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Report to the Chairman, Committee on Finance, U.S. Senate

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TAX POLICY

Puerto Rican Economic Trends

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May 14, 1997

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

In response to your request, this report provides information on economic activity in Puerto Rico, before and after the recent changes in U.S. tax benefits[1] for corporations operating there. Corporations that receive these tax benefits represent a significant sector of the Puerto Rican economy. In recent years Congress has reduced the size of the tax benefits and set an expiration date for the remaining benefits. The last benefits are authorized to be available for tax years beginning before January 1, 2006, although the administration's fiscal year 1998 budget proposes to extend the availability of some of the tax benefits indefinitely.

In light of these tax law changes, you asked us to present information on the recent trends in

- Puerto Rico's principal economic indicators;
- investments by U.S. corporations in Puerto Rico that generate tax-exempt, nonbusiness income; and
- investment and employment promoted by Puerto Rico's Economic Development Administration.

Background

The Section 936 Tax Credit

Income derived from operations of U.S. corporations in U.S. possessions has been subject to special tax provisions since the Revenue Act of 1921. These provisions were primarily intended to help U.S. corporations compete with foreign firms in the Philippines (then a U.S. possession). With the Tax Reform Act of 1976, Congress connected the special tax provisions with the development of possessions' economies. The 1976 Act created section 936 of the IRC, which revised the treatment of corporate income from U.S. possessions. The stated purpose of the tax credit established under that section was to "assist the U.S. possessions in obtaining employment producing investments by U.S. corporations."

[1]Under section 936 of the Internal Revenue Code (IRC).

Prior to 1994, the section 936 tax credit was equal to the full amount of the U.S. income tax liability on income from a possession. The credit effectively exempted two kinds of income from U.S. taxation:

- 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
- certain income earned from financial investments in U.S. possessions or certain foreign countries, generally referred to as qualified possession source investment income (QPSII).

In order for the income from an investment to qualify as QPSII, the funds for the investment must have been generated from an active business in a possession, and they must be reinvested in the same possession. Dividends repatriated from a U.S. subsidiary to a mainland parent have qualified for a dividend-received deduction since 1976, thus allowing tax-free repatriation of possessions income.

The 1993 Budget Act[2] placed caps on the amounts of section 936 credit that corporations could earn for tax years beginning in 1994 or later. The Small Business Job Protection Act of 1996 repealed the tax credit for taxable years beginning after 1995.[3] However, the act provides transition rules under which a corporation that was an existing credit claimant is eligible to claim credits with respect to possession business income for a period lasting through taxable years beginning before 2006. For tax years beginning after December 31, 1995, QPSII received or accrued after June 30, 1996 may not be used in figuring the credit.

Puerto Rican Investment Incentives

Over the years, the government of Puerto Rico has taken several steps to encourage corporations to invest in the island and to retain their earnings there. Under Puerto Rico's current industrial incentives law, corporations engaged in manufacturing or export services generally are allowed 90-percent exemptions on their industrial development income.[4] These exemptions are valid for 10 to 25 years, depending on the location of the business' operations. The Puerto Rican government encourages the

[2]Omnibus Budget Reconciliation Act of 1993, P. L. No. 103-66, S 13227, 107 Stat. 312, 489 (1993). Appendix I provides additional details on the changes made to the credit by this and other acts signed into law since 1982.

[3]Small Business Job Protection Act, P.L. No. 104-188, S 1601, 110 Stat. 1755, 1827 (1996).

[4]The current Tax Incentives Act became effective in 1987 and is due to expire at the end of 1997. The government is currently drafting new incentive legislation.

partially exempt corporations to reinvest their business profits in the island by including in the definition of industrial development income all income derived from specified financial assets. This financial income exempted under Puerto Rican law was also treated as QPSII under federal tax law if it was earned by a possessions corporation.[5]

The "tollgate tax," which Puerto Rico imposes on dividends that resident corporations pay to nonresident shareholders, provides an additional incentive for eligible corporations to reinvest their earnings in Puerto Rico. The rate of this tax on dividends paid out of the income of a tax exempt business is generally 10 percent. However, the rate is reduced if a corporation reinvests a certain portion of its earnings in Puerto Rico for a period of 5 or more years.

The Economic Development Administration (EDA)/Industrial Development Company (PRIDCO) of Puerto Rico promotes investments on the island by both local and overseas businesses. Generally, but not always, the investments promoted by EDA receive tax exemptions under Puerto Rican tax incentive legislation. EDA compiles data on the number of "promotion projects" initiated each month as a result of its activities. It also compiles data on the amount of investment and employment that businesses commit to when initiating a project.

Results in Brief

The recent trends in Puerto Rican economic indicators show an economy that is growing in income, employment, and investment in most years. Income and employment are traditional indicators of current economic performance, while investment is an indicator of the economy's capacity to increase income and employment in the future. Although the growth in these indicators continued after the 1993 changes to the section 936 tax credit, we cannot conclude that the changes have had no effect on the Puerto Rican economy. The Puerto Rican economy is strongly influenced by the U.S. economy. If the changes in the credit have had any negative impact on Puerto Rico's economy to date, this may have been offset by the positive influence of the U.S. economic recovery after 1991. Recent economic initiatives by the Government of Puerto Rico also may have offset any such impacts. Furthermore, the effect of the credit changes may require several years to have an impact on the Puerto Rican economy

[5]A "possession corporation" is one that elects to be taxed under section 936 of the IRC and meets the following two requirements: over a 3-year period preceding a taxable year, 80 percent or more of its income must be derived from sources within a possession; and 75 percent or more of its income must be derived from the active conduct of trade or business within a possession. To qualify for both U.S. and Puerto Rican tax benefits, the corporation would have had to make the investment in the specified assets with earnings derived from its active business in Puerto Rico.

because (1) it may take time for companies to adjust their investment plans and (2) each year's investment by companies represents a relatively small proportion of the commonwealth's total capital stock, which generates employment and income.

Income as measured by Puerto Rico's gross domestic product (GDP) and gross national product (GNP) both increased between 1982 and 1996, with the increases continuing at about the same rates after the 1993 changes in the credit. GDP, a measure of the total income produced in Puerto Rico, grew at a faster rate than GNP, which measures the portion of total income received by Puerto Rican residents. The faster rate of growth of GDP compared with GNP means that an increasing portion of the income produced in Puerto Rico went to U.S. and foreign investors. These trends are consistent with a development strategy based on attracting external investment. Although the share of domestic net income of Puerto Rican residents declined from 69.3 to 59.8 percent between 1982 and 1996, their net income grew in absolute terms from $16.3 billion to $23.8 billion.[6]

Unemployment declined in most years between 1982 and 1996 and also declined or remained unchanged in every year after the 1993 changes to the credit. Investment spending for the plant and equipment that increases the economy's ability to generate income also increased in most years during this period. After leveling off for several years after 1989, possibly due to the U.S. recession, investment increased again in 1995 and 1996. The section 936 tax credit was intended to promote investment and employment in Puerto Rico. Although investment increased, and unemployment did not increase, after the changes to the credit, we do not know if the rate of change of either of these indicators would have been greater if the credit had not been changed.

During the last 2 calendar quarters of 1996, when the tax benefits for QPSII were ending, the total value of investments in Puerto Rico that formerly would have generated QPSII benefits grew from about $15.6 billion to $16.4 billion and then fell to about $14.6 billion. A recent amendment to a Puerto Rican financial regulation may have influenced the financial investment behavior of possessions corporations during that period even more than the repeal of the exemption for QPSII. Consequently, that investment behavior may be a poor indicator of the corporations' longer-term reaction to the repeal.

[6]Unless otherwise noted, all of the dollar values presented in this report have been restated in constant 1996 dollars. Similarly, all growth rates have been computed as changes in constant-dollar figures.

It is possible that the funds that possessions corporations reinvest in Puerto Rico's financial system simply displace other funds that would have been available to Puerto Rican businesses, rather than expand the pool of available funds. A simple comparison of trends shows that total investment in buildings, machinery, and equipment has grown in all but 1 year since 1987, despite the fact that the amount of exempt investment funds held in Puerto Rican financial institutions declined in all but 2 years during that period.

The amount of foreign investment dollars committed to projects promoted by EDA were at their highest levels in the late 1980s and early 1990s and have generally declined thereafter. This trend continued immediately after the 1993 changes in the section 936 tax credit, when in 1994 investment by overseas businesses in EDA promotions was at its lowest level for any year between 1982 and 1996. However, this investment increased moderately in 1995 and 1996.

Objectives, Scope, and Methodology

To present the trends in Puerto Rican economic indicators, we obtained the latest economic data available from the Puerto Rican Planning Board. To present the trends in qualified possessions source investments, we obtained the latest data available from Puerto Rico's Commissioner of Financial Institutions concerning exempt business investments in financial assets in Puerto Rico. To present the trends in investment and employment promoted by Puerto Rico's EDA, we obtained the most recent data compiled on those items by EDA. We also interviewed officials from the aforementioned agencies as well as from the Government Development Bank of Puerto Rico and the Puerto Rican Department of the Treasury on issues relating to data and to Puerto Rican tax laws and industrial incentives laws.

We restated all dollar figures in constant 1996 dollars, using the most appropriate price indexes available. In most cases we used the implicit price deflator for Puerto Rico's GNP.[7] We did not independently verify the accuracy of the data we obtained for this report.

[7]The implicit price deflator for Puerto Rico's GNP is available only for the end of each fiscal year. Puerto Rico's fiscal year ends June 30th. In order to avoid distorting end-of-year adjustments in the report graphs that display quarterly data, we estimated quarterly deflators by assuming that the annual growth in the deflator would occur at a constant rate throughout the year. Also, in order to present consistent trend lines in the cases where our quarterly data extends to December 1996, we projected the deflator to grow for the last two calendar quarters of 1996 at the same pace it did between fiscal year 1995 and fiscal year 1996. Figures for 1996 that we cite in the text have not been adjusted and, therefore, are slightly higher than the adjusted figures represented in the graphs.

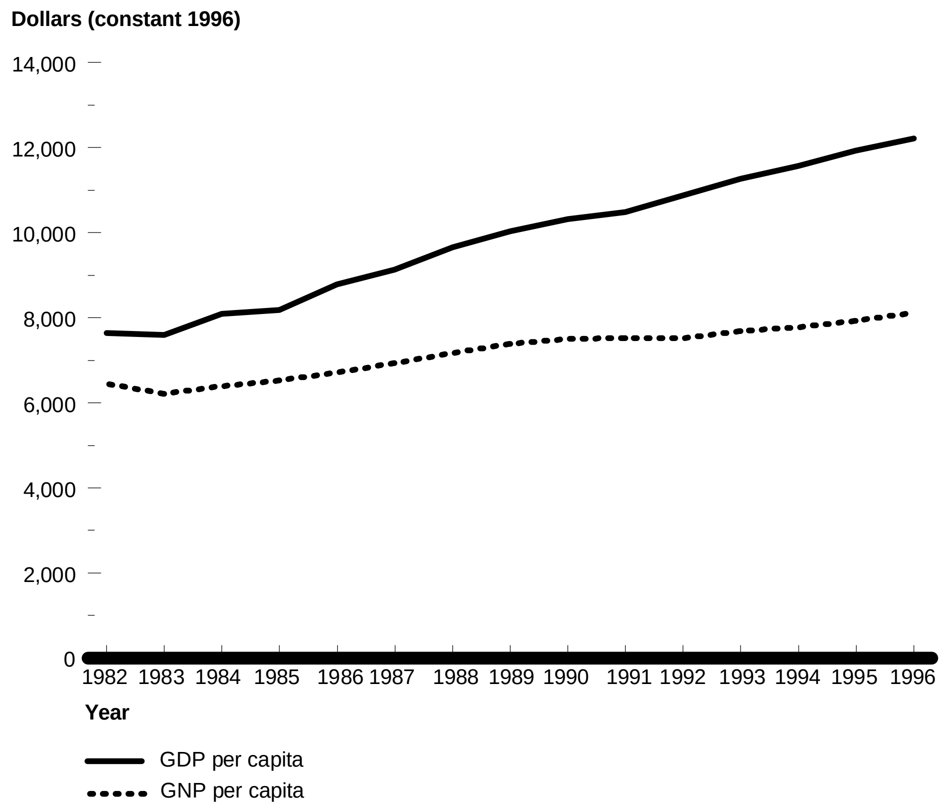
We also reviewed publications of the U.S. Treasury Department and the Internal Revenue Service and some of our prior reports relating to activities of possessions corporations and the effectiveness of the section 936 tax credit. We did not attempt to estimate the effects of the recent changes in the section 936 tax credit on the Puerto Rican economy. We have simply described changes in that economy in recent years.

We did our work in Washington, D.C., in March and April 1997 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of the Treasury of the Commonwealth of Puerto Rico, Puerto Rico's Commissioner of Financial Institutions, the heads of Puerto Rico's Planning Board, and Economic Development Administration, and from the Secretary of the Treasury. These comments are summarized and discussed at the end of this report and are reprinted in appendices IV through VII.

Puerto Rico's Economy

As shown by its GNP and GDP, Puerto Rico's economy has been growing in most years, and this trend continued in the 3 years immediately following the 1993 changes to the section 936 tax credit. (See fig. 1.) Between 1982 and 1996, Puerto Rico's per capita GNP grew at an annual rate of 1.7 percent, and its GDP grew at an annual rate of 3.5 percent. The growth of both indicators slowed somewhat after 1990 following the recession that occurred in the U.S., but per capita GDP began to grow more quickly in 1992 as did per capita GNP in 1993.

