A STUDY OF SECTION 936 OF THE FEDERAL INTERNAL REVENUE CODE AND ITS IMPACT ON PUERTO RICO'S CONSTRUCTION INDUSTRY

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ABSTRACT

Section 936 of the Internal Revenue Code, the "Possessions Tax Credit," offers tax incentives to U.S. companies in order to encourage manufacturing investment and job creation in Puerto Rico and certain other U.S. possessions.

Just 50 years ago, Puerto Rico was one of the poorest lands in the western hemisphere. However, Section 936 and its predecessors have to a great extent helped shift the Island from being "the poorhouse of the Caribbean" to one of the most prosperous economies in Latin America.

The purpose of this thesis is to review how Section 936 affects the Puerto Rican construction industry and the challenges and opportunities it provides to construction firms.

Thesis Supervisor: Prof. Fred Moavenzadeh
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To my Parents
for all their love and support

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INTRODUCTION

Without a doubt the most widely used and heard number in Puerto Rico is 936. This is not just another number, as 936 corresponds to the section of the Federal Internal Revenue Code which provides for tax free treatment of income earned by U.S. corporations from their operations in Puerto Rico and other U.S. possessions.[1]

Although Section 936 has been under constant attack since its enactment in 1976, it has survived to this day with just minor changes. However, due primarily to the economic situation in the U.S., the future of the Section might be in jeopardy. With the beginning of the Clinton Administration and its policies toward the revitalization of the U.S. economy, Section 936 has gained tremendous attention once again; but this time it is almost certain that a major adjustment of the Section is going to take place.

Section 936 is of great importance to the economy of Puerto Rico. It has proven to be the catalyst needed to boost the island's economic development. In just 50 years the island has shifted from being "the poorhouse of the Caribbean" to one of the most prosperous economies in Latin America.[2] The 936 corporations, under the Industrial Incentive Act of 1948 are also offered exemption from P.R. taxes.[3] The combination of total exemption from tax on income, the absence of tariff and quota barriers on trade with the mainland, and an eager and abundant work force have proved interesting to many U.S. manufacturers.[4] Section 936 corporations include a wide range of industries,

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[1] Hereinafter referred to as "Section 936".
[2] Roberto L. Pratts, What are the Alternatives for the Commonwealth of Puerto Rico with Section 936 of the Federal Internal Revenue Code, Thesis at Cornell University, May 1989, p.1.
[3] Ibid.
[4] Ibid.

from electronics and pharmaceuticals to food and apparel. These diverse manufacturers have helped retrain Puerto Rico's labor force and have enable workers to move from low-productivity agricultural jobs to highly productive manufacturing jobs.[6] Throughout the island, Section 936 has created more than 100,000 jobs directly and nearly 200,000 indirectly.[7] These figures correspond to about one third of the total work force on the island.[7]

The creation of these jobs which are high-paying and provide secure employment requiring skilled labor, is not the only benefit that Section 936 provides to the economy of the island. The profits of the 936 corporation are subjected to a "tollgate tax"[8] when transferred from Puerto Rico to the United States. However, this tax is reduced if the profits are deposited in local financial institutions; and the longer the period of deposit, the bigger the reduction of the tax. Therefore, 936 corporations, opting to pay less in taxes, invest their profits in local financial institutions and create what are commonly known as "936 funds" or "eligible funds". These funds are invested in "stipulated" loans, such as mortgages or construction loans, that promote income, production, and employment on the island.[9] In 1990, 936 deposits in the Puerto Rican banking system represented 35 percent of private deposits and 29 percent of total bank deposits, providing a critical low-cost source of financing for economic development.[10]

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[6] Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic growth, p.3

[7] Ibid.

[8] Tollgate Tax: a tax assessed by the Puerto Rico Government on accumulated profits returned to the U.S. mainland. Tax reductions are granted for long-term funds. The statutory rate is 10%, but after considering credits granted for certain investments, the average effective rate is close to 5%. Definition from Alan Udall,Ph.D., Glossary of Terminology, May 1985,p.7.

[9] Alan Udall,Ph.D., Glossary of Terminology, May1985,p.4.

[10] Puerto Rico,U.S.A. Foundation, Price Waterhouse Studies on Benefits of Section 936 and Effects of Repeal, May 1991, p.2.

The mere consideration of modifications to Section 936 creates much uncertainty, which causes drops in investment and employment in Puerto Rico. The debates that preceded the 1982 and 1986 modifications to the law, sent Section 936 commitments on the island plunging by roughly 30 percent. Once the uncertainty surrounding these debates was resolved, job commitments promptly doubled.[11] Nowadays, the Clinton Administration movements toward modification of Section 936, in combination with recession, corporate restructuring, and growing global competition for investment has caused commitments for new industrial ventures in Puerto Rico to plung by 50 percent in late 1992.[12]

It should come as no surprise that the entities interested in the survival of the section have undertaken studies which prove that Section 936 is not only crucial to the Puerto Rican economy, but that it also benefits the economy of the U.S. The Government of Puerto Rico has joined forces with the private sector and is working together towards the protection of Section 936. Although many are convinced that changes are going to occur, all public and private institutions, whose investments are interrelated with Section 936's, benefits are determined to protect the essence of what Section 936 represents.

This thesis is a study of the importance of Section 936 to the economy of Puerto Rico with particular emphasis on its impact on the construction industry of the Island. Chapter 1 familiarizes the reader with an understanding of the significance of Section 936 to the Puerto Rican economy. The primary intention of this Chapter is to guide those readers who lack knowledge of Section 936 and its provisions, and how they affect Puerto Rico,

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[11] Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic growth, p.8.

[12] Doreen Hemlock, Newspaper: The San Juan Star, "New Industries Ventures Plummet 50%", Saturday, January 23, 1993, p.18.

the United States and the Caribbean Basin. Chapter 1 covers relevant topics such as the background of Section 936, the requirements for a firm to become a 936 corporation, the Section's overall impact on the economies of Puerto Rico, the United States and other Caribbean countries, and the current status of Section 936's debates. This first chapter also serves as a springboard for directing the study towards the focus of this thesis: Section 936's impact on the construction industry of Puerto Rico.

The local government, through the Commissioner of Financial Institutions, supports the construction industry by including construction as an activity eligible to receive 936 funds loans. These funds are funneled to the construction industry by requirements on investments imposed by the Commissioner of Financial Institutions on the financial institutions who are eligible to hold such funds. Chapter 2 analyses the impact of such requirements on the construction sector of the economy using recent available data.

Chapter 3 analyses the impact on the construction industry by the proliferation of projects brought on by the establishment of many manufacturing firms in the Island attracted by Section 936's benefits. Through case study analysis, the chapter concentrates on providing an insight into the operational activities of two firm which have greatly benefited by this proliferation of projects. The revenues of both firms derive almost entirely from projects by 936 firms. The analysis of these cases helps the reader understand the importance and impacts of Section 936 on the construction industry sector.

Finally, Chapter 4 contains the conclusions and recommendations regarding the impacts and effects of Section 936 on the construction industry of Puerto Rico.

Although the operation of 936 has been the subject of many studies since the Section's enactment, prior to 1993 none of these studies have discussed in specific terms, the effects that the funds originated by Section 936 have upon the construction sector of the economy. However, in April 1993 by request of the Associated General Contractors(AGC) Chapter of Puerto Rico, a study was performed based on the used "Input-Output" economic model. This model permits identification of the inter-industrial relations within the economy and quantifies the direct, indirect and induced impacts that 936 generate in sectors of the economy, in terms of production, jobs and salaries.[13] The AGC study analyzes the interrelation between the construction industry and Section 936, and because it quantifies the values of the impacts, it is an extremely useful reference.

There is no denying that manufacturing is the sector of the economy which has been impacted the most by Section 936. However, taking into consideration that construction is a powerful indicator of the state of any economy, the impacts of Section 936 upon this sector of the economy of Puerto Rico are indeed important.

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[13] Junta de Planificación de Puerto Rico, Progreso Económico: "El Impacto de las 936 sobre la Economía de Puerto Rico", Marzo 13-19,1993, p.S11.

CHAPTER 1: SECTION 936 AND THE PUERTO RICAN ECONOMY

1.1 Section 936: Puerto Rico and the United States

Section 936 of the Internal Revenue Code, "The Possession Tax Credit", applies to all U.S. possessions. However, it has been Puerto Rico the "possession" where this Section and its predecessors has had and still does have the strongest impact on the economy not only of Puerto Rico but also that of the United States. As addressed in the next section of this chapter, no one ever imagined the extent of the favorable impact that Section 936 and its predecessors would have on the Puerto Rican economy.

Puerto Rico became a possession of the U.S. in the Treaty of Paris of 1898 after the U.S. defeated Spain in the Spanish-American War. The Foraker Act, enacted by Congress in 1900, exempted Puerto Rico from United States Internal Revenue laws and granted Puerto Rico the fiscal autonomy to levy and collect its own taxes. The Commonwealth of Puerto Rico consequently has primary tax jurisdiction over the income of Puerto Rican residents derived from Puerto Rican sources.[14] The combination of Section 936 and Puerto Rico's autonomy over its taxes has been the driving force which has kept Puerto Rico attractive to many firms. Not only are there tax advantages provided by the Section itself, but also the Government of Puerto Rico through the Industrial Incentive Act (IIA)[15], provides tax incentives to companies who invest and have their operations on the Island.

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14 Roberto L. Pratts, What are the alternatives for the Commonwealth of Puerto Rico with Section 936 of the Federal Internal Revenue Code, Thesis at Cornell University, May 1989, p.4.

15 IIA is the legislation that provides exemption from Puerto Rico corporate profit tax. The 1987 IIA is currently in effect providing partial tax exemption on a sliding scale based on how long the tax exemption grant has been in effect and where the operation is

Section 936 is the only tax advantage available to U.S. multinationals comparable to "tax-sparing" agreements which virtually every other major industrialized nation has with developing countries and which enable foreign-based companies to operate with much lower costs than U.S. firms.[16] Table I shows examples of tax-sparing agreements between nations. To attract jobs, developing countries give local tax breaks to offshore companies that locate there. In exchange, the industrialized nations where these companies are based forego taxes they would ordinarily collect on the companies earnings.[17] Because U.S. policy permits no such arrangements with foreign countries, U.S. firms often operate at a disadvantage.

TABLE 1.1

EXAMPLES OF TAX SPARING AGREEMENTS BETWEEN NATIONS IN 1990

	BRAZIL	INDIA	MALAYSIA	TRINIDAD AND TOBAGO	JAMAICA
JAPAN	●	●	●	●	
GERMANY	●	●	●	●	●
UNITED KINGDOM		●	●	●	●
FRANCE	●	●	●	●	
CANADA	●	●	●		●
UNITED STATES					

Source: Puerto Rico U.S.A Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic Growth, p.4.

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located.The exemption grant is a legal document providing tax exemption in Puerto Rico. Corporations must negotiate such an agreement for each industrial unit they establish and each product manufactured. Definition from Alan Udall, Ph.D., Glossary of Terminology, May 1985, p.4.

[16] Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.-Purto Rico Economic Growth, p.1

[17] Ibid p.4

U.S. firms are aided by just one comparable tax benefit: Section 936. Hundred of mainland U.S. companies have come to rely on Section 936 as a key aide to their international competitiveness. It has enable them to reduce their operating costs, spurred research and development and expanded foreign trade.[18] By maintaining competitiveness and encouraging the repatriation of manufacturing profits from Puerto Rico to the mainland, Section 936 helps keep U.S. parent corporations viable and enhances employment opportunities in the States.[19]

Puerto Rico is a major market for U.S. goods. Virtually all raw materials, supplies and equipment for manufacturing in Puerto Rico come from the United States. Trade activities between U.S. and Puerto Rico has skyrocketed since the creation of Section 936. Table II shows the position of Puerto Rico as a major U.S. trading partner. These numbers are impressive given the fact that Puerto Rico is a small Caribbean island.

TABLE 1.2

PUERTO RICO IS A MAJOR U.S. TRADING PARTNER

U.S. TRADING PARTNER	BILLIONS OF DOLLARS (1988)
CANADA	$ 150.2
JAPAN	127.5
MEXICO	43.9
GERMANY	40.8
TAIWAN	36.9
UNITED KINGDOM	36.4
SOUTH KOREA	31.5
FRANCE	22.4
PUERTO RICO	22.0
ITALY	18.4

Source: Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic Growth, p.5.

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18 Puerto Rico U.S.A Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic Growth, p.4

19 Ibid

This tiny island of roughly 3,500 square miles and 3.5 million people ranks just below France as an importer of U.S. goods and services.[20] The island's per capita trade volume with the mainland U.S.- nearly $6,300 for each person in Puerto Rico- actually surpasses that of Canada, U.S. leading trade partner.[21]

1.1.1 Puerto Rico versus U.S. Congress

It is important to establish that the Commonwealth of Puerto Rico, by being a "possession" of the United States, has limited power, if any, in the U.S. Congress. Puerto Rico has an elected Resident Commissioner who represents only one vote in the House of Representatives. However that vote is at a committee level and not in the floor of the House. Therefore the Resident Commissioner's views towards any modifications of Section 936 may not be significant unless is coupled with intense lobbying by government and private entities from Puerto Rico. The most important entity in which private supporters have come to rely upon to protect the essence of what Section 936 represents, is the Puerto Rico U.S.A Foundation (PRUSA). PRUSA is a non-profit membership organization of approximately 70 mainland manufacturing companies, financial institutions and other firms with operations in Puerto Rico related to Section 936. Membership includes companies representing food, apparel, electronics, instrument, electrical machinery, medical services and pharmaceutical industries.

