Economic Policy Bulletin

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TREASURY'S PUERTO RICAN AUSTERITY PLAN

SUMMARY

The Treasury proposal to repeal Section 936, if implemented, would deal a devastating blow to the Puerto Rican economy. Most possessions corporations would begin promptly to disinvest in their Island operations. As they reduced the amounts of their capital facilities to levels consistent with the much higher cost of capital resulting from repeal of the Section 936 credit, the volume of their output and employment on the Island would also be severely curtailed. Although the process of disininvestment would be spread out over several years, the adverse effects on the Puerto Rican economy would begin to be felt immediately. These economic reverses would pose a serious challenge to United States foreign and defense policies, in addition to the enormous economic problems that would arise in Puerto Rico.

In its "**Tax Reform for Fairness, Simplicity and Economic Growth,**" the Treasury Department proposes to repeal Section 936 dealing with the tax treatment of possessions corporations. Possessions corporations, also known as 936 corporations, are subsidiaries of U.S. companies which receive a credit against their federal income tax liabilities equal to the amount of tax which would otherwise be payable on business and non-business income originating in Puerto Rico and certain other U.S. possessions. Most of these corporations are located in Puerto Rico. Accordingly, analysis is restricted to possessions corporations in Puerto Rico.

The Treasury maintains that section 936 has proved to be an ineffective means by which to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations."(1) It proposes, therefore, to repeal the existing 936

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.

credit and to provide a temporary wage credit which would phase out in transition to full federal taxation of possessions corporations' income. The wage credit would be a fixed dollar amount per hour worked by employees in 936 manufacturing industries. The amount would be 60% of the minimum wage per hour worked in the years 1987-1992. Beginning in 1993 the credit would decrease by ten percentage points a year until completely phased out in 1998. At the end of the transition period income from operations in Puerto Rico would be taxed identically to income earned by U.S. companies in any foreign jurisdiction. Treasury implies that the existing foreign tax credits would serve as sufficient inducement for firms to continue to locate operations in Puerto Rico.(2)

The elimination of 936 is seen by Treasury as, at worst, only temporarily disrupting the Puerto Rican economy.(3) Treasury acknowledges that individual industries (pharmaceuticals and electronics were identified in the proposal) might be so adversely affected as to discontinue or reduce the scope of their operations in Puerto Rico, but maintains that the proposal should attract more labor-intensive industries.

The logic behind this assumption is difficult to fathom. If an industry, either labor-intensive or capital-intensive, has not already chosen to locate its operations in Puerto Rico, where under existing law it is largely free of federal taxes, why should it do so in response to a temporary credit that results in a lower tax offset than the existing 936 credit? Moreover, the assertion that the wage credit will lead to a more labor-intensive investment pattern in Puerto Rico rests on the mistaken assumption that the wage credit reduces the cost of labor. The wage credit is a credit against the federal income tax liability on the possession corporations' profits. As such, it has no effect on the price of labor.

The availability of foreign tax credits after the expiration of the wage credit will also be of minimal value. Wage rates -- the cost of labor -- are higher in Puerto Rico than in its neighbors or other regions of the world eager to attract investment since Puerto Rican wage rates are tied to the U.S. minimum wage. Industries seeking low-wage residences for labor-intensive operations frequently locate in regions where the prevailing wage is a fraction of the U.S. minimum wage and would face the same foreign tax credit in Puerto Rico as they would elsewhere. There is no logical reason to expect these labor-intensive industries to select the relatively high-cost location that Puerto Rico has become when equally attractive locales offer lower labor costs.

The repeal of the Section 936 credit would have a seriously adverse effect on the volume of investment and the amount of

capital facilities committed to possessions corporations by their mainland parent companies. The result would be a serious curtailment of business activity throughout the Island economy, with a consequent severe loss in jobs, total output, and real income. Moreover, these adverse consequences would begin to materialize immediately, rather than being deferred until the end of the transition period.