Figure 1: Gross Domestic and Gross National Product Per Capita, 1982-1996



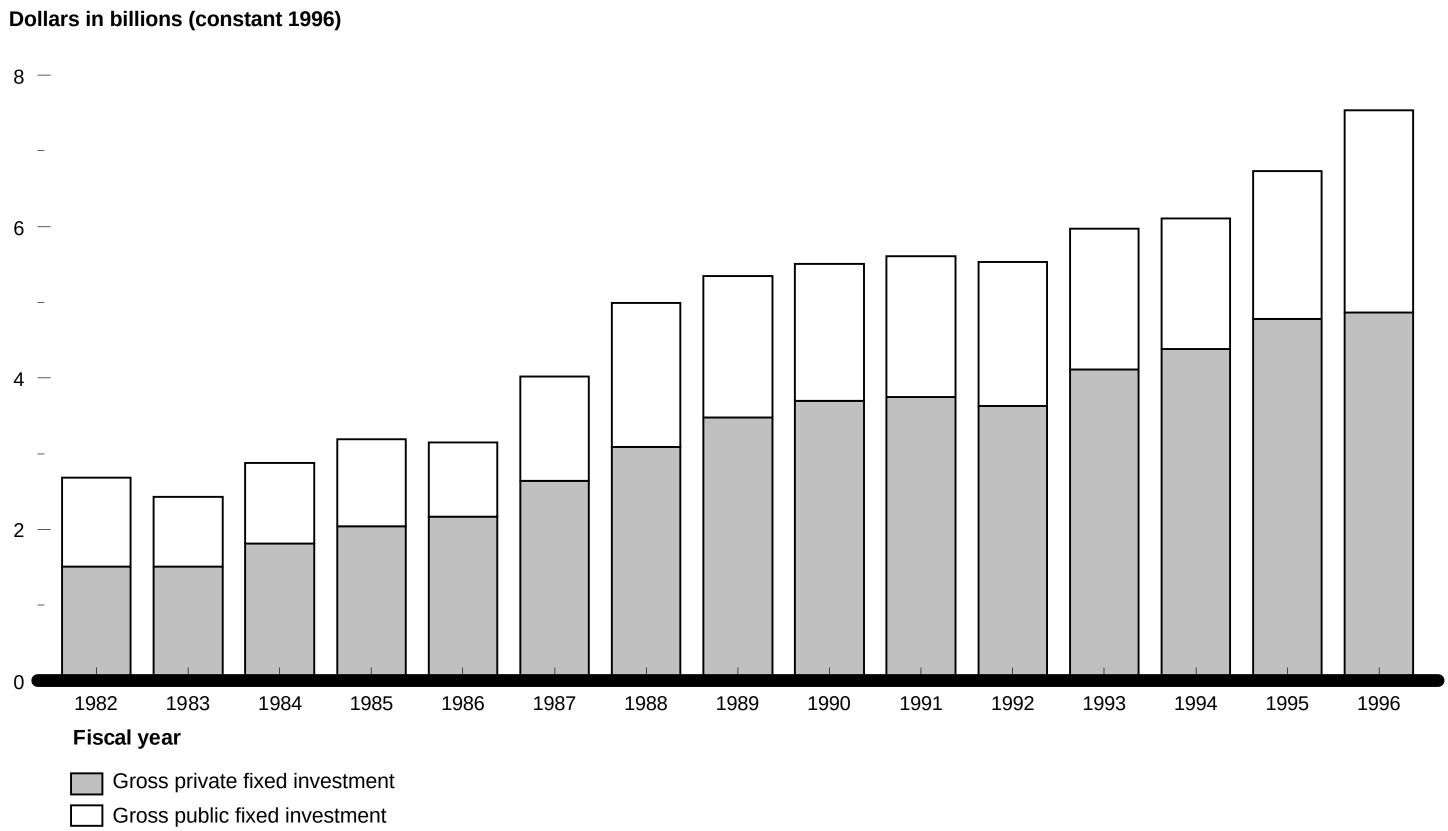
Note: Figures were adjusted for inflation using the Puerto Rican GDP and GNP deflators.

Source: Puerto Rico Planning Board, Economic Report to the Governor, various years.

The faster rate of growth for Puerto Rico's GDP compared with GNP means that an increasing portion of total income produced in Puerto Rico went to U.S. and foreign investors rather than to Puerto Rican residents. GDP is a measure of total income produced in Puerto Rico, and GNP is a measure of the income produced that is received by the residents of Puerto Rico. The difference between the two represents, for the most part, remittance of profit and interest income to U.S. and foreign investors. The trends in GDP and GNP are consistent with Puerto Rico's development strategy, which emphasizes long-term tax reductions to firms that locate in Puerto Rico, and with the provisions of the U.S. IRC—such as the section 936 tax credit, which allowed tax-free repatriation of profits to the mainland. Although the share of residents of Puerto Rico in total net income from property and employee compensation declined from 69.3 to 59.8 percent between 1982 and 1996, residents' income grew in absolute terms from $16.3 billion to $23.8 billion. (For more details on resident and nonresident income in Puerto Rico, see app. II.)

Investment in Puerto Rico, which is a key factor in the growth in the Puerto Rican economy, has begun to grow again after leveling off in the early 1990s. (See fig. 2.) Gross domestic fixed investment is the amount of resources used to replace capital consumed during the year and to add to the capital stock. This investment includes both public and private spending on the construction of housing and production facilities, and spending on machinery and equipment. Gross private fixed investment grew significantly between 1982 and 1989 and then leveled off for several years, possibly due to the recession that occurred in the United States. Growth in investment picked up again in 1995 and 1996. (See app. II for more details on investment.)

Figure 2: Public and Private Gross Fixed Investment, 1982-1996



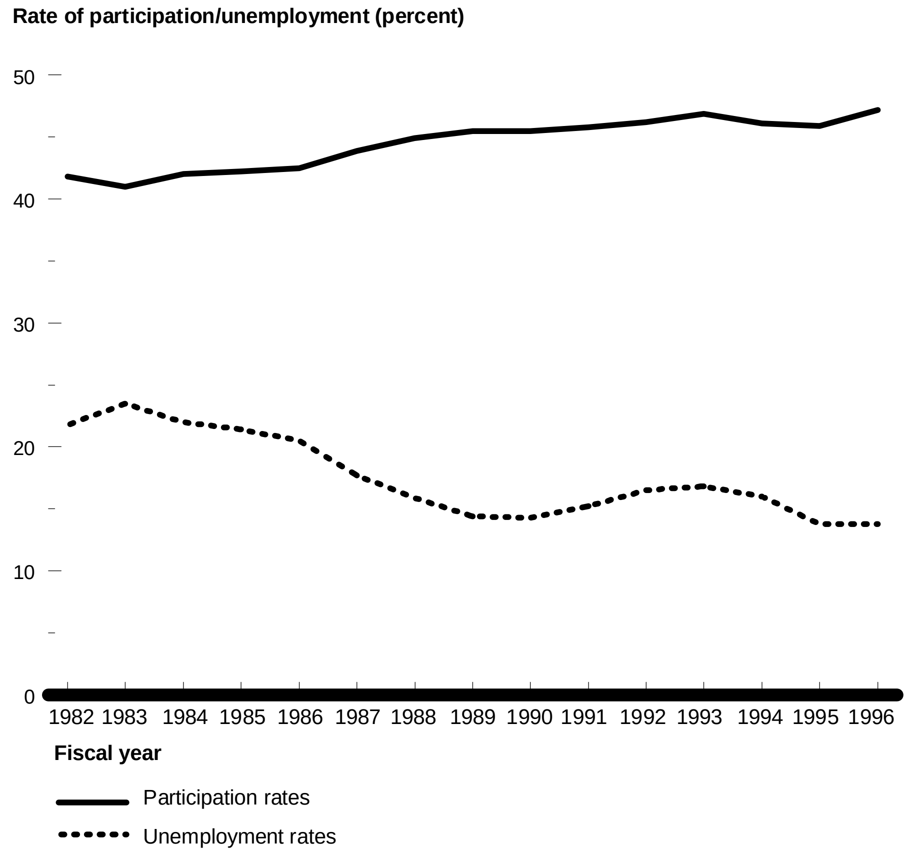
Note: Figures were adjusted for inflation using the Puerto Rican GNP deflators for investment.

Source: Puerto Rico Planning Board, Economic Report to the Governor, various years.

The section 936 tax credit was intended to promote investment and income growth in Puerto Rico, and the limitations on the credit may reduce the attractiveness of U.S. investment in Puerto Rico. Although investment and income have grown after the limitations became effective, we cannot conclude that the credit changes have not had any effect on investment or income. The rates of growth may have been greater without the credit changes. Moreover, it may require more years for the credit changes to affect investment and income because (1) it may take time for companies to adjust their investment plans and (2) each year's investment by companies represents a relatively small proportion of the commonwealth's total capital stock, which generates employment and income.

From 1982 to 1996, unemployment in Puerto Rico generally declined, while the participation of Puerto Rican residents in the labor force increased. (See fig. 3.) The unemployment rate in Puerto Rico was 23.5 percent in 1983, following the recession that the United States entered in 1981 and 1982, but declined in most years after 1983 to reach a low of 13.8 percent in 1995 and 1996. The labor force participation rate increased during this period from an average rate of 43 percent during the 1980s to an average of 46 percent during the 1990s. The trend in employment continued after the changes to the section 936 tax credit with the unemployment rate falling or remaining unchanged in every year after 1993.

Figure 3: Labor Participation and Unemployment Rates, 1982-1996



Source: Puerto Rico Planning Board, Economic Report to the Governor, various years.

Total nonagricultural employment in establishments in Puerto Rico grew from 660,000 in 1982 to 945,000 in 1996. Over this period, the share of manufacturing employment declined from 22.4 percent of the total to 16.3 percent, and the share of government employment fell from 36.2 percent to 32.6 percent. Manufacturing employment has actually fallen in absolute terms since it peaked in 1990. In contrast, the share of employment in the retail trade sector rose from 12 percent to 15.8 percent, and the share of the nonfinancial service sector rose from 13.3 percent to 18.5 percent. (For more details on employment in Puerto Rico, see app. II.)

Recent Trends in Qualified Possessions Source Investments

Prior to 1996, possessions corporations with active trades or businesses in Puerto Rico could reinvest the earnings from those activities in eligible financial investments in Puerto Rico and earn income that was effectively exempt from both U.S. and Puerto Rican income taxes.[8] For tax years beginning after December 31, 1995, QPSII received or accrued after June 30, 1996, does not qualify for a federal tax credit.[9] However, the Puerto Rican income tax exemption and tollgate tax both remain in place and provide some disincentive to an immediate repatriation of all financial assets held by possessions corporations.

As of December 1996, total investment in the exempt financial assets amounted to $14.6 billion, or $3,927 per resident of Puerto Rico. This $14.6 billion figure is the best available accounting of the current value of investments that formerly would have generated tax benefits under the QPSII credit. Almost all investments that would have generated QPSII tax benefits are included in that amount,[10] and only about 1 percent of that amount is attributable to businesses that would not have qualified for QPSII benefits.[11] Exempt businesses can make eligible financial investments either directly or through the intermediation of eligible financial institutions. Businesses invested $10.5 billion of the $14.6 billion through financial institutions and invested the remaining $4.1 billion directly.

[8]A possessions corporation must also have been granted an exemption under Puerto Rico's industrial incentives law to receive this double benefit. Historically, almost all possessions corporations have been granted at least partial exemptions from Puerto Rican income tax. According to IRS, for tax year 1993 there were about 455 active possessions corporations in Puerto Rico. Data from the Puerto Rican Department of Treasury show that 439 possessions corporations received at least partial exemptions in fiscal year 1993.

[9]According to Puerto Rico's Commissioner of Financial Institutions, most of the tax-year ends for possessions corporations with large investments in Puerto Rican financial institutions are October 31 and November 30. For those corporations, the QPSII benefits ended as of October 31 and November 30, 1996.