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20 Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic Growth, p.5

21 Ibid

The Congressional tax committees dealing with Section 936 are the Ways and Means in the House, Finance in the Senate, and their Joint Tax Committee. These committees, together with the Treasury Department in the Executive Branch, have come to possess tremendous power over Puerto Rico's economy. The legislation that created Section 936 requires reports from the Treasury Department at two-year intervals. These reports have taken a generally negative tone toward the legislation and have sparked continuing controversy between the U.S. Treasury Department, the Puerto Rico Government, and the 936 corporations.[22] The U.S. Treasury primarily views the credits obtained by the 936 firms as taxes forgone by the Federal Government rather than as benefits provided to the economy of not only Puerto Rico, but also that of the United States. The reports are based on the assumption that in the absence of the opportunity to manufacture in Puerto Rico, the 936 corporation would have their production operatives in the United States.

These congressional committees have the only jurisdictional responsibility when it comes to Section 936. Nowadays, there are three elected Puerto Ricans in Congress: José Serrano (D-N.Y.), Nidia Velázquez (D-N.Y.) and Luis Gutiérrez (D-Il.). Although they do not directly represent Puerto Rico there are many Puerto Ricans in their respective districts to whom they have pledge unity towards defending Section 936. However, none of the federal organizations just mentioned has a native Puerto Rican in its policy making level.

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[22] Alan Udall, Ph.D., Glossary of Terminology, p.8

1.2 Section 936 Predecessors:

Section 936 and its predecessors have been active since 1921.[23] During this period of time, U.S. firms where at a disadvantage in competing with foreign firms operating at the Philippines (a U.S. possession at that time). The disadvantage arose from the fact that foreign competitors, especially British rivals, were not taxed on their foreign income as U.S. firms were. English law generally deferred taxation on foreign income until it was transferred back to England, however, U.S. law taxed income as it was earned.[24] Therefore, foreign competitors had a tax advantage over U.S. firms when investing and having their operations in a U.S. possession.

The Revenue Act of 1921, corrected this inequity by creating section 931 "Possession Corporation" (as subsequently amended).[25] The essential elements of Section 931 of the Internal Revenue Code of 1954 became part of U.S. law as Section 262 of the Revenue Act of 1921.[26] Tax exemption, supported primarily by U.S. firms operating in the Philippines, was believed to encourage export trade to the Far East from the U.S. base in the Philippines, while at the same time reducing incentives for the U.S. firms operating there to reincorporate outside the United States.[27] Section 931 provided exemption from federal taxation on gross income to those U.S. firms that derived at least 80 percent of their gross income from sources within a U.S. possession and at least 50

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[23] Roberto L. Pratts, What are the alternatives for the Commnwealth of Puerto Rico with Section 936 of the Federal Internal Revenue Code, p.4

[24] José Torres, Impact of Section 936 of the U.S. Internal Revenue Code on the Commercial Banking Sector in Puerto Rico, p.18

[25] Roberto L. Pratts, What are the alternatives for the Commonwealth of Puerto Rico with Section 936 of the Federal Internal Revenue Code, p.5

[26] Department of Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, First Annual Report, p.9

[27] Ibid p.10

percent of its gross income from the active conduct of trade and business.[28] Corporations that satisfied these requirements came to be called "possessions corporations", "931 corporations" or sometimes simply "931's".[29] U.S. parent companies usually organized their 931 corporations as subsidiaries in order to assure that 80 percent of gross income had its source in one or more possessions.[30]

Although nowadays Puerto Rico is clear example of prosperity due to the tax incentives provided, it was virtually ignored in the original public debate.[31] Section 931 was enacted without any reference to Puerto Rico. This is the reason why section 936 predecessors are sometimes referred to as "policies by accident" for the development of the Island's economy which at that time was one of the poorest in the western hemisphere.

1.2.1 Puerto Rico and Section 931:

The decade of the 1940's represented a transition era in Puerto Rico. This period marked the time when Puerto Rico began shifting its economy from agricultural to industrial. Puerto Rico started offering local tax incentives to augment the 1921 possession exemption and over succeeding decades, scores of U.S. companies located their operation on the island.[32]

The first tax incentive legislation enacted in Puerto Rico was the Industrial Incentive Act of 1948, which provided an exemption from Puerto

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[28] ibid
[29] ibid
[30] ibid
[31] ibid
[32] Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic Growth, p.2

Rico taxes. The objective of this act and its subsequent amendments, was to stimulate industrial development and thus provide more jobs and a better standard of living for Puerto Ricans.[33] The Act extended to qualified companies an exemption from income, property and municipal taxes in addition to also granting exemption from excise taxes on materials, machinery and equipment utilized in the production of goods for export or sold to other manufacturers in Puerto Rico.[34] Along with tax exemptions, the Act also provided assistance to new industries by cash grants and low interest loans for initial start up costs, acquisition of real estate facilities and training of employees.[35]

The Industrial Incentive Act of 1948, and its subsequent amendments were known as "Operation Bootstrap". Through it, Puerto Rico started its modern history of industrial development and achieved over two decades of solid economic growth. The first twenty years of industrialization in Puerto Rico covering the 1950's and 1960's occurred largely in labor intensive markets and low wage sectors and were characterized by extremely rapid growth even though the base from which this started was very small.[36] The primary reasons that attracted U.S. companies to locate in Puerto Rico were tax exemption, low wages, tariff walls, same currency and similarity in the legal systems.[37]

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33 Roberto Pratts, What are the alternatives for the Commonwealth of Puerto Rico with Section 936 of the IRC, p.6

34 José Torres, Impact of Section 936 of the U.S. Internal Revenue Code on the Commercial Banking Sector in Puerto Rico, p.32

35 Ibid

36 Ibid p.34

37 Ibid

1.3 Section 936 of the Internal Revenue Code

The possession corporation exemption under Section 931 remained unchanged until the Tax Reform Act of 1976, which brought about new and significant changes and placed them in a newly created code, Section 936.[38] With Section 936, Congress changed the 1921 law of the tax system on U.S. firms possessions income from a tax exemption to a tax credit.

1.3.1 Firms Requirements under Section 936:[39]

Under Section 936, three different types of income derived by U.S. firms doing business in Puerto Rico are exempt from U.S. income taxes:

1) Income derived from sources outside the United States from active conduct of a trade or business within Puerto Rico. (Section 936(a)(1)(A)(i)).

2) Qualified possession source investment income (commonly known as QPSII). QPSII[40] refers to the gross income derived by a 936 corporation operating within Puerto Rico, and which is attributable to the investment within Puerto Rico (for the use therein) of the funds derived from the active conduct of its trade or business within Puerto Rico, or from such investments. (Section 936(a)(1)(B) and (d)(2)).

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38 Department of Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, First Annual Report, p.11.

39 This section is largely extracted from: Ricardo Muñiz, ESQ., Tax Partner in Goldman & Antonetti, Refresher Session on Section 936, the 1987 Tax Incentive Act and Dividend Distribution Rules, presentation at CITIBANK,N.A., 16th Annual 936 Conference, March 30,1989.

40 QPSII- interest income that qualifies for tax exemption. Accumulated 936 profits that remain on the Island may be reinvested in certain financial assets which contribute to economic development. When income from these investments is repatriaied, it is also free from U.S. corporate taxation. Definition from Alan Udall, Ph.D., Glossary of Terminology, p.6

3) Income derived from sources outside the U.S. from the sale or exchange of substantially all assets used by the 936 corporations in the active conduct of its trade or business within Puerto Rico.(Section 936(a)(1)(A)(ii)).

In order to qualify for Section 936's tax credit, the applying corporation must meet the following two criteria:

1) 80 percent or more of its gross income must be derived from sources within Puerto Rico (Section 936(a)(2)(A)); and

2) at least 75 percent of its gross income must be derived from the active conduct of a trade or business within Puerto Rico (Section 936(a)(2)(B)).

It should be clarified that income derived from manufacturing activities is not the only activity which qualifies to receive the benefits of Section 936 credits. Income derived from trading activities, and from the performance of services is also included.

1.3.2 Differences from Section 931[41]

The major differences between Section 931 and 936 are:

1) Under 931, dividends paid by a possession corporation to its U.S. parent were fully taxable to the U.S. parent, but amounts received upon liquidation of the possession corporation were exempted from tax. As a consequence, 931 corporations accumulated substantial earnings and invested them in the Eurodollar market in anticipation of a tax free liquidation. In order to accelerate the repatriation process to the mainland and eliminate the incentives to liquidate, Section 936 allowed U.S. parents to receive dividends

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[41] This Section is largely extracted from: Department of Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, First Annual Report p.12

from possession corporations free from U.S. tax. Therefore, the 936 corporation could shift a portion of their profits back to the U.S. parent corporation and those repatriated profits were not subjected to federal taxation. The dividends which could be deducted were not limited to 936 subsidiaries, but also included dividends paid out from earnings accumulated while the subsidiaries qualified under Section 931.

2) Under Section 931, any corporation operating in a possession which suffered a loss in a given year could join its parent corporation in filing a consolidated return for such year. Therefore, 931 corporations avoided taxes in profitable years but were able to offset any loss against other taxable income in unprofitable years. With Section 936, the subsidiary must elect the benefits of Section 936, and that election is irrevocable for a period of 10 years. During this period of time the subsidiary and its parent corporation cannot join and file a consolidated return, however electing 936 status can be delayed until profitable years begin.

3)The method of effecting the exemption was changed. Under 931, a possession corporation was exempted from U.S. tax on all income derived from sources outside of the United States. Section 936 provides a credit to offset any U.S. tax on income from the active conduct of a trade or business in a possession, or on QPSII.

In essence, the change had negative, as well as positive components for the investment in Puerto Rico. Section 936 does not allow possession corporations to avoid federal taxes on Eurodollar and other foreign income as Section 931 had. However a primary obstacle to paying dividends was eliminated by allowing parent corporations a dividend-received deduction. This eliminated the necessity to liquidate a possession corporation to repatriate earnings free of federal taxes. Liquidation usually meant cessation of operations and discharge of workers.

1.3.3 Adjustments to Section 936

With Section 936 Congress decided that the earnings of 936 firms would be used to benefit the possessions or be returned to the United States, instead of being invested in foreign markets. The Section was revised to limit it to the earnings obtained in Puerto Rico and required 936 firms to reinvest their earnings on the island. At the same time it permitted the repatriation of earnings free from federal taxes without the necessity of liquidation.

The next series of changes to Section 936 occurred in 1982, when Congress restricted the allocation of intangible income between parent companies and Section 936 affiliates.[42] Intangible income includes gross income of a corporation attributable to any intangible property which includes: (1) patents, inventions, formulas, and process and design know-how; (2) trademarks, tradenames; (3) copyrights, and literary, musical, or artistic compositions; (4) franchises, licenses, or contracts; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, costumer list, or technical data; on (6) any similar item which has substantial value independent of the services of any individual.[43] At that time, the Federal Government perceived that there was a mishandling in the assignment and use of intangible income that was exempt in order to produced higher levels of

[42] Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic Growth, p.2.
[43] Internal Revenue Code, Section 936 (h)(3)(b).

earnings free of taxes.[44] The problem of intangible income was addressed and corrected in The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA corrected this situation by adding a very complex set of allocation rules to Section 936 for tax years beginning after 1982.

Besides dealing with the treatment of intangible income there was another important alteration. It consisted of a reduction of the percentage of investment income eligible for the credit. The passive income permitted was reduced from 50 percent to 35 percent of the total income; and the norms to obtain and determine the benefits from the tax exemption became more strict.[45]

Until the present, the last major adjustment to Section 936 was incorporated during the mid-1980's. The adjustment was embodied in the Caribbean Basin Economic Recovery Act which permits Section 936 funds in Puerto Rico banks to be used in Caribbean Basin Initiative (CBI) countries that agree to exchange tax information with the U.S.[46] President Reagan's CBI programs strategy was to aid the development of Caribbean nations by providing duty-free access to the U.S. market without requiring tariff reductions on their part.[47]Because Puerto Rico is a possession of the U.S., it is not a participating nation. However, production sharing agreements involving other Caribbean countries may use Puerto Rico's portion of production to qualify goods for duty-free entry to the U.S.[48]

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44 Mariano A. Mier Romeu, Newspaper: El Nuevo Dia feb 5 1993, "Artillería pesada hacia la exención de las 936", Monday, February 8, 1993, p.8

45 Ibid

46 Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.-Puerto Rico Economic Growth, p.2.

47 ALan Udall, Ph.D., Glossary of Terminology, p.1.

48 Ibid

1.4 Economic Development with Section 936

To this point the thesis has provided the background of Section 936 and presented the basic facts needed to understand what is Section 936 and how it applies to Puerto Rico. This section demonstrates the impact that Section 936 has had on the overall economy of the island, and shows that the U.S. and many Caribbean countries have benefited from this tax incentive policy.

1.4.1 Development in Puerto Rico

Puerto Rico's historical development clearly demonstrates that a scheme of tax incentives policies has been the correct catalyst needed to accelerate the growth of the island economy. Section 936, combined with the local tax incentives have attracted a large number of industries to the island stimulating industrial development and thus providing more jobs and a better standard of living for Puerto Ricans. From 1950 to 1970, living standards improved dramatically. Life expectancy sharply increased from 61 to 72 years and literacy rate rose from 75 percent to 89 percent of the island's population.[49]

Puerto Rico's real Gross National Product (GNP) more than tripled within a 20 years span, a remarkable increased match only by a few countries. During this period of transformation, Puerto Rico's real GNP increased 5.3 percent per year in the 1950's and 7.0 percent per year in the 1960's, compared with a U.S. average annual GNP growth rate of 3.3 percent per year for those

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49 Robert R. Nathan Associates, Inc., Section 936 and Economic Development in Puerto Rico, Prepared for Puerto Rico - U.S.A. Foundation, p.9

two decades.[50] Table 1.3 shows a comparison between Puerto Rico's and U.S. GNP growth rates for years 1950 throughout 1980 in 10 years intervals.

TABLE 1.3 Puerto Rico's and U.S. GNP Growth Rates
(Average Annual Growth Rate)

	PUERTO RICO	UNITED STATES
1950-1960	5.3	3.3
1960-1970	7	3.8
1970-1980	4.6	2.8

Source: Economic Report to the Governor,1985
and Economic Report of the President,1986.

