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PUERTO RICO AND THE SECTION 936 TAX INCENTIVES

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL OVERSIGHT AND RENEGOTIATION

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

DECEMBER 15, 1982

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PUERTO RICO AND THE SECTION 936 TAX INCENTIVES

WEDNESDAY, DECEMBER 15, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
SUBCOMMITTEE ON GENERAL OVERSIGHT AND RENEGOTIATION,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in room 2222, Rayburn House Office Building, Hon. Joseph G. Minish (chairman of the subcommittee) presiding.

Present: Representative Minish.

Also present: Representative Robert Garcia.

Mr. GARCIA [presiding]. I want to thank everybody for being here. The Subcommittee on General Oversight and Renegotiation of the full Committee of Banking, Finance and Urban Affairs is about to start the hearings.

Before I do, let me say that the chairman, Mr. Minish, is on his way. He is over at the Senate right now. He will be here soon.

Stan Parris, the ranking minority member, is also, I understand, going to be joining us a little late.

I want to say to all of you who are here that at the present time there is a vote taking place in the House, but it is one of those votes that I feel is a nuisance vote, it is approving the Journal.

What I would like to do is proceed with the hearings, to get them started. There is a long list of witnesses. That way we will make certain everybody has an opportunity to enter into the record what they feel is important for the future of section 936 as it pertains to Puerto Rico.

I want to thank Chairman Minish and the members of the Subcommittee on General Oversight and Renegotiation. I especially want to thank the chairman for scheduling these hearings on the section 936 program and its impact on the Island of Puerto Rico.

The section 936 tax program is extremely complex and it is obviously not the jurisdiction of this committee to examine tax law. However, like most tax policy, the implications of a tax program such as section 936 can run deeply into the fabric of an economy, especially one that is as fragile as Puerto Rico's.

The section 936 program, a tax incentive system designed to encourage the location of new industry on Puerto Rico, has recently become the object of much attention to the tax writing committees of Congress. However, what many fail to recognize as they review the program, is that the section 936 program is much more than an industrial location and job creation effort. The funds generated by

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the program provide a significant portion of the assets in many of the commercial banking and thrift institutions on the island.

That is where we, as the Banking Committee, have decided we have some jurisdiction. Indeed, upward of 40 percent of the assets of the banking community can be attributed to the section 936 program.

In order to maintain the special tax provisions, the section 936 companies are required to circulate the funds into the island's economy. These funds contribute to the island's housing industry in the form of mortgages, to the island's governments in the form of municipal bonds and industrial development bonds, and to the island's economic structure in the form of commercial and consumer loans. Obviously, any changes to the section 936 program could have significant implications on the economic development of Puerto Rico, America's flag in the Caribbean.

I believe that it is important that Congress look more closely at the program and that the Banking Committee explore the implications this tax policy has on the financial community of Puerto Rico, an island where unemployment is conservatively estimated at 25 percent, which has experienced a drastic reduction in Federal assistance, especially with the loss of the CETA program and which saw its gross production decline by 3.9 percent in fiscal year 1982.

It is time to establish a record on the many benefits of the section 936 program and to create a better understanding of the implications it has on the island's financial structure.

Again I want to take this opportunity to thank the chairman, and Chairman Minish will be with us in a short while, and to the other members of the subcommittee, especially Congressman Parris who will be joining us.

We have a number of excellent witnesses. I want to start off by thanking Congressman Baltasar Corrada, who is with us today. During the 936 crisis—I don't know how much sleep he got. I know it was a very difficult time for him. I think the fact the entire hand was not chopped off is a great tribute to him and his ability to negotiate here in Congress.

With that, I would like to ask you to start.

STATEMENT OF HON. BALTASAR CORRADA, RESIDENT COMMISSIONER FROM PUERTO RICO

Mr. CORRADA. First of all, Mr. Chairman, I would like to extend my appreciation to Chairman Minish for scheduling these hearings promptly and particularly my good friend and colleague, the other Puerto Rican in Congress——

Mr. GARCIA. All two of us.

Mr. CORRADA. Two of us are here—Robert Garcia, a member of the Banking Committee, who unquestionably has been the key person in urging Chairman Minish to schedule these important hearings as far as the economic development of Puerto Rico is concerned.

Mr. Chairman, members of the subcommittee, I appreciate the opportunity to testify at this hearing today to express my views on a subject which is of utmost importance to the 3.2 million Ameri-

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can citizens living in Puerto Rico; to their economic and social development and to their general well-being.

I will briefly explain how meaningful and critical section 936 of the Internal Revenue Code is to Puerto Rico, to our industry and to our people.

Once the importance of this tax policy is fully understood, I am sure my fellow Congressmen will share the view that it is in the best interest of the U.S. Government to keep it in place with a reasonable degree of certainty, for many years to come.

Puerto Rico has been a U.S. possession since the year 1898. It is the fourth largest island and the most densely populated of the politically and economically troubled Caribbean.

Up to the 1940's we were considered one of the poorest regions of the world relying almost exclusively on our agriculture and harvesting traditional Caribbean products like sugar cane, coffee, and tobacco. We had a per capita income of $200 per year. We had a life expectancy rate of only 46 years and an infant mortality rate of 109 per 1,000 live births.

Under such an extreme poverty level and high level of frustration anti-American sentiments flourished. At that time. I am speaking of the thirties and early forties. Forty years later, however, Puerto Rico has been transformed. Even though our geographic and natural limitations are still there, our most cherished resources, our human resources, have risen above any expectation.

With an average per capita income of close to $4,000, Puerto Rico is a model for many developing countries. Infant mortality has fallen to 19 per 1,000 live births and life expectancy is now 74 years, which is about what it is for the U.S. mainland as well.

All these economic and social changes have occurred through a continuous process that has evidenced human creativity within our framework of political democracy and a free enterprise system.

When we ask ourselves how this came about, we have to turn to one of the key factors, Puerto Rico's ability to attract U.S. capital investments.

Since the 1950's, Puerto Rico has been following an economic development strategy based upon two important elements. First, the Puerto Rico tax incentives law which provides local tax relief for companies establishing in Puerto Rico, and second, U.S. Federal tax policies toward U.S. investments in Puerto Rico.

Section 936 has been critical to Puerto Rico's process of industrialization. Most of the capital investments made in Puerto Rico under this program have been in the manufacturing sector. High technology industries have been established with their correspondent upgrading and development of a highly skilled and well-paid Puerto Rican work force. The mere change from cheap labor manufacturing to high technology industries is economic development in itself.

Section 936 companies account for over half the 139,000 manufacturing jobs in Puerto Rico and currently are responsible for the creation and maintenance of more jobs than other sectors of our economy like construction, agriculture, and tourism.

Their income taxes and taxes paid to the Puerto Rican Treasury for the repatriation of dividends to the U.S. parent companies represent about $150 million to our general revenue fund.

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Section 936 companies hold approximately $5.5 billion deposited in financial institutions operating in Puerto Rico which account for over 40 percent of the total deposits of commercial banks operating in Puerto Rico and thus a very important element of our banking system liquidity.

The availability of these relatively low cost funds makes it possible for our financial institutions to lend them at a significantly lower interest rate than funds obtained from other sources.

The Puerto Rican Treasury Department through the issuance of rulings and regulations has been exercising its supervisory authority to secure that most of these funds are channeled into productive investments in our economy. This has produced a positive effect in our local economy, particularly in times of high interest rates and economic recessions.

Our economy is integrated with the U.S. mainland economy from which we purchase currently over $5.7 billion worth of goods and services every year.

Our section 936 companies produce in Puerto Rico thousands of components and parts which are essential to U.S. parent companies for production in mainland factories. Thousands of jobs in the U.S. mainland are tied to the production made by section 936 companies in Puerto Rico.

Unfortunately, the U.S. economy is not at its best. There are big deficits, high interest rates, and staggering unemployment which have forced U.S. Government officials to trim budgets, raise taxes, and revise Federal programs—raise taxes to some and lower taxes to others.

Puerto Rico has taken more than its share of the Federal cutbacks since 1980, particularly in the food stamps program, public service jobs, and economic development loans and guarantees. Part of this is reflected by our current high unemployment rate of 22.8 percent.

Our sagging economy experienced a negative growth of 3.9 percent for fiscal year 1982, compared with the times when we used to have a 6 or 7 percent net growth in our gross domestic product. Even as recently as 1978–79, we were having net real growth in our GNP of between 3 to 4 percent.

It is true, we are experiencing bad economic times in the U.S. mainland but it is also true that the same is happening in Puerto Rico and probably with more serious effects. From an alltime high of 159,000 jobs in 1979, manufacturing employment has dropped to 139,000 currently.

Most of the decline in manufacturing employment could be attributed to the economic conditions in the United States, but some of it has been caused by the cloud of uncertainty that developed around the 936 program earlier this year, and last year as well.

In the mind of some in Congress and in the U.S. Treasury Department it appears that perhaps there was not reasonable proportion between the benefits made by the investors and the number of jobs created in our economy by this tax policy.

Congress decided then to look into this matter earlier this year in the midst of a need to raise $100 billion in additional revenues.

We all remember those hectic weeks of debates and parliamentary maneuvering, when marathon meetings were held until the

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early hours of the morning. For many of us that period meant restless nights and days of anxiety while making titanic efforts to undo what the U.S. Senate had done to section 936 which would have spelled disaster for our economic development.

May I point out, particularly to my dear friends and colleagues, Charley Rangel and Bob Garcia, Charley being a member of the Ways and Means Committee, Bob being a member of this committee, and, of course, of the New York delegation, who were of tremendous help to us in our effort to change what the Senate had done. Of course, a compromise was arrived at.

It was of the utmost concern to the Senators that dealt with section 936 that jobs be created and maintained on the island. We now have in place a modified version of section 936 which represents the culmination of 2 years of negotiations between the Government of Puerto Rico and the U.S. Treasury.

This agreement carries the endorsement of Gov. Romero Barcelo and of myself, as well as that of the Reagan administration and a broad spectrum of the business sector.

This may not be a perfect law but it is a significant improvement over what we had before, particularly because by correcting some potential for abuse we now have a sound fiscal policy less vulnerable to change.

If all the parties concerned approach the revised section 936 program with a firm determination to make it work I believe we will see many benefits to Puerto Rico, to the section 936 companies and to the Nation.

However, rumors have been spread through the business community that U.S. Congress contemplated revisiting this recently modified program in the near future. Such unfounded rumors have caused some promising new investment to be placed on hold.

I am convinced that the next several years are needed to observe how the recent changes made to section 936 work. This same belief was expressed by U.S. Treasury Assistant Secretary John Chapoton, in a recent letter to Senator Robert Dole, chairman of the Senate Finance Committee.

The big loser, if we keep changing this tax policy, can only be Puerto Rico. The companies can go elsewhere and the U.S. Treasury can always find its revenues someplace.

The thousands of direct jobs and all the other benefits that Puerto Rico derives from its section 936 companies must be protected and this cannot be done adequately unless a degree of certainty is provided to the program.

To conclude, I would like to restate that section 936 is not just a revenue-producing measure. It is a tax policy intimately linked to the economic and social development of 3.2 million American citizens.

The U.S. Treasury Department has the dual, and somewhat conflicting role of collecting taxes and preparing an annual report to Congress about a unique arrangement which is vital to the well-being of these 3.2 million American citizens living in Puerto Rico.

From its first section 936 reports it is clear that the Treasury's tax collector role has greatly influenced and even overwhelmed its section 936 evaluation role. Not enough recognition has been given

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to the tremendous contribution beyond direct jobs and wages that section 936 companies have made to Puerto Rico.

A broad assessment of Puerto Rico's economic development has been missing in the narrow cost calculation made by those who have been entrusted with the duty of drawing up the only annual evaluation of section 936.

We have to make sure that Congress is well informed about what section 936 means to Puerto Rico. We must bring to the island as many Members of Congress as we can so that they can see for themselves just how important this tax policy is to our economic development and to allow them to gain a firsthand knowledge of how section 936 is being implemented, and thus accurately assess the impact of this tax policy in our economy.

Congress has oversight jurisdiction over Federal tax policy as well as constitutional powers to enact Federal tax laws. Thus, any Federal tax policy may come under the scrutiny of Congress at any time. However, any renewed effort by Congress to further amend section 936 at present will be counterproductive.

If any modifications to section 936 are needed in the future, they should come only after careful evaluation over a number of years of the changes just made, and their only aim should be to improve Puerto Rico's ability to attract capital investments and to create more jobs in our economy.

I am sure that the sincere concern most Members of Congress have toward the well-being of their fellow American citizens living in Puerto Rico will override any short-term budgetary gain to be made by any change to this program, a gain, by the way, which would be more illusory than real, more theoretical than practical.

By leaving this tax policy untouched for the next several years Congress will be honoring its commitment to promote the well-being of their fellow Americans in Puerto Rico .

Thank you.

[Mr. Corrada's prepared statement follows:]

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BALTASAR CORRADA
RESIDENT COMMISSIONER, PUERTO RICO

KENNETH MARTY-LÓPEZ
ADMINISTRATIVE ASSISTANT

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TESTIMONY OF HON. BALTASAR CORRADA, RESIDENT COMMISSIONER FROM PUERTO RICO, BEFORE THE SUBCOMMITTEE ON GENERAL OVERSIGHT AND RENEGOTIATION OF THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS.

DECEMBER 15, 1982

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I APPRECIATE YOUR ALLOWING ME THE OPPORTUNITY TO TESTIFY AT THIS HEARING TODAY TO EXPRESS MY VIEWS ON A SUBJECT WHICH IS OF UTMOST IMPORTANCE TO THE 3.2 MILLION AMERICAN CITIZENS LIVING IN PUERTO RICO, TO THEIR ECONOMIC AND SOCIAL DEVELOPMENT AND TO THEIR GENERAL WELL BEING.

I WILL BRIEFLY EXPLAIN HOW MEANINGFUL AND CRITICAL SECTION 936 OF THE INTERNAL REVENUE CODE IS TO PUERTO RICO, TO OUR INDUSTRY AND TO OUR PEOPLE.

ONCE THE IMPORTANCE OF THIS TAX POLICY IS FULLY UNDERSTOOD, I AM SURE MY FELLOW CONGRESSMEN WILL SHARE THE

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VIEW THAT IT IS IN THE BEST INTEREST OF THE U.S. GOVERNMENT TO KEEP IT IN PLACE WITH A REASONABLE DEGREE OF CERTAINTY, FOR MANY YEARS TO COME.

PUERTO RICO HAS BEEN A U.S. POSSESSION SINCE 1898. IT IS THE FOURTH LARGEST ISLAND AND THE MOST DENSELY POPULATED OF THE POLITICALLY AND ECONOMICALLY TROUBLED CARIBBEAN.

UP TO THE 1940'S WE WERE CONSIDERED ONE OF THE POOREST REGIONS OF THE WORLD RELYING ALMOST EXCLUSIVELY ON OUR AGRICULTURE AND HARVESTING TRADITIONAL CARIBBEAN PRODUCTS LIKE SUGAR CANE, COFFEE AND TOBACCO. WE HAD A PER CAPITA INCOME OF $200 PER YEAR. WE HAD A LIFE EXPECTANCY RATE OF ONLY 46 YEARS AND AN INFANT MORTALITY RATE OF 109 PER 1,000 OF LIVE BIRTHS.

UNDER SUCH AN EXTREME POVERTY LEVEL AND HIGH LEVEL OF FRUSTRATION ANTI-AMERICAN SENTIMENTS FLOURISHED. 40 YEARS LATER PUERTO RICO HAS BEEN TRANSFORMED. EVEN THOUGH OUR GEOGRAPHIC AND NATURAL LIMITATIONS ARE STILL THERE, OUR

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MOST CHERISHED RESOURCES, OUR HUMAN RESOURCES, HAVE RISEN ABOVE ANY EXPECTATION.

WITH AN AVERAGE PER CAPITA INCOME OF CLOSE TO $4,000, PUERTO RICO IS A MODEL FOR MANY DEVELOPING COUNTRIES. INFANT MORTALITY HAS FALLEN TO 19 PER THOUSAND LIVE BIRTHS AND LIFE EXPECTANCY IS NOW 74 YEARS.

ALL THESE ECONOMIC AND SOCIAL CHANGES HAVE OCCURRED THROUGH A CONTINUOUS PROCESS THAT HAS EVIDENCED HUMAN CREATIVITY WITHIN OUR FRAMEWORK OF POLITICAL DEMOCRACY AND A FREE ENTERPRISE SYSTEM.

WHEN WE ASK OURSELVES HOW THIS CAME ABOUT, WE HAVE TO TURN TO PUERTO RICO'S ABILITY TO ATTRACT U.S. CAPITAL INVESTMENTS.

SINCE THE 1950'S PUERTO RICO HAS BEEN FOLLOWING AN ECONOMIC DEVELOPMENT STRATEGY BASED UPON TWO IMPORTANT ELEMENTS. FIRST, THE PUERTO RICO TAX INCENTIVES LAW WHICH PROVIDES LOCAL TAX RELIEF FOR COMPANIES ESTABLISHING IN PUERTO RICO AND, SECOND, U.S. FEDERAL TAX POLICIES TOWARD U.S. INVESTMENTS IN PUERTO RICO.

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SECTION 936 HAS BEEN CRITICAL TO PUERTO RICO'S PROCESS OF INDUSTRIALIZATION. MOST OF THE CAPITAL INVESTMENTS MADE IN PUERTO RICO UNDER THIS PROGRAM HAVE BEEN IN THE MANUFACTURING SECTOR. HIGH TECHNOLOGY INDUSTRIES HAVE BEEN ESTABLISHED WITH THEIR CORRESPONDENT UPGRADING AND DEVELOPMENT OF A HIGHLY SKILLED AND WELL PAID PUERTO RICAN WORK FORCE. THE MERE CHANGE FROM CHEAP LABOR MANUFACTURING TO HIGH TECHNOLOGY INDUSTRIES IS ECONOMIC DEVELOPMENT IN ITSELF.

SECTION 936 COMPANIES ACCOUNT FOR ABOUT HALF THE 139 THOUSAND MANUFACTURING JOBS IN PUERTO RICO AND CURRENTLY ARE RESPONSIBLE FOR THE CREATION AND MAINTENANCE OF MORE JOBS THAN OTHER SECTORS OF OUR ECONOMY LIKE CONSTRUCTION, AGRICULTURE AND TOURISM.

THEIR INCOME TAXES AND THE TAXES PAID TO THE PUERTO RICAN TREASURY FOR THE REPATRIATION OF DIVIDENDS TO THE U.S. PARENT COMPANIES REPRESENT ABOUT 150 MILLION DOLLARS

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TO OUR GENERAL REVENUE FUND.

SECTION 936 COMPANIES HOLD APPROXIMATELY 5.5 BILLION DOLLARS DEPOSITED IN FINANCIAL INSTITUTIONS OPERATING IN PUERTO RICO WHICH ACCOUNT FOR OVER 40% OF THE TOTAL DEPOSITS OF COMMERCIAL BANKS OPERATING IN PUERTO RICO AND THUS A VERY IMPORTANT ELEMENT OF OUR BANKING SYSTEM LIQUIDITY.

THE AVAILABILITY OF THESE RELATIVELY LOW COST FUNDS MAKES IT POSSIBLE FOR OUR FINANCIAL INSTITUTIONS TO LEND THEM AT A SIGNIFICANTLY LOWER INTEREST RATE THAN FUNDS OBTAINED FROM OTHER SOURCES.

THE PUERTO RICAN TREASURY DEPARTMENT THRU THE ISSUANCE OF RULINGS AND REGULATIONS HAS BEEN EXCERCISING ITS SUPERVISORY AUTHORITY TO SECURE THAT MOST OF THESE FUNDS ARE CHANNELLED INTO PRODUCTIVE INVESTMENTS IN OUR ECONOMY. THIS HAS PRODUCED A POSITIVE EFFECT IN OUR LOCAL ECONOMY, PARTICULARLY IN TIMES OF HIGH INTEREST RATES AND ECONOMIC RECESSIONS.

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OUR ECONOMY IS INTEGRATED WITH THE U.S. MAINLAND ECONOMY FROM WHICH WE PURCHASE OVER $5 BILLION WORTH OF GOODS AND SERVICES EVERY YEAR. OUR 936 COMPANIES PRODUCE IN PUERTO RICO THOUSANDS OF COMPONENTS AND PARTS WHICH ARE ESSENTIAL TO U.S. PARENT COMPANIES FOR PRODUCTION IN MAINLAND FACTORIES. THOUSANDS OF JOBS IN THE U.S. MAINLAND ARE TIED TO THE PRODUCTION MADE BY 936 COMPANIES IN PUERTO RICO.

UNFORTUNATELY, THE U.S. ECONOMY IS NOT AT ITS BEST. BIG DEFICITS, HIGH INTEREST RATES AND STAGGERING UNEMPLOYMENT HAVE FORCED U.S. GOVERNMENT OFFICIALS TO TRIM BUDGETS, RAISE TAXES AND REVISE FEDERAL PROGRAMS.

PUERTO RICO HAS TAKEN MORE THAN ITS SHARE OF THE FEDERAL CUTBACKS SINCE 1980, PARTICULARLY IN THE FOOD STAMPS PROGRAM, PUBLIC SERVICE JOBS AND ECONOMIC DEVELOPMENT LOANS AND GUARANTEES. PART OF THIS IS REFLECTED BY OUR CURRENT HIGH UNEMPLOYMENT RATE OF 22.8%. OUR SAGGING ECONOMY

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EXPERIENCED A NEGATIVE GROWTH OF 3.9% FOR FISCAL YEAR 82.

IT IS TRUE WE ARE EXPERIENCING BAD ECONOMIC TIMES IN THE U.S. MAINLAND BUT IT IS ALSO TRUE THAT THE SAME IS HAPPENING IN PUERTO RICO AND PROBABLY WITH MORE SERIOUS EFFECTS. FROM AN ALL TIME HIGH OF 159 THOUSAND JOBS IN 1979, MANUFACTURING EMPLOYMENT HAS DROPPED TO 139 THOUSAND.

MOST OF THE DECLINE IN MANUFACTURING EMPLOYMENT COULD BE ATTRIBUTED TO THE ECONOMIC CONDITIONS IN THE U.S. BUT SOME OF IT HAS BEEN CAUSED BY THE CLOUD OF UNCERTAINTY THAT DEVELOPED AROUND THE 936 PROGRAM EARLIER THIS YEAR.

IN THE MIND OF SOME IN CONGRESS AND IN THE U.S. TREASURY DEPARTMENT IT APPEARS THAT PERHAPS THERE WAS NO REASONABLE PROPORTION BETWEEN THE BENEFITS MADE BY THE INVESTORS AND THE NUMBER OF JOBS CREATED IN OUR ECONOMY BY THIS TAX POLICY. CONGRESS DECIDED TO LOOK INTO THIS

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MATTER EARLIER THIS YEAR IN THE MIDST OF A NEED TO RAISE $100 BILLION IN ADDITIONAL REVENUES.

WE ALL REMEMBER THOSE HECTIC WEEKS OF DEBATES AND PARLIAMENTARY MANEUVERING, WHEN MARATHON MEETINGS WERE HELD UNTIL THE EARLY HOURS OF THE MORNING. FOR MANY OF US THAT PERIOD MEANT RESTLESS NIGHTS AND DAYS OF ANXIETY WHILE MAKING TITANIC EFFORTS TO UNDO WHAT THE U.S. SENATE HAD DONE TO SECTION 936 WHICH WOULD HAVE SPELLED DISASTER FOR OUR ECONOMIC DEVELOPMENT.

IT WAS OF THE UTMOST CONCERN TO THE SENATORS THAT DEALT WITH SECTION 936 THAT JOBS BE CREATED AND MAINTAINED ON THE ISLAND. WE NOW HAVE IN PLACE A MODIFIED VERSION OF SECTION 936 WHICH PRESENTS THE CULMINATION OF TWO YEARS OF NEGOTIATIONS BETWEEN THE GOVERNMENT OF PUERTO RICO AND THE UNITED STATES TREASURY. THIS AGREEMENT CARRIES THE ENDORSEMENT OF GOVERNOR ROMERO BARCELO AND OF MYSELF, AS WELL AS THAT OF THE REAGAN ADMINISTRATION AND A BROAD

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SPECTRUM OF THE BUSINESS SECTOR. THIS MAY NOT BE A PERFECT LAW BUT IT IS A SIGNIFICANT IMPROVEMENT OVER WHAT WE HAD BEFORE, PARTICULARLY BECAUSE BY CORRECTING SOME POTENTIAL FOR ABUSE WE NOW HAVE A SOUND FISCAL POLICY LESS VULNERABLE TO CHANGE. IF ALL THE PARTIES CONCERNED APPROACH THE REVISED SECTION 936 PROGRAM WITH A FIRM DETERMINATION TO MAKE IT WORK I BELIEVE WE WILL SEE MANY BENEFITS TO PUERTO RICO, TO THE 936 COMPANIES AND TO THE NATION.

HOWEVER, RUMORS HAVE BEEN SPREAD THROUGH THE BUSINESS COMMUNITY THAT U.S. CONGRESS CONTEMPLATED RE-VISITING THIS RECENTLY MODIFIED PROGRAM IN THE NEAR FUTURE. SUCH UNFOUNDED RUMORS HAVE CAUSED SOME PROMISING NEW INVESTMENT, TO BE PLACED ON HOLD.

I AM CONVINCED THAT THE NEXT SEVERAL YEARS ARE NEEDED TO OBSERVE HOW THE RECENT CHANGES MADE TO SECTION 936 WORK. THIS SAME BELIEF WAS EXPRESSED BY U.S. TREASURY

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ASSISTANT SECRETARY, JOHN CHAPOTON IN A RECENT LETTER TO SENATOR ROBERT DOLE, CHAIRMAN OF THE SENATE FINANCE COMMITTEE.

THE BIG LOSER IF WE KEEP CHANGING THIS TAX POLICY CAN ONLY BE PUERTO RICO. THE COMPANIES CAN GO ELSEWHERE AND THE U.S. TREASURY CAN ALWAYS FIND ITS REVENUES SOME PLACE. THE THOUSANDS OF DIRECT JOBS AND ALL THE OTHER BENEFITS THAT PUERTO RICO DERIVES FROM ITS 936 COMPANIES MUST BE PROTECTED AND THIS CANNOT BE DONE ADEQUATELY UNLESS A DEGREE OF CERTAINTY IS PROVIDED TO THE PROGRAM.

TO CONCLUDE, I WILL LIKE TO RE-STATE THAT SECTION 936 IS NOT JUST A REVENUE PRODUCING MEASURE. IT IS A TAX POLICY INTIMATELY LINKED TO THE ECONOMIC AND SOCIAL DEVELOPMENT OF 3.2 MILLION AMERICAN CITIZENS.

THE U.S. TREASURY DEPARTMENT HAS THE DUAL, AND SOME WHAT CONFLICTING ROLE OF COLLECTING TAXES AND PREPARING AN ANNUAL REPORT TO CONGRESS ABOUT A UNIQUE ARRANGEMENT WHICH IS VITAL TO THE WELL-BEING OF THE 3.2 MILLION AMERICAN CITIZENS

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LIVING IN PUERTO RICO. FROM ITS FIRST 936 REPORTS IT IS CLEAR THAT THE TREASURY'S TAX COLLECTOR ROLE HAS GREATLY INFLUENCED AND EVEN OVERWHELMED ITS 936 EVALUATION ROLE. NOT ENOUGH RECOGNITION HAS BEEN GIVEN TO THE TREMENDOUS CONTRIBUTION BEYOND DIRECT JOBS AND WAGES THAT 936 COMPANIES HAVE MADE TO PUERTO RICO.

A BROAD ASSESMENT OF PUERTO RICO'S ECONOMIC DEVELOPMENT HAS BEEN MISSING IN THE NARROW COST CALCULATION MADE BY THOSE WHO HAVE BEEN ENTRUSTED WITH THE DUTY OF DRAWING UP THE ONLY ANNUAL EVALUATION OF SECTION 936.

WE HAVE TO MAKE SURE THAT CONGRESS IS WELL INFORMED ABOUT WHAT SECTION 936 MEANS TO PUERTO RICO. WE MUST BRING TO THE ISLAND AS MANY MEMBERS OF CONGRESS AS WE CAN SO THAT THEY CAN SEE FOR THEMSELVES JUST HOW IMPORTANT THIS TAX POLICY IS TO OUR ECONOMIC DEVELOPMENT AND TO ALLOW THEM TO GAIN A FIRST HAND KNOWLEDGE OF HOW SECTION 936 IS

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BEING IMPLEMENTED, AND THUS ACCURATELY ASSESS THE IMPACT OF THIS TAX POLICY IN OUR ECONOMY.

CONGRESS HAS OVERSIGHT JURISDICTION OVER FEDERAL TAX POLICY AS WELL AS CONSTITUTIONAL POWERS TO ENACT FEDERAL TAX LAWS. THUS, ANY FEDERAL TAX POLICY MAY COME UNDER THE SCRUTINY OF CONGRESS AT ANY TIME. HOWEVER, ANY RENEWED EFFORT BY CONGRESS TO FURTHER AMEND SECTION 936 AT PRESENT WILL BE COUNTER PRODUCTIVE.

IF ANY MODIFICATIONS TO SECTION 936 ARE NEEDED IN THE FUTURE, THEY SHOULD COME ONLY AFTER CAREFUL EVALUATION OVER A NUMBER OF YEARS OF THE CHANGES JUST MADE, AND THEIR ONLY AIM SHOULD BE TO IMPROVE PUERTO RICO'S ABILITY TO ATTRACT CAPITAL INVESTMENTS AND TO CREATE MORE JOBS IN OUR ECONOMY.

I AM SURE THAT THE SINCERE CONCERN MOST MEMBERS OF CONGRESS HAVE TOWARD THE WELL BEING OF THEIR FELLOW AMERICAN CITIZENS LIVING IN PUERTO RICO WILL OVERRIDE ANY SHORT TERM BUDGETARY GAIN TO BE MADE BY ANY CHANGE TO THIS PROGRAM, A GAIN, BY THE WAY, WHICH WOULD BE MORE ILLUSORY THAN REAL, MORE THEORETICAL THAN PRACTICAL. BY LEAVING THIS TAX POLICY UNTOUCHED FOR THE NEXT SEVERAL YEARS CONGRESS WILL BE HONORING ITS COMMITTMENT TO PROMOTE THE WELL BEING OF THEIR FELLOW AMERICANS IN PUERTO RICO.

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Chairman MINISH [presiding]. Thank you, Mr. Corrada, for an excellent statement.

The subcommittee will stand in recess for 20 minutes. We have votes on the floor. We should be back here as soon as possible.

[Brief recess.]

Chairman MINISH. The subcommittee will come to order.

Mr. Corrada, would you like to join us up here?

Will Mr. Agosto come to the committee table, please?

Senator, it is a pleasure to have you here. We understand that you have a time problem. We can put your full statement into the record, and you can proceed as you wish.

STATEMENT OF HON. MIGUEL HERNANDEZ AGOSTO, PRESIDENT OF THE SENATE OF PUERTO RICO

Mr. AGOSTO. Thank you very much, Mr. Chairman. I appreciate very much this opportunity to appear before this committee to present our views in relation to section 936 of the Internal Revenue Code.

I further appreciate the special arrangements you have made for me to appear before you today.

Just for the sake of brevity, I will refer to my summary, beginning on page 4, from the third paragraph on.

It should be the purpose of section 936 corporations to take the jobs to the people. This should be done while the Congress refrains from tampering with the provisions of section 936.

The fundamental purpose of section 936 is to induce U.S. firms to make direct investments in Puerto Rico. It is a well-known fact that in an atmosphere of uncertainty, investment does not take place. The Congress should remove uncertainty about the future of section 936 and its various provisions so that the existing and potential section 936 corporations can take the necessary risks leading to direct investment in Puerto Rico.

The Congress should recognize that provisions in the laws such as the section 936 are necessary because of our needs and future of our free enterprise economic system.

Under our economic system, we must seek economic development from private capital investment. The role of public sector is limited to infrastructure which includes the construction of roads, ports, airports, utilities, and provision for in health facilities.

Through billions of dollars of investment, Puerto Rico has created a workable economic infrastructure within which the private enterprise can thrive, make investment, manufacture products, create jobs, and reap profits.

We are cognizant of the fact that unless private investment takes place, we cannot maximize the outcome of our efforts.

We must induce the investors. The fiscal system of Puerto Rico has successfully induced the investors to come to Puerto Rico which was made possible by our Investment Acts of 1948, 1974, and partly by section 931 which was legislated in 1921 and continued to be applicable—until 1976.

A major characteristic of section 931 was that it was not significantly changed during its history of 55 years. It provided the inves-

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tors with the rules of the game in which they could prepare the game plan and operate their businesses.

Mr. Chairman, we should provide the same kind of stability to section 936. We should let this section operate and draw experience from its operation. Any changes that the Congress may want to make in section 936 should be guided by the needs of those for whom this section has been legislated. When one out of every three workers is unemployed, the Congress should make the section 936 more accommodative.

On the part of Puerto Rico, we are considering the ways and means as to how can we use section 936 funds for the purpose of economic development. Experience has shown that investment in construction has a major impact on the economy of Puerto Rico. Leakages from this sector are limited and therefore the multiplier effect is high.

Within the construction sector, one of the areas needing stimulation is housing. Due to declining family incomes and high interest rates, housing construction has sharply declined.

We are considering that the financing structure of housing should be adapted to the nature and character of section 936 funds.

The section 936 passive funds are available for short-term purposes and the housing finance needs can be met by the availability of long-term capital. The normal housing mortgages are for a period of 30 years.

The Senate of Puerto Rico is considering the possibility that for a few years (for example, for 7 years) mortgage financing can be provided through section 936 funds and for the remainder years the mortgage financing can be provided through new institutional and conventional arrangements.

We are exploring how mortgages can be initiated by section 936 corporations and how section 936 corporations mortgage paper can be repurchased by both Government and private financial institutions.

In this exploratory venture, there should be a significant role for a number of Federal agencies such as the FHA, FmHA, GNMA and others involved in the provision of housing for families living in both urban and rural areas of Puerto Rico.

An effective plan to channel section 936 funds into housing may require changes in regulations adopted by Federal agencies or even new legislation. We think this is possible but it will take time.

I am sure that programs to channel section 936 funds into commercial agriculture, modernization of business, and tourism development can be effectively organized. Again, this takes time.

The decade of 1980 is unfolding. It is quite clear that the challenges of this decade will require bold and innovative action. The elected representatives of the people have obligations to identify the problems of the people, evaluate alternative ways to solve them, design necessary policies and programs, and implement the selected policies and programs.

For the 3.3 million people of Puerto Rico, the most important problem is unemployment, and I believe that section 936 can help alleviate this problem. Therefore, I recommend:

First, an absolutely essential change should be made: Section 936 should honor the contracts already made by the Government of

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Puerto Rico with investors under its Industrial Incentives Act. In this way existing corporations will know the rules under which they operate from the Federal and Commonwealth governments for a reasonable period of time.

What I mean is this. If the contract is for 10 years or 15 years or 20 years, whatever length of time, then section 936 provisions should not be altered during the term of the contract with the Government of Puerto Rico. They should go hand-in-hand and thus give stability and remove uncertainty to the operations in Puerto Rico.

Second, that the Congress should make it clear that no changes will be made in the near future in section 936 of Internal Revenue Code. This section should be allowed to operate for a long time so that the existing and potential investors have full confidence in it, and it should allow time to develop effective programs to channel section 936 funds into development.

This is exactly what happened with the previous section 931 enacted in 1921. It wasn't changed significantly until 1976.

Third, Congress and the administration should help facilitate the channeling of section 936 funds for long-term purposes, such as construction of homes by adopting, as needed, new legislation or regulations to stimulate such action.

What I mean is this: We in Puerto Rico have the responsibility to design and formulate programs, development programs which will attract section 936 funds. In this effort, we may have need of new Federal legislation or changes in regulations to the point that these are required, in order to facilitate the investment of 936 funds in Puerto Rico. This should be done.

All this takes time; time that we need in Puerto Rico to channel these funds into the economy for the development of the island and the well-being of the people of Puerto Rico.

I think that in making this statement of allowing time for the operation of section 936, we in Puerto Rico stand for it. There are no partisan differences. There are no differences between government and the private sector.

I urge you gentlemen to join us in providing this kind of stability for the development of Puerto Rico.

[The prepared statement of Mr. Agosto follows:]

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Prepared Statement of Migrud Hernandes Agosto

Mr. Chairman:

I thank you for this invitation to give testimony on the Impact of Section 936 of the Internal Revenue Code (IRC) on the Economy of Puerto Rico. This document represents my complete testimony. Before this Committee, I shall summarize this document in the alotted time:

The Section 936 was legislated in 1976, and before it, the Section 931 of IRC was operative. This section provided for the rule of conduct for direct investment of the U.S. Corporations in Puerto Rico. Therefore, in this testimony, for historical purposes, I shall analyze the economic impact of Section 931. In addition, I shall discuss Section 936 in the context of its impact on the economy, manufacturing sector, and government revenues. The contention of my testimony is 1) that the Section 936 has very positive impact on our economy, manfucaturing activity and government revenues, 2) that both the present and future jobs and income needs of Puerto Rico are great, and 3) that, therefore, the United States Congress should remove any doubts about the future of Section 936, and thereby, reduce risks emerging from Congressional actions on the volume and direction of investments and loans by the 936 corporations in Puerto Rico.

ECONOMIC IMPACT OF SECION 931

Section 931 of the U.S. Internal Revenue Code (IRC) was legislated in 1921. During 1930's and World War II, it was not possible to make use of this Section. A deliberate and conscious effort was made in 1948 to make use of the Section 931., when Puerto Rico enacted its Industrial Incentives Act, under which industrial firms were given exemption from the payment of income taxes in Puerto Rico for a limited period.

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Provisions of Section 931

Section 931 of IRC made a provision that United States corporations which derived more than 80% of its gross income from sources within possessions of the United States and more than 50% of the gross income was derived from the active conduct of a trade or business within said possessions for a cumulative three year period, would only be subject to Federal income taxes on income received in the United States. In the case of qualifying corporations, this meant that such a corporation could operate under the Puerto Rico tax exemption program, reinvest its earnings in foreign countries and receive up to 20% of its income from sources outside the United States and Puerto Rico and pay no taxes anywhere on said income unless the foreign country happened to assess a tax. A foreign corporation operating in Puerto Rico is subject to local taxes only on its Puerto Rico source income and in the case of a corporation which received a local industrial tax exemption grant, the entire Puerto Rico source of income of said corporation was usually covered by said grant.

With the flexibility of being able to invest its earnings abroad, primarily in tax exempt certificates of deposit in foreign countries and other possessions of the United States, without paying income tax, said corporation could wait until the end of its normal tax exemption period under the tax laws of Puerto Rico, without paying ordinary dividends or repatriating profits to its parent. Eventually, the possession corporation was liquidated tax free into its United States parent, an event that normally occurred at the expiration of the tax exemption period. Financing of other foreign subsidiaries from the tax exempt earnings generated by the possession corporation and the repatriation of earnings of the foreign subsidiary was also possible free from Federal and Puerto Rico income taxes.

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Economic Impact of Section 931 (1950-73)

The standard of living of a family in Puerto Rico was very low in 1950. Per capita income was $296, as compared to $1497 for the nation as a whole. One fourth of the population could not read or write. About 40 percent of the population did not have piped water and 51 percent of the families did not have electricity. For every 1000 persons, there were barely 16 telephones or one telephone for 63 persons. The change of such conditions was not an easy task, particularly when there was a high degree of population density, small land area (3,500 square miles), and virtual absence of known natural resources.

It was felt then, as well as now, that we must find adequate employment opportunities for our growing population and labor force. The creation of jobs required substantial investments in capital resources and educational endowment to compensate for the lack of natural resources. Because of low family incomes and high unemployment rates, it was not possible to finance the required investment from resources within Puerto Rico.

The small economic size of the local market was another constraint in the way of improving the standard of living of the American citizens living in Puerto Rico. Thus, our economic strategy required that we should produce for local market as well as for exports. However, because of the distance of 1000 miles from the contiguous U.S., the factor of transportation cost was seen to be a major problem, particularly when the trade between Puerto Rico and U.S. must be carried out in the American flagships, which are generally more costly than other competing shipping facilities.

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It was a challenging task. But people of Puerto Rico and their elected representatives, under the guidance of Don Luis Muñoz Marín, accepted the challenge and designed policies and programs to improve economic and social conditions of Puerto Rico. The conditions changed dramatically during the period of 1950-1973.

During the perio of 1950-1973, Puerto Rico's annual gross national product increased from $755 million to $6,270 million, which produced an increase in per capita personal income from $347 to $1,183 in constant 1954 dollars. During the same period the island's population increased from 2,200,000 to 2,865,000. As a result, the labor force rose from 684,000 to 858,000, while employment grew from 596,000 to 757,000. The labor force participation rate of the population 16 years and older declined from 53.0 percent to 45.0 percent, while the unemployment rate remained substantially unchanged, 12.9 vs. 11.8 percent.

The industrial development program significantly altered the structure of the island economy. Between 1950 and 1973, employment in agriculture declined from 35.9 percent to 6.5 percent of total employment, while employment in construction, trade, and other service activities increased commensurately. Manufacturing employment outside the home needlework industry more than doubled, from 55,000 to 142,000.

For the period of 1950-1973, through efforts of the Economic Development Administration, net income from manufacturing increased from $89 million to $1,543 million or from 14 percent to 30 percent of the value of product during this period, and this is a measure of great importance because Formento's promotional efforts and other factors affecting industrialization were made possible by Section 931. The composition of Puerto Rican manufacturing output has been altered substantially during the 23 years. The establishment of new industries produced a more diversified base.

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As a result of a growth of manufacturing in Puerto Rico, trade with the mainland has risen markedly, and the degree of integration of the insland's economy into the mainland system has increased. This is reflected in the rise in the volume of Puerto Rican merchandise exported, which increased from $24.4 million or 32 percent of output in 1950 to $2,532 million or 40 percent of output in 1973. Imports, on the other hand, increased from $350 million to $3,471 million during the same period. Most of these exports and imports are from the U.S.

During the period 1950-1973, as a result of changes in the economy, family income increased from $1,495 to 7,448, an increase of 398 percent, or an average annual increase of 7.3 percent. Along with economic improvements, a great deal of social improvements were brought about. These improvements came about due to deliberate efforts of Puerto Rico within the context of the Section 931 of IRC. It should be pointed out that during the period of 1950-1973, gross fixed investment as a percentage of GNP increased from 14.7 percent to 28.6 percent. Private investment as a percentage of GNP increased from 6.8 percent to 16.5 percent and public investment increased from 7.9 percent to 9 percent. Thus, it can be seen improvements in economic conditions were brought about by full fledged participation of the private sector. The role of the public sector in the economic development of Puerto Rico was that of a catalyst, providing infrastructure consisting of schools, hospitals, roads, ports, airports, water, sewerage, etc.

The structural change in the economy of Puerto Rico increased the movement of people from rural areas to urban areas where the jobs were in the industrial and service sectors of the economy. Job opportunities in industry increased the demand for university and technical education. University and college enrollment increased by six times during the period of 1950-1973. The expansion of urban population also increased the demand for all types of utilities, and transportation and communications services. Also, health services were improved, life expectancy in Puerto Rico rose from 61 to 74 years, while in the U.S. contiguous states it rose from 68-73 years.

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OIL CRISIS AND RECESSION OF 1974-1976

The spectacular economic growth of Puerto Rico was adversely affected by a sudden oil increase in 1974. It should be pointed out that almost all the energy needs of Puerto Rico are satisfied by oil imports from the foreign countries. During the period 1974-1976, oil prices almost quadrupled.

Oil price increase brought about recession in the U.S. In 1972 prices, GNP of the U.S. declined from $1,230.4 billion in 1974-I to $1,161.1 in 1975-I, a decline of $69.3 billion or 5.6 percent.

Oil price increase and the U.S. recession created serious economic problems for Puerto Rico. Total employment declined from 775,000 in May 1974 to 682,000 in January 1976, a loss of 93,000 jobs or 8.8 percent. During the same period the manufacturing sector lost about 18,000 jobs and the construction sector lost about 35,000 jobs. In fact, within a short period of a few months, the construction jobs were halved.

The number of unemployeds was 110,000 in May 1974. By January, 1976, this number had increased to 192,000, an increase of 75 percent. During the same period. the rate of unemployment increased in Puerto Rico from 12.6 percent to 22.0 percent. The details are shown in the following tables: No. 1,2 & 3.

Within the same period, per capita GNP declined from $1,214 to $1,174 in constant 1954 prices and personal consumption expenditures also declined from $1,128 in 1974 to $1,099 in 1975.

The recession impacted the construction industry very heavily and the value of construction activity declined from $1481 million in 1975 to $1004 million in 1977, a decline of 32 percent within a period of two years.

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TABLE 1

TOTAL UNEMPLOYMENT IN PUERTO RICO, 1970-77, BY MONTH

(000)

Year	Jan.	Feb.	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.	Annual Average Natural	Annual Average Fiscal
1970	87	80	76	76	75	31	85	88	89	89	83	88	83	78
1971	100	92	82	80	82	97	98	100	100	99	99	93	93	88
1972	113	104	96	94	92	98	100	110	101	99	101	95	100	99
1973	113	102	101	94	90	97	114	107	107	99	93	91	101	100
1974	116	114	109	105	111	124	123	121	115	112	119	121	116	107
1975	147	147	145	138	138	163	169	171	164	164	171	174	157	132
1976	192	183	171	153	150	135	186	185	178	177	186	175	177	171
1977	195	172	175	184	190	209	200	194	194	182	178	167	187	184

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TABLE 2 RATE OF UNEMPLOYMENT, 1970-77, BY MONTH

(Percent)

Year	Jan.	Feb.	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.	Annual Average Natural	Annual Average Fiscal
1970	11.4	10.2	9.9	10.0	9.9	10.6	11.0	11.3	11.5	11.3	10.6	11.3	10.7	10.3
1971	12.7	11.8	10.5	10.2	10.4	11.9	11.8	12.3	12.0	11.9	11.9	11.2	11.6	11.2
1972	13.5	12.4	11.4	11.3	11.2	11.6	11.7	13.0	11.9	11.6	11.8	11.2	11.9	11.9
1973	13.2	12.0	11.8	11.1	10.6	11.2	13.1	12.3	12.1	11.5	10.5	10.4	11.6	11.8
1974	13.2	12.8	12.3	12.0	12.6	13.9	13.9	13.9	13.3	13.3	13.7	14.0	13.2	12.2
1975	17.1	16.9	16.7	16.1	16.0	16.8	19.2	19.8	18.8	18.7	19.2	19.9	18.1	15.3
1976	22.0	20.6	19.1	17.3	16.7	19.9	19.7	20.4	19.5	19.4	20.1	19.1	19.5	19.3
1977	21.3	18.7	19.1	20.2	20.8	22.1	21.0	20.2	20.1	19.1	18.7	17.9	19.9	20.0

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TABLE 3

LABOR FORCE IN PUERTO RICO, 1970-77, BY MONTH

(000)

YEAR	Jan.	Feb.	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.	Annual Average Natural	Annual Average Fisc
1970	769	781	768	756	762	762	772	777	773	784	784	780	772	760
1971	783	783	783	781	790	817	826	814	827	832	831	829	808	784
1972	832	842	835	828	824	850	856	848	848	860	854	845	844	831
1973	854	851	855	853	854	864	867	865	866	866	886	880	865	854
1974	878	885	883	872	886	892	888	872	867	862	866	864	876	879
1975	862	867	867	856	861	867	883	862	873	877	887	875	870	867
1976	874	886	895	887	899	929	943	907	915	913	926	920	908	885
1977	913	918	914	911	917	944	952	958	968	954	956	933	937	920

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A sharp drop in jobs, rising unemployment, declining standard of living and declining construction activity prompted the Government to seek new economic policy instruments. Since the key to economic development is investment, an obvious answer was to provide additional incentives to industrial investors.

It should be noted that the contribution of other economic sectors are important, yet limited. The tourism sector, for example, contributes about 7 percent of GNP. Thus, industrial sector is the one which leads the economic growth and other sectors follow the leader. In fact, on the manufacturing sector depends the rest of the economy of Puerto Rico.

ECONOMIC IMPACT OF SECTION 936

Provisions of Section 936 of 1976

The provisions of the Tax Reform Act of 1976 covering the area of possession corporations contained basically the following features:

1. The three year cumulative 80%-50% gross income and active conduct of trade or business tests within a possession of the United States must still be met in order to qualify as a possession corporation.

2. Instead of excluding from gross income for Federal income tax purposes, the income generated within a possession of the United States as under the predecessor Section 931, the entire income generated by a possession corporation, whether from sources within or outside the possession, will be subject to Federal income taxes. However, a credit against the Federal income tax will be allowed for the Federal Income Tax applicable to the income earned within the possession in which the corporation actively conducts the trade or business. This means that any income earned outside Puerto Rico by a possession corporation, whether from other possessions where no trade or business is actively conducted or from foreign countries will no longer be exempt from Federal income taxes.

3. For all practical purposes, Section 936 provides the same basic results as its predecessor Section 931, but only with respect to the income earned within the possessions of the United States (including Puerto Rico) in which the trade or business of the corporation is actively conducted. Under the predecessor Section 931, the income earned by the possession corporation within the possession in which the trade or business was actively conducted was excludable from the Federal income tax return of the possession corporation. Under the new Section 936, this income is now includable in the Federal income tax return but because of the credit which is allowed against the

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Federal income tax for the Federal income tax applicable to said income, the income so earned still ends up being exempt from Federal income taxes. Thus, the basic change brought about by Section 936 in this particular area was basically limited to the current Federal taxation of income earned from other possessions in which no trade or business is actively conducted or from other sources outside Puerto Rico and the United States.

4. No foreign income tax credit or deduction was to be allowed against the Federal income tax for any taxes paid to possessions of the United States or foreign countries on any income earned within the possession in which the trade or business is actively conducted, which otherwise qualifies for the Federal income tax credit for the Federal income tax applicable to said income. This means that no credit will be allowed against the Federal income tax for any taxes paid to Puerto Rico on income earned within Puerto Rico by a possession corporation, or on dividends paid to the United States corporate stockholder of said corporation. However, income taxes paid to possessions of the United States and foreign countries on income earned outside the possession in which the trade or business is actively conducted still qualify for the foreign income tax credit against the Federal income tax. The reason for the allowance in this case is that said income is fully taxable in the United States without the benefit of the Federal income tax credit applicable to the possession source income under Section 936.

5. Dividends paid by a possession corporation to its United States domestic parent or other corporate shareholdres will qualify for the 100% or 85% dividend received deduction. This means that in the case of a wholly-owned subsidiary qualifying as a possession corporation, dividends may not be paid to its United States parent completely free from Federal income taxes. While, the effective date for the taxation of income earned outside the possession in which the trade or business

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is actively conducted is October 1, 1976, the 100% or 85% dividend received deduction applies to dividends paid out of earnings generated prior or subsequent to said date.

6. In order to take advantage of the possession corporation status, the qualifying corporation should make a positive election to that effect. Said election could not be revoked before the expiration of the 9th taxable year following the year for which the election first applies except with the consent of the Secretary of the Treasury. Revocation of the election is permitted without the Secretary's consent for any taxable year after the expiration of the 9th taxable year of the election.

9. Corporations which have made the election to be treated as possession corporations will not be allowed to be included in the consolidated income tax return of the parent company during the period of the election. This provision eliminated the benefit which was previously available under predecessor Section 931 where the possession corporation could be included in the consolidated income tax return of the United States parent in a loss year and excluded in a profitable year.

Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

1. Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") became law on September 1982. Section 213 of TEFRA makes certain amendments to Section 936 which affect the Federal income tax treatment of U.S. corporations operating in Puerto Rico which have elected the benefits of Section 936 ("936 Corporations").

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2. Effective after December 31, 1984, the portion of a 936 corporation's gross income which must be derived from the active conduct of a trade or business has been increased from 50% to 65%. This means that for any given taxable year beginning after December 31, 1984 and for the immediately preceding two taxable years (this nature of income test is based on a three year average) a 936 corporation can not derive more than 35% of its total gross income from passive investments. A transitional rule is provided, however, with respect to taxable years beginning in calendar year 1983 and 1984. For these years the applicable percentage of the minimum amount of income which a 936 corporation must derive from the active conduct of a trade or business is 55% and 60%, respectively. A 936 corporation which fails to satisfy this active trade or business income requirement is ineligible for the benefits of Section 936 and, therefore, is subject to Federal income taxes with respect to its entire income.

3. The most important amendment made by TEFRA relates to the tax treatment which will be given to the income of a 936 corporation attributable to intangible property. The essence of the new rules is that 936 corporations will be permitted to determine the amount of income which is eligible for the Section 936 credit according to one of the following three income methods "cost plus", "cost sharing", or "profit split".

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4. Cost Plus Method: In the case of a 936 corporation which does not make the special "election", the amount of income which may be sheltered from Federal income taxes by the Section 936 will be limited to an amount which represents a "reasonable" profit on the manufacturing costs (including in appropriate cases the costs of raw materials) incurred by such corporation. In essence, a 936 corporation falling in this category will be required to determine the amount of income which is exempt from Federal income taxes on the basis of the "cost plus" formula typically used by contract manufacturers.

5. Cost Sharing: A U.S. company will be permitted to transfer certain manufacturing intangible assets to its section 936 subsidiary shares, through a cost sharing payment, in the annual product research expenditures (direct and indirect) incurred by all of its affiliates.

If the cost-sharing payment is made, the 936 subsidiary will be deemed to own the manufacturing intangible assets and will be entitled to a full return with respect to the products produced in Puerto Rico. The cost-sharing payment is to be computed as follows:

$$\frac{\text{Third-party sales proceeds of the affiliated group of product produced in whole or in part (or service rendered) by 936 corporation}}{\text{All third party sales proceeds of the affiliated group of products produced in whole or in part (or services) rendered) by all affiliates (U.S. and foreign) in the same product area}} \times \text{Worldwide product area research expenditures}$$

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Manufacturing intangible covered by cost sharing option must be related to the products produced in Puerto Rico. They include patents, inventions, formulas, processes, designs, patterns, and know-how. Assuming the 936 company meets one of the significant business presence tests, it will be deemed to own all the manufacturing intangible. No other intangibles, including marketing intangibles, such as trademarks, trade names, brand names, franchises, licenses or contracts, etc., can be transferred to the section 936 subsidiary.

6. 50%-50% Profit Split: The cost sharing option still requires the setting up of transfer prices for sales to the U.S. parent company that reflect the value of manufacturing intangibles. The valuation process may be further complicated by the presence (or development) of marketing intangibles, which would require a separate valuation. Income from the use of marketing intangible cannot be reflected in the transfer price to the parent company.

Under this election, the "combined taxable income" of the 936 corporation and its U.S. affiliates will be split 50% each. Hence, 50% of such profit will be allocated to U.S. affiliates.

The combined taxable income of a 936 corporation and its U.S. affiliates will be determined on a product-by-product basis, as follows:

Gross receipts of the affiliated group from sales to unrelated third parties and/or foreign affiliates of products produced in whole or in part in Puerto Rico.

minus

Total cost relating to such products incurred by the 936 corporation and its U.S. affiliates

equals

Combined Taxable Income to be split 50/50

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Impact on the Manufacturing Sector of 936

The impact of the 936 corporations can be studied by means of analysis as to how many jobs such coroporations create and by means of how much net income (national income) is generated by them. In order to study these questions, we must look at the data compiled by the Puerto Rico Planning Board and the Department of Labor and Human Resources.

The Department of Labor compiles data on the jobs created by the Economic Development Administration (EDA) which is synonymous with the jobs created by 936 corporations. In June of 1976, there were 115,500 Fomento promoted jobs in Puerto Rico, and by June 1981, the number of such jobs had increased to 131,000. Thus, during this period of 5 years, EDA promoted jobs increased by 15,500, which is approximately 9 percent of total manufacturing jobs (139,000) in September, 1982.

It should be noted that the number of EDA promoted jobs has declined since June, 1981, due mainly to the U.S. and world recession. The number of jobs was 119,100 in September, 1982. It should be noted that the EDA promoted jobs in Puerto Rico have a very high positive correlation with the industrial production index in the U.S. While EDA promoted jobs declined between June of 1981 and August of 1982 by 8.5%, the U.S. industrial production index declined by 9.7%. The details of EDA promoted jobs and the industrial production index of the U.S. are given in the next 2 tables.

Further, it should be pointed out that EDA promoted manufacturing plants generated net manufacturing income amounting to $2,129 million in 1976. This amount by 1981 had increased to $4,124 million, an increase of 93.7% or an annual average increase of 14.1%. This amount of value added by the manufacturing plants was distributed among wage earners and in the form of interest, dividends and rent. The production workers of the manufacturing sector were paid $53 million in the form of salaries and wages in the month of June of 1976. These wage payments by August of 1981 had increased to $89.9 million, an increase of 69.6%. Of course, the wages of production workers by August, 1982 have declined to $82.3 million. The decline can be attributed to the prevailing recession. The details of wages paid to the production workers are given in Table 6 .

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TABLE 4 EDA PROMOTED JOBS IN PUERTO RICO
(in Thousands)

Year	Jan.	Feb.	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.	Annual Average Natural	Annual Average Fiscal
1973	115	117	121	110	122	123	119	122	123	124	125	123	121	116
1974	118	121	123	124	124	124	125	122	122	122	121	116	122	123
1975	111	110	107	106	105	106	105	107	106	110	112	112	108	114
1976	112	114	114	117	116	116	117	117	118	119	119	118	116	112
1977	116	118	119	120	120	120	121	122	120	123	122	121	120	118
1978	119	121	124	127	126	128	128	127	130	131	132	130	127	123
1979	128	131	131	133	132	130	130	128	131	133	133	134	131	130
1980	132	132	128	132	131	131	129	128	129	131	132	132	130	131
1981	129	132	131	131	131	131	131	131	130	130	128	127	128	128
1982	128	128	128	128	123	132	119	120	119					

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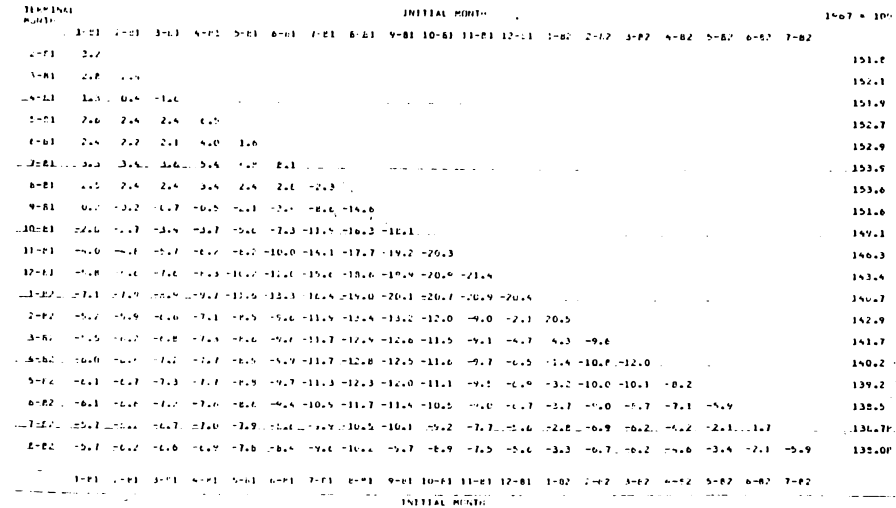
TABLE 5 U.S. INDUSTRIAL PRODUCTION COMPOUNDED ANNUAL RATES OF CHANGE



Source: Federal Reserve Bank of St. Louis, Oct. 22, 1982.

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TABLE 6

WAGES PAID TO PRODUCTION WORKERS OF THE MANUFACTURING SECTOR

(MILLIONS OF DOLLARS)

MONTH	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81	1981/82	1982/83
JULY	49.1	43.8	53.3	58.7	67.5	75.0	79.2	88.9	82.1
AUG	47.9	44.8	52.6	58.4	67.8	74.5	81.3	89.9	82.3
SEPT	48.2	44.3	53.2	59.1	69.4	79.2	83.1	88.0	
OCT	47.5	46.1	55.1	61.7	71.9	80.4	83.7	89.4	
NOV	47.6	48.8	56.2	60.6	74.1	81.9	88.7	89.2	
DEC	45.2	49.1	55.2	59.5	70.7	81.1	86.7	87.7	
JAN	41.6	49.7	52.6	60.7	72.6	78.6	88.1	86.5	
FEB	43.5	50.5	56.4	64.5	77.4	83.8	88.8	87.8	
MAR	43.2	50.9	57.7	66.0	77.1	82.7	90.5	85.7	
APR	43.1	49.2	58.0	67.5	73.0	82.4	88.9	86.4	
MAY	43.6	53.6	58.2	66.1	74.6	82.8	89.9	85.4	
JUNE	43.1	53.0	58.6	68.1	73.4	80.9	88.7	84.2	
SUM	542.6	583.8	667.1	750.9	869.5	963.3	1037.6	1049.1	164.4

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IMPACT OF SECTION 936 ON THE GOVERNMENT REVENUES

The Fiscal system of Puerto Rico imbibes in it a good deal of elements of the Fiscal systems prevalent in the U.S. mainland at the Federal, State and local levels. When a person or a corporation has a dollar of income or a dollar of expenditures that particular activity is subject to tax.

Manufactuiring activity generates manufacturing profits, rent, interest, dividends and wages. While the income emerging from the concepts of profits, rent and interest might be tax exempt, there are incomes classified under the concept of wages which are subject to personal tax and indirect taxes. Also it should be pointed out that when incomes arising from dividends, interest, rents and profits are spent, they are subject to excise taxes, licenses, etc. This section of my presentation discusses the impact of 936 corporation activities on the Government revenues in Puerto Rico.

Revenues for the General Fund

The revenues for the General Fund of the GOPR are shown in Table 7

TABLE 7 GOPR: GENERAL FUND REVENUES (CASH) FOR F.Y. 1978-1982

(Thousands of Dollars)

	1978	1979	1980	1981	1982
Revenues from internal sources					
Property taxes	$ 46,547	$ 55,537	[illegible]	[illegible]	[illegible]
Income taxes					
Individuals	380,783	443,788	514,273	590,503	647,376
Corporations	180,966	197,802	233,9[illegible]	281,598	[illegible]
Partnerships	9,237	3,970	[illegible]	[illegible]	[illegible]
Withheld from non-residents	23,408	27,021	26,525	31,436	[illegible]
Tollgate taxes	49,064	64,987	81,251	[illegible]	[illegible]
Total income taxes	643,458	737,565	863,035	966,696	[illegible]
Inheritance and gift taxes	8,584	10,203	[illegible]	12,373	14,120
Excise taxes					
Alcoholic beverages	115,329	125,607	[illegible]	144,188	[illegible]
Cigarettes	70,700	72,445	83,194	[illegible]	[illegible]
Motor vehicles and accessories	99,683	110,012	[illegible]	[illegible]	[illegible]
5 percent general tax	82,449	83,466	94,371	[illegible]	[illegible]
Other excise taxes	127,216	86,297	[illegible]	[illegible]	[illegible]
Total excise taxes	495,377	477,830	[illegible]	[illegible]	[illegible]
Licenses	27,983	29,080	[illegible]	[illegible]	[illegible]
Lottery	39,206	45,341	41,096	[illegible]	[illegible]
Miscellaneous non-tax revenues	34,914	38,570	[illegible]	[illegible]	[illegible]
Total revenues from internal sources	1,296,069	1,394,129	[illegible]	[illegible]	[illegible]
Revenues from non-Commonwealth sources					
Customs	[illegible]	64,224	[illegible]	[illegible]	[illegible]
Federal excise taxes	155,314	[illegible]	[illegible]	[illegible]	[illegible]
Total revenues from non-Commonwealth sources	212,001	[illegible]	[illegible]	[illegible]	[illegible]
Total	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Source: Dept. of the Treasury

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Tax System of Puerto Rico

The tax system of Puerto Rico includes almost all the conventional taxes, including income tax, excise taxes, property taxes, licenses, etc. A brief description of each one of the taxes is provided in the following sections.

Personal Income Tax- Puerto Rico's income tax system of normal tax and surtax rates was replaced in 1979 by a new single system of rates, ranging from 11.4% on the first $2,000 of taxable income to 75.05% on taxable income in excess of $200,000 for the 1979 tax year and from 10.0% on the first $2,000 of taxable income to 71.1% on taxable income in excess of $200,000 thereafter. Two sucessive additional 5% reductions in personal income taxes are effective for the 1981 and 1982 tax years. For 1981 the rates range from 10.26% on the first $2,000 of taxable income to 67.55% for taxable income in exvess of $200,000 and for 1982 from 9.72% on the first $2,000 of taxable income to 64% on taxable income in excess of $200,000 thereafter. When wages of the workers increase due to 936 corporations manufacturing activity, like other activities income, the incomes from manufacturing are also subject to income tax.

Corporate Income Tax- Corporations and partnerships that are subject to income taxes are taxed at a normal rate of 22% of "normal tax net income" and are also subject to surtaxes on "surtax net income" of 9% on the first $75,000, with graduating rates up to $275,000 of "surtax net income" and any additional "surtax net income" is taxes at the maximum rate of 23%.

The GOPR also imposes a Toll Gate Tax on dividends and profit shares repatriated to United States corporations operating under Section 936 of the Internal Revenue Code. The basic Toll Gate Tax rate is 10%, but it is subject to reduction with respect to profits earned on the island and invested there in certain eligible instruments for specified periods of time.

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Revenues from non-Commonwealth sources include Federal grants, customs duties collected in Puerto Rico, and excise taxes on shipments of tobacco products and alcoholic beverages (mainly Puerto Rican rum) from the island to the mainland United States. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth.

The revenues from customs duties will increase due to increased expenditures on imported goods. However, excise taxes or offshore shipments are not affected by increased economic activity in Puerto Rico.

Adjustments in Revenues

The revenues given in table 7 should be adjusted so as to approximate them to the economic base of Puerto Rico. The adjustment will require that certain revenues should be excluded and others included.

The revenues from the Federal excise taxes should be excluded. The revenues earmarked for the Highway Authority and the University of Puerto Rico should be included. Some adjustments for property taxes are also necessary. On the basis of the adjustments, table 8 has been prepared.

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Excise Taxes

Prior to February 4, 1975, specified commodities and services were subject to excise taxes at various rates. Among the taxed items were gasoline, alcoholic beverages, cigarettes, motor vehicles, tires and tubes, jewelry, electrical and gas appliances, television and radio sets, public shows, hotel rooms, and others. Effective February 4, 1975, all goods not previously subject to excise taxes and not specifically exempted became taxable at the wholesale level at a rate of 5% based on taxable value (FOB cost plus 32% for imported goods and manufactured cost plus 10% for goods produced in Puerto Rico). Improved manufacturing activity should increase expenditures on various items subject to excise taxes.

Property Taxes

Real and personal property are assessed by the Department of the Treasury, and taxes thereon are collected by it, but for municipal and Commonwealth purposes. Personal property, which is assessed approximately at market value and consists almost entirely of inventories and other business property, accounts for approximately 37% of total assessed valuation.

The Commonwealth property tax rate is $4.03 per $100 of assessed value for real property and $2.03 per $100 of assessed value for personal property. With increased manufacturing activity, people and business acquire both real and personal property, which are subject to tax.

Other Revenues

Other internal taxes are estate, gift, and license taxes. Motor vehicle license plate and registration fees comprise the major portion of license tax receipts. They are affected by increased incomes.

Commonwealth non-tax revenues consist principally of lottery proceeds, documentary stamps, permits, fees and forfeits, interest earned on bank deposits, proceeds of land sales, income from investments and reciepts from public corporations in lieu of taxes. All these are affected by increased incomes.

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TABLE 8 REVENUES ATTRIBUTED TO THE ECONOMIC BASE OF PUERTO RICO
(Million of $)

	1978	1979	1980	1981	1982
General Funds Revenues	1,508	1,630	1,809	1,985	2,096
Less: Federal Excise Taxes	- 212	- 236	- 240	- 301	- 285
Plus: Highway Authority, Gasoline Tax	109	112	109	103	97
Plus: UPR Earmarked Funds	117	124	129	139	150
Plus: Adjustment for Property Tax	158	171	194	198	203
Plus: Others	96	99	74	47	50
Adjusted Revenues	1,776	1,900	2,075	2,171	2,311

Source: Department of the Treasury:
The Document on Issuance of Bonds, Sept. 15, 1982

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Adjusted Revenues and Net Income

Table 9 shows that the revenues based on the economic base of Puerto Rico constituted 23.8 percent of net income (national income) in F.Y. 1982. This means that when net income increases by one dollar, revenues of the Government increase by 23.8 cents. This relationship fluctuates depending on the changes in revenues and net income. During the past five years, revenues as percent of net income remained within the range of 22.percent and 24.0 percent.

TABLE 9 ADJUSTED REVENUES OF THE GOVERNMENT AND NET INCOME OF PUERTO RICO

(Dollar figures in millions)

Year	Adjusted Revenues (1)	Net Income (2)	(1) as Percentage of (2)
1978	$1,776	$7,402	24.0%
1979	1,900	8,269	23.0
1980	2,075	9,072	22.9
1981	2,171	9,722	22.3
1982	2,311	9,703 1/	23.8

Source: Table 9, and Puerto Rico Planning Board.

1/ The data for 1982 is estimate based on GNP increase of 3.9 percent in constant prices and increase in consumer price index of 3.7 percent.

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Government Revenues Attributable to Section 936

Through the impact of Section 936, the Government in Puerto Rico receive approximately $696 million of revenues. It may be noted that in the estimation of these revenues, only compensation of employees have been taken into account. Obviously, the 936 corporation activities through local purchases also create economic benefits for the Puerto Rican economy. A good number of 936 plants use the real estate and industrial parks of the Puerto Rico Industrial Development Company. This public corporation makes payments for the upkeep of industrial parks and buildings.

The Government revenues attributable to the 936 corporations constituted 35.1 percent of the General Fund Revenues of the Government of Puerto Rico in 1981. This percentage was 38.3 in 1978.

TABLE 10 IMPACT OF SECTION 936 ON THE REVENUES OF THE GOVERNMENT
(Dollar Figures in Millions)

Year	Compensation of Employees in all Manufacturing	Compensation Under 936 Corporations 1/	Income with Multiplier Effect 2/	Effective Rate	Government Revenues
1978	$1323	$1204	$2408	24.0 %	$577.9
1979	1497	1377	2754	23.0	633.4
1980	1658	1542	3084	22.9	706.2
1981	1786	1660	3120	22.3	695.8

1/ It is assumed 91-93% of total compensation to employees accrue to the employees of 936 Corporations.

2/ Assumes a multiplier of 2, implying one dollar of compensation to employees leads to an additional dollar of net income in Puerto Rico.

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IMPACT OF SECTION 936 ON THE BANKING ACTIVITY

Section 936, among other things, grants a credit which offsets the Federal tax on Qualified Possession Source Investment Income (QPSII) earned by a U.S. corporation making a 936 election. QPSII is defined as gross income which is (a) from sources within a possession in which a trade or business is conducted, and (b) is attributable to the investment of funds derived from the active conduct of a trade or business in that possession. Thus, Section 936, made an important change from the earlier Section 931 which exempted all non-U.S. source income of possession corporations. Financial investments by 931 firms were therefore made outside of Puerto Rico because the investment income would thereby be free from both U.S. and Puerto Rican taxes. For this investment income to continue to be free of U.S. taxes, Section 936 required that they be invested in Puerto Rico.

To make use of the 936 provision, the Puerto Rico Industrial Incentive Act of 1978 grants a tax exemption from Puerto Rican tax for investment income derived from the investment of Industrial Development Income in certain specified investments. For most investments, this exemption had existed under the 1963 law, also. The investments that generate exempt interest, rents, and dividends investments are:

1. Puerto Rico Government obligations and loans to the Government Development Bank or other government agencies,

2. Mortgage loans or loans guaranteed by an agency of the Federal or Puerto Rico government,

3. Loans to the maritime industry,

4. Loans to small business operating in Puerto Rico which are guaranteed by the Puerto Rican or US governments,

5. Obligations issued by the Conservation Trust Fund of Puerto Rico.

6. Capital obligations issued by Puerto Rican banks as authorized by the Puerto Rico Banking Law,

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7. Investments in public buildings including schools and hospitals,

8. Nonredeemable preferred stock of banking institutions organized under the laws of Puerto Rico, and

9. Fixed-term deposits in qualifying banking institutions.

Table 11 provides the data on the outstanding 936 funds in Puerto Rico in May, 1982. Of $7.8 billion of 936 funds, about 84 percent were being used as loans and investments in the private and public sectors of the economy. For the public sector the 936 funded loans were for the purpose of investment in the infrastructure of Puerto Rico. The loans given to the private sector were for the financing of investment in plant and equipment, as well as to finance inventories and meet the operating capital needs of the commercial, industrial and hotel businesses.

TABLE 11 936 FUNDS, BY ELIGIBLE ACTIVITY
(Millions of $)

	May, 1982	Percent
Investment and Loans to Government	$1,797.1	23.1
Commercial Loans	3,690.3	47.5
Eligible Consumer Loans	238.5	3.1
Mortgage Loans	1,147.0	14.7
Real Estate Investment	98.8	1.3
Others	804.6	10.3
Total	7,776.3	100.0

Source: The Department of Treasury, Government of Puerto Rico.

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The new regulations on 936 corporations are affecting the 936 funds in Puerto Rico. The 936 corporations are in the process of analyzing their investment portfolios and due to the new restrictions, a liquidation of approximately $650 million will be required. If this is added to a repatriation equal to the $2.0 billion repatriated last year, we can expect an outflow of funds of approximately $2.6 billion. On the other hand, retained earnings would amount to $3.6 billion, not considering the impact of the changes in intangibles. If these are reduced by 30% under the new law, some $2.6 billion would enter the market. The funds that leave the system would be compensated for by the funds that enter.

The fund pool that would remain in our financial system should give a great degree of liquidity to the system. It would permit continued attention to the financial needs of the Government and of productive, viable private projects that promote the economic development of Puerto Rico.

In these months of high interest rates, 936 funds have kept the rates of interest somewhat lower than what would they otherwise be. As shown in table 12, in Calendar Year 1980, the spread between 936 rate and commercial paper and prime rate was 1.20 percent and 3.58 percent, respectively. Lower interest rates have been helpful in mitigating the depth of the 1981-82 recession, a recession considered deepest since the depression of the 1930's.

TABLE 12 COMPARABLE INTEREST RATES

1980	90-Day 936 Rate	90-Day U.S. Commercial Paper Rate	Prime Rate	Spread Between 936 Rate and Commercial Paper	Spread Between 936 Rate and Prime Rate
January	11.25%	13.04%	15.25%	1.79%	4.00%
February	11.96	13.77	16.75	1.81	4.79
March	13.22	16.81	19.25	3.59	6.03
April	11.53	15.78	19.50	4.25	7.97
May	8.75	9.49	14.00	0.74	5.25
June	8.12	8.48	11.50	0.14	3.38
July	8.38	8.39	11.25	0.011	2.87
August	9.18	9.57	11.11	0.39	1.93
September	11.61	10.97	11.26	(0.10)	(0.47)
October	13.16	12.52	14.02	(0.36)	1.86
November	14.19	15.18	16.00	0.99	1.81
Monthly Average				1.20%	3.56%

Source: Citibank—Puerto Rico Treasury Department

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IMPACT OF THE SECTION 936 IN THE FUTURE

Like many other recessions, the 1981-82 recession should end. In the United States economy, it is expected that the consumers will soon increase their expenditures, that housing starts will further accelerate, purchase of consumer durables will improve, and the industrial and commercial firms will start increasing expenditures on plant and equipment. The economy of Puerto Rico mainly through Section 936 should start participating in the forthcoming economic recovery. Puerto Rico should participate in economic recovery and should support the national recovery. It should be noted that the U.S. exports to Puerto Rico amounting to $5.1 billion in 1980 generated for the national economy 152,700 jobs. Such purchases, as shown in the enclosed chart, create jobs in a number of states. These purchases are made possible because Section 936 helps create production, income and jobs in Puerto Rico.

We must understand the importance of Section 936 not only in the near future but also in the long run. This provision in the I.R.C. is the most important source of prospective funds for direct investment in Puerto Rico. In my judgement, the role of Section 936 in the future economic growth of Puerto Rico will be equal to hitherto, or greater.

In the economy of Puerto Rico, we have approximately 240,000 workers unemployed. If we also include 60,000 workers who have withdrawn from the labor force, due to lack of jobs, it will be seen that there are 300,000 workers unemployed. During the next eighteen years, the labor force is expected to increase by about 40 percent from a little over 1 million to about 1.4 million. If we assume a rate of unemployment of 10 percent as normal in Puerto Rico, we must create approximately 500,000 jobs in Puerto Rico between now and the year 2,000. This will require the creation of about 26,000 jobs per year up to the year 2,000. With very substantial support of Sections 931 and 936, Puerto Rico's economy has been able to create 13,400 jobs per year during the period 1970-81.

It should be emphasized that Section 936 is designed to help the American citizens living in the Commonwealth of Puerto Rico and U.S. possessions. Thus,

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936 funds should be invested in activities that tend to increase income and employment of the people. We should continuously strive for channeling of these funds in the sectors of manufacturing, construction, tourism, agriculture and services. It is through this process that we can create jobs for the people who are suffering with rates of unemployment 2-3 times higher than the national unemployment rates and whose per capita incomes are merely one-third of the national average of $10,500.

Like any other American citizen, workers of Puerto Rico have moved about in the nation in search of jobs. My economic advisors have told me that it is cheaper to take jobs (and investment) to where the workers are rather than the other way around.

Consistent with the past, it should be the purpose of Section 936 to take the jobs to the people. This should be possible if the U.S. Congress refrains from tampering with the different provisions of Section 936. The fundamental purpose of the Section 936 is to induce the U.S. firms to make direct investment in Puerto Rico. It is a well known fact that in an atmosphere of uncertainty investment does not take place. The Congress should remove uncertainty about the future of Section 936, and its various provisions, so that the existing and potential 936 corporations can take the necessary risks leading to direct investment in Puerto Rico.

The Congress should recognize that such provisions in the laws, as the Section 936, are necessary because of our needs and future of our free enterprise economic system. Under our economic system, we must seek economic development through private capital investment. The role of public sector is limited to infrastructure, which includes the construction of roads, ports, airports, utilities and provision for educational facilities and health facilities. Through billions of dollars of investment, Puerto Rico has created a workable economic infrastructure within which the private enterprise can thrive, make investment, manufacture products, create jobs and reap profits.