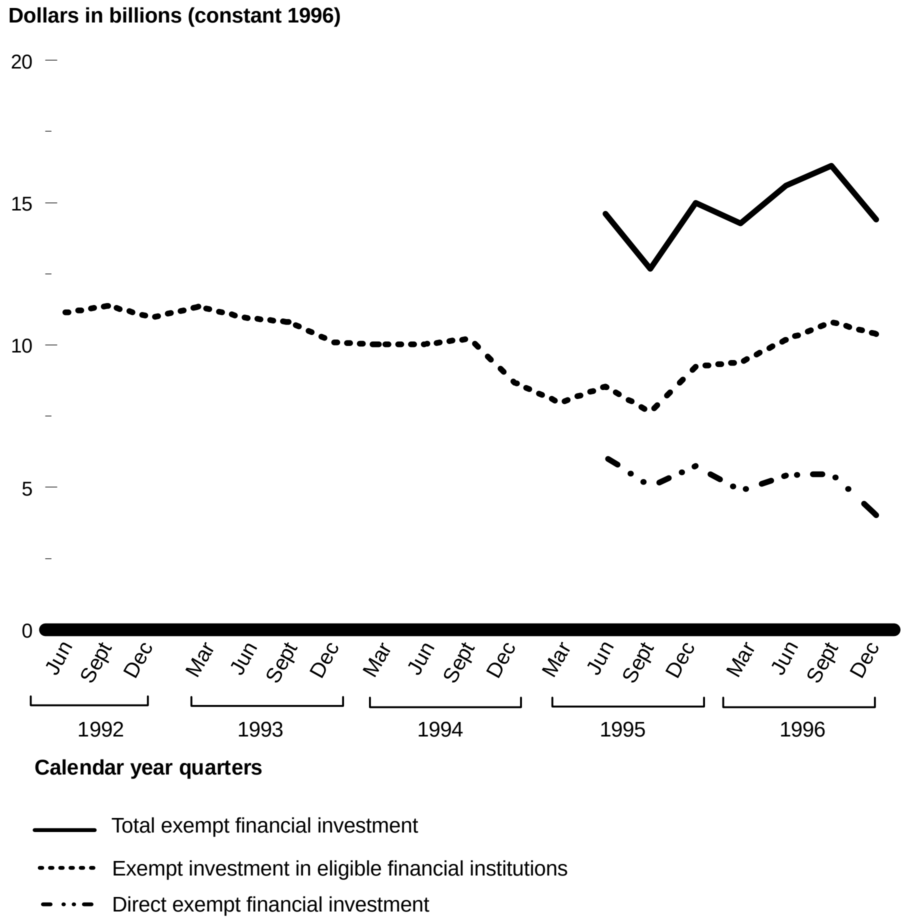
[10]Possessions corporations operating in Puerto Rico did not receive much, if any, tax benefit from section 936 unless their income from Puerto Rico was also exempt from the commonwealth's income tax. In the absence of section 936, the corporations would have received foreign tax credits for income taxes paid to Puerto Rico. These foreign tax credits would have provided roughly the same benefit as the section 936 credit. Consequently, only financial investments that produced Puerto Rican exempt income would generate tax benefits under the QPSII credit. The $14.6 billion figure is the Government of Puerto Rico's best accounting of all financial investments in Puerto Rico that produce tax exempt income.

[11]Locally owned Puerto Rican businesses that have been granted industrial incentive exemptions may also reinvest their earnings in the eligible financial assets. However, an official from Puerto Rico's Department of Treasury told us that possessions corporations earned 99 percent of all income from eligible financial assets.

Figure 4 presents aggregate data available on exempt financial investments in recent years.[12] Total exempt financial investment grew noticeably during the second and third calendar quarters of 1996, reaching $16.4 billion at the end of September 1996. Most of this increase was offset by a decline during the fourth quarter of 1996. During those 3 quarters, exempt investments in eligible financial institutions grew more rapidly and then declined less sharply than direct exempt financial investments. Moreover, as the data in figure 5 indicate, there was a pronounced shifting of funds out of instruments with maturities of 1 year or less and into instruments with longer maturities.

[12]Although the government of Puerto Rico has compiled data on the amount of eligible investments in financial institutions for many years, it has been able to collect data on the amount of eligible investments that corporations make directly only since June of 1995.

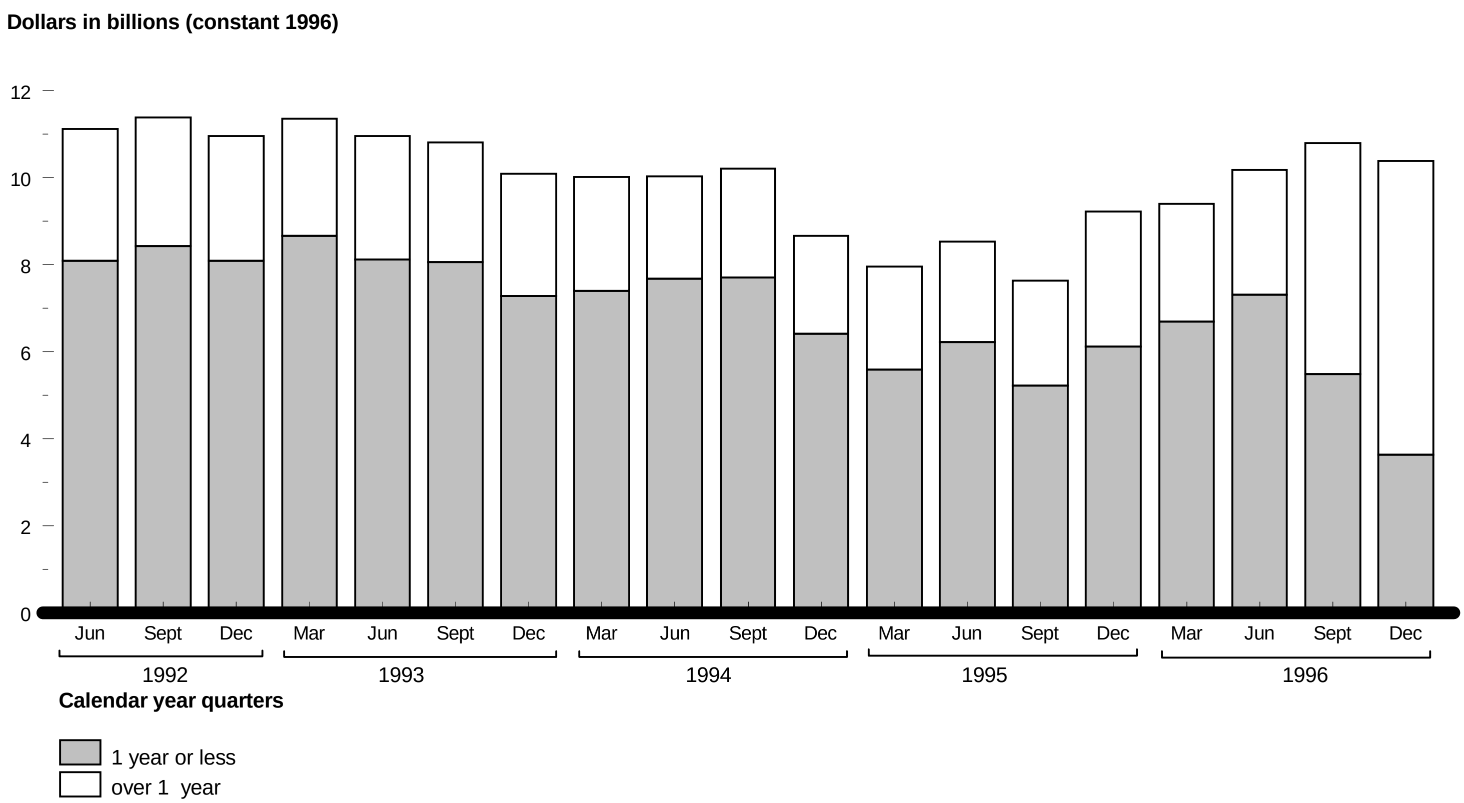
Figure 4: Exempt Financial Investments, 1992-1996



Note: Data points represent end of quarter balances. Figures were adjusted for inflation using the Puerto Rican GNP deflator. Data on direct and total investment were available only since June 1995.

Source: Government of Puerto Rico, Commissioner of Financial Institutions.

Figure 5: Exempt Investments in Eligible Financial Institutions, by Maturity, 1992-1996



Note: Figures were adjusted for inflation using the Puerto Rican GNP deflator.

Source: Government of Puerto Rico, Commissioner of Financial Institutions.

According to Puerto Rico's Commissioner of Financial Institutions, much of the short-term growth in investments with longer maturities may be a response to a recent amendment to the commonwealth's regulation that governs tax exempt funds held in eligible financial institutions. The amendment had the affect of reducing the rate of interest that financial institutions could pay on exempt funds placed in instruments with maturities of 5 years or more. Possessions corporations that planned on reinvesting earnings in Puerto Rico to obtain a lower tollgate tax rate are likely to have accelerated their investments in long-term instruments in order to lock in more favorable rates before the effective date of the amendment.[13]

Due to the influence of the amendment to Puerto Rico's financial regulation, the investment behavior of possessions corporations during the first 6 months after the repeal of QPSII may be a poor indicator of their longer-term reaction to the repeal. Nevertheless, the sharp increase in long-term investments held in eligible financial institutions indicates that those funds, at least, are not likely to be repatriated in the immediate future.

No Clear Relationship Between Trend in Exempt Investments in Financial Institutions and Trend in Total Investment

It is possible that the funds that possessions corporations reinvest in Puerto Rico's financial system simply displace other funds that would have been available to Puerto Rican businesses, rather than expand the pool of available funds. A 1989 report by the U.S. Treasury Department on the effects of the possessions tax credit concluded that the exemption for QPSII likely had little effect on total real investment in Puerto Rico. The report noted that

> "In spite of the fact that no 936 funds were available, a much higher level of real private investment was financed in the early 1970s than in the first ten years after the enactment of the QPSII provision. The fact that most of the fluctuations of total private investment since 1976 have been attributable to cyclical changes in inventories also suggests that the availability of 936 funds has not had a major impact on Puerto Rican growth."[14]

The simple graphical comparison in figure 6 reveals no obvious relationship between (1) changes in exempt investment funds held in eligible financial institutions and (2) total gross fixed investment in Puerto Rico each year. Figure 6 shows that the balances of exempt investments in financial institutions declined in every year after 1987, except 1992 and

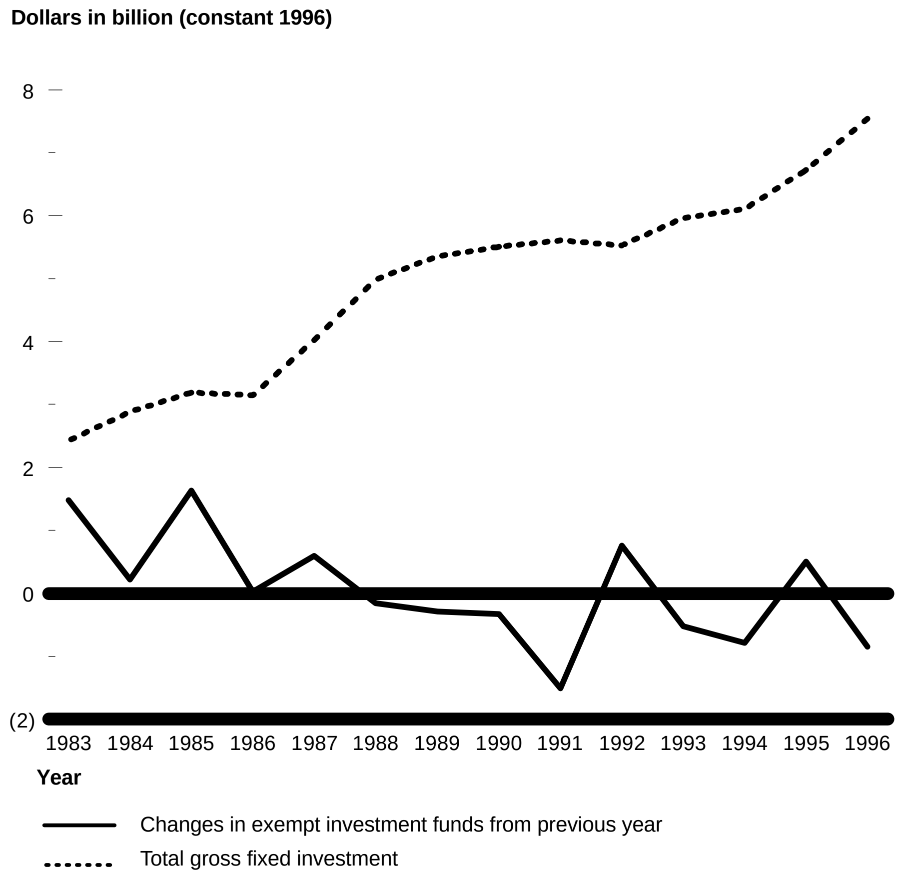
[13]The effective date of the amendment was October 1, 1996; however, some funds that were held in the Government Development Bank were allowed to be converted to longer maturities after that date, under the old rules.

[14]U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report, Mar. 1989, p. 80.

1995.[15] This pattern of divestment of financial assets had no obvious impact on the steady additions to gross fixed investment in Puerto Rico in most years since 1987. We do not know what the year-to-year changes have been in the financial assets that possessions corporations hold directly.

[15]Part of the decline in balances since 1987 may be attributable to changes made to the possessions tax credit by the Tax Reform Act of 1986. That act increased the share of a possessions corporation's gross income that has to be derived from the active conduct of a trade or business from 65 percent to 75 percent. QPSII is passive income, and some corporations may have had to reduce the amount of that type of income they earned to meet the new requirement. Financial regulations introduced by the government of Puerto Rico in 1988 may have been another factor contributing to the decline in exempt investments in financial institutions. The new regulations discouraged institutions from attracting funds from possessions corporations with the intention of investing the money outside of Puerto Rico.

Figure 6: Gross Fixed Investment and Changes in Exempt Investment Funds in Eligible Financial Institutions, 1983-1996



Note: Figures were adjusted for inflation using the Puerto Rican GDP and GNP deflators. The data on exempt investment funds for each year represent the difference between the average daily balances for December of that year and the average daily balance for the preceding December. Exempt investment fund data for December 1991 were not available; data for January 1992 were used as substitutes.

