

# ECONOMIC REPORT

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## PUERTO RICO AND SECTION 936: A CASE STUDY OF THE EFFECTIVE USE OF PRIVATE SECTOR INCENTIVES

For those who have a professional concern with ensuring expanding opportunities for rewarding employment, there is no better setting for sharpening the focus of those concerns than Puerto Rico. This beautiful island has been a laboratory in which it has been demonstrated how strong and constructive the response of the private sector of the economy can be to appropriately designed tax incentives. There is much for everyone to learn from the experience of Puerto Rico with respect to public policy strategies for economic development initiated in the private sector.

Even a quick tour of San Juan brings home to one a sense of the vitality of the people who live and work in Puerto Rico, of their sense of urgency about progress in their economic life. One of the most impressive attributes of that progress is that rather than rejecting or destroying established cultural values, it is built on a foundation of solid traditions. In contrast with so many of our mainland cities, San Juan's urban progress has not been at the cost of losing the beauty of the past. Old San Juan, for example, spans the centuries and reminds one today of the sources of the intellectual and cultural strength of the fine people whose energy is transforming this land economically.

The statistical record of that economic transformation is an extraordinary one. Some of the major accomplishments over the last three decades may be highlighted by citing a few of the statistics which describe the changes in the amount and composition of employment, output, and income in Puerto Rico.

Slightly more than three decades ago, Puerto Rico was one of the poorest lands in the western world — "The Poorhouse of the Caribbean." In a little over thirty years, the Puerto Rican economy has been transformed from an impoverished, predominantly agricultural economy to a technologically advanced, industrial economy. It is difficult to capture the full import of this transformation in simple words and numbers, but one cannot help but be impressed by them.

\* Measured in constant (1972) dollars, GNP increased from \$1.565 billion in 1950 to \$7.383 billion in 1980. This is an increase of 372 percent. The percentage increase in real GNP in the U.S. as a whole was less than half — 176 percent.

\* Per capita real GNP in Puerto Rico increased from \$709 to \$2,324 or by 228 percent over these 30 years. In the United States, as

a whole, per capita real GNP rose from \$3,526 to \$6,475 or by 84 percent.

- \* The average yearly growth rate of real GNP in Puerto Rico was 5.3 percent over the three decades; it was 3.4 percent during the same period in the U.S. as a whole.
- \* Per capita real GNP increased by 4.0 percent a year, on the average, in Puerto Rico, almost twice as fast as the 2.1 percent average annual growth in the U.S. as a whole during these years.

This dramatic growth did not occur as a result of an explosion in the agricultural sector of the Island's economy. Quite the contrary; it came about as a result of a tremendous shift of employment from agriculture to other sectors, combined with a huge increase in labor's productivity.

- \* In 1950, more than a third — 36 percent — of the employed labor force worked in agriculture; manufacturing employment was 9.3 percent of total employment, little more than the amount of employment in home needlework, which was 8.6 percent of the total. In 1980, agricultural employment was only a fifth of what it had been 30 years earlier, accounting for only 5.2 percent of total employment. Manufacturing employment has almost tripled in absolute terms, and more than doubled — to 19 percent — as a share of total employment. In the U.S. as a whole, the number of manufacturing wage and salary workers increased by one-third over the three decades; as a fraction of the total of such employment, manufacturing employment fell from more than a third in 1950 to 22.4 percent in 1980.
- \* Net income originating in manufacturing was 14.5 percent of total net income in 1950; by 1980, this share was 3-1/4 times the 1950 percentage, accounting for 47.5 percent of total net income. This experience contrasts sharply with that of the U.S. as a whole where income originating in manufacturing fell by more than a fifth.
- \* This growth in output and income in manufacturing was not financed by exploiting labor — by paying workers less than their contribution to total output and income. On the contrary, total real compensation in manufacturing and real compensation per manufacturing employee soared over this 30-year period. Total real compensation for manufacturing employees increased by 740 percent; real compensation per manufacturing employee was almost three times as much in 1980 as in 1950. Over the period productivity of workers in manufacturing increased by more than 3-1/2 percent a year, on the average.
- \* As these data show, the growth in manufacturing output and income was not achieved by importing cheap labor, an important element in the rapid growth of certain European economies. Across the entire labor force spectrum, expanding employment has meant expanding the number of jobs filled by Puerto Ricans, almost one for one. Even in the most

demanding management and technical jobs, over 93 percent of these positions are filled by Puerto Rican men and women.

Particularly in the last decade, a very substantial share of the employment growth has been in high technology industries.

- \* In chemicals and allied products, especially pharmaceuticals, almost 9,000 jobs were added from 1971 to 1981. In nonelectrical machinery manufacturing, particularly computers, employment increased almost five-fold in this period. Over 7,000 jobs were added in electrical and electronic machinery, equipment and supplies production. Employment in the manufacture of scientific instruments more than doubled.
- \* In the pharmaceutical industry alone, employment gains have been remarkable. From 1970 to 1980, almost 9,300 jobs were added, nearly 6,400 of which were production workers. The size of pharmaceutical establishments grew, from 20 workers per establishment in 1960 to 143 per establishment in 1980.

