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The Rise and Fall of Section 936: The Historical Context and Possible Consequences for Migration

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Introduction

Section 936 refers to the "Overseas Possessions Corporation" legislation, amended in 1976, of the Federal Tax Code.[1] This legislation was at the heart of the incentives package that promoted the island's manufacturing sector after World War II. As Rivera-Batiz and Santiago point out in their work, Section 936 represented the third stage of industrial policymaking on the island over the last Half Century.[2] Coupled with local tax incentives, this 936 modification of the Internal Revenue Code represented a generous federal tax incentive. It continued the practice of permitting companies to repatriate profits nearly tax free, and it also allowed income generated from their investments in Puerto Rico (for a minimum of six months) to be repatriated to their US–based parent firms tax free. It encouraged the appearance of knowledge intensive industries on the island (e.g., electronics and pharmaceuticals), which could assign various royalties to their Puerto Rican subsidiaries and gain major tax benefits to boot. It also encouraged a rapid growth of the financial system on the island.

These "936 funds," or corporate investment monies deposited in Puerto Rican banks, became a major source of funding for commercial loans, mortgages, and government loans in Puerto Rico. Through the Federal government's Caribbean Basin Initiative (CBI) of 1982, 936 funds also became a low-cost loan source for commercial development activities in other countries in the region.

Congress began the phase-out of Section 936 in 1996, and some analysts in Puerto Rico and the United States predicted a major out-migration from the island, but to date this has not occurred. Yet an emigration may still occur as tax exemption ends completely in 2006. Given more than 100 years of US–Puerto Rican relations, and given that such a centennial demands an analysis of the various aspects of this tie, we shall examine the history of the island's economic policies and consequences for migration over the decades.

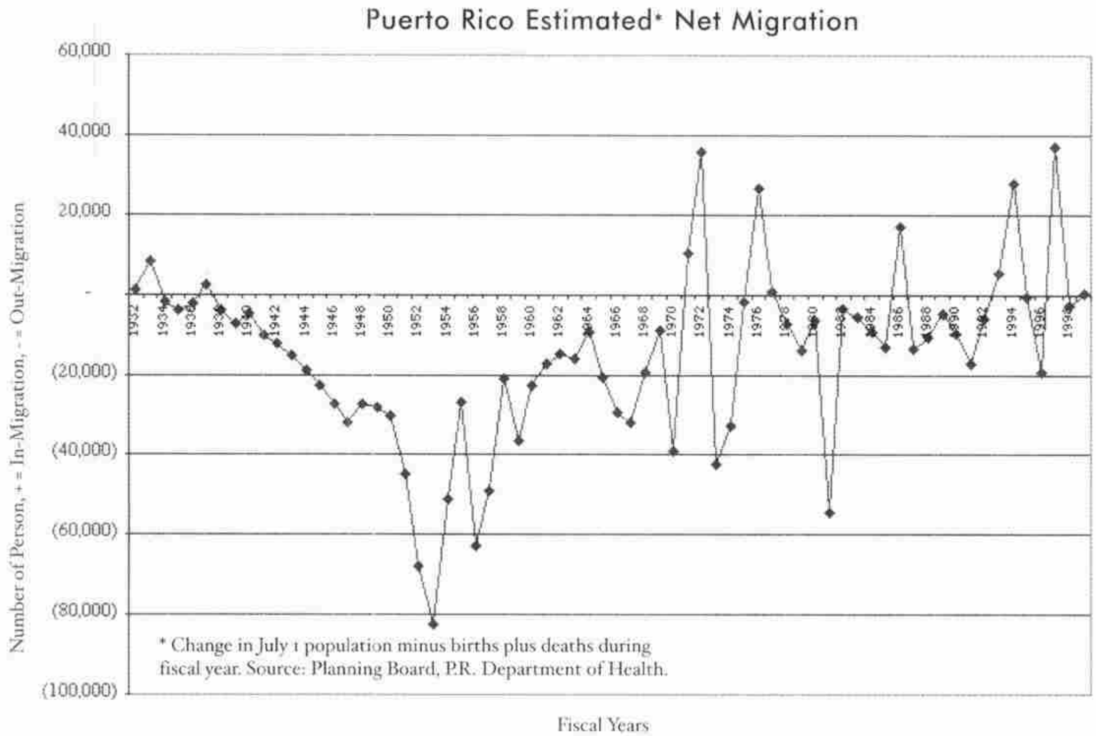
A Brief Overview of Puerto Rican Migration to the Mainland