While Puerto Rico has created infrastructure, we are congnizant of the fact that unless private investment takes place, we can not maximize the outcomes of

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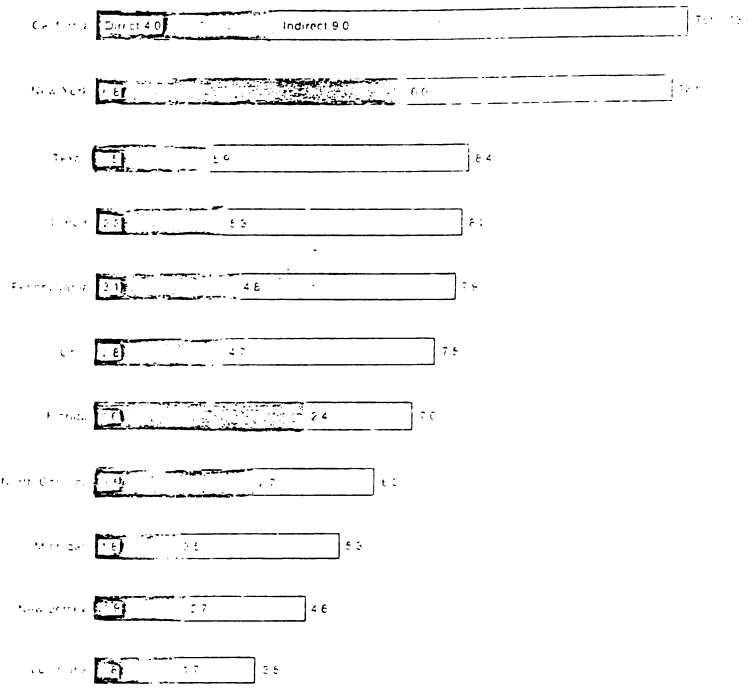
Employment Generated in the States Most Affected by Puerto Rico's Purchases from U.S. Mainland, Year Ending June 30, 1977

(In Thousands)



Source: Economic Development Administration, Puerto Rico's Purchases from Mainland States, Fiscal Year 1977, Economic Associates, Inc., Washington, D.C., June 1978.

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our efforts. We must induce the investors. The fiscal system of Puerto Rico has successfully induced the investors to come to Puerto Rico, which was made possible partly by our own Industrial Incentive Acts of 1948, 1974, and 1963 and partly by Section 931 which was legislated in 1921 and continued to be operative until 1976. A major characteristic of Section 931 was that it was not significantly changed during its history of fifty five years. It provided the investors with the rules of the game, in which they could prepare the game plan and operate their businesses.

Mr. Chairman, we should provide the same kind of stability to Section 936. We should let this section operate and draw experience from its operation. Any changes the Congress wants to make in Section 936, it should be guided by the needs of those for whom this Section has been legislated. When out of every three workers, one is unemployed, the Congress should make the Section 936 more accomodative and less restrictive for the existing and potential 936 investors in Puerto Rico and the U.S. possessions.

On the part of Puerto Rico, we are considering the ways and means as to how we can use 936 funds for the purposes of economic development. Experience has shown that investment in construction has a major impact on the economy of Puerto Rico. Leakages from this sector are limited and therefore the multiplier effect is high.

Within the construction sector, one of the areas needing stimulation is housing. Due to declining family incomes and high interest rates, housing construction has sharply declined. We are considering that the financing structure of housing should be adapted to the nature and character of 936 funds. The 936 passive funds are available for short term purposes and the housing finance needs can be met by long terms availability of capital. The normal housing mortgages are for a period of 30 years. The Senate of Puerto Rico is considering the possibilities that for a few years (for example for 7 years) mortgage financing can be provided through 936 funds and for the remainder years the mortgage financing can be provided through new institutional and conventional arrangements. We are exploring as to how mortgages can be purchased by 936 corporations and how 936 corporations mortgage paper can be repurchased by both government and private

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financial institutions. In this explorative venture, there should be a significant role for a number of Federal agencies such as the F.H.A., Fm. H.A., GNMA and others involved in the provision of housing for families living in both urban and rural areas of Puerto Rico. An effective plan to channel 936 funds into housing may require changes in regulations adopted by federal agencies or even new legislation. We think this is possible but it will take time.

I am sure that programs to channel 936 funds into commercial agriculture, modernization of business, and tourism development can be effectively organized. Again, this takes time.

The decade of 1980 is unfolding. It is quite clear that the challenges of this decade will require bold and innovative action. The elected representatives of the people have obligations to identify the problems of the people, evaluate alternative ways to solve them, design necessary policies and programs, and implement the selected policies and programs. For the 3.3 million people of Puerto Rico, the most important problem is unemployment, and I believe that Section 936 can help alleviate this problem. Therefore, I recommend:

1. An absolutely essential change should be made: Section 936 should honor the contracts already made by the Government of Puerto Rico with investors under its Industrial Incentives Act. In this way existing corporations will know the rules under which they operate from the Federal and Commonwealth governments for a reasonable period of time.

2. That the Congress should make it clear that no changes will be made in the near future in Section 936 of I.R.C. This section should be allowed to operate for a long time so that the existing and potential investors have full confidence in it, and to allow time to develop effective programs to channel 936 funds into development.

3. Congress and the Administration should help facilitate the channeling of 936 funds for long-term purposes, such as construction of homes by adopting, as needed, new legislation or regulations to stimulate such action.

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Chairman MINISH. Thank you, Senator.

You mention that Government revenues attributable to the section 936 corporations constitute 35.1 percent of the general fund revenue of the Government of Puerto Rico in 1981.

Has there been any estimate made of how this figure might change as the result of the amendments embodied in the Tax Equity and Fiscal Responsibility Act of 1982?

Mr. AGOSTO. Not that I know of, sir. Those are the figures accumulated from past experience. I know of no estimate. Probably the Secretary of the Treasury or the Director—the ED Aministrator may have figures and projections on that.

Chairman MINISH. One of the concerns, of course—and it is understandable—is that the people entering into contracts in Puerto Rico know that the present section 936 act will not change in any foreseeable future.

Is that your concern?

Mr. AGOSTO. That's correct. That's correct. You see, many times these plans between the time that they begin considering Puerto Rico as a location and the time they make a decision and begin construction, you may have 3, 4, 5 years; and then they make a favorable decision to establish in Puerto Rico. All of a sudden, you have a change in the rules of the game. That is very difficult. You can't ask people to invest their money, corporations to invest their money in that way, with that kind of uncertainty. All we are asking is give us time for section 936 to develop, to develop programs, to channel section 936 funds into the development of Puerto Rico, and then, as we accumulate experience in this direction, then let's analyze and do the things that are right according to the objectives that we set.

Chairman MINISH. Thank you, Senator.

Mr. Garcia?

Mr. GARCIA. Thank you, Mr. Chairman.

There are a couple of questions. The responsibility of this committee is not only banking, but we have one of the major subcommittees in the Congress, which is Housing and Urban Development. I am really interested when you talk about reinvestment of section 936 dollars into the housing stock of Puerto Rico. Would you be kind enough, if you don't mind, Senator, to elaborate exactly, No. 1, I know Puerto Rico has been affected by the cuts in the housing programs over the last couple of years, but how would the section 936 funds go into housing and that Puerto Ricans will benefit directly from the 936 funds?

Mr. AGOSTO. This is an idea which we are just exploring. As I mentioned in my paper, basically, the idea is this: Assume we have a 30-year mortgage. Preliminary exploration with section 936 corporations indicate that they would be willing to invest money as long as 7 years. We are looking into ways whereby we could make some arrangement to repurchase those mortgages at the end of the 7 years either with fresh section 936 funds or through some other conventional institutional arrangement. Those are the things we are discussing now with different advisers in the Senate.

Then we might be able to channel considerable amounts of money into housing. This is an example of the things we have to do in Puerto Rico for which we need time. We must design the pro-

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grams that will be attractive to section 936 funds—investment of section 936 funds; so that takes time. It takes cooperation between different branches of government. It takes coordination between the Federal and the Commonwealth governments, so that given enough time, we may be able to design enough programs to adequately make use of section 936 funds.

I give this to you as an example of the things that are under consideration now. I am sure that the administration will also have a number of ideas under consideration for the use of these funds. This is to emphasize the need that we have to assure section 936 companies that the rules of the game will not be changed and that they can continue planning ahead for investment in Puerto Rico.

Mr. GARCIA. Let me say. I know you have an 11:20 appointment. It is 11:15. I would like to add on to what you have said so we can let you go. If you would like to come back, we would be delighted to have you back again.

Just let me say, because in this audience there are people here who work for 936 firms, there are other people here who are representing at this hearing section 936 firms. They will not be testifying. This testimony is coming from Puerto Rico and the members of the Puerto Rican community itself. I would hope those persons who are in this room and who have enjoyed the support of the section 936 tax program would hear what you have just said as it pertains to housing, because I think one of the basic problems we have had with the section 936 program is that there has not been a sense by some Members of Congress in both this House and the other House that those moneys are really going into the infrastructure and to help the Puerto Rican community directly.

So those people who are in this audience who are representing those firms, I would hope that they would hear what you have just said and explore with you the possibilities of implementing this program so that when people decide that again another chip has to be take away from the section 936 program, that they think twice, because it means so very much for the people of Puerto Rico.

Mr. AGOSTO. I appreciate your comments, Congressman.

Chairman MINISH. Mr. Corrada?

Mr. CORRADA. Thank you, Mr. Chairman.

I don't have any questions for Senator Agosto, but I would like to point out that I am pleased at his appearance here today and his coming to testify on a matter of great significance to Puerto Rico's economic development. Between my party and Mr. Agosto's party, we hold over 94 percent of the votes in the 1980 elections; and although we have differences concerning many issues in Puerto Rico, I think that we stand together concerning this issue about the need to preserve section 936 as a tool for the economic development of Puerto Rico.

Second, I would like to point out that later in the hearings, we will listen to the testimony of the secretary of the treasury of Puerto Rico, Carmen Ana Culpeper, and the administrator of the Administration for Economic Development in Puerto Rico, Mr. Jose Madera. Particularly Mrs. Culpeper will address the issue of how section 936 funds deposited in the Puerto Rican financial banking institutions may be utilitzed to further move those funds into the Puerto Rican economy for the development of infrastructure, for

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other projects that have a very significant impact on Puerto Rico's economic development; and I am glad, of course, that Senator Hernandez Agosto addressed that in his testimony.

Chairman MINISH. Senator, nice to have you. We understand you are running a few minutes late. So you are excused.

Mr. AGOSTO. Thank you very much, Mr. Chairman, Congressmen.

Chairman MINISH. Will the panel of the Honorable Carmen Ana Culpeper and Jose Madera come to the witness table, please?

Ms. Culpeper, you may proceed.

STATEMENT OF HON. CARMEN ANA CULPEPER, SECRETARY OF THE TREASURY, PUERTO RICO

Ms. CULPEPER. Mr. Chairman, on behalf of our Governor, I must congratulate you and your committee for giving us the opportunity of briefing you on the benefits Puerto Rico derives from section 936 and how vital it is for us that section 936 be left untouched in the coming years. The benefits of section 936 of the IRS Code to Puerto Rican economy can hardly be overstated because, in fact, section 936 has become absolutely vital to our economic system. While enumerating the benefits of this special provision and dividing them into functional areas, we often lose sight of the central fact: Without section 936, Puerto Rico's economy, as we know it today, would hardly exist. At least half the deposit base of our banking system, one-third of our economic or income tax collections, and a signficant fraction of our gross product are directly traceable to the section 936 corporations.

Though I intend to address only two specific issues within the section 936 panorama; namely, the passive income issue and the local fiscal impact of section 936 provisions, I want these items to be seen within the context of the pervasive importance of the possession corporation system for the Puerto Rican economy.

Though section 936 firms are effectively exempt from U.S. taxes on their Puerto Rican source earnings, they are not fully exempt from Puerto Rico taxes; and, of course, personal income resulting from their operations has also been fully taxable. The result is that the Puerto Rico Treasury now depends to a great extent on the revenues stemming directly from section 936 operations. In fiscal year 1982, about 15 percent of our general fund revenues resulted from such direct operations, not counting secondary effects such as tax revenues from local suppliers of 936 firms and other multiplier effects.

This dependency on revenues from tax exempt corporations is entirely healthy and is increasing. Since the passage of the 1978 Industrial Incentives Act, firms which were once entirely exempt from Puerto Rico taxes are now paying income taxes to Puerto Rico, about $50 million per year at current rates. The formal phasein scheme is complex, but basically newly promoted firms begin paying 10 percent of their nominal Puerto Rico tax obligation immediately and move progressively toward full payment at 5-year intervals depending on their location on the island. Tax collections from this source have increased at some 20 percent per year since the first effective year of that act and should increase even faster as more firms are phased into lower exemption levels. This process

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is healthy in that it accustoms Puerto Rican industry and the treasury to a more sustainable fiscal system, one resembling more closely the U.S. model.

Another revenue source for the treasury which stems directly from the section 936 system is the so-called tollgate tax paid on section 936 earnings as they are repatriated to the United States. This tax operates as a postponed income tax and can be adjusted depending upon the priority of user funds and the length of time they remain in Puerto Rico. Obviously, such a tax is useful for more than revenue generation, serving as a control for the use of section 936 funds while on the island and for their flow from the island.

I save our most important revenue source until last. The personal income tax resulting from section 936 payrolls. During 1982, we expect to receive some $240 million in personal income taxes from employees of section 936 corporations, a figure accounting for fully 11 percent of our general fund revenues and more than one-third of our total personal income tax. I don't want to enter directly into employment effects of the system, since my colleague will be covering that issue; but most economists estimate that the employment multiplier of section 936 firms are 2.5 or higher.

The final effect of this employment on our fiscal system probably accounts for more than two-thirds of our personal income tax collections. This figure should indicate more than just the importance of section 936 to the Puerto Rico Treasury. They should show you an increasingly efficient fiscal system, a treasury increasing its section 936-based revenues even though the economy is in recession, and an economy adjusting to production under the corporate income tax. Neither of these developments would be possible without the stable and favorable climate of possession corporation taxation system.

Before entering further into the need for that stability, let me touch on another extremely important aspect of the operation of section 936 firms in Puerto Rico. That is the use of their accumulated earnings and where they are put.

Under TEFRA, section 936 corporations will be around to earn no more than 35 percent of their qualified possessions source income from so-called passive sources, basically from interest bearing financial instruments. Though these firms were allowed as much as 50 percent from passive sources before TEFRA, the negative effects of the change are not likely to be great since most corporations were under the 50-percent limit and the new limit is being phased in over a period of 3 years.

Further changes could cause serious harm because a significant pool of capital, the section 936 funds. I intend to show these funds are extremely important to our economy and that they are being effectively regulated by our treasury to provide optimum results to Puerto Rico, but that uncertainty about the section 936 system can seriously prejudice both these positive features.

Currently, the section 936 pool contains about $6 billion. Funds available for the productive investments in Puerto Rico, $4.9 billion of these are placed into the commercial banking sector. If I were to explain no further, that figure alone would indicate the importance of the section 936 system and how—and what status the symbol is of the U.S. free enterprise can offer to the capital-poor economies

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of the Puerto Rican Basin. The use of these funds and their effect on the cost of capital in Puerto Rico are more impressive. Our Industrial Incentive Act in conjunction with Puerto Rico Treasury regulations issued this past February strictly regulates their use to which section 936 funds must be put in order to qualify for favorable tollgate tax treatment. Generally, they must be invested locally in eligible activities which include productive assets, public financial instruments, or qualifying mortgages, either directly or through local financial intermediaries.

This chart we have with us illustrates the benefits or the beneficial uses that they have been put to use. Nearly $6.9 billion in total eligible activity, $3.2 billion of those are placed in the commercial loans area. About one-quarter is in government obligations. Another 16 percent is in mortgages; and the remainder is in other development-related investment. It is fair to say that much of this activity would not exist without section 936 and without regulations by the Puerto Rico Treasury.

In addition, the existence of such a large pool of funds tends to lower costs of borrowing locally. This time series graph which is under the pie chart shows the differential between the Puerto Rico CD rate and the Eurodollar rate. Notice personally the differential has increased since the imposition of our new regulation on the use of section 936 funds last February.

Of course, that differential appears smaller in absolute terms at lower interval rates, but in proposal terms, it is stil increasing. In November of 1982, the differential was 400 basis points, or 4 percent points, a significant advantage for investors in Puerto Rico, and the rate has been maintained, in fact, in about 60 percent of the Eurodollar rate after our regulations became into effect.

The all-important liquidity afforded the Puerto Rican financial system by this pool of funds has uses beyond direct lending, however. Over the past several months, the existence of the section 936 funds market and consequent availability of low-cost financing has made possible the solution of a significant number of banking problems and has reduced to a minimum the failure of financial institutions in Puerto Rico. Thus, the benefit of section 936 funds to banking transcends the local economy and is significantly important to the Federal banking regulation agencies, such as FDIC and the Federal Home Loan Bank Board.

They have been able to solve problem bank situations without actual deposit payments from their insurance funds. Evidentally, the section 936 pool and its regulation by the Puerto Rico Treasury have produced positive effects on both the use and cost of funds in Puerto Rico, but these effects could be destroyed by action or inaction interfering with the stabilty of the tax exemption system. This final time series shows the changes in the term structure of section 936 funds market. Notice that since 1982, when the news broke concerning contemplated U.S. Treasury restrictions on section 482 and on into August, when TEFRA was being considered, short-term CDI's have become predominant in the market. Though our regulations are designed to encourage long-term investment, depositors are hesitant to commit funds when they are uncertain as to their future treatment under the section 936 system. Given more stability in the tax law itself, we can reach our goal of long-term stabil-

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ity of local investment. Without it, our effectiveness is severely limited.

In short, gentlemen, a successful regulatory program, a component of one of histories most successful economic development programs is in danger of destruction due to uncertainty.

I don't intent to present problems without solutions. The Puerto Rico fiscal system is dependent on section 936 and so is the Puerto Rico financial community, but both are being threatened by uncertainty about section 936 systems.

What can we do about it? I have two solutions, one having to do with the law itself and one having to do with commentary.

First, I propose a 5- to 10-year moratorium on further changes to section 936. Both TEFRA and recent Puerto Rico regulations have addressed criticisms of the system. In the case of TEFRA, we will not know for sure until 1985 of its results. We should give the system a chance to work in a stable environment before meddling with it again.

Second, I propose that the U.S. Treasury reports on the system be limited to every 2 years and that they be accompanied by a brief commentary prepared by the Treasury of Puerto Rico. These reports have generally been rather negative in tone and have been given inordinate attention by the investment community. They are not, after all, statements of congressional or Treasury policy. Their statistical methodology is questioned even by the Treasury economists. Limiting their publication and presenting an alternative statistical analysis would certainly provide a more balanced perspective on this important aspect of the U.S. tax law.

I have tried to present the problem the Puerto Rico Treasury faces due to uncertainties about section 936 within the larger context of the entire Puerto Rico economy, but I don't think the generalization should stop there. The Puerto Rico economy is a prime example of the development potential of the U.S. economic system. We have been the model held to the underdeveloped nations, extolling the benefits of capitalism. If we fortify and stabilize the possession corporations system, we will provide a model of a stable capitalist development, more valuable than any number of programs or tax breaks to foreign countries.

Thank you again for your interest in section 936 and in Puerto Rico. Our government would welcome the visit of all Congressmen interested in seeing the effects of our economic development program. We hope you accept our invitation.

[The prepared statement of the Honorable Carmen Ana Culpeper, with attached charts, follows:]

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REMARKS OF THE HON. CARMEN ANA CULPEPER,
SECRETARY OF THE TREASURY OF PUERTO RICO,
BEFORE THE COMMITTEE ON BANKING, FINANCE,
AND URBAN AFFAIRS OF THE
U. S. HOUSE OF REPRESENTATIVES

Introductory Comments:

The benefits of Section 936 of the IRS Code to the Puerto Rico economy can hardly be overstated, because in fact Section 936 has become absolutely vital to our economic system. While enumerating the benefits of this special provision and dividing them into functional areas, we often lose sight of this central fact: without Section 936, Puerto Rico's economy as we know it would hardly exist. At least half the deposit base of our banking system, one third of our income tax collections, and a significant fraction of our gross product are directly traceable to the 936 corporations. Though I intend to address only two specific issues within the 936 panorama -- namely the passive income issue and the local fiscal impact of 936 provisions -- I want these items to be seen within the context of the pervasive importance of the Possessions Corporation System for the entire Puerto Rico economy.

Local Fiscal Impact

Though 936 firms are effectively exempt from U. S. taxes on their Puerto Rico source earnings, they are not fully exempt from Puerto Rico taxes, and of course personal income resulting from

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their operations has always been fully taxable. The result is that the Puerto Rico Treasury now depends to a great extent on revenues stemming directly from 936 operations. In fiscal year 1982, about 15 percent of our General Fund revenues resulted from such direct operations, not counting secondary effects such as tax revenues from local suppliers of 936 firms and other multiplier effects.

This "dependency" on revenues from tax exempt corporations is entirely healthy and is increasing. Since the passage of the 1978 Industrial Incentives Act, firms which were once entirely exempt from Puerto Rico taxes are now paying income taxes -- about $50 million per year at current rates. The formal phase-in scheme is complex, but basically newly promoted firms begin paying 10 percent of their nominal Puerto Rico tax obligation immediately and move progressively toward full payment at five year intervals, depending on their location on the Island. Tax collections from this source have increased at some 20 percent per year since the first effective year of the Act, and should increase even faster as more firms are phased into lower exemption levels. This process is healthy in that it accustoms Puerto Rico industry and the Puerto Rico Treasury to a more sustainable fiscal system, one resembling more closely the U. S. model.

Another revenue source for our Treasury which stems directly from the 936 system is the so-called "tollgate tax", paid on

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936 earnings as they are repatriated to the U. S. This tax operates as a postponed income tax and can be adjusted depending on the prior uses of funds and the length of time they remain in Puerto Rico. Obviously such a tax is useful for more than revenue generation, serving as a control for the use of 936 funds while on the Island and a valve for their flow from the Island. Currently we receive about $80 million per year in revenues from this source, about 4 percent of our General Fund.

Now, I've saved our most important revenue source until last -- the personal income tax resulting from 936 payrolls. During 1982 we expect to receive some $240 million in personal income taxes from employees of 936 corporations, a figure accounting for fully 11 percent of our General Fund revenues and more than one third of our total personal income tax. I don't want to enter directly into the employment effects of the 936 system, since my colleague Mr. Madera will cover that issue, but most economists estimate the employment multiplier of 936 firms at 2.5 or higher. The final effect of this employment on our fiscal system is thus very significant, probably accounting for more than two thirds of our personal income tax collections.

These figures should indicate more than just the importance of Section 936 to the Puerto Rico Treasury. They should show you an increasingly efficient fiscal system -- a Treasury

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increasing its 936-based revenues even though the economy is in recession and an economy adjusting to production under the corporate income tax. Neither of these developments would be possible without the stable and favorable climate of the Possessions Corporation Taxation System. But before entering further into the need for that stability, let me touch on another extremely important aspect of the operations of 936 firms in Puerto Rico -- the use to which their accumulated earnings are put.

The Passive Income Issue

Under TEFRA, 936 corporations will be allowed to earn no more than 35 percent of their Qualified Possessions Source Income from so-called "passive" sources, basically from interest bearing financial instruments. Though these firms were allowed as much as 50 percent from passive sources before TEFRA, the negative effects of the change are not likely to be great, since most corporations were under the 50 percent limit and the new limit is being phased in over a three year period. Further changes could cause serious harm, however, because the passive income provision allows the accumulation in Puerto Rico of a significant pool of capital -- the "936 funds". I intend to show that these funds are extremely important to our economy and that they are being effectively regulated by our Treasury to provide

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optimum results in Puerto Rico, but that uncertainty about the 936 system can seriously prejudice both these positive features.

Currently the 936 pool contains about $6 billion -- funds available for productive investment in Puerto Rico. If I were to explain no further, that figure alone would indicate the importance of the 936 System, and would stand as a symbol of the benefits the U. S. free enterprise system can offer to capital-poor economies of the Caribbean Basin. But the uses of these funds and their effect on the cost of capital in Puerto Rico are even more impressive. Our own Industrial Incentives Act, in conjunction with Puerto Rico Treasury regulations issued this past February, strictly regulates the uses to which 936 funds must be put in order to qualify for favorable tollgate tax treatment. Generally they must be invested locally in productive assets, public financial instruments, or qualifying mortgages, either directly or through local financial intermediaries. This pie chart illustrates the beneficial uses to which these funds have been put. Nearly half the $6.9 billion in total eligible activity -- $3.2 billion -- is in commercial loans, about one quarter is in government obligations, another 16 percent is in mortgages, and the remainder is in other development related investments. It is fair to say that none of this activity would exist without Section 936 and

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most of it would not exist without conscious regulation by the Puerto Rico Treasury.

In addition, the existence of such a large pool of funds tends to lower the cost of borrowing locally. This time series graph shows the differential between the Puerto Rico CD rate and the Eurodollar rate. Notice especially that the differential has increased since the imposition of our new regulations on the use of 936 funds last February. Of course that differential appears smaller in absolute terms at lower interest levels, but in proportional terms it is still increasing. In November of 1982, the differential was four hundred basis points -- four percentage points -- a significant advantage for investors in Puerto Rico.

The all important liquidity afforded the Puerto Rico financial system by this pool of funds has uses beyond direct lending, hbwever. Over the past several months, the existence of the 936 funds market and the consequent availability of low cost financing has made possible the solution of a significant number of banking problems through purchase and assumption transactions and mergers. In other words, the 936 market has allowed us to avoid outright liquidation in problem cases. Thus the benefit of 936 funds to banking transcends the local economy and is of significant import to Federal bank regulation agencies such as the FDIC and FSLIC. They have been able to solve problem bank situations without actual deposit payments from their insurance funds.

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Evidently the 936 pool and its regulation by the Puerto Rico Treasury have produced positive effects on both the use and the cost of funds in Puerto Rico. But these effects could be destroyed by action or inaction interfering with the stability of the tax exemption system. This final time series shows the changes in the term structure of the 936 funds market. Notice that since this past August, when TEFRA was being considered, short term CD's have become predominant in the market. Though our regulations are designed to encourage long term investment, depositors are hesitant to commit funds when they are uncertain as to their future treatment under the 936 system. Given more stability in the tax law itself, we can reach our goal of long term stability of local investment; without it, our effectiveness is severely limited.

In short, gentlemen, a successful regulatory program -- a component of one of history's most successful economic development programs -- is in danger of destruction due to uncertainty.

Concluding Remarks

I don't intend to present problems without solutions. The Puerto Rico fiscal system is dependent on Section 936 and so is the Puerto Rico financial community, but both are being threatened by uncertainty about the 936 system. What can we do about it? I propose two solutions, one having to do with the law itself and one having to do with commentary.

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First, I propose a five to ten year moratorium on further changes in Section 936. Both TEFRA and the recent Puerto Rico Treasury regulations have addressed earlier criticisms of the system. Undoubtedly they will be effective, but in the case of TEFRA we will not know for sure until after 1985. We should give the system a chance to work in a stable environment before meddling with it again.

Second, I propose that the U. S. Treasury reports on the 936 system be limited to one every two years and that they be accompanied by a brief commentary prepared by the Treasury of Puerto Rico. These reports have generally been rather negative in tone and have been given inordinate attention by the investing community. They are not, after all, statements of Congressional or even Treasury policy, and their statistical methodology is questioned even by Treasury economists. Limiting their publication and presenting alternative statistical analyses would certainly provide a more balanced perspective on this important aspect of U. S. tax law.

I've tried to present the problems the Puerto Rico Treasury faces due to uncertainties about Section 936 within the larger context of the entire Puerto Rico economy. But I don't think the generalization should stop there. The Puerto Rico economy has been the prime example of the development potential of the U. S. economic system: we've been the model held up to underdeveloped nations, extolling the benefits of capitalism. If we fortify and stabilize the possessions corporation system, we will provide a model of stable capitalist development more valuable than any number of aid programs or tax breaks to foreign countries.

Thank you for your time and consideration.

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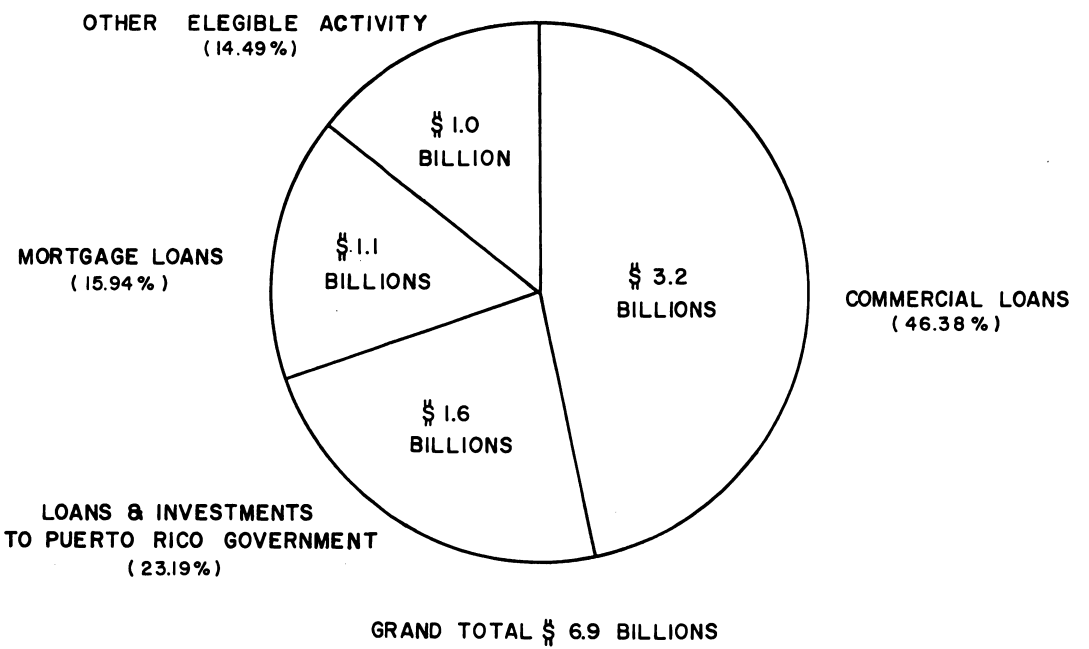
TOTAL ELEGIBLE ACTIVITIES

ALL COMMERCIAL BANKS

(OCTOBER - 1982)



GRAND TOTAL $ 6.9 BILLIONS

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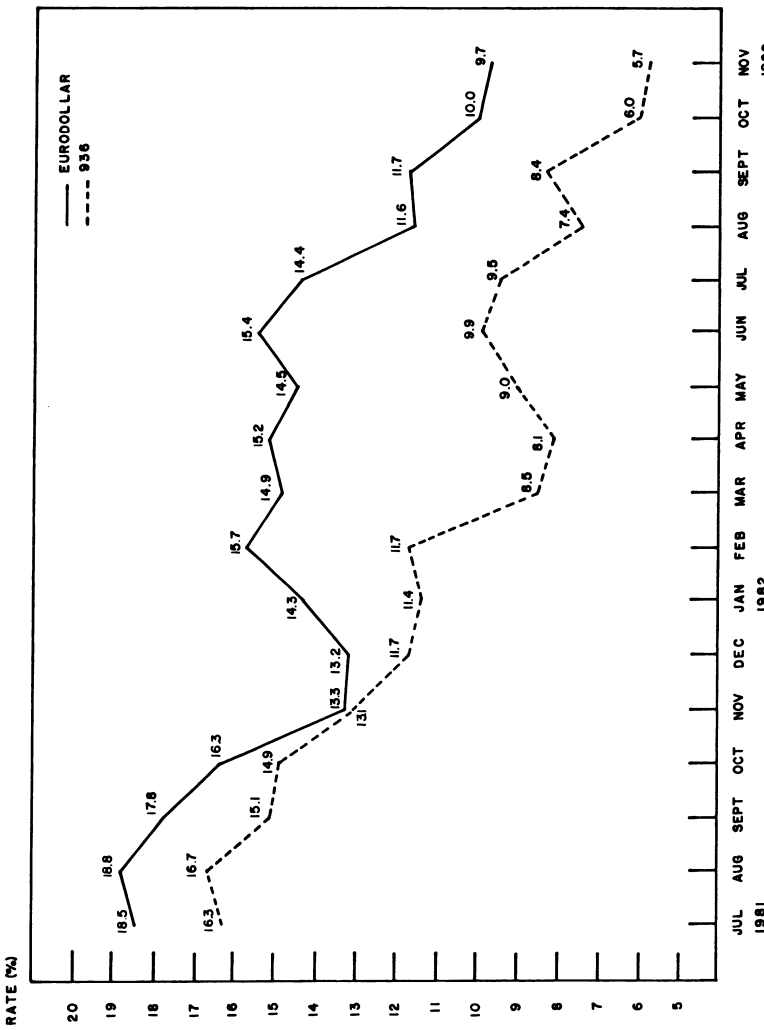
936 VS. EURODOLLAR RATE
(THREE MONTH RATES)



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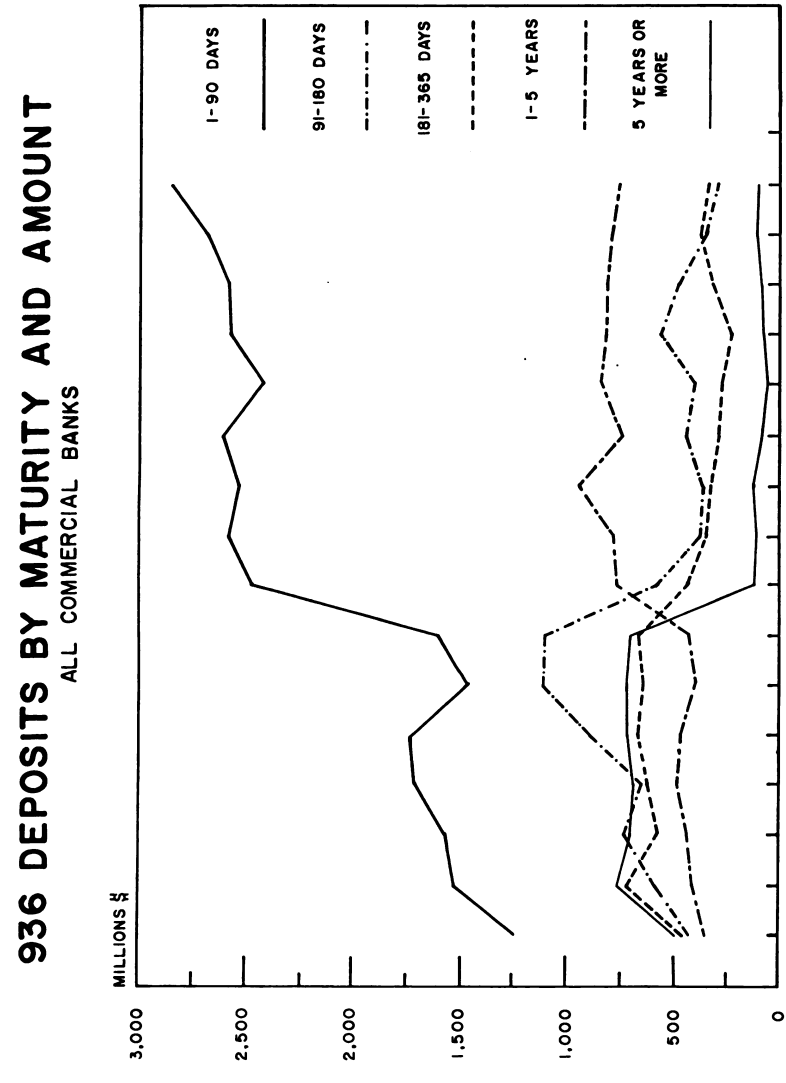

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Chairman MINISH. Mr. Madera, if you can just cut some of this? It is a very lengthy reading.

STATEMENT OF HON. JOSE R. MADERA, ADMINISTRATOR, ADMINISTRATION FOR ECONOMIC DEVELOPMENT, PUERTO RICO

Mr. MADERA. Mr. Chairman, I have a three-part presentation of which over 90 percent of it is just for reference material. Part 2 is with graphic displays of facts that will undoubtedly help anybody understand better the impact and part 3 is the first public display of our criticism and critique of the four section 936 reports heretofore printed. It is inconceivable to us that this Congress has been led to reach certain conclusions about the program without those reports including the critiques and remarks of the people of Puerto Rico.

On that basis, we shall just address ourselves to the formal presentation and be delighted to answer any questions. We would like to thank this committee, because this is the first time since section 936 was adopted in 1976 that the people of Puerto Rico have had the opportunity to publicly comment on it.

The economic advance of Puerto Rico has been built upon the development of manufacturing industry from the first apparel, tobacco and furniture factories of Operation Bootstrap to today's high-technology firms which produce goods in such areas as computers, electronics, pharmaceuticals, and precision instruments. As figure 1 indicates, manufacturing in Puerto Rico continues to be the primary source of net income and of the growth of net income on the island, despite the recent effects of worldwide recession. Net manufacturing income in fiscal year 1982 stood at over $5.2 billion or 51.3 percent of total net income. In 1950 the manufacturing share of a much smaller net income was 14.5 percent. This share rose to over 21 percent by 1960; then to 26 percent in 1970 and has nearly doubled since 1970. (See table 1.). Total manufacturing employment has increased from about 55,000 in 1950 to around 150,000 today. Section 936—and before 1976, its predecessor, section 931—combined with the Commonwealth of Puerto Rico's industrial incentives acts have formed the core around which manufacturing has expanded. Manufacturing has provided the leading sector for Puerto Rico's economic development. As of June 1982, 112 of the Fortune 500 companies were operating 351 manufacturing subsidiaries on our island of 3.2 million population. These firms and over 2,000 other on- and off-island investors in turn provide growing external benefits and linkages to local manufacturing industries, and to the rapidly expanding white collar service sector.

The Treasury's annual reports on section 936 have invariably overstated the costs and understated the benefits of section 936 to Puerto Rico and to the rest of the United States. Part of the reason for this lies in the fact that they do not fully take account of qualitative changes in the development of the manufacturing sector and in its linkages and external benefits to other sectors of the economy.

Figure 2 gives a combined picture of the quantitative and qualitative increases in manufacturing employment: Between 1950 and 1981, real employee compensation in manufacturing increased by

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820 percent. This resulted from an increase of about 280 percent in manufacturing employment and an increase of 290 percent in real compensation per employees. From 1970 to 1980, manufacturing employment in Puerto Rico increased by 13.1 percent. This is 2.8 times as high as the rate of mainland manufacturing employment growth. Table 2 gives a complete breakdown of the depth and diversity Puerto Rican employment of manufacturing sectors for 1971, 1976, and 1981. The idea is to disabuse the notion that seems to prevail that in Puerto Rico there are just a few pharmaceutical companies generating all the income. That is not correct and it is misleading.

The increasing quality of Puerto Rican manufacturing employment is reflected in the rising share of dynamic high-technology industries in manufacturing employment and output. In 1971, machinery, computers, electronics, chemicals, petroleum products, and precision instruments accounted for 22 percent of manufacturing employment. By 1976 their share had risen to 30 percent and in 1981 these high-technology firms accounted for about 40 percent of manufacturing employment in Puerto Rico. Table 3 illustrates that despite the worldwide recession and the damage done to the island's petrochemical industry overall employment in high-technology industries has been growing at 6.6 percent per year. The computer industry has increased employment by over 20 percent per annum. Employment in pharmaceuticals has grown by nearly 10 percent per year. The increasing quantity of productive and rewarding employment in Puerto Rico's high-technology manufacturing industries is an impressive achievement. The benefits spill over to the wider Puerto Rican economy and the American community as a whole. A study done for fiscal 1980 estimated that the $5.1 billion purchased by Puerto Rico from the U.S. mainland in that year created employment for 153,000 mainland citizens. Purchases from the United States increased to $5.7 billion in fiscal 1981. Half of this amount was intermediate goods and raw materials bought by island manufacturers.

That profit haystacks to the U.S. Treasury.

The quality of labor force and employment has also increased in the economy as a whole due in large part to the development of the manufacturing sector. Table 4 shows that the share of white collar employment has grown from 40 to 47 percent of the total over the period 1973 to 1981, an increase of about 80,000 jobs. The share of professional and related workers in total employment grew from 1 to 15 percent over the same period, yielding an increase of over 42,000 jobs. Over 93 percent of Puerto Rico's management and technical positions are filled by Puerto Ricans.

The growth of manufacturing and export service industries under section 936 and the rise of the 936 funds market has provided powerful direct and indirect stimuli to the growth of modern, white collar business, professional and technical service industries in Puerto Rico. Accounting, public relations, management consulting, marketing, insurance, computer programing, data processing, engineering, architectural, legal, financial, and related service have expanded rapidly. Table 5 shows that employment for a partial tabulation of skilled white collar services has grown at an annual rate of 6.5 percent to reach a level of nearly 50,000 jobs in 1981. Over

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the same period business services alone grew by an annual rate of 8.3 percent to provide nearly 22,000 jobs. Finance, insurance, and real estate employment grew by 5.1 percent per year to yield 25,000 jobs in 1981. In addition to their stimulus to a more productive industrial sector, these skilled jobs produce a sizable payroll injection into Puerto Rico's economy and income tax revenues. Most of these skilled service personnel are Puerto Ricans whose bilingual background gives Puerto Rico the basis for an expanding role as a Latin American Caribbean service center. For example, when a Puerto Rican software expert can understand the needs of a Venezuelan business firm and implement a successful operating system for them on the American computer which the Puerto Rican also understands, Puerto Rico's service exports rise and Puerto Rico is helping to expand the markets for U.S. hardware.

The infrastructure developed to supply Puerto Rico's manufacturing sector provides spillover benefits to the economy and society at large. The extensive network of highways, electric power, telecommunications, airlines, water supply, and waste treatment, have been made possible by the economies of scale and the profit and payroll taxes generated directly and indirectly through spending multipliers of our 936 industries. For example, overseas toll revenues of the Puerto Rico Telephone Co., have increased 241 percent between 1976 and 1981. In the latter year these receipts constituted 45.4 percent of overall operating revenues of the company.

The industrial company, which I Chair, generates all its revenues from the private sector. It is one of the few public corporations in Puerto Rico that makes a profit.

Firms incorporating under or converting to Puerto Rico's tax exemption program as amended in 1978 receive partial exemption from Puerto Rican tax. These exemptions decline over time at a rate designed to encourage plant location in less developed regions of the island. Profits repatriated to off-island investors are subject to a tollgate tax which is structured to encourage profit retention in longer term Puerto Rican investments. The annual compound rate of increase of corporate tax collections from companies operating under the incentives program from fiscal 1978 to 1982 was 30 percent. Total taxes collected from them during this period were $500 million. (See table 6.)

The rising payrolls of section 936 corporations provide a growing base for personal income taxation. The multiplier effects of wage earners' consumption and the linkages of these firms through purchases from other firms have enabled Puerto Rico to expand overall corporate and personal income tax collections at a rate approaching 15 percent per year since 1978. (See table 7.) Since the percentage tax of exempt income for each firm operating under the Industrial Incentives Act decreases every 5 years, these partially exempt firms are increasing the share of their direct contribution to the Commonwealth's fiscal resources.

Since discussion of section 936 has devoted considerable attention to the allegation that the pharmaceutical industry has maintained a superficial presence on the island for purpose of tax avoidance, it is worth pointing out that this industry makes a signficant and rapidly growing contribution to the economic development of the island. Table 8 shows the growth in total employment and in pro-

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duction worker employment in the pharmaceutical industry from 1959 to 1981. The 11,746 workers in this industry represent more than a twentyfold increase in two decades. A sample of 62 section 936 pharmaceutical firms operating in 1980 paid $11.8 million in income taxes to Puerto Rico in that year. This constituted 45 percent of all corporate profits taxes paid by an overall sample of 339 manufacturing firms operating in that year. The U.S. Treasury report gives a total of 445 manufacturing firms reporting under section 936 in 1980. In addition, to these income taxes, tollgate taxes paid to Puerto Rico by pharmaceuticals between fiscal year 1978 and 1982 are shown in table 9. It can be seen that these firms contributed $173.2 million which constituted 51 percent of all tollgate taxes paid over the period.

The importance of table 9 is that it is understood also and that is another misleading understanding that Puerto Rico should have labor intensive firms. Gentlemen, if 78 pharmaceutical companies employ 11,700 people, that is an average of 150 per company. On the graphs at the end of the book, there are 346 apparel companies on the island employing 33,000 people. That is for an average of 101 percent. Hence, high technology does employ a substantial number of people. The average pharmaceutical investment in the island employs well over 500 individuals.

Any balanced attempt to measure the benefits of section 936 should include estimates of the linkages, externalities, and qualitative improvements which we have outlined above. The Treasury report does not consider these issues in any detail and has even discontinued the practice employed in the previous report of measuring the direct backward linkages, that is, purchases by specific industries from other local producers. Since no recent input output table for Puerto Rico is available, it is not possible to make a comprehensive estimate of linkages in recent years. A study using the 1972 input-output table measured backward linkages in Puerto Rican manufacturing industries which ranged between 24 and 90 percent of product value. Since that time there is considerable anecdotal evidence to indicate that producers are increasing their local sources of supply. For example, pharmaceutical producers have located bulk chemical suppliers on the island, and electronics and computer manufacturers are actively increasing their locally produced inputs of printed circuit boards, sheet metal, plastic parts and casings, and other products.

A recent survey of 57 firms listed in an Economic Development Administration source book of suppliers to the electronics industry revealed that they employed over 4,000 workers. (See table 10.)

While the Treasury reports on section 936 have understated the diverse benefits of the program, they have also overstated the costs of the program. The calculation of tax expenditures, or tax savings' tax benefits as they have come to be called, is misleading. The names given to these estimates tend to imply falsely that the estimates are of taxes which would actually be collected in the absence of the tax exemption program. The estimates of tax savings are arrived at by merely apply U.S. corporate tax rates to Puerto Rican earnings without making any allowance for alternative tax saving behavior which would result if the existing tax environment were altered.

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This methodology must inevitably overstate true potential tax collections, and by its very orientation it invites readers of Treasury reports to conclude that Treasury analysts are actively contemplating repeal of section 936. Through the resulting damage to investor confidence, each Treasury report has harmed the system which it was intended to maintain.

In this sense we invite, where this committee thinks most appropriate, a debate, an exchange of ideas, so that each side holding different opinions may try to persuade an audience that wants to be persuaded.

Calculations of tax savings do not measure the losses to the Federal Treasury which repeal of 936 would cause through reduced total economic activity, and the relocation of some economic activity overseas. These reductions would dimish the social security contributions from Puerto Rico, and the total income, payroll and associated tax and social security contributions of the mainland suppliers. Puerto Rico paid over $900 million into Federal social insurance and retirement programs in fiscal 1981. Unemployment and welfare payments on the island and on the mainland to new migrants and to previous suppliers of inputs would also increase.

Table 11 shows the rising share and absolute value of direct exports from Puerto Rico to foreign countries. This increase is probably a result both of the increase of dynamic, export competitive high technology manufacturing and of the increasing integration of Puerto Rican manufacturing, and marketing operations on the island. These export-oriented industries would be particularly responsive to the loss of tax advantages outside their market's tariff wall. If research and development is also relocated overseas, America's longrun export competitiveness and technological preeminence will also be reduced. That will translate in a lot of real foregone revenue to the U.S. Treasury.

Puerto Rico is not a tax haven for shell corporations. Her citizens aspire to, and many are achieving excellence in their working careers. Some Puerto Rican electronics and computer firms are approaching zero defects in their product. Thousands of heart pacemakers made in Puerto Rico provide living testimony every heartbeat of every day to the excellence of our industry. In other industries from pharmaceuticals to apparel, it is not difficult to document the quality of our products or the productivity of our workers.

Section 936 is not perfect. But it should be clear that the Puerto Rican Government is increasingly effective in its administration of the system and is striving to further improve its performance. Tax collections from 936 corporations are increasing faster than the island's gross product. Funds invested in the 936 market are increasingly targeted to productive investment in Puerto Rico. Over $800 million of tax-exempt 936 funds that must be redeposited with the Government Development Bank enable the Government Development Bank to finance the operations of the Commonwealth at a reduced cost to taxpayers. Promotions under the Industrial Incentives Act are more likely to result in productive output and employment than in past years. (See table 12.)

The continued success of our development program requires that investors can be confident that the rules will not be changed after

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the game begins. We believe that section 936 as amended last August provides a workable system in which both the development objectives of Puerto Rico and those of the United States as a whole can be served. The Government of Puerto Rico is working closely with our corporate citizens to monitor and document their behavior and its effects both direct and through linkages and external benefits to our economy. We expect to cooperate fully with the institutions and agencies of the United States in the collection, communication and analysis of this information. We intend to make the section 936 system work for Puerto Rico and for America.

[The prepared statement of Mr. Madera entitled "The Impact of the Possessions Corporation System of Taxation on the Economic Development of Puerto Rico" follows:]

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PREPARED STATEMENT OF JOSE R. MADERA

THE IMPACT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION ON THE ECONOMIC DEVELOPMENT OF PUERTO RICO

Effects of Section 936 on
The Economic Development of Puerto Rico

The economic advance of Puerto Rico has been built upon the development of manufacturing industry from the first apparel, tobacco and furniture factories of Operation Bootstrap to today's high technology firms which produce goods in such areas as computers, electronics, pharmaceuticals and precision instruments. As Figure 1 indicates, manufacturing in Puerto Rico continues to be the primary source of net income and of the growth of net income on the island, despite the recent effects of worldwide recession. Net manufacturing income in FY 1982 stood at over $5.2 billion or 51.3 percent of total net income. In 1950 the manufacturing share of a much smaller net income was 14.5 percent. This share rose to over 21 percent by 1960; then to 26 percent in 1970 and has nearly doubled since 1970. (See Table 1). Total manufacturing employment has increased from about 55 thousand in 1950 to around 150 thousand today. Section 936 (and before 1976, its predecessor, Section 931) combined with the Commonwealth of Puerto Rico's Industrial Incentives acts have formed the core around which manufacturing has expanded. Manufacturing has provided the leading sector for Puerto Rico's economic development. As of June 1982, 112 of the Fortune 500 companies were operating 351 manufacturing subsidiaries on our island of 3.2 million population. These firms and over two thousand other off-island investors in turn provide growing external benefits and linkages to local manufacturing industries, and to the rapidly expanding white collar service sector.

The Treasury's Annual Reports on Section 936 have invariably overstated the costs and understated the benefits of Section 936 to Puerto Rico and to

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Figure 1

Net Income By Major Industrial Sector
Fiscal Years 1980, 1981 and 1982

Source: Planning Board of Puerto Rico.

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Table 1

Puerto Rico Net Income in Manufacturing and Manufacturing Share of Total Net Income

Year	Net Income in Manufacturing ($ Millions)	Manufacturing Share of Total Net Income (Per Cent)
1940	27	12.0
1950	89	14.5
1960	289	21.4
1970	958	26.1
1973	1,542	30.4
1974	1,864	33.5
1975	1,941	32.8
1976	2,383	38.4
1977	2,813	42.3
1978	3,268	44.2
1979	3,783	45.7
1980	4,312	47.5
1981	4,730	47.9
1982	5,262	51.3

Source: Puerto Rico Planning Board.

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the rest of the United States. Part of the reason for this lies in the fact that they do not fully take account of qualitative changes in the development of the manufacturing sector and in its linkages and external benefits to other sectors of the economy.

Figure 2 gives a combined picture of the quantitative and qualitative increases in manufacturing employment: Between 1950 and 1981, real employee compensation in manufacturing increased by 820 percent. This resulted from an increase of about 280 percent in manufacturing employment and an increase of 290 percent in real compensation per employee. From 1970 to 1980, manufacturing employment in Puerto Rico increased by 13.1 percent. This is 2.8 times as high as the rate of mainland manufacturing employment growth.1/ Table 2 gives a complete breakdown of the depth and diversity Puerto Rican employment by manufacturing sectors for 1971, 1976, and 1981.

The increasing quality of Puerto Rican manufactuirng employment is reflected in the rising share of dynamic high technology industries in manufacturing employment and output. In 1971; machinery, computers, electronics, chemicals, petroleum products and precison instruments accounted for 22 percent of manufacturing employment. By 1976 their share had risen to 30 percent and in 1981 these high technology firms accounted for about 40 percent of manufacturing employment in Puerto Rico. Table 3 illustrates that despite the worldwide recession and the damage done to the island's petrochemical industry overall employment in high technology industries has been growing at 6.6 percent per year. The Computer industry has increased employment by over 20 percent per annum. Employment in pharmaceuticals

1/ U.S. Employment and Earnings, U.S. Department of Labor, Bureau of Labor Statistics. Census of Manufactures, P.R. Department of Labor and Human Resources.

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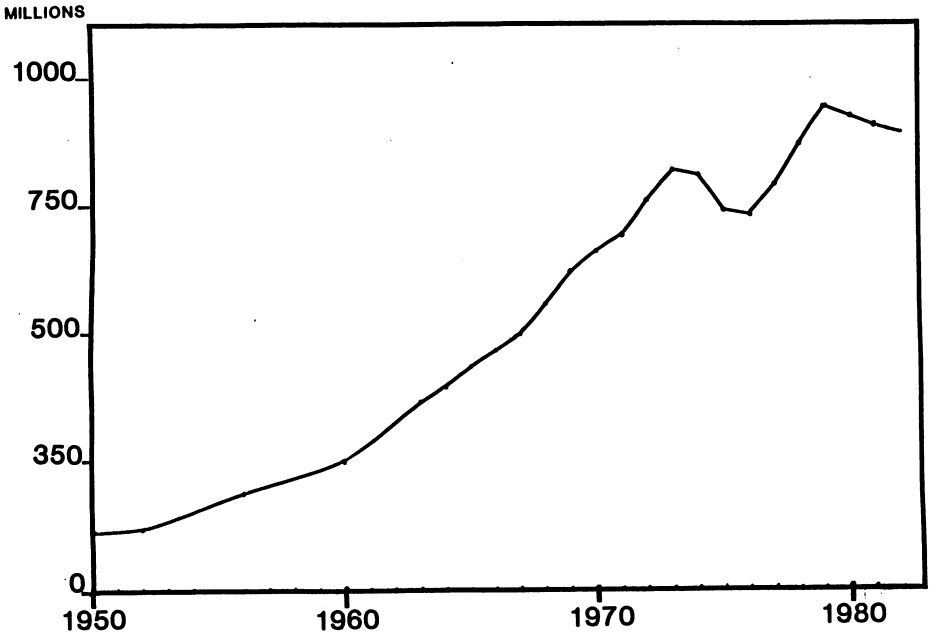
Figure 2

MANUFACTURING INDUSTRY IN PUERTO RICO
EMPLOYEE REAL COMPENSATION
(MILLIONS OF 1972 DOLLARS)



SOURCE: Economic Development Administration
Office of Economic Research

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Table 2

EMPLOYMENT BY TWO DIGIT SIC AS OF OCTOBER 1971, 1976 AND 1981

		Total Manufacturing			Fomento* Promoted		
		1971	1976	1981	1971	1976	1981
20	Food and kindred products	21,746	24,171	21,785	7,586	11,619	12,140
21	Tobacco manufacturers	5,565	4,531	1,668	4,940	3,982	1,634
22	Textile mill products	6,752	4,277	3,228	6,618	4,205	3,160
23	Apparel and related products	36,218	37,054	33,630	33,898	35,391	31,553
24	Lumber and wood products, except furniture	723	1,361	995	348	638	534
25	Furniture and fixtures	4,312	2,376	2,395	2,033	1,206	1,628
26	Paper and allued products	1,431	1,479	1,649	1,172	1,192	1,526
27	Printing, publishing and allied inds.	2,643	2,885	3,212	728	1,060	1,128
28	Chemicals and allied products	6,924	12,520	15,834	6,169	11,818	15,124
29	Petroleum refining and related products	3,119	2,938	2,626	2,394	2,316	2,197
30	Rubber and miscellaneous plastic products	3,886	3,499	4,272	3,534	2,865	3,622
31	Leather and leather products	6,571	4,990	5,201	6,491	4,976	5,158
32	Stone, clay glass and concrete products	7,280	5,333	4,312	3,185	2,566	1,845
33	Primary metal industries	1,080	994	975	1,003	955	918
34	Fabricated metal products, except machinery	5,242	4,724	3,799	3,346	3,182	2,574
35	Machinery, except electrical	1,507	4,325	8,939	907	3,930	8,780
36	Electrical and electronic machinery, equipment and supplies	12,557	13,337	19,774	12,463	13,239	19,733

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		Total Manufacturing			Fomento* Promoted		
		1971	1976	1981	1971	1976	1981
37	Transportation equipment	533	335	634	399	247	509
38	Measuring, analyzing and controlling instruments	6,312	10,611	13,114	6,309	10,587	13,097
39	Miscellaneous manufacturing industries	3,725	3,049	3,628	3,105	2,741	3,339
	Total	138,126	144,789	151,670	106,628	118,715	130,199

Source: Puerto Rico Department of Labor and Human Resources.

*Economic Development Administration of Puerto Rico.

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Table 3

Selected High Technology Industries in Puerto Rico
Level of Employment and Annual Compound Rate of Growth
for Previous Five Years, as of October 1981

SIC	Industry	Employment, Oct. 1981	Annual Compound Rate of Growth, 1976-1981
28	Chemicals and Related Products	15,834	4.8
283	Pharmaceuticals	11,746	9.9
284	Health Products	1,454	5.2
29	Petroleum Refining	2,626	-2.2
35	Machinery, Except Electrical	8,939	15.6
3573	Computers	6,878	20.3
36	Electrical Machinery and Equipment	19,774	8.2
38	Scientific and Precision Instruments	13,114	4.3
	Total, High Technology Manufacturing	60,287	6.6
	Total, All Manufacturing	151,670	0.9

Source: Department of Labor and Human Resources.

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has grown by nearly 10 percent per year. The increasing quantity of productive and rewarding employment in Puerto Rico's high technology manufacturing industries is an impressive achievement. The benefits spill over to the wider Puerto Rican economy and the American community at a whole. A study done for Fiscal 1980 estimated that the $5.1 billion purchased by Puerto Rico from the U.S. in that year created employment for 153 thousand mainland citizens. Purchases from the U.S. increased to $5.7 billion in Fiscal 1981. Half of this amount was intermediate goods and raw materials bought by island manufacturers.[1/]

The quality of labor force and employment have also increased in the economy as a whole due in large part to the development of the manufacturing Sector. Table 4 shows that the share of white collar employment has grown from 40 to 47 percent of the total over the period 1973 to 1981, an increase of about 80 thousand jobs. The share of professional and related workers in total employment grew from 11 to 15 percent over the same period, yielding an increase of over 42 thousand jobs. Over 93 percent of Puerto Rico's management and technical positions are filled by Puerto Ricans.

The growth of manufacturing and export service industries under Section 936 and the rise of the 936 funds market has provided powerful direct and indirect stimulii to the growth of modern, white collar business, professional and technical service industries in Puerto Rico. Accounting, public relations, management consulting, marketing, insurance, computer programming, data processing, engineering, architectural, legal, financial and related services have expanded rapidly. Table 5 shows that employment for a partial tabulation of skilled white collar services has grown at an annual rate of 6.5 percent to reach a level of nearly 50 thousand jobs in 1981. Over the same period

1/ Economic Associates, Inc. "Puerto Rico's Purchases from the United States Year Ending June 30, 1980", Washington, D.C. (December, 1981).

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Table 4

Percentage of Employed Persons by Major Occupational Group, in Puerto Rico 1973 and 1981

	1973[1/]		1981[2/]	
White Collar Workers	40.2		47.1	
Professional and Related		11.1		15.2
Proprietors, Managers and Officials		9.8		11.3
Clerical and Related		19.3		14.4
Sales and Related				6.3
Blue Collar Workers	40.8		35.2	
Craftsmen, Foremen, and Related		14.2		13.4
Operations and Related		19.7		17.8
Laborers, Except Farm		6.9		4.0
Service Workers	12.9		13.0	
Private Household		1.3		0.6
Protective Services		2.5		3.1
Other Services		9.1		9.3
Farm Workers	6.3		4.7	
Farmers and Farm Managers		2.6		2.0
Farm Laborers and Foremen		3.6		2.8
Total Employment (thousands)	757		833	

1/ Persons 14 years of age or more.

2/ Persons 16 years of age or more.

Note: Percentage figures may not add due to rounding.

Source: P.R. Department of Labor and Human Resources.

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Table 5

Employment in Puerto Rico
Selected Skilled Service-Industries

SIC	Description	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	Annual Compound Rate of Growth
60	Finance, Insurance & Real Estate	16,000	18,000	18,000	18,000	18,000	19,000	19,000	21,000	23,000	25,000	5.1%
73	Business Services	10,595	12,198	14,127	14,186	14,699	15,177	16,798	17,516	18,942	21,688	8.3%
81	Legal Services	1,541	1,638	1,884	1,891	1,969	2,047	2,208	2,255	2,221	2,934	7.4%
	Total	28,136	31,836	34,011	34,077	34,668	36,224	38,006	40,771	44,163	49,622	6.5%

Source: Business and Legal Services; Puerto Rico Department of Labor; Employment Security Bureau.

Finance, Insurance & Real Estate: Puerto Rico Planning Board

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business services alone grew by an annual rate of 8.3 percent to provide nearly 22 thousand jobs. Finance, insurance and real estate employment grew by 5.1% per year to yield 25 thousand jobs in 1981. In addition to their stimulus to a more productive industrial sector, these skilled jobs produce a sizable payroll injection into Puerto Rico's consumer economy and income tax revenues. Most of these skilled service personnel are Puerto Ricans whose bilingual background gives Puerto Rico the basis for an expanding role as a Latin American/ Caribbean service center. For example, when a Puerto Rican software expert can understand the needs of a Venezuelan business firm and implement a successful operating system for them on the American computer which the Puerto Rican also understands, then Puerto Rico's service exports rise and Puerto Rico is helping to expand the markets for U.S. hardware.

The infrastructure developed to supply Puerto Rico's manufacturing sector provides spillover benefits to the economy and society at large. The extensive network of highways, electric power, telecommunications, airlines, water supply and waste treatment, have been made possible by the economies of scale and the profit and payroll taxes generated directly and indirectly through spending multipliers of our 936 industries. For example, overseas toll revenues of the Puerto Rico Telephone Company have increased 241 percent between 1976 and 1981. In the latter year these receipts constituted 45.4 percent of overall operating revenues for the company.

Firms incorporating under or converting to Puerto Rico's tax exemption program as amended in 1978 receive partial exemption from Puerto Rican tax. These exemptions decline over time at a rate designed to encourage plant location in less developed regions of the island. Profits repatriated to

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off-island investors are subject to a tollgate tax which is structured to encourage profit retention in longer term Puerto Rican investments. The annual compound rate of increase of corporate tax collections from companies operating under the incentives program from Fiscal 1978 to 1982 was 30 percent. Total taxes collected from them during this period were one half a billion dollars. (See Table 6).

The rising payrolls of 936 corporations provide a growing base for personal income taxation. The multiplier effects of wage earners' consumption and the linkages of these firms through purchases from other firms have enabled Puerto Rico to expand overall corporate and personal income tax collections at a rate approaching 15 percent per year since 1978. (See Table 7). Since the percentage tax of exempt income for each firm operating under the Industrial Incentives Act decreases every five years, these partially exempt firms are increasing the share of their direct contribution to the Commonwealth's fiscal resources.

Since discussions of Section 936 have devoted considerable attention to the allegation that the pharmaceutical industry has maintained a superficial presence on the island for purposes of tax avoidance, it is worth pointing out that this industry makes a significant and rapidly growing contribution to the economic development of the island. Table 8 shows the growth in total employment and in production worker employment in the pharmaceutical industry from 1959 to 1981. The 11,746 workers in this industry represent a more than twenty-fold increase in two decades. A sample of 62 Section 936 pharmaceutical firms operating in 1980 paid 11.8 million in income taxes to

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Table 6

Puerto Rico Tax Collections from Firms Operating
Under Industrial Incentives Acts
(In $ Thousands)

Fiscal Years	1978	1979	1980	1981[a/]	1982[a/]	Total
Law #26	-	598	3,344	3,678	4,046	11,666
Converted	-	13,154	33,979	37,377	41,115	125,625
Law #57	-	900	7,809	8,590	9,449	26,748
Sub Total		14,652	45,132	49,645	54,610	164,039
Tollgate Tax	49,064	64,987	81,251	55,790	85,445[a/]	336,537
Total	49,064	79,639	126,383	105,435	140,055	500,576

a/ Estimated figures

b/ Preliminary figures

Source: Puerto Rico Department of the Treasury,
Office of Economic Affairs. August 1982

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Table 7

Income and Excise Taxes Collected by the
Commonwealth of Puerto Rico
($ Millions)

	Fiscal Years				Annual Compound Rate of Growth 1978-1981
	1978	1979	1980[r]	1981[p]	
Income Taxes, Total	643.5	737.6	863.0	966.7	14.5
Individuals	380.8	443.8	514.3	590.5	15.7
Corporations and Partnerships	190.2	201.8	240.7	289.0	15.0
Withheld to Non-Residents	23.4	27.0	26.8	31.4	10.3
Tollgate Tax	49.1	65.0	81.3	55.8	4.4[1]
Excise Tax, Total	503.8	486.6	538.3	533.3	1.9
Alcoholic Beverages	115.3	125.6	133.2	144.2	7.7
Motor Vehicles & Accessories	99.9	110.2	94.1	103.9	1.3
Other Goods	288.6	250.8	311.0	285.2	-0.4

r - revised figures

p - preliminary figures

[1]Preliminary figures for FY 1982 give tollgate tax collections of $85 million which increases the annual rate of growth from 1978 to 14.9 percent. (See Table 6)

Source: Puerto Rico Treasury

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Table 8

MANUFACTURE OF DRUGS IN PUERTO RICO
Number of Establishments, Total and Production Employment
As of October 1959 to 1981

Years	Number of Establishments	Total Employment	Production Workers
1959	27	551	302
1960	24	477	311
1961	27	484	304
1962	28	644	435
1963	29	699	462
1964	25	655	440
1965	26	779	530
1966	30	1,155	842
1967	33	1,384	1,034
1968	34	1,439	1,073
1969	32	1,848	1,419
1970	39	1,686	1,151
1971	44	2,940	2,213
1972	47	3,535	2,433
1973	54	4,965	3,543
1974	58	5,449	3,846
1975	60	5,964	4,146
1976	69	7,315	5,269
1977	72	8,369	5,813
1978	76	9,774	6,836
1979	76	10,224	7,060
1980	77	10,978	7,533
1981	78	11,746	7,924

Source: Census of Manufactures
Puerto Rico Department of Labor & Human Resources

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Puerto Rico in that year. This constituted 45 percent of all corporate profits taxes paid by an overall sample of 339 manufacturing firms operating in that year. (The U.S. Treasury Report gives a total of 445 manufacturing firms reporting under Section 936 in 1980.) In addition, to these income taxes, tollgate taxes paid to Puerto Rico by pharmaceuticals between FY 1978 and 1982 are shown in Table 9. It can be seen that these firms contributed $173.2 million dollars which constituted 51 percent of all tollgate taxes paid over the period.

Any balanced attempt to measure the benefits of Section 936 should include estimates of the linkages, externalities and qualitative improvements which we have outlined above. The Treasury Report does not consider these issues in any detail and has even discontinued the practice employed in the previous report of measuring the direct backward linkages, i.e. purchases by specific industries from other local producers. Since no recent input output table for Puerto Rico is available, it is not possible to make a comprehensive estimate of linkages in recent years. A study using the 1972 input output table measured backward linkages in Puerto Rican manufacturing industries which ranged between 24 and 90 percent of product value.[1/] Since that time there is considerable anecdotal evidence to indicate that producers are increasing their local sources of supply. For example, pharmaceutical producers have located bulk chemical suppliers on the island, and electronics and computer manufacturers are actively increasing their locally produced inputs of printed circuit boards, sheet metal, plastic parts and casings, and other products.

1/ L. H. Cook, "Inter-industry Linkages in Puerto Rico", a Report Prepared for the Economic Development Administration, 1978.

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Table 9

Puerto Rico Tollgate Taxes Paid by 42 Pharmaceutical Firms and Their Share in Total Tollgate Taxes

Fiscal Year	Tollgate Tax ($ Million)	Percent of Total Tollgate Taxes
1978	28.0	57
1979	13.7	21
1980	49.8	61
1981	28.3	51
1982	53.4	62
Total	173.2	51

Source: Office of Economic Research
Economic Development Administration

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A recent survey of 57 firms listed in an Economic Development Administration source book of suppliers to the electronics industry revealed that they employed over 4 thousand workers. (See Table 10.)

While the Treasury reports on Section 936 have understated the diverse benefits of the program, they have also overstated the costs of the program. The calculation of tax expenditures, or tax savings/tax benefits as they have come to be called is misleading. The names given to these estimates tend to imply falsely that the estimates are of taxes which would actually be collected in the absence of the tax exemption program. The estimates of tax savings are arrived at by merely applying U.S. corporate tax rates to Puerto Rican earnings without making any allowance for alternative tax saving behavior which would result if the existing tax environment were altered.

This methodology must inevitably overstate true potential tax collections, and by its very orientation it invites readers of Treasury reports to conclude that Treasury analysts are actively contemplating repeal of Section 936. Through the resulting damage to investor confidence, each Treasury report has harmed the system which it was intended to maintain.

Calculations of tax savings do not measure the losses to the Federal Treasury which repeal of 936 would cause through reduced total economic activity, and the relocation of some economic activity overseas. These reductions would diminish the Social Security contributions from Puerto Rico, and the total income, payroll and associated tax and Social Security contributions of their mainland suppliers. Puerto Rico paid over 900 million dollars into Federal social insurance and retirement programs in fiscal 1981. Unemployment and welfare payments on the island and on the mainland to new migrants and to previous suppliers of inputs would also increase.

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Table 10

Partial Puerto Rico Actual or Potential Manufacturers Suppliers
To the Local Electronics Industry
November 30, 1982

	Number of Firms	Employment
Suppliers of Plastic Materials	12	636
Suppliers of Electronic Materials	28	2,778
Suppliers of Metal Materials and Services	17	692
Total	57	4,106

Source: Office of Economic Research
Economic Development Administration

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Table 11 shows the rising share and absolute value of direct exports from Puerto Rico to Foreign Countries. This increase is probably a result both of the increase of dynamic, export competitive high technology manufacturing and of the increasing integration of Puerto Rican manufacturing, and marketing operations on the island. These export oriented industries would be particularly responsive to the loss of tax advantages outside their market's tariff wall. If research and development is also relocated overseas, America's long run export competitiveness and technological preeminence will also be reduced.

Puerto Rico is not a tax haven for shell corporations. Her citizens aspire to, and many are achieving excellence in their working careers. Some Puerto Rican electronics and computer firms are approaching zero defects in their product. Thousands of heart pacemakers made in Puerto Rico provide living testimony every heartbeat of every day to the excellence of Puerto Rican industry. In other industries from pharmaceuticals to apparel, it is not difficult to document the quality of our products or the productivity of our workers.

Section 936 is not perfect. But it should be clear that the Puerto Rican government is increasingly effective in its administration of the system and is striving to further improve its performance. Tax collections from 936 corporations are increasing faster than gross product. Funds invested in the 936 market are increasingly targeted to productive investment in Puerto Rico. Over 800 million dollars of tax exempt 936 funds enable the Government Development Bank to finance the operations of the Commonwealth at a reduced cost to taxpayers. Promotions under the Industrial Incentives Act are more likely to result in productive output and employment than in past years. (See Table 12).

The continued success of our development program requires that investors can be confident that the rules will not be changed after the game begins. We

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Table 11

Puerto Rico Direct Exports to Foreign
Countries and Their Share in Total Puerto Rico Exports

Fiscal Year	Exports To Foreign Countries ($'Millions)	Percentage of Total Puerto Rico Exports
1960	18	2.9
1965	31	3.2
1970	118	6.8
1971	126	7.0
1972	149	7.5
1973	202	8.2
1974	376	11.3
1975	357	11.4
1976	412	12.3
1977	459	10.2
1978	549	11.6
1979	758	12.6
1980	847	12.2
1981	1,003	12.8
1982	1,147	13.0

Source: P.R. Planning Board. External Trade Statistics 1960 to 1974. List of Imports and Exports, 1975 - 1982.

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TABLE 12

FOMENTO PROMOTIONS* BY FISCAL YEAR, NUMBER AND PERCENT OF PROMOTIONS ACTUALLY COMMENCING OPERATIONS, AND NUMBER AND PERCENT OF COMMENCEMENTS STILL OPERATING TWO YEARS LATER

Fiscal Years	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Local													
Number of promotions	115	167	218	195	165	156	132	96	76	72	70	80	81
Number commencing operations	70	98	133	124	119	133	115	88	66	69	64	(67)	(64)
Percent promotions commencing	60.9	58.7	61.0	63.6	72.1	85.3	87.1	91.7	86.8	95.8	91.4	-	-
Number operating 2 yrs. after commencements	65	65	100	86	95	108	95	71	58	57	(45)	(8)	(0)
Percent commencement operating 2 yrs. after commencements	92.9	66.3	75.2	69.4	79.8	81.2	82.6	80.7	87.9	82.6	-	-	-
Non Local													
Number of promotions	92	135	158	131	194	141	128	85	110	107	133	75	91
Number commencing operations	67	93	105	89	156	104	104	78	102	98	112	(63)	(56)
Percent promotions commencing	72.8	68.9	66.5	67.9	80.4	73.8	81.2	91.8	92.7	91.6	84.2	-	-
Number operating 2 yrs. after commencements	64	76	88	80	134	97	96	73	95	88	(61)	(2)	-
Percent commencement operating 2 yrs. after commencements	95.5	81.7	83.8	89.9	85.9	93.3	92.3	93.6	93.1	89.8	-	-	-
Total													
Number of promotions	207	302	376	326	359	297	260	181	186	179	203	155	172
Number commencing operations	137	191	238	213	275	237	219	166	168	167	176	(130)	(120)
Percent promotions commencing	66.2	63.2	63.3	65.3	76.6	79.8	84.2	91.7	90.3	93.3	86.7	-	-
Number operating 2 yrs. after commencements	129	141	188	166	229	205	191	144	153	145	(106)	(10)	-
Percent commencement operating 2 yrs. after commencements	94.2	73.8	79.0	77.9	83.3	86.5	87.2	86.7	91.1	86.8	-	-	-

* Promotions include: New Business (NB), Additional Business (AB) and Extensions (XT).

Note: Numbers in parenthesis are too recent to be complete totals.

Source: Office of Economic Research, Economic Development Administration.

December 10, 1982

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believe that Section 936 as amended last August provides a workable system in which both the development objectives of Puerto Rico and those of the United States as a whole can be served. The Government of Puerto Rico is working closely with our corporate citizens to monitor and document their behavior and its effects both direct and through linkages and external benefits to our economy. We expect to cooperate fully with the institutions and agencies of the United States in the collection, communication and analysis of this information. We intend to make the 936 system work for Puerto Rico and for America.

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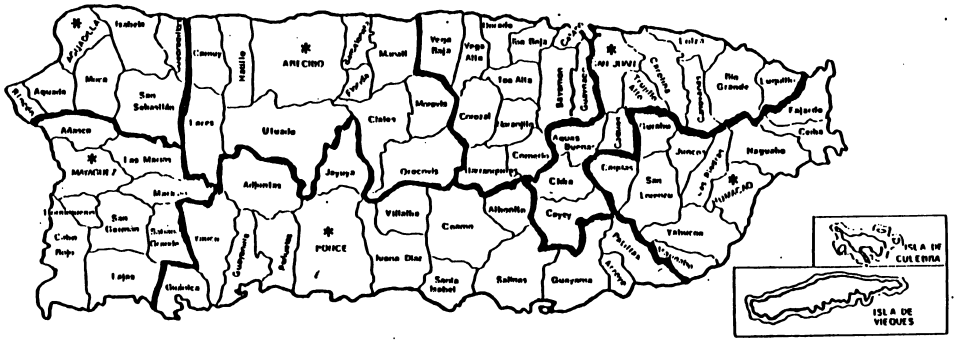
LISTA DE EMPLEOS EN FABRICAS PROMOVIDAS

División de Operaciones

Distribución de Municipios Por Oficinas Regionales



Núm. de Empleos			Núm. de Empleos		
9,288	*	Oficina de Aguadilla	17,585	*	Oficina de Ponce
15,845	*	" " Arecibo	30,098	*	" " San Juan Este
18,331	*	" " Humacao	21,589	*	" " San Juan Oeste
19,471	*	" " Mayaguez	132,207		TOTAL DE EMPLEOS EN FABRICAS PROMOVIDAS

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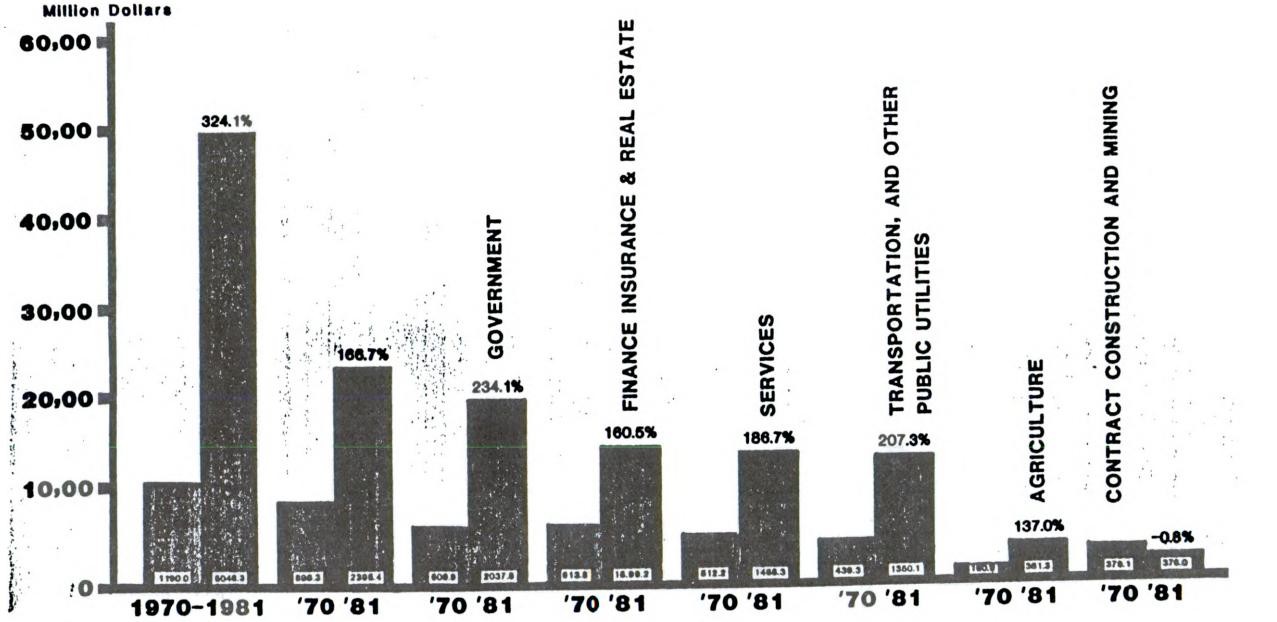
GROSS PRODUCT BY MAJOR INDUSTRIAL SECTOR
FISCAL YEAR 1970 COMPARED TO 1981



Notes: Mining includes quarries only.
Goverment includes agencies and public enterprises N. E. C.
Sum of all sectors represented is higher than GP due to negative balance of Rest of the world account (-$2,881,600,000) and statistical discrepancy (-$1,700,000.)