Source: Government of Puerto Rico, Commissioner of Financial Institutions.

The Economic Development Administration of Puerto Rico

The EDA promotes investments in Puerto Rico by local and overseas businesses. The EDA promotions generally receive tax exemptions and include commitments to hire and pay employees and to invest capital in amounts negotiated between EDA and the investors. The promotions that EDA calls "nonlocal," (i.e., at least 50 percent of the capital invested comes from the United States or other foreign countries) usually involve

U.S.-owned possessions corporations. According to an EDA official, data regarding the investment dollars, employment, and payroll committed to these projects are likely to be an early indicator of the impact of the credit changes on U.S. investment in Puerto Rico. Compared with the investment data presented in figure 2, the data on investment commitments provide a view of an earlier stage of the investment pipeline. For example, investment dollars committed in 1996 may not appear in the government's final accounting of investment expenditures until 1997 or later.

The number of nonlocal promotions was greatest in 1988 when 120 businesses were promoted by EDA. Nonlocal promotions declined in most years after 1988, with this trend of generally declining promotions continuing after the 1993 changes in the tax credit. Nonlocal promotions numbered 33 in 1994, the smallest number of nonlocal promotions for any year between 1982 and 1996.

Investment committed to EDA promotions by nonlocal businesses was greatest in the late 1980s and early 1990s but generally declined thereafter. Investment committed to nonlocal promotions, which tended to be more capital intensive than local promotions, reaching its highest level of $363.5 million in 1990. This investment continued a generally declining trend in 1994, immediately after changes in the credit, but increased moderately in 1995 and 1996. (For more details about EDA promotions, see app. III.)

Agency Comments and Our Evaluation

We obtained written comments on a draft of this report from the Secretary of the Treasury of the Commonwealth of Puerto Rico, Puerto Rico's Commissioner of Financial Institutions, the Acting Chairman of the Puerto Rico Planning Board, and the Acting Administrator and Chief Executive Officer of Puerto Rico's Economic Development Administration. We received oral comments on our draft from an economist from the U.S. Department of the Treasury's Office of Tax Analysis. Treasury's Deputy International Tax Counsel also reviewed the draft but had no comments.

The Secretary of the Treasury of Puerto Rico agreed that the conclusions in our draft were generally consistent with the data we reviewed. However, he said that the draft did not consider economic reforms implemented by the Government of Puerto Rico since 1993, including new incentives and initiatives to promote tourism, agriculture, research and exports; reductions in individual and corporate income tax rates; investments in infrastructure; and modification of financial regulations to reduce negative effects arising from the elimination of the credit for QPSII. The Secretary said that the government's "New Economic Model," along with the expansion of the U.S. economy, had counteracted some of the effects of recent reductions in section 936 tax benefits. Despite these reforms, however, the Secretary was concerned with the future of Puerto Rico's manufacturing sector and the need to further reduce the commonwealth's high unemployment rate and raise its per capita personal income. The Secretary stated that, for these reasons, Puerto Rico needs a revision of section 30A of the IRC that would provide federal tax benefits to new investments in Puerto Rico; specifically a stable wage tax credit as an incentive to U.S. manufacturing firms operating there.

We agree it is possible that recent economic initiatives of the Government of Puerto Rico may have partially counteracted potential negative effects of the changes in section 936. We have added language to this effect in our final report. It was beyond the scope of our work to evaluate proposed revisions of section 30A.

The Commissioner of Financial Institutions concurred in general terms with the conclusions of our draft regarding exempt investment funds in Puerto Rico. He specifically acknowledged that the level of exempt funds in eligible financial institutions does not affect the level of investment in Puerto Rico. The Commissioner provided additional information regarding several factors, including a change in a commonwealth financial regulation, that explained the trends in exempt investment funds during 1996 that we had described in our draft. He noted that corporations with tax years ending after the middle, but before the end, of the calendar year could take advantage of the QPSII tax benefit for a few months after June 30, 1996. The Commissioner also noted that the Government of Puerto Rico was implementing a capital markets reform, which, along with it's 1994 tax reform and a significant modernization of the commonwealth's legal and regulatory framework, has prepared Puerto Rico's financial system to be competitive, even without the QPSII benefits. He, nevertheless, supported enhanced benefits under section 30A to help mitigate any possible long-term adverse effects of the repeal of QPSII. We have revised our discussion of trends in exempt investment funds to reflect the additional information provided by the Commissioner.

The Puerto Rico Planning Board reviewed our use of their data and provided some additional and updated data. The Planning Board also noted several apparent discrepancies between the data that we report and the data that they provided to us. We made some changes to reflect the new data provided by the Planning Board. In most cases we made no changes where the board identified apparent discrepancies, because the discrepancies were small and due to differences in rounding methods.

The Planning Board also commented that the year 1982, which was used as the base year in most growth rate calculations, was a recessionary year and that this could affect the calculation of the growth rates for GNP and GDP per capita. We agree that the choice of base year can affect growth-rate calculations. For example, the growth in GNP per capita would have been slightly lower with 1981 as the base year and slightly higher with 1983 as the base year. However, our purpose was to report trends in the data. The growth rates were used chiefly to summarize the direction of these trends, which was unaffected by the choice of base year.

The Planning Board also commented that caution should be used in reporting GDP per capita because it could be misinterpreted as a measure of the resident population's well-being, even though it includes income received by nonresidents of Puerto Rico. We agree and we believe that our report clearly describes GDP per capita and distinguishes it from GNP per capita, which is a measure of the income received by residents of Puerto Rico.

The Planning Board provided new information on the number of possessions corporations that received at least partial exemptions in fiscal year 1993. They also said that IRS reported that about 474 active possessions corporations operated in Puerto Rico for tax year 1993. After checking with IRS, we determined that there were 474 active possessions corporations in total. Only 455 of those corporations actually operated in Puerto Rico. We use the updated information in this report.

The Economic Development Administration provided comments to clarify our description of their promotions. We have incorporated their comments in our report where appropriate.

The economist from the U.S. Treasury Department suggested minor word changes to appendix I, which we made, where appropriate. He also suggested that it would be of interest to have some discussion of the spread between Eurodollar interest rates and the rates that Puerto Rican financial institutions were offering on tax exempt funds. He said that Treasury had found that the spreads were not significant in the late 1980s. This would imply that the QPSII benefits may not have had a great impact on the cost of capital in Puerto Rico. We agree that evidence of a small difference between Eurodollar rates and those paid on exempt funds in Puerto Rico would imply that the QPSII provision may not have significantly reduced the cost of capital (which, in turn, could have expanded total investment) in Puerto Rico. An analysis that would allow us to determine whether or not the current spreads between these rates are significant was beyond the scope of this report.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time we will send copies of this report to the Ranking Minority Member of the Senate Committee on Finance and to the chairmen and ranking minority members of other appropriate congressional committees. We will also send copies to the Secretary of the Treasury, representatives of the Government of Puerto Rico, and other interested parties. Copies will also be made available to others upon request.

This work was performed under the direction of James Wozny, Assistant Director, Tax Policy and Administration Issues. Major contributors to this report are listed in appendix VI. If you have any questions please contact me on (202) 512-9110.

Sincerely yours,

James R. White

James R. White
Associate Director, Tax Policy
and Administration Issues

Contents

Abbreviations

EDA	Economic Development Administration
GDP	gross domestic product
GNP	gross national product
IRC	Internal Revenue Code
PRIDCO	Puerto Rico Industrial Development Corporation
QPSII	qualified possessions source investment income

Details on Changes in the Section 936 Tax Credit Since 1982

In the 1982 Tax Equity and Fiscal Responsibility Act and the 1986 Tax Reform Act, Congress adjusted the section 936 provisions in an attempt to reduce the ratio of federal revenue loss to employment created and investments made in U.S. possessions. Congress principally adjusted the tax treatment of income derived from intangible assets (such as trademarks, patents, and trade names) and passive investments.

Before the 1982 and 1986 adjustments, corporations could (1) reduce their U.S. income taxes by deducting from their U.S. revenues research and development expenses that led to a patent and then (2) transfer the patent (or other intangible asset) to Puerto Rico and realize tax-free income under section 936 from its use in Puerto Rico. In the 1982 act, Congress required that companies allocate some of their income realized in Puerto Rico from intangible assets to their U.S. parent corporations. The 1986 act changed the allocation procedures again to ensure that a greater portion of income from intangible assets was allocated to U.S. parent corporations.

Regarding qualified possessions source income (QPSII), the 1982 act changed the proportion of gross income that a possessions corporation must earn from the active conduct of a possessions trade or business in order to qualify for the section 936 credit. The act increased the proportion from 50 to 65 percent. This, in turn, decreased the proportion of gross income that a firm could earn from passive investments and still qualify as a possessions corporation. The 1986 act raised the proportion again so that a firm must derive 75 percent of its gross income from the active conduct of a trade or business and no more than 25 percent from passive investments.

The 1986 act also expanded the eligible activities in which QPSII funds could be invested and still qualify for tax exemption. QPSII could now be earned on deposits from which the Government Development Bank and other financial institutions in Puerto Rico made loans for the acquisition or construction of active business assets or development projects in qualified Caribbean Basin Initiative countries.

The 1993 Budget Act limited the section 936 credit as follows. Since 1993 taxpayers were to calculate the credit as under prior law, but the credit was capped under one of two alternative options selected by the taxpayer:

- The “percentage limitation” option provides for a decreasing credit equal to a decreasing percentage of the amount computed under prior law. The percentages were 60 percent in 1994, 55 percent in 1995, 50 percent in

1996, and 45 percent in 1997. The percentage was to be 40 percent in 1998 and thereafter.

- The "economic-activity limitation" option provides a cap on the credit equal to the sum of three factors:

The first factor is 60 percent of the firm's wages paid in the territory, plus allocable employee fringe benefits, with wages limited for each employee to 85 percent of the amount subject to Social Security taxes.

The second factor is a specified percentage of the firm's depreciation deductions for each taxable year. The type of property defines the applicable percentage: 15 percent for property with a relatively short recovery period, 40 percent for property with a medium-length recovery period, and 65 percent for assets with a long recovery period.

The third factor, which applies only to firms that do not use the 50-percent profit-split method of income allocation, is a portion of the income taxes paid to the territorial government. The taxes included, however, cannot exceed a 9 percent effective tax rate.

The Small Business Job Protection Act of 1996 repealed the tax credit for taxable years after December 31, 1995. However, the act provides transition rules under which a corporation that is an existing credit claimant is eligible to claim credits with respect to possession business income for a period lasting through taxable years beginning before January 1, 2006. For tax years beginning after December 31, 1995, QPSII received or accrued after June 30, 1996, may not be used in figuring the credit.

For any taxable year beginning after December 31, 1995, and before January 1, 2006, a corporation that was an existing credit claimant with respect to Guam, American Samoa, or the Northern Mariana Islands may continue to determine its credit with respect to such possession the way it did before the 1996 act. Corporations that were existing credit claimants with respect to Puerto Rico and the U.S. Virgin Islands may continue to claim credits, but those credits are to be subject to income caps.[16] For taxable years beginning in 2006 and thereafter, the credit with respect to all possessions is to be eliminated.

[16]The new rules for these corporations are provided in section 30A of the IRC. In order to claim a credit for tax years after 1997, these corporations must elect the economic-activity limitation option by tax year 1997. The income cap becomes effective for tax years beginning after December 31, 2001. Each taxpayer's cap is based on the average business income that the taxpayer earned in the possession during a specific base period.

Additional Details on Puerto Rico's Economy

Congress has linked the section 936 tax credit to the development of possessions' economies. The credit is intended to promote investment by U.S. corporations that leads to increased employment of the possessions' residents. The intended increase in investment and employment should also be reflected in the growth of income and production of the possessions' economies. In this appendix, we provide additional detail on income, investment, and employment in Puerto Rico.