In quantitative terms, GNP has soared from $3.7 billion in 1950 to more than $20 billion today. Exports and imports have topped $25 billions, an amount greater than all the other Caribbean islands combined. Most of 936 corporations products are for export purposes. In 1982, the pharmaceutical and chemical industries exported 97 percent of their production; the instrument industry exported more than 99 percent; and the electrical and electronic industry exported 98 percent.[51] Puerto Rico has very few natural resources of its own and consequently has to import the raw material and energy to run the 936 firms. The purchases of raw materials are financed through exports.

As mentioned, Section 936 helped Puerto Rico move from agrarian-based to industrial and services-based economy. In 1950, Puerto Rico was primarily an agrarian economy with 36 percent of its work force employed in

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[50] Ibid

[51] Robert Nathan and Associates, Inc., Section 936 and the Economic Development of Puerto Rico, August 1987, p.36

agriculture. By 1988, agriculture employment was down to a 3.2 percent.[52] In contrast, manufacturing employment grew from 9 percent in 1950 to 32 percent in 1988.[53]

Data for 1992 reflect that manufacturing continues to be the principal component of the economy of Puerto Rico and that within this sector, 936 firms continue to have a strong influence. Currently, manufacturing contributes to 38.7 percent of GNP.[54] Industries engage in manufacturing range from labor-intensive industries such as apparel, to capital-intensive industries such as electronics and pharmaceuticals. Nowadays, it is estimated that there are 568 firms operating under Section 936.[55] These firms directly employ 107,350 persons which is more than 60 percent of the total jobs employed in manufacturing on the island.[56]

Employment by 936 firms is spread all over the island. Table 1.4 shows the number of jobs and 936 firms that are operating in each municipality of Puerto Rico.

In addition to the jobs generated directly, 936 firms generate indirect employment in the rest of the economy. The creation of these indirect jobs is due primarily to the demand for products used as inputs in the manufacturing process, and through investments in construction, machinery and equipment.[57]

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52 Robert R. Nathan Associates, Inc., Section 936 and Economic Development in Puerto Rico, p.10

53 Ibid

54 Junta de Planificación de Puerto Rico, Progreso Económico: "El Impacto de las 936 sobre la Economía de Puerto Rico", Marzo 13-19,1993

55 Mariano A. Mier Romeu, Newspaper: El Nuevo Día, "Artillería pesada hacia la exención de las 936, Monday, February 8,1993, p.8

56 A.G.C. (P.R. Chapter), The Impact of Section 936 on Puerto Rico's Economy and Construction Sector, Prepared by Estudios Técnicos, April 1993, p.9.

57 Ibid

TABLE 1.4: 936 Direct Employment and Firms by Municipality

Municipa -lity	Jobs	Firms	Municipa -lity	Jobs	Firms
Adjuntas	142	1	Lajas	827	2
Aguada	1,447	4	Lares	242	1
Aguadilla	4,129	23	Las Marías	645	1
AguasBuenas	612	5	Las Piedras	3,522	18
Aibonito	1,837	5	Loíza	302	3
Añasco	2,529	8	Luquillo	3,281	8
Arecibo	3,910	19	Manatí	4,436	15
Arroyo	619	6	Maricao	301	2
Barceloneta	6,732	11	Maunabo	104	2
Barranquitas	581	4	Mayaguez	7,279	20
Bayamón	1,553	28	Moca	806	2
Cabo Rojo	833	4	Morovis	950	2
Caguas	2,558	22	Naguabo	785	7
Camuy	2,033	2	Naranjito	0	0
Canóvanas	646	10	Orocovis	150	1
Carolina	3,071	25	Patillas	340	3
Cataño	290	4	Peñuelas	424	4
Cayey	2,076	9	Ponce	5,513	23
Ceiba	498	2	Quebradillas	827	1
Ciales	1,013	2	Rincón	456	4
Cidra	2,646		Río Grande	512	5
Coamo	539	3	Sabana Grande	1,260	3
Comerío	33	1	Salinas	177	3
Corozal	425	2	San Germán	2,101	9
Culebra	150	1	San Juan	15,810	29
Dorado	2,008	13	San Lorenzo	1,480	8
Fajardo	1,747	11	San Sebastián	1,255	3
Florida	0	0	Santa Isabel	1,074	9
Guánica	499	2	Toa Alta	283	4
Guayama	2,286	11	Toa Baja	1,900	9
Guayanilla	46	2	Trujillo Alto	302	3
Guaynabo	685	13	Utuado	201	2
Gurabo	1,410	16	Vega Alta	1,717	12
Hatillo	364	4	Vega Baja	3,558	14
Hormigeros	697	4	Vieques	92	1
Humacao	3,666	26	Villalba	418	2
Isabela	2,291	5	Yabucoa	2,026	9
Jayuya	115	1	Yauco	336	2
Juana Díaz	554	4	Juncos	788	9

Source of firms: Newspaper: El Nuevo Día, Monday, February, 8,1993, P.8
Source of Jobs: A.G.C. Study prerared by Estudios Técnicos, April 1993, p.10

Furthermore, additional jobs are created through the demand generated by the purchase of goods and services by employees in 936 firms and employees in firms that provide goods and services to 936 corporations.[58]

To quantify the number of indirect jobs created, employment multipliers have been determined using economic models such as the Input-Output Model. Many agencies, public and private, have determined their own employment multipliers but because assumptions have to be made in order to use the model, the multipliers tend to be different in each study performed. However, most multipliers fall in the range from 1.5 to 3.9 depending on the industry which is being analyzed. Table 1.5 gives a list of the estimated total employment multipliers for 936 manufacturing corporations.[59]

TABLE 1.5: Estimated Total Employment Multipliers Attributable to Section 936 Manufacturing Corporations,1984

INDUSTRY	Total Employment Multipliers
Food products	3.6
Textiles mills products	2.4
Apparel	1.6
Chemical and allied products	4.7
Rubber and plastic products	2.6
Leather	1.5
Fabricated metal products	2.6
Machinery	3.9
Electrical and electronic Equipment	2.3
Instruments	2.2
Other Manufacturing	2.3

Assuming a multiplier of 1.5, means that for every 100 direct jobs in 936 firms, 50 additional jobs are created in the economy. A recent study funded by the Associated General Contractors of America (AGC), Puerto Rico Chapter, estimates that each direct job in 936 firms generates approximately 1.2

58 Roberto L. Pratts, What are the Alternatives Available for the Commonwealth of Puerto Rico With Section 936 of the I.R.C., p.16

59 Robert Nathan and Associates, Inc., Section 936 and the Economic Development in Puerto Rico, August 1987, p.39.

additional jobs in the economy. Therefore, total employment attributed by 936 firms is estimated to be 233,061 jobs which accounts for almost 25 percent of the total employment in the Puerto Rican economy.[60] Within the total economy, the 936 firms have larger employment multipliers than non-936 firms because they tend to require larger investments in construction and also pay higher salaries. The wages paid by 936 firms is about 18 percent higher than those non-936 firms and the employment is increasing faster than non-936 employment.[61]

Another important contribution to the economy due to Section 936 is that by spurring economic growth in Puerto Rico, the public sector's resources have grown and have made possible increases in social services.

An analysis of the benefits of Section 936 would be incomplete without reference to the financial sector of the economy. 936 firms deposits in local financial institutions or "936 funds", have enabled Puerto Rico to develop a sophisticated and competitive banking sector. While Chapter 2 gives a more complete analysis of the impact of 936 funds on Puerto Rico with a focus on the construction industry, some important points are discussed in this section.

936 corporations deposits in the Puerto Rico banking system represented 35 percent of private deposits and 29 percent of total deposits in 1990. In fiscal year 1988, $6.8 billions were deposited by 936 firms in local banks.[62] As of December 31,1991, direct 936 deposits as determined by one of the local financial institution which holds the largest amount of deposits, were

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[60] A.G.C. (P.R. Chapter), The Impact of Section 936 on Puerto Rico's Economy and ConstructionSector, prepared by Estudios Tecnicos, April 1993, p.9

[61] Robert Nathan and Associates, Inc., Section 936 and the Economic Development in Puerto Rico, p.40

[62] Roberto L. Pratts, What are the alternatives available for the commonwealth of Puerto Rico with Section 936 of the I.R.C., p.18

in excess of $8 billion.[63] The Commissioner of Financial Institutions, in its January of 1993 report, states that 936 direct deposits are almost $10 billions.[64] The importance of these deposits relates primarily to the fact that they provide a source of liquidity and low interest rates loans to the economy of the Island. These funds are invested in lending activities, such as mortgages or construction loans, that promote income, production, and employment on the island.[65] There is no doubt that the major and most important ingredient for the development of the financial sector have been the 936 funds.

In short, every sector of the economy of Puerto Rico has been touched directly or indirectly by the effects of Section 936. To discuss all the benefits provided by the Section would be almost an endless task and out of context for the purpose of this thesis. Those who have had the opportunity to experience the transition period from the 1950's throughout the beginning of the 1990's, can assert that Section 936 has proved to be the necessary tool needed to develop and maintain the stability of the Puerto Rican economy. However, Puerto Rico is not sole beneficiary of Section 936. As demonstrated in the next section, the U.S. also benefits to a great extent.

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63 This information was extracted from material given in an interview with Mr. Juan Guerrero Preston, Senior Vice President and Manager of Investment Division of the Banco Popular de Puerto Rico.

64 Commonwealth of Puerto Rico, Commisioner of Financial Instituions, Report on Securities and 936 Division, January 1993. p1

65 Alan Udall, Ph.D., Glossary of Terminology, May 1985, p.4

1.4.2 Benefits to the United States

Although the effects of Section 936 benefits in the U.S. are not as visible as they are in Puerto Rico, (perhaps because of the size of the economy and of the country itself), they are without a doubt important and to some extent critical, to the economy of this superpower.

The principals which are now contained in Section 936 were developed in the 1920's. As previously mentioned, the Revenue Act of 1921 was enacted to aid U.S. firms with operations in the Philippines to compete with foreign firms. Although nowadays the place of interest is mainly Puerto Rico and the number of the Section has changed to 936, in essence the purpose of the original Revenue Act of 1921 has been maintained. Many U.S. companies have come to rely on Section 936 as a key to their international competitivness. Section 936 has been of crucial importance in the worldwide success of some of the most competitive U.S. industries. The struggle of U.S. industries to compete with foreign firms is well known and documented. The U.S., once the industrial leader of the world, has in the past decades, lost its leadership edge to strong foreign competitors, especially from Japan and Western Europe. One of the few, if not the only, science and technology-based industries in which the U.S. remains the leader in innovation and sales is in the pharmaceutical industry. However, the lead is being hotly contested by Japan, Germany, Great Britain and Switzerland.[66] Section 936 has had an important role in sustaining U.S. leadership.

Three of the most research-intensive industries of the U.S.- electrical and electronic equipment, scientific instruments and pharmaceuticals- have

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66 Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.- Puerto Rico Economic Growth, p.4

operations in Puerto Rico. The tax benefits of Section 936, which have increased companies' cash flow, have permitted the investments of additional resources in research and development. In the pharmaceutical industry for example it is estimated that each $100 increase in after-tax cash flow results in an additional $37.48 of research and development expenditures.[67]

As mentioned before, Puerto Rico lacks natural resources of its own. Therefore, to sustain its production capabilities it has to import the resources needed for production. Virtually all raw materials, supplies and equipment for manufacturing in Puerto Rico comes from the United States. Puerto Rico ranks as the tenth largest purchaser of U.S. exports, buying over $9 billion of goods in fiscal year 1989.[68] In addition, 87 percent of Puerto Rico's total exports are to the U.S. This trading has a positive impact on employment in the U.S. The Government of Puerto Rico has estimated that the island's total annual purchases of goods from the U.S. have created 150,000 jobs in the states.[69]

Another benefit provided by Section 936 to the U.S. is that it helps stabilize the economy of Puerto Rico and other Caribbean nations, therefore providing the U.S. a measure of tranquillity in the region. In the case of Puerto Rico, without Section 936, unemployment rates would be much higher and consequently migration to the U.S. would increase. This situation would be similar for other Caribbean nations. In addition, because Puerto Rico is a possession, it is entitled to receive Federal transfer payments which would increase to about $337 million a year in 1995.[70] In essence, Section 936 can be viewed as a key bulwark for peace, because it has helped to create an educated

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67 Ibid

68 Puerto Rico U.S.A. Foundation, "Highlights of Benefits and Costs of Section 936", prepared by Price Water House Studies, p.2

69 Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.- Puerto Rico Economic Growth, p.5

70 Puerto Rico U.S.A. Foundation, "Highlights of Benefits and Costs of Section 936", prepared by Price Water House Studies, p.2

and prospering middle class, the most effective buffer against political unrest.[71] This is certainly a benefit for the U.S. which cannot necessarily be measured in terms of money. However, by maintaining a tranquil environment in its neighboring regions, the U.S. can direct its attention and resources towards other situations of its own economy.

1.4.3 Impacts on the Caribbean Basin

As previously mentioned, the Caribbean Recovery Act of 1986, modified the tax code to allow other Caribbean nations to participate in the benefits resulting from Section 936. With this new act Congress encouraged 936 companies to invest in economic development projects in other Caribbean countries.[72]

Puerto Rico and the 936 firms have positively adopted the resolution thus, many Caribbean nations are beginning to enjoy the benefits provided by the Section and to use it as a tool for their own prosperity. One way that benefits are mutually shared is by establishing production sharing arrangements in which the labor-intensive parts of a given production process are transferred to, and performed in a low-wage based country, such as Haiti; and the high skill-intensive parts are performed in high-wage areas such as Puerto Rico or the U.S.[73] This measure consequently creates employment opportunity in the Caribbean.