Source: Economic Report to the Governor 1981-'82 Planning Bureau

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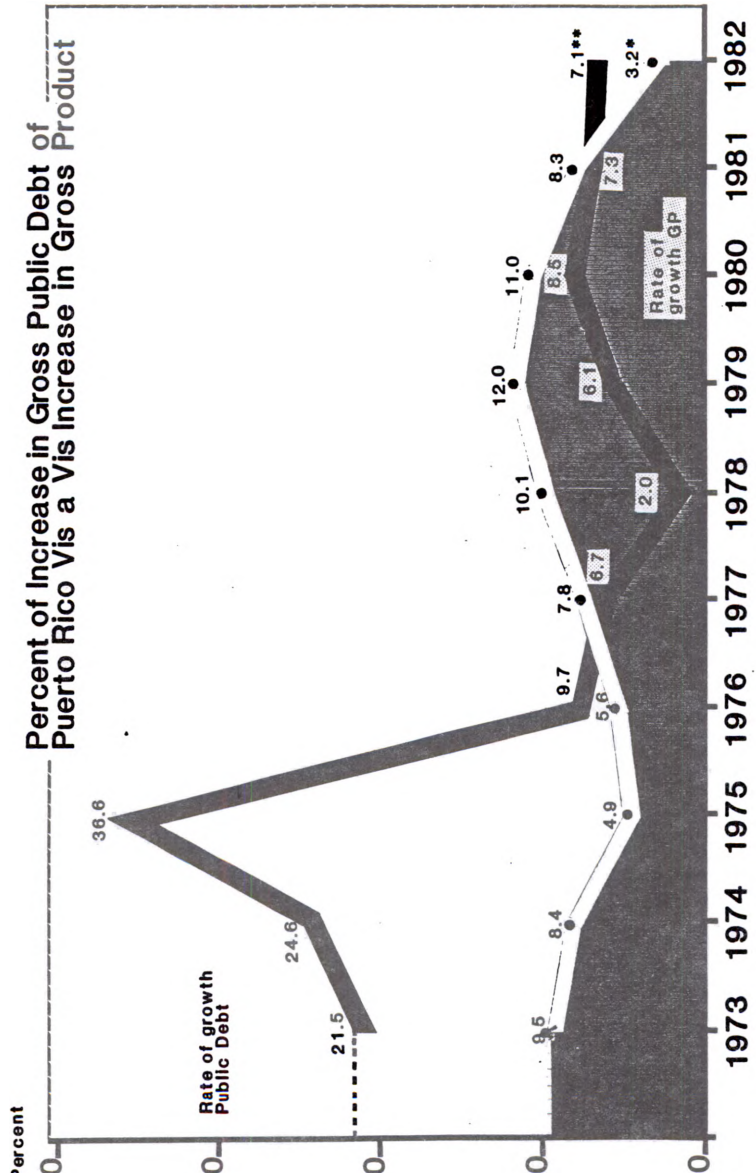

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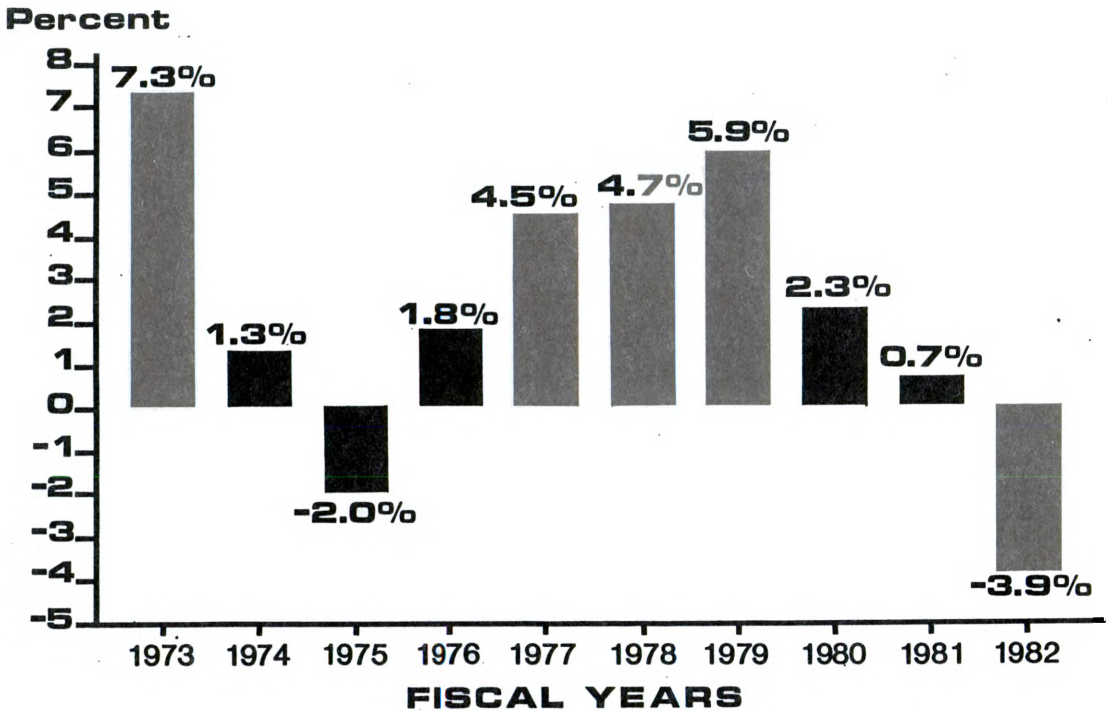
Annual Expansion in Real Gross Product



* Preliminary

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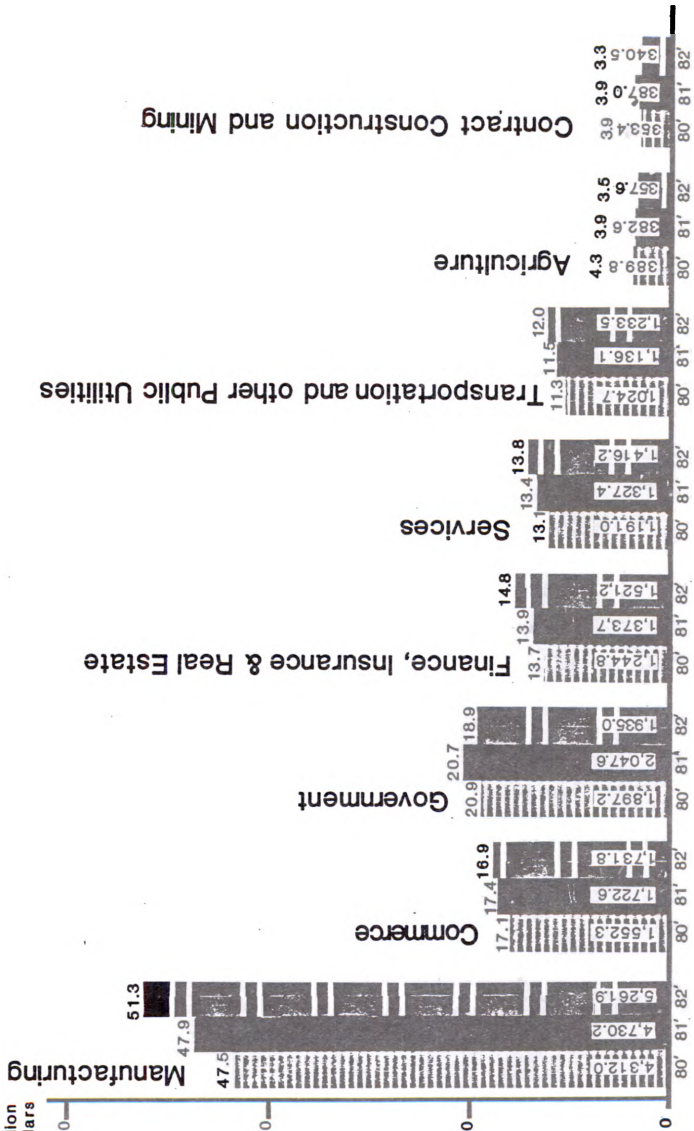

Source: Planning Board of Puerto Rico.

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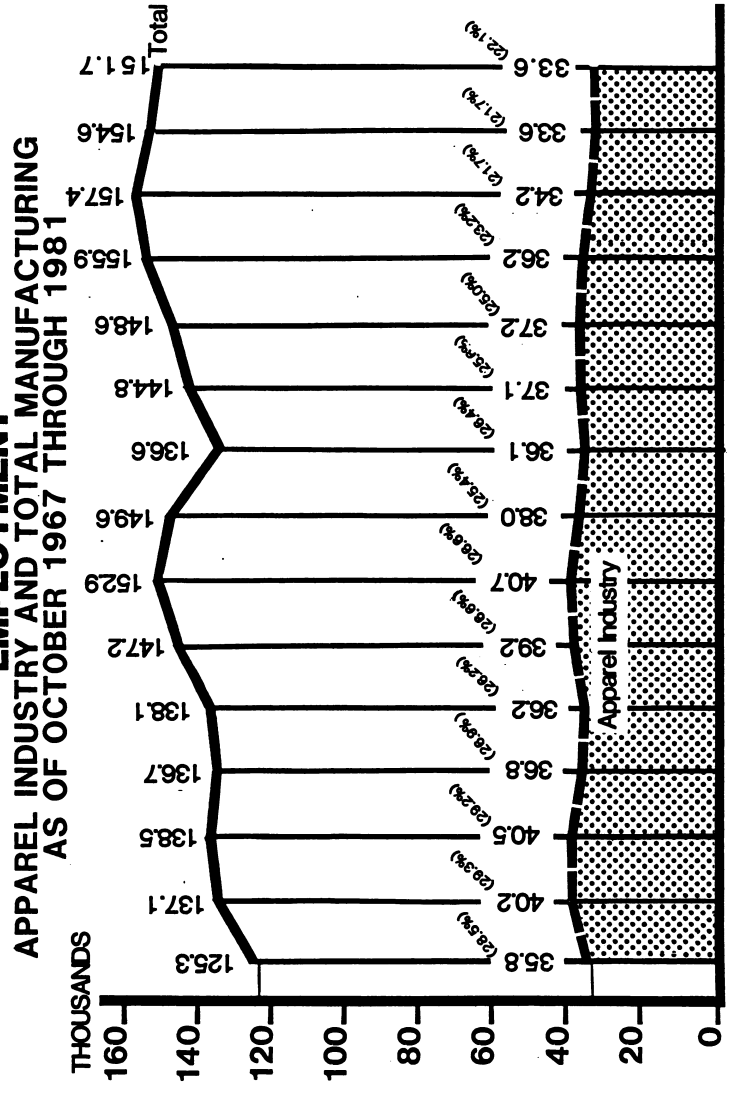

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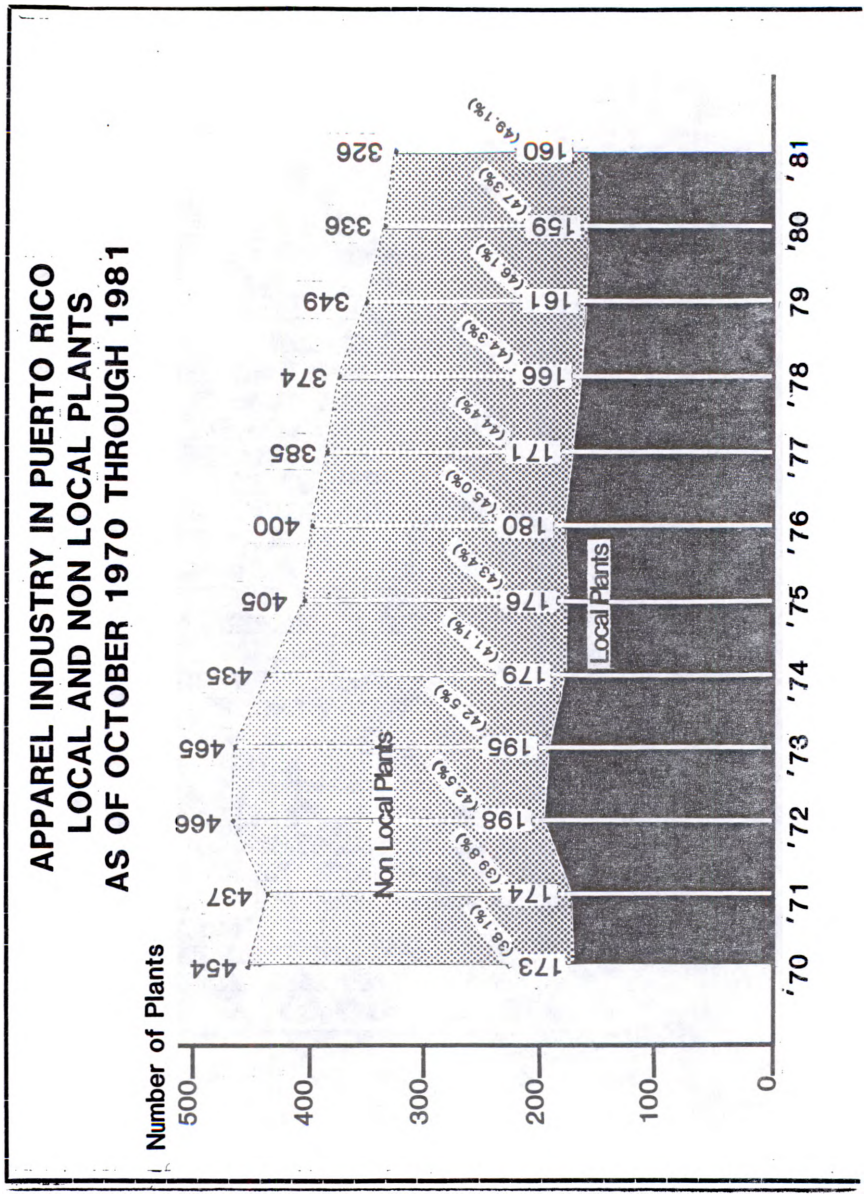

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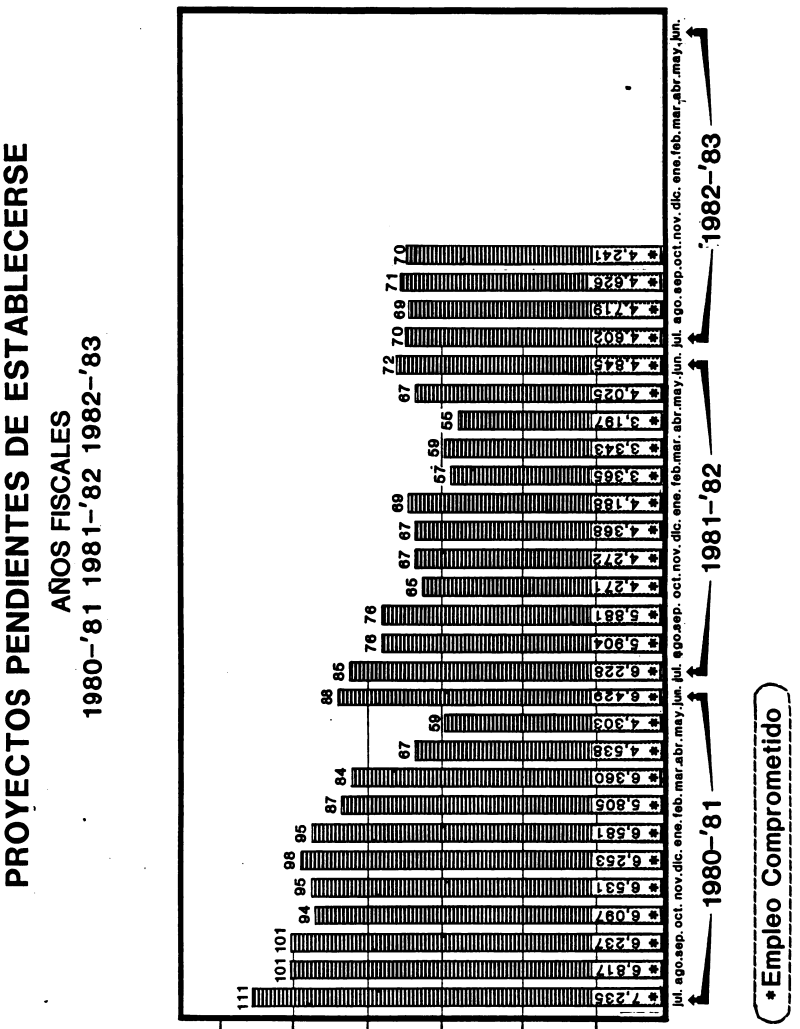

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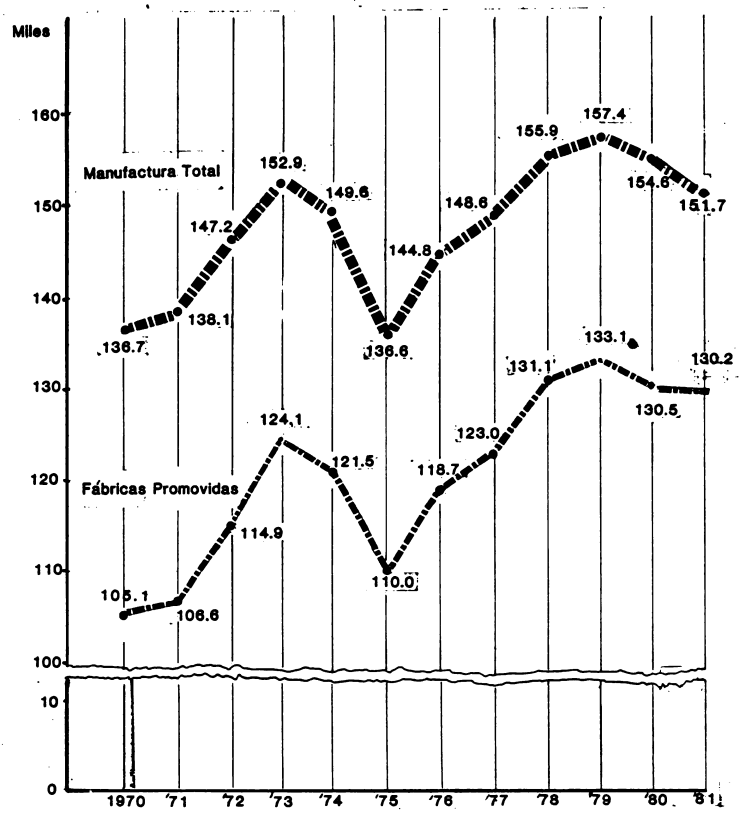
EMPLEO TOTAL EN LA MANUFACTURA Y EN LAS FABRICAS PROMOVIDAS POR FOMENTO

CENSOS DE MANUFACTURA OCTUBRE 1970 A OCTUBRE 1981



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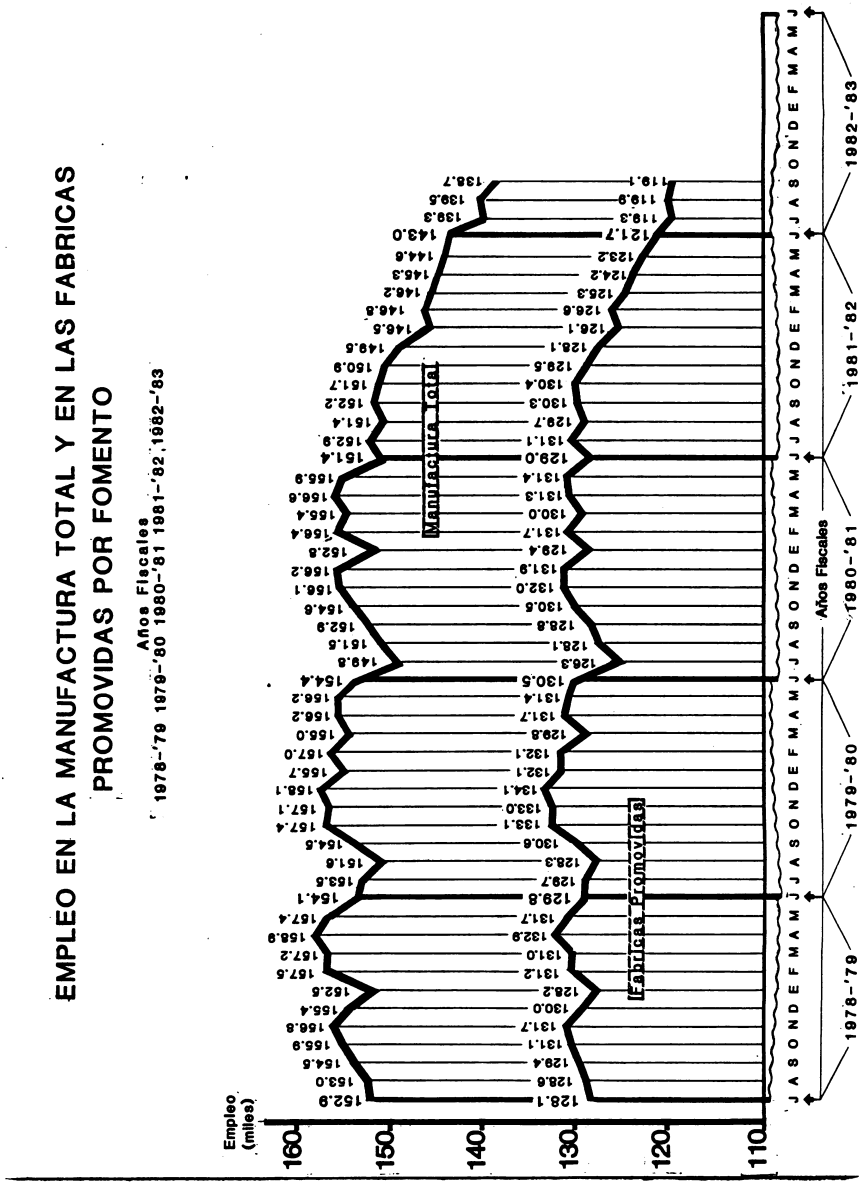
EMPLEO EN LA MANUFACTURA TOTAL Y EN LAS FABRICAS PROMOVIDAS POR FOMENTO

Años Fiscales
1978-'79 1979-'80 1980-'81 1981-'82 1982-'83



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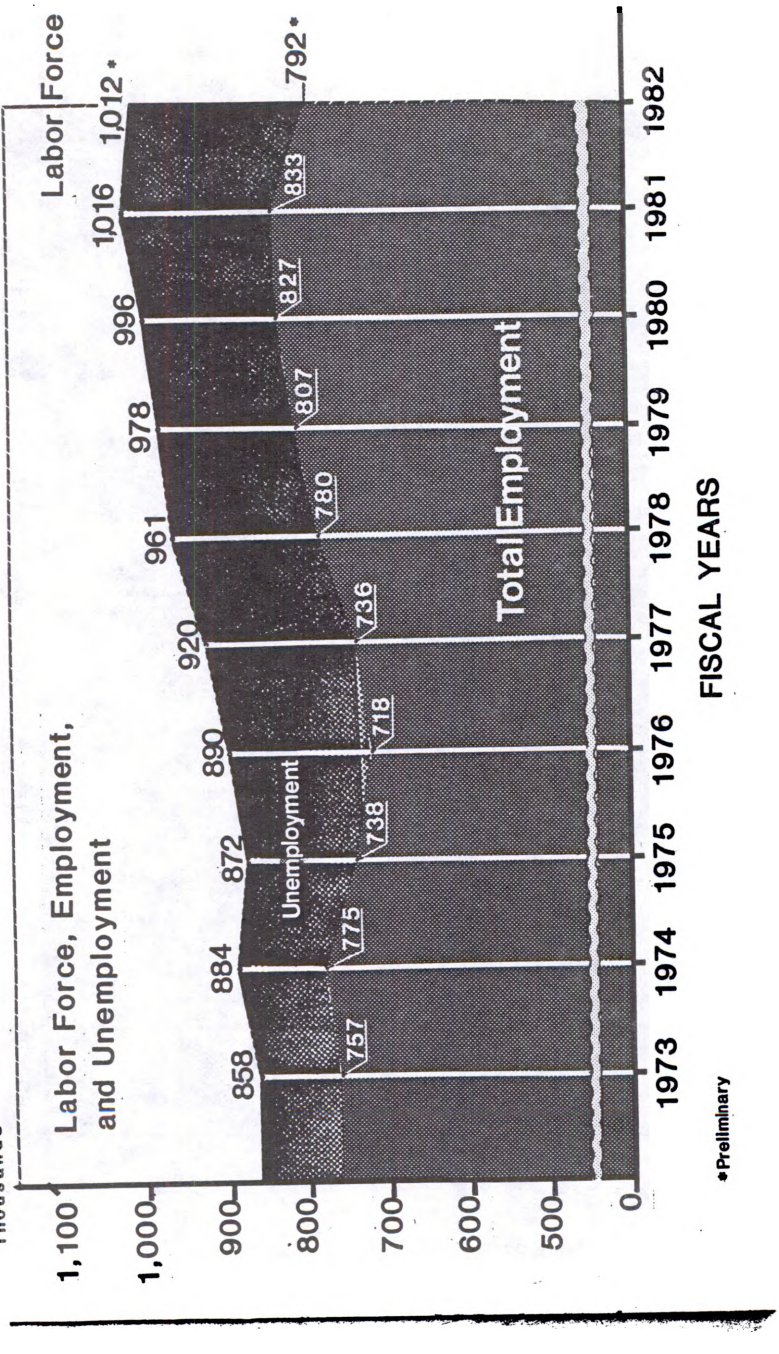

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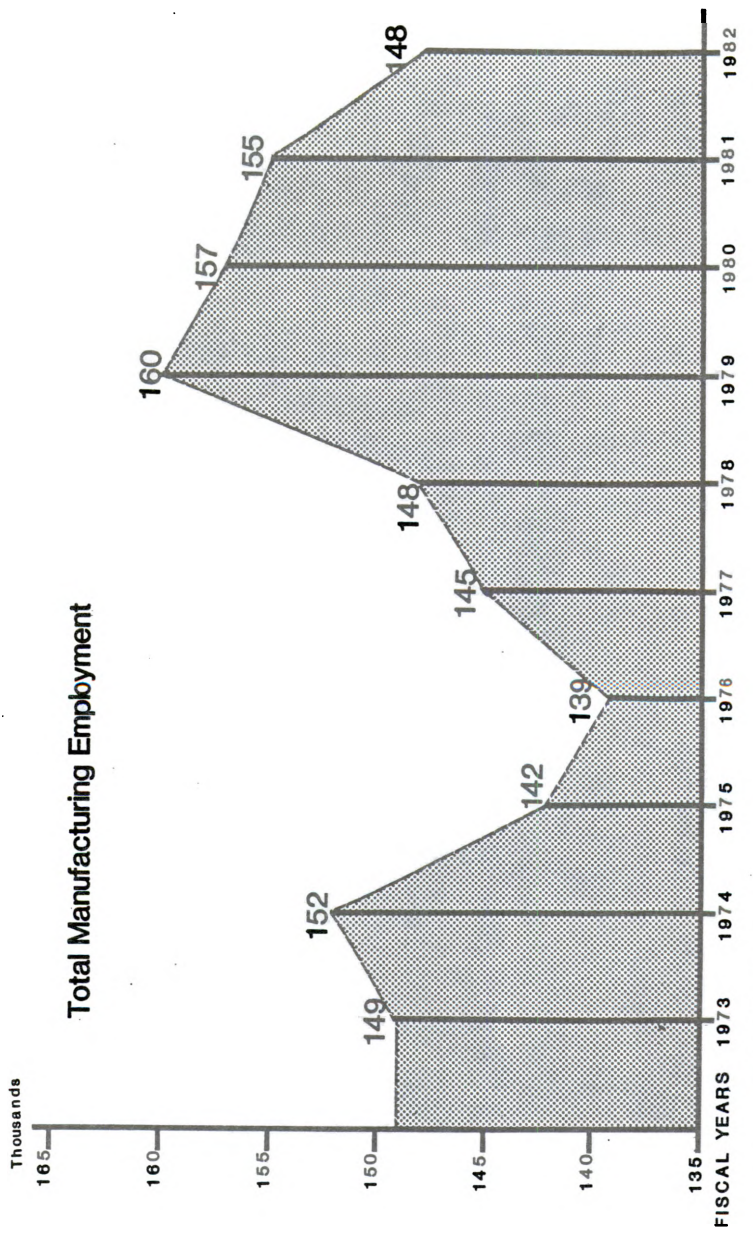

*Preliminary

Source: Commonwealth Department of Labor and Human Resources Household Survey.

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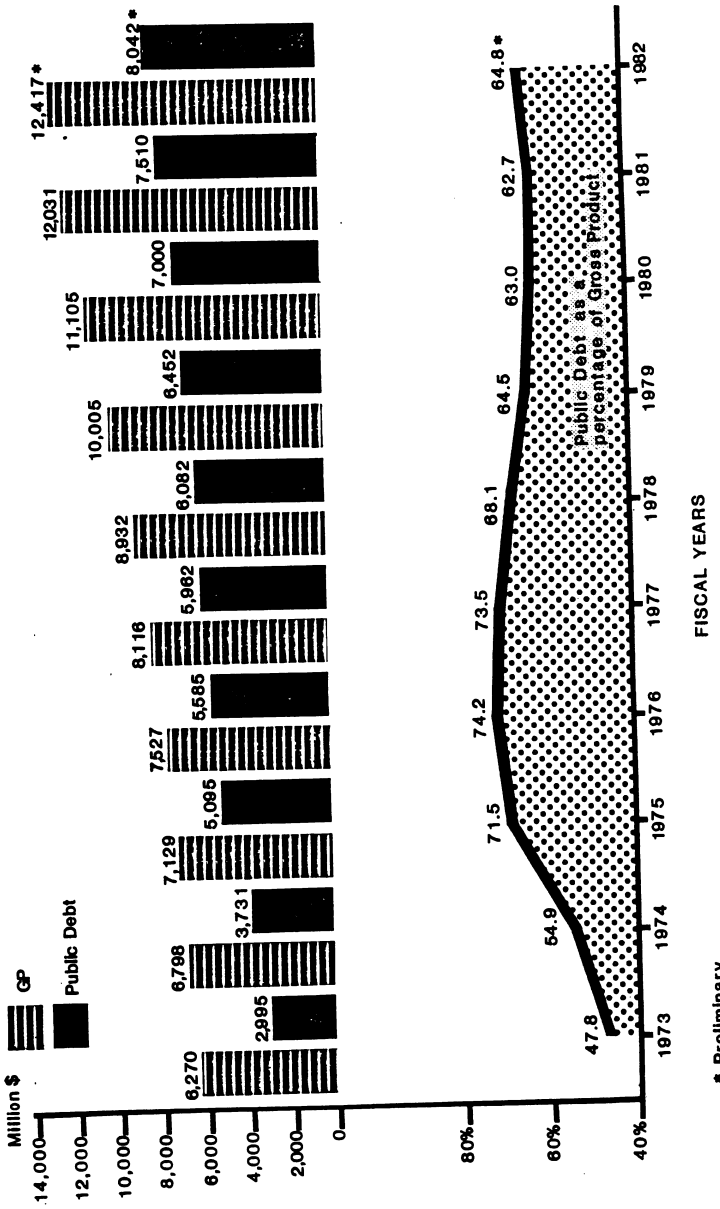

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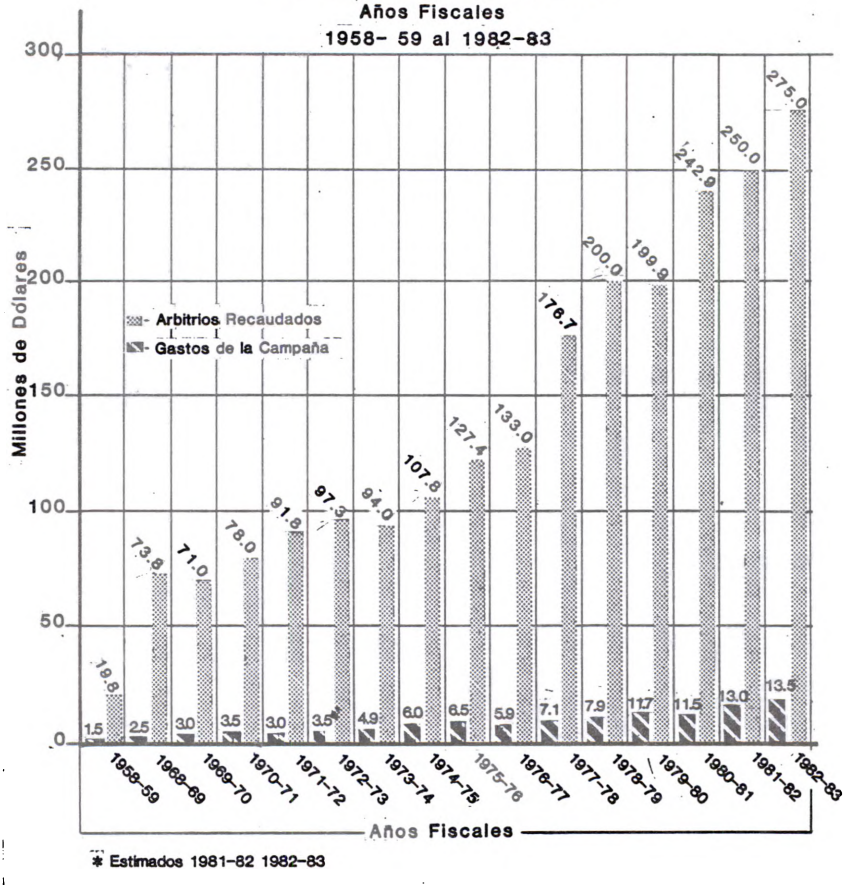
ARBITRIOS RECAUDADOS POR CONCEPTO DE EMBARQUES DE RON Y GASTOS DE LA CAMPAÑA DE PUBLICIDAD DEL GOBIERNO DE PUERTO RICO

Años Fiscales
1958- 59 al 1982-83



* Estimados 1981-82 1982-83

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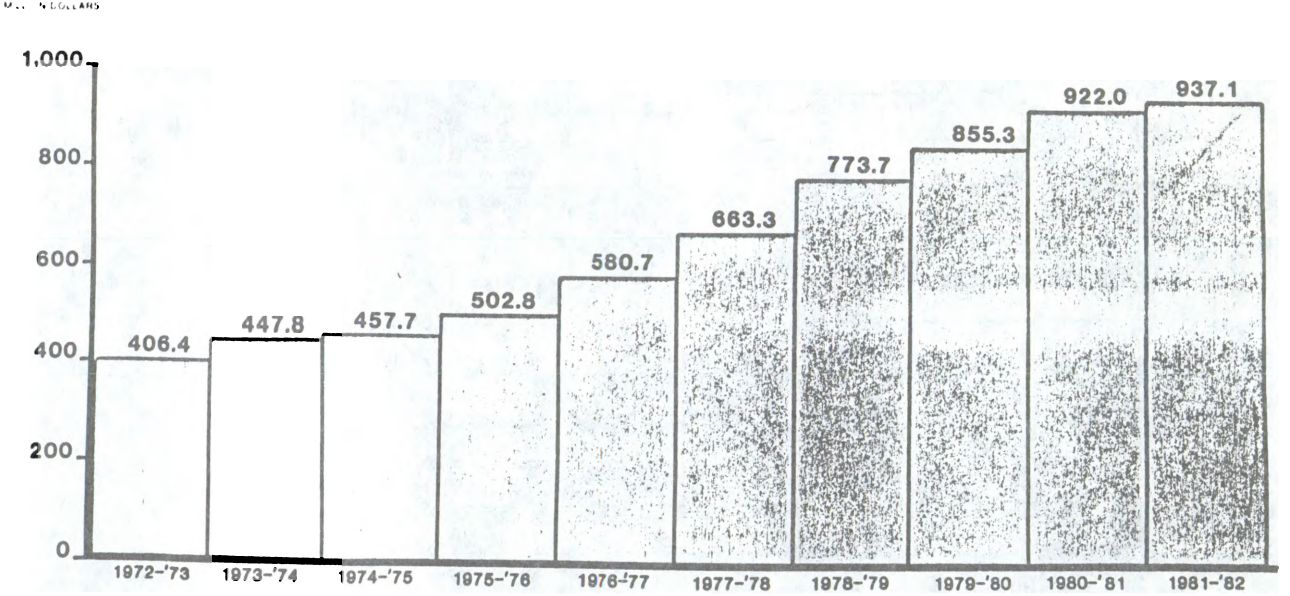
ESTIMATE ON ANNUAL PRODUCTION WORKERS PAYROLL IN FOMENTO PROMOTED PLANTS

FISCAL YEARS 1972-'73 TO 1981-'82



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NUMBER OF ESTABLISHMENTS AND EMPLOYMENT FOR SELECTED INDUSTRIAL GROUPS
AS OF OCTOBER 1976 & 1981

SIC	Total Manufacturing	Number of Establishments As of October 1976	1981	Percent Increased	Employment As of October 1976	1981	Percent Increased
28	Chemicals and allied products	176	166	-5.7	12,520	15,834	26.5
28	Chemicals and related products except pharmaceuticals and health products	74	50	-32.4	4,074	2,634	-35.4
283	Pharmaceutical industries	69	78	13.0	7,315	11,746	60.6
284	Health products	33	38	15.2	1,131	1,454	28.6
29	Petroleum refining and related products	20	24	20.0	2,938	2,626	-10.6
35	Machinery, except electrical	53	85	60.4	4,325	8,939	106.7
35	Machinery except electrical and electronic computing	50	56	12.0	1,593	2,061	29.4
3573	Electronic computing equip.	3	29	866.7	2,732	6,878	151.8
36	Electrical machinery equip. and supplies	131	135	3.1	13,337	19,774	48.3
38	Scientific and precision instruments	79	93	17.7	10,611	13,114	23.6
	TOTAL	459	503	9.6	43,731	60,287	37.9

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SIC	Promoted Firms	Number of Establishments As of October 1976	1981	Percent Increased	Employment As of October 1976	1981	Percent Increased
28	Chemicals and allied prods.	149	142	- 4.7	11,818	15,124	28.0
28	Chemicals and related products except pharmaceuticals and health products	55	33	-40.0	3,483	2,060	-40.9
283	Pharmaceutical industries	67	74	10.5	7,271	11,648	60.2
284	Health products	27	35	29.6	1,064	1,416	33.1
29	Petroleum refining and related products	10	13	30.0	2,316	2,197	-5.1
35	Machinery, except electrical	42	77	83.3	3,930	8,780	123.4
35	Machinery except electrical and electronic computing	39	48	23.1	1,198	1,902	58.8
3573	Electronic computing equip.	3	29	866.7	2,732	6,878	151.8
36	Electrical machinery equip. and supplies	124	130	4.8	13,239	19,733	49.1
38	Scientific and precision instruments	75	91	21.3	10,587	13,097	23.7
	TOTAL	400	453	13.3	41,890	58,931	40.7

Source: Puerto Rico Department of Labor and Human Resources.

Office of Economic Research
December 6, 1982

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FUNDS ASSIGNED ,EMPLOYMENT AND PERCENTAGE CONTRIBUTION TO TOTAL GROSS PRODUCT AGRICULTURE AND INDUSTRIAL SECTORS FISCAL YEARS 1970,1975,1979,1980 AND 1982

	AGRICULTURE SECTOR			INDUSTRIAL SECTOR		
FISCAL YEARS	AGRICULTURE			MANUFACTURE		
	Employment (Thousands)	Share of gross product (%)	Funds Assigned (millions)	Employment (Thousands)	Share of gross product (%)	Funds Assigned (millions)
1970	68	3.4	$75.8	132	25.4	$21.6
1975	49	3.7	131.2	137	32.4	63.8
1979	38	3.4	371.1	160	43.1	96.7
1980	44	3.4	447.8	157	44.2	94.9
1981	40	3.0	444.7	155	44.1	111.6
1982	36	2.7	467.2	144	46.7	80.0

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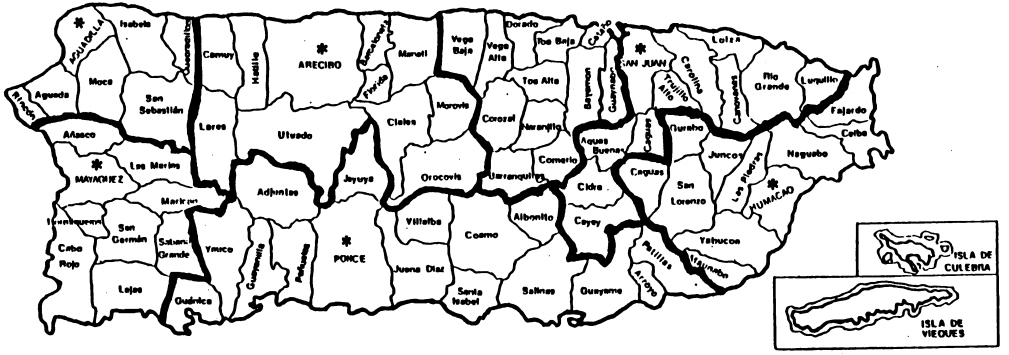
Empleo en Fabricas Promovidas

Distribución de Municipios Por Oficinas Regionales



Núm. de Fabricas		
62	*	Oficina de Aguadilla
119	*	" " Arecibo
192	*	" " Humacao
124	*	" " Mayaguez

Núm. de Fabricas		
244	*	Oficina de Ponce
570	*	" " San Juan Este
388	*	" " San Juan Oeste
1,699		TOTAL DE UNIDADES FABRILES OPERANDO EN PUERTO RICO Noviembre 1982 (Incluye no manufactura, ayudadas y AB)

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DISTRIBUCION POR MUNICIPIOS DE FABRICAS PROMOVIDAS POR FOMENTO OPERANDO ACTUALMENTE

FABRICAS LOCALES

MUNICIPIO	NUM. FABRICAS	EMPLEO ACTUAL	% TOTAL FABRICA	MUNICIPIO	NUM. FABRICAS	EMPLEO ACTUAL	% TOTAL FABRICA	MUNICIPIO	NUM. FABRICAS	EMPLEO ACTUAL	% TOTAL FABRICA
ADJUNTAS	1	***	0.15	GUAYAMA	3	38	0.45	PENUELAS	4	70	0.600
AGUADA	2	***	0.30	GUAYANILLA	3	36	0.45	PONCE	26	918	3.933
AGUADILLA	2	***	0.30	GUAYNABO	29	1,020	4.38	QUEBRADILLAS	2	***	0.300
AGUAS BUENAS	3	61	0.45	GURABO	3	65	0.45	RINCON	0	***	0.000
AIBONITO	4	454	0.60	HATILLO	3	224	0.45	RIO GRANDE	7	286	1.066
ANASCO	2	***	0.30	HORMIGUEROS	1	***	0.15	RIO PIEDRAS	92	2,239	13.900
ARECIBO	9	196	1.36	HUMACAO	3	143	0.45	SABANA GRANDE	1	***	0.155
ARROYO	1	***	0.15	ISABELA	3	22	0.45	SALINAS	2	***	0.300
BARCELONETA	3	178	0.45	JAYUYA	2	***	0.30	SAN GERMAN	1	***	0.155
BARRANQUITAS	2	***	0.30	JUANA DIAZ	5	74	0.76	SAN JUAN	28	521	4.233
BAYAMON	76	1,951	11.48	JUNCOS	6	70	0.91	SAN LORENZO	7	763	1.066
CABO ROJO	5	22	0.76	LAJAS	1	***	0.15	SAN SEBASTIAN	3	90	0.455
CAGUAS	46	1,540	6.95	LARES	1	***	0.15	SANTA ISABEL	0	***	0.000
CAMUY	0	***	0.00	LAS MARIAS	0	***	0.00	TOA ALTA	6	110	0.911
CAROLINA	53	1,208	8.01	LAS PIEDRAS	6	200	0.91	TOA BAJA	25	469	3.788
CATANO	27	608	4.08	LOIZA	0	***	0.00	TRUJILLO ALTO	15	279	2.277
CAYEY	3	145	0.45	LUQUILLO	0	***	0.00	UTUADO	2	***	0.300
CEIBA	2	***	0.30	MANATI	3	50	0.45	VEGA ALTA	5	25	0.766
CIALES	5	224	0.76	MARICAO	1	***	0.15	VEGA BAJA	8	191	1.211
CIDRA	16	278	2.42	MAUNABO	2	***	0.30	VIEQUES	3	33	0.455
COAMO	5	548	0.76	MAYAGUEZ	23	887	3.47	VILLALBA	2	***	0.300
COMERIO	3	23	0.45	MOCA	1	***	0.15	YABUCOA	2	***	0.300
COROZAL	3	44	0.45	MOROVIS	5	78	0.76	YAUCO	8	198	1.211
CULEBRA	0	***	0.00	NAGUABO	1	***	0.15	CANOVANAS	12	282	1.811
DORADO	11	421	1.66	NARANJITO	5	101	0.76	FLORIDA	0	***	0.000
FAJARDO	1	***	0.15	OROCOVIS	3	34	0.45				
GUANICA	3	42	0.45	PATILLAS	0	***	0.00	TOTAL	662	18,335	100.000

*** - NO SE OFRECE EL NUMERO DE EMPLEOS EN LOS MUNICIPIOS QUE TIENEN MENOS DE TRES FABRICAS PERO ESTOS SE REFLEJAN EN EL TOTAL

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ADMINISTRACION DE FOMENTO ECONOMICO
OFICINA DE ESTUDIOS ECONOMICOS
DIVISION DE COMPUTOS ELECTRONICOS

10-NOV-82

DISTRIBUCION POR MUNICIPIOS DE FABRICAS PROMOVIDAS POR FOMENTO OPERANDO ACTUALMENTE

FABRICAS NO LOCALES

MUNICIPIO	NUM. FABRICAS	EMPLEO ACTUAL	% TOTAL FABRICA	MUNICIPIO	NUM. FABRICAS	EMPLEO ACTTAL	% TOTAL FABRICA	MUNICIPIO	NUM. FABRICAS	EMPLEO ACTUAL	% TOTAL FABRICA
ADJUNTAS	2	***	0.21	GUAYAMA	16	1,679	1.68	PENUELAS	17	1,100	1.79
AGUADA	6	820	0.63	GUAYANILLA	1	***	0.11	PONCE	55	5,403	5.78
AGUADILLA	21	3,642	2.21	GUAYNABO	24	887	2.52	QUEBNADILLAS	4	839	0.42
AGUAS BUENAS	9	1,261	0.95	GURABO	16	1,137	1.68	RINCON	5	596	0.53
AIBONITC	7	1,534	0.74	HATILLO	5	339	0.53	RIO GRANDE	16	1,565	1.68
ANASCO	11	1,999	1.16	HORMIGUEROS	7	786	0.74	RIO PIEDRAS	46	3,125	4.83
ARECIBC	27	3,292	2.84	HUMACAO	41	3,888	4.31	SABANA GRANDE	5	1,032	0.53
ARROYO	8	281	0.84	ISABELA	9	1,685	0.95	SALINAS	6	457	0.63
BARCELCNETA	20	4,792	2.10	JAYUYA	5	208	0.53	SAN GERMAN	8	2,618	0.84
BARRANCUITAS	2	***	0.21	JUANA DIAZ	5	394	0.53	SAN JUAN	7	36	0.74
BAYAMON	58	3,829	6.09	JUNCOS	12	1,969	1.26	SAN LORENZO	12	1,269	1.26
CABO ROJO	8	1,572	0.84	LAJAS	2	***	0.21	SAN SEBASTIAN	5	994	0.53
CAGUAS	39	3,088	4.10	LARES	0	***	0.00	SANTA ISABEL	11	888	1.16
CAMUY	6	1,396	0.63	LAS MARIAS	1	***	0.11	TOA ALTA	7	1,120	0.74
CAROLINA	58	5,648	6.09	LAS PIEDRAS	23	2,411	2.42	TOA BAJA	10	1,494	1.05
CATANO	7	377	0.74	LOIZA	3	527	0.32	TRUJILLO ALTO	1	***	0.11
CAYEY	17	2,638	1.79	LUQUILLO	17	1,040	1.79	UTUADO	1	***	0.11
CEIBA	5	330	0.53	MANATI	22	3,781	2.31	VEGA ALTA	14	1,429	1.47
CIALES	2	***	0.21	MARICAO	1	***	0.11	VEGA BAJA	20	3,094	2.10
CIDRA	18	1,764	1.89	MAUNABO	2	***	0.21	VIEQUES	3	190	0.32
COAMO	6	786	0.63	MAYAGUEZ	42	8,230	4.41	VILLALBA	5	395	0.53
COMERIC	3	566	0.32	MOCA	3	675	0.32	YABUCOA	8	1,737	0.84
COROZAL	2	***	0.21	MOROVIS	2	***	0.21	YAUCO	3	306	0.32
CULEBRA	1	***	0.11	NAGUABO	11	564	1.16	CANOVANAS	19	1,102	2.00
DORADO	15	1,647	1.58	NARANJITO	3	265	0.32	FLORIDA	1	***	0.11
FAJARDO	22	2,105	2.31	OROCOVIS	1	***	0.11				
GUANICA	5	613	0.53	PATILLAS	4	307	0.42	TOTAL	952	111,099	100.00

*** = NO SE OFRECE EL NUMERO DE EMPLEOS EN LOS MUNICIPIOS QUE TIENEN MENOS DE TRES FABRICAS PERO ESTOS SE REFLEJAN EN EL TOTAL

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ADMINISTRACION DE FOMENTO ECONOMICO
OFICINA DE ESTUDIOS ECONOMICOS
DIVISION DE COMPUTOS ELECTRONICOS

10-NOV-82

DISTRIBUCION POR MUNICIPIOS DE FABRICAS PROMOVIDAS POR FOMENTO OPERANDO ACTUALMENTE

MUNICIPIO	NUM. FABRICAS	EMPLEO ACTUAL	% TOTAL FABRICA	MUNICIPIO	NUM. FABRICAS	EMPLEO ACTUAL	% TOTAL FABRICA	MUNICIPIO	NUM. FABRICAS	EMPLEO ACTUAL	% TOTAL FABRICA
ADJUNTAS	3	115	0.19	GUAYAMA	19	1,717	1.18	PENUELAS	21	1,170	1.30
AGUADA	8	826	0.50	GUAYANILLA	4	50	0.25	PONCE	81	6,321	5.02
AGUADILLA	23	3,656	1.43	GUAYNABO	53	1,907	3.28	QUEBRADILLAS	6	857	0.37
AGUAS BUENAS	12	1,322	0.74	GURABO	19	1,202	1.18	RINCON	5	596	0.31
AIBONITO	11	1,988	0.68	HATILLO	8	563	0.50	RIO GRANDE	23	1,851	1.43
ANASCO	13	2,063	0.81	HORMIGUEROS	8	787	0.50	RIO PIEDRAS	138	5,364	8.55
ARECIBO	36	3,488	2.23	HUMACAO	44	4,031	2.73	SABANA GRANDE	6	1,048	0.37
ARROYO	9	284	0.56	ISABELA	12	1,707	0.74	SALINAS	8	506	0.50
BARCELONETA	23	4,970	1.43	JAYUYA	7	221	0.43	SAN GERMAN	9	2,648	0.56
BARRANQUITAS	4	325	0.25	JUANA DIAZ	10	468	0.62	SAN JUAN	35	557	2.17
BAYAMON	134	5,780	8.30	JUNCOS	18	2,039	1.12	SAN LORENZO	19	2,032	1.18
CABO ROJO	13	1,594	0.81	LAJAS	3	552	0.19	SAN SEBASTIAN	8	1,084	0.50
CAGUAS	85	4,628	5.27	LARES	1	***	0.06	SANTA ISABEL	11	888	0.68
CAMUY	6	1,396	0.37	LAS MARIAS	1	***	0.06	TOA ALTA	13	1,230	0.81
CAROLINA	111	6,056	6.88	LAS PIEDRAS	29	2,611	1.80	TOA BAJA	35	1,963	2.17
CATANO	34	985	2.11	LOIZA	3	527	0.19	TRUJILLO ALTO	16	459	0.99
CAYEY	20	2,783	1.24	LUQUILLO	17	1,040	1.05	UTUADO	3	148	0.19
CEIBA	7	341	0.43	MANATI	25	2,831	1.55	VEGA ALTA	19	1,454	1.18
CIALES	7	1,046	0.43	MARICAO	2	***	0.12	VEGA BAJA	28	3,285	1.73
CIDRA	34	2,042	2.11	MAUNABO	4	222	0.25	VIEQUES	6	223	0.37
COAMO	11	1,334	0.68	MAYAGUEZ	65	9,117	4.03	VILLALBA	7	428	0.43
COMERIO	6	589	0.37	MOCA	4	733	0.25	YABUCOA	10	1,842	0.62
COROZAL	5	1,469	0.31	MOROVIS	7	606	0.43	YAUCO	11	504	0.68
CULEBRA	1	***	0.06	NAGUABO	12	671	0.74	CANOVANAS	21	1,384	1.92
DORADO	26	2,068	1.61	NARANJITO	8	366	0.50	FLORIDA	1	***	0.06
FAJARDO	23	2,208	1.43	OROCOVIS	4	109	0.25				
GUANICA	8	655	0.50	PATILLAS	4	307	0.25	TOTAL	1,614	129,434	100.00

*** - NO SE OFRECE EL NUMERO DE EMPLEOS EN LOS MUNICIPIOS QUE TIENEN MENOS DE TRES FABRICAS PERO ESTOS SE REFLEJAN EN EL TOTAL

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DISTRIBUCION DEL EMPLEO EN LAS INDUSTRIAS MANUFACTURERAS, POR TIPO DE INDUSTRIA

PUERTO RICO: OCTUBRE 1969 AL 1981

Grupo Industrial	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Industrias Livianas	98,244	94,080	89,686	94,616	95,635	91,343	84,655	86,173	85,669	87,282	83,925	81,584	77,391
Alimentos y relacionados	20,903	20,580	21,746	23,530	22,712	23,721	22,950	24,171	23,880	24,824	24,427	23,368	21,785
Tabaco y Productos de Tabaco	6,027	6,120	5,565	5,557	5,569	5,306	4,980	4,531	3,210	2,849	2,229	2,104	1,668
Productos Textiles	8,675	8,904	6,752	7,693	7,594	7,165	4,898	4,277	4,885	5,055	4,196	3,356	3,228
Ropa y Productos Análogos	40,513	36,819	36,218	39,200	40,721	38,027	36,075	37,054	37,197	36,241	34,155	33,575	33,630
Madera y Producto de Madera	754	788	723	1,703	1,598	1,411	1,296	1,361	1,256	1,228	1,164	1,100	995
Muebles	4,180	4,301	4,312	3,346	3,297	2,772	2,595	2,376	2,303	2,624	2,878	2,473	2,395
Papel y relacionados	1,396	1,392	1,431	1,199	1,362	1,165	1,242	1,479	1,549	1,421	1,611	1,597	1,649
Imprenta y Publicaciones	2,450	2,558	2,643	2,863	2,897	3,030	2,570	2,885	2,895	3,076	3,090	3,454	3,212
Cuero y Productos de Cuero	9,094	8,309	6,571	6,100	6,655	6,148	5,161	4,990	5,663	6,171	5,877	6,642	5,201
Industrias Manufactureras Miscelâneas	4,252	4,309	3,725	3,425	3,230	2,598	2,888	3,049	2,831	3,793	4,298	3,915	3,628
Industrias Medianas	29,805	31,809	35,277	37,123	40,339	38,633	34,271	37,504	38,255	42,770	45,720	45,298	45,271
Productos Plásticos y de Goma	4,173	4,057	3,886	3,813	3,744	3,641	2,744	3,499	3,247	3,847	4,534	4,708	4,272
Productos de Piedra, Barro y Cristal	6,493	6,838	7,280	7,459	7,239	7,292	6,169	5,333	5,098	5,493	5,393	4,816	4,312
Productos Fabricados de Metal	4,498	4,952	5,242	5,835	5,470	5,618	4,610	4,724	4,271	4,740	4,803	4,143	3,799
Maquinaria y Equipo Eléctrico	10,507	10,716	12,557	12,290	14,817	12,548	9,919	13,337	14,069	16,219	17,335	18,024	19,774
Instrumentos Científicos y Profesionales	4,134	5,246	6,312	7,726	9,069	9,534	10,829	10,611	11,570	12,471	13,655	13,607	13,114
Industrias Pesadas	10,478	10,848	13,163	15,508	16,893	19,581	17,691	21,112	24,629	25,882	27,730	27,761	29,008
Químicos y relacionados	4,951	4,890	6,924	9,384	11,042	11,914	10,615	12,520	15,388	15,942	16,690	15,606	15,834
Refinerías de Petróleo y relacionados	2,630	2,907	3,119	3,174	2,764	2,822	2,620	2,938	2,709	2,812	2,681	3,018	2,626
Productos Primarios de Metal	1,087	1,114	1,080	1,089	1,204	1,045	987	994	1,193	1,245	970	1,206	975
Maquinaria Excepto Eléctrica	1,262	1,392	1,507	1,438	1,291	3,347	3,055	4,325	4,892	5,427	6,947	7,353	8,939
Equipo de Transportación	548	545	533	423	592	453	414	335	447	456	442	578	634
TOTAL	138,527	136,737	138,126	147,247	152,867	149,557	136,617	144,789	148,553	155,934	157,375	154,643	151,670

FUENTE: Censos de Industrias Manufactureras de Puerto Rico,
Depto. del Trabajo y Recursos Humanos

Administración de Fomento Económico
Oficina de Estudios Económicos
División de Economía General
Sección de Estadísticas
Julio 1982

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DISTRIBUCION DEL EMPLEO EN LAS INDUSTRIAS MANUFACTURERAS PROMOVIDAS POR FOMENTO

PUERTO RICO: OCTUBRE 1969 AL 1981

Grupo Industrial	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Industrias Livianas	73,724	70,417	66,919	71,165	74,949	71,301	65,486	67,010	66,667	69,252	66,164	64,016	61,800
Alimentos y relacionados	5,803	5,889	7,586	9,407	9,818	10,660	10,346	11,619	11,525	13,164	12,838	12,243	12,140
Tabaco y Productos de Tabaco	5,381	5,371	4,940	4,704	4,971	4,662	4,166	3,982	2,772	2,623	2,130	2,043	1,634
Productos Textiles	8,550	8,728	6,618	7,532	7,535	7,099	4,825	4,205	4,810	4,993	4,122	3,217	3,160
Ropa y Productos Análogos	37,294	34,420	33,898	36,757	38,860	36,442	34,555	35,391	35,462	34,477	32,423	31,579	31,553
Madera y Productos de Madera	332	360	348	808	747	579	543	638	572	583	559	483	534
Muebles	1,941	2,041	2,033	1,580	1,730	1,512	1,338	1,206	1,181	1,396	1,683	1,538	1,628
Papel y relacionados	1,120	1,098	1,172	945	1,128	948	978	1,192	1,267	1,244	1,433	1,364	1,526
Imprenta y Publicaciones	693	764	728	811	869	1,056	1,099	1,060	1,067	1,213	1,194	1,327	1,128
Cuero y Productos de Cuero	9,067	8,239	6,491	5,716	6,580	6,077	5,074	4,976	5,651	6,150	5,852	6,624	5,158
Industrias Manufactureras Misceláneas	3,543	3,507	3,105	2,905	2,711	2,266	2,562	2,741	2,360	3,409	3,930	3,598	3,339
Industrias Medianas	24,517	25,825	28,837	30,513	34,112	32,603	28,660	32,439	33,302	37,704	40,870	40,373	40,871
Productos Plásticos y de Goma	3,960	3,825	3,534	3,514	3,371	3,430	2,216	2,865	2,684	3,294	3,945	4,009	3,622
Productos de Piedra, Barro y Cristal	2,867	2,791	3,185	3,347	3,475	3,501	2,890	2,566	2,295	2,567	2,565	1,994	1,845
Productos Fabricados de Metal	3,101	3,291	3,346	3,720	3,465	3,632	2,885	3,182	2,792	3,227	3,413	2,818	2,574
Maquinaria y Equipo Eléctrico	10,455	10,672	12,463	12,210	14,737	12,511	9,857	13,239	13,989	16,167	17,304	17,961	19,733
Instrumentos Científicos y Profesionales	4,134	5,246	6,309	7,722	9,064	9,529	10,812	10,587	11,542	12,449	13,643	13,591	13,097
Industrias Pesadas	8,518	8,829	10,872	13,242	15,017	17,596	15,889	19,266	22,988	24,179	26,109	26,112	27,528
Químicos y relacionados	4,162	4,209	6,169	8,612	10,231	11,071	9,952	11,818	14,679	15,196	15,985	14,937	15,124
Refinerías de Petróleo y relacionados	2,180	2,321	2,394	2,417	2,260	2,373	2,086	2,316	2,290	2,279	2,270	2,442	2,197
Productos Primarios de Metal	983	1,027	1,003	1,038	1,141	975	918	955	1,126	1,190	919	1,123	918
Maquinaria Excepto Eléctrica	795	882	907	911	925	2,869	2,623	3,930	4,567	5,164	6,608	7,158	8,780
Equipo de Transportación	398	390	399	264	460	308	310	247	326	350	327	452	509
Total	106,759	105,071	106,628	114,920	124,078	121,500	110,035	118,715	122,957	131,135	133,143	130,501	130,199

FUENTE: Censos de Industrias Manufactureras de P.R. - Depto. del Trabajo y Recursos Humanos

Administración de Fomento Económico
Oficina de Estudios Económicos
División de Economía General
Sección de Estadísticas
Julio 1982

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NUMBER OF ESTABLISHMENTS AND EMPLOYMENT BY TWO DIGITS SIC AS OF OCTOBER 1981

SIC		Total Manufacturing		Fomento Promoted	
		Number of Establishments	Employment	Number of Establishments	Employment
20	Food and Kindred Products	379	21,785	105	12,140
21	Tobacco Manufactures	15	1,668	8	1,634
22	Textile Mill Products	26	3,228	23	3,160
23	Apparel and Related Products	304	33,630	257	31,553
24	Lumber and Wood Products, Except Furniture	129	995	30	534
25	Furniture and Fixtures	115	2,395	54	1,628
26	Paper and Allied Products	40	1,649	36	1,526
27	Printing, Publishing and Allied Industries	117	3,212	28	1,128
28	Chemicals and Allied Products	166	15,834	142	15,124
29	Petroleum Refining and Related Products	24	2,626	13	2,197
30	Rubber and Miscellaneous Plastic Products	69	4,272	59	3,622
31	Leather and Leather Products	38	5,201	35	5,158
32	Stone, Clay Glass and Concrete Products	170	4,312	36	1,845
33	Primary Metal Industries	25	975	19	918
34	Fabricated Metal Products, Except Machinery	223	3,799	77	2,574
35	Machinery, Except Electrical	85	8,939	77	8,780

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SIC		Total Manufacturing		Fomento Promoted	
		Number of Establishments	Employment	Number of Establishments	Employment
36	Electrical and Electronic Machinery, Equipment and Supplies	135	19,774	130	19,733
37	Transportation Equipment	19	634	16	509
38	Measuring, Analyzing and Controlling Instruments	93	13,114	91	13,097
39	Miscellaneous Manufacturing Industries	83	3,628	52	3,339
	Total	2,255	151,670	1,288	130,199

Source: Department of Labor

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MANUFACTURING IN PUERTO RICO
REAL COMPENSATION OF EMPLOYEES
FISCAL YEARS 1950 TO 1982

Fiscal Years	Total Employee Compensation (Million Dollars)	Real Compensation 1972 = 100 (Million Dollars)	Manufacturing Employment	Real Compensation per Employee ($)
1950	61.6	109.4	55,000	1,989
1960	180.4	247.5	81,000	3,056
1970	607.9	653.7	132,000	4,952
1971	658.8	680.7	132,000	5,157
1972	751.3	751.3	141,000	5,328
1973	841.8	812.5	142,000	5,722
1974	925.8	802.9	147,000	5,462
1975	964.8	734.2	137,000	5,359
1976	1,028.1	727.6	133,000	5,471
1977	1,149.4	785.6	144,000	5,456
1978	1,323.4	863.8	156,000	5,537
1979	1,496.7	932.5	160,000	5,828
1980	1,657.5	919.3	157,000	5,855
1981	1,787.3	897.2	154,500	5,807
1982	1,853.4	882.6	144,600	6,014

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FOMENTO PROMOTED HIGH TECHNOLOGY PLANTS

	NAME	LOCATION	EMPLOY-MENT
1.	AIR PRODUCTS AND CHEMICALS OF P.R. INC.	GUAYANILLA	14
2.	P.R. CRYOGENICS CORP.	CATAÑO	24
3.	UNION CARBIDE CARIBE	PEÑUELAS	17
4.	P.M.S. CO. OF P.R.	CAROLINA	7
5.	P.R. PIGMENTS (AD-CO COLOR CO.)	VEGA BAJA	22
6.	ALLIED CHEMICAL DE P.R. INC.	VEGA ALTA	8
7.	INDUSTRIAL CHEMICALS CORP.	PEÑUELAS	36
8.	MULTI-CHEMICAL PRODUCTS INC. #2	GUAYNABO	12
9.	SCHERING ANTIBIOTIC CORP.	MANATI	68
10.	SMITH KLINE BECKMAN CORP.	NAGUABO	85
11.	REICHOLD CHEMICAL DEL CARIBE #2	GUAYNABO	15
12.	UNION CARBIDE CARIBE INC. #10	PEÑUELAS	*
13.	A.H. ROBINS MFG. CO.	ARECIBO	110
14.	ABBOTT CHEMICALS INC.	BARCELONETA	397
15.	BILCHEM LTD.	PONCE	39
16.	BRISCHEM INC.	BARCELONETA	50
17.	BRISTOL DE P.R. INC.	BARCELONETA	27
18.	ELI LILLY AND CO. INC. #1	MAYAGUEZ	133
19.	MERCK SHARP & DOHME QUIMICA DE P.R.	BARCELONETA	307
20.	P.C.R. DE P.R. INC.	HUMACAO	10
21.	SCHERING CORP. (P.R.)	MANATI	210
22.	WESTERN FHER LABS. INC.	PONCE	116
23.	A. H. ROBINS MANUFACTURING CO.	ARECIBO	110
24.	A. H. ROBINS MANUFACTURING CO. #2	ARECIBO	
25.	ABBOTT PHARMACEUTICAL INC.	BARCELONETA	163
26.	ALCON LABS.	HUMACAO	42
27.	ALCON PUERTO RICO	HUMACAO	170
28.	ALLERGAN AMERICA	HORMIGUEROS	86
29.	ALLERGAN CARIBBEAN CORP.	HORMIGUEROS	62
30.	ARBROOK MANUFACTURING CORP.	CAGUAS	18
31.	ARNAR STONE DEL CARIBE INC.	AGUADILLA	76
32.	ARNAR-STONE INC.	AGUADILLA	14
33.	B.M.O. MFG. INC.	ARECIBO	40
34.	BIO DYNAMICS CARIBBEAN INC.	PONCE	12
35.	BIO DYNAMICS PUERTO RICO INC.	PONCE	11
36.	BRISTOL ALPHA CORPORATION	BARCELONETA	362
37.	BRISTOL CARIBBEAN INC.	MAYAGUEZ	41
38.	BRISTOL LABORATORIES INC.	MAYAGUEZ	111
39.	CAPSUTABS CORP.	ARECIBO	30
40.	COOPER VISION PHARMACEUTICAL INC.	SAN GERMAN	398
41.	CYANAMID AGRICULTURAL DE P.R. INC.	MANATI	138
42.	DENVER CHEMICAL P.R. INC.	HUMACAO	74
43.	DERMCO INC.	GURABO	44
44.	DORASOL LABORATORIES	RIO PIEDRAS	14
45.	DURHAM P.R. INC.	MAYAGUEZ	17
46.	EATON LABORATORIES INC.	MANATI	103
47.	ELI LILLY AND CO. #2	MAYAGUEZ	*
47A.	ELI LILLY INDUSTRIES INC.	CAROLINA	805
48.	ENDO INC.	MANATI	46
49.	ENDO PHARMACEUTICALS INC.	MANATI	54
50.	EX-LAX INC.	HUMACAO	111
51.	GRANCHEL MEDICINE CORP. INC.	RIO PIEDRAS	10
52.	JANSSEN INC.	GURABO	53
53.	LABORATORIOS STIEFEL INC.	MAYAGUEZ	3
54.	LEDERLE PARENTERALS	CAROLINA	207
55.	LEDERLE PARENTERALS INC.	CAROLINA	
56.	M.S.D. AGVET INC.	BARCELONETA	11
57.	MC NEIL LABORATORIES	DORADO	207
58.	MC NEIL LABORATORIES CO.	DORADO	
59.	MERRELL NATIONAL LABS. INC.	CAYEY	47
60.	NESSAN LABORATORIES INC.	CAROLINA	14
61.	NORTH DAKOTA (TRAVENOL LABS. INC.)	JAYUYA	41
62.	NUTRITIONAL SPECIALTIES INC.	ARECIBO	7
63.	OHIO MEDICAL CARIBE INC.	GUAYAMA	136
64.	ORTHO PHARMACEUTICALS CORP.	MANATI	160
65.	PFIZER PHARMACEUTICAL INC.	BARCELONETA	387
66.	ROCHE PRODUCTS INC.	MANATI	608
67.	S. K. & F. CO.	CIDRA	264
68.	S. K. & F. LAB. CO.	GUAYAMA	381
69.	S. K. & F. LAB. CO.	CIDRA	*
70.	S. K. & F. LABS. #1	CAROLINA	562
71.	S. K. & F. LABS. #2	GUAYAMA	*
72.	SCHERING BIOCHEMICAL CORP.	MANATI	39
73.	SCHERING INDUSTRIES INC.	MANATI	82
74.	SCHERING PHARMACEUTICAL CORP.	MANATI	217
75.	SEARLE AND CO.	CAGUAS	414
76.	SEARLE AND CO. #2	CAGUAS	
77.	SEARLE AND CO. #3	CAGUAS	
78.	SEIN MENDEZ LABORATORIES INC.	RIO PIEDRAS	48
79.	SQUIBB MFG. INC.	HUMACAO	494
80.	SYNTEX P.R. INC.	HUMACAO	68

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	NAME	LOCATION	EMPLOYMENT
1.	AIR PRODUCTS AND CHEMICALS OF P.R. INC.	GUAYANILLA	14
2.	P.R. CRYOGENICS CORP.	CATAÑO	24
3.	UNION CARBIDE CARIBE	PEÑUELAS	17
4.	P.M.S. CO. OF P.R.	CAROLINA	7
5.	P.R. PIGMENTS (AD-CO COLOR CO.)	VEGA BAJA	22
6.	ALLIED CHEMICAL DE P.R. INC.	VEGA ALTA	8
7.	INDUSTRIAL CHEMICALS CORP.	PEÑUELAS	36
8.	MULTI-CHEMICAL PRODUCTS INC. #2	GUAYNABO	12
9.	SCHERING ANTIBIOTIC CORP.	MANATI	68
10.	SMITH KLINE BECKMAN CORP.	NAGUABO	85
11.	REICHOLD CHEMICAL DEL CARIBE #2	GUAYNABO	15
12.	UNION CARBIDE CARIBE INC. #10	PEÑUELAS	*
13.	A.H. ROBINS MFG. CO.	ARECIBO	110
14.	ABBOTT CHEMICALS INC.	BARCELONETA	397
15.	BILCHEM LTD.	PONCE	39
16.	BRISCHEM INC.	BARCELONETA	50
17.	BRISTOL DE P.R. INC.	BARCELONETA	27
18.	ELI LILLY AND CO. INC. #1	MAYAGUEZ	133
19.	MERCK SHARP & DOHME QUIMICA DE P.R.	BARCELONETA	307
20.	P.C.R. DE P.R. INC.	HUMACAO	10
21.	SCHERING CORP. (P.R.)	MANATI	210
22.	WESTERN FHER LABS. INC.	PONCE	116
23.	A. H. ROBINS MANUFACTURING CO.	ARECIBO	110
24.	A. H. ROBINS MANUFACTURING CO. #2	ARECIBO	
25.	ABBOTT PHARMACEUTICAL INC.	BARCELONETA	163
26.	ALCON LABS.	HUMACAO	42
27.	ALCON PUERTO RICO	HUMACAO	170
28.	ALLERGAN AMERICA	HORMIGUEROS	86
29.	ALLERGAN CARIBBEAN CORP.	HORMIGUEROS	62
30.	ARBROOK MANUFACTURING CORP.	CAGUAS	18
31.	ARNAR STONE DEL CARIBE INC.	AGUADILLA	76
32.	ARNAR-STONE INC.	AGUADILLA	14
33.	B.M.O. MFG. INC.	ARECIBO	40
34.	BIO DYNAMICS CARIBBEAN INC.	PONCE	12
35.	BIO DYNAMICS PUERTO RICO INC.	PONCE	11
36.	BRISTOL ALPHA CORPORATION	BARCELONETA	362
37.	BRISTOL CARIBBEAN INC.	MAYAGUEZ	41
38.	BRISTOL LABORATORIES INC.	MAYAGUEZ	111
39.	CAPSUTABS CORP.	ARECIBO	30
40.	COOPER VISION PHARMACEUTICAL INC.	SAN GERMAN	398
41.	CYANAMID AGRICULTURAL DE P.R. INC.	MANATI	138
42.	DENVER CHEMICAL P.R. INC.	HUMACAO	74
43.	DERMCO INC.	GURABO	44
44.	DORASOL LABORATORIES	RIO PIEDRAS	14
45.	DURHAM P.R. INC.	MAYAGUEZ	17
46.	EATON LABORATORIES INC.	MANATI	103
47.	ELI LILLY AND CO. #2	MAYAGUEZ	*
47A.	ELI LILLY INDUSTRIES INC.	CAROLINA	305
48.	ENDO INC.	MANATI	46
49.	ENDO PHARMACEUTICALS INC.	MANATI	54
50.	EX-LAX INC.	HUMACAO	111
51.	GRANCHEL MEDICINE CORP. INC.	RIO PIEDRAS	10
52.	JANSSEN INC.	GURABO	53
53.	LABORATORIOS STIEFEL INC.	MAYAGUEZ	3
54.	LEDERLE PARENTERALS	CAROLINA	207
55.	LEDERLE PARENTERALS INC.	CAROLINA	
56.	M.S.D. AGVET INC.	BARCELONETA	11
57.	MC NEIL LABORATORIES	DORADO	207
58.	MC NEIL LABORATORIES CO.	DORADO	
59.	MERRELL NATIONAL LABS. INC.	CAYEY	47
60.	NESSAN LABORATORIES INC.	CAROLINA	14
61.	NORTH DAKOTA (TRAVENOL LABS. INC.)	JAYUYA	41
62.	NUTRITIONAL SPECIALTIES INC.	ARECIBO	7
63.	OHIO MEDICAL CARIBE INC.	GUAYAMA	136
64.	ORTHO PHARMACEUTICALS CORP.	MANATI	160
65.	PFIZER PHARMACEUTICAL INC.	BARCELONETA	387
66.	ROCHE PRODUCTS INC.	MANATI	608
67.	S. K. & F. CO.	CIDRA	264
68.	S. K. & F. LAB. CO.	GUAYAMA	381
69.	S. K. & F. LAB. CO.	CIDRA	*
70.	S. K. & F. LABS. #1	CAROLINA	562
71.	S. K. & F. LABS. #2	GUAYAMA	*
72.	SCHERING BIOCHEMICAL CORP.	MANATI	39
73.	SCHERING INDUSTRIES INC.	MANATI	82
74.	SCHERING PHARMACEUTICAL CORP.	MANATI	217
75.	SEARLE AND CO.	CAGUAS	414
76.	SEARLE AND CO. #2	CAGUAS	
77.	SEARLE AND CO. #3	CAGUAS	
78.	SEIN MENDEZ LABORATORIES INC.	RIO PIEDRAS	48
79.	SQUIBB MFG. INC.	HUMACAO	494
80.	SYNTEX P.R. INC.	HUMACAO	68

* REPORTS WITH ANOTHER.