Domestic Net Income in Puerto Rico

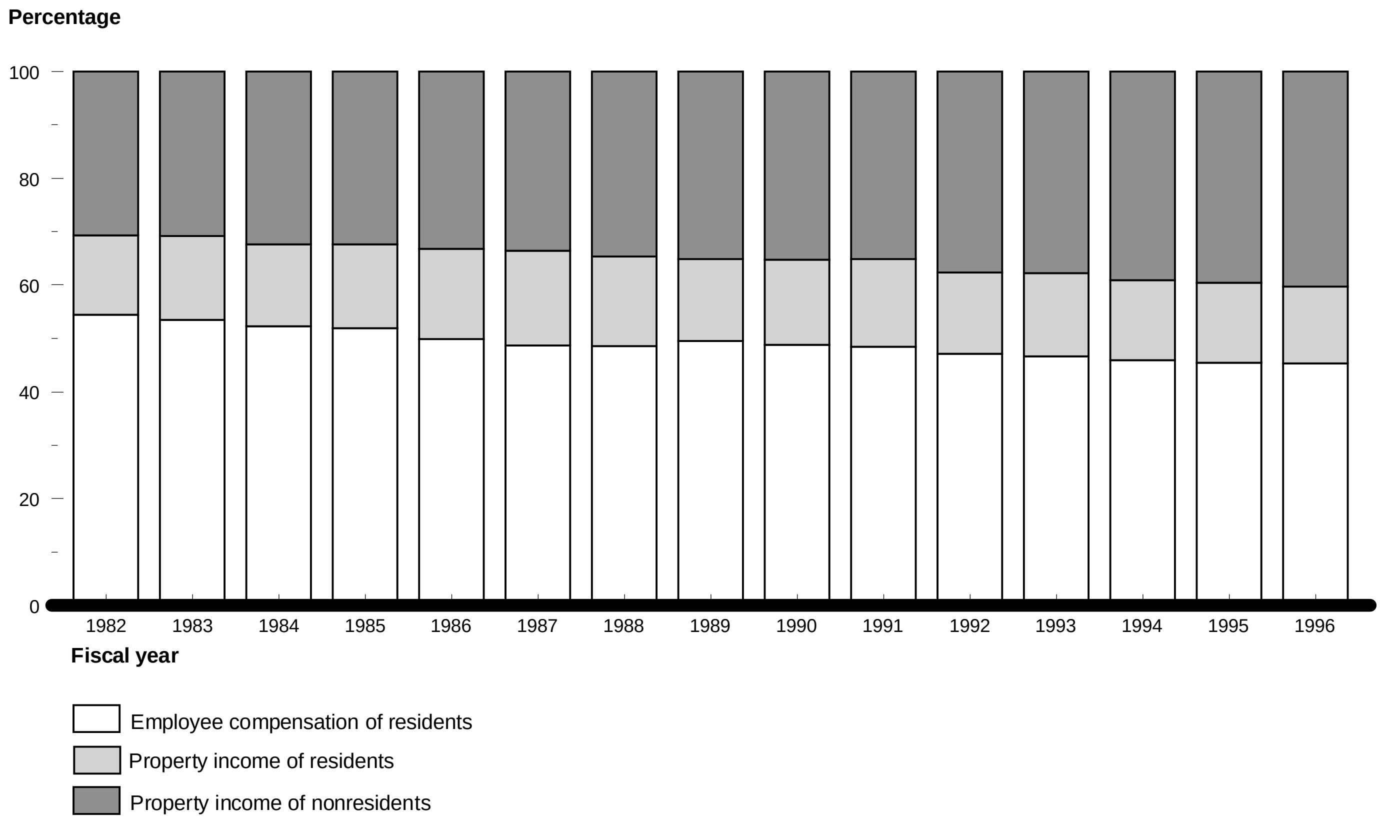
Employee Compensation and Property Income

Domestic net income is income produced in a country. It is earned by workers in wages and other compensation and by property owners in profit and interest. It may also be divided into employee compensation and property income earned by Puerto Rican residents and property income earned by nonresidents

As shown in figure II.1, property income has been growing as a share of net income, and the property income of nonresidents has been growing as a share of total property income. The share of property income grew from 45.5 percent of domestic net income in 1982 to 54.6 percent in 1996, and the share of nonresidents in total property income grew from 67.6 percent to 73.6 percent. The result of these trends is that the share of domestic net income earned by Puerto Rican residents from both property and employee compensation declined from 69.3 percent to 59.8 percent between 1982 and 1996, although residents' income grew in absolute terms from $16.3 billion to $23.8 billion.

Figure II.1 also shows that these trends were not interrupted by the changes to the credit in 1993. The share of property income in domestic net income increased between 1993 and 1996 from 53.4 percent to 54.6 percent, and the nonresident share of property income increased from 70.8 percent to 73.6 percent. In contrast, the residents' share of total net income continued its decline from 62.2 percent to 59.8 percent, although the net income of Puerto Rican residents grew from $22.6 billion to $23.8 billion.

Figure II.1: Percentage Distribution of Domestic Net Income by Employee Compensation and Property Income, 1982-1996



Source: Puerto Rico Planning Board, Economic Report to the Governor, various years.

Employee Compensation and Property Income in the Manufacturing Sector

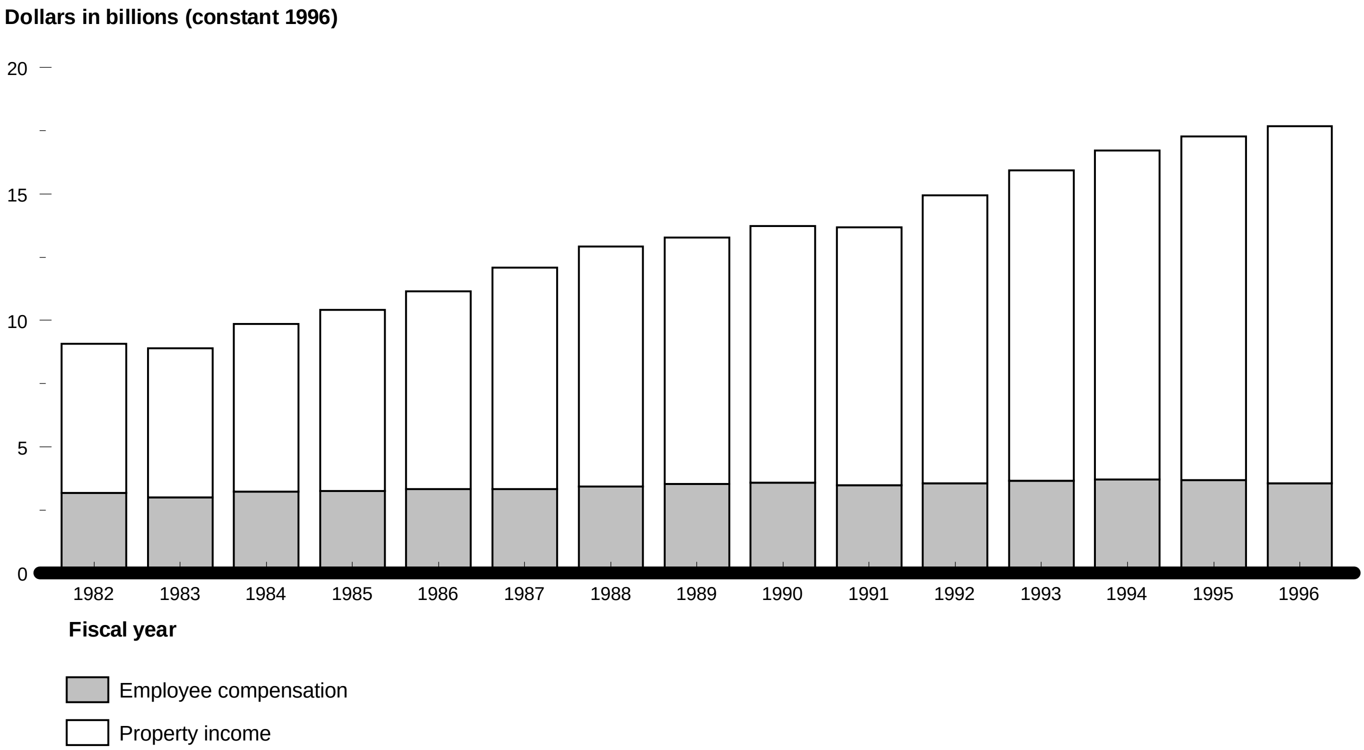
Most of the tax benefits earned under section 936 have been earned by corporations in the manufacturing sector.[17] From 1982 through 1996, both property income and employee compensation increased in the manufacturing sector. However, employee compensation decreased as a percentage of total net income in manufacturing. These trends for the entire period also characterized the period after the changes in the credit from 1994 through 1996.

[17]Puerto Rico's tax incentives are limited largely to businesses operating in the manufacturing or export sectors. Nonmanufacturing companies that pay the full Puerto Rican income tax can claim a U.S. foreign tax credit for those taxes paid. Consequently, those companies receive little, if any, additional U.S. tax reduction through section 936.

As shown in figure II.2, employee compensation in the manufacturing sector increased from $3.2 billion in 1982 to $3.6 billion in 1996. As a percentage of domestic net income produced in the manufacturing sector, employee compensation dropped from 35 percent to 20.2 percent. This trend was also true between 1993 and 1996, when the share of employee compensation declined from 23 to 20.2 percent.

The growth of property income in the manufacturing sector accounted for a significant share of the growth in property income in the overall economy. From 1982 through 1996, property income in Puerto Rico increased by $11 billion, from $10.7 billion to $21.7 billion. The increase in property income in the manufacturing sector accounted for $8.2 billion, or 74.5 percent of the overall increase. Over the same period, employee compensation in Puerto Rico increased by $5.2 billion, from $12.8 billion to $18 billion. The increase in employee compensation in the manufacturing sector accounted for about $400 million, or 7.7 percent of the overall increase.

Figure II.2: Employee Compensation and Property Income in the Manufacturing Sector, 1982-1996



Note: Figures were adjusted for inflation using the Puerto Rican GNP deflator.

Source: Puerto Rico Planning Board, Economic Report to the Governor, various years

The growth of property income in the manufacturing sector continued to account for a significant share of overall growth in property income after the 1993 change to the credit. During this period, the increase in property income in manufacturing accounted for 79.3 percent of overall growth in property income. However, the trend in employee compensation was different. Between 1993 and 1996, total employee compensation increased by 6.4 percent, while employee compensation in manufacturing declined by 2.7 percent.

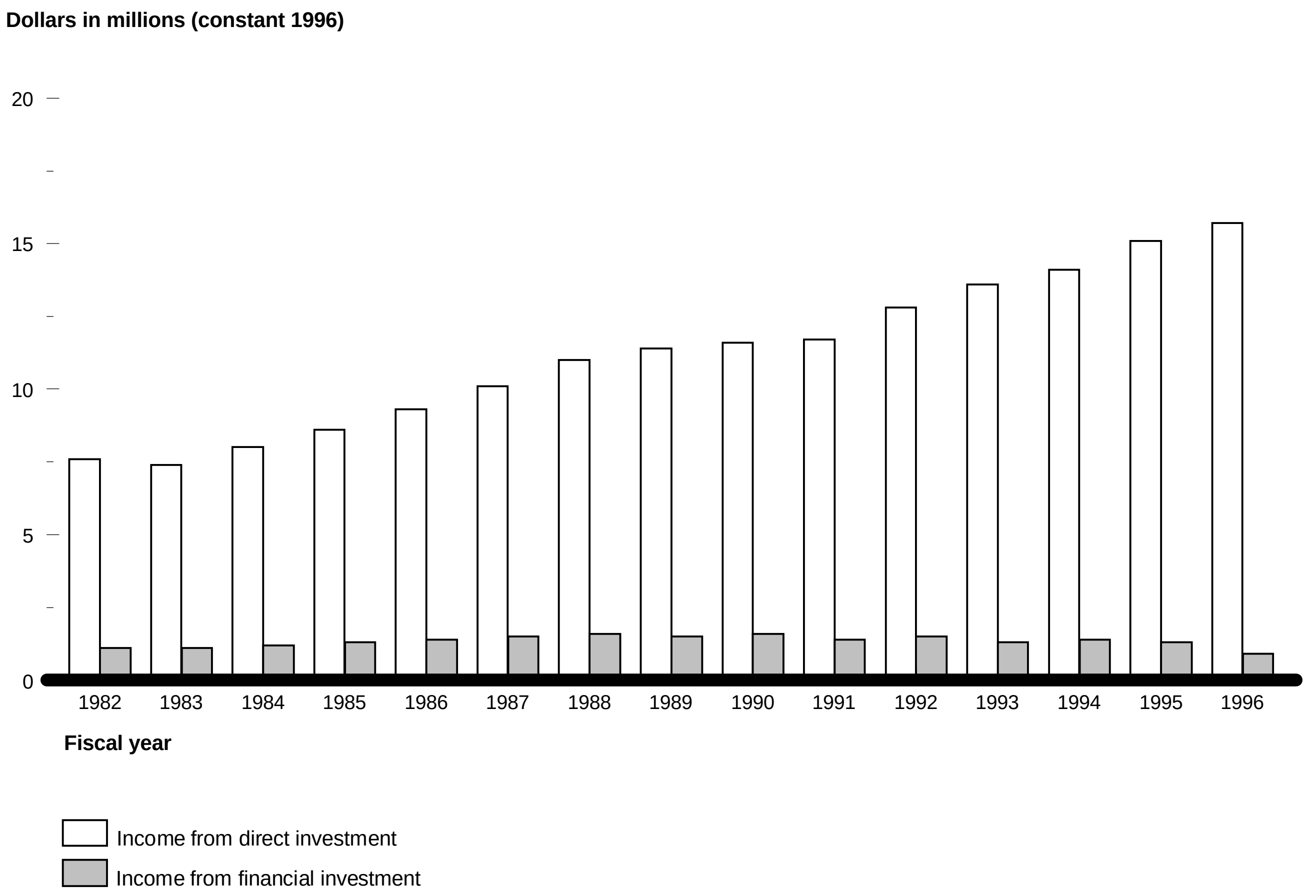
Income From Foreign Investment in Puerto Rico

The increasing role of nonresidents in the growth of the Puerto Rican economy is indicated by the growth in income from the direct investments of nonresidents in Puerto Rico. The income from direct investments is the profit and interest income of companies operating in Puerto Rico that are owned and controlled by nonresidents. Income from financial investments is income from other assets owned but not controlled by nonresidents such as dividends paid by domestic Puerto Rican companies and interest paid by the Puerto Rican government.