The expansion of employment has not been confined to manufacturing. Impressive gains in jobs in trade and services occurred over the three decades. As one might expect, this diversification of employment has been associated with a marked upgrading of employment. In just the eight-year period from 1973 to 1981, white-collar employment grew by about 88 thousand jobs, from 40.2 percent of total employment to over 47 percent. Within this category, almost 43 thousand of the additional jobs were in professional and related positions.

The rapid growth in the private sector of the Puerto Rican economy both gave rise to increasing demands on the public sector and provided it with the financial capacity to service those demands. In 1950, only 45,000 persons were employed by government in Puerto Rico. By 1980, the number had reached 202,000, almost a quarter of total employment.

One final observation about this truly remarkable record of employment growth and economic progress is called for. It has not occurred at the expense of jobs, output, or income on the U.S. mainland or elsewhere. As the data shows, the most impressive employment gains in the private sector of the Puerto Rican economy have occurred in the very same industries which have registered the most pronounced growth in jobs and output on the mainland.

Moreover, Puerto Rican economic growth has required increasing imports, principally from the mainland. In 1980, for example, Puerto Rican business establishments and households bought \$1.5 billion of goods and services from the mainland U.S. It is estimated that about 153,000 mainland jobs were involved in producing these goods and services. A year later, imports from the mainland had increased to \$5.7 billion, implying an increase in mainland employment to meet these output requirements.

Of course, there have been reverses along this economic growth path. The Puerto Rican economy is extremely sensitive to changes in economic conditions

elsewhere, particularly in the mainland United States. Recession developments on the mainland lead quickly to even sharper downturns in Puerto Rico, and recovery on the mainland transmits its expansionary impulse to the Island economy only with a significant time lag. In the 1979 - 1982 recession, the rising unemployment rate on the mainland was dwarfed by that in Puerto Rico, reaching more than a fifth of the labor forces in 1981 and 1982.

Notwithstanding such reverses, the overall record of economic development from the early postwar years to the present is really remarkable. It can be capsulized briefly by pointing out that in the late 1940's, the Island's economic demography was a prototype of the sources of social unrest and upheaval --- a handful of affluent persons and the overwhelming proportion of the population living in grinding poverty. No middle class, generating social and political stability as well as a solid economic base, existed. The contrast with today's economic profile is striking.

To what is this truly impressive record of economic progress attributable? Obviously, many factors contributed to the Island's economic development. One of the most important of these is the ethos of the Puerto Rican people. The transformation of this economy could not have occurred but for the pride of workmanship, the willingness to take on the most difficult jobs, the zest for achievement that has made the potential for economic development a reality. One cannot really comprehend what has happened here over the last thirty years if one ignores the contribution of the cultural and ethical heritage of the Puerto Rican people.

These attributes of the population were a necessary but not a sufficient condition for the transformation of the Puerto Rican economy. The catalytic agent which energized the surge of economic progress was the inflow of private capital, primarily but not exclusively from mainland U.S. This relies on one of the most ancient and fundamental of economic principles, viz., that the pace of advance of labor's productivity depends critically on the amount and quality of the capital with which labor works. It is, of course, not merely physical capital which advances labor productivity; the accumulation of human capital makes an enormous contribution as well. But one must not lose sight of the well-nigh universally established fact that the ability to accumulate the human capital which makes that contribution itself depends critically on the quantity and quality of nonhuman capital that has been put in place. Without the latter, there are severe limits on the opportunity to use one's time and energies in education, training, and the other activities which expand knowledge and its applicability in economic activity. In 1940, per capita income in Puerto Rico was about \$121 a year; most of the working population eked out a bare existence in the fields in back-breaking hand labor; there were little energy, time, and resources with which to struggle out of illiteracy, disease, malnutrition, and general physical and mental debilitation. People in that condition do not accumulate large quantities of the human capital which can be productively used in economic life.

The inflow of capital to Puerto Rico did not just happen. It resulted in substantial part from the decision by the government of Puerto Rico to undertake an energetic, systematic, and well-organized effort to attract

outside capital in order to promote job-creating industrial and business development. This decision was arrived at following unsuccessful efforts to pursue these goals through direct public investment. However painful the lesson, it was well learned that solid economic progress must rely primarily on the vigor and initiatives of the private sector. It was also clearly perceived that those initiatives, depending critically on the inflow of capital, had to be encouraged by appropriate incentives rather than frustrated by a hostile public policy climate.