Although Section 936 became US law and a Puerto Rican investment incentive only in 1976, US investment on the island and migration to the mainland have been significant factors in Puerto Rican history since the beginning of the twentieth century. A sizable body of literature links migration to the States with economic conditions although specific economic incentives do not necessarily play a part on the island or the mainland (Iglesias 1964; Sanchez-Korrol 1994; Haslip-Viera 1996; Sanabria 1996).[3] None of these pieces systematically examines the theoretical debate on causes of migration, but it seems likely that these authors would reject a simple "push-pull" analysis or a straightforward link between island and mainland economic conditions. These authors implicitly support a nuanced, sociohistorical approach to analyzing migration; their research focuses not only on economic underpinnings but also focuses on microstructures. In other words, while the scholars' efforts consider economic factors in migrations, the phenomenon is also viewed as socially embedded in migrant networks (see Portes and Rumbaut 1990: 231).

The first migrants to the States, especially those who made their way to New York between 1900 and 1940, were 'los pioneros,' or the pioneers. They constructed the social networks that facilitated the massive migration following the end of the Second World War. By the 1920s, unemployment in Puerto Rico had reached epidemic proportions. As a result, by 1930 the Puerto Rican population in New York City had reached 52,774 persons. The high out-migration to the States would no doubt have continued, except that the lack of jobs on the mainland, due to the Depression, proved a powerful disincentive.

The story of the massive Puerto Rican migration linked to the end of the Second World War and the start of Operation Bootstrap has been told numerous times (History Task Force 1979; Dietz 1986; Rodriguez 1991). Writers give much weight to the changing economic conditions wrought by Operation Bootstrap; the switch from agriculture to manufacturing is thought to have been largely caused by dependence on federal tax incentives. The reality of thousands of returning veterans and the need for a new economic model based on manufacturing rather than sugar meant that officials now needed to attract manufacturing firms to the island by a host of local policies. Moreover, such policies needed to fit within the US legal and currency systems. The local incentives included low wages, subsidized buildings, worker training programs and local tax holidays. Additionally, the federal policy of tax exemption under section 262/931, the forerunner of Section 936, would become one of the most important measures intended to increase the outside investment. Even so, not enough jobs were being created in manufacturing to compensate for the declining numbers of jobs in agriculture. As a result, limited opportunities on the island, coupled with perceived opportunities for work on the mainland, along with an established migrant social network, especially in New York, contributed to the exodus.

The social consequences of the early years of Operation Bootstrap (1948–1964) were mixed. Large numbers of islanders experienced an enhanced quality of life, but also high levels of unemployment occurred and rates of out-migration were high. The graph below indicates a sustained large out-migration from the mid–1940s to the mid–1960s, with 1950 to 1956 having consistently high numbers.[4] Thus, by 1960, about 900,000 Puerto Ricans lived on the US mainland. The island government viewed migration throughout this period as a political and economic safety valve, although it was careful



to avoid formal pronouncements on this point. It is illustrative to note the figures on what many analysts refer to as the "Great Migration" from the mid–1940s to the mid–1960s (Rodríguez 1991).