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81.	SYNTEX OF P. R. INC.	HUMACAO	163
82.	TRAVENOL LAB. (IDAHO) INC.	JAYUYA	12
83.	TRAVENOL LABS. (WYO) INC.	JAYUYA	41
84.	U.S.V. P.R. DEV. CORP.	MANATI	19
85.	U.S.V. PHARMACEUTICAL MFG. CORP.	MANATI	85
86.	UPJOHN CO. OF P.R.	ARECIBO	238
87.	UPJOHN MFG. CO. (THE)	ARECIBO	518
88.	UTAH TRAVENOL LABS.	CAROLINA	896
89.	VICKS OLAY INC.	CAYEY	207
90.	W.J.K. CORP.	HUMACAO	24
91.	WARNER LAMBERT INC.- FAJARDO DIVISION	FAJARDO	141
92.	WARREN TEED OF P.R.	HUMACAO	25
93.	WINTHROP LABS. INC.	BARCELONETA	143
94.	E.L. MANUFACTURING CORP.	DORADO	81
95.	PORTO CHEMICAL CORP.	GUAYNABO	10
96.	JABONES FINOS INC.	TRUJILLO ALTO	6
97.	NATIONAL CHEMSEARCH CARIBBEAN INC.	CAROLINA	94
98.	SOL CARIBE INC.	TOA BAJA	12
99.	VERPAS PRODUCTS INC.	CAROLINA	34
100.	AMERICAN CHEMICAL CORPORATION	BAYAMON	60
101.	BESST CHEMICAL CORP.	BAYAMON	15
102.	BROWNING FERRIS CHEMICAL SERVICES	PONCE	21
103.	C & K MANUFACTURING INC.	BAYAMON	24
104.	CLOROX OF PUERTO RICO	CAGUAS	30
105.	CROSSCO MFG. CORP.	RIO PIEDRAS	20
106.	PETROFAX INC.	CAROLINA	12
107.	STAR CHEMICAL OF P.R. INC.	CAROLINA	15
108.	WATER TREATMENT SPECIALISTS INC.	CATARO	5
109.	ELSO INC. (E.L. MFG. CORP. #5)	DORADO	56
110.	MALTER CARIBBEAN INC.	RIO PIEDRAS	21
111.	RAMCO CHEMICAL INC.	BAYAMON	4
112.	ALBERTO CULVER P.R. INC.	NAGUABO	52
113.	ALLANT INTERNATIONAL INC.	CATARO	6
114.	ALVARA INTERNATIONAL PRODUCTS INC.	CATARO	3
115.	CARTER P.D. INC.	RINCON	93
116.	CHANEL MFG. CO. INC.	HUMACAO	25
117.	CHEMPROD CORP.	BAYAMON	9
118.	COLORADO PUERTO RICO INC.	HUMACAO	1
119.	COMBE PRODUCTS INC.	HUMACAO	35
120.	COSMETIC & CHEMICAL MFG. INC.	GUAYNABO	11
121.	DENTCO INC.	HUMACAO	75
122.	FLOR-QUIM INC.	PATILLAS	22
123.	GENERAL CHEMICAL AND COSMETICS INC.	CAROLINA	52
124.	GENERAL COSMETICS INDUSTRIES INC.	CANOVANAS	4
125.	JOHNSON & JOHNSON BABY PRODUCTS INC.	LAS PIEDRAS	20
126.	JOHNSON & JOHNSON BABY PRODUCTS INC.	LAS PIEDRAS	59
127.	JOHNSON BABY PRODUCTS CO.	LAS PIEDRAS	78
128.	LUPAV CORPORATION	CANOVANAS	3
129.	NELL-VALL CORP.	CATARO	2
130.	PRINCE MATCHABELLI MFG. CO.	LAS PIEDRAS	85
131.	REEDCO INC.	HUMACAO	85
132.	ARMSTRONG PAINTS OF P.R. INC.	CANOVANAS	15
133.	COLLOIDS AND CHEMICALS CORP.	CAGUAS	30
134.	GENERAL PAINT CORP.	CATARO	7
135.	GLEEM PAINTS OF P.R. INC.	CIDRA	11
136.	HARRIS PAINTS	BAYAMON	52
137.	LUNA PAINTS CORP.	BAYAMON	22
138.	RELIANCE UNIVERSAL OF P.R. #2	BAYAMON)	54
139.	RELIANCE UNIVERSAL OF P.R. #3	BAYAMON)	
140.	SUPERIOR PAINT MFG. CO. INC.	RIO PIEDRAS	131
141.	UNION CARBIDE (LINDE DIV.)	PERUELAS	*
142.	CARBOTEX INC.	CANOVANAS	4
143.	COLORCON PUERTO RICO INC.	HUMACAO	18
144.	AVICON INC.	HUMACAO	23
145.	HYDROCARBON RECOVERY SYSTEMS INC.	RIO PIEDRAS	9
146.	INLAND CHEMICAL P.R. INC.	MANATI	19
147.	INSTRUMENTATION LABORATORY DE P.R. LTD.	CIDRA	56
148.	PEERLESS OILS CHEMICALS INC.	PERUELAS	6
149.	UNION CARBIDE CARIBE INC. #1	PERUELAS)	924
150.	UNION CARBIDE CARIBE INC. #4	PERUELAS)	
151.	UNION CARBIDE CARIBE INC. #5	PERUELAS)	
152.	UNION CARBIDE CARIBE INC. #6	PERUELAS)	
153.	UNION CARBIDE CARIBE INC. #7	PERUELAS)	
154.	UNION CARBIDE CARIBE INC. #8	PERUELAS)	
155.	UNION CARBIDE CARIBE INC. #9	PERUELAS)	
156.	UNION CARBIDE CARIBE INC. #2	PERUELAS)	
157.	UNION CARBIDE CARIBE INC.	PERUELAS)	
158.	SUPER A FERTILIZER INC.	MAYAGUEZ	25
159.	CARIBE BIOCHEMICALS INC.	MANATI	188
160.	INDUSTRIAS NACIONALES	RIO PIEDRAS	11

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161.	MULTI-CHEMICAL PRODUCTS INC.	GUAYNABO	*	
162.	VINELAND CHEMICAL CO. OF P.R. INC.	RIO GRANDE	2	
163.	BORINQUEN ADHESIVES AND CHEMICALS INC.	PONCE	5	
164.	CARIBE COATING	PONCE	5	
165.	FULLER ADHESIVES OVERSEAS INC.	BAYAMON	15	
166.	GLEEM PAINTS OF P.R. CO. INC.	CIDRA	4	
167.	LANCO MFG.	SAN LORENZO	16	
168.	LOCTITE P.R. INC.	SABANA GRANDE	145	
169.	MAPEI DE P.R. INC.	SAN JUAN	5	
170.	RELIANCE UNIVERSAL OF P.R. #4	BAYAMON	54	
171.	RELIANCE UNIVERSAL OF P.R. INC. #1	BAYAMON	*	
172.	WORTHEN CARIBE INC.	PONCE	8	
173.	BORDEN'S INK OF P.R. INC.	CAROLINA	7	
174.	CABO ROJO ENTERPRISES	CABO ROJO	6	
175.	MARK-TEX DE P.R. INC.	VEGA BAJA	5	TOTAL SIC 28
176.	MASTER BUILDERS	CAROLINA	3	PLANTS 178
177.	WATER SERVICES CARIBBEAN INC.	CAROLINA	5	EMPLOYMENT 14,961
178.	CARIBBEAN GULF REFINING CORP.	BAYAMON)		
179.	CARIBBEAN GULF REFINING CORP. #2	BAYAMON)	400	
180.	CARIBBEAN GULF REFINING CORP. #3	BAYAMON)		
181.	ESSO STANDARD OIL S.A. LTD.	PENUELAS	5	
182.	PHILLIPS PARAXYLENE INC.	GUAYAMA	30	
183.	PHILLIPS P.R. CORE INC.	GUAYAMA	292	
184.	UNION CARBIDE CARIBE INC. #11	PENUELAS	*	
185.	UNION CARBIDE CARIBE #3	PENUELAS	*	
186.	YABUCOA SUN OIL CO. INC.	YABUCOA	380	
187.	ALCO CORPORATION	CANOVANAS	50	
188.	PETROLEUM CHEMICAL CORP.	BAYAMON	10	
189.	DANOSA CARIBBEAN INC.	BAYAMON	45	
190.	FELCO P.R. INC.	GUAYNABO	5	
191.	PLACCO CO. OF P.R. INC. #2	GUAYNABO)	35	TOTAL SIC 29
192.	PLACCO P.R. INC.	GUAYNABO)		PLANTS 17
193.	AUTOCHEMICAL CORP.	CATAÑO	12	EMPLOYMENT 1,285
194.	HEMISPHERE OIL CO.	YABUCOA	21	
195.	POWER SERVICES CARIBE CO.	CATAÑO	125	
196.	MAQUINARIA CAFETALERA INC.	BAYAMON	11	
197.	ASCENSORES WESTINGHOUSE INC.	SANTA ISABEL	180	
198.	REXNORD PUERTO RICO INC.	COAMO	89	
199.	A A KANEK TOOL & DIE MFG. INC.	CATAÑO	3	
200.	AMERICAN TOOL & DIE INC.	BAYAMON	25	
201.	BAYAMON PRECISION MACHINERY	CATAÑO	7	
202.	C. G. HEATH INC.	RIO PIEDRAS	10	
203.	COMMONWEALTH TOOL INC.	MAYAGUEZ	3	
204.	DESIGN TOOL CORP.	RIO PIEDRAS	3	
205.	DYNAMIC TOOL & DIE CORP.	TOA BAJA	1	
206.	P. R. INDUSTRIES	CAGUAS	170	
207.	INDUSTRIAL MACHINE SHOP	GUAYNABO	12	
208.	INDUSTRIAL PRECISION SHOP INC.	PONCE	7	
209.	JO-MA MANUFACTURING INC.	TOA BAJA	8	
210.	MACHINERY PARTS & DIE MAKERS INC.	PONCE	18	
211.	MONARCH TOOL & DIE CORPORATION	CAGUAS	7	
212.	PROGRESSIVE TOOL & MFG. CORP.	MAYAGUEZ	9	
213.	SAN LORENZO INDUSTRIES	SAN LORENZO	43	
214.	VIKING DIE CORP.	CAGUAS	7	
215.	AERO SPS INC.	ARASCO	5	
216.	MAYTEX TOOL & DIE CORP.	CANOVANAS	3	
217.	P. H. GUEX TOOLING & FASTENING SYS.	VEGA ALTA	31	
218.	REX USA TOOL CORP.	HUMACAO	9	
219.	OMARK ANTILLES INC.	CIDRA	112	
220.	OMARK CARIBBEAN INC.	BAYAMON	210	
221.	B.V.I. VIBRO TOOLS INC.	BAYAMON	17	
222.	BURGESS VIBROCRAFTERS INC. (P.R. BRANCH)	BAYAMON	17	
223.	PHOTORECEPTORS SYSTEMS INC.	CANOVANAS	75	
224.	UNITED RUBBER FULLER CO.	VILLALBA	18	
225.	BAKER BROS. OF P.R. INC.	LAS PIEDRAS	6	
226.	CLIS MANUFACTURING CORP.	GUAYNABO	3	
227.	CROSS HYDRAULIC INC.	HUMACAO	7	
228.	BEARING BUDDY INC.	PATILLAS	14	
229.	FORD MOTOR CORP. CARIBBEAN INC.	CANOVANAS	76	
230.	RANSBURG MFG. CORP.	NAGUABO	53	
231.	RANSBURG PRODUCTS CORP.	NAGUABO	27	
232.	WESTINGHOUSE STURTEVANT OF P.R.	SANTA ISABEL	n.a.	
233.	ENERGY RECOVERY SYSTEMS INC.	ARROYO	15	
234.	FILTERTEK DE P.R. INC. #2	MAUNABO	80	
235.	FILTERTEK P.R. INC.	PATILLAS	73	
236.	MILLIPORE CORP. OF P.R.	CIDRA	250	
237.	PALL FILTER PRODUCTS CO.	FAJARDO	65	
238.	PALL HYDRAULICS P.R. INC.	LUQUILLO	31	
239.	ABLE COMPUTER TECHNOLOGY P.R. INC.	PONCE	41	
240.	APPLIED MAGNETICS CARIBE INC.	CAROLINA	273	

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241.	APPLIED MAGNETICS CARIBE INC. DIV. #2	CAROLINA	*
242.	APPLIED MAGNETICS OF P.R. #2	CAROLINA	*
243.	CHRISLIN INDUSTRIES INC.	CANOVANAS	11
244.	COMPUTER & INSTRUMENTATION OF P.R. INC.	VILLALBA	127
245.	DATAPRODUCTS P.R. INC.	PONCE	235
246.	DIGITAL EQUIPMENT CORPORATION	AGUADILLA	1,092
247.	DIGITAL EQUIPMENT CORPORATION	SAN GERMAN	1,810
248.	DIGITAL EQUIPMENT CORPORATION DE P.R.	SAN GERMAN	*
249.	DOCUMATION INC. DE P.R.	MAYAGUEZ	253
250.	HEWLETT PACKARD PUERTO RICO CO.	AGUADILLA	285
251.	HONEYWELL INFORMATION SYSTEMS DE P.R.	VEGA BAJA	177
252.	INFORMATION MAGNETICS INC.	MOCA	268
253.	INTEGRAL DATA SYSTEMS DE P.R.	JUNCOS	67
254.	INTEL PUERTO RICO INC.	LAS PIEDRAS	41
255.	INTERTEL DEL CARIBE MFG. INC.	ARECIBO	49
256.	KENNEDY CO. P.R. INC.	LUQUILLO	18
257.	M.F.E. CARIBE	LUQUILLO	63
258.	MDS GANTEL (P.R.) CORP.	JUNCOS	146
259.	MICON CARIBE	CAYEY	98
260.	MICRODATA P.R. INC.	CAROLINA	84
261.	OAKLEAF CARIBE INC.	CAROLINA	47
262.	PARADYNE CARIBBEAN INC.	PONCE	169
263.	PRIME COMPUTER INC. DE P.R.	PONCE	119
264.	PROCOMP INC.	LUQUILLO	16
265.	QUME CARIBE INC.	LAS PIEDRAS	207
266.	QUME CARIBE INC. #2	HUMACAO	809
267.	STORAGE TECHNOLOGY P.R. INC.	PONCE	429
268.	TELEVIDEO SYSTEMS OF P.R.	PONCE	31
269.	WANG LABS P.R. INC.	CAGUAS	70
270.	DATA APPLICATION EQUIPMENT CO.	AGUADA	223
271.	FUGEL CARIBBEAN CORP.	AGUADILLA	33
272.	FRIGO MANUFACTURING CORP. #1	COROZAL	12
273.	REFRIBOX INC.	CATARO	16
274.	STATE SITE METAL	PONCE	7
275.	THERMO KING CARIBBEAN	CIALES	242
276.	THERMO KING OF P.R. INC.	ARECIBO	260
277.	THERMO ROOMS INC.	CAGUAS	7
278.	ALFA CASTING CORP.	TOA BAJA	15
279.	AUTOTROL P.R. INC.	TOA ALTA	T.C.
280.	RIO GRANDE INDUSTRIES INC.	RIO GRANDE	20
281.	G.E. RECONSTRUCTION COMPANY	PONCE	35
282.	MAYAGUEZ FILTERS CO. INC.	MAYAGUEZ	1
283.	MECO INC.	MAYAGUEZ	2
284.	P.R.D. OF PUERTO RICO INC.	FAJARDO	42
285.	RANSBURG PARTS INC.	NAGUABO	27
286.	ASSEMBLERS AND FABRICATORS OF P.R.	RIO PIEDRAS	12
287.	PETER PAUL ELECTRIC INC.	FAJARDO	20
288.	MINI TRAN INC.	TRUJILLO ALTO	180
289.	PRODUCTOS ELECTRONICOS	SANTA ISABEL	141
290.	PRODUCTOS WESTINGHOUSE (TRANSFORMERS)	MAYAGUEZ	103
291.	PRODUCTOS WESTINGHOUSE INC.	MAYAGUEZ	73
292.	SOLA BASIC PUERTO RICO INC.	CAROLINA	48
293.	STANRIC INC.	RIO GRANDE	*
294.	STELCO ELECTRICAL PRODUCTS INC.	CAROLINA	4
295.	TRANSFORMADORES WESTINGHOUSE INC.	GURABO	112
296.	ZINSCO ELECTRICAL PROD. OF P.R. INC.	CAGUAS	30
297.	ZINSCO ELECTRICAL PRODUCTS	CAGUAS	*
298.	ANTILLES INC.	CANOVANAS	7
299.	BORINQUEN CIRCUIT BREAKERS	CANOVANAS	11
300.	CARIBE CIRCUIT BREAKERS CO. INC. 1 & 2	CANOVANAS	16
301.	DORADO MOULDING CO. INC.	CANOVANAS	37
302.	E.L. MANUFACTURING CORP.	DORADO	51
303.	FUSIBLES WESTINGHOUSE DE P.R.	LUQUILLO	60
304.	G.E. ARASCO INC.	ARASCO	60
305.	G.E. ARASCO INC.	VIEQUES	10
306.	G.E. CIRCUIT BREAKERS	SAN GERMAN	290
307.	G.E. CIRCUIT BREAKERS	RIO GRANDE	225
308.	G.E. GEPOL INC.	ARECIBO	248
309.	G.E. LOW VOLTAGE PRODS. INC.	RIO PIEDRAS	155
310.	G.E. POWER PRODUCTS INC.	RIO PIEDRAS	30
311.	G.E. PROTECTIVE DEVICES INC.	HUMACAO	406
312.	G.E. PROTECTIVE RELAYS	ARASCO	382
313.	G.E. SWITCHGEAR INC.	VIEQUES	178
314.	I.V.I. MFG. INC.	CABO ROJO	38
315.	ICO DE P.R. INC.	CABO ROJO	77
316.	INTERRUPTORES INC.	TOA BAJA	306
317.	MATERIALES PLASTICOS	PONCE	20
318.	MINIX WESTINGHOUSE	LUQUILLO	17
319.	POWER BREAKERS INC.	VEGA BAJA	285
320.	PRECISION PROTECTIVE DEVICES INC.	RIO GRANDE	179.

TOTAL SIC 35

PLANTS 91

EMPLOYMENT 9,912

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321.	PRORELCO DE PUERTO RICO INC.	SALINAS	157
322.	SYLVANIA CIRCUIT BREAKERS	COMERIO	170
323.	SYLVANIA UNELEC INT'L.	CANOVANAS	57
324.	TORK INTERNATIONAL LTD.	NAGUABO	35
325.	WESTINGHOUSE BREAKERS	AGUAS BUENAS	268
326.	ELECTRONIC CORP. OF AMERICA INT'L.	RIO PIEDRAS	241
327.	ELECTRONICS CORP. OF AMERICA INT'L. P.R.	RIO PIEDRAS	*
328.	G.E. PILOT DEVICES INC.	VEGA ALTA	130
329.	INDUSTRIAL CONTROL OF P.R. INC.	MAUNABO	88
330.	PRODUCTOS MOTRICES INC.	GURABO	91
331.	PRODUCTOS MOTRICES INC. #2	GURABO	*
332.	WESTINGHOUSE CONTROLS OF P.R. INC.	COAMO	327
333.	AEROSPACE SYSTEMS INC.	VEGA BAJA	35
334.	UNION CARBIDE GRAFITO INC.	YABUCOA	546
335.	MOTOROLA COMPONENTS	VEGA BAJA	84
336.	SEWTECH MANUFACTURING CORP.	CATAÑO	15
337.	COINCO P.R. INC.	QUEBRADILLAS	26
338.	D.O.M. OF PUERTO RICO INC.	CIDRA	14
339.	DUR-O-MATIC OF P.R. INC.	CIDRA	5
340.	DUR-O-MATIC OF P.R. INC. #2	CIDRA	5
341.	MAREY HEATERS CORP.	SAN JUAN	3
342.	ILLUMINATION PRODUCTS CORPORATION	RIO PIEDRAS	18
343.	LIGHTALARMS INT'L. INC.	OROCOVIS	75
344.	SYLVANIA LIGHTING CO.	FAJARDO	67
345.	AMPGARD DE P.R.	TOA BAJA	45
346.	BRYLOC CORP.	AIBONITO	164
347.	COMINCO CORP. INC.	BAYAMON	23
348.	DUAL LITE OF P.R. INC.	CAROLINA	53
349.	G.E. CONTROLS INC.	VEGA ALTA	300
350.	G.E. INDUSTRIAL PRODUCTS INC.	MANATI	144
351.	G.E. WIRING DEVICES INC.	JUANA DIAZ	181
352.	GIBSON ELECTRIC OF PUERTO RICO INC.	LUQUILLO	160
353.	P.R. CONNECTORS INC.	ARROYO	11
354.	PAMCOR INC.	RIO PIEDRAS	140
355.	PRODUCTOS DE CONTROL COROX	CEIBA	197
356.	PRODUCTOS ELECTROMECANICOS INC.	SAN LORENZO	109
357.	RAYCHEM INDUSTRIES INC.	VEGA BAJA	60
358.	RAYCHEM OF P.R. INC.	VEGA BAJA	14
359.	SYLVANIA CONNECTOR PRODUCTS	HUMACAO	67
360.	T.I.I. INDUSTRIES INC.	TOA ALTA	405
361.	THOMAS & BETTS CARIBE INC.	VEGA BAJA	45
362.	THOMAS & BETTS CARIBE INC.	TOA BAJA	86
363.	ARROW STEEL PROCESSING & MFG. CORP.	JUNCOS	13
364.	T.I.I. INDUSTRIES INC.	TOA ALTA	*
365.	VI-CAR INDUSTRIES	BAYAMON	10
366.	WIRING DEVICES OF P.R. (G.E.)	PONCE	86
367.	LAMPARAS ELECTRICAS INC.	CAYEY	164
368.	DUAL LITE CARIBE INC.	CAROLINA	60
369.	DUAL LITE OF P.R. #2	NAGUABO	52
370.	ATARI CARIBE INC.	FAJARDO	825
371.	MATSUSHITA ELECTRIC (AUDIO DIVISION)	CAGUAS	249
372.	MOTOROLA RADIO SINTETIZADOS DE P.R. INC.	VEGA BAJA	137
373.	MOTOROLA TELCARRO P.R. INC.	VEGA BAJA	252
374.	PRECISION TOOL CO.	BAYAMON	CLOSED
375.	P.R. RECORD & MFG. CO. INC.	SAN JUAN	10
376.	COMMUNICATION TECHN. CORP. CARIBBEAN	FAJARDO	16
377.	MITEL CARIBE INC.	BAYAMON	415
378.	PAMCOR INC.	LAS PIEDRAS	101
379.	PAMCOR INC. DIV. B	RIO PIEDRAS	140
380.	PORTA SYSTEM CARIBBEAN CORP.	RIO PIEDRAS	125
381.	SUTTLE CARIBE INC.	HUMACAO	83
382.	SYNCOR INDUSTRIES CORP.	MAYAGUEZ	23
383.	APPLIED MAGNETICS CARIBE INC. #4	CAROLINA	*
384.	BERKELEY-TELONIC INT'L. INC.	MAYAGUEZ	21
385.	CHECKPOINT SYSTEMS OF P.R.	PONCE	62
386.	H.T.L. CARIBE INC.	LUQUILLO	18
387.	INFOTRON PUERTO RICO INC.	PONCE	17
388.	INTERNATIONAL DATA SCIENCE	LUQUILLO	14
389.	MOTOROLA PORTATILES DE P.R.	VEGA BAJA	271
390.	MOTOROLA PORTAVOZ DE P.R. INC.	VEGA BAJA	280
391.	MOTOROLA RADIOMOVIL DE P.R. INC.	VEGA ALTA	160
392.	PRADCO CARIBE INC.	NAGUABO	114
393.	R.C. A. BORINQUEN INC.	JUNCOS	995
394.	SENSORMATIC ELECTRONICS DE P.R. INC.	MOCA	225
395.	VEGA-TRONICS INC.	VEGA ALTA	55
396.	TUBOS ELECTRONICOS WESTINGHOUSE INC.	CAYEY	40
397.	NEW SENECA ELECTRONICS INC.	VEGA BAJA	165
398.	SILVERAY TUBE CO. INC.	TOA BAJA	4
399.	CENTRONICS P.R. INC.	DORADO	156
400.	CHOMERICS P.R. INC.	JUNCOS	20

* REPORTS WITH ANOTHER.

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401.	ELECTRO CIRCUITS INC.	ARECIBO	T.C.
402.	HOLBROOK ENERGY MANAGEMENT CORP.	RIO PIEDRAS	2
403.	INTEL CARIBBEAN INC.	LAS PIEDRAS	157
404.	SEMI-CONDUCTORES WESTINGHOUSE INC.	GURABO	103
405.	SIGMA DE P.R. INC.	HATILLO	104
406.	SILICON GENERAL P.R. INC.	AGUADA	13
407.	ZELTEX P.R. INC.	AGUADA	45
408.	MATSUSHITA (CAPACITORS DIVISION)	CAGUAS	73
409.	MATSUSHITA (MOTORS DIVISION)	CAGUAS	*
410.	CHACE SPECIALTIES METAL	CAROLINA	93
411.	G.E. INDUSTRIAL CONTROL OF P.R. INC.	PATILLAS	197
412.	T.R.R. INC.	VEGA BAJA	104
413.	ADJUNTAS ELECTRONIC MFG. CORP.	ADJUNTAS	5
414.	ALLEN GROUP OF P.R. INC.	FAJARDO	262
415.	ALTRON DE P.R. INC.	FAJARDO	21
416.	C.W. CARIBE INC.	CEIBA	32
417.	ELECTRICAL CONTROLS & DISTRIBUTION PROD.	CAROLINA	20
418.	ESCOD DE P.R. INC.	GUANICA	91
419.	HOWELL DATA SYSTEMS	CAROLINA	30
420.	INTEL PUERTO RICO INC.	LAS PIEDRAS	41
421.	KELVIN INDUSTRIES INC.	FAJARDO	160
422.	L.H. CARIBE	CAYEY	73
423.	LUTRON DE P.R.	HUMACAO	145
424.	MASCO CORP.	AGUADILLA	366
425.	PELCO CARIBE LTD.	CAROLINA	18
426.	PERKIN-ELMER CARIBBEAN CORP.	MAYAGUEZ	74
427.	POWER ELECTRONICS INC.	ISABELA	115
428.	PRODUCTOS CIRCUITOS DE P.R. INC.	JUANA DIAZ	31
429.	SERVITRONICS MFG. INC.	CAGUAS	6
430.	SYNTEX DIAMOND PRODUCTS CORP.	RIO PIEDRAS	17
431.	SYSTEMATIC INDUSTRIES INC.	RIO GRANDE	35
432.	SYSTEMS CORPORATION DE PUERTO RICO	HUMACAO	179
433.	TERMINAL PRODUCTS INC.	HORMIGUEROS	37
434.	WANG PUERTO RICO INC.	JUNCOS	260
435.	WESTINGHOUSE STURTEVANT OF P.R. #2	SANTA ISABEL	N.A.
436.	GENERAL BATTERY CO.	CAROLINA	67
437.	MED-REL INC.	HUMACAO	200
438.	N.D.M. CORPORATION OF P.R.	SABANA GRANDE	104
439.	TECHNICON ELECTRONICS CORP.	HUMACAO	262
440.	AUTOMOTIVE PRODUCTS MFG.	BAYAMON	13
441.	ECHLIN OF PUERTO RICO	PONCE	236
442.	ENCO-DELTA MFG. INC.	BAYAMON	10
443.	G.T. MFG. CORP.	RIO PIEDRAS	60
444.	POWER PARTS INC.	CAROLINA	240
445.	STANRIC INC.	RIO GRANDE	202
446.	POWERLINE MFG. CORP.	CAGUAS	10
447.	AIM INTERNATIONAL INC.	MAYAGUEZ	19
448.	ALLEN GROUP (THE)	FAJARDO	*
449.	BOEHRINGER MANNHEIM P.R. INC.	PONCE	32
450.	COMPUTER & INSTRUMENTATION DE P.R. INC.	PONCE	58
451.	GENERAL MONITORS CARIBBEAN INC.	CANOVANAS	28
452.	ISOMEDIX PUERTO RICO INC.	VEGA ALTA	13
453.	MACRO VUE INC.	CAYEY	60
454.	MIC-LANCE INC.	CANOVANAS	41
455.	NOVA BIOMEDICAL CARIBE INC.	RIO PIEDRAS	25
456.	SECUNDUS INC.	SAN LORENZO	13
457.	WARNER LAMBERT INC.	BARCELONETA	59
458.	BAUSCH & LOMB CARIBE INC.	JUNCOS	23
459.	CHACE PRECISION MATERIAL	CAROLINA	95
460.	EMERSON ELECTRIC CO.	DORADO	46
461.	EMERSON PUERTO RICO INC.	DORADO	150
462.	WARICO INTERNATIONAL INC.	CAROLINA	22
463.	BOURNS P.R. INC.	CIDRA	155
464.	CONDOR SYSTEMS INC.	SAN JUAN	5
465.	DWYER INSTRUMENTS INC. P.R.	NAGUABO	41
466.	ORION RESEARCH PRODS. P.R. INC.	RIO PIEDRAS	55
467.	PANAMETRICS P.R. INC.	CAROLINA	23
468.	ALLEN GROUP ELECTRONIC P.R. INC.	FAJARDO	262
469.	DATA DESIGN (SIERRA INSTRUMENTS)	CIDRA	19
470.	KENT METERS INC.	ISABELA	50
471.	KENT METERS OF P.R. INC.	ISABELA	50
472.	PRIMUS MFG. INC.	SAN LORENZO	15
473.	REN MFG. CO.	CATAÑO	20
474.	STATHAM INSTRUMENTS	RIO PIEDRAS	*
475.	BECKMAN INSTRUMENTS P.R. INC. #2	CAROLINA	230
476.	BOURNS PUERTO RICO INC.	HUMACAO	169
477.	G.E. INDICATING DEVICES	CAGUAS	180
478.	G.E. INDICATING DEVICES (GEID INC.)	CAGUAS	*
479.	OHMICO CARIBE INC.	DORADO	14
480.	PORMETCO INC.	SALINAS	57

TOTAL SIC 36

PLANTS 160
EMPLOYMENT 18,163

T.C. - TEMPORARILY CLOSED.
* - REPORTS WITH ANOTHER.
N.A. - NOT AVAILABLE.

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481.	POWER ENGINEERING INC.	CATARO	19
482.	SCHLUMBERGER INSTRUMENT DE P.R.	PONCE	113
483.	SPECTROL CARIBE CORP.	ARASCO	228
484.	SUNTESTER DE P.R. INC.	ARECIBO	101
485.	WESTON CARIBE INC.	PONCE	25
486.	WESTON CARIBE INC. #2	PONCE	12
487.	WESTON P.R. INC.	PONCE	118
488.	WESTRONICS (WESTON INSTRUMENTS)	PONCE	76
489.	BECTON DICKINSON P.R. INC.	JUNCOS	183
490.	BELL & HOWELL INSTRUMENTS CO.	CAROLINA	11
491.	ENDEVCO CORP. OF P.R. INC.	RIO PIEDRAS	18
492.	ENDEVCO CORP. (PTR)	RIO PIEDRAS	11
493.	STANTRONICS INC.	RIO GRANDE	43
494.	TEMP-AWAY INC.	CANOVANAS	N.A.
495.	P.K.N. CORP.	MAYAGUEZ	16
496.	WATERS PUERTO RICO INC.	CIDRA	75
497.	B-D CATHETER CORPORATION	CANOVANAS	N.A.
498.	BARD CARDIOPULMONARY INC.	LAS PIEDRAS	26
499.	BELL & HOWELL DEVICES INC.	CAROLINA	58
500.	CONCEPT P.R. INC.	FAJARDO	46
501.	DADE DIAGNOSTICS INC.	AGUADA	223
502.	E-Z-EM CARIBE INC.	SAN LORENZO	43
503.	EDWARDS LABORATORIES INC. #1	ARASCO	251
504.	EDWARDS LABORATORIES INC. #2	ARASCO	457
505.	GOULD STATHAM INSTRUMENT	RIO PIEDRAS	220
506.	HEYER SHULTE DEL CARIBE INC.	ARASCO	124
507.	IOWA TRAVENOL LABS. INC.	JAYUYA	26
508.	MCGAW LABORATORIES INC.	SABANA GRANDE	765
509.	MEDICAL STERILE PRODUCTS INC.	RINCON	30
510.	MEDTRONICS P.R. INC.	VILLALBA	165
511.	MONTANA TRAVENOL LABS INC.	CAROLINA	61
512.	PALL BIOMEDICAL INC.	LUQUILLO	14
513.	PHARMASEAL CORP.	TOA ALTA	52
514.	PHARMASEAL INC.	TOA ALTA	627
515.	PHARMASEAL LABS INC.	TOA ALTA	57
516.	TRAVENOL LAB (COLORADO) INC.	MARICAO	953
517.	TRAVENOL LAB (DELAWARE) INC.	JAYUYA	88
518.	TRAVENOL LABS (ALASKA) INC.	AIBONITO	1,004
519.	TRAVENOL LABS (ALASKA) INC.	CULEBRA	280
520.	U.S.S.C. PUERTO RICO INC.	PONCE	921
521.	V. MUELLER DEL CARIBE INC.	AGUADILLA	34
522.	ABBOTT HOSPITAL INC.	BARCELONETA	1,036
523.	BARD IMPLANTS INC. (U.S.C.I. PRODUCTS)	LAS PIEDRAS	58
524.	BAUER & BLACK INC.	LAS PIEDRAS	N.A.
525.	CHESEBROUGH-PONDS INC.	LAS PIEDRAS	242
526.	CUTTER RICO INC.	LAS PIEDRAS	51
527.	DAVIS & GECK	MANATI	830
528.	FREDERICK LEE INC.	MAYAGUEZ	56
529.	OR PRO LABORATORIES	RIO PIEDRAS	12
530.	PEG BANDAGE INC.	LAS PIEDRAS	115
531.	SHILEY CARIBBEAN	ARECIBO	62
532.	CERAMCO CO.	LAS PIEDRAS	29
533.	CONCEPT OF P.R. INC.	FAJARDO	46
534.	EXCELCO INT'L. CO.	SAN JUAN	10
535.	JOHNSON & JOHNSON D.O.C. INC.	GURABO	240
536.	ORTHO-TAIN ENTERPRISES	TOA ALTA	9
537.	STIM-U-DENT	GURABO	9
538.	COTTED OPTICAL CORP.	SALINAS	39
539.	EYES UNLIMITED	MAYAGUEZ	2
540.	LABORATORIO OPTICO DEL OESTE	MAYAGUEZ	3
541.	PAN AMERICAN OPTICAL MFG. CORP.	GUAYNABO	43
542.	PROFESSIONAL OPTICAL SERVICES INC.	BAYAMON	7
543.	RODENSTOCK CORP.	YAUCO	167
544.	M.B. JACKETS DE P.R. INC.	CAGUAS	47
545.	R.C.A. DEL CARIBE INC.	BARCELONETA	344
546.	L.W.W. INC.	CAYEY	N.A.
547.	MAJOR INTERNATIONAL INC.	CAROLINA	12
548.	SEA ELECTRONICS AIDS INC.	MAYAGUEZ	10
549.	T.M.X. LTD.	BAYAMON	40
550.	TRANSWORLD DIALS CORP.	LAS PIEDRAS	8

TOTAL PLANTS 550

TOTAL EMPLOYMENT 57,451

TOTAL SIC 38

PLANTS 104
EMPLOYMENT 13,130

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PROJECTS PENDING ESTABLISHMENT

	NAME	MUNICIPALITY	COMMITTED EMPLOYMENT	
A.	P. R. ORGANICS INC.	ARECIBO	30	
B.	BOLAR LABORATORIES INC.	HUMACAO	15	
C.	CHEMOPLEX OF P.R. INC.	RIO PIEDRAS	50	
D.	VICKS P.R. INC.	CAYEY	50	SIC 25
E.	INDUCHEM INC.	PONCE	10	PLANTS 6
F.	FORTO CHEMICAL COATING CORP.	GUAYNABO	10	EMPLOYMENT 165
G.	DEL-REY TOOLING CORPORATION	CATARO	14	
H.	SYKES DATATRONICS INC.	VEGA BAJA	300	
I.	WANG P.R. INC.	JUNCOS	500	SIC 35
J.	CARIBE COINCO INC.	QUEBRADILLAS	30	PLANTS 5
K.	INTERNATIONAL HERMETICS CORP.	RIO PIEDRAS	23	EMPLOYMENT 867
L.	GENERAL ILLUMINATING INC.	CAROLINA	159	
M.	COMMONWEALTH MFG. CORP.	GURABO	159	
N.	CRESCENDO AUDIO PRODUCTIONS INC.	RIO PIEDRAS	13	
O.	MASCO COMMUNICATIONS INC.	AGUADILLA	18	
P.	TELLAB'S CARIBE INC.	FAJARDO	120	
Q.	NARCO AVIONICS INTERNATIONAL INC.	MAYAGUEZ	125	
R.	INDUSTRIAL CONTROL OF P.R. INC.	ARROYO	100	SIC 36
S.	SAYLES ELECTRIC CO.	TOA BAJA	50	PLANTS 9
T.	SYSTEM CORP. INC.	CAGUAS	28	EMPLOYMENT 772
U.	EMERSON PUERTO RICO INC.	DORADO	150	
V.	LYNX ANALYZER CO. INC.	CATARO	75	
W.	BENTLEY P.R. INC.	ARASCO	30	
X.	ELECTRO BIOLOGY P.R. INC.	GUAYNABO	50	
Y.	THE CANNULAE CORP.	BAYAMON	35	
Z.	SARTORIUS MFG. P.R. INC.	YAUCO	50	SIC 38
AA.	SURGICO LTD.	CEIBA	50	
BB.	AMO DEL CARIBE INC.	ARASCO	22	PLANTS 9
CC.	B & H MICROFILM COMPONENTS INC.	CAGUAS	300	EMPLOYMENT 762

TOTAL

PLANTS 29
EMPLOYMENT 2,566

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APPENDIX B

SELECTED COMMENTARIES, REPORTS ON THE U.S. TREASURY ANNUAL REPORTS OF THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION

General Comments on the Second Annual Report on the Operation and Effect of the Possessions Corporation System Taxation

The Second Annual Report on the Possessions Corporation System of Taxation is an unbalanced and misleading document because the writers seem not to have taken into sufficient consideration the main purpose of the Report and who its major audience is intended to be.

The Department of Treasury was ordered by the U.S. Congress to prepare an annual report on the possessions corporation taxation system (936 law) because the Congress wished to have the operation of their law evaluated. As the Report's excellent second chapter explains, the 936 law is the most recent in a series of laws beginning in 1921 when the Congress first endeavored to pass tax legislation which would permit U.S. corporations operating out of U.S. possessions to compete effectively in world markets. The Tax Reform Act of 1976 included some changes in the possessions system of taxation because of flaws which had developed in the system. Any evaluation of the possessions system has an obligation to place primary emphasis on the question of how well section 936 has succeeded in correcting those flaws. As the General Explanation of the Tax Reform Act of 1976 states:

> It is the understanding of Congress that the Department of the Treasury is to review the operations of section 936 corporations in order to apprise Congress of the effects of changes made by the Act. (emphasis added)

Unfortunately, virtually no attention is given at all in the report to this most fundamental question.

Probably the major flaw of the previous (931) system was that profits made in Puerto Rico often were not repatriated to the U.S. or reinvested in

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Puerto Rico, but were placed in offshore investments such as the Eurodollar market. This was certainly not beneficial to the United States economy.

Only two sentences in the entire report are devoted to the salutary changes for the mainland economy that have taken place as a result of 936. They are to be found on page six of the introduction and summary chapter and they read as follows:

> In 1977, possessions corporations began to repatriate dividends at an annual rate of approximately $1.2 billion. This represents nearly 70 percent of current earnings.

No further elaboration is given. No direct comparison with the situation in previous years is provided. No comment is made on the desirability or undesirability of this development as far as the intentions of the framers of the 936 law are concerned. No judgment is rendered as to whether the law is accomplishing what it was intended to accomplish in this area or whether it is not. There is no speculation as to what this (we think favorable) development might portend for the future of the 936 system.

Also on page 6 and later in Chapter IV (page 78) it is acknowledged further, with the assistance of Table II that "... possessions corporations have greatly increased their portfolio investments in Puerto Rico since 1976..." In this case, however, the judgment is quickly offered that however large the investments might be or might become in the future, they are destined to be of little significance to the economy of Puerto Rico. This rather surprising conclusion is arrived at by the use of admittedly scant evidence and reasoning of the following sort:

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> The fact that the Puerto Rican capital market is highly integrated with the U.S. capital market means that all investors, including possessions corporations, can readily compare after tax rates of return in Puerto Rico and the United States, and will quickly adjust their financial portfolios in response to changes in these returns. A "good" investment in Puerto Rico will be financed with or without the financial portfolios of possessions corporations; a "bad" investment will not.

Certainly this is an item of conjecture which could be debated. If true, it makes pointless the strenuous efforts that the Puerto Rico government is making to encourage reinvestment by 936 corporations on the island and it is at odds with the economic judgment of the framers of the 936 law itself. On page 278 of the Report of the Senate Finance Committee on the Tax Reform Act of 1976, a weakness of the 931 system is described as follows:

> ... investing the business earnings of these possession corporations outside of the possession where the business is being conducted does not contribute significantly to the economy of that possession either by creating new jobs or by providing capital to others to build new plants and equipment.

Clearly the Senate committee felt that if these funds were to be invested in Puerto Rico they would benefit the economy of Puerto Rico.

Wherever the truth lies in this question, the fact comes through clearly that when a negative conclusion on 936 can be arrived at through conjecture, the authors do not hesitate to do so -- and this is not the only example. On the consequences of the now massive yearly repatriations of profits to the mainland, a positive change of undeniably great significance, the authors maintain a stony silence.

Another problem with the old system was that companies operating in Puerto Rico which were affiliated with U.S. companies would consolidate

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their tax returns with the parent company in years when they had losses, reducing the tax liability of the parent company in those years. Presumably that problem has been corrected with the requirement that firms opt for 936 status for a 10 year period without the option of slipping out of that status in loss years. Table 10 shows, apparently, that this feature of the law has also been a success since a significant proportion of the U.S. firms have chosen 936 status. A narration connecting these developments with the intentions of the Congress would have been helpful. Also evidence, which is available, of certain 936 companies which have had to swallow their losses without being able to thereby reduce their U.S. tax liabilities would have further attested to the effectiveness of this feature of the 936 law.

A final negative aspect of the old possessions tax system was the encouragement that it gave to possessions corporations to liquidate their operations in Puerto Rico upon the expiration of their tax exemption decree in order to repatriate accumulated profits free of U.S. taxes.

Perhaps it will take many years of experience in which the rate of liquidations and plant closings is traced in order to determine if this problem has been corrected. Unfortunately, the Report does not address itself to this question at all. It is noted that there has been a shift away from such traditional labor-intensive industries as apparel and shoes and toward more capital intensive industries as pharmaceuticals and electronics. The fact that the latter types of industry are much less readily liquidated than the former is not commented upon. Neither is the great

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reduction in the rate of plant closings that has occurred in the years since the passage of 936.

Since the report gives such slight attention to the major changes resulting from the change from 931 to 936, since they devote so few words and such little analysis to that which they were specifically ordered to analyze, one might wonder how the authors might have used the 115 pages required for the document. One thing they might have done is to look at the reasons the Senate Finance Committee gave for not making any more changes in the possessions system than they did. If since that time some changes have occurred that would undermine the committee's rationale for the course of action taken, then certainly the Report should comment upon it. If no fundamental changes have occurred, then that, too, should be worthy of comment as a guide for possible future Congressional action.

As its main reason for not making major changes, the Senate Finance Committee mentioned the extra burden of U.S. Government-imposed costs that the possessions had to bear when in competition with neighboring countries for investments such as those brought on by Federal minimum wages and requirements to use U.S. flagships in shipping between the mainland and the possessions as reasons not "to disturb the existing relationship between the possessions investment incentives and U.S. tax laws". (Page 278 Report of the Senate Finance Committee on HR 10612. As an aside, on a point that will become important later in this critique, it should be observed that the Committee did not assume that there would be "no behavioral change" on the part of potential investing companies regardless of the tax law. Rather, to influence behavior was the main purpose of the 936 law as has been the case with Possessions tax law from the beginning.)

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Had they addressed themselves to this question the preparers of the 936 Report would have had to conclude that no changes have occurred to mitigate these disadvantages. In fact, Federally mandated minimum wages in Puerto Rico have risen significantly since 1976 and are scheduled to reach virtual parity with the mainland in 1981. No change has been made in the shipping laws and the labor cost advantages of neighboring countries have not changed significantly since 1976.

Rather than to direct their attention to these major questions, to those aspects of the law in which the Congress was clearly most interested, the preparers of the Report chose instead to emphasize those things that concern the United States Treasury the most. This is what we mean when we say that losing sight of the intended audience is the document's basic fault. Not only is this to be a report for the U.S. Congress but it is also one that is closely watched all over the world by actual and potential investors in Puerto Rico. At stake is a fiscal arrangement which has been instrumental in lifting the island from the depths of poverty to a standard of living higher than any in Latin America. The preparers of the only annual U.S. Government appraisal of this fiscal arrangement have a responsibility to be as fair and balanced in their appraisal as they know how to be. They are not to write a brief on behalf of the Internal Revenue Service of the United States Treasury.

Immediately following the passage in which Congress tells the Treasury to report on the results of the changes in the Possessions Law is the following passage:

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> Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions.

The preparers of the Report have seized upon this part of their mandate to set up their own calculus of costs versus benefits in which the costs are reckoned to be the presumed "tax expenditures" of the U.S. Treasury and the benefits are jobs and salaries in Puerto Rico resulting from the law. They do not, in their so-called cost-benefit analysis, confine themselves at all to the "revenue effects of the (936?) provision", but instead take on the whole possessions and Puerto Rico tax incentive system, concluding authoritatively that the program is "cost ineffective".

Apart from the explanation of the technicalities of the tax law and the historical summary, it is this cost-benefit analysis which dominates and gives organization to the document. One section is entitled promisingly "Impact of the Adoption of Section 936 and Recent Changes in the Puerto Rican Tollgate Tax and Industrial Incentives Program." It turns out not be the overall evaluation of 936 that is hoped for but the "impact" referred to is on their narrow and flawed cost-benefit calculus. The "among other things" part of the mandate is generally ignored, resulting in the serious omissions already mentioned, and it is ignored to the degree that there is no discussion at all of any effects of the provision or the system on the United States economy.

The cost-benefit exercise is seriously deficient both on its cost and its benefit side. The biggest deficiency on the cost side is summarized antiseptically by the authors as follows:

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> The Federal tax expenditure estimates and projections are... based on the assumption of "no behavioral change". The assumption of no behavioral change should not be taken literally; undoubtedly possessions corporations (and other persons) would behave differently in the absence of the possessions corporation provisions. The reason for following the assumption here is that it allows tax expenditures to be estimated using available information on existing law and behavior. Estimating the effect on tax expenditures of behavioral changes would require additional analysis of, and assumptions about, what would happen if the possessions corporation provisions were repealed, and knowledgeable observors may differ in their assessment of what would happen.

Fair enough. The authors admit they are performing an academic exercise in order to get some numbers and they are doing it by assuming that all the 936 corporations that are in Puerto Rico at present would be there and would have been able to grow and prosper at the same rate even if they had been required to pay corporate taxes at the full U.S. rate. What they don't say is that this assumption results, in all likelihood, in an enormous overestimate of the "costs" of the system. "Knowledgeable observors may differ", but most would expect that a substantial number of 936 firms would have chosen a foreign location instead of Puerto Rico if they had been required to pay full U.S. taxes. Some firms would not have been able to expand as rapidly as they have. Others might not even exist.

Moreover, this disclaimer, this entreaty not to take the term "tax expenditure" literally, comes but once and it is made on page 55. Before that the expression is used no less than 22 times. On the second page (page 5) and after the sixth instance of its use we find the following discussion:

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> ...the tax expenditure per employee in 1977 for all possessions corporations was $8,222, which is slightly less than the average employee compensation paid of $8,507. This means that for every dollar of compensation paid to a Puerto Rican employee by a possessions corporation, Federal tax revenues were reduced by nearly one dollar.

One could hardly hope to find a clearer and more prejudicial example of "taking literally" the expression "tax expenditure", especially since it comes when the expression is first used in the Introduction and Summary chapter. Its frankly literal use also underlies the cost-benefit analysis, the judgment of cost ineffectiveness of the possessions system, and, ultimately the entire Report.

Just three pages after the disclaimer and the entreaty, when discussing tax expenditure in the pharmaceutical industry, the authors give us the same literal interpretation that they had provided on page 6. Overall, in the 115 pages of the report this not-to-be-taken-literally expression turns up some 150 times. Of the 28 tables in the document, 19 are on the subject of tax expenditure. Given the drum-beat repetition of its use and the (convenient?) failure of the authors to follow their own advice, one might share our concern that Congressional or business readers of the Report might be led to a mistaken understanding of the "tax expenditure" concept and consequently a faulty judgment on the operation of Section 936.

The fundamental error on the benefit side in the method of evaluation employed can be easily seen by looking at the recent experience of the electronics industry in Puerto Rico and how this experience is seen in the Report. Electronics, especially the high-technology part of it such as micro-processors, is a

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very fast-growing industry both in the United States and in Puerto Rico. It is very significant for the U.S. economy because it represents one area in which we still have the competitive lead in spite of heavy subsidies being laid out by such countries as England, France, and Japan to help their industries compete with ours. New England is particularly indebted to the industry, having been revived by electronics after falling into the economic doldrums for many years caused by the loss of many of its traditional manufactures.

For Puerto Rico mini-computers have been a godsend. Page 46 of the Report explains quite well the competitive problems that Puerto Rican industry now must encounter. The micro-processor industry fortunately comes to us hungry both for our surplus labor, much of it skilled and well-paid, and for investment funds to support expansion in the U.S. With its demand for wide variety of inputs it has the potential to spread its tentacles throughout the economy and create a genuine industrial complex.

The change from 931 to 936 has been especially timely for advanced technology electronics and for Puerto Rico. Under 931 these companies would not have been able to get nearly as much money back to the U.S. to finance expansion as they now do without liquidating their Puerto Rico operations. Perhaps 936 is a major reason why more of these companies are coming to Puerto Rico in recent years, and why more of them are staying and expanding.

Because its innovations have led to high profits, if the Report were to talk about the growth of the micro-processor industry in Puerto Rico in particular -- which it does not -- it would no doubt disapprove. The

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closest the Report comes to discussing these developments directly is the concluding paragraph on page 82:

> The three industries with the lowest benefit -- cost ratios -- chemicals (including pharmaceuticals), electrical and electronic equipment, and scientific instruments -- have been three of the fastest growing industries over both the entire 1973-1978 period, and the more recent 1976-1978 period. The reverse is true of the three industries with the highest benefit-cost ratios -- food and kindred products, textile mill products, and apparel. These three industries have grown very slowly, or actually lost employment, between 1976 and 1978 and over the entire 1973-1978. These comparisons suggest that the possessions corporation system as revised will continue to make Puerto Rico most attractive to relatively high profit operations of U.S. firms in selected industries that produce relatively fewer benefits to Puerto Rico than the traditional, labor intensive industries.

That summary serves as its own indictment of the method of assessing benefits employed in the Report. We would be consigned to low-wage, low-skill industries in perpetuity.

Clearly, major changes are called for in the Report before it can measure up to basic standards of fairness and objectivity and before it can accomplish its intended objective. First, emphasis should be given to the effect of changes wrought by 936 in the possessions system. This analysis should comprise most of the body of the Report.

To the extent that the Treasury feels it must evaluate the entire possessions system of taxation it should do so in the full historical, political, social, legal, and economic context. In the largest sense, has it or has it not been beneficial to Puerto Rico and to the United States?

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In this context they should keep in mind that a provision which provides benefits to or counters disadvantages of U.S. corporations at the expense of some initial loss of taxes does not prima facie represent a cost to the United States. They should also recognize explicitly the connection between the remarkable economic transformation of Puerto Rico since 1945 and the possessions system. We might also remind them that the most important things are not always the easiest to measure. In fact, usually the reverse is true.

Any judgments as to cost effectiveness should be addressed to the tax exemption program of Puerto Rico and not to the possessions system. It is the government of Puerto Rico that has chosen to forego tax money in order to achieve certain developmental objectives. Constructive suggestions as to how we might more effectively achieve those objectives would be welcome. As Dr. Newton points out in his comments the tax collections of the U.S. Government would probably be unaffected by elimination of Section 936.

Finally, we invite the Treasury's serious attention to all the detailed changes we have suggested throughout our commentary.

Economic Development Administration of
Puerto Rico
Office of Economic Research
April 8, 1980

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Second Annual Report

Page by Page Critique

Page 4. a. Reasons for change in manufacturing structure. You should mention improvements in skills, infrastructure, general manufacturing experience, and the conscious efforts of Fomento to get higher paying jobs for our people among the reasons for the structural change.

b. Benefits to the Puerto Rican economy. You should mention the social benefits such as the creation of a middle class, the incentive for education through the job opportunities provided, and the useful skills that are learned on the job. Maybe if you were to take note of these things pharmaceuticals and electronics would not rank so much lower than apparel on your scale of benefits.

c. Overstated benefits. You say that benefits are overstated because opportunity costs of the resources used are not considered. This may be a source of overstatement but your neglect of those things mentioned above is a major source of understatement. Consequently, your conclusions about "net benefit" are not sound.

We find reminders of overstated benefits at every opportunity in the report but never the reminder of grossly overstated costs that result from the "no behavioral change" assumption.

d. Cost effectiveness. Your suggestions as to how to improve the cost effectiveness of the tax exemption program is one

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that might be more appropriately addressed to the Government of Puerto Rico privately. The possessions system of taxation has existed for many years. Only since 1947 has the Government of Puerto Rico instituted manufacturing tax exemption as a tool to foster economic development. Comparing our development with what it was before and observing those countries which have chosen to emulate our methods convinces us that we took the right basic course. Expert suggestions as to how we might make our program more cost effective are welcome. However, we have ample reason to be concerned over public judgments by an agency of the U.S. Government that the entire possessions system of taxation is "cost ineffective".

Page 5. We, of course, object strenuously to this initial repeated use of the "tax expenditure" term and the completely wrong, literal interpretation of the concept. For what it is worth, we think you will find that the pharmaceutical's share of this magnitude will be somewhat reduced this year.

Your conclusions about concentration of benefit would be much less objectionable if tempered by the observation that, in business, some firms and some industries are a great deal more profitable than others and that all industrial recruiters favor the more profitable ones because of the higher quality and greater security of the jobs created.

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Page 6.

-- "While these benefit-cost ratios are too high, because benefits are overstated and costs understated..."

This statement is untrue and unnecessary as we explain in detail in our general comments.

-- "This wide interindustry variation provides a statistical indication of the cost ineffectiveness of the possessions corporation system."

This statement is also false because of the theoretical shortcomings of the model employed. Again, the support for our statement is in the general comments.

-- "Chapter IV concludes with an analysis of the impact of the adoption of section 936 and the recent changes in the Puerto Rican tollgate tax and Industrial Incentive Program."

The conclusion of Chapter IV falls far short of this objective. The "impact" spoken of is only upon the spurious cost-benefit calculus, not overall in the U.S. and Puerto Rico.

The concluding three paragraphs of this page are the most important in the entire report and should have been elaborated on in far more detail as explained in the general comments.

Page 7.

-- "These U.S. and Puerto Rican legislative changes have not, however, had a dramatic effect on the basic costs, benefits, or cost effectiveness of the possessions corporation system."

Might not this be because these laws were not intended to have any such dramatic immediate impact? The U.S. law, in fact, was not designed to have any effect at all on these supposed costs-benefits

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but was directed at entirely different objectives. The P.R. law is written so that taxation will take effect gradually, making it easier for comparisons to taxable status. Any law which would have produced such a "dramatic effect" on costs and benefits would have no doubt been a disaster for the economy of Puerto Rico because of the "behavioral change" that would have occurred among companies.

-- "... Federal tax expenditure .. is expected to reach $1.2 billion by 1984."

This is too far in the future for such a precise estimate, especially when there are so many admitted imponderables in how companies will respond to the new Puerto Rico incentive law.

-- "Benefits to Puerto Rico may also have been marginally reduced, through the disincentive effect of the tax increases..."

If this is true then there would be an accompanying reduction of costs because of the reduced "tax expenditure". Is it legitimate to assume "behavioral change" in your model only when it suits you?

-- The text does not provide sufficient support for the assertion that "the availability of credit or long run interest rates" have not been affected in Puerto Rico by the law changes.

-- "On balance, the cost effectiveness of the possessions corporation system may not have been altered in any significant degree by the recent legislative changes."

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But, then again, it may have. The Puerto Rico law in particular should have such an effect in the long run. The 936 law was designed primarily to help the U.S. economy and that is not included in your "cost effectiveness" calculations.

-- "... the system will continue to attract the high profit... operations of U.S. firms in particular industries that provide relatively few benefits to the Puerto Rican economy. The system may provide less of an incentive in the future to the traditional labor intensive industries."

The problem with this observation as with the concluding paragraph on page 82 is that the meaning of the word "relatively" is unclear. Relative to their "costs" in terms of "tax expenditures" the high-profit, high-technology firms may provide fewer benefits than the traditional industries. But you appear to be saying that, in sum total, the benefits to Puerto Rico of the modern industries are fewer. You must know that this is simply not the case. The list of advantages of high-technology industries is long: greater security, more opportunity, higher wages, more dignity, more linkages, etc. and this is why industrial promoters around the country pursue them. Might there not be an ever-so-slight colonial bias in your reasoning? Do you really think that the natural role of Puerto Rico is to provide low-skill standard merchandise to the United States market?

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Page 8. "The intent of these departures is to reach a non-tax policy objective: increased employment in Puerto Rico."

This is far from the only objective. The initial intent of the U.S. possessions corporation provisions was not this at all. To a certain extent, even today, greater employment in the possessions is a by-product of the system as one can learn from reading this chapter carefully. To treat these tax arrangements as just another form of public works or revenue sharing is to reason in a historical, social, political, and legal vacuum.

The Incentive Acts of Puerto Rico were indeed designed to take advantage of features of the possession system which could be used to promote industrialization and modernization of the economy and society of the island. The goal, however, has never been just to create jobs. Cutting sugar cane is a job but it is not a particularly rewarding one. The same can be said for many kinds of sweatshop labor.

Since you insist on putting the entire Federal and local tax system on trial in this report you must conclude that it has indeed resulted in extraordinary economic development for Puerto Rico, and that it is the sort of development that could hardly have been accomplished through simple Federal largesse.

Page 25. "Textiles were the fastest growing industry..." Apparel, not textiles, was fastest growing. Textiles have never represented a very large part of manufactures in Puerto Rico.

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Page 31.

"Puerto Rico's economic growth after 1947 has often been called an 'economic miracle'... By any historical or international yardstick, this was a remarkable performance."

Don't you think there might be some noteworthy connection between the possessions system of taxation and this "remarkable performance"? We refer to our concluding commentary on page 8 of your report.

Page 48

"The Costs and Benefits of the Possessions Corporation System".

Our objection to most of what follows is contained in our general comments. To be fair you do need to make some realistic assumptions about what might happen in the absence of section 936.

Page 49

"However, any such benefit would presumably entail an offsetting cost in credit markets in the United States."

But wasn't the purpose of 936 to bring investments home from Europe, not from the U.S.? And aren't you employing a double standard when you speculate about possible costs to the U.S. economy but never speculate about any benefits, especially when benefits to the U.S. economy is what 936 is all about?

Page 50 ff.

-- Opportunity cost discussion. This is another example of how you bias the argument in your favor whenever you get the chance. There are many reasons why the benefit estimates might be too low and the cost estimates too high but the reader will look in vain for speculation on these things in your report.

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-- Multiplier and linkage discussion. The huge expenditures of Puerto Rico in the U.S. are not immaterial to this discussion since overall benefit to both economies in what the Congress intended with its law.

Although we don't have the statistics yet for a good measurement, it is reasonable to assume that, because of the nature of the industry, electronics will have more linkages with the rest of the P.R. economy than do apparel, or pharmaceuticals.

Page 60. Discussion on "real" assets. Are you sure the U.S. and P.R. measurements are comparable? Might not the U.S. measures have also included land? At any rate, we think you make too much of this differential. It doesn't really clearly show "unique operating characteristics" for possessions corporations.

Page 68, 70

Twice more you tell us that you have probably overestimated benefits to Puerto Rico without once reminding us of the huge overestimates of costs or the possible areas of benefit underestimates.

Page 71

"The preceding Sections of this Chapter have presented statistical data on the total costs, benefits, and cost effectiveness of the possessions corporation system."

That is a very large claim which our previous discussion should make clear is simply not true.

Page 73

We do not know where Chemical Week got their estimates for future tax collections. Our latest estimates of income tax payments for the current year of only those firms that have converted is $24.1

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million. Should those that are currently pending also convert, the estimate goes up to $67.3 million. This does not include estimates of payments of those partially exempt under the old law or new operations under the new law.

Ricardo Muñiz at the Treasury defers to us on these estimates because of the greater sophistication of our techniques.

You should make the point strongly that these tax collections should rise steadily because of the gradual tax increases (exemption decreases) that are built into the new system.

Page 76. Update of New Law Information

Petitions filed under the new law through December 1979: 176. Still around half expect initial profits at under $100,000/year. Five are service firms. Forty-two percent were filed by non-Puerto Rican firms.

526 conversion petitions were filed through December 31, 1979. This represents about 37 percent of grants outstanding. As of February, 1980, 199 of these petitions had been approved.

Page 81

"Banks (and brokers) cannot risk making additional long term loans, the type of loan needed to finance real investment in Puerto Rican plant and equipment, if the funds at their disposal from possessions corporations are only committed for short periods of time."

There are many other determining factors for such loans than length to maturity of a bank's liabilities. The quality and variety

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of the bank's assets, diversity of its liabilities, and its capital/asset ratio are also important determining factors in a bank's ability to make long-term loans.

This entire section is very speculative. Mr. Muñiz has promised to come up with some more concrete information.

Page 82.

Your judgment of little change in cost effectiveness is based on insufficient projection into the future and, of course, your fundamentally flawed cost-benefit calculus.

Office of Economic Research
Economic Development Administration

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Summary Comments on Second Annual 936 Report

1. Inadequate discussion of benefits of 936 law to U.S. economy, only P.R. benefits versus U.S. Treasury costs. Here are some benefits to the U.S. that might have been mentioned:
    a. Permits highly innovative firms to reap more of the benefits of their innovation. Reinvestment in U.S. creates jobs there, e. g. Wang and Digital in New England.
    b. Micro-processor industry in other countries, for example, is subsidized heavily by their governments. 936 law provides some compensation to help increase our competitiveness.
    c. Multiplier effect of P.R. consumer expenditures is much larger when whole U.S. is included and not just P.R. because P.R. is 7th largest customer of U.S. in the world.
    d. The purpose in changing from 931 to 936 was not to give a generous gesture to P.R. but to cause more funds to be repatriated to U.S. Since its major goal was to bring more benefits to U.S. economy it should be evaluated in those terms, not as a form of charity.
2. Repeated use of the concept and term "tax expenditure" is prejudicial to the 936 program. It is based upon the assumption that all profits earned in Puerto Rico are profits that would have been earned in the U.S. in the absence of the 936 law. This is obviously not true.
    a. Investments would quite possibly been made in foreign locations.
    b. Investments might not have been made at all.
    c. Tax exempt profits earned in Puerto Rico finance expansions in U.S. and consequent tax payments.

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The term "tax expenditure" should always be placed in quotes to remind the reader -- who might not be well-versed in the common terminology of Treasury officials and the discipline of public finance -- that the expression cannot be taken literally.

3. Report suffersfrom the common problem of economic analysis that things which are difficult to measure are ignored.
    a. Social benefits of high wage, high technology industry overlooked e.g. creation of strong middle class, spur to ambition provided by more fulfilling jobs.
    b. Shift to higher wage industries partly result of Fomento promotional policy and improvement in overall physical and human infrastructure.
4. Confusion in Report over primary purpose of 936, direct jobs in P.R. or overall benefit to P.R. economy.
    a. Overemphasis on direct jobs yields apparent preference for low-wage, low-profit, low-investment, heavily cyclical, standard product industry.
    b. Primary purpose is neither of these, but to find best tax arrangement for all parties concerned in unique political and social setting. Best evaluation of 936 would be in contrast to possible alternatives.
5. Far too little consideration given to developments under new law in Puerto Rico. We should expect a much more detailed treatment in next report.

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6. Benefits of reinvestments of 936 funds in P.R. very difficult to measure. Report assumes little benefit based upon insufficient data.
7. If the law must be regarded as one which provides a form of transfer payment from U.S. Treasury to Puerto Rico, then, although it is well and good to evaluate it in light of how a perfect system of this type could operate, it is quite unrealistic and unfair to do so without also comparing it to other forms of public assistance. How does it compare in effectiveness to other forms of transfers to Puerto Rico? How does it compare in its efficiency and equity to such programs in the U.S. as farm price supports, urban renewal, aid to families and dependent children, etc.

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Basic Observations on the 2nd Annual 936 Report

Certain conclusions unfavorable to the present law are very nearly inevitable given the way in which the Congressional mandate for the report is written and given the fact that the U.S. Treasury is the agency charged with the task of preparing it. The primary interest of the Treasury, and its branch, the Internal Revenue Service, must be to provide and administer revenue for the Federal Government. Any legislation which Treasury perceives might weaken its ability to accumulate revenue from one source brings pressure upon it to make up the perceived loss from other sources, and it becomes in Treasury's interest to resist it. Even though the stimulative effect on production of lower taxes and tax incentives and consequent greater capacity of the economy to generate more taxes in the long term is gaining more recognition and acceptance among economists, it is still a novel position for the U.S. Treasury to take.

The problem with the mandate is perhaps even more serious. The preparers are asked, "among other things" to submit "an analysis of the revenue effects to the provision as well as the effects on investment and employment in the possessions". Given what is explicit and what is not in their orders, it is only natural that the preparers of the report should build their case, for the most part, around a comparison of the gains of the Puerto Rican economy versus the losses the U.S. Treasury owing to the provision, as though the act amounted to nothing more than a cash expenditure by the U.S. Government to the island of Puerto Rico. In this approach all feeling is lost for the complicated socio-economic-political question of what tax arrangement is fairest and best for all parties concerned when we are dealing with U.S. corporations operating within a U.S. possession.

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Individual U.S. citizens living in Puerto Rico do not pay taxes to the Federal Government on income earned in Puerto Rico. It follows that U.S. corporations should not, either, since for many purposes they are treated as individuals by U.S. law. Under the previous tax law, section 931, U.S. corporate income in Puerto Rico became fully taxable when it was brought back to the United States in the form of dividends. Consequently, very little of this corporate income was repatriated to the U.S., but was used to finance operations of multinationals in other countries or was invested in Eurodollar instruments. It was to remedy this situation that section 936 was created to supersede section 931. The 936 law should be evaluated primarily, then, in terms of how well it has succeeded in correcting the flaws that existed under 931. These are flaws that were deemed injurious to both the U.S. and the Puerto Rico economies.

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Comments on 936 Draft

Third Annual Report

Introduction

We would like to preface our comments by complementing this year's '936' team on a greatly improved version of the annual possessions system report. We are encouraged by the several revisions in response to our earlier comments and by the completely new work on the financial section. Our remaining reservations are largely matters of emphasis and interpretation, though we also have a few specific suggestions.

1. We still have no discussion in the report of the effect of the change from 931 to 936 on the U.S. economy. It is still our opinion that this part of the report should receive the greatest emphasis because it was the primary purpose for it.

   We feel that the discussion of the benefits of the 936 system of taxation should be amplified, though here again this year's first draft is already an improvement. The final draft might include: (1) a statement (perhaps even a rough estimate) of the externalities of the taxation system; (2) a brief comparison of the Puerto Rico economy to other developing economies without the benefit of 936, and (3) a statement of the positive effects of the system on the U.S. economy as a whole.

2. While the explanation of the shortcomings of the "tax expenditure" approach is well done, there is nevertheless no alternative calculation of "cost" included in the report. We suggest a second "tax expenditure" calculation based on an alternative counterfactual scenario. For example "with the hypothetical repeal of section '936', corporate taxes paid in Puerto Rico would be made deductible and the effective tax rate would rise to x%".

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If some such alternative calculation were not included, then the title of Chapter 3 -- "The Costs and Benefits... -- would be highly misleading. As the authors have pointed out, "tax expenditures" are not true costs.

3. More emphasis should be given to the dramatic recent changes in manufacturing structure resulting from the rise of the very high technology electronics industry. This is the one major change that stands out when we move from the pre to the post 936 period.
   a. Might this development be related to the changing tax laws?
   b. What does this change portend for the economy of Puerto Rico and the United States?
   c. What might it portend for the future of the possessions tax system?
4. The report, or what we have of it, continues to be an evaluation of the possessions system and not just of the changes made, but without any historical or larger economic or political context. The fact must be recognized somewhere that the possessions system has been and continues to be instrumental in lifting Puerto Rico from the depths of poverty. The reader must be given a sound basis for forming an answer to the question, "Does this tax arrangement serve the national interest?"

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SUGGESTIONS FOR IMPROVEMENTS IN THE ANNUAL REPORT OF THE TREASURY ON SECTION 936 OF THE U.S. INTERNAL REVENUE CODE

Governor's Economic Advisory Council
San Juan, Puerto Rico

March 27, 1981

In 1976, as part of a general reform and revision of the United States tax laws, Congress altered the legal provisions governing the tax exemption of United States Corporations operating in Puerto Rico from the original legislation (generally known as Section 931) to the revised law (Section 936). The general intent of the new legislation was to increase the benefits of tax exemption for the economic development of the Territories. This was to be done by discouraging firms from liquidating in order to send back accumulated profits tax free at the end of their exemption period, and by encouraging firms operating in United States territories either to remit their profits back to the United States on a current basis or to invest them in ways which would promote the long-term development of these areas.

At the same time, Congress requested the Treasury to prepare an Annual Report on the operation of this new system. This was a positive step in itself, and had the reports been carried out in the constructive spirit in which Congress drafted the legislation, they could have been a valuable reference. Unfortunately, as we will show below, the three reports so far issued by the Treasury have used unrealistically narrow criteria for evaluating the costs and benefits of the legislation, and have taken an extremely negative attitude toward it. Many businessmen, carefully watching the tone of the reports emerging from the Treasury, have concluded that the entire program of tax exemption may well be slated for elimination, and now regard Puerto Rico as a relatively high-risk area in which to invest.

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Recent actions of the IRS in altering published regulations so as to limit the profits which corporations can claim from their Puerto Rican operations can only further this mood of uncertainty. As a result, the reinvestment of profits, job creation and economic development--which were the original purposes of the Act--have been negatively affected by these reports.

This paper points out the major shortcomings and conceptual errors which have characterized these reports up to the present and shows how alternative approaches would improve their quality and usefulness. We begin with a discussion of the tax expenditure concept, and follow this with a summary of the other areas of weakness. We make no attempt to identify and correct errors of fact in the reports, dealing only with broad issues. We conclude with some suggestions for additions and changes in emphasis, which would give a more realistic view of the true situation, and improve the usefullness of the reports to Congress, the business community and the Territorial governments.

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Section 1: The Tax Expenditure Concept

The most important problem areas in the Treasury reports are related to "tax expenditure". This concept does not measure what its name indicates because the assumptions implicit in the calculation are unrealistic (see below). The name would seem to indicate "tax revenue foregone" due to some particular program, in this case the "936" system. However, the estimation of this quantity has been reduced by the Treasury to an artificial formula which uses unrealistic assumptions and fails to give a true picture of the revenue losses associated with the provision. These shortcomings of the measure are recognized explicitly or implicitly in the reports, but the Treasury's "tax expenditure" estimates are still widely quoted as if they represented losses of revenue to the United States Treasury which could be eliminated if Section 936 were repealed. Thus, considerable further qualification and interpretation of the "tax expenditure" concept--or its total elimination from the reports--seems appropriate in this case. We will discuss this point at greater length in the third section of this report, after documenting the problems with the concept in greater depth.

First, let us refresh our memories concerning the Treasury's procedure for estimating "tax expenditure". The process begins with an estimate of the total profits of all corporations which are covered under Section 936. From total profits, the applicable United States taxes are calculated, based on an assumed rate of 40 percent. Puerto Rican taxes (which are deductible by United States firms against their United States tax bill) are then subtracted from this total to arrive at a net revenue loss to the United States Treasury.

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This procedure involves several assumptions which are so unrealistic as to render the analysis irrelevant for purposes of policy evaluation. These artificial assumptions are as follows:

(1) If the Possessions System of Taxation were [illegible] the Puerto Rican government would continue to tax firms at the same rates as before

(2) If the Possessions System were removed, so that 936 firms were subjected to full United States taxation,[1] their behavior would not change in any respect

(3) Because of assumption (2) above, United States parent companies or other economic units on the mainland would likewise be unaffected by the change.

The unrealism or these assumptions is obvious. The Treasury implicitly recognizes Puerto Rico as the primary taxing jurisdiction under current legislation, since it leaves out of the tax expenditure estimates all nonmanufactufing firms covered by Section 936. These are subject to Puerto Rican tax at roughly the same rate as United States firms.

The implication of this argument is that the Treasury's estimate of tax expenditure will depend on Puerto Rico's tax policy.

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[1] If Section 936 were repealed, all firms covered by the provision would be subject to United States taxation, with the choice of taking a deduction or a credit on taxes paid to Puerto Rico. For most firms (those with existing grants of tax exemption) Puerto Rico could not raise its own taxes for many years. For non-exempt firms and new investments it would pay Puerto Rico to tax at United States rates. In either case, firms would pay the full United States rate to one jurisdiction or the other after such a change.

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For example, under Puerto Rican legislation, tax collections for manufacturing firms will increase rapidly in future years. More firms will be subject to tax, and the average tax rates steadily increase as firms move further into their partial exemption periods. These changes would reduce the Treasury's estimate of tax expenditure, independently of any other effects. However, if Puerto Rico were to reduce overall business taxes in order to attract more non-manufacturing firms the Treasury's estimates of tax expenditure would increase.

As long as one is considering a situation in which current legislation is in force, it might be more realistic and less confusing to concentrate in the reports on Puerto Rican tax expenditure rather than Federal tax expenditure. We will return to this point in the third section of this report, after completing our discussion of tax expenditure.

Point (2) above is even more unrealistic. When calculating "tax expenditure", the implicit assumption is made that, were United States taxes to be collected, then output, employment, investment, and other aspects of firms behavior would ramain the same as they presently are. Yet, the very reason for the existence of the "936" Section system is to change those quantities: to raise output, employment and investment by lowering the effective tax rates in the outlying United States Territories. Under full taxation, those quantities would certainly change and the tax base would therefore also change. A realistic calculation of "tax revenue foregone" thus requires a specification of alternative taxation system and of firms' responses to these changes.

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Ir corporations operating on the Island were subjected to full Federal taxation, so that many were forced to shut down or reduce operations, the resulting recession in Puerto Rico would also be transmitted to the United States mainland, further reducing Federal tax collections and increasing transfer payments.[1] Point (3) above indicates that the Treasury has ignored this effect as well.

To summarize, the assumptions of the Treasury's tax expenditure approach are unrealistic, and overstate the revenue gains which would result from the elimination or modification of Section 936. This approach could well mislead Congress concerning the effects of changes in this legislation. Although the Treasury has recognized these problems in its Third report, the tax expenditure estimates are still quoted in other discussions as if they were realistic estimates of revenue losses. This impression is regreatable and needs to be corrected. We will present some suggestions for doing so in the final section of this report. First, however, let us turn to some other problem areas which have emerged in the Treasury's Annual Reports.

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[1] A study made elsewhere by the Governor's Economic Advisory Council estimated that if the elimination of Section 936 reduced industrial production in Puerto Rico by as much as twenty five percent, the direct and indirect effect of the resulting changes on Federal transfer paymants and tax collections would roughly cancel out the expected increase in revenues from the business profits tax.

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Section 2: Implications of the Reports for Development Policy in Puerto Rico

The overall purpose of the reform of Section 936 was to aid economic development and job creation on the Island of Puerto Rico and in the other offshore United States Territories. The Treasury Department was charged by Congress with the task of evaluating the effectiveness of the changes from Section 931 to Section 936 in accomplishing this task.[1]

Unfortunately, the Treasury has taken a narrow, static approach which is limited to calculating the costs and benefits of the legislation at a given point in time. This approach has not permitted the historical perspective necessary to compare the performance of the present law with the original one it replaces. Even worse, it has allowed implications to appear which are highly misleading to policymakers concerned with the development of Puerto Rico, both on the Island itself and on the mainland.

Basically, the Treasury's approach has been as follows. First, the tax expenditure methodology, which we criticized above, has been used to estimate the "costs" of the program to the Federal

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[1] "It is the understanding of Congress that the Department of the Treasury is to review the operations of Section 936 corporations in order to apprise Congress of the effects of the changes made by the Act. The Treasury is to submit an annual report to the Congress setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects to the provision as well as the effects on investment and employment in the possessions." See General Explanation of the Tax Reform Act of 1976, pp 277-278.

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government in each separate industry group.[1] Second, some measure of benefits has been calculated for each industry to compare with the total "costs". The Treasury's sophistication in applying this methodology has increased in that the measure of benefits has been improved from simple employment and payroll calculations to include the indirect effects brought about by linkages of each industry with the rest of the economy, and the multiplier effects of the wage payments. The static, cost-benefit framework has remained basically intact through three reports, however.

Because of the assumptions built into the Treasury's methodology, the conclusions of the analysis are very predictable, and the refinements added in successive reports have not changed them in any fundamental respect. The industries which score high on the Treasury's analysis are the labor-intensive ones such as apparel, leather products and food processing. Because profit rates in these industries are relatively low in Puerto Rico, as they are on the mainland, the costs to the Treasury of providing tax exemption are relatively moderate in these cases. At the same time, they provide a considerable number of jobs, so that their overall benefit-cost ratio appears favorable according to the Treasury's methodology. By contrast, capital intensive industries such as scientific instruments, electrical and electronic equipment and pharmaceuticals score relatively low according to these measures.

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[1] One additional problem here is the biased nature of the sample of 301 firms used to calculate tax expenditures. Since all pharmaceutical firms were compared with samples of firms from other industries, biased results could occur. This point refers to the Third Annual Report.

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The Treasury reports leave the clear impression that industries which score lower than average on its scale are expensive to support, provide few benefits to Puerto Rico, and have been attracted only by tax exemption. By singling out the industries with the lowest scores according to its measures, the Treasury gives the clear impression that labor-intensive industries are legitimate beneficiaries of tax exemption and should be encouraged, while capital-intensive firms are abusing the priviledge of tax exemption and should be discouraged in some way.

A little historical perspective will help us to see the fallacies in these arguments, and the misleading and potentially damaging nature of their implications for development policy. First, Puerto Rico has passed through several phases of industrialization. During the 1950's the Island attracted many firms in labor intensive industries such as apparel, furniture and tobacco. Later, in the 1960's, a number of petroleum refining firms were brought in, because energy costs at that time were lower here than on the mainland. Finally, during the 1970's the Island attracted many high-technology companies producing chemical products, electronic components and instruments. Throughout all of these phases of industrialization, the same blanket tax exemption policy has been in effect--either in the form of the old Section 931 or the current Section 936. Thus, tax exemption itself is in no way responsible for attracting any particular group of industries to Puerto Rico.

A number of secular changes in the Puerto Rican and United States economies have combined to produce the shift away from labor-

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intensive industry in Puerto Rico. These changes have included the opening up of the United States economy to competition from foreign countries with low labor costs and the increasing willingness of United States firms to invest in these areas, which have affected labor-intensive industries everywhere in the United States. In addition, the progressive application of full United States minimum wages in Puerto Rico, together with the gradual appearance of a pool of skilled executive and managerial manpower here, improvements in Island infrastructure, and the greater accessibility made possible by the use of jet aircraft have also affected Puerto Rico's attractiveness to investors. Finally, it is possible that the tendency of current United States tax system to make insufficient allowance for depreciation in the current environment of high inflation may make tax exemption more attractive to capital-intensive firms. These factors, in addition to others, must have combined to make Puerto Rico relatively more attractive to capital-intensive firms and less attractive to labor intensive companies than was true thirty years ago.

As a result of these trends, Puerto Rico has been undergoing an extremely rapid transformation of its industrial structure. The labor-intensive industry groups such as apparel have been losing significant numbers of jobs in recent years as these firms become increasingly less profitable. Fortunately, these job losses have been more than cancelled out by gains in the profitable high-technology industries, enabling the Island's industrial sector to continue its earlier development, even though at a slower pace than before. From what little one can predict of economic trends in the 1980's it would appear that the future of the labor-intensive

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industries is not bright, either in Puerto Rico or in the United States as a whole. Competition from less developed countries seems likely to intensify, while demographic pressures will probably make labor increasingly costly relative to capital in the United States during the 1980's. The technologically-based industries, where the United States has traditionally had the greatest international cost advantage, seem likely to grow most rapidly, and it is in these areas where Puerto Rico's future industrial growth seems brightest.