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71 Puerto Rico U.S.A. Foundation, Section 936: The Keystone for U.S.- Puerto Rico Economic Growth, p.7

72 Ibid p. 8

73 Alan Udall,Ph.D., Glossary of Terminology, p.8

Initially, the act required that at least $100 million in loans be invested.[74] This requirement was fulfilled and by 1991 it was reported that the amount invested had actually reached nearly $650 million.[75] These investments were not only for 936 firms production purposes, but also included loans to the governments and local private institutions for investing in their own economies. In addition, Puerto Rico purchases more than $500 millions of goods each year from Caribbean countries.[76] By 1991, this investment hade added nearly 20,000 jobs and financed economic development projects throughout the Caribbean.[77] By February of 1993, it was estimated that $874 millions in 936 funds had been invested in eligible Caribbean countries. This investment and the 61 production-sharing firms established have created close to 30,000 jobs in the Caribbean Basin.[78]

1.5 Current Status of Section 936

With the election of President Clinton, Puerto Rico and Section 936 are once again an issue of discussion in the United States Government, especially in Congress. President Clinton's economic program is aimed at reducing the federal deficit through cuts in spending and increases in revenues. Section 936 is one of many in a long list of potential "reforms" that are being analyzed and scrutinized to determine its role in the President's recovery program.

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[74] From Statement of Honorable J.J. Pickle of Texas," Section 936 and the Caribbean Basin Initiative", May 19,1992

[75] Puerto Rico U.S.A. Foundation, <u>Section 936: The Keystone for U.S.- Puerto Rico Economic Growth</u>, p.9

[76] Ibid

[77] Ibid

[78] Mariano A. Mier Romeu, Newspaper: El Nuevo Dia, "Artillería pesada hacia la exención de las 936", February 8,1993,p.9

Although it is not the first time that Section 936 has come under attack, many people are convinced that major changes and modifications are going to occur. What no one really knows, is the extent and magnitude of the possible changes. However every entity, either for or against Section 936, is concentrating its efforts on defending its position. Currently, the U.S. Congress, the Government of Puerto Rico, 936 firms and their lobbyists, and many other entities are in continuous motion trying to find an agreeable position in what it seems to be a never ending battle.

In February of 1993, Senator David Pryor (D-Ark.) introduced the first major proposal in the new waves of attack on Section 936. Senator's Pryor proposal would replace the tax section with a wage credit scheme which would cap tax credit at 40 percent of qualified wages, and only salaries up to $20,000 would be counted.[79] Senator Pryor has always been one of Section 936 most fierce opponents and refers to it as " the most abusive of tax shelters - maybe of all times".[80] His attack is directed primarily at the pharmaceutical industry which besides having benefited from tax shelters, mainly Section 936, continues to charge high prices for its products. This has been the major point of counterattack by 936 supporters. Puerto Rico's Manufacturers Association argues that it is wrong to link 936 benefits only to pharmaceutical companies. Although the pharmaceutical industry has demonstrated the steadiest, most dependable growth in recent years, other industries such as apparel, food, and electronics, have higher employment rates.[81] These three manufacturing sectors of the Puerto Rican economy, as well as many others, would be adversely affected by Senator Pryor's proposal. It is estimated that this

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79 Sergio M. Marxuach, Puerto Rico Home Mortgage: "Weekly Economic Commentary", March 3,1993, p.4

80 Doreem Hemlock, Newspaper: The San Juan Star , "Senator Presents bill replacing 936 with wage credit", Feb.17, 1993, p.2

81 U.S. Bureau of Labor Statistics and the Puerto Rico Department of Labor

proposal would decrease benefits of 936 corporations from $2,500 million to $800 million.[82] Senator Pryor, as chairman of the Committee on Aging, responds to one of the most powerful, best funded and well organized lobbies in Washington -The American Association of Retired Persons.[83] This may explain the Senator's attitude towards the pharmaceutical industry, where older people tend to account for a high percentage of consumption. Economist believe that reducing benefits to less than one third of what they are now, will have serious negative effects on the economy.

President Clinton's economic package includes a proposal for Section 936 which caps a company's non-taxable benefits at 65 percent of employee compensation with salaries up to $60,000 counted toward the total.[84] Although this proposal offers more benefits than Senator Pryor's, it is criticized because it still undermines to great extent the Section. In an economic study prepared by Estudios Técnicos for the AGC in April 1993, the impact to the economy of Puerto Rico was analyzed with a 65 percent wage credit proposal. Using U.S. Treasury data for 1989 income tax returns of 936 corporations, the study founds that high technology companies would be the most affected industries, in that the wage credit proposal would affect 57.7 percent or 60,833 jobs in manufacturing and 65.3 percent or $1.4 billion in gross compensation.[85]

Section 936 is not only an economic controversy. Because of the relationship between Puerto Rico and the United States, there are also political influences that affect the decisions to be made. Currently, the political party in control, the New Progressive Party, supports the idea that Puerto Rico

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82 Mariano A. Mier Romeu, Newspaper : El Nuevo Dîa, " Carnada muy flaca el crédito the Pryor", Wednesday, February 17,1993, p.6

83 Puerto Rico Home Mortgage: "Weekly Economic Commentary", March 3,1993, p.4

84 Ibid p.3

85 A.G.C. (PR Chapter), <u>The Impact of Section 936 on Puerto Rico's Economy and Construction Sector</u>, prepared by Estudios Técnicos, april 1993, p.24

should become a state of the United States. Although out of context for the purpose of this thesis, it should be noted that if Puerto Rico becomes a state, Section 936 would no longer apply to the Puerto Rican economy. While there are many other factors to be considered regarding possible statehood, this one is also an important political issue.

Already this issue has created disputes among the leaders of the political party in control. Resident Commissioner Carlos Romero Barcelo sees in the elimination of Section 936, the birth of statehood for Puerto Rico. Although many agree with this statement, problems arise with respect to the nature and timing of the Resident Commissioner's actions. Romero's proposal calls for a phase out of the tax benefits over a ten year period; increases the wage credit to 100% of wages paid; includes an investment tax credit; and insists on parity for Puerto Rico when it comes to federal funds.[86] While this proposal is probably better than those proposed by Senator Pryor and President Clinton, whether or not Puerto Rico receives equal treatment in the funding of federal programs is a different matter. Puerto Rico does not pay any federal taxes which is a detail that makes it less probable to devise a good argument in favor of parity.[87] In addition, the Clinton administration is seriously considering reforms in the federal entitlement programs such as Medicare, therefore making the matter more difficult. In contrast, the Governor of Puerto Rico, Dr. Pedro Roselló, has vowed to resist any attempts by Congress and the Clinton administration to eliminate or reduce Section 936 tax benefits until alternatives are found to the tax incentives that have been a major component in Puerto Rico's economic development strategy over the past couple of decades, or a statehood option for the Island is offered.

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86 Sergio M. Marxuach,Puerto Rico Home Mortgage: "Weekly Economic Commentary", March 10,1993, p.3

87 Ibid

One of the alternatives being considered is to designate Puerto Rico as an "enterprise zone". The enterprise zone program, originally proposed by the Reagan administration during the early 80's, would eliminate all taxes on all capital gains and on half of the taxable income generated by firms located in areas designated as "enterprise zones".[88] Governor Roselló's proposal asks Congress to designate all of Puerto Rico as an enterprise zone so as to be able to attract new industries to the Island. Although this proposal contains a strong supply-side flavor, it is not clear yet whether or not the incentives provided would by themselves, create a competitive advantage.

There are many other alternatives being suggested as possible modifications and/or solutions, some receiving more attention than others. Example are: to include Section 936 in a new compact free association with the United States; tie Section 936 incentives to help depressed areas in the United States; and adopting Section 901 of foreign tax credits.[89] Some of these proposals have been made by the other political parties. Therefore they tend to be more often criticized and not seriously considered for further development by the political party in power.

Besides all the alternatives proposed, it seems that once more, all interested entities, especially on the Island, have set aside their differences, and have unified once more to protect Section 936 with their best defensive efforts. By June of 1993, it appears that their efforts have started to produce results. Although modifications are going to occur, they have become less and less drastic.

President Clinton's proposal was aimed at collecting $7 billion dollars in a 5 year period. However, Senator Daniel Patrick Moynihan, Chairman of the

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[88] Ibid p.4
[89] ibid

Finance Committee, stipulated that the amount collected would fall to $3.8 billion dollars.[90] The Senator understands that higher amounts would prove to be detrimental to the economy of the Island. Of course the Senator's conclusion has been encouraging for the defenders of Section 936.

With Sen. Moynihan's proposal, manufacturing industries with operation in Puerto Rico whose income nowadays is 100 percent exempt from federal taxes, will have to choose between two options.[91] The first of these options is based on a credit on income. The credit would be 60 percent of total income in 1994, and then it would be reduced by 5 percent each year until 1998 where it would be a credit of 40 percent. The second option boils down to a 95 percent credit on wages and marginal benefits paid by the firms. Both of the options also entail a credit between 50 and 100 percent of the depreciation of the physical plant and machinery depending on their useful lives. In addition, the proposal also provides for passive income to be completely exempt from taxes.

Although it is still debated whether or not the proposal is a good deal, many feel that there are signals for a compromise in the Section 936 battle. All of the proposals mentions are still in the preliminary phases of negotiations. There is still much work to be done in order to reach a final agreement, but it seems that those who are defending the Section, are been heard by those who will make the final decision, namely the United States Congress. Everyone involved has presented their ideas and arguments. What remains to be done is the step that takes the longest time - and that is to accommodate and adapt the various positions to aim at a proposal that will be satisfactory and fair for the economy of the Island. However, a final decision

90 Salome Galib Bras, Newspaper: El Nuevo Dia, "La nueva configuración de la 936", June 22,1993, p.6

91 Ibid

has to be reached soon because, as discussed in the next section, the periods during which the Section is the center of attention and modifications are being considered, create an ambiance of uncertainty on the island which is detrimental to the economy.

1.6 Costs of Uncertainty

The economic history of Puerto Rico clearly exhibits that in the absence of stability and the presence of uncertainty around Section 936 and its future tax benefits, the economy of Puerto Rico comes to a halt. These periods of uncertainty are responsible for declining investment and employment in Puerto Rico. The debates that preceded the 1980's modifications to the law, cost Puerto Rico an estimated amount of $60 million in investments and around 1,900 jobs.[92] Today, the current movements toward modification of Section 936 in combination with recession, corporate structuring, and growing global competition for investment, caused commitments for new industrial ventures in Puerto Rico to plummet by 50 percent in late 1992.[93]

Although some sectors of the economy are more affected than others, the cloud of uncertainty is felt throughout the Island once Section 936 becomes the focus of debate. The effects move through the entire economy, starting at the top and trickling down, affecting, directly or indirectly, practically everyone. Once the attack is started, those firms who benefit from the Section are the first to react. The reaction generally entails stopping

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92 Roberto L. Pratts, What are the alternatives available for the Commonwealth of Puerto Rico With Section 936 of the IRC, May 1989, p.26

93 Doreen Hemlock, Newspaper: The San Juan Star, "New Industries Ventures Plummet 50%", Saturday, January 23, 1993, p.18

current and proposed plans for investment. These investments are usually, plant expansions and/or upgrading production facilities, which therefore affect the construction industry. In addition, suppliers of machinery and equipment, and services oriented firms are also affected by the standstill of new investments.

The numbers of employees in the 936 firms, from executives and engineers to laborers, also decline in face of the uncertainty created by the attacks. Many 936 firms threaten to cease operations or at least cut them to a minimum, if the benefits they receive by operating in Puerto Rico under Section 936 are lost. Although this rather drastic action, may or may not be a tactic where the company is "playing a game" to see if they can stir up things and get what they want, there is no doubt that these type of statements create insecurity among the firms' employees. Many employees feel insecure and to some degree threatened by the attacks and the future outcome of not only the Section but the firm's reaction to the changes. The insecurity falls mainly on the stability of their jobs. Practically all employees fear that they might loose their jobs and consequently tend to make the necessary adjustments to be prepared just in case this event occurs.

Because employees feel insecure about their future, they make adjustment in their spending. They tend to save more or at least invest their money in more conservative types of investment in order to be able to meet their primary expenses if they in fact loose their jobs. These changes are transmitted throughout the economy of the Island. For example car sales is a very sensitive market and reacts to any type of news. Several dealers have reported sales slumps as much as 50 percent since Sen. David Pryor introduced his proposal.[94] In the real estate and construction industry, developer and engineer Rafael Casanova, president of Nidco Construction Corp., declares that sales of lots and larger parcels of land have registered a tremendous decrease. He understands that this is happening because people are being more cautious in their spending and they prefer to save and postpone some of their plans rather that to make monthly payments for something they will not use immediately.[95] The housing sector, mainly because of the high demand and low interest rates, seems not to have been seriously affected yet. However, development and purchases of houses tend to be in the range under the $100,000 mark. This situation demonstrates a conservative approach by clients in this market. Houses under $100,000 tend to have a reasonably low down payment. Casanova has noticed that many professional have the income to qualify for a loan mortgage, but in many cases they cannot afford the down payment, not necessarily because they do not have the money but rather because they do not want to spend all or most of their savings and have little or nothing left for emergency situations.[96]

Employees of 936 firms are not the only one that goes through these changes. Working people in every sector of the economy goes through the same process although not necessarily with the same intensity. Nevertheless, there is no question that everyone on the Island gets tangled in the web of uncertainty to some degree when the existence of Section 936 is questioned.

The Government of Puerto Rico and the 936 defenders have been successful in protecting the essence of Section 936. Nowadays, although a final decision has not been made yet, it seems that Puerto Rico still will be attractive

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94 Dough Zehr, Newspaper: The San Juan Star," Island car sales plummet as fears of a 936 loss rise", Saturday, February 20,1993, p.17

95 Edward Zayas, Newspaper: Caribbean Business, "Good news and bad news in real estate," Thursday, June 24, 1993, p.33

96 Ibid

for investment and thus maintain the stability of its economy. However, the decision must be made soon because the atmosphere of uncertainty creates a wave of negatives effects on the economy which keeps growth at a minimum level. In addition, whatever decision is taken concerning the future of Section 936 it should be one where Puerto Rico can be assured that no more drastic measurements will take place thus granting the stability and security needed to prosper.

Chapter 2. The Construction Industry and 936 Funds

The Commissioner of Financial Institutions (CFI) Office reports that 936 funds were the highest ever in the first half of 1993. Table 2.1 gives a comparison of 936 investments in financial institutions between months December 1992 through May 1993 and the respective months for the previous year.

