TESTIMONY OF THE

HONORABLE

RAFAEL HERNANDEZ COLON

GOVERNOR OF THE

COMMONWEALTH OF PUERTO RICO

BEFORE

THE HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS HEARINGS

ON

ALTERNATIVES FOR TAX REFORM

JULY 11, 1985

Honorable
RAFAEL HERNANDEZ COLON
Governor of Puerto Rico

Thank you for this opportunity to testify on the urgent need to preserve section 936 of the Internal Revenue Code. This section and its predecessors in the tax code have been designed to attract investment for the development of Puerto Rico's economy, which is severely handicapped by overpopulation, lack of resources, and affected by federal legislation which increases our costs of production and transportation but does not burden our surrounding Caribbean Basin countries. No issue is more important to the well-being of the Puerto Rican people, the more than three million U. S. citizens who live there, and their two million brothers and sisters living in the United States.

The Administration's proposal to replace section 936 with a wage-credit, an admittedly less effective incentive, would destabilize our entire economy, throw thousands of Puerto Ricans out of work, and force many to flee to the U. S. mainland in search of jobs. It would destroy a unique and timely opportunity to transform the promise of the Caribbean Basin Initiative into an economic and political reality.

Section 936 works. It permits the Government of Puerto Rico to forego taxes on income earned in Puerto Rico in a way that stimulates employment and sustains our economic development. It accounts for at least 30% of existing jobs in Puerto Rico. It generates 40% of the funds on deposit in the Puerto Rican banking system. It reduces the welfare burden that otherwise would fall on the United States Treasury. Compared to our neighbors in the Caribbean, we have achieved through 936 an economic miracle, but the per capita income of our citizens, $4,096, is still less than one-third the U. S. average and less than half that of the poorest state.

Unemployment in Puerto Rico is at 22% because the past ten years witnessed a series of adverse economic factors that no tax incentive could have overcome. The oil shocks of the early 1970s and the change in oil allocation rules cost Puerto Rico thousands of jobs in the refinery industry. The steep rise in energy costs on an Island which is 99 percent dependent on foreign oil, the full application of U. S. minimum wage, environmental and other costly regulatory requirements, the substantial lowering of U. S. tariffs that previously had protected Puerto Rican goods coming to the U. S., all created an economic environment in which only section 936 prevented a major recession in Puerto Rico.

The Administration's proposal to change the 936 incentive to a considerably less potent variant must be considered in light of the very difficult situation in which the Puerto Rican economy finds itself and our need to reduce the intolerably high rate of unemployment. Let us analyze the Administration's proposal.

The Administration's proposal on section 936 would not increase U. S. tax revenues. In fact, according to Treasury revenue estimates, the repeal of section 936 proposed by the Administration would actually add to U. S. budget deficits in the first two years. The disruption of the Puerto Rican economy would end up costing the Treasury hundreds of millions of dollars annually in increased unemployment and other transfer payments. Migration of unemployed Puerto Rican workers to crowded job markets in the U. S. mainland would add to fiscal problems of state and local governments. The destruction of Puerto Rico's economy would seriously damage the credibility of the U. S. promise to invigorate the economies of countries in Latin America and the Caribbean. A destabilized Puerto Rico would become a target of opportunity for subversive influences in the Caribbean.

The Administration recognizes, as did the Congress as recently as 1982, that using the tax code to enable Puerto Rico to attract U. S. companies is both essential and appropriate. The products of Puerto Rico could not compete in the U. S. and the rest of the world without tax incentives to compensate for the disadvantages of manufacturing in the Commonwealth. The Administration proposes to replace income-based incentives, which have been used successfully for the past fifty years, with an untried, wage-based credit of dubious value.

Obviously, my Government would enthusiastically endorse a wage-based or any other type of credit if we were convinced that, as Treasury claims, the new credit would increase employment more efficiently and in a less costly manner than section 936. Unfortunately, there is no evidence that the experiment proposed by Treasury would work and much to suggest that it would be an economic and political disaster.

A wage-credit would drive away many of the high technology companies —in chemicals, pharmaceuticals, and electronics— that have become vital contributors to Puerto Rico's economy. These companies are capital intensive; a single factory may put $50 million or more at risk. A wage-credit does not recognize the size or risk of these investments, nor does it give credit for the invaluable benefits of advanced technology and manufacturing and management techniques these companies bring to Puerto Rico. Yet their physical capital and know-how materially increases worker productivity, creates many high quality, high paying jobs, and produces skilled and motivated Puerto Ricans to fill them. There is no doubt that these jobs and other benefits would be lost to Puerto Rico if section 936 were replaced by a wage-credit.