The Treasury Reports are silent on these important points, and, indeed, their methodology would seem to have pointed to a development strategy for Puerto Rico which is opposite to what the Island actually has been following. Had the Treasury's methodology been available to the planners of "Operation Bootstrap" in the 1950's it would have shown us the relatively high costs of supporting these labor intensive industries at that time, when they were making relatively good profits here and growing rapidly as a result. Now, when these industries are dying, they would appear in a more favorable light according to the same methodology, because they are now making lower profits. Likewise, the petroleum refining industry, which as run into severe problems on the Island in recent years, with one large firm currently in bankruptcy, and with little if any employment growth, is painted in a much more favorable light than the rapidly growing pharmaceutical industry.

The basic problems with the Treasury's cost-benefit methodology, then (aside from the difficulties concerning tax expenditure), are that it is static and automatically favors industries with low

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profit rates, other things being equal. This narrow cost benefit framework does not provide sufficient historical perspective for the proper evaluation of the measures being discussed. It is very possible that if the Treasury's implicit recommendations should become widely publicized and generally accepted, either the Congress, the government of Puerto Rico--or both--might actually try to follow them at some point in the future, with disastrous consequences for the economic development of the Island. Thus, it is imperative that future reports have a broader perspective which takes into account both the historical factors affecting each industry and the unique contributions which each sector may be making to the Island's economy.[1] We will make some specific suggestions in the following section as to how this might be done.

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[1]The tradeoff between static benefits and future growth prospects in the choice of investments is treated extensively in the professional literature on economic development planning. It might be useful for Treasury officials working in this area to familiarize themselves in a general way with previous work on investment criteria and on static versus dynamic evaluation of comparative advantage.

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Section 3: Suggested Modifications to the Annual "936" Report

The preceding sections clearly showed the importance of revising the Treasury's approach to its Annual Report so that it can fulfill the role which was intended for it. This need is especially great when we consider the importance of Section 936 to the economic development of Puerto Rico and the other United States Territories, and the wide attention which the reports receive in the business community. As a minimum, the following changes need to be made.

First, the reports should not be written in a negative tone which casts doubt on the continued existence of the provision itself. Such an approach can only produce uncertainty in the minds of prospective investors and work against the basic purposes of the Act itself in creating productive investment and employment in the offshore Territories. The Report should therefore contain a strong statement of the need for such a provision and the commitment of Congress and the Treasury to cooperate with the governments of Puerto Rico and the other Territories to help make the provision work successfully.

The tax expenditure approach in itself tends to encourage uncertainty, since it implicitly assumes removal of the provision. We suggest that future Reports be carried out using a working assumption that United States legislation will remain unchanged, while analyzing the effects of possible changes in Puerto Rican legislation. The Kreps Report took this approach. To do this would remove many of the negative and unrealistic aspects of the Treasury's tax expenditure analysis by casting any tax expenditures in terms of revenues foreby Puerto Rico. Any analysis of Federal tax expenditures which

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might be required by law could be presented in an Appendix or footnotes. This approach could also lead the Treasury to offer constructive suggestions and assistance to the Puerto Rican government in formulating its tax policy, and might improve communication between local and Federal officials. Most important, it would remove the implicit threat that the legislation supporting many of the Island's development policies could be repealed at any time.

Such an approach to the problem would not preclude the examination of alternative forms of treating taxation in Puerto Rico.

this area. Other alternatives which could be examined could include a case study of the termination of Section 936 in the Canal Zone, an examination of the potential effects of treating firms currently covered by 936 as foreign firms entitled to a tax credit, or other similar alternatives. In all such cases, however, the basic working assumption of maintaining current Federal legislation would make the preparers of future reports treat such analysis outside the principal framework of the report, labeling them as what they really are: experiments with hypothetical policy changes. As far as the tone and implicit recommendations of the report are concerned, this change in approach would present a very favorable contrast to the Present situation in which current tax laws are constantly being

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compared to an alternative scenario in which they would be completely eliminated.

Finally, the working assumption that current legislation would be maintained could be useful in breaking the Treasury's sterile fixation on cost-benefit analysis and leading to constructive discussions of the basic historical trends underlying the current industrial transformation of Puerto Rico and how the "936" legislation has been contributing to or modifying these changes. Excellent models for this kind of report would be the industry studies written by the minimum wage commissions in preparation for revising minimum wage levels in particular industry groups on the Island.

With the greater historical perspective that such an approach would bring, a comparison of the performance of Section 936 with the former Section 931 would fit more naturally into the discussion, as would an analysis of the qualitative characteristics of the most important industry groups on the Island and their contribution to the Island's development. The absorbtion of 936 funds might also be examined through a sampling of bank loans, complementing--but not replacing--the current approach of balance sheet and income statement analysis.[1]

We recognize that these suggestions represent a sweeping

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[1]As an example of the kinds of issues which could be examined here, the Bank of America was allowed to enter Puerto Rico on the understanding that it would make substantial loans in agriculture. The nature and effect of these loans could be studied, and it would probably be possible to estimate the extent to which the farmers received preferential loan rates.

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change of approach by the Treasury, and that they would create what amounts to an entirely new report. Such a change would represent a considerable effort on the Treasury's part. Nevertheless, the current Reports, widely watched by prospective investors in Puerto Rico, have had a negative effect which has seriously hindered our ability to attract private investment. Thus, we feel that a major refocusing of the Treasury reports is necessary if Section 936 is really to do what was intended--to encourage the economic development of Puerto Rico and the Offshore Territories.

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Draft
Comments on the/Fourth Report of the U.S. Treasury
On the Operations and Effect of the Possessions Corporation System of Taxation

The Draft Fourth Report of the Treasury on the Operation and Effect of the Possessions Corporation System of Taxation has both notable similarities to and differences from the three previous reports. It can be argued that the Treasury Reports are not objective, independent analyses of the Possessions Corporation System of Taxation but rather that they have become active elements in an evolving socio-economic system which features continuing mutual interaction among the Treasury Reports, government legislative and regulatory activities and private sector industrial behavior.

All four Treasury Reports have focused their analysis on the identification of activities within the 936 Corporations system which generate significant tax-exempt income. Then the Reports present measurements which imply that the economic benefits to the Possessions economies, mainly Puerto Rico, are of a lesser magnitude than the tax which could allegedly be collected on this income. At the micro level this methodology has placed the 936 industries with the highest rates of return under scrutiny. In recent years in Puerto Rico these have been the high technology industries which have accounted for the greatest growth in the quantity and quality of employment in Puerto Rico, and which are leading sectors of the American industrial system. The less dynamic, low technology sectors which have generated less employment growth and income in Puerto Rico and which have been called "sunset industries" in the U.S. appear in a less critical light under the Treasury analysis.

At the macro level, the Fourth Annual Report continues the tendency of earlier reports to emphasize negative aspects of Puerto Rican economic performance since the early 1970's while noting that performance in the earlier

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years from 1948 to 1970 has been termed an "economic miracle".[1/] Of course in this earlier period the low technology industries such as apparel, leather products and tobacco products were more important in the growth of the Puerto Rican economy. The Report states that since the early 1970's real gross investment has exhibited a significant downward trend while the unemployment rate has tended to rise over this period.

The reductions in Puerto Rican investment during the 1970's are cited without acknowledgement of the extreme damage done to the island's petrochemical industry after the energy shock of 1973. For example the report states that "Private investment in plant and equipment in 1977 was only one-half the peak reached in 1971",[2/] without mentioning that private construction of refineries fell from $267 million in 1971, about one half of private construction plant investment, to only $16 million in 1977, which was about 4 per cent of plant investment.[3/]

Despite the difficulties faced by the Puerto Rican economy in the 1970's manufacturing employment rose by 19 percent and real manufacturing payroll increased by 41 percent reflecting the increasing quality and skill level of manufacturing employment on the island. Over the same decade mainland manufacturing employment increased by only 5 percent. (See Figure 1).

The orientation and methodology of the Treasury Reports preclude objectivity. The Treasury Reports are an integral part of the evolving 936 system. An analysis of the history of the 936 debates and their effects indicates that the Treasury is operating at a level where to analyse the system is to change it. A convincing argument can be made that, other things equal, employment

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1/ Fourth Annual Report, p. 51.
2/ Fourth Report, p. 50.
3/ Source: P.R. Planning Board.

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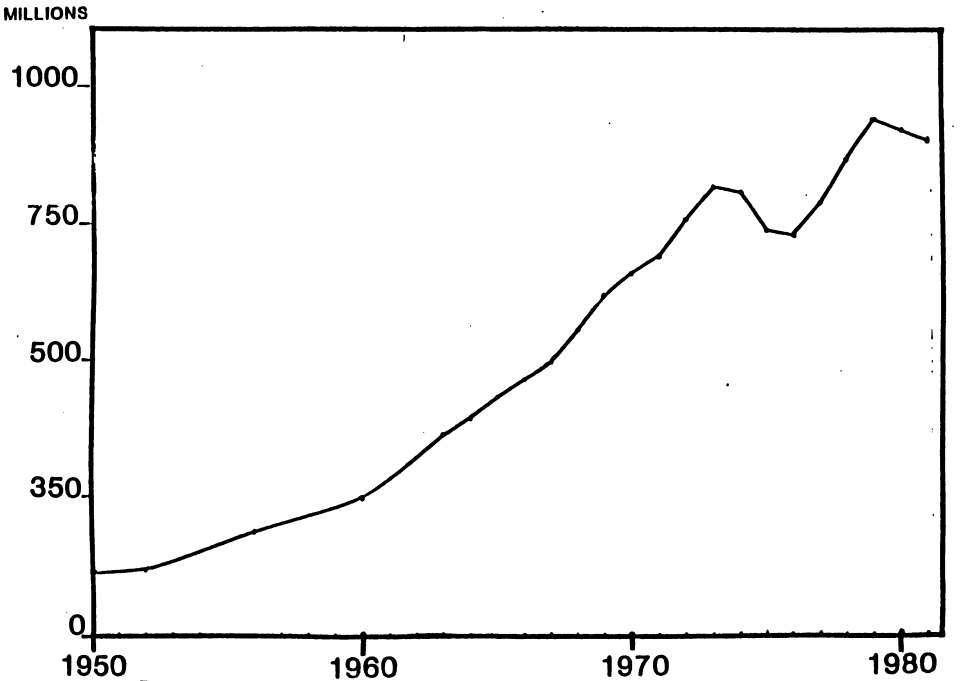
FIGURE 1

MANUFACTURING INDUSTRY IN PUERTO RICO
EMPLOYEE REAL COMPENSATION
(MILLIONS OF 1972 DOLLARS)



SOURCE: Economic Development Administration
Office of Economic Research

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growth, and the rate of investment are lower and the marginal and average rates of return in dynamic high technology industries are higher than they would be in Puerto Rico if the 936 reports did not exist. Conditions of high uncertainty caused by the reports act as a significant deterrent to investment in Puerto Rico and only those projects which can produce a rate of return high enough to include an offsetting risk premium will be undertaken. Projects with rates of return which are greater than the opportunity cost of capital but less than the cost plus the perceived risk premium will not be undertaken. Therefore, the findings of the 936 reports are partly self generating. An investor who has read the 936 reports and perceives that they will elicit legislative and regulatory escalation of tax collections is faced with a high degree of uncertainty about the expected rate of return to investment in Puerto Rico. In high technology industries where the situation is clouded by the complex issues of tax benefits on intangible income, the uncertainty is even higher. This process is illustrated in Figure 2.

If 936 Reports continue to present computations of high rates of return and low rates of growth of investment and employment in a manner that implies a failure of the 936 system and a basis for advocacy of modifications in tax law and regulations the problems will continue to be multiplied by circular feedback.

The Fourth Annual Report continues to rely on the static estimation of "tax expenditures" or "tax savings/tax benefits" as they have come to be called in the Fourth Report. The Report precedes its tax analysis with an analysis of the income and assets of 936 corporations which it compares to allegedly similar measures for all mainland corporations. Table 4-3 (p. 89)

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presents the Treasury estimates of the ratios of operating income to operating assets and of operating income per employee for selected high technology and low technology industries. 936 corporations are found to have 4.1 times as high a ratio of operating assets as do mainland corporations. The 936 operating income per employee averages 5.9 times higher than mainland corporations. The ratios for high technology industries are generally higher than for low-technology industries and exhibit greater divergence for 936 corporations than for mainland corporations.

We do not dispute the proposition that Puerto Rican industry is more profitable and productive than mainland industry nor the proposition that high technology industries are in some senses more productive than low technology industries. However the figures presented in Table 4-3 are misleading and overstate the differences for several reasons, only three of which are mentioned by the Report: 1. Puerto Rico average wage rates are lower than those of the mainland. 2. 936 corporations do not generally report until after their initial loss making start up period has passed. 3. The Puerto Rican government rents buildings at low cost to some manufacturers.

When the Treasury adjusts the ratio of operating income to operating assets by average wage differentials between Puerto Rico and the mainland, the overall difference between 936 and mainland ratios are reduced by about twenty percent but remain significant for high technology industries while the ratios become similar in the low-technology industries. Again we see that the Treasury methodology continues to view lower wage and lower profit industries more benignly.

In an estimate of the effects of rental subsidies on the income/asset ratio, the Treasury concludes that adjusting the assets to include government

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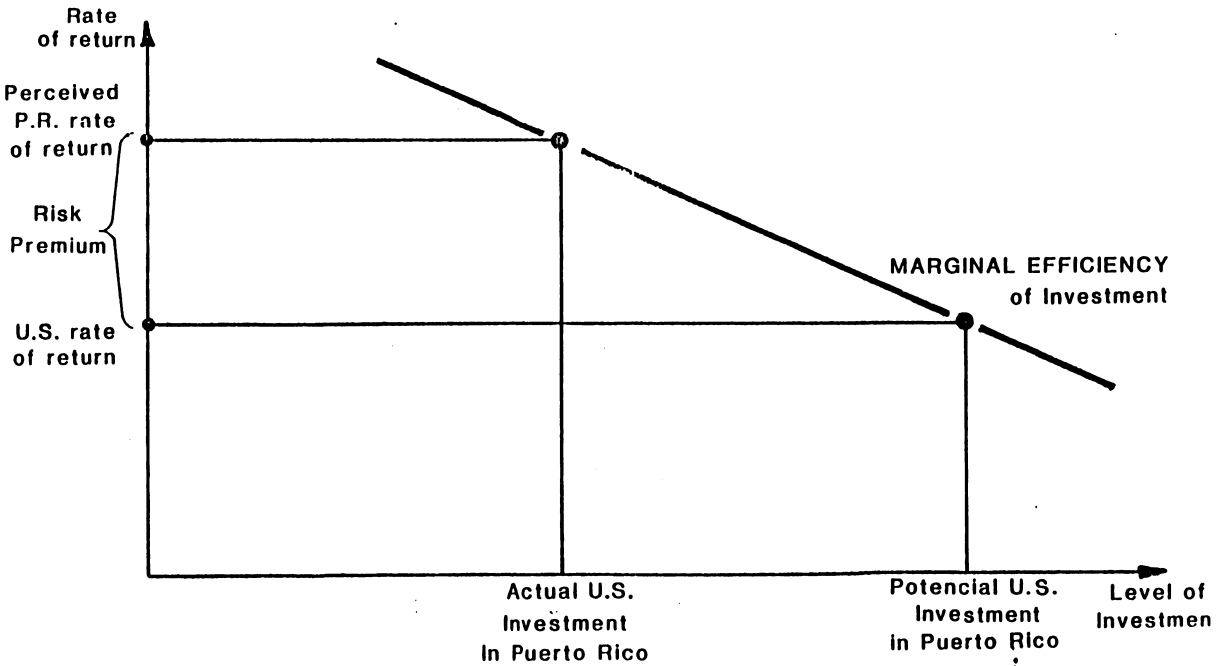
THE EFFECT OF RISK/UNCERTAINTY CAUSED BY 936 REPORTS ON U.S. INVESTMENT IN PUERTO RICO



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owned buildings would reduce the ratio for all building from 52.3 percent to 49.0 percent. This seems to be a reasonable correction for government leased buildings. However, some 936 companies lease buildings from non 936 real estate corporations. In these cases neither the rental income nor the real assets would appear in the 936 ratios. To the extent that the rate of return on industrial real estate is below that on other assets, and to the extent that 936 firms are more likely to use Real Estate Corporations the 936 ratios should be adjusted downward still further.

The Treasury sample of 936 corporations differs in another significant way from the total universe of mainland firms in that 936 firms do not generally report as such until after their start-up period. Since the mainland firms statistics includes such infants, the Treasury estimates that excluding loss making firms would raise the mainland income/asset ratio only from 12.7 percent to 14.4 percent.

Having made these adjustments the Report concludes that significant differences in the rates of return to high technology 936 industries and those on the mainland persist and we are offered no other explanations for the source of these differences except that intangible income is greater in high technology industries than in low technology industries. No discussion of other differences in the 936 sample and the overall mainland sample are considered, although there is ample reason to believe that 936 firms in Puerto Rico when compared by SIC category with the corresponding mainland universes will differ considerably with respect to the distribution of firm sizes, the age of the capital stock and the mix of products produced. It may be valid to characterize 936 corporations in the SIC category Electrical and Electronic

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Table 1

COMPARISON OF 936 CORPORATION AND MAINLAND CORPORATIONS DISTRIBUTION OF EMPLOYMENT IN SUBGROUPS OF MAJOR
Standard Industrial Classifications

SIC	Name	U.S. Corporations		936 Corporations	
		Employment	Percent	Employment	Percent
35	Non Electrical Machinery	2,083,300	100.0	3,493	100.0
351	Engines & Turbines	129,600	6.2	-	-
352	Farm & Garden Machinery	150,900	7.2	-	-
353	Construction Machinery	333,000	16.0	204	5.8
354	Metalworking Machinery	297,800	14.3	112	3.2
355	Special Industrial Machinery	185,000	8.9	17	0.5
356	General Industrial Machinery	313,500	15.1	467	13.4
357	Office & Computing Machinery	259,300	12.4	2,144	61.4
358	Refrigeration Machinery	191,500	9.2	522	14.9
359	Miscellaneous	222,700	10.7	27	0.8
36	Electrical Machinery & Apparatus	1,723,110	100.0	11,498	100.0
361	Electrical Distributing Equipment	115,300	6.7	3,591	31.2
362	Electrical Industrial Apparatus	198,400	11.5	1,172	10.2
363	Household Appliances	162,300	9.4	-	-
364	Electric Wiring & Lighting	165,000	9.6	1,408	12.3
365	Radio & T.V. Receiving Equipment	97,700	5.7	-	-
366	Communications Equipment	458,500	26.6	2,120	18.4
367	Electronic Components	373,510	21.7	2,062	17.9
368	-	-	-	-	-
369	Miscellaneous	152,400	8.8	1,145	10.0

Source: U.S. Census of Manufactures, 1977. 936 Corporations: Last reported employment 1982 from Economic Development Administration: 19 Firms in SIC 35 and 71 firms in SIC 36.

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equipment as high technology but it is misleading to compare them to the same aggregate category on the mainland since this will include all U.S. corporate production of such things as light bulbs, wire transformers, vacuum cleaners, washing machines, electric ranges, gas ranges, and outdoor cooking equipment. Similarly, the category non electrical machinery which will contain 936 firms classified under electronic computing equipment will also contain a wide array of mainland operations in low-technology and loss-making industries.

Table 1 below shows that for two SIC groups which the Report uses to compare "high technology" industries the industrial mix of the 936 corporations is radically different from those of the allegedly comparable mainland statistical categories. Furthermore significant differences probably remain even within the subcategories concerning the distribution of firm size, the age of capital stock and other determinants of the rate of return.

Perhaps in response to criticism of earlier reports the Treasury has developed a more detailed method of computing tax savings/benefits/expenditures for 1979 and 1980 than were produced in previous years. Time series presented for earlier years are computed on a more aggregate basis, applying a fixed average effective tax rate based on 1972 tax returns to aggregate possessions corporation income. For 1979 and 1980 the Treasury estimates tax benefits by subtracting from taxable income of 936 manufacturing corporations the additional depreciation available under U.S. tax law, then applying the U.S. statutory tax rate and deducting investment tax credits and Puerto Rican tollgate and income taxes paid. As in previous reports high technology 936 manufacturers show large tax benefits relative to employment and payroll. The depreciation allowances potentially available to those companies having non-936 Real Estate

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Corporations will be significantly understated and consequently taxable income will be significantly overstated.

As has been shown before, it is misleading to use such ratios as cost/benefit measures since the actual costs are overstated and the benefits are understated. The Fourth Report has abandoned the limited efforts of previous reports to measure the benefits of 936 investments in Puerto Rico via backward and forward linkages to other Puerto Rican (and mainland) industries and multiplier effects of consumer expenditures of 936 payrolls.

Linkages in high technology manufacturing on the island have been growing dramatically as local firms provide more inputs to 936 manufacturers. According to Planning Board statistics the electronic computing industry increased its exports from the island from $63 million in FY 1980 to $152 million in FY 1981 while imports of components fell from $8.8 million to $7.5 million between the two years. (These figures, are for exports and imports to the U.S., but most foreign trade in computing products is transshiped via the U.S.)

In addition to growing manufacturing linkages to the local economy, the Treasury should be aware that under the 936 program there has not only been a significant expansion of the skills and number of manufacturing wage earners butthe quantity and quality of Puerto Rican management and professional workers has expanded to form a growing middle class. Under the stimulus of an expanding, high technology manufacturing sector, professional service activities in banking, and finance, accounting, management consulting, electronic data processing, communications, advertising, public relations and many other fields have expanded dramatically.

Overseas toll revenues of the Puerto Rico Telephone Company have increased 241 percent between 1976 and 1981. In the latter year the receipts constituted 45.4 percent of overall operating revenues.

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The fact that high technology investments in Puerto Rico have contained significant counter cyclical elements is not noted, nor is any notice given to the significant long run benefits of human capital formation which the experience of growing employment in high technology industries is having on the Puerto Rican labor force.

The report concedes that the computed tax benefits will overstate the actual revenue collections which would be achieved in the absence of Section 936 due to alternate tax saving activities and changed investment behavior of U.S. investors. The report distinguishes among tax savings available for fixed, financial and intangible assets. In the discussion of tax savings on physical assets models are presented of effective tax rates by industry groups under the U.S. tax laws operating in 1979-81, 1981-82 (ERTA) and after 1982 (TEFRA). These tax rates are said to be on "New Depreciable Assets" and no information is given on how intangible income is treated in the different industries, or if it is dealt with at all. The analysis of physical assets concludes with a paragraph which seems to imply that low technology industries operating in Puerto Rico would hardly be affected by the reneal of Section 936:

> "If a possessions corporation derives most of its income from investment in physical assets, then it might elect to reincorporate in Puerto Rico or in a foreign country if Section 936 were repealed. With respect to firms that took this course, the repeal of the possessions corporation credit would not result in a large gain to the U. S. Treasury of the tax benefits provided under Section 936. Those possessions corporations

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with the largest percentage of their income attributable to physical assets are in the low technology industries. In 1980, the combined income of possessions companies in low-technology industries represented only 11.2 percent of this income of all 936 manufacturing corporations." 3/

This overlooks the taxation of repatriated foreign earnings which companies incorporating under Commonwealth or foreign law would have to pay. This oversight and the small share of these firms in total income gives the false impression that repeal of 936 would not be damaging to the fifty percent of Puerto Rican manufacturing employees who still work in these industries. The Treasury behaves as if its mandate to write 936 reports is intended as a mandate to seek reasons for the repeal of the act.

The report should also note that the potential motivation for 936 firms to locate overseas is large and growing. Puerto Rican direct exports to foreign countries have grown at a compound rate of 23 percent over the decade to 1981, doubling their share in total off-island exports. With repeal of section 936 many of the firms producing for export might move their operations overseas. With the loss of the present mainland linkages of these firms, U.S. tax collections would fall rather than rise.

On page 11 the Report states "that (tollgate) tax yielded $55 million in revenues in the year ending June 1981."

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Tollgate tax collections in FY 1981 were the lowest collections since 1978. In 1982 preliminary estimates give collections as $85,445,000. The following table gives overall Puerto Rican income tax collection by tax exemption status from 1978 to 1982.

(In $ Thousands)

	1978	1979	1980	1981[a/]	1982[a/]	Total
Law #26	-	598	3,344	3,678	4,046	11,666
Converted	-	13,154	33,979	37,377	41,115	125,625
Law #57	-	900	7,809	8,590	9,449	26,748
Sub Total		14,652	45,132	49,645	54,610	164,039
Tollgate Tax	49,064	64,987	81,251	55,790	85,445[a/]	336,537
Total	49,064	79,639	126,383	105,435	140,055	500,576

a/ Estimated figures
b/ Preliminary figures

Source: Puerto Rico Department of the Treasury, Office of Economic Affairs.

The compound annual rate of increase of total corporate income tax collections from 1978 to 1982 from these companies operating under the tax exemption program is 30 percent.

The Fourth Report estimates that roughly 60 percent of the income of 936 manufacturing corporations was a return on intangibles and that this income would be taxable in the absence of 936 since the transfer of intangibles to foreign corporations is a taxable transaction. The 60 percent estimate is arrived at by using the ratio developed in table 4-3 which shows the overall rate of return to operating assets in 4.1 times higher

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for 936 corporations than that on the mainland and by assuming that this "discrepancy" is due to intangible assets.[4/] This form of reasoning implies a clockwork neoclassical world for tangible assets where the rate of return is equalized across space and therefore any and all observed differences in income must be due to intangibles. If we make only the limited adjustments which the Treasury applied to the 4.1 ratio, the ratio is reduced by one third[5/] and the estimated share of intangible income falls to about fifty percent. It has already been argued that the Treasury's adjustments are not exhaustive nor even inclusive of the most important causes for differing rates of return. Whatever the return to intangible income may be, the Report finally notes that its taxation may not be a simple matter of legislative abolition of section 936. In a commendable expansion of consciousness the Report voices an awareness of the crucial broader issues of tax policy and technologically dynamic industries:

> "In the long run, however, there may be other adjustments by U.S. parent companies which may substantially reduce the revenue pick-up from repealing section 936. For example, U.S. high-technology companies, which have been enjoying a much higher after-tax return because of 936 benefits, would tend both to reduce their total R & D effort and to shift some of their R & D from the United States to foreign locations. If U.S. firms reduced their total R & D effort or shifted some of their R & D from the United States to foreign locations, the effect of

4/ P. 175, n. 16

5/ P. 93

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> the repeal of section 936 would be to reduce the income of high-technology U.S. firms. If such an effect occured by 1986, then the estimated $1.2 billion revenue impact of section 936 for the year would overestimate the gain to the U.S. Treasury from the repeal of section 936". 6/

Not only could such policies as repeal of section 936 reduce the gain to the U.S. Treasury but they could seriously affect the growth of U.S. employment, exports, and income both immediately and into the very long run. Tax policies which impede technological change are contrary to the national interest. We urge the Treasury to listen to its own advice, and to discontinue its practice of producing 936 reports which impede the development of the Puerto Rican economy through their emphasis on a static tax expenditure methodology which inevitably overstates the costs and understates the benefits of the system and invites investors to conclude that repeal of the system is advocated. Under these circumstances the negative findings of the Reports are partly a result of the report activity itself. This fact must be incorporated into any objective analysis of the 936 system.

6/ Fourth Report, P. 176.

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Page-by-Page Comments on the Fourth 936 Report

P. 1: "U.S. manufacturing firms in Puerto Rico are currently exempt from Puerto Rican tax on 90-100 percent of their income."

This is misleading in that it implies that all U.S. firms in manufacturing enjoy this level of exemption and that they will continue to do so. The percentage exemption for those firms who have the benefit of a grant under the present or a previous tax law depends among other things on when the grant was made, what tax exemption zone the firm is operating in and whether conversion of legal exemption status has been exercised.

P. 3: "Since 1972, however, the average annual rate of growth of real GNP in Puerto Rico has fallen to less than one-half the rate in the 1960's. The annual flow of private investment in new plant and equipment in 1980 and 1981, measured in constant dollars was only 50 percent of its value 10 years earlier."

Changes in Puerto Rican GNP growth should be compared with changes on the mainland. As mentioned in the general comments investment figures which include refineries distort the long term trends since hindsight has demonstrated the transitory nature of these undertakings in Puerto Rico.

Year	Real Private Investment in Plant Equipment (1972 Dollars)	Excluding Private Refinery Construction (1972 Dollars)
1967	511	413
1968	483	404
1969	537	455
1970	802	537
1971	853	571
1972	758	561
1973	628	603

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Cont. Year	Real Private Investment in Plant & Equipment (1972 Dollars)	Excluding Private Refinery Construction (1972 Dollars)
1974	541	518
1975	484	410
1976	491	462
1977	447	435
1978	471	460
1979	446	435
1980	435	414
1981	432	419

Source: Puerto Rico Planning Board

P.3-4: "Employment growth also has slowed. After expanding by 43 percent between 1960 and 1970, Puerto Rican non-farm employment (other than public administration) grew by only 14 percent in the 1970's. By comparison, private sector non-farm employment in the United States grew at approximately the same rate, 27 percent, in both decades."

True but the figure is depressed most by the fall of construction employment from 76,000 in 1970 to 44,000 in 1980. Manufacturing employment over the period increased from 132,000 to 157,000 an increase of 19% while over the same period U.S. manufacturing employment grew by only 5 percent.

P. 5: "But a Puerto Rican location for physical assets may not be significantly more advantageous than a location in a low-tax, low wage developing country."

This statement is easily refutable, and unnecessarily derogatory. It should be removed.

P. 29: "...; three cases are presently before the United States Tax Court concerning the transfer of intangibles. The Internal Revenue Service estimates that deficiencies with respect to all open tax years through 1982 will amount to roughly $3 billion."

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If statements such as the one above are written in Treasury documents it is not difficult to believe that the reports act as a significant deterrent to investment in Puerto Rico under section 936.

936 corporate citizens are already fearful that changes in regulation and legislation have not ended with the passage of TEFRA as the following quote from a memo to Fomento from a 936 corporation tax attorney illustrates:

"We are concerned that new products which require capital investment in facilities and equipment may be difficult to justify to corporate management because of the extended time required to achieve a return on investment and speculation that the tax laws affecting Section 936 companies could be further revised in the next two to three years." (emphasis added)

P. 49: "Most Federal grant programs for State and local governments and most Federal income maintenance programs for individuals also apply to Puerto Rico, although only partially in some cases."

The GAO estimated that in 1979 would have received an additional $721 million had it been treated in the same manner as the states. This is about 70 percent of the Treasury's estimate of tax savings for 1979.

P. 50: See p. 2 of General Comments.

P. 55: Table 3-2. Some of the unemployment figures do not correspond to those in the cited source. Economic Report to the Governor, 1980-81.

PP.56-61: See comments for p.3.

PP.80-81: "But Puerto Rico does not offer substantially greater tax savings for real investment than many low-tax developing countries. Although dividends from a 936 corporation to its U.S. parent are not taxable in the United States, while dividends from a foreign

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affiliate are, the U.S. tax on foreign earnings is generally deferred as long as the foreign affiliate retains its income abroad. Moreover, many U.S. multinationals have excess foreign tax credits that can be used to offset the U.S. tax on dividends from low-tax foreign countries."

While those multinationals that have excess foreign tax credits can use them to obtain tax advantages similar to those available in Puerto Rico it is by no means clear that in other cases the deferral of taxation through delayed repatriation confers equivalent advantages.

P. 83: "The fact that 936 corporations have retained a large pool of financial assets in Puerto Rico, even when the return was at a substantial discount from Eurodollars, indicates that these companies do not have other locations available for receiving tax-free interest income."

This statement is rather extreme. It would be more reasonable to say that holding Puerto Rico tax-free financial assets is shown to be marginally preferable to other alternatives given the rate of interest, Puerto Rican tollgate taxes and possible future investment opportunities.

PP. 96-97: "The data on the modest fixed capital requirements of 936 corporations indicate that, in general, only a relatively small segment of the production process of U.S. corporations has been moved to Puerto Rico."

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The authors of the report are overextending the credibility of their estimates of differences in the return to operating assets in Puerto Rico and the U.S. if they are going to use these ratios to argue both that 936's are allocating intangible income to Puerto Rican operations and that they are locating minimal segments in the production process on the island.

The Report is more generous when it notes that:

"The tax benefits that U.S. parent corporations have claimed through the transfer of U.S. intangibles to Puerto Rico may eventually have another favorable, but indirect, effect on Puerto Rico. The increased after-tax returns in high-technology industries stimulate additional R & D to develop new products. After the products are developed, their production may, at least in part, be located in Puerto Rico."

We might add that this mechanism would also create employment, exports and taxable income in the United States.

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P. 153 - footnote 7 - The report notes that the mix of industry of all mainland corporations differs from that of 936 corporations and they estimate an adjustment necessary to make mainland and 936 balance sheets comparable. However it is not indicated at what level of disaggregation this adjustment was made. It has been argued in the general comments that disaggregation to only the 2 digit SIC level masks many divergences in the corporations included and that comparisons of 936 with overall mainland categories are misleading because of differences in the size, age, and other characteristics of the corporate assets.

P. 164, 169 ff. -

Effective Rates of Taxation Computed from Tax Benefits/ Net Income;936 Manufacturing industries in Table 5-4:

	1974	1975	1976	1977	1978	1979	1980
Effective rates of taxation (%)	48.8	45.3	45.0	45.0	42.1	40.3	42.0

These effective rates of taxation are much higher than most of those shown for the U.S. in Table 5-6 p. 172. The Treasury argues that high effective tax rates would apply to 936 corporations because of low levels of depreciable assets and investment relative to taxable income. We have already argued that the measurements of operating assets are understated. Imposition of U.S. tax regulations would cause immediate changes in accounting reports of operating assets and of course in the long run behavior of investors on the island.

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PP. 170 & 134 - The Treasury states that Puerto Rican tax payments are deducted from potential tax benefits and they report that 936 corporations paid 3.5 percent of their income in Puerto Rican taxes in 1980. They use this ratio to reduce tax benefits for 1981 to 1983 and use a five percent deduction for 1984 through 1987. These deductions are probably too small since Puerto Rican income and tollgate taxes have been growing at 30 percent per annum and 1983 will begin to see firms incorporated with an initial 90 percent exemption dropping to 75 percent exemption, giving 2 1/2 times as much taxable income.

P. 173 - The report states that in the absence of the QPSII provision of section 936, income from financial assets would largely become taxable by the U.S. This may be true and indeed the objective of the legislation is to provide funds for Puerto Rican development. Since increasingly strict regulation of how 936 funds are used have been implemented, criticisms leveled at the earlier performance of the system appear no longer to apply.

Office of Economic Research
Economic Development Administration
November 1982

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Chairman MINISH. Thank you, Mr. Madera. I want to thank you for summarizing your statement. I didn't mean to give the impression that no one would read it, you can be assured the full statement will be put in the record.

I also want Madam Treasurer and yourself to know that we will make the tax writing committee aware of this testimony once the record is printed. That is the committee that has jurisdiction over the section 936 matter.

Speaking for myself and myself alone—because I understand my two colleagues are well versed with this—I know more about 936 than I did before the hearing and the effect it has on Puerto Rico.

Madam Treasurer, on page 3, six lines from the bottom: "The final effect of this employment on our fiscal system is thus very significant, probably accounting for more than two-thirds of our personal income tax collections."

Can you expand on that a little?

Ms. CULPEPER. Basically, coming back to the figure that Mr. Madera also gave you, and according to the employment, specially during our worst economic times, the manufacturing sector of Puerto Rico has been the one that has maintained itself healthy throughout. The unemployment has reached basically in other areas and in the areas of the 936 corporations. It is in these corporations where the employees have paid significantly in their personal income taxes toward the general fund. If they were not there and the employment was there, of course, our personal income tax collections would be much less.

In other words, would be a third less.

I think in Mr. Madera's——

Mr. MADERA. Page 15, table 7.

Ms. CULPEPER. He has a good table of how the income tax totals are derived. In 1981, we had a total of $966 million of which individuals accounted for $590 million, and out of that, we believe that almost one-third, or $200 million and so, were derived from personal income taxes of employees of 936 corporations.

Mr. MADERA. If I may compliment the Secretary's statement, in 1978, we implemented, with the consent of Congress, the minimum wage to the island. In 1976, the annual production payroll in manufacturing, production only, was $525 million per annum. Last year, it was $937 million per annum; coupled with the transition from traditional industries to high technology, the professional class and the white collars that have been developed in the manufacturing and services sector has increased for a compound annual growth on individual taxes averaging 15.7 percent.

When you add that to the corporations and partnerships increase, at a rate of 15 percent, and the tollgate tax of a compound of 4.4, you have a very substantial percentage of the total collections coming from that sector directly.

Chairman MINISH. Mr. Madera, I also would like clarification on your statement, particularly the point that you made during the testimony, if I understood you correctly, that most people perceive that all the section 936 firms are pharmaceuticals; and if I under-

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stood you correctly, that's a small percentage of that. Am I correct in that?

Mr. MADERA. That is correct, sir. Table 2 gives you by two digit SIC, standard industrial classification, the employees in each of the sectors from 1951, 1976, and 1981. In the second part, you have a breakdown of the high technical firms and you can see the substantial contribution they all make.

Chairman MINISH. Thank you, sir.

Mr. Garcia?

Mr. GARCIA. Thank you, Mr. Chairman.

If the tax body over in the other House had their way and we were to remove section 936, just absolutely remove it, give you 12 months and that was the end of the exemption program, what would have happened to the banks and financial institutions in Puerto Rico?

Ms. CULPEPER. Well, I could say right now that probably the money would be repatriated, of which accounts for 40 percent of the deposits of the total banking sector. We certainly have about 90 percent of financial institutions having big problems. Those problems would insure then that the FDIC and the FSLIC would have to account for the insurance that they have in deposits of many other people.

Mr. MADERA. If I may compliment, sir, since my previous employment was in the banking world prior to coming to public service, there are two major banking institutions on the island. There are four big mainland money center banks, two Canadian banks, two European banks, both Spanish banks, and in the last year, when a recession occurs, all banks usually have to make quite large reserves for bad loans; and in Puerto Rico, the cushion provided by section 936 funds have enabled them to reinvest many of thse profits that are spread. To my understanding, at least 40 to 50 percent of the net income of these two large Puerto Rican banks are as a direct consequence of their investment portfolio underpinned by section 936 assets.

If we were to cut in half their profits, and the recession were to continue, or the withdrawal of these funds were to take place, it is my earnest opinion that the banking industry in Puerto Rico as such would be taken over by someone else.

Ms. CULPEPER. Another point to the effect is that many of the loans that have been placed in either the short- or long-term environment have been placed at lesser rates because of the section 936 funds' availability. So to the effect that the funds would be taken out of this system, of course, then if they are the floating rate, the institution could increase the rate to the person that they have made the loan to; but to the effect that the loan would have been in a fixed term, it would be a complete reduction into an earnings picture at that point in time.

Chairman MINISH. Would the gentleman yield for a question?

Mr. GARCIA. Sure.

Chairman MINISH. Do I understand you to say that because of the section 936 funds, you may not have had the problem with the S&L's that we have had on the mainland?

Ms. CULPEPER. That is correct. In fact, an institution up to the present, there has only been two institutions in which the FSLIC

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has been working with them in terms of extra loans; but they have not gone under. We only had during all this period of time a small bank which was a problem and we had a merger, Mr. Chairman, of its assets by a major bank without any problem to any of its depositors.

Chairman MINISH. Thank you.

Mr. GARCIA. I would just like to continue, if I may.

The reason why I believe what we are doing here in terms of establishing this record and the importance is the question I just asked you: Why and how is it that this committee, a banking committee, is involved in matters concerning taxation. It seems to me when I have had an opportunity to speak to some of the people in Puerto Rico who have that responsibility, who are running those financial institutions, that we found it very clear that we had a responsibility in terms of setting up some sort of dialog to insure that a record is established; but there's another question that is before us. As you know, we are in a special session. In a special session, many things come down the pike. One of the areas that we are concerned about during this week in December is the question of the CBI, the question of the Caribbean Basin Initiative. While I prefer not to get into that conversation, there is a direct linkage between what we are talking about here and the CBI.

To both of you, as you can hear the bells are going. There's a conference report we have to go vote on; then we are going to go into another set of votes. There are a number of questions that we would like to ask.

Chairman MINISH. The subcommittee will stand in recess at this time and we will come back at 2 o'clock and, Ms. Culpepper, Mr. Madera, we will continue then.

Mr. MADERA. We will be delighted to come back, sir.

[Whereupon, at 12 noon, the subcommittee was recessed, to reconvene at 2 p.m., this same day.]

AFTERNOON SESSION

Chairman MINISH. The meeting will come to order.

At the recess, Mr. Garcia was asking questions. We will now go back to Mr. Garcia.

Mr. GARCIA. I think we left a question. We were talking about the Caribbean Initiative. As you may or may not know, it is interesting at this particular moment, as we opened up the questioning before the noon break, I asked you for your response, your feeling about the Caribbean Basin Initiative.

It is interesting what 2 hours can do in Washington. I understand at this moment the Rules Committee is taking up a rule on the Caribbean Basin Initiative for possible consideration by the House to move the bill to the House within the next day or two.

It seems to me that because Puerto Rico has faced the hardships they have faced with the section 936 program and what it has meant to the financial institutions of Puerto Rico, now with the added thrust if it becomes a reality of a CBI, what effect do you feel at this particular moment this would have again?

And I want to concentrate just on financial institutions in Puerto Rico, if the combination of the CBI coupled with any extended addi-

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tional cuts or additional section 936 cuts, what effect would this have on the financial institutions in Puerto Rico?

Mr. MADERA. By way of background, sir, when the Economic Recovery Act was implemented, Puerto Rico was excluded from it. Coupled with the CETA cutbacks and the housing funds, those were three events that, coupled with the recession, put Puerto Rico at a quite large disadvantage. As we came to Washington, we met with many officers from the executive branch, and we were always informed that all the defects, or the flaws, or the problems would be resolved with later legislation, particularly through the CBI. Then we had the section 936 event that transpired.

In spite of that, we continued—at least the administration of the government in Puerto Rico continued, to support CBI. However, at all times we expressed a concern on the tuna issue and the rum issue. We were led to believe, at least in all the conversations, that those two issues, and also making extensive to the island the ACRS and the ITC rules, those amendments would incorporate all the concerns that we had.

None of these items are part of the CBI as such, and in addition to that, a convention deduction for tourism has also been put on the bill. Puerto Rico in 1976 had 450 conventions, last year about 1,200. On the basis of those four points, at least I personally can no longer on that basis support the CBI legislation.

There have been some discussions specifically on section 936 funds insofar as to whether they should be made extensive to other islands around the Caribbean. On that basis, our present position is that if the section 936 funds are—the intent is to help the economic development of Puerto Rico, it could be misconstrued if those funds were to be utilized outside of Puerto Rico.

However, insofar as the service sector growth on the island, if Puerto Rico were to become the conduit through which economic activity could be passed on the island, then it would be up to the honorable Congress to determine whether loans or activities sourced within Puerto Rico, the actual booking of the transactions would be there, would be one way or one new idea or avenue to explore.

As the CBI legislation stands right now, I believe in justice and equity we should start by helping ourselves at home. It is sort of an illusion to try to help the Caribbean at the expense of the citizens in Puerto Rico and the Virgin Islands.

Mr. GARCIA. I have one last question, if I may.

One of the basic problems we had during the course of the debate on section 936 was the question of how the U.S. Treasury Department overestimated the costs and underestimated the benefits as it directly related to section 936.

I guess what I am trying to say with that is that it was during that period of time when it was the Treasury Department who was coming in with figures, facts, and statistics that were not being supported by the Congress in the sense that we have figures that would coincide or show they were in error.

Were those figures that the Treasury put together, do you consider those figures to be accurate, or were there maybe some misconceptions on the part of some people?

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Mr. MADERA. On the third part of our presentation, you have all the comments that Fomenta prepared on the second, third, fourth, and fifth section 936 report. Much to our chagrin, none of these comments have ever been incorporated on the section 936 reports, something that leads us to believe that the indictment against the system is there, but Congress has never seen the other side of the coin.

On the specific question that you ask vis-a-vis how the numbers come up, I dare say that in terms of economic development, it leaves much to be desired because the way it is usually done is they take the entire profits reported by the section 936 companies, apply the U.S. tax rate on it, and furthermore then they say 20 percent of the income is operating income, 20 percent passive income, and 60 percent intangibles. Hence, U.S. Treasury forgoes *x*. That is quite a simplistic approach.

When Mr. Dole presented his amendment in the Senate Finance Committee, it utilized the same exact figures, on the basis of $4 billion, apply a 45-percent tax rate, 60 percent attributable to intangibles, and he came out with $1.3 billion. I don't think that is a correct way of estimating the benefits, and none of the benefits to Puerto Rico directly, which after all is the intent of 936—at least that's the intent of Congress—none of that is incorporated in the report.

We feel now that you have copies of this, we would be delighted to discuss, whenever appropriate, so that we can have a candid conversation on how Treasury has sustained its conclusions which we think are full of fallacy, sir.

Mr. GARCIA. Thank you very much, Mr. Madera.

Getting back to the question of the investment of the 936 funds as short-term rather than long-term instruments, what type of impact is this having? I guess I might as well ask you, Madam Secretary. What type of impact is this having vis-a-vis short- versus long-term instruments?

Ms. CULPEPER. In the last 2 years, we had a general market trend of going short, which has undoubtedly changed the minds of the tax persons and the people that are investing for section 936 corporations in the general market terms. But since I would say about August of last year, which the market knew and the section 936 corporations knew we were working hand in hand with Treasury in devising new regulations for intangibles, the money started going shorter term until those regulations started out.

From the rumors of just regulation, of course, that transmitted into congressional action, and from congressional action I think it has long been until about last week, which we had an assertment from Mr. Dole to the fact he was not revisiting section 936 in the next year, for money to go in long.

However, we have had in the many years before a lot of transactions that have required long-term investment, and they have been successful. One of the reasons is because our average repatriation rate is not 10 percent, it is 4 percent. It is due to the fact that a lot of the money has been left over 5 years invested in Puerto Rico. We have a number of instruments right now available in the market, especially in the mortgage sector, which they have been repossessed and sold and they are long term.

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An example is a transaction done by a savings and loan institution for some bonds that they are putting out, guaranteed with mortgages, to section 936 corporations. They are also backed by the FSLIC, and it is a very interesting transaction; it came in in about the last 2 weeks.

It takes into consideration both the idea that Mr. Agosto, who was here previously, was stating. The market is already working on these projects. I believe in the last week, in fact, there were new types of transactions than mortgage marketing which will be from 7 to 15 years transacted with section 936 moneys.

So, definitely, there is a possibility of having long-term transactions to the benefit of Puerto Rico, only that we had only about a year because of the uncertainty of the regulation then of legislation, the money had to stay short.

Mr. MADERA. If I may comment, sir, I think a clear example of the benefits, banks, of course, want to price their transactions at the marginal cost of funds, so they will try not to ever be caught short between long-term or intermediate-term loans and to have a funding problem.

But if you take the fact that banks can't receive 936 deposits just because they want to, they must comply with the regulation, and they must justify to the Secretary of the Treasury that there are certain eligible activities onto which then they can accept section 936 deposits. Those eligible activities are at least government obligations is one, so the banks right now have $1.6 billion in government obligations which are long-term bonds and loans, and they fund it with recurring maturities of section 936 funds.

In addition to that, the banks must redeposit with the Governmental Development Bank a certain percentage of the funds by the way of more obligations and/or cash. At the present time the Government Development Bank, of which Madam Secretary and myself are on that board of directors, we have something like $700 million to $800 million we reinvest and are able then to buy back notes that mature from certain public corporations.

On that basis, at least the government, it is our estimate we are saving anywhere from $40 million to $50 million on interest a year on this.

As you go out to other sectors, many corporations and commercial businesses can obtain loans at 200 to 300 basis points under the prime rate prevailing on the mainland. This, of course, is a benefit that is passed directly to the island community in order to reduce startup costs or capital expansion programs, be it on private citizens or corporations in the private sector.

Mr. GARCIA. Madam Secretary, I just want both of you to know, as a matter of fact, that right now the Rules Committee is meeting on a rule for the CBI, the Caribbean Basin Initiative. My colleague Congressman Corrada is over there at the present time fighting against the rule. I don't know if he will be able to join us again. I know the Rules Committee is meeting.

Madam Secretary, Mr. Madera, how do the 936 funds work in the housing field?

Ms. CULPEPER. Let me emphasize an aspect of the regulation of the Treasury Department for the first time this year emphasized that 3 percent of the section 936 deposit had to be invested in the

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mortgage field, especially in the area where construction was to be begun 1 year ago.

Six percent is to be used as an accumulative basis at the year end of 1983.

The purpose was, in fact, to promote long-term investment, especially in a sector which has one of the greatest multiplier effects in the construction field in Puerto Rico and at a time of the year when our economy was certainly hit by international economics, as everybody was.

We are looking to see at the end of this year whether compliance will be met. We have made the—our regulations for the first time, they have to—the financial institutions must submit audited statements by their CPA's to the effect that the regulations have been complied with.

This is a new certification that was required in our regulations that went into effect in February.

Of course, although we know that the amount of money that has gone into construction has been quite a bit, we did it with the purpose of again sort of putting a promotion on construction during these two particular years.

We know a lot of the financial institutions have used, to a certain extent, the section 936 money to finance or to reduce their cost of funds in a pool concept so that they could, at a point in time, finance mortgages at a long-term rate lower than they were in the States.

Most of our mortgages, by the way, in Puerto Rico right now are lower than they are here in the States on a lot of the construction projects.

Chairman MINISH. Is this in single-family homes, high rise condominiums?

Ms. CULPEPER. Several. Both in the single and in the high rises.

Mr. MADERA. If I may expand, this scenario is very dynamic at the present time. Let there be no doubt, with all candor, the Government is doing everything it can to sort of have banks follow our conduct on this. The problem that we face right now is that for a construction company to embark upon a construction project, they must be at least guaranteed a recapture price or an approximation that there will be a purchaser and they can live with the rate structure.

On that basis, we have sort of suggested to the banks that on the basis of their section 936 deposit base, they do a pool proportionate to the deposit base that they have. Then they can issue letters of credit in proportionate shares and have section 936 companies buy participation certificates.

They can roll it over every 5 to 7 years.

In Canada they have the NHA market like that.

We have had difficulty on that. The Secretary is preparing regulations to make sure that we can follow the desired conduct. There are some problem areas. Each side can articulate some reasons why they can or cannot do it, but this is part of the dynamics of improving and performing better on their section 936.

Mr. GARCIA. Are the difficulties coming from the financial institutions?

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Mr. MADERA. I would say the issue is we have not defined to each other. One thing is helping the construction sector; one thing is just the housing sector.

Construction is a more generically broad term. It is a matter of how we define it and what the priorities are.

Ms. CULPEPER. One thing I wanted to emphasize to you was the fact that our regulations are dynamic. We issued them in February; however, we have been issuing circular letters to the effect of redefining or making sure the industry understands our definition of what was in the regulations.

If they have to be amended because of the market and how it changes in the States, we certainly will do so to make sure that the money goes wherever the investment is appropriate for the economic betterment of Puerto Rico.

We do not intend to make a regulation which does not fix itself to the market. We have a number of things happening around the financial world which we must make sure that our regulation bears a relationship to.

Chairman MINISH. Madam Secretary, thank you very much.

Mr. Madera, thank you very much. Your testimony will be very helpful to the subcommittee, I am sure.

Thank you.

The next panel is made up of Frank Rexach, president of the Puerto Rico Manufacturers Association; Bertram Finn, Jose Fernandez, Jose Rivera Janer, and Ramiro Colon.

Why don't we start with Mr. Fernandez?

STATEMENT OF JOSE ENRIQUE FERNANDEZ, PRESIDENT, A.G. BECKER PUERTO RICO, INC.

Mr. FERNANDEZ. Good afternoon. Thank you for the opportunity to express my thoughts regarding the present system of corporate taxation for section 936 of the Internal Revenue Code as it is generally known.

It seems that we in Puerto Rico since 1974 have had sections 931 to 936 or the elimination of these sections as part of our daily conversations or menus for breakfast, lunch, and dinner.

It was in 1974 that the then chairman of the House Ways and Means Committee, Representative Wilbur Mills, first proposed the elimination of section 931, the predecessor of section 936.

It seems that since then every year, every business and government sector of Puerto Rico mobilizes itself to come to Washington to try to convince the Members of Congress and the administration of the complete necessity of continuing the possession system of corporate taxation.

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The members of the Puerto Rican community are here every year to discuss the past as well as the future of Puerto Rico.

We remember and lived the Puerto Rico of the early fifties. The island then depended entirely on agriculture, no manufacturing.

I was a little boy of 9 years old in 1952. Through my eyes the only thing that I could see and can remember was extreme poverty in San Juan as well as through the island. People lived in wood shacks similar to the ones that people live in now in Haiti and the Dominican Republic, the poorhouses of the Caribbean now.

This was a title reserved for Puerto Rico in the 1980's. It was very sad to go to your grandfather's small farm in the town of Cayey to celebrate Christmas and watch on the road the boys and girls naked or dressed in rags in front of the wood shacks, that no one of us would even consider to use as a pigpen.

Out of despair, Puerto Ricans emigrated to the United States looking for a job, for an opportunity to improve themselves. Such was their plight that they came to New York and they didn't even speak English.

In the early fifties the push to bring manufacturing to the island started with vigor and since then approximately 150,000 jobs have been created; on average directly in manufacturing. Because of the opportunities created by these jobs, the migration to the United States declined and in many years there are more people coming back to Puerto Rico.

My grandfather was a chemist in a sugar mill near Ponce. Every summer I stayed with him until I was 14 and saw how little economic activity was created by agriculture. Ninety percent of the labor was unskilled; sugarcane cutters worked from 6 a.m. to 4:30 p.m. at 50 cents an hour.

A manufacturing facility, on the other hand, creates not only the manufacturing jobs, but tremendous amounts of indirect jobs. It starts with the purchase of land and the construction of facilities which create a good number of jobs for a year or two.

Manufacturing facilities create a need for lawyers, accountants, architects, engineers, telephone services, water and sewer service, electricity—it creates jobs in all spheres of the service industry.

Employment firms, who could have thought of the employment firm industry in Puerto Rico in the fifties, to find jobs where?

In my opinion every working individual in Puerto Rico depends directly or indirectly on section 936 corporations whether they work in a retail store or in a factory.

Such is the impact of the section 936 program in the economy of Puerto Rico. The retail store employee cannot have a job or a store to work in if the economic activity would not have been created by the manufacturing job itself.

If I were an employee of a gasoline station, I would depend on the revenues from those people that work with or work for manufacturing firms to purchase the gas that produces the profits that give me my job.

There was no such thing as a service industry in Puerto Rico in the early fifties. If there was, it was very small.

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Since then a very big banking industry has been established with new entries such as Bank of America, Continental Illinois, three new Spanish banks and several more local banks.

Investment bankers have grown from one in the early fifties to eight of the major houses. All top eight major accounting firms are now represented in Puerto Rico with very large offices serving their clients.

Several other new industries flourished with the growth of manufacturing in Puerto Rico mortgage banking, insurance companies, law firms.

The multiplier effect on Puerto Rico has been excellent from where Puerto Rico was in 1952.

Section 936 corporations, as we refer to them, created profits which were channeled into investments in Puerto Rico through banks, S&L's, mortgage bankers, and investment bankers, and other financial intermediaries.

A very sophisticated market has developed for the use of these funds. One of the first applications that dates back to 1971 was the purchase of the then section 931 corporation of GNMA or Government National Mortgage Association pooled certificates with Puerto Rico mortgages in them.

At a time when Puerto Rico residential mortgages were not being purchased by any U.S. buyers, section 936 corporations stepped in and purchased over $1 billion of these long-term investments with an average life of 12 years.

Section 936 corporations are still buying industrial mortgages but not as many because of the uncertainty and frequent changes in section 936 that are proposed every year.

Section 936 corporations used to consider longer term investments up to 10 years, depending upon the duration of the tax holiday, now the majority of the market is 30 to 90 days except in special cases.

This is a result of the corporate treasury people being concerned over how investments can be affected by changes in the law.

Section 936 funds were and are used to finance the Puerto Rico government through the purchase of Puerto Rican municipal bonds by section 936 corporations or by banks giving section 936 funds via lines of credit to the Commonwealth, its agencies, and instrumentalities.

The amount of investment by section 936 corporations in all of the above to the Commonwealth of Puerto Rico at the present time is in excess of $800 million.

Section 936 funds, mainly through banks and to a very small extent through similar institutions—investment bankers—are available to Puerto Rican businesses who need funds to develop and expand. These businesses now receive reduced rates because of the lower cost of section 936 funds.

Section 936 funds were of tremendous help and support to the S&L's during the recent high interest rate period. At the present time through repos, they help S&L's finance part of their conventional mortgage portfolio.

Just recently they purchased $100 million mortgage-backed notes of First Federal Savings with a standby from the Federal Home Loan Bank of New York.

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Section 936 funds were used to finance industrial expansion directly through banks or through 936 to 936 loans placed by investment banks or through their purchase of industrial development bonds, or through their purchase of notes similar to commercial paper.

In my opinion, there is not one area of the Puerto Rican economy that does not use section 936 funds directly or indirectly.

One aspect of all the above cases is that the financing provided is below market rates. This is because yields to section 936 corporations from their investments in Puerto Rico are tax-exempt so that rates are currently fluctuating at 50 to 70 percent of the taxable rate.

Section 936 funds also go to the government of Puerto Rico directly through corporate taxes and toll gate taxes. This is generating $60 to $80 million annually and means that through the toll-gate route from $1.5 to $2.5 billion of these profits are brought back to the United States by these corporations annually.

In last year's tax bill, the benefits for 936 corporations established in Puerto Rico were changed to raise $1.3 billion of Federal revenue; a very sizable amount for an island with a 23-percent unemployment rate. But everybody must contribute within his ability to help the central government. But Puerto Rico's means and ability to pay are limited.

The difference between the fifties and the eighties for a Puerto Rican can best be summarized with the word "opportunity." In the fifties there were no opportunities, no future, no hope for our children.

At the present time the opportunities remain for all of us with the section 936 program. It allows us to create direct jobs in the manufacturing sector of the economy. It helps us to create many indirect jobs in the service and government sector of the economy.

Whether the opportunity remains in Puerto Rico for Puerto Ricans is going to depend on the stability and the changes that take place in section 936 in the following years.

[Mr. Fernandez' prepared statements and responses to questions submitted by Chairman Minish after the hearing follow:]

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Statement to the Subcommittee on General Oversight and Renegotiation of the Committee on Banking, Finance and Urban Affairs
By Jose E. Fernandez, President of A.G. Becker Puerto Rico Incorporated

Mr. Chairman, Honorable Members of the Committee; Good afternoon. My sincere thanks for the opportunity to express my thoughts regarding the "Possession System of Corporate Taxation" or Section 936 of the Internal Revenue Code as it is generally known.

It seems that we in Puerto Rico since 1974 have had Sections 931 - 936 or the elimination of these sections as part of our daily conversations or menus for breakfast, lunch and dinner. It was in 1974 that the then Chairman of the House Ways and Means Committee, Representative, Wilbur Mills, first proposed the elimination of Section 931, the predecessor of Section 936. It seems that since then that every year, every business and government sector of Puerto Rico mobilizes itself to come to Washington to try to convince the members of Congress and the administration of the complete necessity of continuing the "Possession System of Corporate Taxation". I am very happy, Mr. Chairman, with your interest in establishing a record in the Section 936 program for Congress's future use.

Every year decisions in all sections of Puerto Rican enterprise are stopped, delayed or cancelled because of annual changes that could be or are about to take place to Section 936.

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In my opinion, every working individual in Puerto Rico depends directly or indirectly on 936 corporations whether they work in a retail store or in a factory. Such is the impact of the Section 936 program in the economy of Puerto Rico. The retail store employee cannot have a job or a store to work in if the economic activity would not have been created by the manufacturing job itself. If I were an employee of a gasoline station, I would depend on the revenues from those people that work with or work for manufacturing firms to purchase the gas that produces the profits that give me my job.

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A.G. BECKER PUERTO RICO
INCORPORATED

December 23, 1982

Rep. Joseph G. Minish
Chairman
U. S. House of Representatives
Ninety Seventh Congress
Washington, D. C. 20515

Dear Representative Minish:

I would like to thank you once again for the opportunity to appear last week before your Committee to express my opinions on a very important issue for Puerto Rico. Section 936 of the U. S. Internal Revenue Code is much more than an incentive program for U. S. firms to locate plants in Puerto Rico. This provision is one of three principal building blocks upon which Puerto Rico's entire economic well being is structured. As such, it's influence permeates into every sector - ultimately to every individual - within our economy.

The hearings by the Subcommittee on General Oversight and Renegotiation held on December 15, 1982, will serve as the beginning for a long process in which Puerto Rico demonstrates to the Congress the vital role that this provision plays in Puerto Rico's economy. Puerto Rico has an uphill fight on its hands in this respect, however, with Congressmen such as yourselves - who recognize this fact - we shall succeed in maintaining the economic health and well being of the 3.3 million american citizens residing in Puerto Rico.

In accordance with your request, I am answering the questions that were posed:

Q. Have the Investment Banking firms played a role in developing the GNMA market?

A. Yes, the investment banking industry was the one that developed the GNMA market in Puerto Rico and marketed such instrument succesfully to 936 corporations.

The sale of GNMA pools, constituted from mortgages on residential properties in Puerto Rico to the possessions system corporations (Section 931 and later Section 936 firms) emerged rather slowly in 1971. After the development of this product, as an eligible investment in Puerto Rico, for Section 931 firms, we consummated the first sale of a GNMA to a 931 firm in April 1971. By the end of 1971, some twenty-five 931 firms had purchased GNMA's from investment bankers for their investment portfolios.

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From that start there are approximately $1.0 Billion of GNMA's currently held by Section 936 firms in their portfolios. Some 60 to 70 major 936 firms now participate in the Puerto Rico GNMA market. Individual firms have GNMA's totalling from $5 to $100 millions in their portfolios. The majority of these GNMA's are held by the pharmaceutical firms, which, incidentally, are holding GNMA portfolios with significant losses from the face value of the GNMA pools because of the much higher level of interest rates prevailing today in comparison to prior years.

Because the interest received from the GNMA's constituted from residential mortgages is tax exempt for Section 931 and Section 936 firms, there is a premium above par value for these securities. This premium has varied from as much as 10 points to 0. More recently, there has been a rather significant decline in the premium. From January 1982 through December 1982, the premium ranged from 1/2 to 3 points. The decline in the premium is attributable to the uncertainty surrounding the tax treatment of these long term investments for Section 936 firms.

It should be emphasized that when the premium was higher, this meant lower effective borrowing rates on the mortgage pools. This lower borrowing cost was passed on to individuals, by the financial institutions and mortgage bankers. The effective mortgage rates for FHA and VA borrowers whose mortgages were put in GNMA pools was 1/2 to 1% less than rates for comparable mainland borrowers. This allowed some people, who otherwise may not have qualified at the higher rates, to purchase their own homes in Puerto Rico. This is a rather significant benefit that has heretofore been overlooked.

Q. What is the investment banker's role today with respect to Section 936 and the secondary market for housing?

A. The investment banker plays a key role in financing housing in the Puerto Rican Section 936 market. The principal instruments for the financing of housing in Puerto Rico have been the GNMA mortgage pool, the FNMA participation certificates, and, a relatively new mortgage backed note. Let me examine each of these instruments, and analyze the role of the investment banker in each.

Investment bankers and banks work with the mortgage banker as the individual mortgages for GNMA pools are developed. The mortgage bankers must carry

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these mortgages from the time they are issued until they are placed into a GNMA pool and sold. The investment banker provides the 936 funds to "warehouse" (temporary financing) the individual mortgages. Once the pools are created of sufficient size, the investment banker either purchases the pool for its own inventory, or arranges for the sale of the GNMA to a 936 firm or to a final buyer. However, because of the fact that 936 firms receive tax exempt interest on their purchases, the GNMA's sell at a premium in in Puerto Rico for all buyers. As previously mentioned, this permits an effectively lower interest rate for the original mortgage issued to the individual home buyer by the mortgage banker.

Once the GNMA has been issued and sold the investment banker provides an active secondary market by offering to buy and sell for his own inventory. This added liquidity in the secondary market has provided an incentive for 936 firm to purchase GNMA's for their investment portfolios and has enabled the continuance of the premium on Puerto Rico GNMA's.

The investment bankers have been the principal means by which the low cost 936 funds have been provided to the Savings and Loan industry. Recently the financial problems of the Savings and Loan's have deterred the 936 firms from investing directly in the S & L's. The investment bankers, however, have been able to channel funds to the S & L's by means of repurchase agreements. Today the S & L's have some $600 million of low cost 936 funds through this vehicle. The savings generated by the lower cost of funds has allowed many associations to stay in the black and others have been able to minimize their problems.

A. G. Becker has developed a new mortgage backed instrument in conjunction with the Federal Home Loan Banks and the Federal Savings and Loan Insurance Corporation (FSLIC) that provides lower cost 936 funds, for extended periods, to the Puerto Rican savings and loan institutions. A copy of the prospectus for the recent $100 million issue completed for the First Federal Savings and Loan Association is enclosed for your review. We hope to extend the benefits from this type of transaction to other institutions throughout the island.

These transactions will put the S & L industry on a firmer financial basis, which will enable the institutions to provide a higher level of service in their respective geographical regions, and most importantly will reduce or eliminate the exposure of the FSLIC within Puerto Rico. A healthy S & L industry is good for Puerto Rico and is good for the U. S.

I am sure that I could continue to discuss the role that the investment banking industry has played in the secondary housing market in Puerto Rico, however, I have, hopefully, identified the major points of this role.

Once again thank you for this opportunity, and I will always be at your disposal to assist you in the future.

Sincerely,

José Enrique Fernandez
President
A. G. Becker P. R., Inc.

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Interest income on the Notes under certain circumstances will, in the opinion of McConnell Valdés Kelley Sifre Griggs & Ruiz-Suria, constitute qualified possession source investment income under Section 936 of the U. S. Internal Revenue Code of 1954, as amended, and, when received by certain qualified investors, will be exempt from Puerto Rico income taxes. (See "Taxation" in this Offering Circular).

$100,000,000

FIRST FEDERAL SAVINGS & LOAN ASSOCIATION OF PUERTO RICO

Mortgage-Backed Notes, 1982 Series A

Dated: November 9, 1982 **Due: As described herein.**

The Federal Home Loan Bank of New York will issue to the Association a Firm Commitment to Advance Funds for the purpose of paying the principal of and interest and premium, if any, on the Notes, in the event any such payment is not made by the Association. Interest on the Notes will be payable on May 1 and November 1 of each year, commencing May 1, 1983, and at maturity. The Notes will be issuable in registered form in denominations of $200,000 or $5,000 increments above $200,000. The principal of and interest on the Notes will be payable on behalf of the Association by the Trustee, J. Henry Schroder Bank and Trust Company, New York, New York.

THE SECURITIES OFFERED HEREBY DO NOT CONSTITUTE SAVINGS ACCOUNTS OR DEPOSITS AND ARE NOT INSURED BY THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION OR ANY OTHER GOVERNMENT AGENCY.

THE NOTES ARE NOT SUBJECT TO THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT OF 1933 OR THE PUERTO RICO UNIFORM SECURITIES ACT AND HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION OR THE PUERTO RICO SECURITIES BUREAU.

INITIALLY OFFERED AT PAR PLUS ACCRUED INTEREST

The maturity of the Notes may be accelerated by virtue of the occurrence of certain events described herein. If the Association fails to pay any installment of principal of or interest or premium, if any, on the Notes upon such accelerated maturity date, or upon any other date on which a payment of principal of or interest or premium, if any, on the Notes is due, the Federal Home Loan Bank of New York, upon notice and request by the Trustee, will be obligated to advance funds to make such payments.

The Notes are offered subject to prior sale when, as, and if issued by First Federal Savings and Loan Association of Puerto Rico and accepted by the Underwriter. The issuance of the Notes is subject, among other conditions, to the approval of legality by McConnell Valdés Kelley Sifre Griggs & Ruiz-Suria, San Juan, Puerto Rico, Counsel to Underwriter. It is expected that delivery of the Notes will be made in New York, New York on or about November 9, 1982.

A.G. BECKER PUERTO RICO
WARBURG PARIBAS BECKER

Dated: November 4, 1982

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Appendices

Appendix A—Report of Deloitte Haskins & Sells, Independent Certified Public Accountants for the Association, and Consolidated Financial Statements of the Association at December 31, 1981 and 1980 and for the years then ended.

Appendix B—Firm Commitment to Advance Funds of the Federal Home Loan Bank of New York.

Appendix C—Report of Price Waterhouse, independent accountants for the Federal Home Loan Bank of New York, and Financial Statements of the Federal Home Loan Bank of New York at December 31, 1981 and 1980 and for the years then ended.

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SUMMARY

The following is a Summary of certain information contained in this Offering Circular, to which reference should be made for a complete statement thereof. The Notes are offered to potential investors only by means of the entire Offering Circular, including this Summary and the Appendices to this Offering Circular. No person is authorized to detach this Summary or otherwise use it without the entire Offering Circular, including this Summary and the Appendices thereto.

Issuer: The Notes are to be issued by First Federal Savings and Loan Association of Puerto Rico (the "Association"), a federally chartered mutual savings and loan association.

Notes: The Mortgage-Backed Notes, 1982 Series A (the "Notes"), will be issued under and secured by a Trust Agreement and will constitute direct obligations of the Association. It is anticipated that there will be subsequent issues of Notes issued by the Association secured by the same mortgages and having the benefit of the Firm Commitment to Advance Funds to be issued by the Federal Home Loan Bank of New York (See "The Firm Commitment"), but the aggregate principal amount of all such Notes shall not exceed $100,000,000 nor shall the maturity of any such Notes be later than January 31, 1988 (See "Description of the Notes and the Trust Agreement—Additonal Series of Notes").

Amount and Terms: The maximum principal amount of the Notes issued will be $100,000,000, and the latest maturity of the Notes will be January 31, 1988.

The Notes will mature on the date and will bear interest from November 9, 1982, at the rates as follows:

Principal Amount	Maturity Date	Interest Rate
$ 2,500,000	5/9/83	7¾ %
11,200,000	5/11/83	7¾
2,500,000	5/16/83	7¾
11,000,000	5/18/83	7¾
2,800,000	5/24/83	7¾
12,000,000	5/25/83	7¾
2,400,000	5/26/83	7¾
7,000,000	6/1/83	7¾
2,000,000	6/6/83	7¾
10,100,000	6/8/83	7¾
7,000,000	8/10/83	8
5,000,000	8/20/83	8
800,000	11/1/83	8¼
1,000,000	11/30/83	8¼
5,000,000	12/22/83	8¼
700,000	11/1/84	9¼
17,000,000	11/16/87	10⅜

Interest Payment Dates: May 1 and November 1 of each year, commencing May 1, 1983, and at maturity.

Denominations: $200,000 and $5,000 increments above $200,000.

Mortgage Collateral: The Notes will be secured by a pool of Mortgage Loans, consisting of whole mortgage notes, originated and serviced by the Association, secured by mortgages constituting first liens on single-family residential or condominium properties located in Puerto Rico. The Association is required to deposit and maintain with the Trustee, at all times while any

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Notes are outstanding, Mortgage Loans that are either current or in arrears less than 60 days and on which (1) the aggregate outstanding principal balance equals at least 100% of the principal amount of the Notes outstanding, and (2) the aggregate amount of interest payable each month equals at least 115% of the amount of the interest accruing each month on the outstanding Notes.

Initially, the Mortgage Loans delivered to the Trustee will have an outstanding aggregate principal balance of approximately $143,210,000 and will bear interest at a weighted average yield of approximately 8.89%.

Firm Commitment to Advance Funds Issued by the Federal Home Loan Bank of New York:

The Notes also will have the benefit of a Firm Commitment to Advance Funds issued to the Association by the Federal Home Loan Bank of New York ("FHLB-NY") for the purpose of paying the principal of and interest and premium, if any, on the Notes. The Trustee will be designated as agent of the Association for purposes of requesting advances under the Firm Commitment. Under the Firm Commitment, when requested to do so by the Trustee, the FHLB-NY will be obligated to advance the sum necessary to pay any payment of principal of and interest and premium, if any, on the Notes when due. The FHLB-NY will receive a fee from the Association for issuing the Firm Commitment.

Limited Rights of Acceleration:

The Trustee is authorized to accelerate the Maturity Dates of the Notes without the consent of the FHLB-NY only in the event that the Association fails to maintain its qualification under Section 936 of the Internal Revenue Code of 1954, as amended, or in the event the FHLB-NY fails to make a required advance under the Firm Commitment. In the event of any other defaults under the Trust Agreement, the maturities of the Notes may be accelerated only with the consent of the FHLB-NY. If the FHLB-NY is required to make an advance under the Firm Commitment, the FHLB-NY will have an option to require the maturities of all the Notes to be accelerated.

Acceleration Premium

Notes having a maturity date of more than five years from the date thereof that are accelerated to a date prior to the fourth anniversary of the date thereof will be repaid at 101% of the principal amount thereof plus the interest accrued on such principal amount. No other Notes will be entitled to a premium in the event of acceleration.

Tax Exemption:

Interest income on the Notes received by certain qualified investors, in the opinion of McConnell Valdés Kelley Sifre Griggs & Ruiz-Suria, based on a ruling received from the Commonwealth of Puerto Rico, will constitute "industrial development income" as "eligible interest" as those terms are defined in the Puerto Rico Industrial Incentives Acts of 1963 and 1978. Any premium paid will be subject to U. S. Tax. In addition, in the opinion of McConnell Valdés Kelley Sifre Griggs & Ruiz-Suria, interest income and any premium received will, under certain circumstances, constitute qualified possession source investment income under Section 936 of the Internal Revenue Code of 1954, as amended. (See "Taxation").

Underwriter:

A.G. Becker Puerto Rico Incorporated is the sole underwriter of the Mortgage-Backed Notes, 1982 Series A, to be issued by the Association. A.G. Becker Puerto Rico Incorporated is purchasing the Notes at a price equal to 100% of the principal amount of the Notes and will

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receive a fee of $515,255.48. An additional fee will be received for any subsequent issue of Additional Notes.

Expenses: The Association will pay expenses, including commitment and underwriters fees, in connection with the issuance of the Notes, estimated to be approximately $1,350,000. Fifty thousand dollars of these expenses are to be reimbursed by the underwriter.

Trustee: The trustee is J. Henry Schroder Bank & Trust Company (the "Trustee"), having its principal offices at One State Street, New York, New York.

All documents referred to herein are available for inspection at the offices of the Trustee or the Association. All references to such documents are qualified entirely by the documents themselves.

The Association extends to each offeree, and to the offeree's representative, the opportunity to ask questions of, and receive answers from the Association, or any person acting on its behalf, concerning the terms and conditions of the offering and to obtain any additional information, to the extent that the information is available without unreasonable effort or expense, necessary to verify the accuracy of the information contained in this Offering Circular.

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$100,000,000
FIRST FEDERAL SAVINGS & LOAN ASSOCIATION OF PUERTO RICO

Mortgage-Backed Notes, 1982 Series A

This Offering Circular of First Federal Savings and Loan Association of Puerto Rico (the "Association") sets forth certain information in connection with the sale of $100,000,000 Mortgage-Backed Notes, 1982 Series A (the "Notes"). The Notes are issued and secured under a Trust Agreement (the "Trust Agreement"), dated as of November 1, 1982, by and between the Association and J. Henry Schroder Bank & Trust Company, as trustee (the "Trustee"). The summaries of the Trust Agreement and other documents included in this Offering Circular do not purport to be comprehensive or definitive and are qualified in their entirety by reference to each such document. All capitalized terms used in this Offering Circular and not otherwise defined herein have the same meanings as set forth in the Trust Agreement.

SOURCES OF PAYMENT FOR THE NOTES

The Notes constitute direct obligations of the Association and are payable under the Trust Agreement from:

(1) moneys derived from a pool of Mortgage Loans pledged and assigned under the Trust Agreement which—

(a) are represented by whole mortgage notes, originated and serviced by the Association, secured by mortgages constituting first liens on single-family residential or condominium properties located in Puerto Rico,

(b) are either current in the payment of principal and interest or are in arrears less than 60 days, and

(c) (i) the aggregate outstanding principal balance equals at least 100% of the principal amount of the Notes outstanding, and (ii) the aggregate amount of interest payable each month equals at least 115% of the amount of the interest accruing each month on the outstanding Notes;

(2) other funds from the operations of the Association; and

(3) moneys transferred to the Trustee by the Federal Home Loan Bank of New York ("FHLB-NY") pursuant to the Firm Commitment to Advance Funds (the "Firm Commitment") for the purpose of paying the principal of and interest and premium, if any, on the Notes. (See "The Firm Commitment").

The Association anticipates that funds needed to repay principal on Notes maturing in less than five years will be obtained through the issuance of additional series of Notes which also will be secured by the Mortgage Loans and will have the benefit of the Firm Commitment. Such Additional Notes may not be issued without the consent of the FHLB-NY. At the present time the FHLB-NY has no intention of withholding such consent, but it is under no obligation to give it. The obligation of the FHLB-NY under the Firm Commitment with respect to outstanding Notes would not be affected by its failure to consent to any subsequent issuance of Notes. (See "Description of the Notes and the Trust Agreement—Additional Series of Notes" and the "Firm Commitment").

With respect to any unpaid amount of principal of and interest and premium, if any, on the Notes, after recourse to moneys derived from the Firm Commitment and recourse to the Mortgage Notes, the Noteholders will rank as general creditors of the Association on a parity with the Association's savings

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depositors, but the Noteholders will not be entitled to benefits resulting from insurance of the Association's savings deposits by the Federal Savings and Loan Insurance Corporation ("FSLIC").

USE OF PROCEEDS

The Association will use the proceeds of the Notes to repay advances from the FHLB-NY, to repay other borrowings, and to pay expenses incurred in connection with the issuance of the Notes.

THE ASSOCIATION

First Federal Savings and Loan Association of Puerto Rico was organized as a federally chartered mutual savings and loan association on October 29, 1948. Since its formation the Association has been a member of the Federal Home Loan Bank System and FHLB-NY and its savings deposits have been insured by FSLIC.

The Association is the largest savings and loan association in Puerto Rico. As of December 31, 1981, its total assets amounted to approximately $1.0 billion, of which approximately $788.1 million were mortgage loans and mortgage related securities. The Association's assets at that date represented 40.1% of the assets of all savings and loan associations located in Puerto Rico. Its business is conducted through its main office located at 1519 Ponce de Leon Avenue, San Juan, Puerto Rico, and 22 branch offices located in Puerto Rico and the United States Virgin Islands. Fourteen of the Association's offices are located in the San Juan metropolitan area. The Association receives the majority of its savings deposits from San Juan metropolitan area residents, and most of its mortgage loans are originated in and around the San Juan metropolitan area. This area is characterized by intense competition between financial institutions, primarily savings and loan associations and commercial banks.