As shown in figure II.3, income from the direct investment of nonresidents grew between 1982 and 1996, both in total amount and also as a share of all income from investments owned by nonresidents. The income from direct investment increased from $7.6 billion in 1982 to $15.7 billion in 1996, growing at an annual rate of 5.3 percent. This income also increased as a share of total income from investments owned by nonresidents from 87.4 percent in 1982 to 92 percent in 1996.

Figure II.3 also shows that these trends in income from the investments of nonresidents continued after the changes to the credit in 1993. Between 1994 and 1996, income from the direct investment of nonresidents increased from $14.4 billion to $15.7 billion, and increased as a share of total income paid to nonresidents from 91.1 to 92 percent.

Figure II.3: Income on Externally Held Investments, 1982-1996



Note: Figures were adjusted for inflation using the Puerto Rican GNP deflator.

Source: Puerto Rico Planning Board, Balance of Payments, various years.

Components of Investment in Puerto Rico

Spending on machinery and equipment was the largest component of investment in Puerto Rico between 1982 and 1996, representing on average about two-thirds of total private investment spending. Table II.1 shows that spending on machinery and equipment increased in most years from about $0.8 billion in 1982 to about $3.2 billion in 1996. This represented an annual rate of growth of 10 percent. The other components of private investment grew less rapidly. Spending on the construction of industrial and commercial buildings grew from about $0.3 billion in 1982 to $0.9 billion in 1996, for an annual rate of growth of 8.9 percent. Private spending on housing construction fluctuated more from year to year than the other components of investment. Spending on housing construction was about $0.4 billion in 1982, climbed to $0.72 in 1991, declined to about $0.57 billion in 1992 and 1993, and grew again to $0.97 billion in 1996.

Investment in machinery and equipment declined in 1991 and 1992 following the U.S. economic downturn, but recovered in 1993 and continued to grow until it declined slightly in 1996. Investment in industrial and commercial buildings fell in 1990 but grew through 1996. Investment in housing fell in 1992 but grew in every year thereafter.

Table II.1: Gross Fixed Private Domestic Investment, 1982-1996

Dollars in millions (constant 1996)

Year	Private housing investment	Private industrial and commercial investment	Private investment in machinery and equipment
1982	$405.2	$269.6	$834.5
1983	362.7	221.4	921.7
1984	323.6	375.5	1,115.3
1985	391.5	333.4	1,315.2
1986	406.9	338.9	1,424.1
1987	503.6	462.2	1,669.4
1988	555.9	554.5	1,981.0
1989	580.7	595.3	2,303.9
1990	705.7	575.6	2,418.1
1991	715.9	634.2	2,395.0
1992	569.8	676.0	2,388.3
1993	574.0	775.2	2,762.0
1994	660.6	804.7	2,914.1
1995	750.9	809.7	3,224.0
1996	973.6	884.0	3,187.6

Note: Figures were adjusted for inflation using the Puerto Rican GNP deflators for investment.

Source: Puerto Rico Planning Board, Economic Report to the Governor, various years

Employment by Economic Sector in Puerto Rico

As Table II.2 shows, total nonagricultural employment in establishments in Puerto Rico grew from 660,000 in 1982 to 945,000 in 1996. Over this period, the share of manufacturing employment declined from 22.4 percent of the total to 16.3 percent and the share of government employment fell from 36.2 percent to 32.6 percent. Manufacturing employment has actually fallen in absolute terms since its peak in 1990. In contrast, the share of employment in the retail trade sector rose from 12 percent to 15.8 percent and the share of the nonfinancial service sector rose from 13.3 percent to 18.5 percent.

Table II.2: Employment by Major Industrial Sector, 1982-1996

(Numbers in thousands of persons)

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Total	**660**	**635**	**665**	**695**	**709**	**746**	**796**	**832**	**841**	**838**	**844**	**862**	**879**	**912**	**945**
Manufacturing	148	141	148	149	149	148	154	156	157	152	152	151	150	153	154
Mining[a]	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/	a/
Construction	29	23	25	28	26	32	39	44	44	44	46	47	45	46	52
Trade	110	107	112	119	124	132	142	149	154	156	155	163	171	181	188
Wholesale	31	29	30	31	30	32	35	36	37	37	37	37	36	38	40
Retail	79	77	83	89	94	100	107	113	117	119	118	126	135	143	149
Finance, Insurance & Real Estate	29	28	29	30	32	34	36	37	37	37	37	39	41	42	44
Transportation, Communication and other Public Utilities	15	15	16	16	16	17	18	19	20	21	21	22	23	23	24
Service	88	85	88	96	100	108	117	126	132	134	139	147	157	164	175
Government	239	236	246	257	261	273	289	301	296	291	293	292	291	304	308

[a]Totals for mining (a/) represent numbers of less than 2,000.

Source: Puerto Rico Planning Board, Economic Report to the Governor, various years

Information on Economic Development Administration Promotions

The Economic Development Administration (EDA)/ Industrial Development Company of Puerto Rico (PRIDCO) promotes investments by local and overseas businesses. Generally, but not always, the investments promoted by EDA receive tax exemptions under Puerto Rican tax incentive legislation. According to an EDA official, EDA promotions may also receive cash grants from the government of Puerto Rico.

The EDA promotions, which are negotiated between EDA and the business owners, include commitments to hire and pay employees and to invest capital in specified amounts. According to an EDA official, for promotions that receive tax incentives, EDA must be convinced that the commitments are realistic and made in good faith. For promotions involving cash grants, the businesses must comply with the employment commitment before the cash is disbursed.

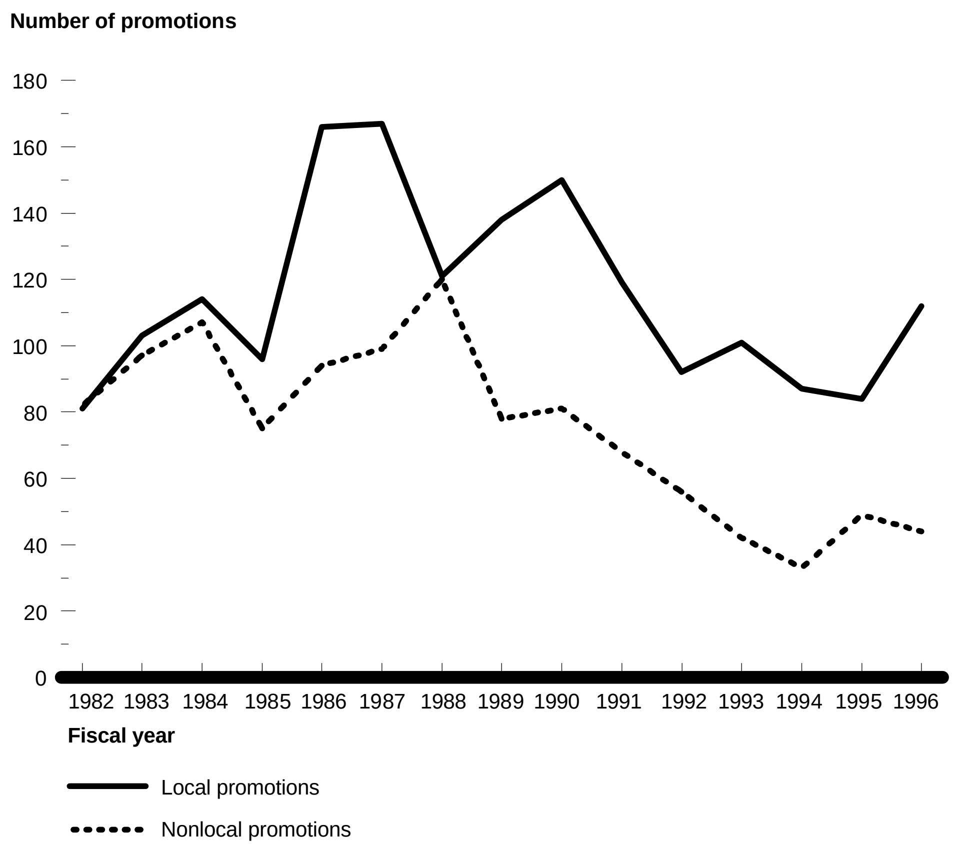
To receive a tax exemption, the business owners must submit an application to the Office of Industrial Tax Exemption. This office may recommend a grant of exemption to the Secretary of State for promotions that also receive the endorsement of EDA, the Treasury Department, the Environmental Office, and the municipality in which the business is located. The tax exemption may be granted to local and nonlocal promotions. Promotions are considered nonlocal if they receive at least 50 percent of the capital invested from the United States or other foreign countries.

Promotions of the Economic Development Administration

EDA promoted a total 2,856 businesses between 1982 and 1996. Local promotions accounted for 1,731, or 61 percent of the total promotions. As shown in figure III.1, local promotions outnumbered nonlocal promotions in nearly every year between 1982 and 1996. The number of local promotions reached their highest level of 167 businesses promoted in 1987. The number of nonlocal promotions was greatest in 1988 when 120 businesses were promoted by EDA. Nonlocal promotions declined in most years after 1988 while local promotions declined in most years after 1990.

The trend of generally declining promotions continued after the 1993 changes in the tax credit. Local promotions numbered 84 in 1995, the smallest number of promotions since the 81 businesses promoted by EDA in 1982, but increased to 112 promotions in 1996. Nonlocal promotions numbered 33 in 1994, the smallest number of nonlocal promotion for any year between 1982 and 1996. Nonlocal promotions increased to 49 in 1995 but declined again to 44 in 1996.

Figure III.1: the Number of Local and Nonlocal Promotions by the Economic Development Administration, 1982-1996



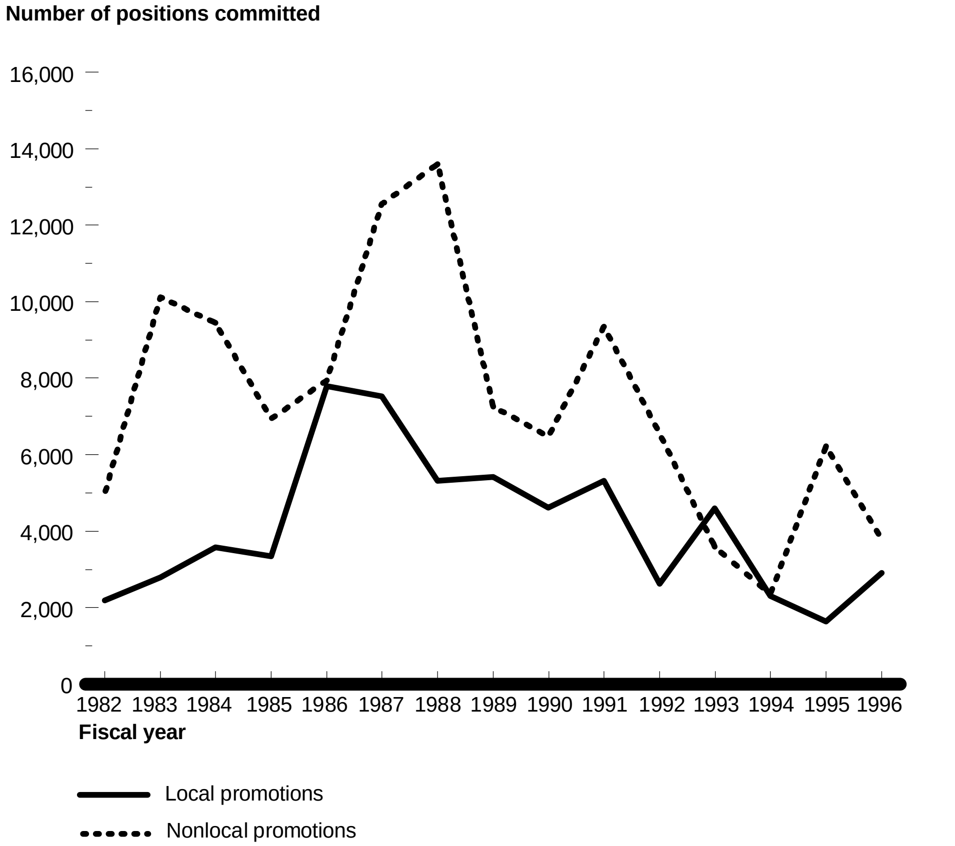
Source: Economic Development Administration of Puerto Rico.

Employment Committed to Economic Development Administration Promotions

Businesses promoted by EDA committed to hiring a total of 173,195 employees between 1982 and 1996. Nonlocal businesses committed to hiring 111,206 employees, or 64 percent of the total committed employment. As shown in figure III.2, employment committed by nonlocal businesses exceeded commitments by local businesses in nearly every year between 1982 and 1996. The employment commitment of nonlocal businesses reached its highest level of 13,596 in 1988 and declined in most years thereafter. The employment commitment of local businesses reached its highest level of 7,787 in 1986 and declined in most years after 1986.

The trend of generally declining employment commitments continued after the 1993 changes in the credit for both local and nonlocal businesses. Nonlocal businesses committed to hire 2,367 employees in 1994, the smallest commitment by nonlocal businesses of any year between 1982 and 1996. Their employment commitment increased to 6,218 in 1995 but fell again in 1996 to 3,785. Local businesses committed to hire 1,636 employees in 1995, the smallest commitment by local businesses in any year between 1982 and 1996. Their commitment increased in 1996 to 2,913.

Figure III.2: Employment Committed to Local and Nonlocal Promotions, 1982-1996



Source: Economic Development Administration of Puerto Rico.