Table 2.1: 936 Investments in Financial Institutions (millions)

December 1991	$9,112	March 1992	$9,591
December 1992	$9,948	March 1993	$10,216
January 1992	$9,004	April 1992	$9,584
January 1993	$9,876	April 1993	$10,137
February 1992	$9,380	May 1992	$9,826
February 1993	$10,181	May 1993	$10,129

Source: Office of Commissioner of Financial Institutions

This trend, to a great extent, is attributed to three reasons[97], two of which are directly connected to the current debates on Section 936.

The CFI states that an expected decrease in the "toll gate tax", which is paid once the 936 firms transfer revenues to their headquarters accounts in the U.S., has been a major factor in maintaining and increasing deposits on the Island. Governor Pedro Roselló is considering a reduction of the toll gate tax as a way to increase new ventures on the Island. However, whether or not this action more than compensates the loss in public revenues is still unclear and unknown.

97 Magdalys Rodriguez; Newspaper: El Nuevo Día, "Inversiones 936 en abundancia"; July 25,1993; p.116

The uncertainty on the future of Section 936 has paralyzed investments in new production installations and equipment. Firms have opted to place their funds in the financial system. The majority of these investments have been short term in nature (30, 60, and 90 days). This action is being taken by firms until a final decision on the fate of Section 936 is made. The increase in deposits is believed also to be a tactical move by 936 firms, in order to make financial institutions who are the recipients of the funds, lobby against changes to Section 936. The increase in deposits is obviously a benefit to the financial institutions, and many feel that it is a direct method used by 936 firms to enlist help to fight changes to the tax law.

936 firms' deposits in local financial institutions which are called 936 funds, have enabled Puerto Rico to develop a sophisticated and competitive financial sector which has provided liquidity and low interest rates loans within the Puerto Rican economy.[98] Local government regulations register construction activities as eligible to receive 936 funds. This acknowledgment greatly benefits the construction industry by making available low cost funds for construction projects.

2.1 936 Funds and The Commissioner of Financial Institutions

Financial institutions who are recipient of 936 funds include: commercial banks, savings & loans institutions, brokers, and trusts. Table 2.2 shows the distribution of such funds among holders. Share percentages tend to be constant.

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[98] Robert R. Nathan Associates, Section 936 and Economic Development in Puerto Rico, August, 1987, p.44

Table 2.2: 936 Funds Distribution (January 1993; millions)

Commercial Banks:	$6,453	65.33%
Banco Popular		
Citibank		
Chase Manhattan		
Other banks		
Broker Houses:	$2,540	25.72%
Paine Webber		
Lehman Brothers		
Other Brokers		
Savings & Loans:	$829	8.40%
Trusts:	$54	0.55%

Source: Commissioner of Financial Institutions

Financial institutions authorized to receive 936 deposits in Puerto Rico are subjected to regulations governing the use of such funds. The Commonwealth's Commissioner of Financial Institutions (CFI) is responsible for enacting and enforcing the applicable rules, currently embodied in Regulation 3582, which replaced the previous Regulation 3087 on March 1, 1988.[99] The basis of the regulations is the definition of eligible activities to which funds may be channeled and the establishment of minimum and additional eligible activity generation requirements.[100]

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99 Puerto Rico Bankers Association, The Impact of Section 936 on Puerto Rico's Economy and Banking System, Prepared by Estudios Técnicos, p.5

100 Ibid p.6

2.1.1 Minimum and Additional Eligible Activity Generation Requirements

The minimum generation requirement is tied to an institution's ratio of assets to liabilities. The CFI imposes a larger generation requirement the lower the institution's ratio, with an upper limit of 125 percent of the applicable 936 funds. However, no financial institution may have a minimum requirement of less than 100 percent; in other words, each dollar of 936 deposits must be matched by at least one dollar of eligible activity investment.[101] Table 2.3 indicates the minimum eligible activity generation requirements that financial institutions must comply with in order to be recipient of 936 funds.

Table 2.3 Minimum Eligible Activity Generation Requirement

Puerto Rico's Asset/ Liability Ratio	Eligible Activity Index
80% or more	1.00
Between 70% and 79.9%	1.10
Between 60% and 69.9%	1.20
Less than 60%	1.25

Source: Regulation 3582 of the Commissioner of Financial Institutions

The CFI defines the minimum eligible activity level as an amount equal to the product of the daily monthly average of eligible funds received times the eligible activity index. The eligible activity index is determined by the Commissioner with the approval of the members of the public sector of the Financial Board and the Administrator of the Economic Development Administration of Puerto Rico.

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[101] Puerto Rico Bankers Association, The Impact of Section 936 on Puerto Rico's Economy and Banking System, Prepared by Estudios Técnicos, p.49

For each deposit, repurchase agreement[102], or other transaction involving the receipt of eligible funds by an eligible institution in which the interest rate paid by the eligible institution on such funds exceeds the applicable market rate index, the eligible institution is required to generate additional eligible activity, in excess of the minimum eligible activity level required.[103] Currently, the market rate which is used as an index is the bid side of the Eurodollar deposit rate (LIBID). The additional generation requirement forces institutions to finance eligible activity in excess of the minimum requirement on an increasing scale when the rate paid by the institution for 936 deposits exceeds 70 percent of LIBID. Table 2.4 shows the Eurodollar Comparable Rate Table informally referred to as the TABLITA. The *tablita* details the funding requirements for rate payments above 70 percent of LIBID.

Table 2.4. Additional Eligible Activity Generation Requirements

936 Funds rate as % of LIBID	Additional. generation requirement (%)
70 or less	0
70.01 to 73	5
73.01 to 76	15
76.01 to 79	25
79.01 to 82	35
82.01 to 85	45
85.01 to 88	60
88.01 and over	100

Source: Regulation 3582 of the Commissioner of Financial Institutions

At the upper end of the scale, the Regulation requires an institution paying 88.01 percent or more of LIBID, to generate one additional dollar of

102 Repurchase agreement: a type of loan in which the borrower "sells" securities to the lender, who agrees to "sell" them back, and the lender to 'repurchase" them at a later time. Definition from Alan Updall, Glossary of Terminology, p.6.

103 Commissioner of Financial Institutions, Regulation 3582, Section 6.3.1(a),p.23

eligible activity for each dollar of deposits obtained at that relatively high cost. Therefore, given the two requirements and the position of the financial institutions, eligible activity generation can range from a minimum of one to a maximum of 2.25 dollars of eligible activity for each 936 dollar deposited.

Eligible funds received in transactions with fix maturities of three years or more having a fixed rate of interest, or with a rate of interest fixed as a percentage of a specific published index on the date of the transaction are not subjected to the requirements imposed by the *tablita.* This step encourages long term investment in the financial institutions of the island.

These regulations drive financial institutions to assume an activist position in seeking qualified borrowers and in keeping the cost of 936 funds low. They also encourage the pass-through of low deposit costs to final borrowers by forcing the institutions to compete for eligible activity. In the event that local demand for financing is weak - as may happen during a slow period in the Island's economy -- institutions will tend to offer unattractive rates to 936 depositors, thus encouraging repatriation of earnings to the mainland.[104] Therefore, the rules are consonant with Congress' dual intent of promoting productive investment in the possessions and fostering repatriation of earnings not absorbed productively by the possession economy.[105]

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104 Puerto Rico Bankers Association, The Impact of Section 936 on Puerto Rico's Economy and Banking System, Prepared by Estudios Técnicos, p.51

105 Ibid

2.2 Construction: An Eligible Activity

In addition to activity generation requirements, Regulation 3582 dictates special percentage investment requirements of 936 deposits in activities in sectors which are considered critical to stimulate growth of the economy of Puerto Rico. The construction industry is one of the sectors of the economy covered by these investment requirements. Although construction is an eligible activity to receive 936 funds, these investment requirements ensure that the industry is recipient of the benefits provided by the low cost funds.

Before March 1992, the special investment requirements totaled 23 percent of total 936 deposits. Regulation 3582 divided this total in three separate subdivisions. They were simply named: the 15% Investment Requirement (Section 6.1.1.), the 7% Investment Requirement (Section 6.1.3.) and the EDB[106] 1% Investment Requirement (Section 6.1.2). Construction activities' eligibility is explicitly mentioned in the first two subdivisions. Nevertheless, they have to compete and share the requirements with other somewhat less risky activities.

In order to ensure growth and development of the construction industry, Regulation 3582 was amended to include an additional 5 percent investment requirement. The amendment, which has been operating since March 1992, requires financial institutions with 936 deposits to generate loans for new construction activity. Although the requirement also includes loans to small businesses, among others, the construction industry has been the sector that has benefited the most.

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106 EDB: Economic Development Bank of Puerto Rico

Table 2.5 shows an example of how 936 funds were distributed to meet the special investment requirements for the month of January. The table includes all activities recipient of the investment requirements.

Table 2.5 Special Investment Requirements (January 1993; thousands)

15 % Investment Requirements

Interim Construction Loans By Savings and Loan Banks	$ 48,959
Certificates of Indebtedness and/or Repurchase Agreements designated by the Government Development Bank (GDB)	$ 412,336
Loans and/or Investments in obligations of the Commonwealth of Puerto Rico, or its Instrumentalities	$ 602,281
Total 15% Investments	$ 1,063,576

7% Investment Requirement

Loans to or obligations of:	
A. Acquisition, construction, or rehabilitation of housing for low or Middle Income Families in Puerto Rico	$ 1,136
B. Tourism Hotels and Paradores	$ 27,419
C. AFICA	$ 167,126
D. Agricultural or agropecuarian Activities	$ 52,506
E. Letters of Credit	$ 41,536
F. Caribbean Basin Initiative	$ 267,222
G. Economic Development Bank (EDB)	$ 21,510
H. Manufacturing Concerns covered by EDA's P.R. Industries Program	$ 46, 251
I. Other Investments	$ 62,274
Total 7% Investments	$ 668,978

Table 2.5 (Continuation)

5% Investment Requirement

Loans to or Obligations Issued After March 3, 1992:	
A. Interim Construction Loans	**$ 238,169**
B. EDB	$ 135,101
C. Loans in participation with EDB	$ 523
D. Loans or obligations Designated by the Commissioner and EDA's Administrator	$ 21,247
Total 5% Investments	$ 395,040

Source: Commissioner of Financial Institutions

The loan activities in bold letters clearly represent investments which benefit the construction industry. In January 1993, the CFI reports that more than $288 million of 936 funds special requirements investments have been devoted to a great extent, to interim construction loans. Moreover, there are other loan activities in Table 2.5 which in effect have direct impact on the construction industry of Puerto Rico.

Puerto Rico is well known for its beautiful beaches and historic sites. Millions of people come each year to enjoy them, causing the hotel industry constantly reorganize and expand to meet the ever increasing inflow of people. The Government of Puerto Rico considers tourism to be an important sector of the economy of the Island; therefore, hotels investments activities are considered eligible to receive 936 funds. In January 1993, more than $27 million of 936 funds special requirements investments was loaned to the hotel industry, most of which was used for expansion and maintenance of facilities which require the services provided by the construction industry.

Another activity which benefits and stimulates the development of the construction industry of Puerto Rico involves the loans or obligations to AFICA, which is the Spanish acronym for the Puerto Rico Industrial, Medical, and Environmental Pollution Control Facilities Financing Authority. This agency, since its creation in 1977, offers medium and long term financing by arranging special tax-exempt issues of industrial revenue bonds at rates below conventional lending rates for large industrial investments on the Island in the sectors included in its name. The proceeds of the bond sales are used by AFICA to make disbursements to the project owner according to a financing agreement. These disbursements are used by the project owner to pay for the costs of the project for which the bonds have been issued.

A study prepared by Estudios Técnicos for the Puerto Rico Bankers Association, reports that in the first eight years since its creation, AFICA financed 99 projects for a total of about $2.1 billion. These projects include the design and construction of many types of facilities which require the services of engineering and construction firms. Investments, more than two-thirds of which went into industrial projects, for both 936 and non-936 firms, also were utilized to build hospitals, water treatment plants, schools and universities, new hotels and shopping centers, and other types of projects which are vital to maintain the development and growth of the Puerto Rican economy. Table 2.6 shows the number of projects financed by AFICA for fiscal years 1978 through 1986 and Table 2.7 shows the distribution of AFICA financing by sectors.

Table 2.6 Projects Financed by AFICA Fiscal Years 1978-1986

Fiscal Year	Value of Bonds	Number of Projects
1978	$11,225,000	2
1979	23,500,000	1
1980	77,440,000	6
1981	126,155,772	9
1982	430,000,000	16
1983	246,575,000	18
1984	748,537,000	28
1985	57,710,000	6
1986	406,900,000	13
Total	$2,128,042,772	99

Source: The Impact of Section 936 on Puerto Rico's Economy and Banking System, Prepared for the Puerto Rico Bankers Association by Estudios Técnicos, January 1989

Table 2.7 Distribution of AFICA Financing by Sectors (Thousands of Dollars)

Fiscal Year	Industrial	Environmental Control	Hospital and Medical	Commercial	Higher Education
1978		11,225			
1979		23,500			
1980	57,690	7,000	12,750		
1981	96,296		29,860		
1982	413,000	17,000			
1983	215,750		30,825		
1984	631,767	15,200	101,570		
1985	26,750		30,690		
1986	3,500	176,000	15,670	188,630	23,100
Total	1,444,753	249,925	221,635	188,630	23,100
% of Total	67.9	11.7	10.4	8.9	1.1

Source: The impact of Section 936 on Puerto Rico's Economy and Banking System, Prepared for the Puerto Rico Bankers Association by Estudios Técnicos, January 1989.

Although the activities of this agency has been reduced primarily because of restrictions on industrial revenue bonds, its current activities still have a strong impact on the economy of the Island in general including the construction industry.

The January 1993 CFI report states that AFICA is recipient of more than $167 million of 936 special investments requirement funds. Therefore, adding all the amounts previously identified, the construction industry was injected with more than $350 million of 936 special investment requirement funds which obviously had a positive impact on its growth and development.