The Association has elected the credit provided for under Section 936 of the U. S. Internal Revenue Code of 1954, as amended ("Section 936"). Such credit is allowed as to any taxable year if, for the three-year period immediately preceding the close of such taxable year (a) 80% or more of the gross income of the Association was derived from sources within Puerto Rico ("Puerto Rico Source Income") and (b) 50% or more of the gross income of the Association was derived from the active conduct of a trade or business within Puerto Rico ("Active Conduct Income"). For taxable years beginning after December 31, 1982, the required percentage of Active Conduct Income will increase to 55% in 1983, 60% in 1984 and 65% in 1985 and thereafter. For the three-year period immediately preceding December 31, 1981, 82.5% of the Association's gross income for such period was Puerto Rico Source Income and 98.1% was Active Conduct Income. The following table shows the amount of gross income, Puerto Rico Source Income and Active Conduct Income of the Association for each of the preceding three years:

	December 31, (000's omitted)				
	1979	1980	1981	Total	% of Gross Income
Gross Income	$64,689	$80,669	$105,861	$251,219	100 %
Puerto Rico Source Income	55,896	66,524	84,759	207,179	82.5%
Active Conduct Income	63,192	78,984	104,156	246,332	98.1%

SIGNIFICANT DEVELOPMENTS AFFECTING THE ASSOCIATION

The Association incurred substantial operating losses in fiscal years 1980 and 1981 and has continued to incur losses since the end of fiscal 1981. These losses resulted, in substantial part, from the fact that the interest rate spread (i.e. the difference between the interest income earned on loans and investments and the interest expense incurred on savings accounts and borrowings) experienced by the Association has been negative. Most of the loans in the Association's portfolio are long term fixed rate mortgage loans. Since funds available for new, higher or variable interest rate loan originations are limited in relation to the size of the Association's existing portfolio, the average rate of interest earned by the Association on its loan portfolio cannot be changed significantly in a short period of time. Conversely,

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the savings accounts and borrowings on which the Association must pay interest generally have short maturities and in many instances have interest rates that vary with the market rate. Consequently, the cost of the Association's savings and borrowings can vary rapidly and, in the recent high-interest rate environment, has increased dramatically. (See "Yields Earned and Rates Paid" under the discussion of "Business"). During 1981, the Association's deposit accounts decreased while the Association's advances from the FHLB-NY and borrowings from other sources increased substantially. (See "Business"). The shift of Association liabilities from lower cost deposits to FHLB-NY advances and other borrowings contributed to the increase in the Association's cost of funds. Until market interest rates decline or the Association can substantially restructure its assets and liabilities, the Association expects to continue to experience negative spreads and resultant operating losses.

The losses sustained by the Association resulted in a reduction in the Association's net worth to less than the levels required under federal regulations. (See Note 1 to Consolidated Financial Statements, Appendix A). On November 20, 1981, the Federal Home Loan Bank Board ("FHLBB") and FSLIC, which have supervisory and regulatory authority over the Association, took certain actions intended to prevent the insolvency of the Association and to restore its net worth to levels deemed satisfactory by FSLIC. These actions included the purchase by FSLIC of an Income Capital Certificate ("ICC"), issued by the Association, having an original stated value of $35 million, which supplements the capital resources of the Association and is included within the Association's net worth. In return, the Association received a promissory note of FSLIC in the same amount ("ICC Note"). FSLIC purchased the ICC pursuant to a Purchase Agreement between FSLIC and the Association (the "Purchase Agreement") dated November 20, 1981 and a Master Agreement of the same date between the same parties (the "Master Agreement"). At the same time, Pan American Federal Savings and Loan Association of Puerto Rico ("PAF"), which had also incurred substantial losses and had net worth below regulatorily acceptable levels, was merged into the Association. (See Note 1 to Consolidated Financial Statements, Appendix A). The liabilities acquired from PAF included a relatively large proportion of high cost certificate accounts and borrowings, which exacerbated the shift of Association liabilities from deposits to borrowings.

Under the Master Agreement, FSLIC has the right but not the obligation to purchase additional ICC's issued by the Association. The maximum outstanding stated value of ICCs that can be issued under the Master Agreement is $125 million. Subject to that limitation, it is anticipated that FSLIC will continue to so purchase ICCs for as long as FSLIC and FHLBB believe that such purchases are necessary to avoid the insolvency of the Association and that such purchases are the most desirable means of minimizing the insurance liability and risk of FSLIC.

There can, of course, be no assurance that FSLIC will purchase any further ICCs from the Association. If the Association continues to incur operating losses and FSLIC determines not to purchase additional ICCs or otherwise provide for the continued operation of the Association, the Association could become insolvent and be liquidated by FSLIC or otherwise default in its obligations to make regular payments on the Notes. In the event of default in the payment of principal of or interest or premium, if any, on the Notes by the Association, the FHLB-NY, upon notice and request by the Trustee, will be required to advance funds in the amount of such payment and the Trustee will be required to use the funds so advanced to pay the Noteholders. (See "The Firm Commitment"). In the event that FSLIC determines to liquidate the Association, it is likely that the maturity of the Notes would be accelerated. Such acceleration could have adverse consequences to Noteholders. (See "Taxation").

Under the Purchase Agreement and the Master Agreement, FSLIC obtained certain extraordinary supervisory rights and powers with respect to the Association. The Purchase Agreement provides, among other things, that the Association must submit for FSLIC approval operating plans covering the Association's proposed operations for six-month periods, and FSLIC must approve in advance specified transactions of the Association not already approved in the operating plan. The Association is not permitted to incur additional debt or make any investments in excess of amounts projected in the operating plan without the prior written consent of FSLIC. (See Note 1 to Consolidated Financial Statements, Appendix A, and "Management's Discussion of Financial Condition and Results of Operations").

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Among the powers granted to FSLIC under the Purchase Agreement is the power to cause the Association to merge or consolidate with another association or corporation. The Association has not received any indication that FSLIC intends to utilize this merger power at this time. However, if the Association were caused to merge or consolidate, and if the entity resulting from that transaction did not or could not elect or maintain the qualification which the Association presently maintains under Section 936, the maturity of the Notes would be accelerated. Such acceleration could have adverse consequences to Noteholders. (See "Taxation").

CAPITALIZATION

The following table presents the capitalization, excluding savings accounts and certain other short-term liabilities, of the Association as of June 30, 1982, and a pro forma capitalization at said date after giving effect to the sale of the Notes:

	June 30, 1982	Pro Forma, as of June 30, 1982
	(000's omitted)	
FHLB-NY Advances		
One year or less	$ 62,530	$ —
More than one year	14,441	—
Total	$ 76,971	$ —
Other Borrowed Money		
One year or less	$180,126	$165,347
More than one year	8,250	—
Total	$188,376	$165,347
Mortgage Backed Notes, 1982 Series A	—	$100,000
Net Worth:		
Income Capital Certificates	$ 35,000	$ 35,000
Deficit	(15,015)	(15,015)
Total	$ 19,985	$ 19,985
Total Capitalization	$285,332	$285,332

[1] Reflects use of Note proceeds to repay FHLB-NY advances and other borrowings. Proceeds available for such use will be reduced by expenses incurred by the Association in connection with the issuance of the Notes.

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SUMMARY OF CONSOLIDATED INCOME

The following summary of consolidated income for each of the five years in the period ended December 31, 1981 should be read in conjunction with the audited financial statements and the related notes included as Appendix A hereto. The unaudited consolidated results of operations of the Association for the six months ended June 30, 1981 and 1982 are also summarized below. In the opinion of management of the Association, all adjustments necessary to a fair presentation of the consolidated results of its operations for those periods have been made. Interim results of operations are not necessarily indicative of results for the entire year.

	Year Ended December 31 (000's omitted)					Six Months Ended June 30 (000's omitted)	
	1977	1978	1979	1980	1981[1]	1981	1982[2]
Income:							
Interest on loans; fees	$37,294	$46,978	$57,488	$66,742	$ 76,196	$37,278	$39,841
Interest and gain on sale of investments; other income	4,435	5,006	6,835	12,264	25,773	9,011	13,295
Total Income	$41,729	$51,984	$64,323	$79,006	$101,969	$46,289	$53,136
Costs and Expenses:							
Interest on Savings Accounts	$24,489	$27,871	$36,006	$53,564	$ 73,908	$34,886	$35,318
Interest on FHLB-NY Advances and Other Borrowings	2,514	5,894	13,425	16,704	38,029	13,426	19,292
Total Interest Cost	$27,003	$33,765	$49,431	$70,268	$111,937	$48,312	$54,610
Operating and other expenses	11,867	14,498	14,991	17,285	18,985	9,299	9,227
Total Costs and Expenses	$38,870	$48,263	$64,422	$87,553	$130,922	$57,611	$63,837
Net income (loss) before taxes on income and cumulative effect of change in accounting method	$ 2,859	$ 3,721	($ 99)	($ 8,547)	($ 28,953)	($11,322)	($10,701)
Provision (credit) for taxes on income	223	243	(243)	76	106	—	—
Income (loss) before cumulative effect of change in accounting method	2,636	3,478	144	(8,623)	(29,059)	(11,322)	(10,701)
Cumulative effect of change in accounting method	780	—	638	—	—	—	—
Net income (loss)	$ 3,416	$ 3,478	$ 782	($ 8,623)	($ 29,059)	($11,322)	($10,701)

[1] Reflects merger with PAF for the period from November 20, 1981; data for other years has not been adjusted to reflect the merger since the effect of the merger upon periods prior to this date is not considered material.

[2] Reflects merger with PAF for the entire period.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Association's adverse operating results in recent years reflect the conditions which have prevailed throughout the savings and loan industry: unprecedented high interest rates, together with the commitment of savings and loan associations to finance large amounts of long-term, fixed-rate residential mortgages.

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In accordance with the Purchase Agreement, the Association submitted an operating plan to FSLIC setting forth the specific goals and objectives of the Association for the period from January through June, 1982. In addition, it has submitted a second six-month operating plan to cover the July-December period. The operating goals of both operating plans are based upon general objectives of austerity, retrenchment and the elimination of the underlying causes of the Association's losses. Both operating plans have been approved. The Association's operating plans for both six-month periods include the following elements:

(a) a general strategy designed to reduce the relative importance of liabilities exposed to interest rate fluctuations, and of assets with fixed returns;

(b) on the asset side of the balance sheet, programs intended to upgrade the return on investments, and to attain a shorter average maturity of assets through sale, substitution, or conversion to negotiable financial instruments of existing loans and mortgage related securities;

(c) on the liability side of the balance sheet, programs intended to reduce the cost of funds and increase the average maturity of borrowings through the repayment or substitution of variable rate sources of funds and the use of hedging techniques.

Pursuant to its operating plans, the Association is restricting its lending program to short term loans and loans that can be sold in the secondary markets. The Association has also developed a variable rate loan program. The Association is restricting the overall volume of its loan commitments. At December 31, 1981, the Association had commitments to originate and purchase new mortgage loans totaling approximately $31 million. At June 30, 1982, such commitments totaled approximately $11 million. In addition, the Association is limiting its securities investments to short-term investments made only with any excess funds that are available after repayment of variable rate borrowings. The Association is implementing a strict program of expense controls and is increasing the automation of its operations. Further, the Association is making an in-depth analysis of various ancillary services which are provided by the Association (both directly and through service corporations) with a view to discontinuing those operations which are not expected to be profitable.

The Association's management recognized that its deteriorating financial condition required extraordinary action and in mid-1981 proposed alternative strategies to federal regulatory authorities for strengthening its net worth position. Included among these proposed actions was the issuance of the Notes. Management believes that the steps that have been taken to date in strengthening its net worth position and in developing the strategy outlined in the operating plans form the basis for the Association's recovery.

The Association's losses decreased during the period ended June 30, 1982, because of a decrease in the general level of interest rates and a decrease in the interest rates associated with Section 936 funds. The Association's losses for the six-month period ended June 30, 1982, were $10.7 million, which is $0.6 million less than the losses for the first six months of 1981 and $7.0 million less than losses for the last six months of 1981. Losses for the third quarter of 1982 were approximately $5.56 million.

In September and October, 1982 the Association began to implement a program, contemplated by its operating plans, to sell most of its mortgage-backed securities and to hedge its deposits. Management does not believe that these transactions will have a material effect on the Association's income in the fourth quarter of 1982.

BUSINESS

General

The business of the Association consists primarily of attracting savings deposits from the general public and making loans secured by deeds constituting first mortgage liens on residential and other real estate. Income is derived principally from interest charged on real estate loans and fees received in connection with such loans, and to a lesser extent from securities in which the Association is permitted to invest. The major item of expense of the Association is the interest it pays on savings deposits and on borrowings. The funds for its lending activities are provided primarily by savings deposits, borrowings from the FHLB-NY and commercial banks, other borrowings such as this issuance of the Notes, the sale of loans, and the amortization and repayment of outstanding loans.

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The following table sets forth selected consolidated financial data for the Association as of the dates indicated:

	December 31,					June 30,	
	1977	1978	1979	1980	1981[1]	1981	1982[3]
			(000's omitted)			(000's omitted)	
Total Assets	$584,579	$720,440	$797,389	$915,758	$1,043,650	1,003,683	1,011,828
Loans Receivable Net[4]	504,592	612,993	698,934	763,198	829,382	788,946	811,556
Savings Accounts	466,600	506,432	559,740	687,493	686,756	707,417	701,970
Advances from FHLB-NY	32,680	79,180	102,980	75,580	91,490	92,580	76,971
Other Borrowings	19,561	49,627	58,642	85,603	205,888	156,749	188,376
Net Worth	30,049	33,527	34,309	25,686	30,690[2]	14,362	19,985[2]

[1] Reflects merger with PAF for the period from November 20, 1981; data for other years has not been adjusted to reflect the merger, since the effect of the merger upon periods prior to this date is not considered material.

[2] Includes $35 million in ICCs.

[3] Reflects merger with PAF for the entire period.

[4] Includes accrued interest net of allowance for uncollectible interest and allowance for credit losses.

Lending Activities

The Association's primary lending activity is to originate mortgage loans for its own account. At certain times the Association will purchase loans from others or will purchase a participation interest in a loan originated by another lender. Virtually all of the mortgage loans originated by the Association are secured by real property located in Puerto Rico. The primary lending area is the San Juan metropolitan area.

The Association's total loan portfolio, including mortgage-backed securities, totaled approximately $805 million at June 30, 1982, representing approximately 79.6% of its total assets. On that date approximately 93.7% of the total loan portfolio consisted of loans secured by first mortgages on residential and commercial properties, and the balance consisted primarily of loans secured by mortgages on other real estate, loans secured by savings accounts, and home improvement loans. Loans for construction, land acquisition and improvements represented 2.2% of the Association's loan portfolio at that date. Mortgages insured by the Puerto Rico Housing Bank and Finance Agency (the "Housing Agency") represented approximately 23.5% of the Association's loan portfolio at June 30, 1982 and mortgages insured or guaranteed by the Federal Housing Administration or the Veteran's Administration represented approximately 2% of that portfolio.

Mortgage-backed securities guaranteed by the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association amounted to 11.1% and 6.9%, respectively, of the Association's loan portfolio at June 30, 1982.

Savings Activities

Passbook savings accounts are accounts from which customers are permitted to withdraw funds at any time without penalty. Interest rates on these accounts are established by the Board of Directors of the Association subject to the maximum allowable interest rates permitted under federal regulations. The Association is currently paying 4.5% per annum, compounded daily, on pass-book savings accounts.

The Association also makes available to its depositors a number of savings certificates with varying terms, interest rates and minimum deposit requirements. The interest rate payable on 182-day certificate accounts in amounts of between $10,000 and $50,000 (money market certificates) is determined on the basis of prevailing money market rates at the time the account is opened. On savings certificates of $50,000 or more, the term and interest rates are negotiable. The maximum rates payable on most of the Association's accounts are established by the Depository Institutions Deregulation Committee ("DIDC") pursuant to the Depository Institutions Deregulation and Monetary Control Act of 1980 (the "Deregulation Act"). Under the Deregulation Act, DIDC is directed to phase out interest rate ceilings over a six-year period that began on March 31, 1980. Interest rate ceilings on passbook and other deposit

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accounts at savings and loan associations and other financial institutions have been raised a number of times by DIDC, and new kinds of accounts having no rate ceilings have been established. It is anticipated that rate ceilings on deposit accounts will continue to rise until they are eliminated by DIDC; the Association believes that elimination of such rate ceilings will have an adverse effect on its results of operations.

Borrowings

The principal source of the Association's borrowings is advances from the FHLB-NY upon the security of the Association's capital stock in the FHLB-NY, its home mortgages, the ICC Note and other assets (principally, securities which are obligations of or guaranteed by the United States). (See "The Federal Home Loan Bank of New York"). As of June 30, 1982, the Association had outstanding advances from the FHLB-NY in the principal amount of approximately $77 million and had delivered to the FHLB-NY mortgages and other collateral in the outstanding principal amount of approximately $199 million to secure such advances. Due to the deterioration in the Association's financial condition, the Association was required to begin delivering collateral to the FHLB-NY in mid-1981. In order to facilitate further FHLB-NY advances to the Association, FSLIC has guaranteed repayment to the FHLB-NY of certain advances to the Association, made or renewed on or after November 20, 1981, including advances, if any, that may be made pursuant to the Firm Commitment. (See "The Firm Commitment").

Borrowings by the Association from sources other than the FHLB-NY consist primarily of repurchase transactions in which the Association sells mortgage loans or securities subject to an agreement to repurchase at a future date. Such transactions are with financial institutions, including A. G. Becker Puerto Rico Incorporated.

Yields Earned and Rates Paid

The net earnings of the Association depend primarily upon the difference or spread between the income it receives from its loan and investment portfolio and its cost of money, consisting principally of the interest paid by it on savings accounts and, to a lesser extent, on FHLB-NY advances and other borrowings. Because real estate loans are primarily long-term, the average rate of interest received by the Association on most of its loan portfolio generally does not change at the same pace or time as interest rates on savings accounts and borrowings.

The following table sets forth for the Association (exclusive of subsidiaries) the average yield earned on loans and investments, the average interest rates paid on savings accounts (net of early withdrawal penalties) and the spread between yields earned and rates paid by the Association for the periods indicated:

	Year ended December 31[1]				Six Months ended June 30
	1978	1979	1980	1981[2]	1982[3]
Average Yield on Total Loan Portfolio	8.26%	8.50%	9.04%	9.59%	9.64%
Average Yield on Investments	7.42	8.88	11.35	14.54	12.30
Average Yield on Loan and Investments	8.19	8.54	9.25	10.43	10.04
Average Cost of Savings	5.66	6.71	8.57	10.75	10.28
Average Cost of FHLB-NY Advances and Other Borrowings	7.70	10.15	11.48	16.02	12.88
Average Cost of Savings and Borrowings	5.93	7.38	9.10	12.09	11.07
Spread[4]	2.26	1.16	.15	(1.66)	(1.03)

[1] Figures were obtained by dividing recorded annual income and expenses categories by the average monthly balances of the accounts.

[2] Reflects merger with PAF for the period from November 20, 1981; data for other years has not been adjusted to reflect the merger since the effect of the merger upon periods prior to this date is not considered material.

[3] Reflects merger with PAF for the entire period.

[4] Spread is the difference between the average yield on loans and investments and the average cost of savings and borrowings for period.

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Regulation

As a member of the Federal Home Loan Bank System, the Association is required to own capital stock in the FHLB-NY in an amount equal to at least 1% of the aggregate of the unpaid principal of its home mortgage loans, home purchase contracts and similar obligations at the beginning of the current fiscal year. Additional investments in capital stock of the FHLB-NY may be required as a condition to obtaining advances from the FHLB-NY since advances cannot exceed, in the aggregate, twenty times an association's stock investment in the FHLB-NY.

Federal savings and loan associations are subject to extensive regulation by the FHLBB. Among the requirements imposed by FHLBB regulations is that the Association must maintain certain liquid assets (principally consisting of cash, certificates of deposit and United States government securities) in amounts prescribed by law and regulations. If the Association's liquidity falls below such required levels, the Association may be prohibited from making or purchasing loans and would be subject to penalties payable to the FHLB-NY. FHLBB regulations currently require member associations to maintain liquid assets equal to not less than 5% of net withdrawable savings accounts and borrowings due within one year, with restrictions as to categories of investments and maturities limited to five years or less. The liquidity requirements may be changed from time to time by the FHLBB within the range of 4% to 10% of an association's savings accounts and borrowings due within one year.

The Association was in compliance with the FHLBB liquidity requirements at June 30, 1982. In calculating the Association's liquidity at June 30, 1982, the Association's $35 million ICC Note was considered a liquid asset. However, subsequent to June 30, 1982, the Association pledged the ICC Note to the FHLB-NY as additional collateral for advances. Consequently the ICC Note is no longer eligible as a liquid asset. If the Association's long term liquidity for regulatory purposes at June 30, 1982 were calculated without inclusion of the ICC Note in liquid assets, the Association's liquidity ratio, as defined in FHLBB regulations, would have been 2.69%, which would have been below the level required for long term liquidity. The Supervisory Agent for the FHLBB has informed the Association that it will not impose a liquidity deficiency penalty as a result of such shortfall. The Association would have been in compliance with short term liquidity requirements.

Insurance of its savings accounts by FSLIC subjects the Association to comprehensive regulation, supervision and examination by FSLIC. The Association is required, among other things, to pay premium charges to FSLIC for such insurance, to maintain, through appropriations of retained income, certain reserve accounts which may be used only to absorb losses and to maintain its net worth at certain specified minimum levels that depend largely upon, and increase or decrease in direct relation to, savings accounts. The Association's net worth as of June 30, 1982 remained below the level required by FSLIC regulations. (See "Significant Developments Affecting the Association").

If the Association violates its duties as an insured institution, engages in unsafe or unsound practices, is in an unsafe or unsound condition or has violated any applicable FSLIC requirements, insurance of the accounts of the Association may be terminated by the FSLIC and remedial action, including the appointment of FSLIC as a receiver or conservator for the Association, may be taken by the FHLBB.

Employment

The Association employs approximately 600 persons. Employees are not represented by any union or collective bargaining group, and employee relations have been good. The Association has a non-contributory pension plan and provides certain other employee benefits.

Litigation

The Association is involved as plaintiff or defendant in a variety of routine litigation incidental to the normal course of business. The Association's management believes that it has adequate defenses or insurance protection with respect to such litigation and that any losses therefrom, whether or not insured, would not have a material adverse effect on the business or financial condition of the Association.

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Management

Board of Directors

Name	Occupation	Year Appointed	Term Expires
Hiram R. Cancio	Chairman of Board, and Partner, Cancio, Nadal & Rivera	1975	1983
Juan B. Aponte	Director	1971	1984
Francisco Carvajal	Chairman, Olympic Mills Industries	1981	1983
Salvador Casellas	Partner, Fiddler, González & Rodríguez	1981	1985
Francisco Fernández	President, Abacus Corporation	1981	1984
Germán Malaret	M.D., Member, San Jorge Hospital	1976	1984
Ronald Martínez	Professor, University of Puerto Rico	1981	1985
Ramón Mellado	Partner, Mellado & Hernández	1981	1985
Antonio Pavía	M.D., Member, Pavia Hospital	1981	1983

Officers

Ismael Pagan Colberg	Acting President
[Vacant]	Executive Vice President
Juan J. Bermúdez	Senior Vice-President, Marketing
Erving Rodríguez	Senior Vice-President, Savings
Carole Acosta	Senior Vice-President, Mortgage Loans
Alejandro Asmar	Senior Vice-President, Finance
Edmundo Hernández	Vice-President, Finance (Investment)
Florencio Rodríguez	Vice-President, Counsel
Jose Luis Ortiz	Assistant Vice President, Acting Controller

The former President, Dr. Juan B. Aponte, was terminated from his position as President on August 20, 1982. Francisco Pedraza, who had submitted his resignation as Executive Vice President in December of 1981, made that resignation effective August 23, 1982. Ismael Pagan Colberg is serving as Acting President pending the appointment of a new President. The Board of Directors of the Association is actively searching for a new President.

THE FEDERAL HOME LOAN BANK OF NEW YORK

The Federal Home Loan Bank of New York will issue to the Association a Firm Commitment to Advance Funds for the purpose of paying the principal of and interest and premium, if any, on the Notes in the event of the failure of the Association to make such payments as they become due. (See "The Firm Commitment" and Appendix B.) The FHLB-NY is a corporation established by the federal government under the Federal Home Loan Bank Act of 1932, as amended (the "FHLB Act"), and is one of twelve regional banks chartered and supervised by the FHLBB, an agency of the federal government.

The capital stock of the FHLB-NY is owned entirely by its member institutions, which are savings and loan associations and savings banks in the states of New York and New Jersey and in Puerto Rico and the United States Virgin Islands. As a member of the FHLB-NY, the Association owns capital stock in the FHLB-NY.

The FHLB-NY is governed by a board of directors comprised of sixteen persons, ten of whom are elected by the members of the FHLB-NY and six of whom are appointed by the FHLBB. Dr. Juan B. Aponte is an elected member of the FHLB-NY board of directors. The board of directors selects the officers of the FHLB-NY and formulates general policies for its operation within the regulations and policies established by the FHLBB. Certain of the officers of the FHLB-NY act as agents of the FHLBB in connection with supervisory matters concerning member institutions and in connection with transactions requiring FHLBB approval, such as applications for charters, mergers and branch offices and the insurance of accounts. Certain officers of the FHLB-NY carry out special supervisory functions on behalf of FSLIC pursuant to the Purchase Agreement. (See "Significant Developments Affecting the Association").

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The principal function of the FHLB-NY is to supply its member institutions with credit to increase the supply of mortgage funds and to meet periodic or unexpected savings withdrawals from member institutions. In performance of this function, the FHLB-NY lends money to its members by means of advances that are for varying terms and at varying interest rates depending upon the advances program pursuant to which the particular advance is made. As of June 30, 1982 the FHLB-NY had approximately $6.6 billion in advances outstanding to member institutions. FHLB-NY funds that are not loaned to members are deposited in banks or trust companies or are invested in government securities or certain other securities authorized under the FHLB Act.

Advances made by the FHLB-NY are secured by, among other things, the FHLB-NY capital stock, mortgages and federal government securities owned by the member institutions receiving such advances. The security interests so obtained by the FHLB-NY are generally unperfected except in those instances in which the FHLB-NY concludes that perfection of its liens is necessary to protect its interests. The FHLB-NY began perfecting security interests in assets of the Association in mid-1981.

The FHLB-NY is wholly self-supporting. It obtains funds from three principal sources: (1) the sale of capital stock to members, augmented by retained earnings; (2) deposits from member institutions; and (3) the sale of Consolidated Federal Home Loan Bank Obligations (which are the joint and several obligations of the twelve Federal Home Loan Banks). As of June 30, 1982, the FHLB-NY's participation in Consolidated Federal Home Loan Bank Obligations (consolidated bonds and discount notes) was equal to approximately $5.78 billion. Additionally, the FHLB-NY collects fees or service charges from its members in connection with commitments to make advances, collection and settlement services, demand deposit services and related services rendered by the FHLB-NY to its members in accordance with FHLBB Regulations. As of June 30, 1982, the FHLB-NY had total capital (comprised of capital stock, statutory and dividend stabilization reserve and undivided profits) in the amount of approximately $904 million. For the six months ended June 30, 1982, the FHLB-NY had net income of approximately $40.5 million.

The FHLB-NY's audited financial statements for the years ended December 31, 1981 and 1980 are made a part of this Offering Circular as Appendix C. The foregoing information, including Appendix C, has been furnished to the Association by the FHLB-NY and the Association assumes no responsibility for the accuracy thereof.

THE FIRM COMMITMENT

In addition to the Mortgage Collateral, the Notes will have the benefit of the Firm Commitment, a copy of which is made part of this Offering Circular as Appendix B, which will be issued by the FHLB-NY. The Firm Commitment will be issued concurrently with the issuance of the Notes and will be for a term expiring on January 31, 1988. Under the Firm Commitment, the FHLB-NY will make advances to pay the principal of and interest and premium, if any, on the Notes as they become due if the Association fails to do so. The Trustee has been designated as agent for the Association for the purpose of requesting that advances be made under the Firm Commitment. The FHLB-NY will make advances by transferring the appropriate amounts to the Trustee for the purpose of making payments to the Noteholders. The aggregate obligation to make advances under the Firm Commitment is limited to $100,000,000 on account of the principal of the Notes plus interest and premium, if any, thereon under the terms of the Notes.

The Firm Commitment will provide that the FHLB-NY will make advances only if, at least five days prior to the date upon which a payment of principal of or interest or premium, if any, on the Notes is due and payable, whether by acceleration or otherwise ("Payment Date"), the FHLB-NY receives: (a) a written request from the Trustee, on behalf of the Association, for an advance ("Request for Advance"), and (b) a Trustee's Certificate specifying, among other things, that the Association has failed to make a deposit in the Note Account as required by the Trust Agreement and the amount by which the balance in the Note Account is insufficient to pay the amount of principal, interest and premium, if any, due on the next Payment Date. Each advance will be made on or before the related Payment Date in an amount which, when added to the balance in the Note Account, will be sufficient to pay the principal of and

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interest and premium, if any, due on the outstanding Notes on such Payment Date. In no event will the FHLB-NY be obligated to make an advance which is in excess of the amount of principal, interest and premium, if any, due and payable on the outstanding Notes on a Payment Date. (See the Firm Commitment included as Appendix B).

Any advance made pursuant to the Firm Commitment will bear interest, payable by the Association, at the rate then being charged by the FHLB-NY under its regular advances program for advances having the shortest term and will be due and payable by the Association immediately and without demand. The obligation of the Association to repay advances made pursuant to the Firm Commitment will be secured by a Security Agreement under which the Association will pledge to the FHLB-NY all of the ICC Notes now or hereafter issued to the Association by FSLIC. The FHLB-NY also will have a second lien on all the Mortgage Collateral pledged to the Trustee as a security for the Notes. Upon the issuance of the Firm Commitment, the Association will pay a commitment fee to the FHLB-NY in an amount of $514,996.37 and will reimburse the FHLB-NY for certain expenses incurred in connection with the issuance of the Notes.

The Trust Agreement provides that if the FHLB-NY is required to make an advance under the Firm Commitment, an Event of Default will have occurred under the Trust Agreement and the FHLB-NY may require the Trustee to accelerate the maturity of all of the Notes. If the Association were to fail to make timely payment of the principal amount so accelerated, or any premium due as a result of acceleration, the Trustee would be authorized to request an advance by the FHLB-NY pursuant to the Firm Commitment in an amount sufficient to pay such principal amount and premiums, if any.

DESCRIPTION OF THE NOTES AND THE TRUST AGREEMENT

The Notes are to be issued as a series of Mortgage-Backed Notes of the Association under the Trust Agreement to be executed by the Association and the Trustee providing for certain rights, duties and obligations of the Association, the Trustee, the FHLB-NY and Noteholders relating to the Notes. The following summary of certain provisions of the Trust Agreement does not purport to be complete and is subject to, and qualified in its entirety by, all of the provisions of the Trust Agreement, copies of which are available for inspection by Noteholders at the offices of the Underwriter, the Trustee and the Association. The section references below are to the Trust Agreement.

The Notes will be direct obligations of the Association and will be secured by a pledge of Mortgage Loans as described below under "Mortgage Loans". The Notes will also have the benefit of the Firm Commitment. (See "The Firm Commitment").

The Notes will mature on the date or dates and will bear interest from November 9, 1982, at the rate or rates as follows:

Principal Amount	Maturity Date	Interest Rate
$ 2,500,000	5/9/83	7¾ %
11,200,000	5/11/83	7¾
2,500,000	5/16/83	7¾
11,000,000	5/18/83	7¾
2,800,000	5/24/83	7¾
12,000,000	5/25/83	7¾
2,400,000	5/26/83	7¾
7,000,000	6/1/83	7¾
2,000,000	6/6/83	7¾
10,100,000	6/8/83	7¾
7,000,000	8/10/83	8
5,000,000	8/20/83	8
800,000	11/1/83	8¼
1,000,000	11/30/83	8¼
5,000,000	12/22/83	8¼
700,000	11/1/84	9¼
17,000,000	11/16/87	10⅜

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Notes having a maturity date of more than five years from the date thereof that are accelerated to a date prior to the fourth anniversary of the date thereof will be repaid at 101% of the principal amount thereof plus the interest accrued on such principal amount. No other Notes will be entitled to a premium in the event of acceleration.

Accrued interest is computed on the basis of a 360-day year. Interest will be payable on May 1 and November 1 of each year, commencing May 1, 1983, and at maturity. Principal of and premium, if any, on the Notes will be made upon presentation and surrender of the Notes at the principal office of the Trustee in New York, New York. (Section 2.03). Interest will be payable by the Trustee by check mailed to the address of the holder appearing on the registration books of the Trustee as of the 15th day preceding each Payment Date. The Notes are to be issued only in denominations of $200,000 and $5,000 increments above $200,000 and will be transferable or exchangeable for Notes of authorized denominations of like aggregate principal amount without charge except for reimbursement of taxes or other government charges, if any. The Association does not contemplate listing the Notes on a national securities exchange.

Mortgage Loans

The Association will pledge the Mortgage Loans to the Trustee for the benefit of the Noteholders in order to secure the performance by the Association of its obligations under the Trust Agreement and under the Notes, including payment of the principal of and premium, if any, and interest on the Notes when due. (Section 3.01). The Association will assign, transfer and convey to the Trustee on behalf of the Noteholders all its right, title and interest to interest payments due and to become due on the Mortgage Loans and to all payments of principal, including prepayments and any other sums including penalties and fees payable on and in respect of the Mortgage Loans. As long as no default exists under the Trust Agreement, the Association may receive and retain any amounts of interest actually received in excess of amounts necessary to pay interest on the Notes and may receive and retain all payments of principal, including prepayments and any other sums including penalties and fees payable on and in respect of the Mortgage Loans. Upon the occurrence of an Event of Default, and for so long as such Event of Default is continuing, all such payments as are received by the Association shall be delivered by the Association to the Trustee. (Section 3.02).

With respect to all Mortgage Loans pledged to the Trustee on behalf of the Noteholders, the Association is required to represent and warrant to the Trustee on the date of pledge and delivery of such Mortgage Loans that: (i) the property subject to each Mortgage is a single-family residence or condominium located in the Commonwealth of Puerto Rico; (ii) each Mortgage is a valid first lien on the property securing the related Mortgage Note, subject only to (a) the lien of current real property taxes and assessments, (b) covenants, conditions and restrictions, rights of way, easements and other matters of public record as of the date of such Mortgage, such exceptions appearing of record being generally acceptable to mortgage lending institutions and the title insurer and (c) other matters to which like properties are commonly subject which do not materially interfere with the benefits of the security intended to be provided by the Mortgage, and such property is free of damage and in good repair; (iii) the Association has good title to, and is the sole owner of, each Mortgage Loan and is fully authorized to pledge the same pursuant to the Trust Agreement, and there is no valid offset, defense or counterclaim to any Mortgage Note or Mortgage, including the obligation of the Mortgagor to pay the unpaid principal and interest on such Mortgage Note; (iv) all principal, interest, tax and any other payments required to be made under the Mortgage Loans have been or will have been made and there is no delinquent tax or assessment lien against any property subject to any Mortgage; (v) each Mortgage Loan is validly pledged to and enforceable by the Trustee free and clear of any lien, claim or encumbrance and no filing with any agency or authority is required to perfect such pledge; and (vi) each Mortgage Loan is in compliance with applicable laws of the United States and of the Commonwealth of Puerto Rico, including usury, equal credit opportunity and disclosure laws. (Section 3.05).

Collateral Requirement

At all times prior to payment of the Notes in full, the Association is required to keep pledged to the Trustee on behalf of the Noteholders Mortgage Loans not in arrears for more than 60 days ("Qualified

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Mortgage Loans") that have an aggregate principal amount outstanding at least equal to the outstanding principal amount of the Notes and generate interest in an aggregate amount at least equal to 115% of the amount of interest accruing on the Notes outstanding. (Section 3.06).

Initially, the Mortgage Loans delivered to the Trustee will have an outstanding aggregate principal balance of approximately $143,210,000 and will bear interest at a weighted average yield of approximately 8.89%.

Compliance with Collateral Requirement

The Trustee is required to review monthly reports to be submitted by the Association to determine whether the Association is in compliance with the Collateral Requirement at the date of such report and, if the Association is not in compliance, to notify the Association and the FHLB-NY of such non-compliance. (Section 3.07).

If at any time the Association becomes aware it is not in compliance with the Collateral Requirement or if at any time it receives a notice from the Trustee that it is not in compliance with the Collateral Requirement, the Association is required promptly, and in any event, within 60 days, to deliver in pledge to the Trustee such additional Mortgage Loans as may be necessary for the Association to be in compliance with the Collateral Requirement. (Sections 3.08 and 7.01). If the Association fails to cure any non-compliance with the Collateral Requirement within 60 days of notice thereof, such failure will constitute an Event of Default. However, the Trustee may not accelerate the Notes as a result of such Event of Default without the consent of FHLB-NY. (Section 7.02).

The Association may at any time request the Trustee to release from the pledge under the Trust Agreement such Mortgage Loans that are not needed to comply with the Collateral Requirement. Provided the Association is in compliance with the Trust Agreement, upon such request and the determination by the Trustee, based upon reports and certifications of the Association, that the release of such Mortgage Loans will not result in non-compliance with the Collateral Requirement, the Trustee will release and redeliver such Mortgage Loans to the Association. (Section 3.09).

The Note Account

A special account shall be created with the Trustee referred to as the "Note Account". The moneys in the Note Account shall be held by the Trustee in trust and shall be subject to a lien and charge in favor of the holders of the Notes. Moneys in the Note Account shall be used solely for the payment of the interest and principal and premium, if any, on the Notes. On or before each Payment Date, the Trustee is required to draw against the Note Account to pay by mail to each registered owner of the Notes the amount of the interest due and payable on such Payment Date. As long as no default shall exist under the Trust Agreement, the interest on moneys in the Note Account shall be for the account of the Association and shall be payable to the Association on each Payment Date following payment to the Noteholders. However, if on any Payment Date the amounts held in the Note Account exclusive of interest earned on such moneys is insufficient to pay all interest due on the Notes on such Payment Date, then the Trustee shall apply such interest to pay interest due on the Notes, provided that if any portion of the interest due on any Payment Date is paid by FHLB-NY pursuant to the Firm Commitment, then the interest on such moneys shall be paid to FHLB-NY. If the balance of the Note Account including interest earned is insufficient on the sixth day prior to any Payment Date to pay interest or principal or the premium, if any, due on the Notes on such Payment Date, then the Trustee on behalf of the Association is required to request FHLB-NY to make an advance under the Firm Commitment in an amount sufficient to make such payment. (Sections 5.03 and 5.04). (See "The Firm Commitment").

Any moneys in the Note Account which shall remain unclaimed by any holders of Notes for a period of two years after the date on which such Notes shall have become due and payable shall, upon request in writing, be paid to the Association or to such officer, board or body as may then be entitled by law to receive the same. Thereafter the holders of such Notes shall look only to the Association or to such officer, board or body, as the case may be, for payment and then only to the extent of the amount so received without any interest thereon, and the Trustee shall have no responsibility with respect to such moneys. (Section 4.04).

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Servicing

The Association shall service and administer the Mortgage Loans and shall have full power and authority, acting alone, to do any and all things in connection with such servicing and administration which it may deem necessary or desirable. The Association is authorized to continue to execute and deliver, in the Association's own name, on behalf of itself, the Noteholders and the Trustee or any of them, any and all instruments of satisfaction or cancellation, or of partial or full release or discharge and all other comparable instruments, with respect to the Mortgage Loans and with respect to the properties subject to the Mortgages. (Section 5.01).

If an Event of Default occurs under the Trust Agreement, the Trustee shall, if so directed by FHLB-NY in writing, appoint another qualified financial institution designated by FHLB-NY to service and administer the Mortgage Loans and such substitute servicer shall have all of the rights, duties and obligations of the Association as servicer of the Mortgage Loans under the Trust Agreement. (Section 5.01).

The Association shall be entitled to receive for its services only indirect compensation in the form of prepayment charges, assumption fees, late payment charges, and interest earned on funds credited to the Note Account and the Interest Reserve Account to the extent permitted under the Trust Agreement. The Association is required to pay all expenses incurred by it in connection with its servicing activities. (Section 5.07).

Mortgage Interest Account

The Association is required to establish with itself an account referred to as the "Mortgage Interest Account" and to deposit therein all payments on account of interest on the Mortgage Loans received by it. No later than seven days prior to any Payment Date the Association is required to withdraw from the Mortgage Interest Account and deposit with the Trustee for credit to the Note Account an amount sufficient to pay interest on the Notes, including Additional Notes, becoming due and payable on such Payment Date. As long as no default by the Association exists under the Trust Agreement, the Association shall be entitled to any sum remaining in the Mortgage Interest Account after each such withdrawal. (Section 5.03).

Reports

Not later than the twentieth day of each month, the Association is required to forward to the Trustee an Officer's Certificate, stating as of the close of business on the last day of the preceding month (i) as to each of the Mortgage Loans, the principal amount outstanding thereon, the amount of interest payable monthly thereon and the date of the last payment thereon, (ii) the aggregate principal amount outstanding on Qualified Mortgage Loans and the amount of interest accruing monthly on such Qualified Mortgage Loans, (iii) a statement of the principal amount outstanding on the Notes, (iv) a statement of the amount of interest accruing monthly on the principal amount outstanding on the Notes, and (v) a determination of whether the Association is in compliance with the Collateral Requirement. (Section 6.02).

On or before July 15 of each year, beginning July 15, 1983, the Association is required to deliver to the Trustee an Officer's Certificate stating, as to each signer thereof, that (i) a review of the activities of the Association during the preceding calendar year and of its performance under the Trust Agreement was under the supervision of one or both of them, and (ii) based on such review, the Association fulfilled all its obligations under the Trust Agreement throughout such year, or if there has been a default in the fulfillment of any such obligation, specifying each such default known to such officer and the nature and status thereof. (Section 6.03).

On or before July 15 of each year, beginning July 15, 1983, the Association is required, at its own expense, to cause a firm of independent public accountants to furnish to the Trustee the following reports (in compliance with the then auditing pronouncements of the American Institute of Certified Public Accountants) as of December 31 of the preceding calendar year: (i) audited consolidated financial statements; and (ii) letter report on compliance by the Association with certain financial and accounting requirements under the Trust Agreement. (Section 6.05).

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Access to Certain Documentation

The Association is required to provide to the Trustee, the Bank, holders of Notes evidencing not less than 25% of the outstanding principal amount of the Notes and examiners and supervisory agents of the Commonwealth of Puerto Rico and any governmental agency having jurisdiction over the Association access to the documentation regarding the Mortgage Loans to the extent required by applicable law or reasonably necessary for the purposes of determining performance by the Association under the Trust Agreement, such access being afforded without charge but only upon reasonable request and during normal business hours at the office of the Association designated by it. (Section 6.05).

Maintenance of Note Income as "Qualified Possession Source Investment Income"

For each taxable year of the Association during any part of which the Notes are outstanding, the Association is required to maintain its election of the credit provided in Section 936 and to continue to meet the conditions of subparagraphs (A) and (B) of Section 936(a)(2). Failure to maintain such election or meet such conditions will result in the acceleration of the Maturity Dates of the Notes. The Association is also required to take any further action that may be or may become necessary to assure that interest paid on the Notes shall be deemed "qualified possession source investment income" under Section 936. Failure to take any such further action will not result in an acceleration of the Maturity Dates without the consent of the FHLB-NY. (Sections 6.08 and 7.02).

Events of Default

Under the terms of the Trust Agreement, the occurrence of any of the events listed below constitute Events of Default: (1) failure by the Association to deposit with the Trustee amounts sufficient for the Trustee to make any payment on any of the Notes when due; (2) failure by the Association to maintain its election of and its qualification for the credit provided in Section 936; (3) material breach or inaccuracy of any representation or warranty of the Association; (4) failure on the part of the Association duly to observe or perform in any material respect any of the other covenants of the Association under the Notes or the Trust Agreement which continues for a period of 60 days after written notice thereof from the Trustee to the Association and the FHLB-NY or from Noteholders representing not less than 25% of the aggregate principal amount of the Notes to the Association, the FHLB-NY and the Trustee; (5) initiation of any proceedings by or against the Association seeking reorganization or similar arrangement, or for the appointment of a conservator or receiver or liquidator of the Association or substantially all of its property; or (6) inability of the Association to pay its debts generally as they become due or the voluntary suspension of payment of its obligations. (Section 7.01).

Acceleration

The Trustee is required to accelerate the Maturity Dates of the Notes, with or without the consent of FHLB-NY, if: (i) the Association fails to maintain its election of the credit provided in Section 936 or to meet the conditions specified in subparagraphs (A) and (B) of Section 936(a)(2), or (ii) the Association fails to make a required payment and such failure is not cured by an advance made by the FHLB-NY pursuant to the Firm Commitment, provided such advance is requested as provided in the Firm Commitment. If any other Event of Default occurs under the Trust Agreement, the Trustee may accelerate the Maturity Dates of the Notes only if it has obtained the consent of the FHLB-NY. If the FHLB-NY is required to make an advance under the Firm Commitment, then the FHLB-NY will have the option to require the Trustee to accelerate the Maturity Dates of all of the Notes. (Section 7.02).

If the Maturity Dates of the Notes are accelerated, the Trustee is required to send notice of such acceleration and the new Maturity Date to the Association, the FHLB-NY, the FSLIC and the Noteholders. Such notice to the FHLB-NY shall be accompanied by a request for an advance pursuant to the Firm Commitment in an amount sufficient to pay the interest, principal and premium, if any, due on the next Payment Date. Such notice to the FSLIC shall provide the FSLIC 30 days to exercise a right to purchase the Mortgage Loans from the Trustee for a price equal to the amount of interest, principal and premium, if any, outstanding on the Notes. If within 30 days after the new Maturity Date there shall not have been deposited with the Trustee by the Association or by the FHLB-NY or by the FSLIC moneys sufficient to pay

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the interest and principal and premium, if any, due on the Notes, then all of the rights of the Association, the FHLB-NY and the FSLIC under the Trust Agreement in and to the Mortgage Loans shall terminate and the Trustee will be required to proceed to take such actions as it deems prudent to collect moneys due Noteholders including, without limitation, to take such action, if any, as may be necessary to collect from the FHLB-NY under the Firm Commitment, to foreclose on the pledge of the Mortgage Loans and take all actions permitted by law to sell the Mortgage Loans and to apply the proceeds of such sale to amounts due on the Notes. (Section 7.03).

Duties of Trustee

Prior to the occurrence of an Event of Default and after the curing of all Events of Default which may have occurred, the Trustee is required to perform such duties and only such duties as are specifically set forth in the Trust Agreement. In case an Event of Default has occurred (which has not been cured), the Trustee is required to exercise such of the rights and powers vested in it by the Trust Agreement as may be necessary to preserve and protect the Note Account and the Mortgage Loans and to enable the Trustee to pay the Noteholders the maximum amount possible under the circumstances and shall be obligated to use the same degree of care and skill as a prudent investor would use in the exercise of such rights and powers. In such case the powers of the Trustee shall include, in addition to those specifically stated in the Trust Agreement, any powers not specifically stated that are necessary to the protection and preservation of the Mortgage Loans and the Note Account and the ability of the Trustee to pay to Noteholders the maximum amount reasonably possible under the circumstances. (Section 8.01).

The Trust Agreement provides that the Trustee has a prior lien on the Mortgage Loans, superior to that of the Noteholders, to secure the payment of the Trustee's fees and expenses. (Section 8.05).

Qualification, Resignation and Removal of the Trustee

The Trustee is required at all times to be a corporation having an office in San Juan or the City of New York, to be authorized to exercise corporate trust powers and to have a net worth of at least $10,000,000. The Trustee may at any time resign and be discharged from the trusts created under the Trust Agreement by giving written notice thereof to the Association, the FHLB-NY and to all Noteholders, provided that either the Trustee or the Association shall have arranged for the assumption by a qualified institution of the duties and obligations of the Trustee and the FHLB-NY shall have consented to such resignation and assumption. (Section 8.06).

If at any time the Trustee shall cease to be eligible in accordance with the provisions of the Trust Agreement and shall fail to resign after written request therefor by the Association, the FHLB-NY or holders of Notes evidencing not less than 25% of the principal amount outstanding on the Notes, then the Association, acting with the written consent of the FHLB-NY, may remove the Trustee and appoint a successor trustee.

The holders of Notes evidencing more than 50% of the outstanding principal amount of the Notes may at any time with the written consent of the FHLB-NY and the Association remove the Trustee and appoint a successor trustee. (Section 8.07).

Termination

The respective obligations and responsibilities of the Association and the Trustee shall terminate upon the final payment to Noteholders of all amounts required to be paid to them or delivery to the Association of any amounts remaining unclaimed after notice to Noteholders. In no event, however, shall the Trust Agreement continue beyond August 1, 2012.

Notice of any termination, specifying the last date upon which any remaining Noteholders may surrender their Notes to the Trustee for payment and cancellation, shall be given by the Association by publication in an Authorized Newspaper and by letter to Noteholders mailed not later than the fifteenth day of the month next preceding the month of the second anniversary of the Maturity Date of the

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Notes specifying (i) the date, which shall be the second anniversary of the Maturity Date of the Notes, upon which final payment of the Notes will be made upon presentation and surrender of Notes at the office or agency of the Trustee therein designated, (ii) the amount of any such final payment and (iii) that the Record Date otherwise applicable to such payment is not applicable, payments being made only upon presentation and surrender of the Notes at the office or agency of the Trustee therein specified. On the day following the second anniversary of the Maturity Date of the Notes, the Note Account shall terminate, and the balance thereof, if any, shall be paid to the Association subject to the obligation of the Association to hold all amounts payable to Noteholders without interest pending such payment. (Section 9.01).

Amendment

The Trust Agreement may be amended from time to time by the Association and the Trustee, with the consent of FHLB-NY but without the consent of any of the Noteholders, to provide for the issuance of one or more series of additional notes, to resolve any ambiguity, to correct or supplement any provision thereof which may be inconsistent with any other provision thereof or to add any other provisions with respect to matters or questions arising thereunder, provided that such action shall not adversely affect in any material respect the interests of any Noteholder.

The Trust Agreement may also be amended from time to time by the Association and the Trustee with the consent of FHLB-NY and holders of Notes evidencing not less than 66⅔% of the outstanding principal amount of the Notes for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of the Trust Agreement or modifying in any manner the rights of the holders of Notes; provided, however, that no such amendment shall (i) reduce in any manner the amount of, or delay the timing of, any payment required to be made on any Note without the consent of the holder of such Note, or (ii) reduce the aforesaid percentage of Notes, the holders of which are required to consent to any such amendment, without the consent of the holders of all Notes then outstanding. (Section 10.01).

Additional Series of Notes

The Association may issue from time to time Additional Notes that shall be subject to the provisions of the Trust Agreement, provided that the following conditions are met:

(a) The amount of all outstanding Notes plus the amount of the Additional Notes to be issued shall not exceed $100,000,000;

(b) No Additional Note shall have a Maturity Date after January 31, 1988;

(c) The FHLB-NY shall have delivered to Trustee its consent, in the form of Exhibit A to the Firm Commitment, to the issuance of such Additional Notes;

(d) The Association and the Trustee, with the consent of FHLB-NY, shall execute a Supplemental Trust Agreement specifying the terms of payment of the Additional Notes and the amounts thereof; and

(e) The Association shall have delivered to the Trustee (i) a copy of the resolution of the Board of Directors of the Association authorizing the issuance of such Additional Notes, specifying the terms thereof, including the interest rate or rates, the tenor or tenors and the Maturity Date or Dates, and directing the authentication and delivery of such Additional Notes to or upon the order of the purchasers mentioned therein upon payment of the purchase price therein set forth plus accrued interest to the date of purchase; (ii) an opinion of counsel with respect to such Additional Notes; (iii) an Officer's Certificate certifying that the Association is and upon issuance of such Additional Notes will be in compliance with the terms of the Trust Agreement; and (iv) such additional Mortgage Loans as may be necessary for the Association to be in compliance with the Collateral Requirement. (Section 2.11).

Limitation on Rights of Noteholders

The Trust Agreement provides that the death or incapacity of any Noteholder shall not operate to terminate the Trust Agreement nor entitle such Noteholder's legal representatives or heirs to claim an

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accounting or to take any action or proceeding in any court for a partition or winding-up of the trust nor otherwise affect the rights, obligations and liabilities of the Trustee, the Association or FHLB-NY.

No Noteholder shall have any right to vote (except as specifically provided) or in any manner otherwise control the operation and management of the Trust Agreement, or the obligations of the parties hereto, nor shall anything therein set forth, or contained in the terms of the Notes, be construed so as to constitute the Noteholders from time to time as partners or members of an association; nor shall any Noteholder be under any liability to any third person by reason of any action taken by the parties to the Trust Agreement pursuant to any provision thereof.

No Noteholder shall have a right of first refusal or right of redemption with respect to any sale or other transfer of a Note by any other Noteholder unless such right is specifically granted in writing by one Noteholder to another, it being understood that for the benefit of all Noteholders the Notes shall be freely transferable.

No Noteholder shall have any right by virtue or by availing of any provision of the Trust Agreement to institute any suit, action or proceeding in equity or at law upon or under or with respect to the Trust Agreement, unless such holder previously shall have given to the Trustee a written notice of default and of the continuance thereof and unless also the holders of Notes evidencing not less than 25% of the outstanding principal balance of the Notes shall have made written request upon the Trustee to institute such action, suit or proceeding in its own name as Trustee hereunder and shall have offered to the Trustee such reasonable indemnity as it may require against the costs, expenses and liabilities to be incurred therein or thereby, and the Trustee, for 60 days after its receipt of such notice, request and offer of indemnity, shall have neglected or refused to institute any such action, suit or proceeding; it being understood and intended, and expressly covenanted by each Noteholder with every other Noteholder and the Trustee, that no holder or holders of Notes shall have any right in any manner whatever by virtue or by availing of any provision of the Trust Agreement to affect, disturb or prejudice the rights of the holders of any other of such Notes, or to obtain or seek to obtain priority over or preference to any other such holder, or to enforce any right under the Trust Agreement, except in the manner therein provided and for the equal, ratable and common benefit of all Noteholders. For the protection and enforcement of the provisions of the Trust Agreement, each and every Noteholder and the Trustee shall be entitled to such relief as can be given either at law or in equity. (Section 10.02).

TAXATION

In the opinion of McConnell Valdés Kelley Sifre Griggs & Ruiz-Suria, counsel to the Underwriter, interest income on the Notes received by corporations that have elected and qualify for the credit provided in Section 936 will constitute "qualified possession source investment income" as defined in Section 936 and will be entitled to the credit provided in Section 936 if: (i) such interest is paid during a taxable year of the Association for which the Association qualifies for the credit provided in Section 936 and is received in Puerto Rico or elsewhere outside the United States and (ii) the Notes are purchased with funds derived from the active conduct of a trade or business in Puerto Rico or from qualified possession source investment income. In addition, in the opinion of such firm, based upon a ruling from the Commonwealth of Puerto Rico, interest income on the Notes received by holders of grants of tax exemption under the Puerto Rico Industrial Incentive Act of 1963 or the Puerto Rico Industrial Incentives Act of 1978 will constitute "industrial development income" as "eligible interest" if the Notes are purchased with "eligible funds" as these terms are defined in said Acts. Any premium that becomes due as a result of an acceleration of the Maturity Dates of the Notes will be paid in New York, N. Y. and, therefore, will constitute U. S. source income that will not qualify as qualified possession source investment income and will be subject to U. S. tax. Such premium will not qualify as industrial development income for Puerto Rico tax purposes.

The principal amount invested by a holder of a grant of tax exemption under the Puerto Rico Industrial Incentives Act of 1978 in Series A Notes that mature more than five years from the date of investment will constitute a qualifying investment under the provisions of Section 4(h)(1) of said Act for the purpose of obtaining a credit of 50% against the withholding tax payable on certain dividends paid by

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such holder if such investment is held for an uninterrupted period of not less than five years or if, due to causes beyond its control, such holder is required to sell, transfer or exchange the Notes before the termination of such five-year period but reinvests the proceeds of such transaction in other investments qualifying for said Section 4(h)(1) credit and holds such investments for an uninterrupted period that will complete the five-year holding period requirement.

On September 3, 1982 President Reagan signed the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") which amends Section 936 to, among other things, reduce the percentage of gross income that may be earned from passive investments such as the Notes (see "The Association"). Investors that have elected the benefits of Section 936 are advised to consult their tax advisors as to the effect of TEFRA upon their qualification requirements.

UNDERWRITING

A.G. Becker Puerto Rico Incorporated is the sole underwriter of the Mortgage-Backed Notes, 1982 Series A, to be issued by the Association. A.G. Becker Puerto Rico Incorporated is purchasing the Notes at a price equal to 100% of the principal amount of the Notes and will receive a fee of $515,255.48. An additional fee will be received for any subsequent issue of Additional Notes.

LEGAL OPINIONS

Legal matters relating to the validity of the Notes will be passed upon for the Association by Patterson, Belknap, Webb & Tyler, New York, New York and for the Underwriter by McConnell Valdés Kelley Sifre Griggs & Ruiz-Suria, San Juan, Puerto Rico. Certain other legal matters will be passed upon for FHLB-NY by Kirkpatrick, Lockhart, Hill, Christopher & Phillips, Washington, D.C., and for the Trustee by Coudert Brothers, New York, New York.

EXPERTS

The consolidated financial statements of the Association and its subsidiaries and the financial statements of the FHLB-NY for the two years ended December 31, 1981 appearing in this Offering Circular as Appendices A and C have been examined, respectively, by Deloitte Haskins & Sells and by Price Waterhouse, independent accountants, as set forth in their respective reports therein. Such financial statements have been included in reliance upon the reports of such independent accountants given upon the authority of such firms as experts in accounting and auditing.

SALE OF NOTES

The Notes are exempt from the registration requirements of the Securities Act of 1933 and have not been registered with the Securities and Exchange Commission. The Notes are also exempt from the registration requirements of the Puerto Rico Uniform Securities Act and have not been registered with the Puerto Rico Securities Bureau.

Prospective purchasers are invited to direct any inquiries as to the terms and conditions of the offering to A. G. Becker Puerto Rico Incorporated, who will obtain any necessary additional information from the Association. The Association has agreed to provide such information to the extent the Association possesses such information or can acquire it without unreasonable effort or expense.

FIRST FEDERAL SAVINGS & LOAN
ASSOCIATION OF PUERTO RICO

By: /s/ ISMAEL PAGAN COLBERG
Acting President

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APPENDIX A

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION
OF PUERTO RICO AND SUBSIDIARIES

Consolidated Financial Statements for the
Years Ended December 31, 1981 and 1980
and Auditors' Opinion

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FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION
OF PUERTO RICO AND SUBSIDIARIES

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AUDITORS' OPINION

First Federal Savings and Loan Association of Puerto Rico:

We have examined the consolidated financial statements of First Federal Savings and Loan Association of Puerto Rico and its subsidiaries (the Association) as of December 31, 1981 and 1980 and for the years then ended, listed in the foregoing table of contents. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As explained in Note 1 to the consolidated financial statements, the Association entered into a Supervisory Agreement with the Federal Savings and Loan Insurance Corporation on November 20, 1981. The ultimate outcome of the actions that the Association may be required to take to comply with the agreement cannot presently be determined, and no allowance for any loss or other adjustments that may result have been made in the financial statements.

In our opinion, subject to the effects on the consolidated financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, such consolidated financial statements present fairly the financial position of the Association and its subsidiaries at December 31, 1981 and 1980 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

March 10, 1982

Stamp No. 291808 was affixed
to the original of this report.

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FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION
OF PUERTO RICO AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED FINANCIAL CONDITION
DECEMBER 31, 1981 AND 1980 (In Thousands)

	NOTES	1981	1980
ASSETS:			
Cash		$ 7,586	$ 9,923
Deposit at interest with banks		87,514	58,805
Federal Savings and Loan Insurance Corporation - Promissory notes	1	35,000	
Investment securities	2,3,8	43,861	50,459
Loans receivable - net	2,4,7,8	829,382	763,198
Real estate owned - Acquired in settlement of loans, less allowance for losses of $309 in 1981 and $302 in 1980	2	6,996	7,259
Premises and equipment (less accumulated depreciation and amortization of $4,244 in 1981 and $3,572 in 1980)	2,5	11,377	12,162
Federal Home Loan Bank stock - at cost	7	6,845	5,437
Federal Savings and Loan Insurance Corporation Secondary Reserve Prepayment		536	755
Accrued interest receivable - On investments		4,759	4,343
Other assets		9,794	3,417
TOTAL ASSETS		$1,043,650	$915,758
LIABILITIES AND NET WORTH			
LIABILITIES:			
Deposits	6	$ 686,756	$687,493
Advances from Federal Home Loan Bank	7	91,490	75,580
Other borrowed money	8	205,888	85,603
Undisbursed portion of loans in process		4,552	20,752
Advances from borrowers for taxes and insurance		10,426	9,942
Dealers' reserve		405	1,037
Other liabilities		9,505	4,201
Deferred credits	2,10	3,938	5,464
Total liabilities		1,012,960	890,072
COMMITMENTS	4,12		
NET WORTH - Substantially restricted:	1,2		
Income Capital Certificates		35,000	
Retained earnings (deficit)		(4,310)	25,686
Total net worth		30,690	25,686
TOTAL LIABILITIES AND NET WORTH		$1,043,650	$915,758

See Notes to Consolidated Financial Statements.

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FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION
OF PUERTO RICO AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED LOSS AND RETAINED EARNINGS (DEFICIT)
FOR THE YEARS ENDED DECEMBER 31, 1981 AND 1980 (In Thousands)

	NOTES	1981	1980
INCOME:			
Interest on loans		$ 74,056	$64,239
Loan fees	2	2,140	2,503
Total		76,196	66,742
Interest on investments, etc.		23,527	10,064
Gain on sale of investments			626
Other		2,246	1,574
Total income		101,969	79,006
EXPENSES:			
Interest on deposits (net of penalties for early withdrawal of $433 in 1981 and $560 in 1980)		73,908	53,564
Interest on advances and other borrowings		38,029	16,704
Total interest cost		111,937	70,268
Employees' compensation and benefits	11	10,396	9,215
Occupancy and equipment		3,569	2,747
Advertising and promotion		927	1,280
Federal insurance premium		566	487
Loss provisions and expenses of loans and real estate owned - net		319	205
Other		3,208	3,351
Total expenses		130,922	87,553
LOSS BEFORE TAXES ON INCOME		(28,953)	(8,547)
PROVISION FOR TAXES ON INCOME	9	106	76
NET LOSS		(29,059)	(8,623)
RETAINED EARNINGS - BEGINNING OF YEAR		25,686	34,309
DEFICIT OF PAN AMERICAN FEDERAL SAVINGS AND LOAN ASSOCIATION AT DATE OF MERGER - NOVEMBER 20, 1981	1,2	(937)	
RETAINED EARNINGS (DEFICIT) - END OF YEAR		$ (4,310)	$25,686

See Notes to Consolidated Financial Statements.

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FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION
OF PUERTO RICO AND SUBSIDIARIES

STATEMENTS OF CHANGES IN CONSOLIDATED FINANCIAL POSITION
FOR THE YEARS ENDED DECEMBER 31, 1981 AND 1980 (In Thousands)

	NOTES	1981	1980
FUNDS WERE OBTAINED FROM:			
Operations:			
Net loss		$(29,059)	$ (8,623)
Add items not requiring funds:			
Interest credited to deposits		38,822	38,552
Depreciation and amortization		651	689
Deferred income taxes		87	75
Provision for losses		798	394
Total from operations		11,299	31,087
Issuance of income capital certificates to the FSLIC	1	35,000	
Mortgage loans:			
Repayments		47,071	38,707
Foreclosed		1,755	5,397
Sold		1,054	82
Consumer loans and other - net decrease		2,992	2,329
Redemption (purchase) of Federal Home Loan Bank stock		(1,408)	3,145
Deposits - increase (decrease)		(39,559)	89,201
Other borrowed money		120,285	26,961
Federal Home Loan Bank advances - increase (decrease)		15,910	(27,400)
Cost of land sold		1,851	
Basis of real estate sold, acquired in settlement of loans		2,808	6,738
TOTAL		$199,058	$176,241
FUNDS WERE USED FOR:			
Loans:			
Mortgage loans originated and purchased		$135,718	$110,122
Loans on savings - net increase		149	1,621
Deposit and investment securities - increase		22,111	50,868
FSLIC - promissory notes	1	35,000	
Deficit assumed in merger with acquired association	1	937	
Real estate owned acquired in settlement of loans		1,865	5,563
Premises and equipment - increase		1,286	3,626
Other - net		4,278	2,261
Cash - increase (decrease)		(2,286)	2,180
TOTAL		$199,058	$176,241

See Notes to Consolidated Financial Statements.

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FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION
OF PUERTO RICO AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 1981 AND 1980 (In Thousands)

1. REGULATORY ACTIONS

Under the regulations of the Federal Home Loan Bank Board (FHLBB), the Association is required to maintain net worth accounts constituting a statutory reserve (which represents a reduction of retained earnings), and meet a minimum net worth requirement both determined on an annual basis at December 31. As a result of substantial losses incurred in 1981 and 1980, the Association did not meet these requirements and, on November 20, 1981, management of the Association and the Federal Savings and Loan Insurance Corporation (FSLIC) agreed to the following actions:

- The Association entered into a supervisory agreement with the FSLIC.
- The FSLIC purchased $35 million of income capital certificates (ICC) issued by the Association and classified as equity securities.
- The Association took over the assets and liabilities of Pan American Federal Savings and Loan Association of Puerto Rico (PAF).

a. Supervisory Agreement - The Agreement accords the FSLIC with the following additional supervisory rights and powers:

- Board of Directors - The FSLIC must approve the nomination of all members to the Board of Directors.
- Operating Plans and Reports - The Association must submit for approval by the FSLIC semiannual operating plans setting forth investment, financial and operating goals and objectives; quarterly operating budgets for the ensuing quarter; and monthly and quarterly financial statements.
- Approval of Specific Transactions - The Association may enter into certain transactions, not covered by the operating plan only with the written approval of the FSLIC.
- Merger - The FSLIC may cause the Association to merge or transfer its net assets to another association or corporation.

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The operating plan for the first six months of 1982 has been approved by the FSLIC and management believes the FSLIC will continue to assist the Association should operating losses persist. In addition, management has not received any indication that FSLIC intends to cause the Association to merge and to the best of its knowledge the Association is in compliance with the Agreement. The financial statements do not include any adjustments relating to the effects of any actions that the Association might be required to take to continue to comply with the Agreement.

b. Issuance of ICC - On November 20, 1981, the Association issued ICC in the amount of $35 million to the FSLIC in return for a negotiable note from the FSLIC due November 19, 1986. Interest equal to the average auction yield for 4½-5½ years United States Treasury notes is payable semiannually. The interest rate at December 31, 1981 was approximately 14%.

The ICC earn a cumulative dividend equal to the average weekly auction rate for 26-week United States Treasury bills. The rate at December 31, 1981 was approximately 12.4%. The dividends are payable and ICC principal is redeemable only upon the Association attaining profitable operations and sustaining specified net worth levels.

When conditions for the payment of dividends and/or repayment of principal occur, the Association will transfer the amount to a liability account. As of December 31, 1981 these conditions have not been met. Dividends in arrears at December 31, 1981 are approximately $463.

c. Merger of PAF into the Association - The combination was accounted for at historical cost at the date of the merger, and the financial statements prior to November 20, 1981 have not been restated to include the operations of PAF since the effects would not be material. The assets, liabilities, and deficit of PAF were as follows:

Assets:	
Investment securities	$ 1,016
Loans receivable	39,971
FHLB stock	865
Total	41,852
Liabilities:	
Deposits	25,628
FHLB advances	17,154
Other - net	7
Total	42,789
Deficit	$ 937

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies of First Federal Savings and Loan Association of Puerto Rico and its subsidiaries (the Association) conform to generally accepted accounting principles (GAAP)

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and to general practices within the savings and loan industry and accounting rules prescribed by the Federal Home Loan Bank Board (FHLBB). A summary of the significant accounting policies followed by the Association and its subsidiaries is set forth below:

a. Principles of Consolidation - The consolidated financial statements include the accounts of the Association and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

b. Investment Securities - Investment securities are carried at cost adjusted for amortization of premiums and accretion of discounts. Gains or losses on sales of investments are determined on the specific identification method.

c. Allowances for Losses - It is the policy of the Association to provide valuation allowances for estimated losses on loans and real estate when a significant decline in value occurs. In providing valuation allowances, costs of holding real estate, including the cost of capital are considered. Major loans, real estate owned including development projects, and lending areas are reviewed periodically to determine potential problems at an early date. Additions to allowances are charged to income.

d. Allowance for Uncollected Interest - The Association provides an allowance for the loss of uncollected interest on uninsured mortgage loans which are more than 90 days past due. For financial statement purposes this allowance is offset against interest receivable. Such interest, if ultimately collected, is credited to income in the period of recovery.

e. Real Estate Owned - Acquired in Settlement of Loans - Real estate owned is carried at the lower of cost (lesser of carrying value of loan or fair value at date of acquisition) or net realizable value. Effective January 1, 1981, gain on sale of real estate owned is accounted for following the provisions of the AICPA Accounting Guide, "Accounting for Profit Recognition on Sales of Real Estate". This practice was permitted by a change in applicable FHLBB regulations adopted in December 1981.

Prior to January 1, 1981, gains on sale of real estate not received in cash were deferred and credited to income in proportion to the reduction in the principal balance of the sales contract. Deferred income at the date of change in method was not material and was credited to income. Losses are charged to operations as incurred.

f. Premises and Equipment - Premises and equipment are carried at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives of the individual assets (5 to 50 years). Amortization of leasehold improvements is computed on the straight-line method over the terms of the leases or estimated useful life of the improvement, whichever is shorter.

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g. Loan Origination and Commitment Fees - Fees are recognized as earned during the year of origination to the extent they do not exceed direct costs of underwriting and closing of loans and are within the limits permitted by the FHLBB. Amounts permitted to be recognized as current income by the FHLBB are 1) loan origination - four hundred dollars plus 2% of loan amount (2½% if construction loan) and 2) commitment fees - 1% through 2% of amounts collected depending on the length of the commitment period. Commitment fees on floating rate commitments (the type generally extended by the Association) are amortized pro rata over the commitment period as required by GAAP. Deferred fees are amortized to income under a method which approximates the interest method.

h. Interest and Fees on Finance Receivables - Interest and fees on finance receivables are recognized into income on the sum-of-the-year-digits method which approximates the interest method.

i. Imputed Interest - The difference between the imputed interest rate and that stated on loans (made at below market rate to facilitate sale of real estate) is amortized to income over the average estimated life of the loans.

3. INVESTMENT SECURITIES

	.....1981.....		.....1980.....	
Description	Carrying Value	Market Value	Carrying Value	Market Value
U.S. Treasury	$ 5,297	$ 5,243	$ 8,426	$ 8,128
U.S. Government Agencies	38,468	34,951	42,023	38,510
P.R. Government - Bonds	96	70	10	8
Total	$43,861	$40,264	$50,459	$46,646
Maturities				
Less than 1 year	$ 7,293	$ 7,160	$ 8,131	$ 7,836
1 - 5 years	34,971	32,149	40,816	37,700
Over 5 years	1,597	955	1,512	1,110
Total	$43,861	$40,264	$50,459	$46,646

Management does not anticipate disposing of any investments at a material loss.

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4. LOANS RECEIVABLE - NET

	1981	1980
Real estate loans secured by first deeds of trust:		
Residential and commercial	$407,883	$478,417
Construction, land acquisition and land improvements	24,649	46,344
Insured by government agencies:		
Mortgage backed securities:		
Federal Home Loan Mortgage Corporation (FHLMC) Participation Certificates	100,226	
Government National Mortgage Association (GNMA) Pool Certificates	56,139	33,712
Federal Housing Administration (FHA) and Veterans Administration (VA)	16,058	16,041
Puerto Rico Housing Bank and Finance Agency	180,203	148,517
A.I.D. loans	2,896	2,923
Total	788,054	725,954
Add (deduct):		
Accrued interest receivable	12,488	7,785
Allowance for uncollectible interest	(1,727)	(1,152)
Allowance for possible loan losses	(1,330)	(1,330)
Total real estate loans - net	797,485	731,257
FHA - Title I	8,168	6,031
Loans on savings accounts	17,340	16,567
Consumer and other	7,029	10,478
Less:		
Deferred finance income	(257)	(827)
Allowance for possible loan losses	(383)	(308)
Total consumer and other loans - net	6,389	9,343
Total loans receivable - net	$829,382	$763,198

At December 31, 1981, certain loans secured by first deeds of trust assigned to secure public deposits totaled $46,000 (1980 - $38,500).

At December 31, 1981, the Association was servicing loans aggregating approximately $98,000, owned by others (1980 - $46,000).

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At December 31, 1981 the Association had loan commitments to originate and purchase loans totaling approximately $31,000 (1980 - $61,000) excluding the undisbursed portion of loans in process.

At December 31, 1981, real estate loans with outstanding principal balances of $29,000 (1980 - $22,000) were in a non-interest accruing status because they were not covered by insurance by governmental agencies and were more than three months past due or represented a modification of loan agreements.

5. PREMISES AND EQUIPMENT

	1981	1980
Major classification:		
Land	$ 669	$ 2,519
Buildings and improvements	7,452	7,141
Leasehold improvements	2,478	2,155
Furniture and equipment	5,022	3,919
Total	15,621	15,734
Less accumulated depreciation and amortization	(4,244)	(3,572)
Premises and equipment - net	$11,377	$12,162

6. DEPOSITS

	1981			1980		
	Interest Rate	Amount	%	Interest Rate	Amount	%
Passbook	4.5% to 5.5%	$187,205	27	4.5% to 5.5%	$202,458	29
NOW accounts	5.25%	9,900	1			
Regular certificate accounts:						
Under $50,000	5.7% to 12%	56,372	9	5.7% to 7.5%	75,763	11
Over $50,000	8.0% to 18%	284,293	41	8.0% to 19.5%	293,517	43
Total		340,665	50		369,280	54
Six month money market certificates	13.7% to 16.5%	143,588	21	9.7% to 15.5%	110,957	16
Accrued interest payable		5,398	1		4,798	1
Total		$686,756	100		$687,493	100

The weighted average stated rate of interest at December 31, 1981 and 1980 was 10.54% and 10.09%, respectively.

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7. ADVANCES FROM FEDERAL HOME LOAN BANK

	Interest Rate	1981	1980
Due within one year	7.5% to 11%	$11,100	$11,600
	13.8% to 15.6%	6,500	
	Variable rates	58,550	47,580
Due after one and within four years	8.45% to 16.40%	15,340	16,400
Total		$91,490	$75,580

Variable rates fluctuate from month to month depending on the amount borrowed and on the prevailing market interest rates. Interest rates during 1981 ranged from 15.75% to 20.00% (10.5% to 20.25% in 1980). Interest rates in effect at December 31, 1981 and 1980 were 15.75% and 19%, respectively.

The Association collateralizes its advances from the Federal Home Loan Bank of New York (FHLB) with mortgage loans and its investment in stock of the FHLB. Real estate and home improvement loans secured by mortgages and mortgage-backed securities, excluding mortgage loans and related securities pledged on other borrowings, are made available as collateral under a Blanket Agreement for Advances and Security Agreement. Under this Agreement the Association is required to maintain a minimum amount of not otherwise pledged qualifying mortgage collateral with an unpaid principal balance at least equal to the outstanding advances, or at the option of the FHLB, it could elect to hold specific collateral with an estimated market value, based on a formula prescribed by the FHLB, at least equal to 125% of outstanding advances. At December 31, 1981 the carrying value of mortgage loans pledged and deposited with the FHLB aggregated approximately $200,500.

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8. OTHER BORROWED MONEY

	1981	1980
Securities sold under agreement to repurchase:		
Conventional repurchase transactions:		
Due within one year - interest ranging from 10.38% to 17.25% in 1981 and 10.75% to 21.0% in 1980	$115,925	$ 40,681
Due within one to five years - interest rate 9.06%	2,250	2,250
Total (collateral pledged, 1981 - $186,760; 1980 - $53,612)	118,175	42,931
Back-to-back money market transactions:		
Due within one year - interest ranging from 10.6% to 18.35% in 1981 and 10.4% to 19.1% in 1980	81,713	29,175
Due within one to five years - interest ranging from 12.4% to 13.67% in 1981 and 13.2% to 13.4% in 1980	6,000	5,900
Total (collateral pledged, 1981 - $237,468; 1980 - $76,664)	87,713	35,075
Other secured borrowings:		
Notes payable due January 1, 1981, interest payable at 12.25% in 1980 (collateral pledged, $6,498)		5,000
Factor's lien (finance receivables - interest payable at 1-3/4% over prime rate - 22-1/4% at December 31, 1980) (collateral pledged, $7,541)		2,597
Total	$205,888	$ 85,603
Carrying values of collateral pledged on borrowings other than from the FHLB are as follows:		
Deposit at interest with banks	$ 85,313	$ 33,675
Securities:		
U.S. Treasury	2,400	3,400
U.S. Government Agencies	19,474	24,477
Real estate loans secured by first deeds of trust:		
Residential	157,317	41,589
FHLMC Participation Certificates	100,226	
GNMA pool certificates	54,691	29,933
Puerto Rico Housing Finance Corporation	4,807	3,700
Finance receivables - net		7,541
Total	$424,228	$144,315

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9. TAXES ON INCOME

Components of provision for taxes on income for year	1981	1980
Currently payable on income from subsidiaries	$ 19	$ 1
Amortization of deferred tax expense	87	75
Total	$106	$76

Bad Debt Reserve - Bad debt deductions for income tax purposes are included in taxable income of later years only if the bad debt reserve is used subsequently for purposes other than to absorb bad debt losses. Because the Association does not intend to use the reserve for purposes other than to absorb losses, no deferred taxes have been provided. At December 31, 1981 bad debt deductions taken for Puerto Rico tax purposes for which no deferred income taxes have been provided aggregated $1,672.

10. DEFERRED CREDITS

	1981	1980
Deferred loan fees	$2,647	$3,591
Discount on loans purchased	519	502
Imputed interest on below market rate loans (Note 2)	605	480
Unrealized profits on real estate sold	51	725
Other	116	166
Total	$3,938	$5,464

11. PENSION, PROFIT-SHARING AND DEFERRED COMPENSATION PLANS

a. Pension Plan - The Association has a non-contributory pension plan covering substantially all of its employees. Pension expense was $450 in 1981 ($440 in 1980) and includes amortization of past and prior service cost over 40 and 30 year periods. The Association makes annual contributions to the plan equal to the amounts accrued for pension expense.