The most recent period of Puerto Rican migration, from 1965 to the present, has been characterized by Clara Rodriguez (1991) as "revolving door migration." She describes a fluctuating pattern of net migration as well as a greater dispersion of migrants throughout the United States away from New York City. During this period, Puerto Rico has experienced changes in the nature of its manufacturing sector, reflecting the government's change in emphasis first from labor-intensive to capital-intensive industrialization and growth in the services sector. This period also encompasses a series of economic traumas on the island first in the 1970s, with the OPEC oil embargo and, as an indirect consequence, the demise of Puerto Rico's petroleum refining and petrochemical industries. Furthermore, in the early 1980s, Puerto Rico faced many federal program cutbacks during the Reagan era. Although the economy has grown in the 1990s, 1996 brought initial restrictions on Section 936 investments and its ultimate phase-out over ten years. We now turn to these changes and their potential consequences for out-migration.

A Restructured Puerto Rican Economy: The 936 Change and Recession

The change to Section 936 in 1976, although intended to cover a loophole in the tax code and to address early cries in Congress of "corporate welfare," reflected and contributed to the capital-intensive character of the manufacturing sector and growth in the service sector. Jobs were lost as the labor-intensive firms moved to lower wage areas, principally in the Caribbean and Asia. The petroleum-refining and petrochemical industries also moved, in this case, due to changing federal oil policy. The changes made to 936 contributed to the already apparent trend toward higher wage jobs, though not necessarily enough jobs were created to replace the ones being lost. While some tax loopholes may have been closed, on balance, the 1976 modifications enhanced the island's attractiveness as an industrial location for specific capital and knowledge-intensive industries (Baver 1993:79). Industries benefiting from the new Section 936 were those with a high research and development component—pharmaceuticals, software, etc.—that companies could assign to their Puerto Rican subsidiaries.

A second result of the change to 936 was that corporations could no longer receive tax-exempt interest income by banking their Puerto Rican profits in US possessions other than Puerto Rico. The rationale for this policy was to end passage of these funds from Puerto Rican banks to other locations or to Eurodollars. The Puerto Rican profits would create a large pool of capital for low-interest loans for productive ventures and job creation on the island. The new funding pool was intended to enable the island government to finance low-income housing and provided mortgage and industrial loans at below-market rates. Consequently, new jobs were created in the construction and finance sectors, but these jobs did not necessarily go to those displaced by the switch from the older manufacturing activities.

The 1980s and Migration: Recent Analyses

The island workforce not only had to adapt to the economic restructuring started in the 1970s but also to cuts in federal budget outlays in the 1980s. While, anecdotally, many characterized this exodus as "a brain drain," the systematic studies of out-migration in the 1980s by Meléndez (1993:9–10) and Rivera-Batíz and Santiago (1996:48–64) find that emigrants represented a cross-section of the island population rather than an overly high percentage of educated people. What is not in dispute, however, is that a significant pool—over 100,000 persons—of "circular," or "floating," migrants existed, and that these back-and-forth travellers generally were less educated and less successful in the workforce than those who stayed either on the island or mainland (Cordero 1989; Meléndez 1993; Rivera-Batíz and Santiago 1996; New York Department of City Planning 1993).

The 1990s and U.S. Tax Politics

Given that a federally legislated tax incentive has been central to the Puerto Rican economy for the last fifty years, it is important to examine why Congress began phasing out the program in the mid–1990s. We shall also speculate on possible economic and migration consequences.

Both before and after the change in 936 in 1976, the section of the federal tax code allowing US corporate tax exemption in Puerto Rico and other US possessions has come under attack as "corporate welfare." There is truth to this charge; starting in the late 1940s and certainly by 1976, tax exemption was a central component of the Puerto Rican economy. Congress modified Section 936 in 1982 and 1986; however, in both rounds of policy-making, effective pressure from the Commonwealth government and lobbyists for what were called the "936 corporations" managed to stave off drastic changes and mute congressional complaints that 936 was an expensive tool for job creation. In 1986, the lobbying effort was especially creative, tying 936 to national security concerns in the Caribbean. In that year, Congress authorized Puerto Rico to lend a portion of 936 profits held in Puerto Rican banks to countries participating in the Caribbean Basin Initiative. In the decade of lending between 1986 and 1996, $1.2 billion in financing was made available for Caribbean-wide infrastructure projects and manufacturing investment throughout the region.[5]