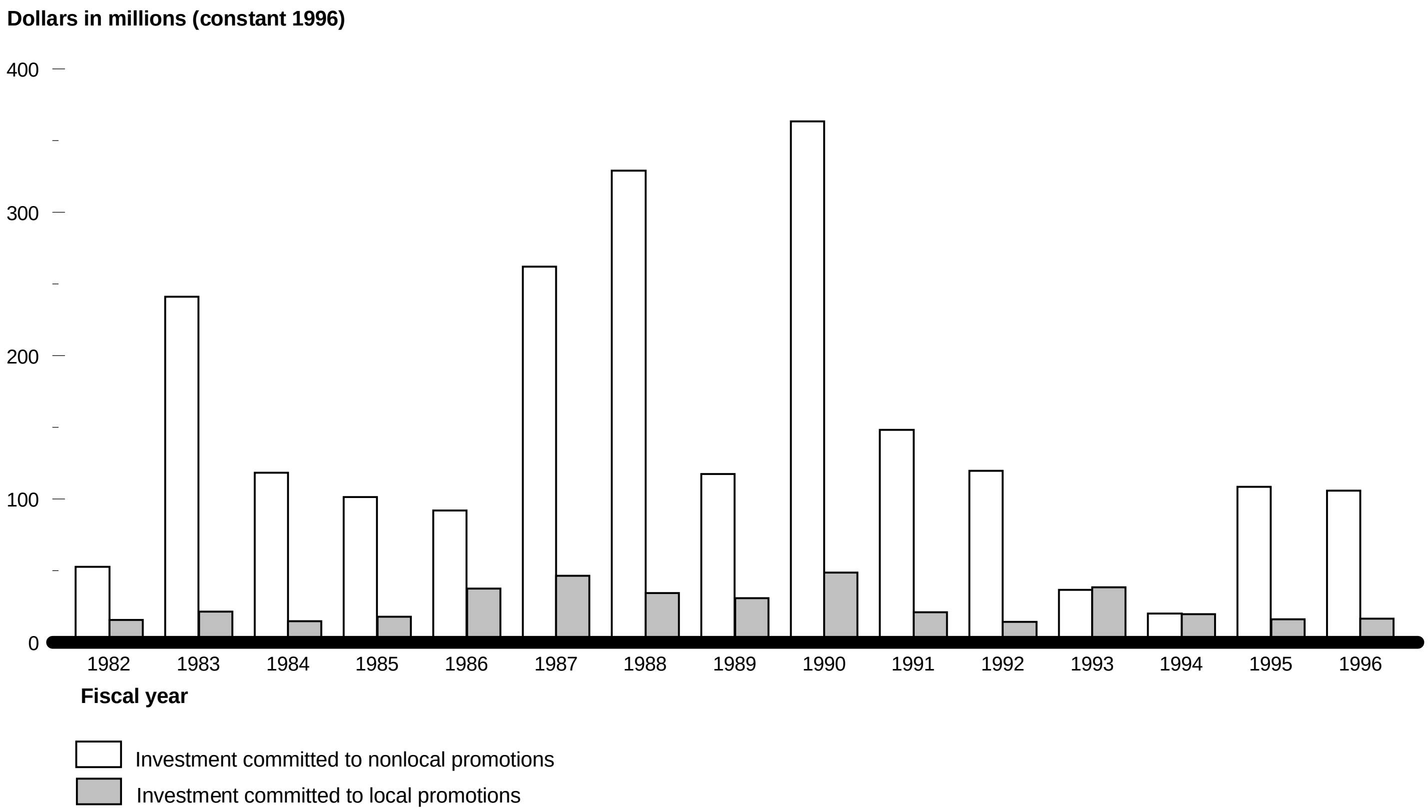
Payroll and Investment Committed to Economic Development Administration Promotions

Between 1982 and 1996, businesses promoted by EDA committed to investing $2.6 billion in Puerto Rico and committed to paying employees $2.2 billion. Nonlocal businesses made the largest share of this commitment by investing $2.2 billion, or 85 percent of the total investment commitment, and by paying employees $1.5 billion, or 67 percent of the total payroll commitment.

Investment committed to local and nonlocal promotions was greatest during this period in the late 1980s and early 1990s. Figure III.3 shows that committed investment for nonlocal promotions reached its highest level in

1990 at $363.5 million, and that committed investment for local promotions which reached its highest level of $48.6 million in 1990. Investment committed to nonlocal promotions continued a generally declining trend in 1994 immediately after the changes in the credit but began to rise again in 1995 and 1996. Investment committed to nonlocal promotions fell to $19.9 million in 1994, the smallest amount of committed investment for any year between 1982 and 1996, but increased to $108.4 million in 1995 and $105.7 million in 1996. After increasing to $38.3 million in 1993, investment committed to local promotions generally declined in subsequent years.

Figure III.3: Investment Committed to Local and Nonlocal Promotions, 1982-1996



Note: Figures were adjusted for inflation using the Puerto Rican GNP deflator for investment in machinery and equipment.

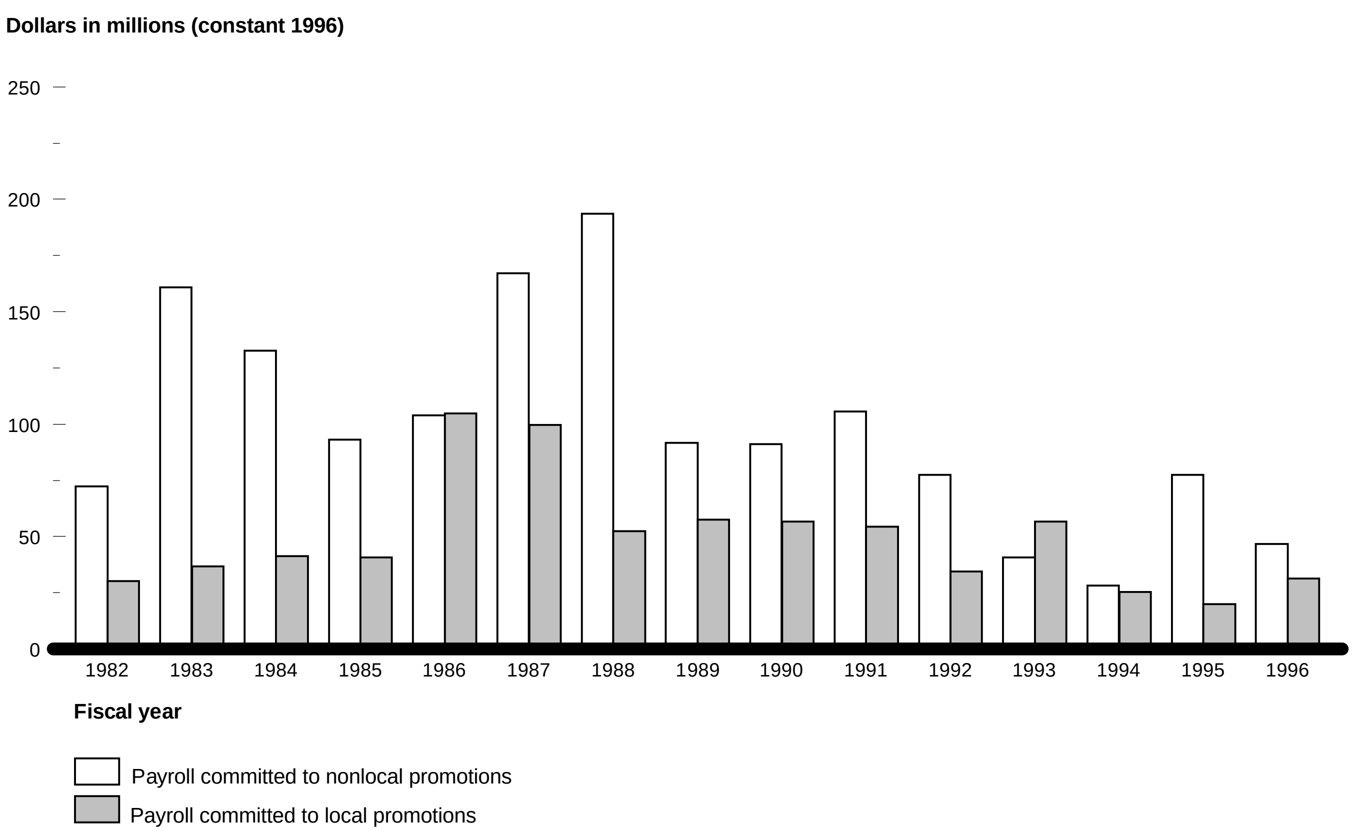
Source: Economic Development Administration of Puerto Rico.

Payroll committed to nonlocal promotions was generally greater in the 1980s than the 1990s. Figure III.4 shows that committed payroll for nonlocal promotions reached its highest level in 1988 at $193.5 million. Committed payroll for local promotions reached its highest level in 1986 at $104.8 million. Payroll committed to nonlocal promotions continued a declining trend in 1994 immediately after the changes to the credit when it fell to $28.2 million, the smallest amount committed for any year between

1982 and 1996. However, committed payroll increased to $77.4 million in 1995, and fell again to $46.7 million in 1996. Payroll committed to local promotions declined in 1994 and 1995, but increased again in 1996.

As a comparison of figures III.3 and III.4 shows, nonlocal promotions tended to be more capital intensive than the local promotions. Between 1982 and 1996, the ratio of committed payroll to investment was 1.8 to 1 in local promotions while this ratio was 0.64 to 1 in nonlocal promotions.

Figure III.4: Payroll Committed to Local and Nonlocal Promotions, 1982-1996



Note: Figures were adjusted for inflation using the Puerto Rican GNP deflator.

Source: Economic Development Administration of Puerto Rico.

Comments From the Secretary of the Treasury of Puerto Rico

TREASURY · INTEGRITY · LOYALTY · JUSTICE · GOVERNMENT OF PUERTO RICO

WINNER: TOTAL EXCELLENCE - GOVERNOR'S AWARD FOR QUALITY IN THE PUBLIC SECTOR 1995 - 1996

Manuel Díaz Saldaña
Secretary

May 1, 1997

Ms. Lynda D. Willis
Director, Tax Policy
and Administration Issues
United States
General Accounting Office
Washington, D.C. 20548

Dear Ms. Willis:

We apreciate your sharing with us the draft report on "Tax Policy: Puerto Rican Economic Trends", which we studied carefully. The report concentrates on the possible effect that the changes enacted by Congress on Section 936 may have on our economy. One main assertion states that the time elapsed since the Omnibus Budget Reconciliation Act of 1993 (OBRA) and the 1996 modifications to Section 936, is too brief as to reach definitive conclusions about the effects of such changes upon the local economy. It also states that the economic variables analyzed do not show a clear trend toward a diminished level of economic activity, nor a decrease in the availability of financial funds.

Conclusions in the report are, in general, consistent with the data you considered. Nevertheless, we want to point out some factors, not taken into account in the report, that influence the outcomes of the local economy. At the dawn of our first term in 1993 we started structuring a **New Economic Model.** In February 1994, soon after the Omnibus Budget Reconciliation Act of 1993 (OBRA), it was officially adopted. Our model emphasized competitiveness and productivity, at the same time that it establishes the goal of economic diversification, instead of the almost exclusive reliance in manufacturing that characterized previous economic policy.

The Government of Puerto Rico immediately began to implement this New Economic Model. The following features are essential elements of our Model:

1. New effective incentives to foster investment in tourism activity were adopted.

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Ms. Lynda D. Willis
May 1, 1997
Page 2

2. A tax reform in 1994, that reduced tax rates to individuals and corporations, and provided new incentives for investment in the nonexempt sector. The reform reduced taxpayers' burden by approximately $400 million.

3. Sizeable investments in infrastructure, to stimulate economic growth, increase productivity and reduce the costs of doing business for the private sector.

4. An overall administrative reform, that includes extensive deregulation and privatization initiatives.

5. The adoption of a new public policy directed at promoting research and development in science and technology.

6. A new law of agricultural incentives that not only provides incentives to traditional agricultural activities, but also promotes agroindustries.

7. An integration of social and economic policies.

8. Modification of 936 funds regulations to reduce negative effects arising from the elimination of QPSII.

9. New initiatives aimed at promoting exports to new markets.

We are also designing new policy measures to develop a Puerto Rican capital market and reviewing local industrial incentives.

All these measures have increased economic activity. Since they took place at the same time as the changes in Section 936, the economic trends represent the net effect of two forces working in opposite directions: the absence of a wage credit for new investments based on actual jobs created, and a strong, reliable local incentive program and new fiscal policies.

As the report noted, the Puerto Rican economy is following a growth path in most sectors. Such growth can be attributed to the expansion in the national economy, that pulls the local one, as well as to the economic policies implemented by the Government of Puerto Rico. Some sectors (particularly construction, tourism and services) are doing very well. But that does not appear to be the case in the manufacturing sector.

SECRETARY OF THE TREASURY

TREASURY GOVERNMENT OF PUERTO RICO

Ms. Lynda D. Willis
May 1, 1997
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During the first semester of fiscal 1996-97, employment in manufacturing declined by 1.2 percent. Total hours worked in manufacturing declined by 4.7 percent during the same period. A semester is far too short time as to establish any trend, but these developments ought to be carefully monitored.