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The actuarial rate of return assumed in both years is 7%. A comparison of the accumulated plan benefits and plan net assets as of the most recent actuarial valuation dates (January 1, 1981 and 1980) for the Association's defined benefit plan is presented below:

	1981	1980
Actuarial present value of accumulated plan benefits:		
Vested	$ 833	$ 718
Nonvested	77	63
Total	$ 910	$ 781
Net assets available for benefits	$2,270	$1,689

b. Profit-Sharing Plan - The profit-sharing plan provides for the Association, at its option, to contribute an amount which is distributed between the participants and a trust fund established under the plan. The plan was amended on January 1, 1981 to provide that the Association's maximum contribution in any year will not exceed 15% of the total salary of all eligible employees and that no contribution has to be made for years during which the Association incurred a loss. Consequently, no contribution was made in 1981. The Association's contribution totaled $272 in 1980.

c. Deferred Compensation Plan - The Association and its subsidiaries also provided $60 and $159 in 1981 and 1980, respectively, for an unfunded deferred compensation plan for the benefit of its officers.

12. LEASE COMMITMENTS

At December 31, 1981, the Association and its subsidiaries had various lease agreements for rental of Branch facilities. These agreements expire at various dates from 1982 to 2000. Total rent expense was approximately $461 in 1981 and $411 in 1980.

The minimum rental commitments of non-cancellable operating leases are as follows:

Year Ending December 31	
1982	$ 439
1983	424
1984	368
1985	318
1986	243
Later years	1,929
Total	$3,721

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13. LITIGATION

The Association is named defendant in an action brought against it in connection with the foreclosure and auction to sell certain properties. The sum claimed is in excess of $4.3 million. It is in the opinion of management and their legal counsel that the above action will not result in an adverse impact on the financial statements.

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APPENDIX B

FIRM COMMITMENT TO ADVANCE FUNDS

This Agreement is made as of the 9th day of November, 1982, between the **FEDERAL HOME LOAN BANK OF NEW YORK,** a corporation organized and existing under the laws of the United States ("Bank"), One World Trade Center, New York, New York 10048, and **FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION OF PUERTO RICO,** a mutual savings and loan association organized and existing under the laws of the United States ("Association"), 1519 Ponce de Leon Avenue, Stop 23, Box 9146, Santurce, Puerto Rico 00910.

WHEREAS, Association has entered into a Trust Agreement (the "Trust Agreement") dated as of November 1, 1982, with J. Henry Schroder Bank and Trust Company, a bank and trust company organized under the laws of the State of New York as trustee ("Trustee"), under which Association intends to issue mortgage-backed notes (the "Notes") having a maximum aggregate outstanding principal amount of US$100,000,000, bearing interest semi-annually and having scheduled maturities no later than January 31, 1988; and

WHEREAS, Association has applied to Bank for a firm commitment to advance funds to Association in such amounts as may be necessary to pay principal, premium and interest on such Notes as the same become due, and subject to the terms and conditions hereof, Bank is willing to issue such commitment.

NOW, THEREFORE, Association and Bank hereby agree as follows:

1. *Definitions.* As used herein, the following terms shall have the following meanings:

(a) "Advances Agreement" means that certain Advances, Collateral Pledge and Security Agreement, dated as of November 21, 1977 between Association and Bank as such agreement has been or may be amended.

(b) "Note Account" means the "Note Account" maintained by the Trustee pursuant to the Trust Agreement.

(c) "Commitment" means the firm commitment of Bank to advance funds set forth in Section 2 hereof.

(d) "Payment Date" means a date upon which a payment of interest on, or the payment of the entire principal of (together with any premium), one or more of the Qualified Notes is due and payable, whether by acceleration or otherwise.

(e) "Qualified Notes" means such Notes which are "Outstanding" as that term is defined in the Trust Agreement and to the issuance of which Bank shall have expressly consented in a writing in the form of Exhibit A hereto.

(f) "Request for Advances" means a written request, in the form of Exhibit B hereto, to Bank on behalf of Association for an advance under the Commitment, given by the Agent specified in Section 6 hereof pursuant to Agent's authority as Trustee under Section 5.03, 5.04 or 7.03 of the Trust Agreement and received by Bank at least five (5) days prior to the next Payment Date, which specifies the amount requested to be advanced, provided that such amount shall not exceed the amount, as certified in the related Trustee's Certificate, by which the balance in the Note Account is less than the amount of principal, interest and premium which is due and payable on Qualified Notes on the next Payment Date.

(g) "Trustee's Certificate" means a certificate, in the form of Exhibit C hereto, executed by Trustee certifying to Bank: (i) that the Association has failed to make a deposit in the Note Account of principal, interest or premium on the Notes that was required to have been made under the Trust Agreement; (ii) the amount of the balance, if any, in the Note Account; and (iii)

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the amount by which such balance in the Note Account is less than the amount of principal, premium and interest which is scheduled to be due and payable on Qualified Notes on the next Payment Date.

2. *Firm Commitment.* In the event that, during the term of this Commitment, Bank receives a Request for Advance and a related Trustee's Certificate with respect to all or some of the Qualified Notes, Bank will, upon the Payment Date specified in such Trustee's Certificate, advance to Association an amount equal to the amount specified in such Request for Advance. Such advance shall be effected by the transfer of funds by Bank, on behalf of Association, to Trustee, in trust for the benefit of the holders of such Qualified Notes under the Trust Agreement. In no event, however, shall Bank be obligated to make an advance in excess of the amount of principal, premium and interest due and payable on Qualified Notes on the next Payment Date. The aggregate obligation of Bank to make advances hereunder shall not exceed $100,000,000 on account of principal on the Notes plus interest and premium, if any, payable thereon under the terms of the Notes.

3. *Terms of Advances.* Any advance made hereunder shall:

(a) constitute an advance under, and be subject to the terms of, the Advances Agreement;

(b) bear interest at the variable rate then being charged by Bank for variable rate advances under Bank's regular advances program; and

(c) be due and payable by Association immediately and without demand.

4. *Security Agreement.* The obligations of Association to repay advances under the Commitment are secured by a Security Agreement, dated as of the date hereof, between Association and Bank (the "Security Agreement"). Reference is hereby made to the Security Agreement with respect to certain rights and obligations of the parties with respect to the subject matter hereof.

5. *Commitment Fee.* Association agrees to pay Bank such administrative fees as may be charged by Bank and to pay Bank a commitment fee equal to three-eighths of one percent (⅜ of 1%) of the principal amount of each Qualified Note per annum for the period during which each such Qualified Note may be outstanding based upon the stated maturity of such Qualified Note. Such administrative fees and commitment fee shall be paid in full with respect to each Qualified Note at the time the Bank issues its consent, in the form of Exhibit A hereto, to the issuance of such Qualified Note.

6. *Appointment of Agent.* Association hereby appoints Trustee as Association's exclusive agent (the "Agent") for purposes of submitting a Request for Advance to Bank, and for the purpose of instituting an action against Bank, on behalf of Association, to enforce Bank's obligations under the Commitment. Bank consents to such appointment.

7. *Term.* The Commitment shall be for a term that expires at the close of business on January 31, 1988.

8. *Amendment.* No modification, amendment or waiver of any provision of this Agreement or consent to any departure therefrom shall be effective unless executed by the party against whom such change is asserted and shall be effective only in the specific instance and for the purpose for which given. No amendment hereto shall limit the amount of the Commitment or otherwise adversely affect either the right of Trustee to request an advance hereunder or the obligation of the Bank to make such advance.

9. *Notices.* Any notice, advice, request, consent or direction given, made or withdrawn pursuant to this Agreement shall be in writing, and unless otherwise specified herein shall be deemed to have been duly given and received by a party hereto when it shall have been mailed to such party at its address given above by first class mail, or if given by hand or by telex, when actually received by such party at its principal office.

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10. *Successors or Assigns.* This Agreement may not be assigned by Association without the express written consent of Bank. All provisions in this Agreement shall bind and inure to the respective successor and permitted assigns of Bank, Association and Trustee.

11. *Entire Agreement: Descriptive Headings.* This Agreement, the Security Agreement and the Advances Agreement embody the entire agreement and understanding between the parties hereto relating to the subject matter hereof and supersede all prior agreements between such parties which relate to such subject matter. The section headings in this Agreement are for convenience only and do not constitute a part of this Agreement.

12. *Governing Law.* This Agreement is governed by Federal statutory law, including the Federal Home Loan Bank Act, as now and hereafter amended, and the regulations of the Federal Home Loan Bank Board now or hereafter in effect, and by Federal common law, which for purposes of this Agreement shall be deemed to incorporate the Uniform Commercial Code as in effect in the State of New York.

IN WITNESS WHEREOF, Association and Bank have caused this Agreement to be signed in their names by their duly authorized officers as of the date first above mentioned.

FEDERAL HOME LOAN BANK OF NEW YORK

By: .....

Title: .....

By: .....

Title: .....

FIRST FEDERAL SAVINGS AND LOAN ASSOCIATION OF PUERTO RICO

By: .....

Title: .....

Trustee's Consent

Trustee has read the foregoing Firm Commitment to Advance Funds and agrees to act as the Agent of Association thereunder pursuant to its authority under the Trust Agreement.

J. HENRY SCHRODER BANK AND TRUST COMPANY, Trustee

By: .....

Title: .....

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Exhibit A
to
Firm Commitment

Consent to Issuance of Notes

Reference is made to that certain Firm Commitment to Advance Funds (the "Firm Commitment"), dated as of November 9th, 1982, between the Federal Home Loan Bank of New York ("Bank") and First Federal Savings and Loan Association of Puerto Rico ("Association"), and to that certain Trust Agreement, dated as of November 1, 1982, between Association and J. Henry Schroder Bank and Trust Company, as Trustee ("Trustee"), as the same may have been amended, pursuant to which Association may issue certain mortgage-backed notes ("Notes") of the Association having a maximum aggregate outstanding principal amount of $100,000,000, and maturing no later than January 31, 1988.

Bank hereby consents to the issuance by Association of Notes having the following characteristics:

Date of Notes	Principal Amount	Interest Rate	Maturity Date

The foregoing Notes shall constitute "Qualified Notes" under the Firm Commitment for as long as the same are "Outstanding" as that term is defined in the Trust Agreement.

FEDERAL HOME LOAN BANK OF NEW YORK

By: .....

Title: .....

By: .....

Title: .....

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Exhibit B
to
Firm Commitment

Form of Request for Advances

, 198

Federal Home Loan Bank of New York
One World Trade Center, Floor 103
New York, New York 10048

Attention: Joseph De Ferrari Jr., Senior Vice President

Re: Firm Commitment to First Federal Savings and Loan Association of Puerto Rico

Gentlemen:

Reference is made to that certain Firm Commitment to Advance Funds (the "Commitment") dated as of November 9th, 1982, between the Federal Home Loan Bank of New York (the "Bank") and First Federal Savings and Loan Association of Puerto Rico (the "Association") whereby the Bank agreed to advance to the Association such funds as may be necessary to pay principal, premium and interest on certain mortgage-backed notes (the "Qualified Notes") issued by the Association under a certain Trust Agreement (the "Trust Agreement") dated as of November 1, 1982 between the Association and the undersigned, J. Henry Schroder Bank and Trust Company, as Trustee. In its capacity as Trustee under the Trust Agreement, the undersigned (the "Agent") has been designated under Section 6 of the Commitment as the exclusive agent of the Association for purposes of requesting an advance under the Commitment.

Unless otherwise defined herein, capitalized terms used in this letter have the same meanings as in the Commitment.

Agent hereby requests, on behalf of the Association, that on or before the next Payment Date, which is . . . . . , the Bank make and advance pursuant to the Commitment in the amount of US$ . . . . . . Such amount is less than or equal to the amount, as certified in the attached Trustee's Certificate, by which the balance in the Note Account is less than the amount of principal, interest and premium which is due and payable on Qualified Notes on the next Payment Date.

Sincerely,

J. HENRY SCHRODER BANK AND TRUST COMPANY, Trustee

By: . . . . . .

Title: . . . . . .

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Exhibit C
to
Firm Commitment

Form of Trustee's Certificate

The undersigned, J. Henry Schroder Bank and Trust Company, ("Trustee") is Trustee under that certain Trust Agreement (the "Trust Agreement"), dated as of November 1, 1982, between First Federal Savings and Loan Association of Puerto Rico (the "Association") and Trustee, pursuant to which certain mortgage backed notes ("Notes") have been issued by the Association. This Certificate is issued to the Federal Home Loan Bank of New York (the "Bank") in connection with a Request for Advance under that certain Firm Commitment to Make Advances, dated as of November 9th, 1982 between the Bank and the Association (the "Commitment"). Except as otherwise defined herein, capitalized terms used in this Certificate have the same meanings as in the Commitment.

Trustee hereby certifies to the Bank that:

(1) The Association has failed to make a deposit in the Note Account of principal, interest or premium on the Notes that the Association was required to have made prior to the date hereof;

(2) The balance in the Note Account as of the date hereof is US$ .....;

(3) The balance in the Note Account as of the date hereof is US$..... less than the amount of principal, premium and interest which is scheduled to be due and payable on Qualified Notes on the next Payment Date.

IN WITNESS WHEREOF, the undersigned Trustee has caused this Certificate to be executed by its duly authorized representative this day of , 198 .

J. HENRY SCHRODER BANK AND TRUST COMPANY, Trustee

By: .....

Title: .....

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APPENDIX C

Financial Statements

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Statements of Condition

December 31, 1981 and 1980 (in thousands)

Assets	**1981**	1980
Cash (Note 2)	**$ 12,155**	$ 20,538
Investments (Note 3)	**1,075,761**	526,778
Advances to members (Note 4)	**5,969,214**	4,536,243
Loans guaranteed by the Agency for International Development, net of participations sold (Note 5)	**54,339**	54,666
Loans to other Federal Home Loan Banks (Note 6)	**50,000**	50,000
Accrued interest receivable	**70,027**	44,796
Furniture, equipment, and leasehold improvements - net	**1,682**	1,340
Investment in Federal Home Loan Mortgage Corporation (Note 7)	**17,550**	17,550
Concessions on consolidated obligations - bonds	**4,094**	2,650
Deferred charges - Bank Board cost of quarters and other capital expenditures	**4,233**	4,474
Other assets	**426**	136
Total assets	**$7,259,481**	$5,259,171

Liabilities and Capital	**1981**	1980
Liabilities:		
Member deposits:		
Demand	**$ 25,061**	$ 26,361
Demand Deposit Account Plus Program	**169,166**	117,245
Overnight	**553,028**	514,468
Term	**121,047**	327,809
Total deposits	**868,302**	985,883
Consolidated obligations (Note 8):		
Bonds	**4,426,000**	2,881,000
Discount notes	**944,902**	582,709
Accrued interest payable	**154,767**	75,325
Unearned commitment and service fees	**1,376**	2,824
Other liabilities	**6,523**	47,540
Total liabilities	**6,401,870**	4,575,281
Contingencies and Commitments (Notes 8, 12 and 13)		
Capital (Note 10):		
Capital stock, $100 par value	**746,495**	584,692
Retained earnings:		
Legal reserve	**94,028**	80,359
Dividend stabilization reserve	**5,575**	7,326
Undivided profits	**11,513**	11,513
Total retained earnings	**111,116**	99,198
Total capital	**857,611**	683,890
Total liabilities and capital	**$7,259,481**	$5,259,171

The accompanying notes are an integral part of these financial statements.

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Statements of Income

For the years ended December 31, 1981 and 1980 (in thousands)

Income:	1981	1980
Interest and fees on advances to members	**$ 685,295**	$ 417,546
Income from investments	**98,971**	67,870
Dividend from FHLMC (Note 7)	**234**	5,850
Interest and fees on loans guaranteed by the Agency for International Development (Note 5)	**4,778**	4,523
Other Income	**5,834**	2,284
Total Income	**795,112**	498,073
Expense:		
Interest and concessions on consolidated obligations	**572,854**	307,888
Interest on deposits	**141,737**	125,736
Bank Board assessments	**1,083**	1,051
FHLBanks' Office of Finance assessments	**465**	313
Other operating expenses	**10,632**	7,119
Total expense	**726,771**	442,107
Net Income	**$ 68,341**	$ 55,966

Statements of Capital Accounts

For the Years ended December 31, 1981 and 1980 (in thousands)

	Capital Stock		**Retained Earnings**		
Balance,	Shares	Par value	Legal reserve	Dividend stabilization reserve	Undivided profits
January 1, 1980	5,400	$539,992	$69,166	$ 8,775	$23,027
Proceeds from sale of capital stock	1,038	103,823	—	—	—
Redemption of capital stock	(591)	(59,123)	—	—	—
Net income for 1980	—	—	—	—	55,966
Statutory transfer (Note 10)	—	—	11,193	—	(11,193)
Transfer from dividend stabilization reserve (Note 10)	—	—	—	(1,449)	1,449
Dividends on capital stock (11%) (Note 10)	—	—	—	—	(57,736)
Balance, December 31, 1980	5,847	584,692	80,359	7,326	11,513
Proceeds from sale of capital stock	1,722	172,171	—	—	—
Redemption of capital stock	(104)	(10,368)	—	—	—
Net income for 1981	—	—	—	—	68,341
Statutory transfer (Note 10)	—	—	13,669	—	(13,669)
Transfer from dividend stabilization reserve (Note 10)	—	—	—	(1,751)	1,751
Dividends on capital stock (8%) (Note 10)	—	—	—	—	(56,423)
Balance, December 31, 1981	7,465	$746,495	$94,028	$ 5,575	$11,513

The accompanying notes are an integral part of these financial statements.

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Statements of Changes in Financial Position

For years ended December 31, 1981 and 1980	1981	(in thousands) 1980
Financial resources were provided from:		
Operations:		
Net income	$ 68,341	$ 55,966
Noncash charges to income:		
Depreciation and amortization of furniture, equipment and leasehold improvements	144	141
Amortizations of concessions on consolidated obligations - bonds	2,036	1,337
Amortization of Bank Board assessments	241	239
Total from operations	70,762	57,683
Net proceeds from issuance of consolidated obligations:		
Bonds	2,543,520	1,064,778
Discount notes	1,681,581	878,363
Advances repaid	1,635,904	1,809,677
Proceeds from sale of capital stock	172,171	103,823
Net decrease in loans guaranteed by the Agency for International Development	327	2,183
Increase in accrued interest payable	79,442	21,684
Discount on consolidated obligations - discount notes	158,612	55,912
Decrease (increase) in cash	8,383	(10,772)
Total	$6,350,702	$3,983,331
Financial resources were used for:		
Payments on maturing consolidated obligations:		
Bonds	$1,002,000	$ 499,000
Discount notes	1,478,000	761,450
Advances made	3,068,875	2,667,706
Net decrease (increase) in members' deposits	117,581	(124,609)
Redemption of capital stock	10,368	59,123
Cash dividends paid on capital stock	56,423	57,736
Net additions to furniture, equipment and leasehold improvements	486	49
Net increase in investment	548,983	32,788
Increase in accrued interest receivable	25,231	15,093
Increase in investment in Mortgage Corporation, deferred charges and other assets	290	5,849
Increase in loans to other Federal Home Loan Banks	—	50,000
Decrease (increase) in other liabilities	42,465	(40,854)
Total	$6,350,702	$3,983,331

The accompanying notes are an intergral part of these financial statements.

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Notes to Financial Statements

December 31, 1981 and 1980

Organization and Related Agencies:

The Federal Home Loan Bank of New York (the Bank), a federally chartered corporation exempt from income taxes, is one of twelve District Federal Home Loan Banks (FHLBanks) which, together with their member institutions, comprise the FHLBank system. The FHLBank System is designed to promote home ownership through extensions of credit to savings and home financing institutions. Member institutions include all federally chartered savings and loan associations, all federally chartered mutual savings banks, and all institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC). Membership is also available to qualifying institutions, such as state-chartered, non-FSLIC insured savings associations and mutual savings banks.

The FHLBanks are instrumentalities of the federal government, they are owned by, and serve as central credit banks for, member institutions. A principal source of funds for the FHLBanks are sales to the public of debt instruments (consolidated obligations) which are the joint and several obligations of all FHLBanks. Other funds are provided by issuance of capital stock, all of which is owned by the Bank's members, and member deposits.

The FHLBank System is governed and regulated by the Federal Home Loan Bank Board (Bank Board) which is an independent federal agency in the executive branch of government. The Bank Board is the chartering and regulatory authority for federal savings and loan associations and federal mutual savings banks. The Bank Board governs the Federal Home Loan Mortgage Corporation (Mortgage Corporation) which is a secondary mortgage market facility. The principal function of the Mortgage Corporation, which is owned by the FHLBanks, is to promote the flow of capital into the housing markets by establishing an active secondary market in residential mortgages. Further, the Bank Board also governs the FSLIC which insures the accounts of savers in federally insured savings and loan associations and federal mutual savings banks. Bank Board expenses are met through assessments to the FHLBanks and the FSLIC and assessments to member institutions for examinations.

Note 1 — Summary of Significant Accounting Policies:

The more significant accounting policies not described elsewhere in the notes to the financial statements are as follows:

Investments:

Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Gains and losses on sales of securities are included in income from investments.

Advances to the Mortgage Corporation:

Proceeds from certain consolidated obligations have been advanced to the Mortgage Corporation at the same interest rates and maturities as the related consolidated obligations. The Mortgage Corporation is effectively reimbursing the Bank for the interest; accordingly, the advances, related consolidated obligations, interest expense, and interest income have been offset and are not reflected in the accompanying financial statements.

Furniture, equipment and leasehold improvements:

These assets are stated at cost less accumulated depreciation and amortization of $939,000 and $794,000 at December 31, 1981 and 1980, respectively. Depreciation and amortization are computed on a straight-line method over the estimated useful lives of the property or, for leasehold improvements, over the life of the lease.

Maintenance and repairs are charged to expense, except that major repairs which extend the useful lives of the assets are capitalized. The cost, less accumulated depreciation, of assets sold or retired is eliminated from the accounts in the year of disposal and the related gain or loss is included in the statement of income.

Federal Home Loan Bank Board assessments:

The Bank expenses its pro rata share of the Bank Board assessment for operating expenses during the year in which the assessment is levied.

The Bank Board has assessed the Bank for its portion of the cost of the Board's building in Washington, D.C. These payments are treated as a deferred charge and are amortized using the straight-line method over a 25-year period.

The Bank Board also assesses the Bank for its portion of the cost of capital expenditures for furniture, equipment and furnishings for the Board's building. Payments against these assessments are treated as a deferred charge, and amortization is computed on the straight-line method over a 5-year period.

FHLBank's Office of Finance assessments:

The FHLBank's Office of Finance manages the Consolidated Securities Fund, the sale of consolidated obligations and certain accounting functions for the twelve FHLBanks as a group. Assessments for the Office's operating costs are charged directly to expense when billed.

Concessions on consolidated obligations:

The amounts allowed dealers in connection with the sale of consolidated obligation bonds are deferred and amortized on the straight-line method to the maturity of the obligations. However, the amounts applicable to the sale of consolidated obligation discount notes are charged directly to expense as incurred because of the notes' short-term maturities.

Discounts on discount notes consolidated obligations:

The discounts from the issue of consolidated obligation discount notes are amortized to expense on the straight-line method to the maturity of the related notes.

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Unearned commitment and service fees:

Commitment fees for advances:

A guaranteed funds commitment is required for each long-term advance and is available without fee, except for a guaranteed fixed-rate commitment. A non-takedown fee is charged in full if none of the committed funds are taken down during the commitment period and reduced on a pro rata basis depending on the amount of the commitment exercised. Non-takedown fees are taken into income immediately. Fixed-rate guarantee commitment fees of $1,000 or more are deferred and amortized to income over the period of the commitment.

AID service fees:

The Bank receives service fees from borrowers for AID loans against which the direct expenses associated with the financing arrangements are netted. The balance is deferred and amortized into income at 1% of the unamortized balance per month.

Interdistrict Mergers:

When a member of this Bank merges into a member of another District Federal Home Loan Bank, the advances, deposits and capital stock pertaining to the merged member continue to be recorded for accounting purposes as if the merged member had remained a member of this Bank.

Note 2 — Cash Compensating Balances:

The Bank has agreed to maintain average collected cash balances with various commercial banks in consideration for certain services. These arrangements are informal and there are no legal restrictions as to the withdrawal of funds. The average compensating balances were approximately $7,950,000 for the year ended December 31, 1981, and $7,050,000 for the year ended December 31, 1980.

Pass-through Deposit Reserves:

The Depository Institutions Deregulation and Monetary Control Act of 1980 authorizes FHLBanks to act as pass-through correspondents for member institutions required to deposit reserves with the Federal Reserve. The amount shown as cash includes $71,000 for year ended December 31, 1981 of pass-through reserves deposited with Federal Reserve offices. Member deposit reserves are included under Demand Deposits.

Note 3 — Investments:

A comparison of book and estimated market values at December 31, follows:

	1981	
	Book value	Market value
	(in thousands)	
U.S. Treasury obligations	$ 92,830	$ 88,122
U.S. Government agencies	20,000	18,662
Federal funds sold	568,000	568,000
Term funds sold	10,000	10,000
Banker's acceptances	49,055	48,950
Certificates of deposit	55,115	54,992
Securities held under resale agreement	52,000	52,000
Participation in the FHLBanks' Consolidated Securities Fund*	228,761	228,345
	$1,075,761	$1,069,071

	1980	
	Book value	Market value
	(in thousands)	
U.S. Treasury obligations	$ 83,585	$ 77,797
U.S. Government agencies	20,000	18,337
Federal funds sold	249,000	249,000
Securities held under resale agreement	80,000	80,000
Participation in the FHLBanks' Consolidated Securities Fund*	94,193	93,515
	$ 526,778	$ 518,649

*The FHLBanks' Consolidated Securities Fund (Fund) was established by the Bank Board to offer a centralized portfolio management system for securities owned by FHLBanks. The Fund is managed by the Office of Finance of the FHLBanks and invests primarily in short-term money market instruments.

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Note 4 — Advances to Members:

At December 31, 1981 and 1980 the Bank had advances outstanding to members at interest rates ranging from 7.50% to 17.95% and from 6.25% to 20.25%, respectively, as summarized below

December 31, 1981			December 31, 1980		
Year of maturity	Amount (in thousands)	Weighted average interest rate	Year of maturity	Amount (in thousands)	Weighted average interest rate
1982	$3,215,290	13.39%	1981	$1,878,178	14.45%
1983	1,257,919	12.08	1982	1,131,342	9.68
1984	913,878	11.93	1983	802,974	10.20
1985	324,601	12.07	1984	467,826	9.91
1986	257,526	14.22	1985	255,923	11.45
	$5,969,214	12.85%		$4,536,243	11.87%

Outstanding advances aggregating $5,969,214,000 at December 31, 1981 and $4,536,243,000 at December 31, 1980, were collateralized by pledged investment securities and first mortgage loans. The capital stock of the Bank owned by borrowing members is also pledged as additional collateral for outstanding advances. Bank system regulations permit a borrowing member to physically retain collateral assigned to the Bank and, in such circumstances, the member executes a written security agreement which describes the type of collateral and agrees to hold such collateral for the benefit of and subject to the direction and control of the Bank.

The Bank is participating in the Community Investment Fund, a five-year advance program initiated in June of 1978. The program provides funds to members meeting eligibility criteria for active involvement in preserving and revitalizing older communities. At December 31, 1981 advances of $625,162,300 were outstanding under this program with an average maturity of 1.3 years at rates ranging from 7.90% to 16.00%. At December 31, 1980 advances totaling $525,780,000 were outstanding with an average maturity of 2.2 years at rates ranging from 7.85% to 13.85%. These rates are ½ of 1 percent below the estimated cost of issuing consolidated obligations of comparable maturities at the time the commitments to advance funds were made. If consolidated obligations had actually been issued at the time the commitments to advance funds were made, the net interest cost of this program would have amounted to approximately $2,901,000 for 1981 and $2,062,000 for 1980.

Note 5 — Loans Guaranteed by the Agency for International Development:

The Agency for International Development (AID) was established by the Foreign Assistance Act of 1961, as amended. Under Sections 221 and 222 of the Act, AID issues guarantees backed by the full faith and credit of the United States of America to eligible U.S. investors insuring against loss of investments, including unpaid accrued interest, in self-liquidating housing projects. The Bank qualifies as an eligible investor.

Under contracts of guaranty, the Bank may, without the approval of AID, sell participating interest to members of any FHLBank. The outstanding loan balances, which mature between 1991 and 2008, are reported net of participations sold totaling $265,924,000 at December 31, 1981 and $269,452,000 at December 31, 1980.

Note 6 — Loans to Other Federal Home Loan Banks:

The Bank made two long-term loans to the Federal Home Loan Bank of Indianapolis on July 25, 1980. One loan for $25 million bears interest at 9.55% per annum, payable quarterly, and is due on July 25, 1984. The second loan for $25 million bears interest at 9.82% per annum, payable quarterly, and is due on August 26, 1985.

Note 7 — Investment in Federal Home Loan Mortgage Corporation:

The investment in the Mortgage Corporation is stated at cost and consists of 11,700 shares of nonvoting capital stock and a $5,850,000 subordinated capital debenture, due June 20, 1987. The shares of capital stock represent 11.7% of the capital stock outstanding, and had an underlying book value of approximately $29,200,000 and $25,883,000 at December 31, 1981 and 1980, respectively. On June 20, 1980, the Mortgage Corporation paid a $5,850,000 dividend to the Bank on its investment in the Mortgage Corporation capital stock in the form of a subordinated capital debenture of the same amount. The subordinated capital debenture issued on June 20, 1980, bears an interest rate of 11.50 percent per annum, payable semiannually, may not be sold, transferred, exchanged or pledged without the express written consent of the Mortgage Corporation, is subordinated in right of payment to the prior payment in full of all other obligations and indebtedness of the Mortgage Corporation, and may be redeemed in whole or in part on or after June 20, 1985 at specified redemption prices at the option of the Mortgage Corporation.

Note 8 — Consolidated Obligations:

Consolidated Federal Home Loan Bank Obligations are the joint and several obligations of all FHLBanks (see "Organization and related agencies" above). The outstanding obligations of the FHLBanks, including the pass-throughs to the Mortgage Corporation (see Note 1), were $57,569,282,000 and $41,012,396,000 at December 31, 1981 and 1980, respectively.

Regulations require the FHLBanks to maintain, in the aggregate, unpledged qualifying assets in an amount equal to the consolidated obligations outstanding. "Qualifying assets" are defined as cash, obligations of or fully guaranteed by the United States, secured advances, and federally insured or guaranteed mortgages. The FHLBanks were in compliance with this requirement at December 31, 1981 and 1980.

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The following is a summary of the Bank's participation in consolidated obligations at December 31:

December 31, 1981

Bonds				Discount notes	
Years of maturity	Range of coupon rates	Weighted average interest rate	Outstanding	Book value	Par value
			(in thousands)	(in thousands)	
1982	7 45-17 05%	13 61%	$1,745,000	$944,902	$990,250
1983	9 00-15 55	12 56	872,000	Due within one year	
1984	9 05-16 40	13 94	1,052,000		
1985	8 10-14 55	12 77	224,000		
1986	9 55-16 40	14 80	480,000		
1987	7 60-10 45	8 25	53,000		
			$4,426,000		

December 31, 1980

Bonds				Discount notes	
Years of maturity	Range of coupon rates	Weighted average interest rate	Outstanding	Book value	Par value
			(in thousands)	(in thousands)	
1981	6 60-15 80%	12 18%	$1,002,000	$582,709	$601,350
1982	7 45-13 10	10 62	807,000	Due within one year	
1983	9 00-14 05	11 09	504,000		
1984	9 05-11 75	10 47	289,000		
1985	8 10-12 80	11 87	146,000		
1986-1987	7 60-11 30	10 00	133,000		
			$2,881,000		

The Bank's participation, as shown above, is reported net of advances to the Mortgage Corporation in the form of pass-throughs of the proceeds of certain consolidated obligations totaling $3,380,000,000 and $3,640,000,000 at December 31, 1981 and 1980 respectively (See Notes 1 and 13). These advances are evidenced by notes receivable from the Mortgage Corporation. The following are summaries of these pass-throughs at December 31:

December 31, 1981

Bonds			
Years of maturity	Range of coupon rates	Weighted average interest rate	Outstanding
			(in thousands)
1982	8 63-11 90%	10 62%	$ 490,000
1983	9 30-14 05	11 87	600,000
1984	8 75-13 85	10 37	500,000
1985	7 38- 9 35	8 27	640,000
1986	9 55-11 30	9 90	250,000
1987-1997	7 38-11 10	8 37	900,000
			$3,380,000

December 31, 1980

Bonds			
Years of maturity	Range of coupon rates	Weighted average interest rate	Outstanding
			(in thousands)
1981	8 65%	8 65%	$ 360,000
1982	8 62-11 90	10 62	490,000
1983	9 30-14 05	11 87	600,000
1984	8 75-11 75	9 50	400,000
1985	7 37- 9 35	8 27	640,000
1986-1997	7 37-11 30	8 70	1,150,000
			$3,640,000

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Note 9 — Borrowings from the U.S. Treasury:

Section 11(i) of the Federal Home Loan Bank Act authorizes the Secretary of the Treasury, at his discretion, to extend credit to the FHLBanks aggregating not more than $4,000,000,000, the terms, conditions, and interest rate to be determined by the Secretary of the Treasury There were no outstanding borrowings from the U S Treasury as of December 31, 1981 or December 31, 1980

Note 10 — Capital:

The capital stock of the Bank has a par value of $100 per share Capital stock held by members in excess of their statutory requirements may be redeemed at par value by the Bank or sold to other Bank members at par value provided the resulting stock transfer is recorded on the books of the Bank

Retained earnings of the Bank consist of undivided profits, a legal reserve, and a dividend stabilization reserve The Bank must transfer 20% of its net income to the legal reserve semiannually until the reserve equals the capital stock amount. Thereafter, 5% of the Bank's net income must be allocated for this purpose

In 1980, the Bank Board authorized the Banks to pay a semiannual dividend for the period ending June 30, and quarterly dividends for the remainder of the year. Dividends are paid out of current year's net income and the dividend stabilization reserve. In 1980, the Bank Board permitted the Banks to utilize up to one-half of undivided profits as of December 31, 1979 for the payment of dividends In 1980 and 1981 the bank had set aside one-half of the Undivided Profits at December 31, 1979 which may not be used for dividends Under this requirement the December 31, 1980 and 1981 Undivided Profits balance of $11,513,000 is unavailable for dividends without prior approval of the Bank Board For 1981, dividends were permitted only to the extent of current year's net income and the dividend stabilization reserve and were authorized to be paid either annually or semiannually Dividends may be paid in the form of capital stock if authorized by the Board of Directors

Note 11 — Employee Retirement Plan:

The Bank is a participant in the Savings Associations Retirement Fund (SARF), and substantially all of its officers and employees are covered by the Plan. The Bank's contributions are determined by SARF and generally represent the normal cost of the Plan (unfunded prior service costs are not significant). Pension costs charged to other operating expenses were $320,074 in 1981 and $338,000 in 1980, which includes amortization of past service cost over ten years. The Bank's policy is to fund pension costs as accrued. SARF does not segregate the assets, liabilities, or costs by participating employer. According to the SARF administrators, as of June 30, 1981, the date of the latest actuarial valuation, the value of the assets of the fund exceeded the liability for the present value of accrued benefits

Note 12 — Commitments:

Rental expense of $728,000 in 1981 and $608,000 in 1980 for premises and equipment has been charged to other operating expense Future minimum rentals are as follows

	Premises	Equipment	Total
1982	$ 507,000	$330,000	$ 837,000
1983	507,000	137,000	644,000
1984	466,000	137,000	603,000
1985	378,000	137,000	515,000
1986-1995	3,301,000	183,000	3,484,000
Total	$5,159,000	$924,000	$6,083,000

The lease agreement for the Bank's premises provides for increases in the basic rentals resulting from increased property taxes and maintenance expense

Commitments for advances to members totaled $218,143,000 at December 31, 1981 and $232,503,000 at December 31, 1980 At December 31, 1981 and 1980 there were no commitments to foreign borrowers for AID guaranteed loans

Note 13 — Contingencies:

As provided for in Section 306(c) of the Federal Home Loan Mortgage Act, the Bank Board has provided for the guarantee by the FHLBanks of certain borrowings of the Mortgage Corporation from the FHLBanks of New York and Atlanta Each of the FHLBanks participates in the guarantee in proportion to its investments in the capital stock of the Mortgage Corporation (see Note 7) At December 31, 1981 the FHLBanks have guaranteed $3,438,300,000 of the Mortgage Corporation's borrowings from the FHLBanks of New York and Atlanta, in the form of pass-throughs of the proceeds of certain consolidated obligations

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Price Waterhouse

153 EAST 53RD STREET
NEW YORK, N Y 10022
212-371-2000

February 25, 1982

To the Federal Home Loan Bank Board
Washington, D.C.

In our opinion, the accompanying statements of condition and the related statements of income, capital accounts and changes in financial position present fairly the financial position of the Federal Home Loan Bank of New York at December 31, 1981 and 1980, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Price Waterhouse

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Chairman MINISH. Thank you, Mr. Fernandez.
Mr. Rexach.

STATEMENT OF FRANCISCO M. REXACH, JR., PRESIDENT, PUERTO RICO MANUFACTURERS ASSOCIATION

Mr. REXACH. Thank you, Mr. Chairman.

Good afternoon. My name is Francisco Rexach. I am the president of the Puerto Rico Manufacturers Association.

With me are Mr. Hector Jimenez Juarbe, executive vice president, and Mr. Wilfredo Miguez, chairman of our taxation committee.

The Puerto Rico Manufacturers Association, with offices at 420 Ponce de Leon Avenue, Penthouse, Hato Rey, P.R., is a voluntary, nonprofit organization established more than 50 years ago with a membership of over 1,000 companies, 70 percent of which are manufacturing firms.

The Puerto Rico Manufacturers Association appears before this body to express its view on the effectiveness of section 936.

We will also comment on various criticisms heard about section 936 from evaluations made to this system of taxation by Federal bodies, in particular the U.S. Treasury Department.

It is our contention that section 936 is working well for Puerto Rico and the United States. A survey of economic indicators for the period through which Puerto Rico has been covered by the PCL demonstrates that an economic miracle has taken place on this Caribbean Island.

During the past 30 years, Puerto Rico has ceased to be the poorhouse of the Caribbean to become one of the most socioeconomically advanced communities in the area.

In fact, more so than many other Central and South American countries.

This event has been possible because of the Federal and insular complementary systems of taxation that have turned our once agricultural economy into a developing industrial one, where manufacturing has a leading position and impact on all aspects of the Puerto Rican community.

Approximately half of the island net per capita income and gross national product comes from manufacturing activities.

The quality of human capital in Puerto Rico has been greatly enhanced by the positive impact that section 936 corporations have had on the island. High skills, extraordinary productivity, sound working environments, and creative human interaction are character traits that can be directly traced to the industrial and economic revolution that has taken place here.

Impact of the possessions corporations law on Puerto Rico:

The island industrial development program started in 1948 with what has been known as "Operation Bootstrap." Efforts by the Economic Development Administration, coupled with a combined system of taxation of the United States and Puerto Rico law, have made it possible for our economy to change from an agricultural to an industrial one in 30 short years.

Many economic observers, including the U.S. Treasury Department, have labeled such a success "an economic miracle."

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The PCL system has indeed worked very well for Puerto Rico and the United States. Consider these developments:

First, gross national product for the island has grown from $1.3 billion in 1948 to double in 1960, to $5.1 billion in 1979 to $7.3 billion in 1980. Our GNP has grown six-fold in 30 short years, an economic miracle indeed.

Second, today Puerto Rico has approximately 2,600 manufacturing plants. Forty-seven percent of the island net income is generated by manufacturing operations on the island.

Third, per capita income has risen from $600 in 1948 to $2,867 in 1982. Family income today in Puerto Rico is $13,406 or 11 times what it was when Operation Bootstrap started.

Fourth, Puerto Rico, on a per capita basis, is the United States' fifth largest world customer. In 1982 exports from maufacturing plants in Puerto Rico generated $8,795 million of sales, while the island imported $8,364 millions thus achieving, through manufacturing, a favorable balance of payment. In addition, in 1981 Puerto Rico exported $1,003,320,214 worth of products to foreign countries, thus contributing significantly to the U.S. balance of payments. In 1982 Puerto Rico exported to foreign countries more dollar value in goods than 15 of the Nation's 50 States.

Fifth, as of July of 1982, section 936 corporations had $7,047 million deposited in Puerto Rico accounting for 40 percent if the island's total bank deposits and contributing to the island's economy by being invested as follows: Commercial loans, $3,164.5 million; mortgage loans, $1,110.5 million; construction loans, $238.5 million; loans to P.R. Government, $1,714.7 million and other eligible activities, $819.6 million.

Sixth, in 1978 the Puerto Rico Industrial Incentives Law was amended to provide for exempted industries to start paying minimum insular taxes in addition to tollgate tax requirements. To date those companies have contributed $483.7 million to the Puerto Rico Treasury by way of $4,164 million of corporate income tax and $319.7 of tollgate tax, a substantial and much needed income to the Puerto Rico Treasury.

Seventh, section 936 corporations in Puerto Rico employ 66,288 persons directly, have an investment in plant and equipment of approximately $650.9 million and generate an annual payroll of $312.8 million. It is estimated that in addition 936 activity generates another two employees for every one it employs directly, so it contributes to another 132,576 jobs in the island.

Eighth, in 1980 Puerto Rico purchased from the United States $4,757.9 million from sources in all 50 States of the Union. It is estimated that said purchases generated that year 151,289 jobs in the United States per se. A substantial volume of said purchases is done by section 936 corporations operating on the island.

Ninth, section 936 is the backbone of Puerto Rico's efforts to develop socioeconomically through the creation of job opportunities. Today manufacturing represents 44 percent of the island's gross product and 20 percent, or 153,000 jobs, of Puerto Rico's total employment. Manufacturing payroll, approximately $1 billion, is double what it was 5 years ago; 94 percent of middle and upper middle management is in the hands of Puerto Ricans as opposed to 22 percent 10 years ago. Fifty-one percent of the $5.7 billion im-

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ported from the United States in 1981 was for the purchase of materials, supplies and accessories by the manufacturing sector. This represents approximately $3 billion worth of net income for the mainland.

Tenth, the Government Development Bank receives approximately $734 million in deposits under the existing section 936 regulations at lower than prime rates thus making it possible for that institution to finance industrial development programs in Puerto Rico at lower costs. During the period of 1979–81, when interest rates in the Nation were skyrocketing, banks in Puerto Rico were able to finance preferred risk customers at lower than prime rates and/or prime rates, thus generating a much needed economic activity. Many local capital companies were able to benefit because of this pass-through low interest costs. We could go on and on illustrating how much section 936 corporations have done for the benefit of Puerto Rico as a whole and the United States in particular. When originally created in 1921, the PCL was intended to give an edge to American companies in world competition. That is still the case and is very important, particularly in the light of recent international trade developments.

The 10 points previously raised touch on measurable economic criteria or parameters. There are still many other benefits which are derived by Puerto Rico and the United States because of section 936, which are more subtle in nature or that have to be quantified by a detailed and comprehensive socioeconomic study.

One must, nevertheless, point out several interesting sources of additional reciprocal benefits to Puerto Rico and the United States.

Consider such aspects as: Social Security payments made by the Puerto Rican workers; improved quality of life resulting from section 936 operations here; contributions made by section 936 corporations for education, health, charity, the arts; the multiplier effect that a multibillion dollar relationship between Puerto Rico and the United States have on both economies; the foregone costs to the United States that would have been incurred in the event of a massive migration of Puerto Rican-U.S. citizens had the section 936 program not been enacted and sustained.

Events that have taken place in the United States in recent years have, without that being the purpose, affected aversely the full development of section 936 in Puerto Rico. A fact recognized by the U.S. Treasury Department is that the decline in investment and growth in the potential employment under section 936 has been thwarted by the decline in the U.S. economic activity, the modifications made to the U.S. minimum wage laws, with which Puerto Rico must comply, and the long-term effect that the Kennedy round of tariff reductions had in developing countries that were able to penetrate the U.S. market and compete successfully with Puerto Rican-produced goods.

Critics of the effectiveness of section 936 for Puerto Rico and the United States incur in various misjudgments and inadequacies that when examined in depth fail to support their hypothesis. Inherent weaknesses in methodology and spectrum of study render invalid conclusions arrived at.

Basic flaws to be found in the analysis made by critics of section 936 are:

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First, estimates as to taxes that would have been collected in the absence of section 936 erroneously presume that said operations would have been (*a*) carried out anyhow, (*b*) be as successful as they have been in Puerto Rico.

Second, benefits estimated under section 936 are limited in scope of analysis to the creation of direct employment. No consideration is given to downstream Puerto Rican capital investment and employment, nor the indirect employment that section 936 corporations operating in Puerto Rico generates on the island and mainland U.S.A.

Third, shortcomings in the analysis also stem from incorrect presumptions as to similarities, but not exactness of U.S. tax laws and Puerto Rican tax laws.

Fourth, no credit is given to the multiplier effect that section 936 corporations have on economic activity of the island and the United States. Of particular significance is the effect that section 936 corporations have in the trade between Puerto Rico and the United States, as well as the contribution that section 936 corporations is making to the U.S. international balance of trade.

Fifth, the time span covered by analysts of section 936 is (*a*) too small to be statistically significant, (*b*) covers a period of economic contraction of the United States and world economies. At the same time, the cost of investment during the period reflects interest rates at historical highs and energy costs at unprecedented high levels. Both factors bear significantly and negatively on the mind of the American investor.

Sixth, critics of section 936 fail to recognize that Puerto Rico's economy is an integral and very important part of the U.S. economy. Thus the Puerto Rican economy cannot be treated as being totally independent from that of the United States, nor does the Puerto Rican Government have full control over all economic developments of Puerto Rico.

It has been amply recognized by economic analysts in Puerto Rico and even at the U.S. Treasury Department that forces beyond Puerto Rico's control have impacted negatively the island attraction for investment.

Significant among these factors are: U.S. recession of 1974–75; structural changes in the world economy; negative impact that the Kennedy round of tariff reductions had for Puerto Rico by allowing foreign countries to penetrate U.S. market and compete successfully with Puerto Rican-produced goods.

Finally, the mere tampering with section 936 creates uncertainty and has discouraged decisionmakers to proceed with investment projects pending the outcome of section 936 legislation this summer, thus adversely affecting Puerto Rico's ability to create jobs through more industrial development. Amendments to section 936 this summer will further limit the island's capabilities to attract investment.

While the new legislation will put an end to some speculation and uncertainty, there still remains the area of the new regulations to be coped with.

We strongly suggest and encourage all lawmakers and decisionmakers in Washington to let section 936 alone for at least 10 years,

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so that it can continue to do, unhampered, its job for the benefit of Puerto Rico and the United States.

Thank you.

[The prepared statement of Mr. Rexach on behalf of the Puerto Rico Manufacturers Association follows:]

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STATEMENT OF THE
PUERTO RICO MANUFACTURERS ASSOCIATION

December 15, 1982

I. INTRODUCTION

My name is Francisco M. Rexach, Jr. I am the President of the Puerto Rico Manufacturers Association. With me today are Mr. Héctor Jiménez Juarbe, Executive Vice President and Mr. Wilfredo Miguez, Chairman of our Taxation Committee.

The Puerto Rico Manufacturers Association (PRMA), with offices at 420 Ponce de León Avenue, Penthouse, Hato Rey, Puerto Rico, is a voluntary, non-profit organization, established more than fifty years ago, whose objectives are:

a. Unite all manufacturers into a strong and effective organization for the furtherance of their mutual interests as they relate to the public and private domains of the Commonwealth of Puerto Rico and the United States.

b. Cooperate with the Government of the Commonwealth of Puerto Rico in the development and advancement of programs desgined to improve the economy of Puerto Rico and all its citizens and, in particular, those programs which contribute to the improvement of the climate for industrial growth.

c. Serve as a clearinghouse for the interchange of ideas and the dissemination of information related to the mutual interests of its members.

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At this moment, PRMA has around 1,050 member companies of which 70% are engaged directly in manufacturing. The balance 30% are service and commercial companies interested in our industrial development.

II. BACKGROUND ON SECTION 936

In 1975 and 1976, Congress considered a series of proposals to change Federal taxation of income from exporting and foreign investment. At first, it contemplated repeal of Section 931, which exempted from Federal taxation the income of companies incorporated in the United States but operating primarily in Puerto Rico, American Samoa, Guam and the Panamá Canal Zone; Congress instead passed a new Section 936. The new Section was intented to maintain tax incentives for investments in Puerto Rico and the possessions and to encourage United States companies to bring money home to the United States if it could not be profitably reinvested in the local economy.

The U. S. Treasury Department has, in recent times, issued various reports on the operation and effect of the possessions corporation system of taxation. Some of those reports, in our opinion, have been somewhat limited as to fully measuring the impact that previously 931 and currently 936 corporations have had in Puerto Rico socio-economic well-being. It is therefore necessary to examine, in a broad scope, developments in Puerto Rico during the period that the 931-936 system of taxation has been in effect to fully appreciate the favorable impact this has had for Puerto Rico as a whole. It is our contention that the system has worked well and will continue to be the backbone of Puerto Rico's industrial revolution and socio-economic progress.

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III. IMPACT OF THE POSSESSION CORPORATIONS LAW (PLC) ON PUERTO RICO

The island industrial development program started in 1948 with what has been known on "Operational Bootstrap." Efforts by the Economic Development Administration coupled with a combined system of taxation of U. S. and Puerto Rico law have made it possible for our economy to change from an agricultural to an industrial one in 30 short years. Many economic observers, including the U. S. Treasury Department, have labelled such a success "an economic miracle." The PCL system has indeed worked very well for Puerto Rico and the U.S. Consider these developments:

1. Gross National Product for the island has grown from $1.3 billion in 1948 to double in 1960, to $5.1 billion in 1979 to $7.3 billion in 1980. Ouur GNP has grown six fold in 30 short years: an economic miracle indeed (See Exhibit I).

2. Today Puerto Rico has approximately 2,600 manufacturing plants. Forty-seven per cent (47%) of the island net income is generated by manufacturing operations on the island.

3. Per capita income has risen from $600.00 in 1948 to $2,867 in 1982. Family income today in Puerto Rico is $13,406 or 11 times what it was when Operation Bootstrap started.

4. Puerto Rico, on a per capita basis, is the United States' fifth largest world customer. In 1982, exports from manufacturing plants in Puerto Rico generated $8,795 million of sales, while the island imported $8,364 millions thus achieving (through manufacturing) a favorable balance of payment. In addition, in 1981

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Puerto Rico exported $1,003,320,214 worth of products to foreign countries, thus contributing significantly to the U. S. balance of payment. In 1982 Puerto Rico exported to foreign countries more dollar value in goods than 15 of the nations 50 states.

5. As of July of 1982, 936 corporations had $7,047 millions deposited in Puerto Rico accounting for 40% of the islands total bank deposits and contributing to the island's economy by being invested as follows:

Commercial loans	$3,164.5 million
Mortgage loans	1,110.5 million
Construction loans	238.5 million
Loans to P. R. Government	1,714.7 million
Other eligible activities	819.6 million

6. In 1978 the Puerto Rico Industrial Incentives Lawwas amended to provide for exempted industries to start paying minimum insular taxes in addition to toll-gate tax requirements. To date, those companies have contributed $483.7 million to the P. R. Treasury by way of $164 million of corporate income tax and $319.7 of toll-gate tax, a substantial and much needed income to the Puerto Rico Treasury.

7. 936 corporation in Puerto Rico employ 66,288 persons directly, have an investment in plant and equipment of approximately $650.9 million and generate an annual payroll of $312.8 million. It is estimated that in addition 936 activity generates another 2 employees for every one it employes directly, so it contributes to another 132,576 jobs in the island.

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8. In 1980 Puerto Rico purchased from the United States $4,757.9 million from sources in all 50 states of the Union. It is estimated that said pruchases generated that year 151,289 jobs in the United States per se. A substantial volume of said purchases is done by 936 corporations operating on the island (See Exhibit II).

9. Section 936 is the backbone of Puerto Rico's efforts to develop socio-economically through the creation of job opportunities. Today manufacturing represents 44% of the islands gross product and 20% (153,000 jobs) of Puerto Rico's total employment. Manufacturing payroll, approximately one billion dollars, is double of what it was five (5) years ago. Ninety-four per cent (94%) of middle and upper middle management is in the hands of Puerto Ricans as opposed to 22% ten years ago. Fifty-one per cent (51%) of the $5.7 billion imported from the U.S. in 1981 was for the purchase of materials, supplies and accessories by the manufacturing sector. This represents approximately 3 billion dollars worth of net income for the mainland.

10. The Government Development Bank receives approximately $734 million in deposits under the existing 936 regulations at lower than prime rates thus making it possible for that institution to finance industrial development programs in Puerto Rico at lower costs. During the period of 1979-1981, when interest rates in the nation were sky rocketing, banks in Puerto Rico were able to finance preferred risk customers at lower-than-prime rates and/or prime rates thus generating a much needed economic activity. Many local-capital companies were able to benefit because of this pass-through low interest costs.

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We could go on and on illustrating how much 936 corporations have done for the benefit of Puerto Rico as a whole and the United States, in particular. When originally created in 1921, the PCL was interded to give an edge to American companies in world competition. That is still the case and is very important, particularly in the light of recent international trade developments.

The ten points preciously raised touch on measurable economic criteria or parameters. There are still many other benefits which are derived by Puerto Rico and the United States, because of Section 936, which are more suttle in nature or that have to be guatified by a detailed and comprehensive socio-economic study.

One must, nevertheless, point out several interesting sources of additional reciprocal benefits to Puerto Rico and the United States. Consider such aspects as: Social Security payments made by the Puerto Rican workers; improved quality of life resulting form 936 operations here; contributions made by 936 corporations for education, health, charity, the arts; the multiplier effect that a multibillion dollar relationship between Puerto Rico and the United States have on both economies; the foregone costs to the United States that would have been incurred in the event of a massive migration of Puerto Rican-U.S. Citizens had the 936 program not been enacted and sustained.

Finally, events that have taken place in the United States in recent years have, without that being the purpose, affected adversedly the full development of Section 936 in Puerto Rico. A fact recognized by the U. S. Treasury Department is that the decline in investment and growth in the potential employment under Section 936 has been thwarted by the decline

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in the United States' economic activity, the modifications made to the U. S. minimum wage laws (with which Puerto Rico must comply) and the long-term effect that the Kennedy round of tariff reductions had in developing countries that were able to penetrate the U. S. market and compete successfully with Puerto Rican - produced goods.

IV. CRITICISM OF SECTION 936

In spite of the benefits and contributions that the 1976 amendments have brought to Puerto Rico, its standard of living and the economy, two major critiques are made of Section 936 system of taxation.

One is that it is too costly for the Federal Government as measured by the size of the tax expenditures it gives rise to because of the presumable revenue loss resulting from the exemptions of the possessions corporations from frederal taxes.

The other is that it does not provide benefits for the economic development of Puerto Rico, for it has not been conducive to productive investment and has not generated jobs and income.

The evaluations made so far of Section 936, as required by law, suffer from methodological and conceptual errors and need to be corrected in future assessment of the program. Thereby, the benefits of the program both to Puerto Rico and the U. S. will have been made clearer.

A. The Cost of Section 936

The cost of the Section 936 system of taxation is measured by the magnitude of the taxes that would have been collected by the Federal Treasury from the incomes of the corporations operating in Puerto Rico in the absence of the section's provisions. In many ways, this measurement leads to an

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overstatement, because of the errors it contains.

For one, such an estimation requires knowledge on what the tax collection would have been in the absence of Section 936. Yet, the measurement of the cost of a tax incentive program through the fiscal sacrifice it involves is very conjectural. It is measurement of foregone alternatives when one knows for sure what the alternatives would have been. Yet, these cannot be known for sure. It is not precisely known what the investments would be in the absence of the preferential tax provisions. What returns would have been available if the resources had been channelled otherwise is not known either. Moreover, it would be mistaken to estimate what the government would have done with the so-called "sacrificed" funds without answering the question as to what part of the revenue would in fact have been collected in the absence of the Section provisions. It would be erroneous to pretend to know that the possessions corporations would have maintained the same scale of operations and continued to locate in Puerto Rico even in the absence of the prevailing legal provisions.

Fiscal sacrifice data can at best be suggestive, but they are not sufficiently meaningful in isolation to measure cost. One should not reach definite conclusions from a rather static measurement of the presumable cost, specially when either the change in taxpayer behavior resulting from the removal of the preferential tax provisions or the simultaneous developments in the economy that affect investment decisions is not considered.

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Secondly, a static measure of cost ignores the wide benefits generated by the program and thereby overstates the magnitude of the tax expenditures. The lens used in viewing the benefits generated by Section 936 provisions is limited and narrow. Attention is focused strictly on the operation of the 936 corporations, therefore, on their profits, and therefore on their corporate tax liabilities. The assessment is confined to the narrow corporate profits area and totally fails to account for the interactions between this corporate sector and the rest of the Puerto Rican economy as well as for the impact on the United States economy. It neglects the indirect benefits generated by the location of these corporations' operations in our island. As a result, it focuses its attention solely on the tax liabilities of the corporate profits and ignores the taxes collected on the additional incomes generated.

First, there is the benefit to the United States economy from the location of possessions corporations in Puerto Rico. This is the income generated in the U. S. economy from the large shipments from the United States to Puerto Rico consisting of goods either to be processed in manufacturing operations on the island or for use in other sectors of the economy. The benefit is not insignificant for the direct and indirect income effects of such shipments on the US economy have been estimated to amount to $4.8 billion in fiscal year 1980. 1/ Surely, the Federal Government collects income and corporate taxes on these incomes, but these are not counted as part of US tax collections. Now,

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1/ Puerto Rico Business Review, Vol. 7, No. 6, June 1982.

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when costs are measured by taxes foregone, one must make sure that these must be net of any tax collections that are related to the activities whose tax cost is being assessed. if so, the tax expenditures will surely be much less.

Secondly, the matter, however, does not end there. There is another tax revenue generating benefit that cannot be ignored. And these are the wage and salary payments to workers employed by the 936 manufacturing corporations. These are subject to Commonwealth income taxes as much as profits of the 936 corporations are within the limits of the tax incentive program. Hence such collections need to be considered as a cost reducing factor in the assessment of the cost of the 936 program.

Additional computational shortcomings may arise for several reasons.

For one, the structure of the tax systems of Puerto Rico and the United States, although close, is not identical and the estimates will have to account for the differences. The US income taxation recognizes investment credits, liberalizes the period over which assets are depreciated, has tax leasing arrangements and allows depreciation charges to be accelerated. These are changes that were introduced over the past two decades and culminated with the Economic Recovery Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982. The U. S. provisions do not necessarily have their counterparts in the tax system of our island. The asset structure of our businesses differs form their counterparts in the Continent. The asset structure of the 936 corporations differs from that of their parent companies. Because of the design of our tax exemption program, building structures are leased rather than outright owned by the corporations. One should also take into account

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the behavioral change the taxpayer/investor will display when faced with a system which allows concentrating the depreciation charges in years when tax liability increases. Hence, what may appear to be a exceptionally high return on physical assets may in fact be the result of differential tax accounting provisions and bookkeeping rules.

To conclude, we believe the Treasury should adopt a much wider economic lens in attempting to estimate the monetary value of the presumable cost of the 936 program.

There is however, an additional point of extreme importance. The benefits of an economic policy package such as Section 936 cannot be measured solely by immediate monetary values. High technology investments, which have increased over the past decade contain significant advantages in that they enhance human skills and encourage human capital formation. There is a long-run benefit which cannot be squeezed into a limited short-run tax expenditure analysis. Moreover, high technology industries contain anti-cyclical elements. Had it not been for their existence, our island's GNP would not have grown at the rates that it has during the troubled seventies and would have declined by a much larger rate in the present recession. In fact, it is in these industries where employment has grown the fastest during the seventies. They have accounted for three out of four new jobs in manufacturing since 1968.

B. Does Not Provide Substantial Benefits to Puerto Rico

The argument has been made that Section 936 has had a virtually imperceptible impact on investment in plant and equipment, housing and inventories in Puerto Rico.

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There are several flaws in this argument, the main one being that the time period over which the program has been and is being assessed is much too short to pass any judgement on any investment behavior. Statistically speaking, the number of the observations are much too small to give any significantly valid result. The program was enacted in 1976, and therefore only three years of events are under scrutiny. Moreover, these are the years when the United States and the Puerto Rican economies were just beginning to recover from the recession caused by the dramatic increases in the oil and commodity prices. These are also the years when institutional adjustments were needed to be made in Puerto Rico to the new tax provisions; when the regulations on their implementation had to be issued, discussed and accepted; when, therefore, there was a great deal of uncertainty as to what the final outcome of the new tax program would imply for doing business in Puerto Rico. These were also the years when the interest rates began their uphill path.

Interpreted at face value, this argument presumes that when funds are available, one can immediately expect an upsurge in <u>real</u> investment. For real investment to take place, however, the marginal efficiency of the capital invested should at least be equal to or exceed the cost of borrowing or the present value of the income streams from the investment should exceed the cost. Yet during the three years of operation of Section 936, the economic situation in the world as a whole was one of increasing cost of borrowing, which implies that investments that would have been undertaken at lower borrowing costs could not be realized. The investment scene was further complicated by the beginnings of an

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inflationary development which started to reduce the real rates of return.

Table I indicates very clearly that, to begin with general economic conditions in fact all through the decade of the seventies were one of see-saw in nature and were plagued with continuous mini-recessions, both in the United States and in Puerto Rico. Although after 1977 there appeared to be a tendency towards recovery for a couple of years, a number of exogenous factors, specially a new upward jolt in oil prices pushed the economies into a recessionary tendency, from which we still as yet have not recovered. It would be absurd, therefore, to expect that given such conditions, there would be an expansion in investment.

TABLE I

Real Rates of Growth in GNP (1972 Prices)

Year a/	US Economy	PR Economy
1970	-0.30	6.00
1971	2.99	6.00
1972	5.74	4.60
1973	5.32	7.30
1974	-1.84	1.30
1975	-0.07	-2.00
1976	6.04	2.10
1977	4.55	4.50
1978	3.98	4.80
1979	7.02	5.90
1980	-0.16	2.30
1981	2.00	0.70
1982	-2.10 b/	-3.90

Source: US Department of Commerce. Survey of Current Business; P.R. Planning Board

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a/ US: calendar year; PR: fiscal year
b/ 1982.I with respect to 1981.I.

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Table 2 indicates the general tendency of the rate of growth in investment to decline in the United States since 1977, with the reserved exception of 1979.

TABLE 2

Gross Fixed Private Domestic Investment in the US

(1972 Prices)

	Total ($ bill.)	Rate of Growth (%)	Construction ($ bill.)	Rate of Growth (%)	Plant & Equipment ($ bill.)	Rate of Growth (%)
1970	150.4		82.3		67.9	
1971	160.2	6.5	92.9	12.9	67.3	- 0.1
1972	178.8	11.6	103.5	11.4	75.4	12.0
1973	191.4	7.1	104.2	0.7	87.1	15.5
1974	172.2	-10.0	86.1	-17.4	86.2	- 1.0
1975	151.5	-12.0	74.1	-13.9	77.7	- 9.9
1976	164.5	8.6	83.8	13.1	89.7	15.4
1977	187.4	13.9	96.5	15.2	91.0	10.1
1978	200.1	6.8	103.0	6.7	97.1	6.7
1979	222.5	11.2	105.6	2.5	116.8	20.3
1980	206.6	- 7.1	94.5	-10.5	112.0	- 4.1
1981	206.7	0.0	94.2	- 0.3	113.4	1.2
1982.I	201.4	- 2.6	89.0	- 5.5	112.4	- 0.9

Source: US Department of Commerce. Survey of Current Business

It is to be noted that in absolute terms, investment in buildings and structures was lower in the first quarter of 1982 than it was a decade ago in 1971. Therefore, given such an investment climate in the United States in the latter part of the seventies, one cannot expect a boom in investment in Puerto Rico, with or without Section 936 provisions. By and large the business community refrained from investing.

There are many reasons why investors refrain from taking risks. But one must be spelled out very clearly and that is the developments in the cost of money. Interest rates have continuously increased from 1977 onwards. Table 3 gives the changes since 1973 in four types of

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TABLE 3

US Interest Rates (%)

	3-Mo. Treasury Bills (new issues)	Commercial Paper (6 mo.)	Mortage Rate (New home purchases)	Discount Rate (NYFR)
1973	7.041	9.15	7.95	7.50
1974	7.886	9.84	8.92	7.75
1975	5.838	6.32	8.75	6.00
1976	4.989	5.35	8.76	5.25
1977	5.265	5.60	8.80	6.00
1978	7.221	7.99	9.30	9.50
1979	10.041	10.91	10.48	12.00
1980	11.506	12.29	12.25	12.87
1981	14.077	14.76	14.17	12.10
Jan.	14.724	15.10	12.80	13.00
Feb.	14.905	14.87	13.02	13.00
March	13.478	13.59	13.48	13.00
April	13.635	14.17	13.62	13.00
May	16.295	16.66	13.56	13.87
June	14.557	15.22	14.12	14.00
July	14.699	16.09	14.14	14.00
August	15.612	16.62	14.60	14.00
Sept.	14.951	15.93	14.69	14.00
Oct.	13.873	14.72	15.04	14.00
Nov.	11.269	11.96	15.68	13.00
Dec.	10.926	12.14	15.23	12.10
1982				
Jan	12.412	13.35	14.67	12.00
Feb.	13.780	14.27	14.44	12.00
March	12.493	13.47	14.93	12.00
April	12.821	13.64	15.13	12.00
May	12.148	13.02	15.11	12.00

Source: US Department of Commerce. Survey of Current Business

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interest rates. Accordingly, the discount rate more than doubled between 1977 and mid-1981: from 5% to 14%. The mortgage rate almost doubled during the same period: from 8.76% to 15.68%. In view of these extremely high and climbing cost of borrowing money, it is reasonable to expect that only limited investment will take place, simply because the returns to capital should exceed these rates, if it is to be profitable.

Section 936 would have been instrumental in channelling the funds to productive investment to Puerto Rico, if the climate for productive investment existed. If it did not exist in Puerto Rico, it was because it did not exist in any other place. No legal provision can channel a non-existing investment; therefore, it would be erroneous to conclude that, given the circumstances, Section 936 is ineffective.

In addition to the high cost of borrowing, inflationary pressures and negative economic growth in some years both in the United States and in Puerto Rico, one more factor needs to be spelled out which played a role specially at the early stage of the program's implementation. And that is the uncertainty stemming from the Federal and Puerto Rican regulatory decisions. Frequent adjustments to the rules governing the use of 936 funds, intercompany pricing issues and expectations with respect to possible stricter regulations affecting 936 corporations, the banks, and the brokers, naturally discouraged and postponed the demand for long-term commitments. In this environment, 936 treasurers preferred to wait and see the new rules and in the meantime concentrated the funds in the short term segment of the market. No responsible treasurer would behave otherwise.

At the expense of being repetitive, I would like to say once again that the time span over which the 936 tax program is being judged is much

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too short. One cannot expect that the learning process of the functioning of the 936 provisions, adjustments and investments could take place overnight.

I should like to stress yet another point, and that is that the elimination of Section 936 from the Internal Revenue Code will be extremely detrimental to Puerto Rico, but would also harm that of the United States. For it would be totally erroneous to think that the Puerto Rican economy is independent from that of the United States. This fact is overlooked when assessing the forward and backward linkages between manufacturing operations and the conclusion is reached that Section 936 is not sufficiently effective in fostering economic development.

The degree of integration that exists between Puerto Rico and the mainland economy, and the linkages between Puerto Rico as an integral region of the United States and the rest of the United States must not be overlooked. Given the small size of our island's economy, exports are a crucial variable in our economic development. They are our bloodline. We cannot imagine growth without exports. Given again the small size of our economy and our limited endowments with natural resources, our industrial production must naturally depend on imported inputs. We also depend on imports in areas other than industrial production. Now, given our common market status with the United States, our industrial production uses to a large extent materials that originate in the United States. We also import a not insubstantial amount of non-industrial inputs. 1/ In addition, our exports of industrial goods are largely

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1/ Imports of consumer goods from the United States were one-third of total imports in fiscal year 1980.

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geared to the mainland United States market. Hence, the inter-industry relationship between Puerto Rico and the United States cannot be ignored. 1/

When the two economies are so closely integrated in a way which makes Puerto Rico a region of the United States, it would be unacceptable to try to look for both downstream and upstream linkages necessarily in the same location, for some of the backward and the forward linkages of a particular industry will be found in fact in the mainland.

The criticism of the 936 operations for failure to generate linkages would be reasonable if Puerto Rico were a relatively closed economy of a very much larger size with abundant natural endowments and yet the linkages did not occur. But since Puerto Rico de facto is a small economic region of the United States, willy-nilly the linkages will take place in the other regions of the United States.

If the development policy in Puerto Rico were one of import substitution, it would have been reasonable to searche for linkages. We all know that the least in the first instance, import substitution appears to create some linkages which makes the politicians and the economists happy over the apparent crystallization of the relationships. However, we also know by now after twenty years of experience in Latin America and elsewhere, how detrimental such import substitution policies have been. Puerto Rico, very wisely, from the very moment of the inception of its economic policy program, adopted export promotion as the prime mover of

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1/ In fiscal year 1980 total shipments from US mainland to Puerto Rico amounted to $5.1 billion, which is 46.5% of the aggregate GNP of the island and 59.3% of total merchandise imports in that year. About one-fifth of these shipments were food products. But more important still, more than one-half consisted of producers' supplies and materials, which include materials to be incorporated and processed into manufactured products. See Puerto Rico Business Review, Vol. 7, No. 6, June 1982.

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its development. In a policy of this nature within an integrated region, it is inconceivable to expect that every single linkage will take place here on the island.

IV. CONCLUSIONS

A. Puerto Rico's economic indicators clearly point out that the PCL system of taxation has worked and that both the island and the U. S. economies have benefited significantly by it.

B. Criticism made as to the workings of Section 936 and assessments made thereof have understated benefits and overstated the costs. A wider lens of scope would yield a positive picture and would do away with the negative criticism directed to the program.

C. The judgement that Section 936 does not stimulate real investment is passed over a period when general economic conditions of recession and inflation accompanied with steadily rising interest rates have been detrimental to real investment in all the world. The period is much too short for an evaluation and it only corresponds to one phase, namely the downward phase, of the business cycle. At least equal time must be allowed for the upswing in the business cycle after further declines in the interest rates and general economic prosperity is resumed, if the stimulus effects of Section 936 are to be evaluated properly. Nothing could be more deterimental to evaluate a policy in the short run, when its fruits are expected to be reaped in the long run. Moreover, the security of the investors in the knowledge of a reasonable continuity of the program would create a more certain business climate and be conducive to attract investment.

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D. One must not lose sight of the fact that Puerto Rico is an integral region of the United States, in fact the least developed one as measured by per capita income, and expect the upstream and downstream effects of the 936 operations to occur within Puerto Rico itself. This totally ignores a very simple economic tenet that all linkages cannot take place within the national economy itself. If as result of Section 936 one job is created in Puerto Rico and two elsewhere in the United State, this does not show the ineffectiveness of Section 936. Quite the contrary, it proves its effectiveness.

In concluding and as a closing remark, I would like to say that the 1982 amendments and the uncertainty that they brought have reduced, although not eliminated, Puerto Rico's attraction as a location for investments. We have no doubt that they will affect our industrial promotion program and will make harder to bring new investments to Puerto Rico. Thus they have reduced our possibilities to create new jobs. As a matter of fact, they may affect jobs already created. Just an example:

The profit split method automatically guarantees 50% of the combined taxable income to the 936 corporations. This makes irrelevant the concept of corporate autonomy and functional analysis with the probable consequence that the corporations will reduce or eliminate the managerial employees from the Puerto Rican operations.

Thank you.

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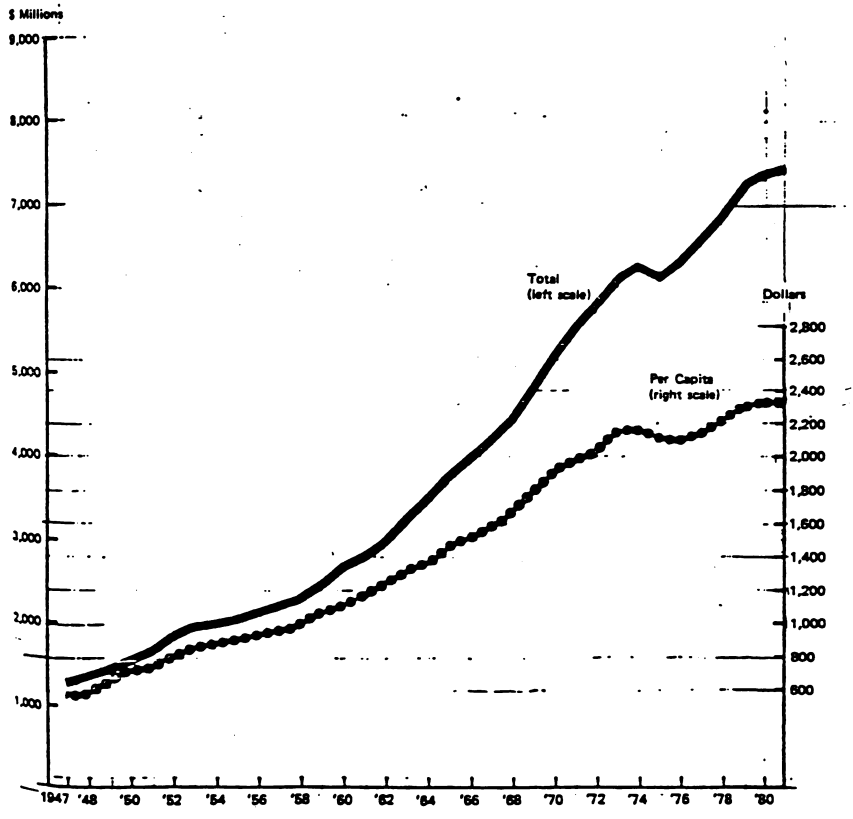
Total and Per Capita Gross National Product of Puerto Rico, 1947-1981 (Constant 1972 Dollars).



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ESTIMATED GROSS INCOME AND EMPLOYMENT GENERATED BY PUERTO RICO'S PURCHASES FROM THE UNITED STATES BY STATE, YEAR ENDING JUNE 30, 1980

State	Income ($ million)	Employment
United States Total	4,757.9	151,289
Alabama	86	3,071
Alaska	7	197
Arizona	31	1,195
Arkansas	56	2,179
California	418	12,875
Colorado	44	1,392
Connecticut	77	2,679
Delaware	14	393
District of Colombia	15	197
Florida	255	6,929
Georgia	106	4,070
Hawaii	11	303
Idaho	14	590
Illinois	257	8,124
Indiana	122	4,160
Iowa	67	2,768
Kansas	49	1,785
Kentucky	63	2,179
Louisiana	148	3,374
Maine	22	787
Maryland	124	3,071
Massachusetts	114	3,964
Michigan	176	5,250
Minnesota	76	2,769
Mississippi	42	1,785
Missouri	89	3,071
Montana	9	499
Nebraska	33	1,392
Nevada	7	303
New Hamsphire	15	590
New Jersey	172	4,554

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State	Income ($ million)	Employment
New Mexico	14	499
New York	486	12,678
North Carolina	147	6,142
North Dakota	11	590
Ohio	240	7,428
Oklahoma	47	1,483
Oregon	41	1,392
Pennsylvania	239	7,821
Rhode Island	19	787
South Carolina	100	3,873
South Dakota	11	393
Tennessee	92	3,373
Texas	282	8,321
Utah	17	590
Vermont	8	303
Virginia	84	2,769
Washington	63	1,876
West Virginia	28	893
Wisconsin	102	3,374
Wyoming	7	197

Note: Figures may not add to totals due to rounding.

Source: Puerto Rico Purchases from the United States,
Fiscal Year 1980
Economic Associates, Inc.
Washington, D. C.
December 1981

Planning Section
Economic Analysis Division
Office of Economic Research
March 29, 1982

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Chairman MINISH. Dr. Finn.

STATEMENT OF DR. BERTRAM P. FINN, CHAIRMAN, ECONOMIC ADVISORY COMMITTEE, PUERTO RICO CHAMBER OF COMMERCE

Dr. FINN. I am Bert Finn, chairman of the economic advisory committee for the Puerto Rico Chamber of Commerce.

On behalf of the chamber of commerce, its 41 affiliated associations, its more than 1,000 individual business members representing each and every sector of the Puerto Rican economy, and its president, I would like to thank this committee and its chairman for holding these important hearings.

The "Possessions System of Corporate Taxation," or section 936 of the U.S. Internal Revenue Code, as it is more generally known, has played a key role in Puerto Rico's economic development.

An understanding of the central nature of this provision in Puerto Rico's development over the past 35 years is needed by the members of this committee and by Federal authorities within the relevant agencies of the executive branch of our Government. Only with a recognition of the important role that this provision has played in the past can the true import of any tampering with this provision be appreciated.

Puerto Rico is a relatively small island, 35 miles wide by almost 100 miles long, located some 1,000 miles to the southeast of Miami, Fla.

Puerto Rico is blessed with a warm climate, beautiful beaches, and tropical foliage. Yet, Puerto Rico has no mineral resources that can sustain or serve as the raw materials supply for industry and Puerto Rico labors under the weight of one of the world's highest population density ratios—almost 900 people per square mile.

As recently as the late 1930's Puerto Rico was called the poorhouse of the Caribbean. There wasn't too much difference between life in Puerto Rico and life on the other neighboring Caribbean islands.

Puerto Rico's economy was based upon three principal agricultural crops: sugar, coffee, and tobacco.

Work was seasonal, and even when it could be obtained, it was poorly remunerated. The manifestations of poverty were readily seen: disease, undernourishment, unemployment, underemployment, hopelessness, and despair.

This is not a very pretty picture yet this was Puerto Rico not more than 40 years ago. What has happened in the interim to improve this situation and pull Puerto Rico from the very depths of poverty?

First and most importantly, Puerto Rico began a far-reaching industrialization program to diversity its economy from dependence upon the agricultural sector.

Second, the Federal Government began to extend many of its programs into the island.

Funds for training, education, health, and physical infrastructure were made available to the island's government.

The industrialization strategy centered upon: tax advantages to manufacturing firms; unimpeded access to the U.S. consumer

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market; a productive labor force; and a generally lower wage scale than prevailed on the mainland.