Treasury tells us that the high technology jobs its proposal will eliminate in Puerto Rico can be replaced with lower wage jobs in labor-intensive manufacturing. Even this is unlikely. Wage scales in Puerto Rico are high relative to other developing economies. The U. S. minimum wage has already driven many labor-intensive companies in the apparel and other industries out of Puerto Rico.

We will not be able to attract labor-intensive companies to Puerto Rico by a wage-credit that reduces the cost of unskilled labor to 40 percent of the U. S. minimum wage, or about $1.15 an hour at present rates, when plentiful labor is available in neighboring Caribbean countries for as little as 33 cents an hour.

Furthermore, not many companies will have confidence that a wage-credit would last long enough to justify establishing a plant in Puerto Rico, despite current Treasury assurances that the credit will be "permanent". Only a few years ago, in the 1982 TEFRA legislation, Treasury sponsored an amendment to section 936, that was advertised as satisfying Treasury's concerns about abuses of section 936 and as bringing a much needed stability to the tax environment in Puerto Rico. Constant amendment of the tax laws relating to Puerto Rico undermines the confidence and stability that is so essential to our ability to attract new investments and new jobs in Puerto Rico. In fact, no one knows just how effective section 936 could be in creating new jobs because it has never been allowed to work with even a modicum of constancy and predictability.

We in Puerto Rico have asked ourselves and I hope you will ask yourselves: why this new and dangerous wage-credit experiment with the Puerto Rican economy and the welfare of thousands of Puerto Rican families when section 936 has proven effective and its full potential has not yet been tapped?

I compaigned and won last November on a platform that affirmed that unemployment in Puerto Rico could be cut dramatically using 936 funds more creatively. The people of Puerto Rico supported my position that the pool of $7 billion of 936 earnings should be directed not as much to the financial system but towards real investment through private industry in our economy.

From the moment I took office in January, my Administration has been engaged in a major effort to maximize job creation through section 936. We have established financial arrangements that will extend the maturity of 936-financed investments, and target these funds into productive real investments in areas such as agribusiness and construction. For example, we will create a $200 million Mortgage Trust which will finance, at lower than market rates, 5,000 housing units per year, thereby solving our housing problem, and revitalizing our much-depressed construction industry. Through this vehicle we will create 18,000 new jobs, a 23 percent increase in construction employment.

In my Inaugural Address, I committed the money deposited in the Puerto Rican Government Development Bank as a consequence of section 936 and our own law —a total of approximately $700 million— to a strategy of shared regional development for the Caribbean. Financing was made available on favorable terms, for new plants in Puerto Rico to corporations ready to invest their own funds in "twin plants" —complementary manufacturing facilities— on other Caribbean islands.

We now have commitments from twenty-one section 936 corporations to make new investments in Puerto Rico and complementary new investments elsewhere in the Caribbean Basin and Central America, provided section 936 remains unchanged.

In Grenada, I met with Prime Minister Blaize, who saw in our proposal a great source of hope for his people. Today we have four pharmaceutical firms prepared to create new plants and jobs in Grenada if we succeed in preserving section 936. The citizens of that country regained their liberty with the help of the Caribbean community and the United States. The rest of the hemisphere and the world are watching to see what will happen there now. We must resolve that the people of Grenada have not been unshackled to become unemployed.

In Jamaica, we are working with Prime Minister Seaga to provide housing —one of that nations most desperate needs— and factories by prefabricating units in Puerto Rico and financing them with section 936 funds.

In Dominica, Prime Minister Charles told me with deep conviction that our plans to use section 936 earnings will make it possible for her farmers to sell all of their fruit rather than leaving it to rot on their trees. This is the number one priority for Dominica. "To the people in Washington," she noted, "it may not sound like we are speaking of section 936 when we speak of rotting fruit, but we are. Without section 936, Puerto Rico would not have the capital to invest in expanded processing to accommodate our fruit."

Given the chance, we will bring thousands of new jobs and new investments to the Caribbean Basin where unemployment is the ally of instability —and a thriving free enterprise can become a bulwark against tyranny.

We also intend to apply the leverage of our 936 resources to the task of investing, on a boarder basis, in health and culture and human capital. We will call on all our educational institutions, on all our business and managerial skills, on the idealism of the young. We plan to be involved at every level. When I look across the Caribbean in years to come, I want to see investors from Puerto Rico joining investors in democratic Caribbean nations at all the frontiers of growth and development. As time passes, I want to see advisors who are from the Eastern Caribbean and Puerto Rico —not from Cuba— providing assistance in Central and Latin America.

We ask the Congress to give us a chance to show how creatively and constructively 936 can be used. We ask the Congress to join in our alliance for prosperity —to assist us in earning a new place in the world economy— and to gain for the United States a new place of honor in the history of the Caribbean.