Regulation 3582's special investment requirements account for only 28 percent[107] of the total amount of 936 funds investments. Once financial institutions comply with the special investments requirements, they can offer and invest the rest of their 936 holdings with few restrictions in any activity, as long as the activity is considered eligible by the CFI to receive the low costs funds. For January 1993, the CFI reported that total eligible activities added up to $12,585,741,000 in 936 funds investments. Table 2.8 shows how the 936 funds were distributed among the eligible activities.

Table 2.8 Direct Eligible Activities (January 1993; Thousands)

Investment an/or Loans to the Government of Puerto Rico	$2,460,129
Commercial Loans	5,038,132
CBI Loans	267,222
Mortgage Loans	3,397,705
Commercial Paper	368,492
Net Book Value of Equipment	306,074
Other Assets	590,364
Loans to Students	131,716
Eligible Activities pursuant Section 6.2.4f	25,907
Total Eligible Activities	$12,585,741

Source: Commissioner of Financial Institutions

107 28%= (15% + 7% + 1% + 5%) investment requirements

The bulk of the loans which directly and/or indirectly impact the construction industry are accumulated in the commercial and mortgage loans activities. These activities are recipient of more than two-thirds of total 936 funds loans.

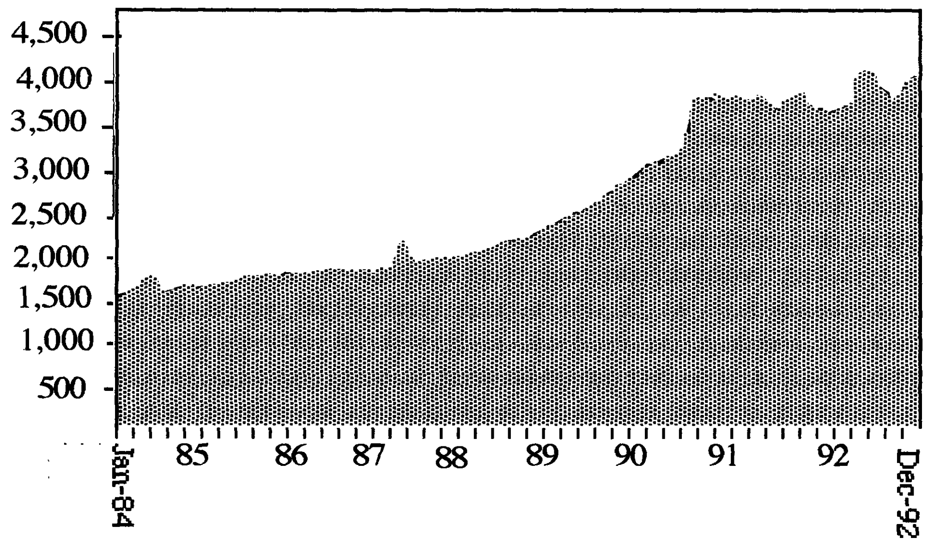
2.2.1 Commercial Loans

Commercial loans account for more than 40 percent of total 936 funds loans. These loans help finance projects which consequently require to contract the services provided by the construction industry for their development.

The bulk of the commercial loans are directed toward providing interim financing for the development of new projects of all types. These loans tend to be invested in the private sector of the market. Although, it is not uncommon for public projects to be financed by commercial loans, it is the private sector which is the major user. The majority of public projects tend to be financed by governmental agencies such as the Government Development Bank (GDB) which basically serves as an intermediary between the financial institutions and the public agencies.

Among the most common types of projects financed by 936 loans are: housing, office buildings, shopping malls, and hotels. The availability of 936 deposits has increased the supply of funds for construction. Since January 1984 interim financing have grown at an average annual rate of 17.3 percent.

Table 2.9. Interim Financing provided by Banking Sector (Jan.84-Dec.92; $ mm)



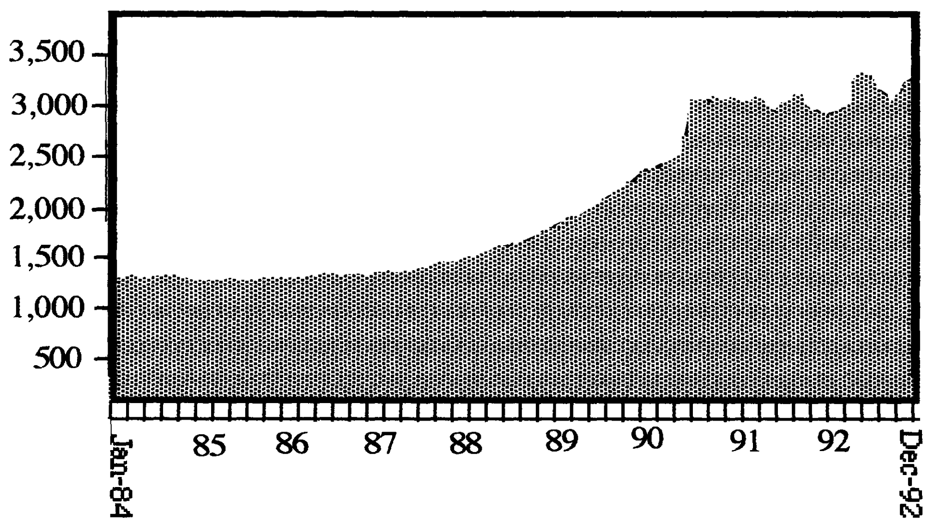
Source: The Impact of Section 936 on Puerto Rico's Economy and Construction Sector, Prepared for the Associated General Contractors of America, Puerto Rico Chapter by Estudios Técnicos, April 1993.

Although the construction industry clearly benefits with the influx of 936 fund into the economy of the Island as interim project financing, there are those who are convinced that the use of such funds has not been optimal, thus leaving room for improvement, especially in the housing sector of the industry. This matter is addressed in more detail latter in this chapter.

2.2.2 Mortgage Loans

Construction mortgage loans or permanent financing is the second largest activity financed with 936 funds. Since January 1984 permanent financing have grown at an average annual rate of 12 percent. In combination with interim financing for the construction sector, outstanding bank mortgage loans have increased their shares in commercial bank loan portfolios, from 19 percent in December 1984 to 30 percent as of December 1992.[108] With more than $3 billion invested as of January of 1993, this activity has been developed to a high degree of efficiency by local financial institutions, hence benefiting many on the Island.

Permanent Financing provided by the Banking Sector
(Jan.84-Dec.92; $mm)



Source: The Impact of Section 936 on Puerto Rico's Economy and Construction Sector, Prepared for the Associated General Contractors of America, Puerto Rico Chapter by Estudios Técnicos, April 1993.

2.2.3 Project Pricing: 936 Funds v. Prime Rate

The benefits brought by 936 funds toward the pricing of projects result from the fact that loans are provided to the financial institutions' clients, in this case developers, at a lower interest rate. The other method used by

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108 A.G.C., The Impact of Section 936 on Puerto Rico's Economy and Construction Sector, prepared by Estudios Técnicos, p.16

financial institutions for lending purposes is based on the *prime rate.* By comparing rates of both methods the reader will have a better understanding of the costs advantages of 936 funds loans over its counterpart.

Nowadays, 936 funds costs to financial institutions are between 3 and 3.5 percent. The financial institutions offer these funds to clients with an additional rate which floats between 2 and 2.5 percent. This added cost depends, among many other factors, on the client. Because local government regulations drive financial institutions to compete for eligible activity and to assume an activist position in seeking qualified borrowers, strong capital clients tend to be offered lower rates. Nevertheless common construction loans are usually obtained at a total rate which regularly floats between 5 and 6 percent.

In contrast, the prime rate floats around 6 percent. Adding the rate charged by financial institutions which vary between 1 and 2 percent, the total rate charged on construction loans float between 7 and 8 percent. Comparing both lending methods by local financial institutions, construction loans cost about 2 percent less to developers using 936 fund loans over prime rate based loans.

The primordial and optimal purpose of the benefits from 936 loans is that projects developers, after receiving these benefits in the projects' pricing, will transfer these benefits to the projects and therefore to its users. However, this transfer does not occur regularly. In reality what happens is that the developer keeps the benefits for additional profit.

While this occurs, the procedure is not illegal in any way. Although financial institutions are regulated with respect to the type of activities of the economy eligible to receive 936 funds loans, there is no concrete definition and control on the use of the funds in the eligible activities. There are loopholes, and the great majority of developers who use 936 funds loans for their projects have been taking advantage of them. The final section of this chapter analyzes this situation. Although it occurs in almost every sector of the construction industry, it is in the housing sector where it is most frequently noticed.

2.2.4. 936 Funds Interim Project Financing and the Housing Sector

It is a known fact that in Puerto Rico there is a shortage of houses at affordable prices. Therefore, housing development is a high demand sector of the construction industry.

Before discussing the problems of housing development on the Island, the term affordable housing is addressed. Puerto Rico lacks a clear definition in terms of a basis price for affordable housing. The entities involved in housing have not defined this term properly; nevertheless, from interviews with developers and bankers, and for the purpose of this thesis, the basis price for an affordable unit is assumed to be in the range of $70,000. This number represents the purchasing power that medium income families have for housing.

Although it is not usually publicly addressed, there are those that feel that 936 funds interim construction loans benefits have been diverted from their main purpose of benefiting many rather than just a few.

For the last ten years a boom has existed in the housing construction sector where developers have concentrated their efforts and resources toward the development of housing projects which give them the highest possible return in this market. This has involved the development of luxury housing.

During the 1970's, almost no one dared to enter this market. The bulk of construction during that period of time were affordable housing and projects of social interest which were directed to medium and low income families. However, as time passed developers found that the market could bear higher priced housing and housing projects began breaking what were then considered unthinkable prices. Nowadays, almost all housing projects are over $150,000 per unit and some are known to reach over $500,000 per unit. Mr. Steven Fenosik, Vice President of the Construction Loans Department of Banco Popular de Puerto Rico, asserted that this trend in the business will keep on developing until the market has been saturated. Today, it is believed that this market has been declining because of the economic uncertainties that exist, mainly created by the uncertain future of Section 936.

Although himself a banker, Mr. Fenosik accepts that bankers share some of the responsibility for the extent to which 936 loans have not been used optimally. Although banks are regulated by the CFI in the use of 936 funds, they tend to avoid projects which might not offer an attractive rate of return. Banks regularly consider projects which offer a low rate of return as too risky and tend to analyze them very carefully. Projects for affordable housing tend to have a lower rate of return and consequently banks tend to dismiss them and to concentrate on investing in higher profitability projects such as luxury housing.

Another point is that generally, developers of affordable housing are relatively small firms which do not have enough capital to attract the full attention of lending institutions. Bankers refer to this type of developers as "small league" developers. Banks consider the "small league" developer as a more risky investment than "big league" developers. Adding to the notion that projects developed by small league developers usually offer lower rates of returns, lending institutions tend not to offer the low cost funds loans to this type of developer, but rather offer them loans at higher rates because banks consider that they deserve a premium for the additional risk undertaken. The big league developers are normally concentrated in types of projects which offer a higher rate of return. Because they represent less risk to banks and banks want to keep them as clients, they offer these developers the opportunity to use low cost funds. Of course, these developers do not transfer the benefit to their clients. Nevertheless, in this case, because of the type of client who buys luxury housing, the benefits are not critical.

Another factor which contributes to this trend is the price of land. Because developers have been concentrating their efforts toward the development of luxury housing, people who owns land are caught up in this movement and start speculating on the value of properties which consequently rises the price of land.

In every country it is typical for the bulk of the population to live near the big cities. This occurs primarily because big cities offer the most variety of social and economic opportunities. Puerto Rico is no exception to this rule. Although many companies are scattered throughout the Island, especially 936 firms, the small size of the Island makes it possible for people to travel relatively short distances from their home to the workplace. Therefore, people tend to live in the areas closest to the major cities. Because many developers have discovered this trend, they have concentrated in building housing for these people who, because of their high paying jobs, have high purchasing power. Consequently, the development of luxury housing have caused land prices to skyrocket. This primarily affects the developer of affordable housing given the fact that land is too expensive for the types of projects they propose to develop. In essence, what this trend has caused is the development of affordable housing to move toward townships away from the main cities where land is still relatively less expensive.

Although there is a benefit with 936 construction loans in terms of a savings in costs when compared to other methods of financing, bankers assert that 936 funds should not be critical for the development of projects, especially housing projects. Mr. Fenosik stated during the interview that he has never been presented with a situation where a housing project could not be developed if not financed by 936 funds. He expressed that when the time comes and a project is presented where financing with 936 funds becomes critical for the success of the project, he advises that other factors be analyzed. These factors include: the structure of the project, price per unit, localization, financing procedures and the status of the economy among others. He clearly stated that if after analyzing these factors, the project's pricing is determined to be the only factor which determine the success or failure of the project, the project should not be developed. In simple terms, pricing can be "a factor" but not "the controlling factor". Although this opinion is shared among many in the banking industry, it is believed by others, especially developers, that it is an excuse for their projects discriminations.

There is no doubt that 936 funds have been beneficial to the construction industry because they have proved to be a low cost mean for projects financing. However, the issue addressed in this section of the chapter, is that 936 funds could benefit more people. Although, there are clear cases where 936 funds have been used optimally, there are many others instances in which only a few have benefited and usually they are those who least need the benefits.

It has to be stated again that none of the practices mentioned earlier are illegal. However, given that there are no clear definitions and regulations as to who uses the funds and for what type of construction projects, there are those involved that take advantage of these loopholes and consequently obtain very high benefits from the low cost 936 funds. This type of behavior is seen in any type of economy in every country, so no one can just point to the local bankers and developers from being profit maximizers. Nevertheless, although not illegal, it can be described as being of questionable morality since those who should receive the benefits are usually not.