Investment, whether in capital-intensive or labor-intensive operations, is a process of adjusting a business's stock of capital to the cost of acquiring and maintaining that capital, given its productivity. Investment decisions, therefore, are not made haphazardly. They reflect efforts by business management to have in place the optimum amount of the best kind of capital facilities for the business's production activity. The optimum amount of the best kind of such facilities depends on the cost of each kind and its productivity. The higher the tax on the income produced by the capital and the greater the risk(4) of committing the company's resources to acquiring and maintaining it, the greater is the cost of the capital. Repeal of Section 936 and its replacement by the proposed wage-based credit would immediately increase the cost of capital for virtually all possessions corporations operating in Puerto Rico. The response would be a process of disinvestment -- of reducing the amount of capital committed to possessions corporations -- which would begin very promptly.

To estimate this shrinkage in capital and the resulting contraction in the Puerto Rican economy, it is necessary first to estimate the increase in the cost of capital which adoption of the Treasury's proposal would entail. This estimate was made with respect to each of the major industry groups in which possessions corporations in Puerto Rico are distributed. On the basis of these estimated increases in the cost of capital, decreases in the optimum amounts of capital facilities used by these corporations were calculated. These decreases would not occur over night; disinvestment is a time-consuming process, for the most part, just as investment does not occur instantaneously. The time required for the disinvestment would probably vary widely from one industry to another, depending on the kind of capital upon which possessions corporations in each industry primarily rely and the magnitude of the increase in capital cost which adoption of the Treasury plan would involve. A detailed investigation of the time path of the disinvestment process by industry group was not feasible; instead, it was assumed that, on the average, 10 years would be required to reduce the amount of capital facilities for all possessions corporations to the levels that would be consonant with the cost of capital resulting from the ultimate full exposure of their profits to the federal income tax. It was also assumed that the disinvestment would occur in equal amounts each year, beginning with the year in which the

legislation is enacted.(5) To the extent that the actual rate of disinvestment would differ from this assumed 10 percent per year, the estimated change in the stock of capital and labor employment will be biased, although the final result will not be significantly affected.

Employment of labor would be curtailed as the scale of 936 operations was cut back. The reduced amount of capital would erode labor's productivity, resulting in both reduced demands for labor services and lower real wage rates.

The analysis of the impact of repealing section 936 was carried out for each of 13 manufacturing sectors in which 936 corporations are represented. These sectors are identified in column 1, of the following table. The table presents estimates of the effects of the Treasury's proposed wage credit in the first year of its implementation. The initial impact of the proposed tax change is to increase drastically the cost of capital; this reduces the optimum amount of capital facilities to be committed to possessions corporations. This new optimum capital stock is shown as a percentage change from the existing stock in column 2. The reduction in desired capital ranges from a low of 32% (apparel) to a high of 60.6% (refining). Associated with the reduced quantity of desired capital is a planned reduction in output and employment, as shown in columns 4 and 5. The reduction in employment ranges from 20% (apparel) to 63.7% (refining). The overall reduction amounts to 42.5 percent of total 936 employment, estimated at 95,000 employees in 1984. This translates into a projected employment loss of 40,000 jobs on the island. In 1983 the labor force in Puerto Rico was 918,000, of whom 23.4% were already unemployed. Assuming that labor force and unemployment rates in 1987 would be similar to those in 1983, the projected reduction in output and employment would ultimately add 4.4 percentage points to the unemployment rate. Assuming a ten year period for the projected disinvestment, this becomes an annual loss of 4,000 jobs. Four thousand jobs may seem small when one is used to the employment patterns of the mainland U.S., where the civilian labor force is approximately 120 million, not 918 thousand. An annual loss of employment in the U.S. commensurate with this loss would entail losing over 400,000 jobs a year for each of the next ten years. Clearly, the absolute magnitude of the employment effect must be considered in relation to the size of the island economy.