In 1993, however, the conjuncture of political and economic conditions in the United States and Puerto Rico signaled the possibility of drastic changes in 936, even its future demise. However, in that year's round of tax policy-making, several members of Congress, who understood the centrality of the incentive for the Puerto Rican economy, warned against ending the exemption, citing scenarios of dire consequences for the mainland—namely a mass Puerto Rican migration with accompanying budgetary costs. The most dramatic and negative scenario has been attributed to New York Senator Daniel Patrick Moynihan, a long-time Puerto Rico watcher and ranking Democrat on the Senate Finance Committee. At a private dinner with President Clinton in 1993, the Senator apparently saved 936, but ultimately, only for three more years. According to journalist Bob Woodward:

> Moynihan demanded that Clinton scale back his planned elimination of the Puerto Rico tax credit. He [Moynihan]. . . raised the specter of revolution in the Caribbean. He said that elimination of the tax program would not only double unemployment in Puerto Rico but could vastly increase migration to NewYork. . . . [Furthermore] the increase in welfare and other social services costs would outstrip the savings achieved from abolishing the tax.[6]

Nevertheless, in 1993, Congress amended the Internal Revenue Service Code, with the "Revenue and Reconciliation Act," to restrict the income of high-tech companies by making a portion of their income taxable at federal levels. Thus, by 1998, the advantage of Section 936 rules compared to Foreign Corporation Tax rules for new companies would disappear. Furthermore, the 1993 amendments created an economic activity credit or wage credit to fund jobs in Puerto Rico. This modification, signed by the new Clinton administration, was intended to improve the cost and effectiveness of the tax incentive and to focus on job creation.[7] Although analysts such as Villamil (1997) may have welcomed the federal focus on jobs, typically they argued that a wage credit alone would not suffice to promote investment in the Puerto Rican economy.

Early in 1996, the US Congress moved to repeal Section 936 entirely as part of a balanced budget proposal. Significantly, for ideological reasons, the pro-statehood Rosselló administration did not lobby Congress to maintain the program. Ultimately, a ten-year phase-out of 936 was signed into law in August of that year as part of the Small Business Job Protection Act, legislation passed to offset the costs to small enterprises of an increase in the federal minimum wage. Beginning the end of Puerto Rico's tax exemption program did not cause an immediate exodus of firms or islanders, but it did give some analysts something to ponder.[8] In 1996, Puerto Rico had a 14 percent unemployment rate with a per capita income of $7,500, or 50 percent of the per capita GDP of Mississippi, the poorest state in the nation. Furthermore, about 300 corporations were doing business in Puerto Rico under

Section 936 at this time. These firms represented about 87 percent of all manufacturing employment and accounted directly or indirectly for about 30 percent of jobs on the island. Soon after the legislation was passed, a *New York Times* article presented a reasonable scenario for the manufacturing sector:

> Economists expect a slowdown in investment by companies not yet operating in Puerto Rico, but some also forecast an immediate pick-up in activity by those on the island as they seek a final fillip before their tax benefits are capped in several years and then phased out by 2006 (Hemlock, 1996).

The End of 936 and Puerto Rican Migration

With the loss of 936, Puerto Rico's economic future is difficult to predict. During the last century, the main factor shaping movement in the island economy has been the condition of the mainland economy; and for the last half century, tax exemption has been important. Still, other factors must also be considered. First, island officials are still hoping that the Federal Government will offer a new incentives program to replace Section 936, which to date has not occurred. Furthermore, some manufacturing enterprises, in the pharmaceutical sector, for example, may choose to remain in Puerto Rico and continue to profit. Indeed, some companies have already begun to change their tax liability strategies by switching the registration of their operations to the foreign subsidiary provisions of the Federal Tax Code. As some industrialists have quipped, "If Section 936 represents a '10' in terms of tax exemption, the benefit that exists for foreign subsidiaries...is a '9.'[9] This switch in tax strategy, however, may represent a short-term response during the ten-year phase-out. Corporate plans after 2006 are unclear.