Currently, the U.S. Government is debating the future of Section 936. One reason why Congress and the Treasury wants to modify or even eliminate the Section is because they believe that Section 936 has not made sufficient impact on the economy of Puerto Rico, and that the benefits provided to the 936 firms far outweigh the benefits produced on the Island. This statement might be to generic, but there is some truth in it.

Although Section 936 was not enacted with the construction industry of the Island in mind, there are benefits from Section 936 which affect the development and prosperity of this sector of the economy. Bankers, developers and the government should realize that the time has come to make some adjustments on the use of 936 funds in the construction industry, especially the housing sector. Many are convinced that Section 936 is going to undergo modifications. Some are trying to prove that with changes in the Section the construction industry as well as the other sectors of the economy will suffer. Now is the time to look for alternatives. The entities involved should, as an alternative, concentrate on the abolishment of the loopholes that exist in order to make sure that the optimal purposes for which 936 funds were created, are in fact carried out to the benefit of those who really need them.

Finally, even though there exists inefficiencies in the transfer of the benefits provided by the low cost funds to that sector of the Puerto Rican population which really needs it, the development of projects creates job for many on the Island. This kind of benefit is present no matter what type of project is being developed, public or private, or for residential, commercial, and industrial use. There are many families that depend on the construction industry and in essence do not care about the type of project on which they work or how it is financed. They only worry that when the project on which they are working on is finished, there are others which will keep providing them with their living necessities. In conclusion, 936 funds may not be always used optimally but they still provide the sustenance for many on the Island.

Chapter 3. The Construction Industry and 936 Firms

The undertaking of manufacturing as a strategy of economic growth, and a deliberate effort by the government of Puerto Rico to provide a modern infrastructure, has provided the construction sector of the economy a complete market for its services. Section 936, in combination with local investments incentives, has been responsible for the proliferation of the many projects in Puerto Rico which have brought the construction industry to a high stage of development. Because of the technological nature of many projects, the Island's construction industry is capable of providing services for the development of all types of projects, no matter their size and requirements. Like many sectors of the economy, the construction industry has gone through a process of modernization, and in less than three decades, has become self-sufficient, reliable and competent.

Nowadays, there are more than 500 firms which benefit from Section 936. Many others have come and gone, but the establishment of their plants in the Island have had a direct impact on the evolution of the construction industry.

3.1 Impact of Manufacturing Sector

Investment in construction by 936 corporations has had a tremendous impact in terms of output, employment, and income. Firms are drawn to Puerto Rico to take advantage of the benefits provided by Section 936. As a result, design and construction firms are called upon to erect their facilities. Billions of dollars have been invested by manufacturing firms with established operations in the Island. There are many firms who had been operating in Puerto Rico for more than 30 years and who continue to require the services of the construction industry for maintenance and expansions of operational facilities. In addition, new firms have been setting up operations each year, therefore adding to the overall demand for construction. Projects depend on the type of manufacturing firm that invests in installations, and on the size of its operations. Projects for labor intensive firms or low-technology firms installations, such as textiles and food, tend to have a lower total cost. These installations basically consist of an operating area and a storage area which usually do not require innovative and specialized engineering and construction services for their erection. However, capital intensive firms or high-technology firms, such as pharmaceutical and electronics, require these special services, and consequently, these projects have a higher cost. There is no doubt that the construction industry has benefited by the installation of operations on the Island, no matter the type of project in question.

Almost every major organization on the Island has conducted a study to asses the impact that Section 936 has on their respective area of interest. The Associated General Contractors of America (Puerto Rico Chapter), probably the most important organization representing the construction industry of the Island, funded a study which examines the importance of Section 936 for the development of the construction industry. The study is the first major analysis done focusing on the construction industry.

The study shows that in fiscal year 1991, investments in construction by 936 companies were responsible for more than 80% of output, employment, and income generated by manufacturing in construction. Table 3.1 provides a comparison between the investments of 936 firms in construction and total manufacturing investment for 1991.

Table 3.1 Construction Investment By Manufacturing Sector (Fiscal Year 1991)

	936 Corporations	Total Manufacturing	936 as % of Manufacturing
Output	$181.8 million	$207.6 million	88%
Employment	1,710	2,407	84%
Payroll	$24.7 million	$28.4 million	87%

Source: The Impact of Section 936 on Puerto Rico's Economy and Construction Sector, Prepared for: The Associated General Contractors of America, Puerto Rico Chapter, by Estudios Técnicos, Inc., April 1993, p.13

Total investment in construction services by the manufacturing sector was $207.6 millions, of which $181.8 million (88 percent) were invested by 936 firms. Direct construction investments generated a total of 2,047 jobs in construction, of which 1,710 (84 percent) are attributed to 936 companies. Although the study indicates that manufacturing accounted for 4 percent of total direct employment in construction, the contribution to construction is expanded in a dynamic sense through the interrelationships of this sector with the economy.[109] This economic activity in turn impacts the construction sector and sustains its corresponding level of employment.[110] In terms of labor income it was estimated that manufacturing generated $28.4 millions in construction payroll, of which $24.7 million (87 percent) corresponded to 936 corporations.

[109] A.G.C.,The Impact of Section 936 on Puerto Rico's Economy and Construction Sector, Prepared by Estudios Técnicos,p.13
[110] Ibid

Table 3.2 Demand For Construction Services by Total Manufacturing and 936 Corporations($Millions, 1982 prices- Fiscal Year 1991)

	936 Corporations	Total Manufacturing
Pharmaceutical	$63.8	$64.1
Chemical	54.7	61.9
Instruments	13.3	13.8
Electronics	13.3	13.8
Machinery	4.9	5.0
Canned foods	7.2	8.6
Other Food Products	10.5	15.5
Apparel/ Textiles	6.5	7.7
Other industrial Sectors	8.7	18.8
Total	181.8	207.6

Source: The Impact of Section 936 on Puerto Rico's Economy and Construction Sector, Prepared for: The Associated General Contractors of America, Puerto Rico Chapter, by Estudios Técnicos, Inc., April 1993, p.14

The table above lists how the investments in construction services were distributed among the different industries of the manufacturing sector. In addition it declares the amounts invested by 936 corporations. The industrial sectors that contributed most to the construction sector are pharmaceutical and chemical industries. They accounted for over half the construction demand of the manufacturing sector for construction services. Together with electronics and instruments they were responsible for 75 percent of construction investments, thereby confirming that high-technology manufacturing investments tend to be larger projects.

Although these figures are for fiscal year 1991, they are representative of the importance that investments by the manufacturing sector have for the development and prosperity of the construction industry. The direct impact on construction by total manufacturing, principally 936 manufacturing, also affects the rest of the economy. The A.G.C. study determines that for every $1.0 million invested by 936 manufacturing companies on construction generates 9 jobs in construction and an additional 5 jobs in the rest of the economy.

3.2 Case Study Approach

The demand for engineering and construction services spurred by the proliferation of industrial projects in Puerto Rico has caused the establishment of many construction firms on the island. The majority of the locally-based construction firms concentrate on the development of low-tech construction, such as housing and road construction. Locally-based construction firms that tend to depend substantially on the 936 plant expansion contracts are: Miramar Construction, Bird Construction, Rodríguez & del Valle, Rexach Construction and specialized firms such as Bermúdez y Longo and Lord Electric (however they tend to be in minority). The bulk of the construction industry for industrial projects primarily consist of U.S. firms which have established operations in the Island. Of the top 400 contractors of the U.S. construction industry, 18 have come to establish operations on the island. Table 3.3 shows a list of these U.S. firms.

Table 3.3 Top U.S. Contractors with Operations in Puerto Rico

Guy F. Atkinson Co.	United Engrs & Constrs. Intl. Inc.	Great Lakes Dredge and Dock Co.
Balfour Beatty Inc.	Chicago Bridge and Iron	CRSS Inc.
Day & Zimmerman Inc.	Fluor Daniel Inc.	Foster Wheeler Corp.
Harnischfeger Engineers	Jones Group Inc.	The Parsons Corp.
Stone & Webster Engr.	The Turner Corp.	H.B. Zachry Co,
Harbert International	Dillingham Con. Holdings	The Badger Co. Inc.

Source:Engineering News-Record, *The Top 400 Contractors,* May,25,1992,p.100

In addition, the proliferation of industrial projects has captured the attention of many of the top U.S. engineering and design firms. Engineering News-Record (ENR) reports that of the top 500 design firms in the U.S., 63 have established operations on the Island. However, many of these firms tend to have small offices and only a few have self-supporting operations. Puerto Rico law requires that all design and engineering for which the technical competence exists in Puerto Rico must be done in Puerto Rico under the supervision of an engineer licensed there. The corporate practice of engineering is not permitted, and the engineers are responsible for work prepared under their direction. Common practice is to perform the process of design in the U.S. and latter affiliate with a local firm for the detailed drawings. In addition to fulfill local regulations, this method of work indirectly helps maintain secrecy of processes. Many firms invest million of dollars in research and want to protect their innovations.

The remainder of this chapter will concentrate on providing an insight of the operational activities of two firms which have greatly benefited by the proliferation of projects, mainly industrial, brought by the benefits provided by Section 936 and the local investment incentives. The two companies analyzed are: Fluor Daniel Caribbean, Inc. and H.B. Zachry Co. (International). These companies are two of the few U.S. based firms that have self-supporting operations in the Island. The revenues of both firms are almost entirely based on projects by 936 firms, therefore, the analysis of their operations will help the reader understand the importance and impact of Section 936 on this sector of the construction industry. The case studies cover background information on their operations and services provided with particular attention being given to the impact of section 936 on their operations. These studies describe the views of the head manager of each company on the market and the future of Section 936.

3.2.1 Fluor Daniel Caribbean, Inc.[111]

Engineering News Record (E.N.R.), in its annual Top 400 Contractors Issue, ranked Fluor Daniel Inc. as the number one construction contracting firm in 1992.[112] With a total of $21,376 million in new contracts awards, of which $4,980 million was for new contracts outside the U.S., and revenues surpassing $14 billion, Fluor Daniel has proved to be a leader in construction and engineering services throughout the world. Table 3.4 provides a list of the locations of offices this company has in many countries worldwide.

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[111] This section is primarily based on an interview with Eng. José Cortés, Vice President & General Manager Operations, and additional printed informadion given by the firm.
[112] Engineering News-Record, The Top 400 Contractors, May,25,1992, p.58

Table 3.4 Fluor Daniel Worldwide Offices
Engineering and Construction

The Americas	Asia / Pacific
Anchorage,Alaska	Bangkok
Bakersfield,California	Beijing,People'sRepublicofChina
Calgary,Alberta,Canada	Brisbane,Australia
Caracas,Venezuela	HongKong
Charlotte,NorthCarolina	Jakarta,Indonesia
Chicago,Illinois	KualaLumpur,Malaysia
Cincinnati,Ohio	Manila,Philippines
CorpusChristi,Texas	Melbourne,Australia
Dallas,Texas	Perth,Australia
Denver,Colorado	Seoul,Korea
Greenville,SouthCarolina	Singapore
Houston,Texas	Sydney,Australia
Irvine,California	Tokyo,Japan
KansasCity,Missouri	
MexicoCity,Mexico	**Europe/Africa/MiddleEast**
Philadelphia,Pennsylvania	Wiesbaden,Germany
RedwoodCity,California	Asturias,Spain
Richmond,Virginia	BergenopZoom,Netherlands
SanJuan,PuertoRico	Camberley,England
Santiago,Chile	Dhahran,SaudiArabia
Tulsa,Oklahoma	Dusseldorf,Germany
Vancouver,Canada	Haarlem,Netherlands
Washington,D.C.	Jeddah,SaudiArabia
	Leipzig,Germany
	London,England
	Madrid,Spain
	Manchester,England

Because of the proliferation of industrial projects on the Island, mainly driven by Section 936 tax incentives, Fluor Daniel Caribbean Division with headquarters in Puerto Rico is only one of the few offices which are completely self-supporting.

Eng. José R. Cortés, Vice President and General Manager, heads operation activities in the Puerto Rico headquarters. Fluor Daniel Caribbean has benefited to a great extent by the settlement of many industrial firms attracted by the incentives provided by the Government of Puerto Rico and Section 936. The company has provided engineering and/or construction services on more than 80 percent of the pharmaceutical industry projects on the Island. In addition, it has developed the three biotechnology firms in existence on the Island (Ortho, Angem and Cairon), and has participated in the elaboration and expansion of industrial, manufacturing, refinery, petrochemical, textiles, food processing, power and water resources projects. In total, Fluor Daniel Caribbean has evolved to be a leader in industrial construction, having design and built more than a billion worth of projects in Puerto Rico and the Caribbean.

Mr. Cortés and his staff are conscious that Section 936 has been the principal booster of projects on the Island and Fluor Daniel has been in direct contact with many of them. This closeness with the market has made Fluor Daniel consider itself as part of the industrial base of Puerto Rico. Mr. Cortés is confident of the quality and type of services his company provides to its clients. However, given the uncertainty created by the questionable future of Section 936, Mr. Cortés is primarily concerned with the effects and consequences on future investments by firms which provide the bulk of the revenues to his company.

3.2.1.1. Background Information

Fluor Daniel was originated from a merger between Fluor Corporation and Daniel International. Both companies had been operating in Puerto Rico for more than 25 years but it was not until 1979 that their activities were consolidated into Fluor Daniel Caribbean, Inc. However the merger did not become effective until 1986.

In 1964, Phillips Fiber, contracted Daniel International, based in Greenville, South Carolina, to build a synthetic fiber plant on the south coast of Puerto Rico. At a cost of $100 million, Daniel entirely developed, design and constructed the Phillips Fiber facility in Guayama, completing it in 1967. Daniel management who worked with the project perceived a bright future for industrial construction in Puerto Rico and decided to establish a division office on the Island. Fluor Corporation, who was already settled on the island at that time, was concentrating their resources toward the development of petrochemicals projects. From textiles in 1966-68, Daniel moved into constructing petrochemical and heavy industrial projects and by 1969 it entered the market of pharmaceutical and chemical industries.