The repeal of 936 would have effects that extend far beyond the direct loss of employment. Estimates of the linkages between 936 employment and other employment on the island -- employment in industries providing inputs of products and services to 936 corporations -- range from 810 to 1,350 additional island employees for each 1,000 persons directly employed by 936 companies. The linkages which provide positive employment gains also operate

Initial Impacts of Section 936 Repeal on Capital and Employment in Possessions Corporations

Percent Changes

(1)	Initial Impact on Cost of Capital (2)	Impact on Optimum Amount (3)	Impact on Levels Output (4)	Impact on Employment (5)
Food & Kindred Products	46.0%	-45.9%	-31.7%	-31.7%
Textile Mill Products	47.5%	-47.7%	-35.0%	-49.9%
Apparel	33.7%	-32.0%	-11.9%	-20.0%
Paper	39.2%	-35.6%	-13.4%	-22.3%
Pharmeceuticals	48.5%	-52.5%	-48.3%	-63.5%
Rubber Products	47.1%	-46.8%	-33.2%	-47.7%
Leather Products	35.5%	-33.7%	-13.5%	-22.3%
Stone-Clay-Glass	46.0%	-43.8%	-26.0%	-39.2%
Fabricated Metal Products	45.2%	-42.9%	-24.7%	-37.7%
Non-Electric Machinery	44.4%	-47.4%	-38.2%	-53.1%
Electronic Equipment	45.9%	-46.8%	-34.6%	-49.3%
Instruments	46.6%	-48.8%	-39.5%	-54.6%
Petroleum Refining	48.6%	-60.6%	-47.1%	-63.7%

in reverse. And this does not take account of the additional jobs created in satisfying the consumption demands of these direct and indirect 936 employees. Loss of jobs in possessions corporations means many more jobs lost throughout the Puerto Rican economy. The ultimate employment effect would be a loss of 75,000 to 100,000 jobs throughout the Puerto Rican economy.

The situation worsens as the wage credit itself evaporates. Those labor-intensive industries which initially obtain some benefit from the wage credit would find that their cost of capital would rise more rapidly over the year 1987-1997 than that of the capital intensive industries. Those industries -- apparel, paper, leather products -- would ultimately face an increase in their cost of capital similar to that experienced by other industries. With the expiration of the wage credit, their increases in the cost of capital would range from 1% to 46% over the 1987 levels. Employment loss would accelerate yearly as the cost of capital would continue to rise over the life of the wage credit and beyond.

Output, employment, and income would be decreased throughout the Island economy. The smaller economic base would also shrink the capacity of the Puerto Rican government to supply public services. Increased dependence on Federal welfare programs would be an inevitable consequence.

The economic crisis conditions in Puerto Rico which would result from repeal of Section 936 would be a major setback for U.S. efforts to promote economic development throughout the Caribbean by relying on private enterprise. It would also materially undermine U.S. political leadership and influence throughout Latin America, indeed throughout the Third World. The seriously adverse implications of these developments for U.S. foreign and defense policies should be given the closest attention and consideration before this tax change is pursued and implemented.*

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*Note: The material in this **Bulletin** is drawn from an in-depth IRET study of the impact that the Treasury's proposal would have on the Puerto Rican economy. Persons interested in obtaining copies of this study should write or call IRET.

FOOTNOTES

(1) U.S. Department of the Treasury, "Tax Reform for Fairness, Simplicity and Economic Growth", Vol. II, page 328.

(2) Idem.

(3) Idem.

(4) Risk affects the expected value of returns to investment activities. The risk that 936 would be eliminated or scaled back has been incorporated into investment decisions since the perception of this risk increased in the early 1980s. The risk premium associated with 936 investments no doubt explains much of the observed stagnation in 936 investments.

(5) The amount of the wage credit entering into federal income tax liability was adjusted each year to reflect the reduced levels of employment associated with the lower levels of possessions corporations activity resulting from the repeal of Section 936. No depreciation deductions by possessions corporations were included in the computation of the federal tax liabilities because, according to Treasury personnel, no such deductions were taken into account in estimating the revenue effects of the Treasury proposal. For the same reason, no foreign tax credit and no deferral of the discharge of the federal income tax liability was included in the estimate of tax liability and the increase in the cost of capital. The implied assumption is that Puerto Rico would continue to offer tax exemptions to possessions corporations even though this exemption would be meaningless because these companies' earnings would be fully taxable under the federal income tax.