Undoubtedly the loss of 936, if not replaced with another federal program, a comprehensive economic initiative by the local government, or both, will have negative consequences for the island economy. The local government has made some specific attempts to address the needs of the manufacturing sector with the Commonwealth Tax Exemption Act of 1998. The local tax incentives and cash subsidies, however, are really intended to encourage firms already on the island to expand rather than to attract new firms. The island government has also worked on expanding the number of Foreign Trade Zones (FTZs) on the island to help the manufacturing sector. As of 1999, FTZs comprised about 4,500 acres on the island.

Since 1996, Puerto Rico's government has lobbied Washington to try to make up for some of the loss that the end of 936 will mean. However, as of the end of 1999, Congress has not acted. Island officials had hoped, for example, that Congress would agree to make permanent (beyond 2005) the Section 30-A wage credit for US firms investing in Puerto Rico. Congress, though, was not in a tax-cutting mood, at least in negotiating the fiscal 2000 budget; it rejected an extension of the wage tax credit along with other proposed Puerto Rican amendments.[10]

It is generally felt that the larger, capital-intensive ventures already in Puerto Rico will remain after 2006 with a change to Controlled Foreign Corporation status.[11] There is no doubt, however, that jobs in the manufacturing sector have declined in the last couple of years. In August 1999, island Labor Department statistics revealed a loss in manufacturing employment for the second consecutive year, a loss in the sector of about 25,000 jobs. Also indirectly attributable to the 936 loss are jobs in finance, insurance, real estate transportation, and communications. San Juan Star editorial writers have responded, however, that "the overall economic situation on the island is not dire," since about 50 percent of jobs will be made up with new promotions.[12]

Part of the reason that the situation is not dire is because the Rosselló administration has been trying to restructure the island's economy. The pro-statehood government, for example, has pushed for a major expansion of the tourism sector. Governor Rosselló also has mounted a major privatization campaign in recent years, involving the telephone company, public hospitals, water supply, and other bastions of the Commonwealth state. In regard to supporting the end of federal tax exemption, however, the privatization campaign is spurred more by the governor's pro-statehood credentials than by island economic growth.[13] A smaller public sector would place Puerto Rico more in line with the fifty states and would appeal to Congressional Republicans.

Economic Change and Migration within the Context of the Status Debate

In addition to contemplating dislocations that might affect the island economy by the loss of Section 936, we should place a discussion of economic change and links to migration in the larger context of the ongoing status debate. Now that the century of the Pax Americana has ended, there has been renewed energy in Washington to resolve its "colony problem."[14]

The present round of status politics actually began a decade ago. To summarize, in 1988, Governor Rafael Hernández Colón requested that the US Congress create a framework for holding a plebiscite in Puerto Rico. The task was taken up by Democrat J. Bennett Johnson, Chair of the Senate Energy and Natural Resources Committee. This legislative effort died in committee in 1991.[15] In reaction, the pro-statehood Partido Nuevo Progresista and its newly elected governor, Pedro Rosselló passed legislation for a local status referendum, nonbinding on the US Congress, which was held in 1993. Commonwealth status won the contest, but by the barest of margins, 48.6 percent, compared to 46.3 percent for statehood, and 5 percent for independence.

In the mid-1990s, some members of the Republican-led Congress and the Democratic Clinton administration gave new impetus to resolving the Puerto Rican status debate given a combination of factors—the end of the Cold War, rising budgetary outlays for the island, and, more symbolically, the approaching centennial of the Spanish American War. This time, the legislative effort was led by Representative Don Young of Alaska, Republican Chair of the House Resources Committee. A plebiscite bill, "The Puerto Rico Status Plebiscite Act," passed in the House in March 1998, but by only one vote (209 to 208). This caused Majority Leader Trent Lott to decline support for the legislation in the Senate. The House vote and Senate inaction revealed the extreme ambivalence in Congress to hold a binding vote, because of the thorny issues that a possible vote for statehood would raise. Those often discussed concerns have been the official language of the fifty-first state, Puerto Rico's relative poverty, the number of legislators and partisan makeup of the island's congressional delegation, and the precedent of Puerto Rican statehood in the debate on statehood for Washington, D.C.[16] Finally, with no plebiscite bill emanating from the US Congress, pro-statehood governor Rosselló orchestrated a December 1998 nonbinding local vote, in which the results were 53 percent to 46 percent against statehood and against the alternatives open to Puerto Rico in the House's March 1998 bill.[17]