Our economy is still taking significant developmental strides. We were able to reduce the unemployment rate from 16.8 percent in fiscal 1993 to 13.8 percent in 1996, but that is still intolerably high. Per capita Personal Income is only $7,882. It is evident that additional efforts are needed to move our economy toward a fuller measure of development, and appropriate instruments are required to reach that goal. This is the reason why Puerto Rico needs a revision of Section 30A to provide federal tax benefits to new investments needed to foster economic growth and the promotion of employment opportunities for our people.

Now on p. 32.

The Government of Puerto Rico is asking Congress for a stable wage tax credit as an incentive to U.S. manufacturing firms operating in Puerto Rico, as an effective instrument for economic development. It should be pointed out that page 40 of the report states that "The increase in employee compensation in the manufacturing sector accounted for about $400 million [from 1982 through 1996]"; since that amount covers both 936 and non 936 corporations, the increase in the tax cost of a 60 percent wage credit over that period would have been less than $240 million over that 14 year period. In consequence, Congress should not be concerned about the tax cost of Section 30A expanded to cover new operations.

Please call us if you need additional information.

Remember, in Hacienda we are at your service.

Cordially,

Manuel Díaz Saldaña
Secretary of the Treasury

SECRETARY OF THE TREASURY

Comments From the Commissioner of Financial Institutions

COMMISSIONER OF FINANCIAL INSTITUTIONS
GOVERNMENT OF PUERTO RICO

JOSEPH P. O'NEILL
COMMISSIONER

May 1, 1997

Ms. Lynda D. Willis, Director
Tax Policy and Administration Issues
United States General Accounting Office
Room 1T 47, 441 G. Street, North West
Washington, DC 20548

Dear Ms. Willis:

Thank you for the opportunity to provide our comments related to the draft of the United States General Accounting Office's report on "Tax Policy: Puerto Rican Economic Trends" which is expected to be issued during this month.

Our comments will be limited to the matters relating to the investments in tax exempt securities by U.S. corporations. The Puerto Rico Department of Treasury, the Economic Development Administration, and the Planning Board will address all other matters.

General Comments

In general terms we concur with the conclusions of the report. Our financial system is a part of the U.S. financial system. To the extent that any proposed project fulfills the credit requirements of lending institutions in Puerto Rico or outside Puerto Rico, the funds will be available to facilitate the real investment. Thus, availability of funds for investment is not an issue. From this perspective we concur that the level of so-called 936 funds does not affect the level of investment in Puerto Rico.

The draft report discusses the lack of growth in the tax exempt investments. This lack of growth is consistent with the evolution of the federal tax credit program. As the tax incentives programs were modified to reward economic activity in the possessions, rather than passive income and outright total income, the investment requirements for passive income were made more stringent which had an effect of limiting real growth in the tax exempt investments.

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Ms. Lynda D. Willis
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Specific Comments

Following are various comments that relate to specific areas of the document. These comments are primarily to provide additional clarity to the issues discussed in the report.

Now on p. 2.

Page 4, paragraph 2, line 6

"Credits attributable to QPSII were eliminated for income earned after June 30, 1996." It is our interpretation that the repeal of QPSII was effective for tax years beginning after December 31, 1995 and for all income generated up to June 30, 1996. Therefore, the companies with year-ends in the third and fourth quarter of the calendar year had a window of a few additional months of QPSII exemption after June 30, 1996.

No longer in report.

Page 20, paragraph 1, line 1

"Evidence of the immediate impact that the repeal of the QPSII exemption has had on financial investments by possessions corporations varies, depending on how changes in investment balances are computed." The substantial fund movements that occurred in that period cause the ambiguity.

First, it is important to note that most of the tax year-ends for the 936 companies with large positions in Puerto Rican financial institutions are October 31 and November 30. After the effective date of the QPSII elimination from the perspective of these companies, most of the funds not utilized for tollgate tax reduction left the Puerto Rico financial system. Therefore, the average daily balance for the quarter ended December 31, 1996 experienced a noticeable reduction when compared with the quarter ended September 30, 1996.

However, on December 31, 1996 a single large transaction helped to cause the month-end balance to result in a figure higher than the average for the month ended December 1996.

In general, fluctuations in the level of investments are a function of the tax strategies of a group of companies that account for the vast majority of exempt investments in the financial system. Undoubtably, the elimination of QPSII has caused certain funds that previously lingered in Puerto Rico to leave. Nevertheless, the combination of the effect of reducing Puerto Rico tollgate, the unfavorable tax treatment of P.R. tollgate tax at the federal level and issues relating to U.S. alternative minimum taxes provide a considerable disincentive to immediately repatriate the funds. Thus, the level of funds continues to be a relatively large amount.

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Now on p. 13.

Page 20, paragraph 1, line 4

This paragraph discusses the changes in levels of exempt investments during the period of elimination of the QPSII. The upswing that occurred in the quarter ended September 30, 1996 is consistent with the fact that many highly profitable 936 companies have year-ends in October and November and the effective date of the repeal of QPSII.

Now on p. 13.

Page 22, paragraph 2, line 3

In the report you correctly state that "... there was a pronounced shifting of funds out of instruments with maturities of 1 year or less and into instruments with longer maturities." The reason for the change is twofold. First, with the elimination of QPSII the attractiveness of investing funds in the Puerto Rican financial system is greatly reduced, and overall the companies will invest now only to reduce tollgate taxes. With tax exemption at both the local and federal levels, the companies enjoyed an after tax return (with practically no risk) higher than any alternate investments in the U.S. with similar risk. Thus, certain companies would leave excess funds in Puerto Rico. Now, without QPSII, the primary and foremost reason to have the funds in Puerto Rico is to reduce the Puerto Rico tollgate tax. Usually, to qualify for tollgate tax reduction, the investment must be done for at least five years.

The other reason for the shift is due to changes in a local regulation that governs the use of the funds. In anticipation of the changes in the regulation, many companies moved substantial funds into the five year maturities days before the effective date. The changes in the local regulation imposed, on a prospective basis, certain interest rate control mechanisms on the longer maturities. Previously, such controls only existed for the less than five year instruments.

Given that the primary reason for investing in exempt instruments in Puerto Rico after QPSII is to reduce the tollgate tax and the changes in the local regulation governing the exempt investments, substantial amounts of funds moved to the longer maturities that comply with the tollgate tax reduction requirements.

Now on p. 16.

Page 24, paragraph 1, line 1

"It is possible that the funds that possessions corporations reinvest in Puerto Rico's financial system simply displace other funds . . . " The financial institutions will always seek the cheapest cost of funding. In Puerto Rico, the cheapest source of funds is the exempt investments made by the manufacturing corporations. Most Puerto Rico banks carry a much higher amount of liquid assets (short and medium term investment securities) than their U.S. peer due to the funding positions driven primarily by legislative forces, not market forces.

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In anticipation of a possible phase out of the exempt investments most financial institutions have already implemented alternate funding programs.

Thus, given the above we believe historically the exempt funds caused the industry to pursue less aggressively other sources of funding.

Now on p. 18.

Page 26, Figure 6

Although you so state in the footnote on the previous page, I would suggest clarifying that the changes are based on the average December balance of each year.

Steps taken by the Government of Puerto Rico

The Government of Puerto Rico is currently implementing a capital markets reform which stimulates local companies to go public, provides more favorable tax treatment to local corporate debt, increases the realm of investments permitted for Individual Retirement Accounts (IRAs) and provides for a revamping of our Banking Act. Furthermore, the Puerto Rico Tax Reform Act of 1994 opened the door to U.S. and international financial institutions to increase the competition in the financial arena and provides additional funding sources to Puerto Rico. Previously such virtually unlimited funding sources were severely limited due to a withholding requirement on interest paid to entities outside Puerto Rico. These measures, along with significant changes implemented in the last four years in modernizing our legal and regulatory framework, have prepared Puerto Rico's financial system to be a world-class competitor with or without QPSII.

Conclusion

In general terms we concur with the exempt investment aspects of the report. The repeal of QPSII has had a small effect on the levels of exempt investments in the financial institutions. Future effects on the financial industry, if any, will probably be gradual given the significant volume of funds that have shifted to the longer maturities. However, the long term effect of the repeal of QPSII is difficult to estimate at this time. Certainly the repeal of QPSII reduced the attractiveness of Puerto Rico from the perspective of the U.S. corporations. The proposed measure relating to enhanced 30A as filed by President Clinton in his fiscal year 1998 budget would help mitigate any possible long term adverse effects of the repeal of QPSII.

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We reiterate our appreciation for allowing us the opportunity to provide our comments. Should you wish any additional details or wish to discuss any of the issues included herein, please do not hesitate in contacting me.

Cordially,

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Comments From the Puerto Rico Planning Board

GOVERNMENT OF PUERTO RICO
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May 1, 1997

Ms. Lynda Willis
Director
Tax Policy and Administration Issues
U.S. General Accounting Office
Washington, D.C.

B-276674

Dear Ms. Willis:

In response to your request we have examined the draft of your report **Tax Policy Puerto Rican Economic Trends**. To be thorough, our review was based on the statistics available in our Agency. Our findings reveal some apparent data discrepancies. On the other hand, Balance of Payments data should be updated to fiscal year 1996. For your convenience we present our findings in a separate chart attached to this letter. More technical comments are also included.

Thank you for the opportunity given the Puerto Rico Planning Board in reviewing and submitting comments to the draft report Tax Policy: Puerto Rican Economic Trends.

Sincerely yours,

José R. Caballero Mercado

José R. Caballero Mercado
Acting Chairman

Enclosures - 10

LHO/SSV/jmg

GOVERNMENT OF PUERTO RICO
OFFICE OF THE GOVERNOR
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May 1, 1997

COMMENTS ON GAO'S DRAFT REPORT ENTITLED: TAX POLICY: PUERTO RICO ECONOMIC TRENDS

Now on p. 4.

* **Page 7**: "Income as measured by Puerto Rico's gross domestic product (GDP) and gross national product (GNP) both increased between 1982 and 1996, with the increases continuing at about the same rates after the 1993 changes in the credit".

The base period, 1982, was a recessionary year.

Now on p. 6.

* **Page 11**: "Between 1982 and 1996, Puerto Rico's per capita GNP grew at an annual rate of 1.7 percent and its GDP grew at an annual rate of 3.4 percent. The growth of both indicators slowed somewhat after 1990 following the recession that occurred in the U.S., but per capita GDP began to grow more quickly in 1992 as did per capita GNP in 1993.

Since GDP is a measure of the total income produced in Puerto Rico, including both: the portion received by Puerto Rican residents and U.S. and foreign investors, we should be careful when using GDP per capita. Many people tend to use it or interpret it as a measure of the resident population's well being, like GNP per capita or personal income per capita.

Now on pp. 11 and 37.

* **Pages 18, 45 and 47**: Total nonagricultural employment in establishments in Puerto Rico for fiscal years 1995 and 1996

Enclosed are the revised figures on total nonagricultural employment for fiscal year 1996. As it usually happen in periods of economic expansion, the figures were revised upward: from 926 thousand to 945 thousand. The monthly figures were revised with the March 1995 benchmark. The revision follows the same methodology of the 50 states, except in the case of manufacturing which use as a benchmark a locally developed census of manufacturing.

Now on p. 12.

* **Page 18**: **Footnote 8**

There are more recent figures on the number of active possessions corporations in Puerto Rico. For tax year 1993 IRS reported that there were about 474 active possessions corporations and the Puerto Rican Department of Treasury show that about 439 possessions corporations tax returns received at least partial exemptions in fiscal year 1993.

Nonagricultural Wage and Salary Employment
Fiscal Years
In thousands of person

	1993	1994	1995	1996
Total	862	879	912	945
Manufacturing	151	150	153	154
Mining	a/	a/	a/	a/
Construction	47	44	46	52
Trade	163	171	181	188
Wholesale	37	36	38	40
Retail	126	135	143	149
Finance, Insurance & Real Estate	39	41	42	44
Transportation, Communication and other Public Utilities	22	23	23	24
Service	147	157	164	175
Government	292	292	304	308

a/ Less than 2,000

Comments From the Economic Development Administration

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GOVERNMENT OF PUERTO RICO
ECONOMIC DEVELOPMENT ADMINISTRATION
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May 1, 1997

Ms. Lynda D. Willis
Director, Tax Policy
and Administration Issues
United States
General Accounting Office
Washington, D.C. 20548

Dear Ms. Willis:

We have reviewed the draft report B-276674 entitled "Tax Policy: Puerto Rican Economic Funds" and, would like to suggest the following:

Now on p. 18.

- Page 27, paragraph 1, line 2:
  "EDA promotions generally receive tax exemptions and commitments to hire....". We suggest it to read: *"EDA promotions generally receive tax exemptions and include commitments to hire..."* which is in accordance with appendix III, page 48, paragraph 2, line 2.

Now on p.18.

- Page 27, paragraph 1, line 4:
  "The promotions that EDA calls "non local", i.e., at least 50 percent of funds invested come from overseas business,....". We suggest: *"The promotions that EDA calls "non local", i.e., at least 50 percent of the capital invested from the United States or other foreign countries,...."* which is in accordance with appendix III, page 49, paragraph 1, line 2.

Please call us if you have any question.

Cordially,

José M. de la Vega
Acting Administrator and
Chief Executive Officer

c Jaime Morgan-Stubbe

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