, representing 13% of the island's total employment and 72% of manufacturing employment.
- o Jobs in manufacturing have increased from 55,000 in 1950 to more than 157,000 today. Instruments, electrical and electronic equipment and pharmaceutical industries have accounted for 3 out of every 4 new jobs in those Puerto Rico manufacturing industries which have experienced an increase in employment since 1968.
- o Manufacturing comprises 39% of Puerto Rico's Gross Domestic Product compared to 20% on the U.S. mainland. The driving engine behind Puerto Rico's economic success has been the growth of the manufacturing sector, fueled by 936 corporations. Workers have been enabled to move from low-productivity agricultural jobs to skilled, highly productive and high paying manufacturing jobs.
- o Payments of income and tollgate taxes by 936 corporations represented 13.1% of Puerto Rico government tax receipts in 1987. For comparison, this was a higher percentage of total receipts than all corporate tax payments to the Federal Government (9.8%) in the same year. Repeal of Section 936 would result in the loss of almost 60 percent of Puerto Rico's corporate tax receipts, assuming that revenues are reduced in proportion to exports.
- o 936 corporation deposits in the Puerto Rico banking system represented 35% of private deposits and 29% of total bank deposits in 1990, providing a critical low-cost source of financing for economic development in Puerto Rico and the Caribbean. Virtually all of these deposits would be withdrawn from the Puerto Rico banking system in the event of repeal of Section 936.

The CBI Perspective

- o As of February 1991, nearly \$650 million (including almost \$500 million in 936 funds) have been approved by Puerto Rico for investment in the Caribbean Basin, creating an estimated 20,000 new private sector jobs in qualified CBI countries. Repeal of Section 936, including the credit for investment income, would effectively end this important program.

**VOLUME II - "Section 936 and the Puerto Rican Economy:
An Analysis of the Effects of Repeal of
Section 936 under Puerto Rico's Present
Commonwealth Status.**

Using a macroeconomic model of the Puerto Rican economy prepared by the Congressional Budget Office and incorporating information from a survey of U.S. companies with Section 936 operations in Puerto Rico, Price Waterhouse, for the first time, has been able to develop reliable estimates of the impact of a repeal of Section 936 on Puerto Rico's economy.

The Price Waterhouse survey included questions regarding 1991 and 1995 investments, exports, imports, employment and wages of Puerto Rico plants under two scenarios: (1) continuation of present law and (2) a hypothetical repeal of Section 936 effective January 1, 1991, under Puerto Rico's present Commonwealth status. The survey covered companies claiming 68.7% of the total possessions tax credit for 1987 and final results were weighted to be representative of the universe of Section 936 companies.

According to the Price Waterhouse study, "repeal" of Section 936 on January 1, 1991, would have devastating consequences for the Puerto Rico economy, with these results by 1995:

- o A 70,000-job reduction in 936 corporation employment and an overall increase in Puerto Rico unemployment of 164,000 jobs, doubling the island's current 15% unemployment rate.
- o A 16% decline in Puerto Rico's gross national product, resulting in a deeper recession on the island than any the United States has experienced in the post-World War II period.
- o A 64% decline in U.S. companies' investment in Puerto Rico and a 57% reduction in exports from Puerto Rican plants.

Finally, the Price Waterhouse survey concludes that U.S. Treasury assumptions regarding revenues "saved" by the Federal Government from a repeal of Section 936 may be substantially over-estimated:

- o Less than 50 percent of possession source income from business activities would become subject to U.S. tax (before payment of royalties and dividends) after a repeal of Section 936 -- in sharp contrast to a U.S. Treasury calculation that 65 percent of this income would become taxable. Upon repeal of Section 936, most companies operating in Puerto Rico would restructure or relocate as foreign corporations. Puerto Rico would begin to collect taxes from remaining possessions corporations, and the companies would claim foreign tax credits for income taxes paid to Puerto Rico.