Conclusion

As the twentieth century comes to a close, the process of globalization is placing new pressures on the Puerto Rican economy for change. We cannot predict what those changes will be but only note that the key industrial investment incentive, Section 936, will end in 2006, and at present, no clearly defined alternative economic strategy has been articulated. Furthermore, the end of the Cold War has resulted in the United States' taking a new look at old colonies; Washington has become interested in changing the present US–Puerto Rican tie. At present, a large majority of Puerto Ricans want to keep some tie with the United States. At the same time, Congress presently finds it economically, politically, and culturally expeditious to offer any status but statehood. While the complex relation is being sorted out, Puerto Ricans will have to continue to adapt to economic and political forces largely not of their own making. Migration is one of the ways they have adapted to changing external circumstances that will continue for the foreseeable future.

1 Section 936 replaced Section 931, which in turn replaced Section 262. The legislation in the Federal Tax Code covering Overseas Possessions Corporations was first enacted in 1921.

2 Francisco Rivera-Batíz and Carlos Santiago, *Island Paradox: Puerto Rico in the 1990s.* New York: Russell Sage, 1996, p.11.

3 The works cited are historical analyses; for a review of the economic analyses on Puerto Rican migration, see Rivera-Batíz and Santiago, Chapter 3.

4 My thanks to John R. Stewart, Jr. for supplying this graph.

5 *Caribbean Business,* November 14, 1996: 24

6 According to author, Bob Woodward (*The Agenda,* pp. 175–176), the first argument Senator Moynihan used was that if 936 were eliminated, the statehood option would win in the 1993 plebiscite. Woodward paraphrases Moynihan's concerns, and hints at the awkward consequences such a vote would have for the Federal government. "Puerto Rico would apply for statehood, and Congress would of course reject the application." Also relevant is a 1990 Congressional Budget Office (CBO) study that examined the effects of a loss of Section 936 for the Puerto Rican economy. Although the study had been requested to determine the general economic impact of a change to statehood, the authors felt that this potential status change, with the accompanying loss of federal tax exemption, "may eventually bring about a significant reduction in the growth of the Puerto Rican economy." (CBO 1990: 1,17)

7 The changes in Section 936 resulting from the Revenue Reconciliation Act of 1993 (OBRA legislation) went into effect in 1998.

8 For a representative piece see, A. W. Maldonado, "A New Look at the Effect of Section 936." *San Juan Star,* January 14, 1996.

9 Hector Figueroa, "Life After Section 936," *Critica,* September 1996:7.

10 *San Juan Editorial,* "Local Economy Needs Incentives," August 1, 1999.

11 *Caribbean Update,* January 1999:18).

12 *San Juan Star,* August 1, 1999.

13 Juan González , "Puerto Rico has Never Seen Anything Like It," *The Progressive,* September 1998, p.p.24–27.

14 Significantly, the political activity around recent status politics has contributed to concern by external investors. For example, Frost and Sullivan, a political risk analysis firm that publishes yearly reports for investors, placed Puerto Rico at the top of its list of stable locations in the late 1980s; but by 1997, it was ranked 22nd. The risk analysis is discussed in Tony Best's article, "What Ever Happened to Puerto Rico's Section 936?" *Carib News,* September 8, 1998, p. 5.

15 Sherrie Baver, *The Political Economy of Colonialism.* New York: Praeger, 1993. pp. 128–134.

16 For example, "Puerto Rico Political Status," *Congressional Digest* (May 1998), passim.

17 Juan Manuel García Passalacqua, "Puerto Rico's Redress of Grievances." *Current History,* 98, March 1999.

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