The predecessors of section 936 played a key role in making the tax incentives meaningful for U.S. investors.

Investors could effectively receive profits at the corporate level free of both Puerto Rican and U.S. corporate income tax. There can be no underestimating the importance of this incentive in Puerto Rico's growth.

Over the past 50 years Puerto Rico's economy has made great strides. The manufacturing sector has developed into the single strongest element in the private sector of our economy. The sector contributed over 150,000 jobs for Puerto Rican workers before the current recession and today still provides over 146,000 jobs, which on average pay our workers almost $5 per hour, not counting fringe benefits and other things, direct salary.

The basic manifestations of poverty have been significantly reduced. The well-being of the island's people has been dramatically improved.

Yet there is still a long way to go in our battle against poverty. The work is by no means complete. The per capita income in Puerto Rico is still only one-third that for the Nation as a whole.

Unemployment has always been higher than the national average by a factor of at least two. Today unemployment stands at almost 23 percent. There is still work to be done.

Puerto Rico must continue to create new jobs to reduce unemployment to more reasonable levels, and to provide more hope of a better future for the 1,000,000 youths now at various levels within our educational system.

The task of creating jobs and economic development has, over the past decade, become more difficult. Many factors beyond our control have contributed to the complexity of maintaining needed levels of economic growth in Puerto Rico:

First, higher crude oil prices during the decade radically changed the nature of the petrochemical industry. Puerto Rico's petrochemical sector was virtually destroyed during the adjustment and retrenchment process. High hopes for continued expansion of this sector came to an abrupt end.

Second, higher oil costs also led to higher transportation and energy costs. Puerto Rico's geographic position, far away from either the source of industrial raw materials or the final market for finished goods, became a greater penalty with rising transportation costs. Higher electricity costs—almost double those of some competing mainland locations—resulted from our system's almost total dependence on crude oil as its basic fuel source. These higher electricity costs reduced our ability to attract industries sensitive to energy costs.

Third, Foreign imports of labor-intensive goods into the U.S. market stunted the growth of these sectors in Puerto Rico. Imports increased because of basic foreign policy initiatives of the United States to reduce tariffs and encourage overseas direct investment, and from other policies such as environmental legislation that foreign producers did not have to contend with. The relative advantages of the foreign producers were sufficient to rule out further growth in the labor-intensive sectors of Puerto Rico. Indeed, we

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have actually been losing jobs gradually over the last 10 years in these areas.

These three factors have greatly complicated our ability to attract investment in depreciable assets and create new manufacturing employment. We have been faced with an evernarrowing spectrum of firms whose characteristics are compatible with a Puerto Rican plant location.

While our industrial investment and growth rates have declined from their higher levels during the 1960's, what growth has been achieved is due in large measure to two factors: First, the development of a skilled pool of available, productive workers; and second, the continued incentive offered by section 936 to mainland firms operating on the island.

Were it not for section 936 during this period, Puerto Rico would have been hard-pressed to attract what investment it did.

At the very time that these events made section 936 even more important for our economy, it has encountered serious difficulties at the Federal level.

For almost 2 years prior to last summer's legislative action on section 936, the U.S. Internal Revenue Service carried out an administrative program during tax audits that seriously challenged the incentive to operate a manufacturing firm in Puerto Rico.

The IRS contended that firms operating in Puerto Rico were simply contract manufacturing facilities for their parent corporation and were, therefore, only entitled to a cost-plus profit, which, as one would surmise, was considerably less than the firm had originally reported.

This program created a significant degree of uncertainty as to the actual benefits derived from Puerto Rican operations, and raised questions as to the longevity of the program as well.

Uncertainty is the enemy of business, and resulted in a reduced level of new manufacturing investment and job creation during this 2-year period. The uncertainty created by these actions further aggravated the already serious recession that was building in Puerto Rico.

I might also add that with uncertainty firms place a risk premium on any project.

The rate of return has to be higher with more risk or more uncertainty than it would without it. So the more the IRS moved in this direction, the higher the hurdle or threshold rate for the return that a project would have to provide in order for the project to be located to Puerto Rico.

This had the adverse effect of aggravating the tax costs for each job that was created in Puerto Rico.

The IRS was taking actions to deter something which in effect actually pushed firms in a direction which they really didn't want them to move.

During the course of the legislative process itself, beginning last July, Puerto Rico was denied the opportunity to be heard by either the House of Representatives or the Senate.

No public hearings were called, and no public forum was provided to analyze what has been proposed. Yet we were the ones who suffered.

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As soon as it became apparent that some legislative change would be made to section 936, all investment in the manufacturing sector came to a halt.

Business would not invest unless they knew the parameters of how they would be taxed. Some firms were able to simply postpone their investments, others decided to go ahead with their project, but in another location.

When the legislation finally emerged there was a sense of relief. Even though a Puerto Rican plant location would be less profitable for many firms, the general consensus was that it would still be profitable enough to continue attracting new investment to Puerto Rico.

However, even though the basic parameters of the new legislation may be clearer than under the prior section 936 legislation, the new provisions are incredibly complex. Many terms must be defined, and processes clarified before firms can actually determine how they are affected.

This will have to be accomplished through regulations.

While the regulations are being developed—and they are not expected to be developed until late spring or next summer—business will not move. This places Puerto Rico right back where it was last summer.

Uncertainty will continue to shut off the flow of new manufacturing investment until the regulations are published or until some guidance is provided to the firms.

Puerto Rico has simply traded one type of uncertainty for another type of uncertainty, but the net result is the same.

As complex as this situation is, letters and statements by senior legislative officials have contributed to clouding the situation even further. A recent letter from the chairman of the Senate Finance Committee, Senator Robert Dole, to the Governor of Puerto Rico and to the Secretary of the Treasury of the United States, has been interpreted by some to indicate the possibility of a legislative revisiting of section 936 in the next several years.

While this is just a possible interpretation, it nonetheless increases the level of uncertainty surrounding the longevity of the newly enacted provisions of section 936.

Before a firm will invest in Puerto Rico, it must know how the operation will be taxed, and for how many years it can look forward to that tax treatment.

If neither of these questions can be answered, at least with a reasonable degree of probability, the flow of investment will be greatly, if not completely reduced.

To the degree that these questions can be answered in a satisfactory manner, there will be a consequent increase in the investment flows to the island.

Today, as we sit here before you, we must report that Puerto Rico is effectively being denied the congressional intent of the revisions enacted last summer to section 936.

Congress enacted this legislation to encourage increased Puerto Rican employment and investment in depreciable property at as low a cost to the Treasury as possible.

Yet the degree of uncertainty regarding the actual benefits to be provided to individual firms under the new provisions and the ex-

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pected life of these provisions have effectively reduced the investment flows by section 936 firms to a bare minimum. Unless actions are taken quickly by responsible leaders in Congress and in the administration, this new provision may never have a chance to work.

The Puerto Rico Chamber of Commerce strongly recommends that the following actions be taken as quickly as possible to get the new section 936 provisions working:

First, there must be a clear, unequivocal statement by congressional leaders and by senior administration officials, even the President, that section 936 will not be changed or modified, further reducing the benefits offered to firms for a minimum period of 10 years.

Second, the time schedule for the issuance of the implementing regulations for the new section 936 provision should be accelerated. Realizing that the regulations will take a considerable amount of time to prepare under any circumstances, the Treasury should begin to issue questions and answers on critical issues as quickly as possible. The fact that nothing is now available has allowed firms to think the worst. The faster the Treasury can issue this guidance, the faster the concerns of business can be dispelled.

Third, over the past several years the U.S. Treasury's annual report on the operation and effect of the possessions corporation system of taxation has itself contributed to the uncertainty surrounding section 936. A major criticism of the report has been that it, itself, is an agent for change expressing a totally one-sided argument against section 936. The Government of Puerto Rico has repeatedly objected to many aspects and misconceptions contained in the report. Yet year after year the Treasury continues to utilize the same approach. If the Treasury will not change their approach, then at a minimum the reader of the report should be aware that there are objections and criticisms of the methodology in the report. The comments of the Government of Puerto Rico from their review of the Treasury's draft report should be incorporated in a prominent fashion within the annual report published by the U.S. Treasury.

Fourth, the accelerated cost recovery system and the investment tax credit available to domestic corporations should be extended to all corporations operating in Puerto Rico that make qualifying investments. These benefits provided to domestic corporations through the Economic Recovery Act of 1981, and then modified last summer in the Tax Equalization and Fiscal Responsibility Act of 1982, have reduced the relative advantages of investing in qualified depreciable assets in Puerto Rico.

That is one of the objectives in the change in section 936. Yet we have another piece of Federal legislation which reduces the incentive to do just that.

The administration attempted to right this situation by extending these benefits to U.S. section 936 firms operating in Puerto Rico as a part of the Caribbean Basin Initiative.

Unfortunately, this section was dropped from the legislation last week during the House Ways and Means Committee's markup of the bill.

We feel that these provisions are essential to equalize our relative attractiveness for new manufacturing investment to what it

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was prior to 1981. We urge that these provisions be extended to Puerto Rico as soon as possible, either as a separate piece of legislation or as a part of another bill now in the legislative process.

Mr. Chairman, we could continue our discussion on this vitally important issue for Puerto Rico's economic well-being.

Yet we realize that there are time constraints upon you. We thank you once again for this opportunity to express our views on section 936, and hope that we have been able to convey to you the critical importance that this provision plays in Puerto Rico's ability to evidence economic growth.

We will now be pleased to answer any questions that you or the members of this subcommittee may have on our presentation.

[The prepared statement of Dr. Finn on behalf of the Puerto Rico Chamber of Commerce and questions submitted to Dr. Finn by Congressman Robert Garcia subsequent to the hearing follow:]

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TESTIMONY OF THE PUERTO RICO CHAMBER OF COMMERCE ON
THE IMPACT OF SECTION 936 ON THE ECONOMY OF PUERTO RICO

MR. CHAIRMAN - Testimony for the Puerto Rico Chamber of Commerce will be presented by: Dr. Bertram P. Finn, Chairman of the Economic Advisory Committee of the Puerto Rico Chamber of Commerce.

On behalf of the Puerto Rico Chamber of Commerce, its 41 affiliated associations, it's more than 1,000 individual business members representing each and every sector of the Puerto Rican economy, and its President, Mr. José R. Colón, I would like to thank this Committee and its chairman for holding these important hearings. The "Possession's System of Corporate Taxation," or Section 936 of the United State's Internal Revenue code as it is more generally known, has played a key role in Puerto Rico's economic development. An understanding of the central nature of this provision in Puerto Rico's development over the past thirty five years is needed by the members of this Committee and by federal authorities within the relevant agencies of the executive branch of our government. Only with a recognition of the important role that this provision has played in the past, can the true import of any tampering with this provision be appreciated.

Puerto Rico is a relatively small island, thirty five miles wide by almost one hundred miles long, located some 1,000 miles to the southeast of Miami, Florida. Puerto Rico is blessed with a warm climate, beautiful

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beaches and tropical foliage. Yet, Puerto Rico has no mineral resources that can sustain or serve as the raw materials supply for industry. And Puerto Rico labors under the weight of one of the world's highest population density ratios - almost 900 people per square mile.

As recently as the late 1930's Puerto Rico was called the poorhouse of the Caribbean. There wasn't too much difference between life in Puerto Rico and life on the other neighboring Caribbean islands. Puerto Rico's economy was based upon three principal agricultural crops: sugar, coffee, and tobacco. Work was seasonal, and even when it could be obtained, it was poorly paid. The manifestations of poverty were readily seen: disease, undernourishment, unemployment, under employment, hopelessness, and dispair.

This is not a very pretty picture, yet, this was Puerto Rico not more than forty years ago. What has happened in the interim to improve this situation and pull Puerto Rico from the very depths of poverty? First, and most importantly, Puerto Rico began a far reaching industrialization program to diversify its economy from dependence upon the agricultural sector. Second, the federal government began to extend many of its programs into the island. Funds for training, education, health and

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physical infrastructure were made available to the island's government.

The industrialization strategy centered upon: tax advantages to manufacturing firms; unimpeeded access to the U. S. consumer market; a productive labor force; and a generally lower wage scale than prevailed on the mainland. The predecessors of Section 936 played a key role in making the tax incentives meaningful for U. S. investors. Investors could effectively receive profits at the corporate level free of both, Puerto Rican and U. S. corporate income tax. There can be no underestimating the importance of this incentive.

Over the past forty years Puerto Rico's economy has made great strides. The manufacturing sector has developed into the single strongest element in the private non governmental economy. The sector contributed over 150,000 jobs for Puerto Rican workers before the current recession, and today still provides over 146,000 jobs which on average, pay our workers almost $5.00 per hour. The basic manifestations of poverty have been significantly reduced. The well being of the island's people has been dramatically improved.

Yet, there is still a long way to go in our battle against poverty. The battle is by no means finished. The per capita income in Puerto

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Rico is still only one third that for the nation as a whole. Unemployment has always been higher than the national average by a factor of at least two. Today unemployment stands at almost 23%. There is still work to be done. Puerto Rico must continue to create new jobs to reduce unemployment to more reasonable levels, and to provide more hope of a better future for the one million youths now at various levels within our educational system.

The task of creating jobs and economic development has, over the past decade, become more difficult. Many factors beyond our control have contributed to the complexity of mantaining needed levels of economic growth in Puerto Rico:

(1) Higher crude oil prices during the decade radically changed the nature of the petrochemical industry. Puerto Rico's petrochemical sector was vertically destroyed during the adjustment and retrenchment process. High hopes for continued expansion of this sector came to an abrupt end.

(2) Higher oil costs also led to higher transportation and energy costs. Puerto Rico's geographic position far away from either the source of industrial raw materials or the final market for finished goods became a greater penalty with rising transportation costs. Higher electricity costs - almost double those of some competiting mainland locations - resulted from our system's almost total dependence on crude oil as its basic fuel source. These higher electricity costs reduced our ability to attract industries sensitive to energy costs.

3. Foreign imports of labor intensive goods into the U. S. market stunted the growth of these sectors in Puerto Rico. Imports increased because of basic foreign policy initiatives of the United States to reduce

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tariffs and encourage overseas direct investment, and from other policies such as environmental legislation that foreign producers did not have to contend with. The relative advantages of the foreign producers were sufficient to rule out further growth in the labor intensive sectors of Puerto Rico. Indeed, we have actually been losing jobs gradually over the last ten years in these areas.

These three factors have greatly complicated our ability to attract investment in depreciable assets and create new manufacturing employment. We have been faced with an ever narrowing spectrum of firms whose characteristics are compatible with a Puerto Rican plant location. While our industrial investment and growth rates have declined from their higher levels during the 1960's, what growth that has been achieved is due in large measure to two factors: (1) the development of a skilled pool of available, productive workers; and (2) the continued incentive offered by Section 936 to a mainland firms operating on the island. Were it not for Section 936 during this period, Puerto Rico would have been hard pressed to attract what investment it did.

At the very time that these events made Section 936 even more important for our economy it has encountered serious difficulties at the Federal level. For almost two years prior to last summer's legislative action on Section 936, the U. S. Internal Revenue Service carried out an administrative program during tax audits that seriously challenged the incentive to operate a manufacturing firm in Puerto Rico. The IRS contended that firms operating in Puerto Rico were simply contract

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manufacturing firms for their parent corporation, and were therefore only entitled to a cost plus profit, which as one would summise, was considerably less than the firm had originally reported. This program created a significant degree of uncertainty as to the actual benefits derived from Puerto Rican operations, and as to the longevity of the program as well.

Uncertainty is the enemy of business, and resulted in a reduced level of new manufacturing investment and job creation during this two year period. The uncertainty created by these actions further aggravated the already serious recession that was building in Puerto Rico.

During the course of the legislative process itself, beginning last July, Puerto Rico was denied the opportunity to be heard by either the House of Representatives or the Senate. No public hearings were called, and no public forum was provided to analyse what had been proposed. Yet, we were the ones who suffered. As soon as it became apparent that some legislative change would be made to Section 936, all investment in the manufacturing sector came to a halt. Business would not invest unless they knew the parameters of how they would be taxed. Some firms were able to simply postpone their investments, others decided to go ahead

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with their project, but in another location.

When the legislation finally emerged there was a sense of relief. Even though a Puerto Rican plant location would be less profitable for many firms, the general consensus was that it would still be profitable enough to continue attracting new investment to Puerto Rico. However, even though the basic parameters may be clearer than under the prior Section 936 legislation, the new provisions are incredibly complex. Many terms must be defined, and processes clarified before firms can actually determine how they are affected. This will have to be accomplished through regulations.

While the regulations are being developed, they are not expected until late next spring and possibly even next summer, business will not move. This places Puerto Rico right back where it was last summer. Uncertainty will continue to shut off the flow of new manufacturing investment until the regulations are published or until some guidance is provided to the firms. Puerto Rico has simply traded one type of uncertainty for another type of uncertainty, but the net result is the same.

As complex as this situation is, letters and statements by senior legislative officials have contributed to clouding the situation even

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further. A recent letter from the Chairman of the Senate Finance Committe, Senator Dole, to the Governor of Puerto Rico and to the Secretary of the Treasury of the United States, has been interpreted by some to indicate the possiblity of a legislative "revisiting" of Section 936 in the next several years. While this is just a possible interpretation it nonetheless increases the level of uncertainty surrounding the longevity of the newly enacted provisions of Section 936.

Before a firm will invest in Puerto Rico it must know how the operation will be taxed, and for how many years it can look forward to that tax treatment. If neither of these questions can be answered, at least with a reasonable degree of probability, the flow of investment will be greatly, if not completely reduced. To the degree that these questions can be answered in a satisfactory manner, there will be a consequent increase in the investment flows to the island.

Today, as we sit here before you, we must report that Puerto Rico is effectively being denied the Congressional intent of the revisions enacted last summer to Section 936. Congress enacted this legislation "to encourage increased Puerto Rican employment and investment in depreciable property at as low a cost to the Treasury as possible." Yet, the degree of uncertainty regarding (1) the actual benefits provided to individual firms under the new provisions and (2) the expected life

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of these provisions, have effectively reduced the investment flows by Section 936 firms to a bare minimum. Unless actions are taken quickly by responsible leaders in Congress and in the Administration, this new provision may never have a chance to work.

The Puerto Rico Chamber of Commerce strongly recommends that the following actions be taken as quickly as possible to get the new 936 provisions working:

1. There must be a clear, unequivocal statement by Congressional leaders and by Senior Administration Officials - best of course would be the President himself - that Section 936 will not be changed or modified, further reducing the benefits offered to firms for a minimum period of ten years.

2. The time schedule for the issuance of the implementing regulations for the new 936 provision should be accelerated. Realizing that the regulations will take a considerable amount of time to prepare under any circumstances, the Treasury should begin to issue "questions and answers" on critical issues as quickly as possible. The fact that nothing is now available has allowed firms to think the worst. The faster the Treasury can issue this guidance, the faster the concerns of business can be dispelled.

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3. Over the past several years the U. S. Treasury's "Annual Report on the Operation and Effect of the Possessions Corporation System of Taxation" has itself contributed to the uncertainty surrounding Section 936. A major criticism of the report has been that it is an agent for change expressing a totally one sided argument against Section 936. The Government of Puerto Rico has repeatedly objected to many aspects and misconceptions contained in the report. Yet, year after year the Treasury continues to utilize the same approach. If the Treasury will not change their approach, then at a minimum, the reader of the report should be aware that there are objections and criticisms of the methodology in the report. The comments of the Government of Puerto Rico from their review of the Treasury's draft report should be incorporated in a prominent manner within the annual report published by the U. S. Treasury.

4. The accelerated cost recovery system (ACRS) and the investment tax credit (ITC) available to domestic corporations should be extended to all corporations operating in Puerto Rico that make qualifying investments. These benefits provided to domestic corporations through the Economic Recovery Act of 1981, and then modified last summer in the Tax Equalization and Fiscal Responsibility Act of 1982, have reduced the relative advantages of investing in qualified depreciable assets in Puerto Rico. The administration attempted to right this situation by extending these benefits to U. S. 936 firms operating in Puerto Rico

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as a part of the Caribbean Basin Initiative. Unfortunately, this Section was dropped from the legislation last week during the House Ways and Means Committee's mark up of the bill. We feel that these provisions are essential to equalize our relative attractiveness for new manufacturing investment to what it was prior to 1981. We urge that these provisions be extended to Puerto Rico as soon as possible, either as a separate piece of legislation or as a part of another bill now in the legislative process.

Mr. Chairman, we could continue our discussion on this vitally important issue for Puerto Rico's economic well being. Yet, we realize that there are time constraints upon your valuable time. We thank you once again for this opportunity to express our views on Section 936, and hope that we have been able to convey to you the critical importance that this provision plays in Puerto Rico's ability to evidence economic growth.

We will now be pleased to answer any questions that you, or the members of this Committee may have on our presentation.

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Question. We have learned that 936 funds have been used to provide commercial loans. What portion of 936 funds are actually available for commercial loan? Do many members of the Chamber of Commerce receive such funds? What kind of businesses receive these funds: service, stores, manufacturing? Has the uncertainty which surrounds the section 936 program contributed to a decrease in businesses opportunity loans?

Answer. This question is not as straight forward as it appears. The distinction between the stock of funds and the flow of funds must be established. The "936" firms have earned annual profits from their operations in Puerto Rico. Some of these profits, over the years have been retained in Puerto Rico by the firms. This retention forms the stock of 936 funds. The stock has been invested by the 936 firms in their own operations (working capital and plant and equipment), in passive investments such Puerto Rican municipal bonds, GNMA's, direct loans to other 936 firms, equity investments in Puerto Rican banks, or deposits in or through Puerto Rican financial institutions.

The flow of funds, on the other hand, reflects the annual earnings of these possessions system corporations. Each year about half of the annual earnings are repatriated as dividends back to the parent corporation, and half are invested in Puerto Rico forming a part of the stock of 936 funds on the island.

The Puerto Rico Treasury Department maintains statistics on the 936 funds invested in Puerto Rico's financial institutions. This use of the funds represents the single largest use of the funds accounting for approximately 70 percent of the total stock. The government's statistics indicate that approximately 47 percent of the funds in financial institutions are channeled to commercial loans, 23 percent are channeled to loans to Commonwealth governmental agencies or municipal governments on the island, and 15 percent are channeled to mortgage or real estate loans.

Thus, to answer the question, a substantial proportion of the 936 stock of funds is already invested in commercial loans. At present I would estimate that approximately 34 percent of the total stock of these funds are invested in some type of commercial loans.

These commercial loans are made to firms within all segments of the economy-agriculture, commerce, service construction and manufacturing. Many firms benefit from the availability of these loans, and the lower cost of funds associated with these funds. While not all firms are sufficiently credit-worthy to receive loans at below prime, many of these firms can obtain funds at rates lower than would otherwise be available to them without this stock of 936 funds.

Many of the firms receiving 936 funds are members of the Puerto Rico Chamber of Commerce. Efforts are being made by the financial intermediaries to bring these funds to more firms on the island. Yet, the funds must be employed in a responsible manner to ensure that the borrower can repay the principal and interest on the loan in a timely manner. No responsible financial intermediary would do otherwise.

The recent uncertainties surrounding Section 936 have made the process of utilizing these funds for commercial loans more difficult. The uncertainty has caused a shift to shorter maturities for 936 deposits in the financial system. These shorter maturities increase the risk to the financial intermediary who takes short term deposits and relends the funds for longer term maturities. This will reduce the amount of funds that the institutions will lend for maturities longer than their deposits. At the same time, this will push part of the risk on to the commercial borrower who will now be faced by a shorter availability of funds. Thus, projects that take some time to generate the cash flow to repay the loan, may find increased difficulty in obtaining lower cost 936 funds.

Question. Underlying the immediate future of the Caribbean is the CBI. How do you think the Caribbean Basin Initiative will affect the economic situation of Puerto Rico and individual businesses on the island?

Answer. The Puerto Rico Chamber of Commerce has taken the position that the Caribbean Basin Initiative, with provision for Puerto Rican rum and the tuna packing industry, will have a beneficial effect on Puerto Rico's economy. This, of course, is in aggregate terms. There are some firms and businesses in Puerto Rico that will be hurt by increased competition from other Caribbean countries.

The provisions of the CBI permitting duty free entry of goods produced or grown in participating countries will have an adverse effect upon our labor intensive manufacturing sectors. In spite of exceptions for apparel and leather products, there will now be an increased incentive to shift any labor intensive manufacturing process out of Puerto Rico. While I cannot identify specific processes or firms that will do this, I know that the basic economics of the process will make it happen.

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Puerto Rico's tourism industry will also be hurt by the extension of tax deductions for conventions held in participating Caribbean countries. This is something that will take some time, so its effects won't be felt in the near future but in two or so years we will see more convention business going to these other areas.

However, in spite of these adverse impacts, we feel that the program also offers the potential for benefits as well, and these benefits could more than offset the adverse impacts. The benefits are going to come from an expanded trade in goods and services that will open up within the region. The commercial and service sectors of our economy will be the greatest beneficiaries of the program. As the other Caribbean economies expand they will demand more goods and services from Puerto Rico. This will, in turn, have favorable effects upon Puerto Rico's economy.

The Puerto Rico Chamber of Commerce has supported, and will continue to support the Caribbean Basin Initiative provided that:

(1) Duty free or tariff free imports of rum into the U.S. market are limited to 120 percent of the amount imported in 1981 or 1982;

(2) Duty free import of apparel is limited by the Multi-fiber Agreement and is not granted duty free access into the U.S. market; and

(3) Canned tuna and leather products are excluded from duty free access.

Chairman MINISH. Thank you, Dr. Finn.

The Chairman will declare a 15 minute recess. We have a vote on the floor.

[Recess.]

Mr. GARCIA [presiding]. I think before the subcommittee recessed for a few minutes, the next speaker was going to be Mr. Jose Rivera Janer.

Mr. Janer, before you start, I see you sitting next to a good friend of mine, Mr. Colon. It is unusual to see bankers and savings and loan people sitting that close. They don't do that in the States.

STATEMENT OF JOSE RIVERA JANER, EXECUTIVE DIRECTOR, PUERTO RICO BANKERS ASSOCIATION

Mr. JANER. We live on such a small island, we have to live together.

Mr. Chairman, Congressman Garcia, members of the staff, my name is Jose Rivera Janer. I am the executive director of the Puerto Rico Bankers Association.

Made up of the 17 commercial banks on the island, the association has its headquarters in the Banco Popular Center, located in Hato Rey, the principal financial district of our capital city of San Juan.

On behalf of the association I wish to express appreciation for this opportunity to assist the Congress in compiling a record on how the possessions corporation system of taxation—"the section 936 program" as we call it for short—has benefited the economy of Puerto Rico and that of the United States.

As requested in your letter of invitation, I am keeping my oral statement to 10 minutes, I hope. I would, however, like to submit additional information for the printed record of these hearings in the very near future.

Chairman MINISH. Without objection, so ordered.

Mr. JANER. To begin, let me emphasize our hope that this hearing in Washington will be followed by hearings in Puerto Rico. It is by firsthand observation that you will gain the greatest possible appreciation of how the section 936 program helps to promote Puerto Rico's economic development.

You need to see with your own eyes what we have achieved, what problems we are solving, and what are the opportunities and

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potential for the future. On behalf of the association, therefore, I extend to the members of this subcommittee, and through you to all the members of the full Committee on Banking, Finance and Urban Affairs, a most cordial invitation to visit with us.

Since other witnesses are presenting testimony from their specialized pespectives, I will limit my brief remarks to the basics of the section 936 program and the commercial banking system. It seems to us that three points merit emphasis.

First, without question, the section 936 program has had a dramatic beneficial effect on the liquidity of the island's banks, contributing to the growth and soundness of both the financial system and the economy as a whole.

As of early 1976, just before Congress enacted the section 936 program, total deposits in Puerto Rico's commercial banks were $4.7 billion. Of that amount, deposits from what were soon to become section 936 corporations were just $125 million, not even 3 percent of the whole.

By September 30 of this year, total deposits of all commercial banks had grown by 136 percent to $11.1 billion, and section 936 funds now account for $4.6 billion, or over 41 percent of total deposits. I would like to emphasize that. Significantly, you can readily see from the size of section 936 deposits and their importance in total deposit growth that the section 936 program is vital to the liquidity of the banking system which is so necessary for the banks' ability to finance new economic activity.

Second, in their role as intermediaries in Puerto Rico, the banks have effectively reinvested these funds throughout the local economy.

As of September 30, 1982, 53 percent of section 936 deposits in banks were invested in local commercial and industrial loans; 23 percent in Puerto Rico government obligation or loans to government agencies; 16 percent in local real estate, construction and mortgage loans; and 8 percent in other eligible development-related loans as defined by the Puerto Rico Treasury Department.

Third, not only do the banks function as the primary intermediary for section 936 funds, but because the interest on section 936 deposits is tax-exempt to depositors, bank loans based on the availability of these low-cost funds can carry significantly lower rates of interest than those available outside of Puerto Rico. Accordingly, the commercial banks in Puerto Rico have passed through to their local borrowers substantial cost benefits arising from the section 936 program.

Our member banks have been working with the Puerto Rico Treasury Department to quantify the loan pricing benefits made available to local borrowers by all banks. We do not yet have complete figures from all of them but I hope you will permit me to provide complete data for the record as soon as completed.

However, data from banks whose section 936 deposits represent 53 percent of all section 936 deposits and which are among the most competitive in loan pricing, shows that:

In 1981, a year of exceptionally high interest rates in the United States and Puerto Rico, the rate of interest charged on eligible loans averaged 5 percent below the average prime rates of those banks on a significant portion of their loans.

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In other words, in 1981 on average loans made by the reporting banks in excess of $2.4 billion, the customers saved $121 million of the interest expense they would have paid had such loans been carried at prime rate.

During the first 9 months of this year, the average interest rate on loans made in Puerto Rico by these banks averaged 4.25 percent below prime. This means a savings to borrowers in Puerto Rico of about $111 million during those three quarters compared to prime rate.

We believe that when this information is more fully developed, it will show a very impressive pattern of section 936 cost-benefit distributed to key sectors of the local economy through the banking system.

The three points that I have summarized very briefly constitute what we mighty call the statistical profile of how benefits of the section 936 program flow through the banking system to the economy of Puerto Rico. They need to be viewed, however, in a broader context because the continuation of these basic benefits depends on the confidence of the section 936 companies that the U.S. and Puerto Rican regulatory environment will not worsen.

They appear not to have that confidence today. Unfortunately, the annual reports on the 936 program prepared by the U.S. Treasury Department, which emphasize the negative aspects of the program, based on their own interpretation of the facts, undermine that confidence.

I must emphasize to this subcommittee that we will not be able to maintain and, more importantly, strengthen our economy if the section 936 program is constantly subjected to modification or if the threat of modification which has charaterized its existence so far continues to exist. I recall an observation of Teodoro Moscosco when he was U.S. Coordinator of the Alliance for Progress under President Kennedy's administration. Mr. Moscoso, who is now chairman of Banco Santander of Puerto Rico, one of our association members, was also the architect of Puerto Rico's industrialization program.

The Alliance for Progress, Mr. Moscoso warned in that occasion, "was being endangered because it was so frequently being pulled up by the roots to see how well it was growing." The Tax Equity and Finance Responsibility Act [TEFRA) amendments to the section 936 program were designed to correct what were perceived by some as shortcomings, and to put the program on a new and more certain course.

In spite of this, there are still repeated indications that the program is to be pulled up by the roots again next year, or the year after, or the year after that. Indeed, Treasury's annual reports, because of their emphasis on the negative aspects of the program, have this very effect.

Fully mindful of the separate functions and responsibilities of each committee of Congress, I urge you to help us search for some other way to preserve the stability of our economic development and its keystone, the 936 program, so that their roots can be enriched and strengthened by the element of certainty rather than stunted by the poison of uncertainty.

Many thanks, Mr. Chairman and members of the subcommittee.

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Chairman MINISH. Thank you, Mr. Janer.

[Mr. Janer's prepared statement, on behalf of the Puerto Rico Bankers Association, follows:]

TESTIMONY OF JOSE RIVERA JANER, EXECUTIVE DIRECTOR
OF THE PUERTO RICO BANKERS ASSOCIATION,
BEFORE THE SUBCOMMITTEE ON GENERAL OVERSIGHT
AND RENEGOTIATION, U. S. HOUSE OF REPRESENTATIVES,
DECEMBER 15, 1982

Mr. Chairman and members of the Subcommittee, my name is Jose Rivera Janer. I am Executive Director of the Puerto Rico Bankers Association.

Made up of the 17 commercial banks on the Island, the Association has its headquarters in the Banco Popular Center, located in Hato Rey, the principal financial district of our capital city of San Juan.

On behalf of the Association I wish to express appreciation for this opportunity to assist the Congress in compiling a record on how the Possessions Corporation System of Taxation -- "the 936 program" as we call it for short -- has benefited the economy of Puerto Rico and that of the United States. As requested in your letter of invitation, I am keeping my oral statement to 10 minutes. I would, however, like to submit additional information for the printed record of these hearings in the very near future.

To begin, let me emphasize our hope that this hearing in Washington will be followed by hearings in Puerto Rico. It is by first-hand observation that you will gain the greatest possible

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appreciation of how the 936 program helps to promote Puerto Rico's economic development. You need to see with your own eyes what we have achieved, what problems we are solving, and what are the opportunities and potential for the future. On behalf of the Association, therefore, I extend to the members of this Subcommittee, and through you to all the members of the full Committee on Banking, Finance and Urban Affairs, a most cordial invitation to visit us.

Since other witnesses are presenting testimony from their specialized perspectives, I will limit my brief remarks to the basics of the 936 program and the commercial banking system. It seems to us that three points merit emphasis.

First: Without question, the 936 program has had a dramatic beneficial effect on the liquidity of the Island's banks, contributing to the growth and soundness of both the financial system and the economy as a whole.

As of early 1976, just before Congress enacted the 936 program, total deposits in Puerto Rico's commercial banks were 4.7 billion dollars. Of that amount, deposits from what were soon to become 936 corporations were just 125 million dollars, not even 3% of the whole.

By September 30 of this year, total deposits of all commercial banks had grown by 136% to 11.1 billion dollars, and 936 funds now account for 4.6 billion dollars, or over 41% of total deposits. Significantly, you can readily see from the size of 936 deposits and their importance in total deposit growth that the 936 program is vital to the liquidity of the banking system which is so necessary for the banks' ability to finance new economic activity.

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Second: In their role as intermediaries in Puerto Rico, the banks have effectively reinvested these funds throughout the local economy.

As of September 30, 1982, 53% of 936 deposits in banks were invested in local commercial and industrial loans; 23% in Puerto Rico government obligation or loans to government agencies; 16% in local real estate, construction and mortgage loans; and 8% in other eligible development related loans as defined by the Puerto Rico Treasury Department.

Third: Not only do the banks function as the primary intermediary for 936 funds, but because the interest on 936 deposits is tax-exempt to depositors, bank loans based on the availability of these low-cost funds can carry significantly lower rates of interest than those available outside of Puerto Rico. Accordingly, the commercial banks in Puerto Rico have passed-through to their local borrowers substantial cost benefit arising from the 936 program.

Our member banks have been working with the Puerto Rico Treasury Department to quantify the loan pricing benefits made available to local borrowers by all banks. We do not yet have complete figures from all of them but I hope you will permit me to provide complete data for the record as soon as completed. However, data from banks whose 936 deposits represent 53% of all 936 deposits and which are

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among the most competitive in loan pricing, shows that:

In 1981, a year of exceptionally high interest rates in the United States and Puerto Rico, the rate of interest charged on eligible loans averaged 5% below the average prime rates of those banks on a significant portion of their loans.

In other words, in 1981 on average loans made by the reporting banks in excess of 2.4 billion dollars the customers saved 121 million dollars of the interest expense they would have paid had such loans been carried at prime rate.

During the first nine months of this year the average interest rate on loans made in Puerto Rico by these banks averaged 4.25% below prime. This means a savings to borrowers in Puerto Rico of about 111 million dollars during those three quarters compared to prime rate.

We believe that when this information is more fully developed, it will show a very impressive pattern of 936 cost-benefit distributed to key sectors of the local economy through the banking system.

The three points that I have summarized very briefly constitute what we might call the statistical profile of how benefits of the 936 program flow through the banking system to the economy of Puerto Rico. They need to be viewed, however, in a broader context because the continuation of these basic benefits depends on the confidence of the 936 companies that the U.S. and Puerto Rican regulatory environment will not worsen.

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They appear not to have that confidence today. Unfortunately, the annual reports on the 936 program prepared by the U.S. Treasury Department, which emphasize the negative aspects of the program, based on their own interpretation of the facts, undermine that confidence.

I must emphasize to this Subcommittee that we will not be able to maintain and, more importantly, strengthen our ecomomy if the 936 program is constantly subjected to modification of if the threat of modification which has characterized its existence so far continues to exist. I recall an observation of Teodoro Moscosco when he was U.S. Coordinator of the Alliance for Progress under President Kennedy's Administration. Mr. Moscoso, who is now Chairmain of Banco Santander of Puerto Rico, one of our Association members, was also the architect of Puerto Rico's industrialization program.

The Alliance for Progress, Mr. Moscoso warned in that occasion, "was being endangered because it was so frequently being pulled up by the roots to see how well it was growning." The Tax Equity & Finance Responsibility Act (TEFRA) amendments to the 936 program were designed to correct what were perceived by some as shortcomings, and to put the program on a new and more certain course. In spite of this, there are still repeated indications that the program is to be pulled up by the roots again next year, or the year after, or the year after that. Indeed, Treasury's annual reports, because of their emphasis on the negative aspects of the program, have this very effect.

Fully mindful of the separate functions and responsibilities of each committee of Congress, I urge you to help us search for some other way to preserve the stability of our economic development and its keystone, the 936 program, so that their roots can be enriched and strengthened by the element of certainty rather than stunted by the poison of uncertainty.

Many thanks, Mr. Chairman and members of the Subcommittee.

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Chairman MINISH. Our next witness is Ramiro Colon, an old friend of mine.

Nice to have you here.

STATEMENT OF RAMIRO L. COLON, JR., PRESIDENT, PONCE FEDERAL SAVINGS & LOAN ASSOCIATION OF PUERTO RICO, PAST PRESIDENT, PUERTO RICO SAVINGS & LOAN LEAGUE

Mr. COLON. I am Ramiro Colon, Jr., president of Ponce Federal Savings & Loan Association of Puerto Rico and past president of the Puerto Rico Savings & Loan League. We appear at this hearing on behalf of the Puerto Rico Savings and Loan League to comment on the considerable benefits derived by the Puerto Rican economy from the investments in Puerto Rico of the surplus funds generated by corporations operating under Section 936 of the U.S. Internal Revenue Code of 1954.

In particular, we will discuss the important role said 936 funds have played in assisting Federal Savings and Loan associations in Puerto Rico in the financing of residential mortgage loans on the island, and in preserving the continuous existence of several island associations, thus preserving the jobs of approximately 1,800 direct employees and reducing the risk of loss to the Federal Savings and Loan Insurance Corporation, which insures the funds deposited in the federally chartered associations.

The Puerto Rico savings and loan industry is composed of 12 federally chartered associations regulated by the Federal Home Loan Bank Board. As of December 31, 1981, the associations operating in Puerto Rico had total assets of approximately $2.8 billion, of which $1.9 billion, or 68 percent, represented construction and mortgage loans.

The residential mortgage loans held by the associations in Puerto Rico as of December 31, 1981, represented 60.2 percent of the total residential mortgage loans held by all financial institutions in Puerto Rico as of said date.

Similar to the situation in the United States, the savings and loan associations in Puerto Rico have been adversely affected in the past years by the increased in the cost of money. The associations' cost of funds (received on a short time basis) substantially increased in recent years while their return on investments has generally remained constant as a result of former loans made at a fixed rate on a long-term basis and which constitute an important part of the association's portfolios.

During calendar year 1981, the federally chartered associations in Puerto Rico experienced an overall loss of approximately $40 million. The losses on an industrywide basis in Puerto Rico continued in 1982 as the combined losses as of June 30, 1982, amounted to $14 million. Yet, many of our associations would not have been able to survive without the benefits of the section 936 funds and would not have been able to contribute, as they have, to the economy of Puerto Rico by providing financing for home construction, and the section 936 funds have been instrumental in providing those funds for such purposes.

However, under present Puerto Rico regulations, the use of section 936 funds to continue financing such activities have been

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severe curtailed, to the detriment of the associations and the Puerto Rico economy as a whole.

The federally chartered associations, through the Puerto Rico Savings and Loan League, are presently discussing the above matter with the Treasury Department in Puerto Rico in order to try to establish such rules that will allow the associations to continue receiving the section 936 funds to finance long-term residential mortgage loans in Puerto Rico.

In view of the fact that the investment of funds by section 936 corporations is also governed by the provisions of code Section 936, the U.S. Congress and the U.S. Treasury Department can definitely be of assistance in the establishment of such rules by issuing clear guidelines with respect to the manner of measuring whether financial institutions have complied with the provisions of the law and the regulations concerning the use of the 936 funds."

The establishment of such clear rules will clarify the misconception generally presented in the Annual Reports on the Operation and Effect of the Possessions Corporation System of Taxation issued by the U.S. Department of the Treasury to the effect that the section 936 funds have provided little net new capital in Puerto Rico and that financial institutions have not properly used the section 936 funds received.

The Puerto Rico industrial incentives law provide exemption from Puerto Rico income taxes and allow other benefits if the section 936 funds are invested in Puerto Rico in specified activities. The investment of said section 936 funds in time deposits with financial institutions is one of such specified or eligible activities.

However, the financial institution receiving such section 936 funds is required to obtain an eligibility status from the Puerto Rico Treasury Department and must use such funds in the manner provided in the regulations.

Basically, the law and regulations require that the funds be invested in Puerto Rico in activities such as loans to commercial, industrial, agricultural, and construction enterprises that are directly instrumental in increasing Puerto Rico's production, income, and employment. Said 936 funds may not be channeled by the financial institutions into consumer loans—with certain exceptions which include automobile loans and student loans.

Failure to meet such requirements will disqualify the interest paid by the financial institution to the 936 corporation from the benefits granted to said corporation under section 936. In addition, Puerto Rico regulations require that such funds not only be invested in Puerto Rico, but that they be invested in specified or eligible activities.

Use of section 936 funds to finance the construction and aquisition of residential property in Puerto Rico is one of the uses allowed and encouraged by the law and regulation.

For purposes of determining compliance with the provisions of the Puerto Rico regulations concerning the use of section 936 funds, the financial institutions are required to demonstrate, on a monthly basis, that their average monthly daily balance of eligible activities in excess of the balance of said activities held by the institution on April 30, 1975, is equal to or exceeds the average monthly daily balance of section 936 funds held. That is, in order

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for an institution to comply with the provision of the Puerto Rico regulations, it must have incremented its eligible activities since April 30, 1975, by at least an amount equal to the section 936 funds held.

Under the above-mentioned requirement, it is generally considered that the section 936 funds held by the institution are used to finance such incremental eligible activities to the extent of such activities.

Following the above provisions of law and regulations, the savings and loan associations in Puerto Rico have increased their holdings in residential mortgage loans since April 30, 1975, by approximately $980 million. Said amount includes approximately $350 million of mortgage loans granted for low cost-social interest housing under the programs sponsored by the Housing Bank and Finance Agency of Puerto Rico.

According to the information available to us, the financial institutions in Puerto Rico (including the savings and loan associations) have incremented their holdings in residential mortgage loans on Puerto Rico residences from $1.8 billion in 1975 to $3.2 billion in 1981, an increase of $1.4 billion.

During the same period, the associations in Puerto Rico have increased their holdings in said mortgage loans from $719 million to $1.65 billion, representing an increase of $931 million or approximately 67 percent of the increment of such financing during said period. Relative to the low cost-social interest housing mortgages sponsored by the Housing Bank and Finance Agency of Puerto Rico, the associations have financed 73.8 percent of said mortgages.

Even though the associations have complied with the provisions of the regulations and were induced by such regulations to finance long-term residential mortgage loans, they have been adversely affected by certain interpretations of the new Puerto Rico requirements that came into effect on February 1, 1982. The most evident example of the adverse treatment suffered by the savings and loan industry in Puerto Rico as a result of such restrictive interpretation is the fact that the associations have not been granted status of eligible institutions under the new regulations.

If this matter is not corrected, the savings and loan associations will no longer receive 936 funds and will not allow the associations to continue financing with 936 funds the long-term mortgage loans previously granted under the regulations then in effect.

This situation has required the associations to either liquidate a portion of their already reduced liquid assets or borrow funds at considerably higher interest rates in order to pay off the section 936 funds withdrawals while still maintaining the mortgage loans granted, thus adversely affecting the already difficult financial condition that the savings and loan association has experienced in the past years.

In our opinion, one of the main reasons the above problem arises is because the Puerto Rico Treasury Department is very concerned with the possibility that the U.S. Congress will revisit again section 936 to the detriment of the Puerto Rican economy.

Therefore, the Treasury Department has adopted a very restrictive interpretation of the comments made by the U.S. Treasury Department in its annual reports regarding the effect of the section

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936 funds in Puerto Rico and rather than following the incremental rule for purposes of determining compliance with the requirements of the use of funds, a substantially complex, and in our opinion, ineffective rule seems to have been administratively developed requiring an almost exact matching—in terms of both amount and maturity—between the section 936 funds received by the financial institution and the eligible activity originated.

As you may know, the section 936 funds are received by the financial institutions on a short-term basis and, therefore, a direct matching with the origination on long-term residential mortgage loans is not practical.

Although the associations have been discussing for the last 10 months possible solutions to the above-mentioned problem with representatives of the Puerto Rico Treasury Department and the Federal Home Loan Bank of New York, it is our purpose to appraise this committee of the actual situation, which if not clarified in the immediate future, will: First, definitely affect the associations' program to continue to finance residential mortgage loans which, on the other hand, is one of the main activities which are, and should continued to be, encouraged by the regulations; Second, not allow the associations to be able to continue to finance long-term mortgage loans, validly originated with section 936 funds under the previous regulations, thus increasing their cost of funds required to maintain such mortgages and, therefore, Third, adversely affecting the already difficult financial condition of the associations which in turn may result in the failure of certain associations in Puerto Rico.

In summary, the section 936 funds have considerably helped the Puerto Rican economy way beyond the number of jobs created by the section 936 corporations directly. The 936 funds received by the savings and loan associations in Puerto Rico have been instrumental in financing the origination and maintaining of long-term residential mortgage loan portfolios, which have resulted in a flow of such funds to the depressed Puerto Rico construction industry.

In addition, the savings and loan associations have considerably decreased their cost of funds, which have been necessary for purposes of reducing the losses realized by said associations as a result of having to maintain in their portfolios residential mortgage loans bearing rates considerably lower than the current rate of said funds.

In this respect, assuming a 3-percent differential between the cost to the associations of regular funds and the section 936 funds, the $500 million held by the associations as of January 31, 1982, represented an annual cost savings to them of approximately $15 million which in certain circumstances has allowed certain associations to continue in existence, thus preserving the 1,800 jobs directly created by the federally chartered savings and loans in Puerto Rico and avoiding possible losses to the Federal Savings and Loan Insurance Corporation on account of the failure of any of our associations.

In addition, since the mortgage loans being maintained by the associations were granted at rates considerably lower than the current market rates, the Puerto Rican borrower is deriving the benefit of the lower section 936 funds rate.

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The use of section 936 funds to finance housing in Puerto Rico is one of the activities that should continue to be highly encouraged. In this respect, the federally chartered savings and loan associations have substantially contributed ot the Puerto Rican economy by making funds available to the construction industry, particularly for the purpose of home construction.

Puerto Rican savings and loan associations will continue, as in the past, if funds are available, to finance housing in Puerto Rico. This is a commitment that has been made and will continue to be honored in spite of the new powers granted to our industry by the Garn-St Germain bill. However, unless the restrictive rules are clarified in coordination with the United States and Puerto Rico Treasury Departments, the financing of such activities with section 936 funds will not be adequately encouraged.

In addition, it would be advisable to encourage section 936 corporations to deposit their funds on a longer term basis by providing additional incentives—for example, reducing the tollgate taxes on funds so invested. Also, in order to induce the section 936 corporations to deposit their funds on longer terms, it would be necessary that some degree of certainty be given by Congress that the provisions of section 936 will not be revisited in the near future. The proposal to maintain section 936 as it is for a period of at least 10 years would definitely accomplish such objective and will also assist the Puerto Rican government in promoting new manufacturing facilities in the island, which are badly needed for purposes of reducing the current high rate of unemployment in Puerto Rico and stimulating the Puerto Rican economy as a whole.

We hope that our comments have provided you with information concerning the substantial benefits derived by the Puerto Rican economy regarding the use of section 936 funds by the federally chartered savings and loan associations and allow you to appraise such benefits.

We appreciate your giving us the opportunity to present our views in this hearing, and thank you for your invitation.

[Mr. Colon's prepared statement, on behalf of the Puerto Rico Savings & Loan League, and additional questions submitted by Congressman Robert Garcia after the hearing follow:]

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Presentation of Mr. Ramiro L. Colon Jr., Esq., President
of Ponce Federal Savings and Loan Association of Puerto Rico
and Past President of the Board of Directors of the Puerto Rico
Savings and Loan League

Before the Subcommittee on Oversight and Renegotiation of
the U. S. House Banking, Finance and Urban Affairs Committee
97th Congress, Washington, D.C.

In Connection with Section 936 of the U. S. Internal Revenue Code

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We appear at this hearing on behalf of the Puerto Rico Savings and Loan League to comment on the considerable benefits derived by the Puerto Rican economy from the investments in Puerto Rico of the surplus funds generated by corporations operating under Section 936 of the U.S. Internal Revenue Code of 1954 ("936 funds"). In particular, we will specifically discuss the important role said "936 funds" have played in assisting federally chartered S&L associations in Puerto Rico in the financing of residential mortgage loans in the island; and in preserving the continuous existence of several island associations, thus preserving the jobs of approximately 1,800 direct employees and reducing the risk of loss to the Federal Savings and Loan Insurance Corporation, which insures the funds deposited in the federally chartered associations.

Background Information Concerning the Savings and Loan Industry in Puerto Rico

The Puerto Rico savings and loan industry is composed of twelve (12) federally chartered associations regulated by the Federal Home Loan Bank Board. As of December 31, 1981, the associations operating in Puerto Rico had total assets of approximately $2.8 billion, of which $1.9 billion, or 68%, represented construction and mortgage loans. The residential mortgage loans held by the associations in Puerto Rico as of December 31, 1981 represented 60.2% of the total residential mortgage loans held by all financial institutions in

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Puerto Rico as of said date.

Similar to the situation in the United States, the federally chartered savings and loan associations in Puerto Rico have been adversely affected in the past years by the increase in the cost of money. The associations' cost of funds (received on a short time basis) substantially increased in recent years while their return on investments has generally remained constant as a result of former loans made at a fixed rate on a long term basis and which constitute an important part of the associations' portfolios.

During calendar year 1981, the federally chartered associations in Puerto Rico experienced an overall loss of approximately $40,000,000. The losses on an industry-wide basis in Puerto Rico continued in 1982 as the combined losses as of June 30, 1982 amounted to $14,000,000. Yet, many of our associations would not have been able to survive without the benefits of the "936 funds" and would not have been able to contribute, as they have, to the economy of Puerto Rico by providing financing for home construction, and the "936 funds" have been instrumental in providing those funds for such purposes. However, under present Puerto Rico regulations, the use of "936 funds" to continue financing such activities have been severely curtailed, to the detriment of the associations and the Puerto Rico economy as a whole.

The federally chartered associations, through the Puerto Rico Savings and Loan League, are presently discussing the above matter with the Treasury Department in Puerto Rico in order to try to establish such rules that will allow the associations to continue receiving the "936 funds" to finance long term residential mortgage loans in Puerto Rico. In view of the fact that the investment of funds by "936 corporations" is also governed by the provisions of

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Code Section 936, the U. S. Congress and the U. S. Treasury Department can definitely be of assistance in the establishment of such rules by issuing clear guidelines with respect to the manner of measuring whether financial institutions have complied with the provisions of the law and the regulations concerning the use of the "936 funds." The establishment of such clear rules will clarify the misconception generally presented in the Annual Reports on the Operation and Effect of the Possessions Corporation System of Taxation issued by the U. S. Department of the Treasury to the effect that the "936 funds" have provided little net new capital in Puerto Rico and that financial institutions have not properly used the "936 funds" received.

The Possessions Corporation System of Taxation - Interplay of Section 936 and the Puerto Rico Industrial Incentive Program

Section 936 is the federal counterpart of the Puerto Rico industrial incentives program. In general, the interplay of both provisions of law provides exemption from federal and Puerto Rico income taxes with respect to the following types of income:

a) Operating income covered by the exemption (normally manufacturing income), and

b) Income from investments in Puerto Rico (including interest on deposits with financial institutions such as banks and S&L associations) of the funds generated by the exempt activities.

In order to claim the above mentioned benefits for federal income tax purposes, Code Section 936, prior to the amendments made by TEFRA, required, among other requirements, that the "936 corporation" derived at least 50% of its gross income (determined annually on the basis of the preceding 3 years) from the active

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conduct of a trade or business within Puerto Rico. That is, under the prior law, a "936 corporation" could have derived up to 50% of its gross income from passive income such as interest on certificates of deposits, dividends and income from other investments.

The Puerto Rico industrial incentives law provide exemption from Puerto Rico income taxes and allow other benefits if the "936 funds" are invested in Puerto Rico in specified or eligible activities. The investment of said "936 funds" in time deposits with financial institutions is one of such specified or eligible activities. However, the financial institution receiving such "936 funds" is required to obtain an eligibility status from the Puerto Rico Treasury Department and must use such funds in the manner provided in the regulations.

Basically, the law and regulations require that the funds be invested in Puerto Rico in activities such as loans to commercial, industrial, agricultural, and construction enterprises that are directly instrumental in increasing Puerto Rico's production, income and employment. Said "936 funds" may not be channelled by the financial institutions into consumer loans (with certain exceptions which include automobile loans and student loans).

Amendments Made by TEFRA to Section 936

According to the Report of the Committee on Finance of the U. S. Senate on H.R. 4961, the recent amendments made by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") to Section 936 were directed to correct two problems in the Possessions Corporation System of Taxation which have been pointed out by three annual reports issued by the U. S. Treasury Department:

(1) unduly high U. S. revenue loss attributable to certain industries due to positions taken by certain taxpayers

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with respect to the allocation of intangible income among related parties, and

(2) continued tax exemption of excessive possession source investment income.

For purposes of correcting the above mentioned problems, Section 936 was amended by TEFRA as follows:

(1) in general, the income attributable to intangible assets used by a "936 corporation" is generally allocated to its U. S. shareholder (the amendment provides for alternate options available to "936 corporations" in determining their net income), and

(2) the percentage of investment income that the "936 corporation" may derive was reduced from 50% to 45% for 1983, 40% for 1984, and 35% for 1985 and thereafter.

With respect to the two problems mentioned above, we will limit our comments in this presentation to address the second problem and the corresponding TEFRA amendment thereof related to the effect on the Puerto Rico economy, particularly the savings and loan industry, of the "936 funds" invested in Puerto Rico. However, to the extent our comments support the position that the benefits derived by Puerto Rico under the possession's corporation system go beyond the creation of direct employment by the "936 corporations," it will also sustain the position that the "tax expenditure-per employee" concept (used for purposes of supporting the existence of the first problem) will not necessarily correctly measure the effectiveness of the system.

Also, although our comments will be limited to the investments in Puerto Rico of the "936 funds," the provisions requiring the

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allocation of the intangible income to the U. S. shareholder of the "936 corporation" will reduce the amount of income that the "936 corporation" will derive from its active business operations and will effectively reduce the amount of "936 funds" in the system. In addition, since the active business income has been reduced, the nominal amount of the investment income that may be derived by the "936 corporation" will likewise be reduced, since it cannot exceed a specified percentage of the gross income of the "936 corporation."

Thus, the amendments made by TEFRA will considerably reduce the amount of "936 funds" which would otherwise been available in the system.

Use of "936 Funds" by Savings and Loan Associations

The provisions of Section 936 require that the financial institutions receiving "936 funds" invest such funds in Puerto Rico. Failure to meet said requirement will disqualify the interest paid by the financial institution to the "936 corporation" from the benefits granted to said corporation under Section 936. In addition, the Puerto Rico law and regulations require that said funds not only be invested in Puerto Rico, but that they be invested in specified or eligible activities. As indicated above, consumer loans to Puerto Rico residents is not a qualified activity. The utilization of the "936 funds" to finance the construction and acquisition of residential property in Puerto Rico is one of the uses allowed and encouraged by the law and regulations.

For purposes of determining compliance with the provisions of the Puerto Rico regulations concerning the use of "936 funds," the financial institutions are required to demonstrate,on a monthly basis, that their average monthly daily balance of eligible activities in excess of the balance of said activities held by the

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institution on April 30, 1975 is equal to or exceeds the average monthly daily balance of "936 funds" held. That is, in order for an institution to comply with the provisions of the Puerto Rico regulations, it must have incremented its eligible activities since April 30, 1975 ("incremental eligible activities") by at least an amount equal to the "936 funds" held. Under the above mentioned requirement, it is generally considered that the "936 funds" held by the institution are used to finance such incremental eligible activities to the extent of such activities.

Following the above provisions of law and regulations, the savings and loan associations in Puerto Rico have increased their holdings in residential mortgage loans since April 30, 1975 by approximately $980,000,000. Said amount of $980,000,000 includes approximately $350,000,000 of mortgage loans granted for low cost-social interest housing under the programs sponsored by the Housing Bank and Finance Agency of Puerto Rico. (Figures are up to Aug., 1982)

According to the information available to us, the financial institutions in Puerto Rico (including the savings and loan associations) have increased their holdings in residential mortgage loans on Puerto Rico residences from $1.8 billion in 1975 to $3.2 billion in 1981, an increase of $1.4 billion. During the same period, the federally chartered savings and loan associations in Puerto Rico have increased their holdings in said mortgage loans from $719 million to $1.65 billion, representing an increase of $931 million or approximately 67% of the increment of such financing during said period. Relative to the low cost-social interest housing mortgages sponsored by the Housing Bank and Finance Agency of Puerto Rico, the associations have financed 73.8% of said mortgages.

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As of February 1, 1982 (effective date of the new regulations approved by the Puerto Rico Treasury Department), the federally chartered savings and loan associations held approximately $500 million in "936 funds" to finance the above mentioned mortgages. It is, therefore, evident from the above supplied information that the "936 funds" channeled through the federally chartered S&L associations have assisted them in originating and maintaining their holdings in long term residential mortgage loans, the activity which is, and should continue to be, highly encouraged for purposes of using "936 funds."

Nevertheless, even though the Associations have complied with the provisions of the regulations and were induced by such regulations to finance long term residential mortgage loans, they have been adverserly and discriminatorily affected by certain interpretations of the Puerto Rico regulations that became in effect on February 1, 1982. The most evident example of the adverse and discriminatory treatment suffered by the savings and loan associations as a result of such restrictive interpretation is the fact that the federally chartered associations have not been granted status of eligible institutions under the new regulations; therefore, the associations may no longer receive "936 funds" as eligible institutions. The above situation has not allowed the associations to continue financing with "936 funds" the long term mortgage loans previously granted under the regulations then in effect. This situation has required the associations to either: (i) liquidate a portion of their already reduced liquid assets; or (ii) borrow funds at considerably higher interest costs in order to pay off the "936 funds" withdrawals while still maintaining the mortgage

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loans granted on a long term basis, further affecting the already difficult financial condition that the savings and loan industry has experienced in recent years.

In our opinion, one of the main reasons the above problem arises is because the Puerto Rico Treasury Department is very concerned with the possibility that the U. S. Congress will revisit again Section 936 to the detriment of the Puerto Rican economy. Therefore, the Puerto Rico Treasury Department has adopted a very restrictive interpretation of the comments made by the U. S. Treasury Department in its annual reports regarding the effect of the "936 funds" in Puerto Rico and rather than following the above mentioned incremental rule for purposes of determining compliance with the requirements of the use of funds, a substantially complex, and in our opinion, ineffective rule seems to have been administratively developed requiring an almost exact matching (in terms of both amount and maturity) between the "936 funds" received by the financial institution and the eligible activity originated.

As you may know, the "936 funds" are received by the financial institutions on a short term basis (generally not exceeding 90 days) and, therefore, a direct matching with the origination on long term residential mortgage loans is not practical.

As indicated on Page 72 of the Third Annual Report on 936 issued by the U. S. Treasury Department, the above mentioned matter is a very complex one and could very well be viewed from different points of view. Although, as indicated before, the associations have been discussing for the last ten months possible solutions to the above mentioned problem with representatives of the Puerto Rico Treasury Department and the Federal Home Loan Bank of New York, it is our

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purpose to appraise this committee of the actual situation, which if not clarified in the immediate future, will: (i) definitely affect the associations' program to continue to finance residential mortgage loans which, on the other hand, is one of the main activities which are, and should continue to be, encouraged by the regulations; (ii) not allow the associations to be able to continue to finance long term mortgage loans, validly originated with "936 funds" under the previous regulations, thus increasing their cost of funds required to maintain such mortgages and, therefore, (iii) adversely affecting the already difficult financial condition of the associations which in turn may result in the failure of certain associations in Puerto Rico, which might give raise to potential losses to the Federal Savings and Loan Insurance Corporation.

Summary and Recommendations

In summary, the "936 funds" have considerably helped the Puerto Rican economy way beyond the number of jobs created by the "936 corporations" directly. The "936 funds" received by the savings and loan associations in Puerto Rico have been instrumental in financing the origination and maintaining of long term residential mortgage loan portfolios, which have resulted in a flow of such funds to the depressed Puerto Rico construction industry. In addition, in the particular case of the savings and loan associations, the "936 funds" have considerably decreased their cost of funds, which have been necessary for purposes of reducing the losses realized by said associations as a result of having to maintain in their portfolios residential mortgage loans bearing rates considerably lower than the current rate of said funds. In this respect, assuming a 3% differential between the cost to the

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associations of regular funds and the "936 funds," the approximate $500 million held by the associations as of January 31, 1982 represents an annual cost savings to them of approximately $15 million which in certain instances, has allowed certain associations to continue their existence, thus preserving the 1,800 jobs directly created by the federally chartered savings and loans in Puerto Rico and avoiding possible losses to the Federal Savings and Loan Insurance Corporation on account of the failure of any of our associations.

In addition, since the mortgage loans being maintained by the associations were granted at rates considerably lower than the current market rates, the Puerto Rican borrower is deriving the benefit of the lower "936 funds" rate.

The use of "936 funds" to finance housing in Puerto Rico is one of the activities that should continue to be highly encouraged. In this respect, the federally chartered savings and loan associations have substantially contributed to the Puerto Rican economy by making funds available to the construction industry, particularly for the purpose of home construction. Puerto Rican savings and loan associations will continue, as in the past, if funds are available, to finance housing in Puerto Rico. This is a commitment that has been made and will continued to be honored in spite of the new powers granted to our industry by the Garn-St Germain Bill. However, unless the restrictive rules are clarified in coordination with the U. S. and Puerto Rico Treasury Departments, the financing of such activities with "936 funds" will not be adequately encouraged. In addition, it would be advisable to encourage "936 corporations" to deposit their funds on a longer term basis by providing additional incentives (for example, reducing the toll gate taxes on funds so invested). Also, in order to induce the "936 corporations" to deposit

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their funds on longer terms, it would be necessary that some degree of certainty be given by Congress that the provisions of Section 936 will not be revisited in the near future. The proposal to maintain Section 936 as it is for a period of at least ten years would definitely accomplish such objective and will also assist the Puerto Rican Government in promoting new manufacturing facilities in the island, which are badly needed for purposes of reducing the current high rate of unemployment in Puerto Rico and stimulating the Puerto Rican economy as a whole.

We hope that our comments have provided you with information concerning the substantial benefits derived by the Puerto Rican economy regarding the use of "936 funds" by the federally chartered savings and loan associations and allow you to appraise such benefits.

We appreciate your giving us the opportunity to present our views in this hearing, and thank you for your invitation.

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CONGRESSMAN ROBERT GARCIA

QUESTIONS ON

Testimony of Ramiro L. Colón, Jr., Esq. at the hearing held by the Subcommittee on General Oversight and Renegotiation held on December 15/82

QUESTION:- Secretary Culpeper indicated during her response to a question asked by Chairman Minish that 936 funds were a major reason that thrifts in Puerto Rico have not experienced the same problems as thrifts here on the Mainland.

ANSWER:- The comment that was made in our testimony is based on the new regulations issued by the Puerto Rico Treasury Department and which became effective on February 1982. The interpretation given by the Puerto Rico Treasury Department is that "direct tracing" on the use of 936 funds has to be made. This requirement is very difficult to comply with when financial institutions, particularly savings and loan associations are receiving 936 funds on a short term basis; say 36, 60 or 90-days, and have to invest them in long term (25 or 30 years) mortgage loans. The fact is that as of this date, the Treasury Secretary of Puerto Rico has not authorized the federally chartered savings and loan associations to become elegible to receive 936 funds directly.

QUESTION:- Is this the case with many of the members of the Puerto Rico Savings and Loan League?

ANSWER:- You can have more imput. Definitely, 936 funds have helped the savings and loan industry in Puerto Rico, particularly because previous regulations did not require tracing or matching of 936 funds with investments and savings and loan associations had as much as $700 billion of 936 funds that reduced the cost of money. Assuming a spread of 3% differential between the cost of 936 funds and other funds, the savings and loan industry in Puerto Rico benefited at the rate of $21 million per year when they had as much as $700 million in 936 funds; and $15 million per year when that figure dropped to $500 million of 936 funds during 1982.

QUESTION:- Is the percentage of assets from 936 funds as high for the thrifts as it is for the banks which have indicated that 936 funds represent an estimated 40% of their assets?

ANSWER:- As of December 31/81 the twelve federally chartered savings and loan associations in Puerto Rico had total assets of $2.8 billion and held $500 million in 936 funds. This represents 18% of their total assets; less than half as much as the commercial banks, but still a sizeable amount. Commercial banks receives the funds directly from 936 corporations without involvement of intermediaries. In the case of savings and loan associations, particularly due to the financial condition of the industry -both on a local and nationwide level, the 936 corporations would not make directly deposits and therefore, the savings and loan associations has to depend on investment bankers which acted as brokers, in order to receive the funds. The intermediaries or brokers will guarantee the repayment of the 936 funds deposited and in turn, would require an additional collateral from the savings and loan associations.

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QUESTION:- If 936 were drastically modified, what impact would you forsee on the thrift sector in Puerto Rico and on the American financial system including mainland institutions and such governmental bodies as the FDIC and FSLIC?

ANSWER:- Presently, savings and loan associations have around $500 million in 936 funds. According to the elegible activity that they had generated since 1975; i.e: mortgage loans, the twelve federally chartered savings and loan associations in Puerto Rico could receive as much as $900 million of 936 funds. Assuming a 3% differential between the cost of 936 funds and other funds received by the savings and loan associations, the cost of money to the associations were they are not to receive 936 funds, will increase between $15 million and $27 million annually. This would possibly cost the failure of several of our savings and loan associations and would particularly cost the Federal Savings and Loan Insurance Corporation a large sum of money and the FDIC would also be affected since several commercial banks has been able to make a profit because of 936 funds.

In order to be able to develop a strong economic basis and promote the industrial, commercial and agricultural sectors of the economy, strong financial associations will definitely be needed. If Puerto Rico has a strong financial sector todate it is due in a large part to the 936 funds. Failure of the financial system in Puerto Rico and the closing of financial institutions, whether they be commercial banks or federal savings and loan associations, would have a negative impact on similar associations in the mainland.

Chairman MINISH. Mr. Colon, I will instruct the subcommittee counsel to look into the regulations that you mentioned on page 8.

Let me ask, gentlemen, is it a fair statement to say that the entire economy and quality of life in Puerto Rico depends upon a stable 936. Would you agree with that statement?

Mr. FERNANDEZ. Yes, sir.

Mr. REXACH. That is a very accurate statement.

Mr. COLON. Definitely.

Chairman MINISH. I talked with Mr. Garcia on the way over in discussing this problem as we were going over to vote. I can tell you that his concern is not exceeded by anyone at the witness table. We will do whatever is in the jurisdiction of the committee to try to be helpful in the matter. We will make the committee, the tax-writing committee, the Ways and Means Committee, and the important people there, aware of your concerns once the record is printed and hopefully some good will come out of this hearing that Mr. Garcia has pressed me to hold.

Counsel just sends me a letter that because the Congress is coming to a close in the next 2 weeks, any material that you want inserted in the record should be with us within the next 7 days.

Mr. Garcia.

Mr. GARCIA. Mr. Chairman, thank you very much. I just would like the witnesses to know and understand the prerogative of the Chair, those who have the responsibility for, in this particular case, the oversight of the banking industry of the U.S. Congress is the chairman, Mr. Minish, of New Jersey.

I would like to take this opportunity in front of all of you to thank him personally, because there are some chairpersons who, in fact, may not have done it. He opened up the door for us to start to establish a record. So to that end, I think all of us are deeply grateful to the chairman for not only his kindness but his patience in sitting with us all afternoon and all morning to hear the testimony as established by those of you who live in Puerto Rico.

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I have a number of questions that I would like to ask, but to be frank, we are working on some legislation on the floor and I expect a vote will be coming up any moment. I think that we have established a great deal in terms of this hearing.

There are some questions I would like to send or give to you personally. I would hope that you would be able to take those questions with the permission of the Chair and respond to them within the next couple of days so that we can enter those questions right after your testimony so that it will be related to that part of your testimony.

One other thing the Chair failed to say, and I guess with his permission I would like to do it. We originally wanted to do this in Puerto Rico. As most of you know—I think I spoke to most of you, but as I said before, the constraints of an extra session, an extraordinary session, has made it virtually impossible.

Some of us don't even know if we will be home by Christmas Eve. That is how crazy it is. But he did say something to me about the fact that hearing what was said—and I thank him for it, but to follow this up with Puerto Rico itself and to be in Puerto Rico to hold these hearings and to follow up on these hearings, coupled with that to try to visit some of the facilities in Puerto Rico where Puerto Ricans are working and where people are supporting families and raising—sending children to school based on the moneys that have been put forth by the 936 tax law.

So with that, again in deep appreciation to Mr. Minish, chairman of this committee, I have no further questions. I would just like to say, especially to you, Mr. Fernandez—and you always single this stuff out—I think your testimony was testimony that hit at some points that heretofore had not been mentioned. I just think it was important that it be recognized in this committee.

I think all the testimony was excellent, but there were one or two points you made that stuck in my mind. I just think that that has to help Puerto Rico, all of you together here, because Puerto Rico needs help.

Mr. Chairman, thank you very much.

Chairman MINISH. Again, thank you, gentlemen, for coming up here and giving us your views on the things that, of course, are dear to the Commonwealth of Puerto Rico. Let me assure you that even though the hearing ended today, the interest that I have—and I speak for the subcommittee—will not go away.

Thank you.

Mr. JANER. Mr. Chairman, may I on behalf of all the members of the panel wish all the members of your family and staff a merry Christmas and happy new year.

Chairman MINISH. Thank you. Same to you and all your friends.

[Whereupon, at 4:10 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

[The following statement of President Alberic O. Girod of the Girod Trust Co. was submitted for inclusion in the record:]

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STATEMENT OF ALBERIC O. GIROD, PRESIDENT
OF GIROD TRUST COMPANY, CONCERNING
THE SECTION 936 TAX INCENTIVE PROGRAM

I am pleased to have the opportunity to submit this statement to the Subcommittee on General Oversight and Renegotiation of the Committee on Banking, Finance and Urban Affairs, on the effects of the Section 936 program. As the chief executive officer of a local financial institution in Puerto Rico, it is clear to me that Section 936 now provides and must provide for the foreseeable future indispensable support for the people and economy of Puerto Rico.

Section 936 of the Internal Revenue Code provides a special tax credit, and effective tax exemption, for subsidiaries of U.S. corporations engaged in the active conduct of a trade or business in Puerto Rico. In Puerto Rico, where unemployment exceeds 20 percent, Section 936 corporations directly employ over 60,000 persons. However, an assessment of the job creation effects of Section 936 simply cannot stop at this level. The creation of these jobs has very positive indirect effects on the local economy as these employees, in turn, purchase goods and services with their income. Moreover, the Section 936 companies also purchase significant amounts of goods and services from

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entities within Puerto Rico. The employees of these entities in turn contribute to the economy of Puerto Rico through the purchase of local goods and services. These indirect positive effects on the economy of Puerto Rico obviously have to be taken into account in assessing the overall effects of the Section 936 program, but, in fact, are often overlooked.

A comprehensive assessment of Section 936 also has to take into account its effect on financial markets in Puerto Rico. The inclusion of "qualified possession source investment income" within the types of income that qualify for the Section 936 tax credit, along with the parallel exemption from Puerto Rico tax for income derived by qualifying businesses from certain specified investments in Puerto Rico have resulted in a unique Section 936 funds market. This pool of funds, which now exceeds $6 billion, must be invested in certain specified types of investments in Puerto Rico. These investments now earn rates of return below those available for comparable investments outside Puerto Rico.

Effective February 1, 1982, the Puerto Rico Department of Treasury issued a series of regulations which were designed to preclude Section 936 funds from leaving Puerto Rico and to encourage their investment in specified activities. The

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effect of these amendments and the prior regulations has been to concentrate the investment of Section 936 funds in three major areas: commercial loans, government obligations and real estate mortgages. There can be no doubt that the existence of the Section 936 pool of funds has increased significantly the levels of these types of investments in Puerto Rico over what they otherwise would be.

Since interest paid on qualified possession source investment income is, in effect, tax-exempt to the investing Section 936 corporations, Section 936 has reduced significantly the cost of money of Puerto Rico financial institutions. As a result, the cost of borrowing funds for various commercial purposes has been significantly lower in Puerto Rico than in other comparable jurisdictions. In fact, local bankers were able to lend Section 936 funds recently at as much as 500 basis points below the prime rate. These reductions are obviously important in expanding the level of economic activity in Puerto Rico; we have all seen the inhibiting effects high interest rates have had recently upon economic activity in the United States.

The availability of this large pool of Section 936 funds also has increased substantially the liquidity of many

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financial institutions receiving these funds in Puerto Rico, thereby providing for a stronger and sounder banking system. This added strength and liquidity is particularly important in the context of some of the weaker commercial banks and savings and loan associations in Puerto Rico. Most of these weaker financial institutions are insured either by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation. To the extent participation in the Section 936 funds market strengthened the financial condition of these institutions or makes these institutions more attractive acquisition candidates, the Section 936 program has reduced or will reduce the costs to these agencies associated with their insurance obligations for deposits in these institutions.

Even though the Section 936 program provides vital benefits for the people and the economy of Puerto Rico, it has not been allowed to realize its full potential in encouraging U.S. companies to open and expand subsidiary operations in Puerto Rico. This failure is attributable to uncertainty created by virtually continuous Congressional evaluation of the merits of the program for almost a decade. The uncertainty inhibits corporations from committing funds for new or additional long-term investments in Puerto Rico. Without the underlying confidence that the basic Section 936

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tax structure will be maintained for the foreseeable future, corporate strategic planners are not acting unreasonably in substantially discounting the long-term tax benefits to their companies of the Section 936 program.

The amendments to Section 936 enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 are viewed now by most Section 936 corporations as serious but not terminal. However, Congress came very close during the recent legislative process to enacting much more drastic limitations to the basic Section 936 structure. Moreover, Senator Robert F. Dole, Chairman of the Senate Finance Committee, and Congressional staff subsequently indicated that Congress may give serious consideration again in the near future to major restructuring of Section 936. Those actions appear to have further eroded the sense of certainty and security that is necessary for the Section 936 program to be a fully efficient incentive for locating and expanding job-creating business operations in Puerto Rico.

Members of Congress have the responsibility to review periodically all existing legislative programs such as Section 936 to ensure that they are functioning effectively. Consequently, I do not question the need to review the

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Section 936 program periodically. However, Congress and the U.S. Treasury Department must be made more aware of the adverse effects of signals they give that indicate serious future consideration of major restrictions or elimination of the Section 936 program. For the program to operate effectively, Congress and the U.S. Treasury must give strong affirmative indications that Section 936 in its basic form -- effective Federal tax exemption for income of U.S. corporations with substantial business activities in Puerto Rico -- will be allowed to continue for the indefinite future. Alternatives of either elimination or a radical contraction of Section 936 or substitution of a closely administered spending program are either too draconian in effect or too impractical to administer to withstand careful scrutiny.

There is no doubt that if Section 936 were repealed, most Section 936 corporations, having lost their major incentive to be in Puerto Rico, would phase out their operations rapidly. Many of their factories would be moved overseas, with a consequent loss of employment to areas outside the United States and a resulting need for increased assistance from the Federal Government to Puerto Rico.

The Section 936 program has been and remains the target of frequent criticism related to its cost in lost

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revenues to the United States Treasury. However, the revenue estimates utilized in this criticism are based upon the erroneous assumption that Section 936 corporations would continue doing business in the United States if Section 936 were repealed. In fact, if, as I have indicated, repeal would cause many Section 936 corporations to transfer their operations overseas, then the revenue to be gained through repeal would largely evaporate and not be realized by the Federal Treasury. Nor do the revenue estimates take into account the effects of the sharp increase in unemployment and diminished personal income in Puerto Rico that repeal of Section 936 would have on the Federal deficit in terms of increased Federal transfer payments to Puerto Rico.

Another major consequence of repeal of Section 936 would be its effect on local financial institutions. In a word, from my personal experience, the effect on financial institutions of the repeal of Section 936 would be disastrous. According to the Puerto Rico Department of the Treasury, Section 936 funds channelled into financial institutions in 1982 amount to approximately $5.5 billion, or more than 40 percent of total deposits in Puerto Rico banks. It is hard to imagine how a banking system anywhere could survive a rapid drain of 40 percent of its deposits. Yet such a

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drain would result if Section 936 were repealed or if the qualified possession source investment income rules were repealed.

The island of Puerto Rico is scarcely 100 miles long and 30 miles wide. It is populated by approximately 3.5 million people, making it one of the most densely populated areas in the world. Aside from being aesthetically attractive, Puerto Rico does not have a significant amount of natural resources. Wage costs, shipping costs, and energy costs are all relatively high. Due to all of these limitations, Puerto Rico has become increasingly dependent on the benefits generated by the Section 936 program.

Thus, I cannot emphasize enough the importance the Section 936 program has for Puerto Rico and the need to give United States investors in Puerto Rico a sense of certainty concerning the long-term existence of the basic Section 936 structure. Countries such as Brazil and Mexico with much more abundant natural resources and much lower industrial costs than Puerto Rico are now at the brink of financial collapse. At such a time, it is in the interest of all United States citizens to allow the Section 936 program to continue to work and to work as efficiently as possible to enable Puerto Rico to improve its economic position and the welfare of its people.

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