The principal set of incentives to attract capital and industrial activity from outside took the form of exemption from Puerto Rican taxes. This step, initiated in 1948, took advantage of — complemented — the then existing U.S. Federal income tax exemption of so-called possession corporations. These are subsidiaries of U.S. mainland companies, operating in Puerto Rico and other U.S. possessions. The exemption of possession corporations' income dates back to 1921 when this provision was enacted in order to reduce the tax-induced competitive disadvantage which U.S. firms faced, particularly vis a vis British companies doing business in the Philippines.

From 1921 to 1976, no changes in the basic statutory provisions were made. The usefulness of the possessions corporation tax exemption was repeatedly reviewed by the Ways and Means Committee in the House of Representatives from 1973 until 1976 in connection with the claim that the original purpose of the exemption — to even up the tax situation of U.S. companies operating in the Philippines — was no longer relevant and hadn't been since 1946 when the Philippines became independent. The more persuasive argument, however, was that the dependence of "Operation Bootstrap" in Puerto Rico on continuation of possession corporation tax exemption and the manifest effectiveness of the program in promoting the Island's economic development warranted its continuation.

The Tax Reform Act of 1976 left the exemption substantially intact, although certain modifications were made. For one thing, the exemption was confined to the income produced by the active conduct of a trade or business in the possession and no longer could be extended to income earned by the possession corporation in a foreign jurisdiction. For another, the exemption does not extend to non-business income, such as interest and dividends, earned on assets located outside of the possession, but is confined to such income attributable to the investment of funds derived from the conduct of a trade or business in the possession. For yet another thing, the mechanics were changed from the exclusion of the possession corporation's income from the mainland company's taxable income to a credit against U.S. Federal tax liability equal to the tax which would otherwise be payable by the parent company to the Federal Government on such income.

As you can readily imagine, tax provisions as congenial as these to investment in possession enterprises cast up a host of technical tax problems. Over most of the years in which the possessions corporation tax exemption has been available, the Internal Revenue Service's rulings, revenue procedures, technical advice memoranda, etc., have adhered more or less closely to the

obvious intent of the Congress. This long era of relative tranquility in taxpayer-IRS relationships, however, came abruptly to an end in 1980. The ensuing, escalating conflict between the IRS and possession corporation taxpayers led to the inclusion in the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) of several provisions which, ostensibly, were intended to afford certainty and to resolve taxpayer-IRS contests but which also result in a significant increase, in many situations, in U.S. Federal tax liabilities on possession corporation income and have generated new uncertainties about the tax exposure of possession corporations.

Had anyone had any doubts about the effectiveness of the Section 936 tax incentives and of the responsiveness of businesses thereto, he no longer would have after seeing the effect of the 1980 IRS actions and the 1982 tax legislation on mainland investment and new ventures in Puerto Rico. The numbers cited above should suffice to indicate the sturdy growth and development of the Island economy as a result of the inflow of capital and the birth of new enterprises and projects. There can be no doubt that this surge of business creation and growth occurred under the direction of the Fomento Organization in response to the substantial investment tax incentives. The abrupt decline in successful new Fomento promotions since July 1980 indicates the negative impact of adverse tax developments on economic activity and progress.

This is not to suggest that the tax events of the last few years spell the end of the Puerto Rican economy's growth. The good corporate citizens of Puerto Rico are not going to run away because of TEFRA. What has been achieved to date has established a solid foundation for further economic progress, even if at a somewhat less spectacular pace. The ingenuity which the officials of the Island government have repeatedly shown over the years has assuredly not been exhausted; it can be counted on to produce new solutions to the new problems which will emerge in a dynamic environment.

Some of these problems are likely to arise as a byproduct of initiatives by the Federal Government which, on other scores, must be seen as constructive as well as highly innovative. The Caribbean Basin Initiative — if, as, and when it finally emerges — will certainly confront the government of Puerto Rico with a major challenge, in contrast with the substantial benefits which the Island economy might have obtained had the earlier CBI concepts and proposals been enacted. Governor Romero has been untiring in his efforts to inform and advise Federal policy makers on this score. If his efforts are not crowned with as much success as might be wished, one can be sure that he and his associates will be equally unflagging in their search for ways to adjust to the resulting changes in the economic environment in such a manner as to preserve and strengthen the basic conditions for continuing economic progress.

Everyone must wish them success. What has been accomplished in Puerto Rico, in the face of the most substantial obstacles one could imagine, has to stand as a monument to what a community can accomplish if public policy works with rather than against the basic private-sector, market-directed impulses for economic development and progress. Puerto Rico is one of the best illustrations one can find of the potential of the "enterprise-zone" approach to economic reconstruction and advance.

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It must be hoped that the Federal Government's policy makers will recognize that in this Island's experience of the last three decades there is to be found a marvelously successful laboratory demonstration of economic achievement relying on the private sector. Similarly, one must hope that future policy developments will seek to fortify those achievements. It is now time to improve on the experiment, not to abandon it.

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