Before the merger took place both companies where rivals on the same battleground. With the formation of Flour Daniel Caribbean, Inc., the new company was able to effect a pooling of resources which has proved to provide a competitive advantage for operations. Daniel Construction provided to the new company its expertise in process engineering while Fluor International provided its global accomplishments in the provision of renowned services in engineering and construction. To better provide its services and take full advantage of the merger, the company's services were divided into sectors. These are: process, government, industrial, hydrocarbons and power. The merger resulted in the creation of a full service engineering and construction company providing a broader range of technical services to more clients in more industries. The company's mission is to provide services of total quality that cannot be matched by others which provide an advantage and complete satisfaction to their clients. Their strategy has had such an effect that more than 75 percent of their clientele return in order to receive the firm's quality oriented services.

3.2.1.2. Services Provided

Flour Daniel Caribbean provides a large array of services. The company's programs are developed to meet specific and unique requirements for the client, which may demand one or a combination of services. These include:

* Project development
* Permitting services
* Site development
* Feasibility Studies
* Construction
* Scheduling, estimating and cost control
* Plant services
* Construction management
* Process design
* Construction equipment and tools
* Environmental services
* Personnel services
* Detail engineering
* Procurement, expediting and trafficking
* Training
* Conceptual engineering

One quality that differentiates Fluor Daniel Caribbean over competitors in Puerto Rico is its ability to provide engineering as well as construction services under one roof in order to satisfy the requirements of a completely integrated, coordinated project design for both design/build and conventional competitive bid projects. Through their design affiliate, Caribbean Architects and Engineers, Fluor Daniel's design capabilities encompass the full range of engineering and design services required in highly complex industrial, pharmaceutical and manufacturing projects. This relationship is advantageous to the client in that it permits use of the fast track method. This method becomes crucial in many projects Fluor Daniel helps to develop. There are many firms that require their products to be on the market as fast as possible and the fast-tracking method provides the means for production to start earlier.

3.2.1.3. Employment Impact

Besides the services provided to many firms, Fluor Daniel Caribbean, has had a tremendous impact on the employment in the construction and engineering industry. Table 3.5 provides an estimate of the number of employees this firm has had on its payroll since 1973.

Table 3.5 Employment by Fluor Daniel Caribbean

Year	Employment	Year	Employment
1973	3,300	1983	2,220
1974	4,900	1984	1,050
1975	3,200	1985	900
1976	3,000	1986	1,200
1977	2,800	1987	1,200
1978	1,900	1988	2,200
1979	1,500	1989	1,100
1980	3,100	1990	1,000
1981	2,000	1991	900
1982	500	1992	800
		1993	800

At the height of the construction industry in Puerto Rico around 1974, the company employed almost 5,000 engineers, construction and maintenance workers and support personnel. During that time they were considered the second largest employer on the island, after the Government of Puerto Rico.

During the years 1972-75, average yearly payroll was $28 million, which brought a real cash flow into the economy of Puerto Rico

Although, the firm has decrease in size since then, it has always made a significant employment impact in the construction industry of the Island. Setbacks in the construction industry and the economy of the Island, and an increase of competitors are major causes for this size decrease. Also, an increase in the availability of good subcontracting companies has compelled Fluor Daniel Caribbean to change its size. In many instances, Fluor Daniel has opted to subcontract part of their work to qualified subcontracting firms. Last, but not least are the Section 936 debate. As table 3.5 shows, the periods when Section 936 has been the focus of attention, the company has had to make changes in its size to compensate for the impact on the construction industry caused by the uncertainty in the economy of the Island. This is demonstrated clearly for the early and mid-1980's. However, although these forces may have caused an impact on the size of the firm in terms of numbers of employees, its services and quality of work have not suffered.

Another contribution made by Fluor Daniel Caribbean was the creation of a skilled labor force. When the company was established in Guayama in 1966, the situation that existed was unique for both Fluor Daniel's management and the Puerto Rican people employed to work on the Philips Fiber project. Management, which consisted entirely of North Americans, was faced with a labor market with little or no experience in heavy and industrial construction. The lack of skilled labor, together with language problems and cultural differences, presented both Fluor Daniel Caribbean's management and construction workers with a real challenge. The company took the initiative to mold mostly agricultural workers into a functional, professional construction unit. This required intense training. Personnel was brought in from the States to teach various skills. The intensive training programs succeeded in producing a very skilled group of craftsmen to form a core of workers for future projects. Training ranged from labor intensive services such as welding and block masonry, to management and engineering positions.

Training is still considered an important practice for the company. The company continuously upgrades and retrains workers. For the past 27 years, thousands have gone through training programs with Fluor Daniel Caribbean, including formal Federal Government sponsored programs. Many of these graduates are employed by the owner of the facilities which they helped build, preferring to stay with a continuous, secure job in the area where their families lived. Others have taken their skills with them into different manufacturing or construction companies. While often this loss is inevitable and hurts the company, management recognizes it as a natural process that is good for Puerto Rico, and has greatly contributed to the growth of the construction industry.

3.2.1.4. Fluor Daniel Caribbean, Inc. and Section 936

Fluor Daniel Caribbean has constructed facilities for over one hundred clients, with investment in excess of one billion dollars. More than 90 percent of those clients were 936 firms. Therefore, it should come as no surprise that when Section 936 becomes controversial, Fluor Daniel Caribbean feels that the core of its business is threatened.

As mentioned previously, everytime Section 936 benefits are debated, the economy of Puerto Rico is affected creating instability and uncertainty in businesses as well as in the population. From Fluor Daniel Caribbean's point of view, the uncertainty created regarding future work for the company becomes an element of controversy not only for management but for the whole company as well. In addition, the Caribbean division has to accommodate the analysis of the situation made by Fluor Daniel headquarters, at Irvine, California. Recognizing the effects the debates on Section 936 have on the economy of the Island, Headquarters puts pressure on its Caribbean division and questions whether or not the company should keep operations on the Island. This becomes an issue and burden on the Caribbean division at the time when capital disbursements for all divisions throughout the world are being made. However, given the fact that the operations in Puerto Rico are self-sufficient, the management of the Caribbean division has the resources to make a more complete analysis of the situation. By always providing sufficient and reliable information to its headquarters, Fluor Daniel Caribbean has always been able to defend its position to maintain a presence on the Island.

Table 3.6 indicates the number of projects that have utilized Fluor Daniel Caribbean's services for the years 1975 through 1992. Before discussing and identifying some relevant facts from the table, it should be noted that because of the magnitude of many of the projects the company has worked on, portions of the work are carried over to following years. Only the part of the work that has been finished is counted for each particular year. In addition, there are other projects which recur every year, such as maintenance contracts the company has with its clients.

Table 3.6 Number of Projects under Design Construction and Maintenance for years 1975-92

Year	Engineering	Construction &Maintenance	Total
1975	22	64	86
1976	55	47	102
1977	38	43	81
1978	28	54	82
1979	35	47	82
1980	44	48	92
1981	54	45	99
1982	67	51	118
1983	36	52	88
1984	74	71	145
1985	76	68	144
1986	101	58	159
1987	117	37	154
1988	107	77	184
1989	11	71	182
1990	92	44	146
1991	72	21	103
1992	65	30	95

The above table shows how the number of projects were affected during the periods of Section 936 debates. During the debate of the early 1980's, Fluor Daniel Caribbean construction and maintenance services increased by 13 percent (6 projects) from the 1981 to the 1982 period and increased only by 2 percent (1 project) from the 1982 to 1983 period. Also, total work decreased by 25 percent during 1983 from a total of 118 projects in 1982 to 88 in 1983. The debates during the mid-1980's had similar effects on the company's quantity of work. Starting at 1985, construction and maintenance services decreased by 4 percent (3 projects) from the previous year, then suffered a 15 percent (10 projects) reduction in 1986, and an additional 36 percent reduction (19 projects) in 1987.

Table 3.7 Fluor Daniel Caribbean Historical Revenues for Years 1981-92

Year	Revenues(thousands)
1981	$79,866
1982	$22,754
1983	$34,523
1984	$61,762
1985	$21,646
1986	$41,894
1987	$38,605
1988	$76,065
1989	$82,689
1990	$36,710
1991	$28,566
1992	$25,207

Table 3.7 provides additional information which exemplifies how Section 936 debates affected Fluor Daniel Caribbean. Revenues for the company were almost $80 million in 1981. However, during the 1982 debate revenues dramatically dropped to $23 million. Although in 1983 revenues increased to $42 millions, the company still had a long way to go to be in the position it was just two years before. Revenues kept increasing until the next wave of attacks on the Section took place. In 1985, revenues dropped to $22 millions from $62 the previous year.

After these downturns occur, the market starts to recover. This generally occurs after a decision is made on the debates, and everyone has the opportunity to adjust to the changes made. It would be unfair to blame the debates on Section 936 as the only cause for instability. High interest rates, depressions on the economies of Puerto Rico and the United States, and increase in global competition, are other powerful economic forces that affect the market. However, because of the closeness between Puerto Rico's economy and Section 936, the debates on the Section tend to augment these negative effects.

Although Fluor Daniel Caribbean has felt the impact, Mr. Cortés indicated that the situation could have been worse, especially comparing the performance of competitors during the same periods going through the same circumstances. During the construction boom periods, when there are numerous projects to be developed, big construction firms, like Fluor Daniel Caribbean, tend to focus their resources primarily toward acquiring the largest projects. This consequently leaves smaller firms to compete for projects requiring less investments. However, when the economy is in a downturn and as a result there is less investment in new projects, big construction companies tend to be less strict about the type and size of projects they bid for. During these times, almost every project is bid on by small as well as big firms. It should come as no surprise that the big firms usually win the contracts, mainly because of the wider range of services they can provide to their clients. Therefore, small firms tend to be on a tightrope during these periods of time. This explains why Fluor Daniel Caribbean may have suffered a less drastic impact than many of its competitors. With their reputation for quality and their array of services, the firm can practically compete on any size and type of project.

After the last Section 936 debate, Fluor Daniel Caribbean had a period of recovery and prosperity. By 1989, their revenues had increased to almost $83 million. However, since the beginning of the 1990's revenues had been shrinking. For the years 1990 and 1991, the reasons why this has occurred cannot be directly linked to Section 936 because for this period of time the Section was not under attack. The causes why this trend might have happened, considering the company's size and share of the market, can be safely assumed to be representative for the construction industry in general and are probably connected to the cyclical nature of the construction industry and of the whole economy not only of Puerto Rico but also the U.S. This first years of the decade were characterized by the existence of depression in the U.S. economy which consequently had its effects on the economy of Puerto Rico, and the Gulf War which may or may not have been of any direct or indirect significance.

However, for 1992 it is more certain that Section 936 influenced the trend. This is because 1992 was an election year and many believed that the U.S. Government was going to change hands. Throughout the periods the Republican Party was in power, Section 936 underwent relatively minor changes. Nevertheless, with the prospects of the election of a new President with promises of a bold economic recovery program, those using Section 936 took an attitude of wait and see. The elections brought President Clinton to power; and as Chapter 1 discussed, Section 936 again became the center of attention for modifications or even elimination. The new wave of attacks have once again created an atmosphere of uncertainty, and until a final decision is made, one can only speculate on the future. For many, especially in the construction industry, the first months of 1993 have been problematic. It is generally believed that the situation is not going to improve greatly until a final decision on Section 936 is made.

In spite of this, Fluor Daniel Caribbean management expects an approximately 40 percent growth in profits in 1993 compared to its 1992 performance. Mr. Cortés primarily attributes this situation to three reasons.

First, although there are numerous 936 firms that have stopped the development of their expansion projects, there are four pharmaceutical firms which have continued to expand. These firms, who are Fluor Daniel Caribbean clients, initiated their expansions before the attacks on Section 936 started and regardless of what has been happening decided to keep on with their investment plans. Mr. Cortés did not want to mention these firms for the context of this thesis because there are at least two of them that have not yet publicly announce their expansion projects. However, he did mention that they were big investment projects, on the order of $50 million in size. A second reason mentioned was that Fluor Daniel Caribbean was engaged in the permitting process for the development of two petrochemical expansions, one for Philips and one for Sun Oil. These are also big investment projects and both are being managed by the company. Finally, he explained that Fluor Daniel has benefited from the satisfaction provided by its services to its clients and the return of clients requesting their services especially in the areas of permitting and design.

Although the total number of projects is less than in previous years, Mr. Cortés explained that many of the contracts have been negotiated instead of been awarded by the usual competitive bidding process. By negotiating contracts, Fluor Daniel Caribbean, can have a better position in which they can maximize its earnings and at the same time maintain its competitiveness with the client. The project in turn is better oriented and more detailed.

Mr. Cortés is confident that a decision on Section 936 will be taken soon and whatever changes may occur will be fair for the U.S. and Puerto Rico. However, he predicts a one to two years period until the economy of the Island returns to normal, especially for the construction industry. First, he explained that it will take time for the community, exterior and interior, to convince themselves that the decision taken is going to be permanent. In addition, many will wait until they figure out how they will be affected with the changes. A second reason Mr. Cortés stated was that since many projects were stopped, there will be a period of approximately one year for projects permitting and design processes to be completed before actual construction starts, at least for the types of projects they are involved in.

Mr. Cortés expressed that the company is waiting for a final decision on Section 936 to be made to perform a study of the impact the changes will have on the market, especially on Fluor Daniel Caribbean Inc., and what adjustments they have to make on their strategies to maintain its status as leader in its line of business. He believes that there is nothing gained in making a study now when it is not known with certainty what changes are going to take place on the near future.

3.2.1.5. Growth Alternatives

To maintain its position as leader on the market, Fluor Daniel Caribbean managers are analyzing several alternatives which may fortify their share of the markets. They understand that diversification is a key factor to attain the goal. However, management realizes than an in-depth analysis of each alternative is required before taking action.

One alternative considered by the firm is to enter into lower technology jobs such as housing and road construction. However, this alternative is challenged primarily by two issues. First, Fluor Daniel Caribbean specializes in high-tech construction. By entering the market of lower technological jobs the firm perceives that they might loose focus on their high technological services. Second, the market is practically saturated and competition would be fierce. These types of projects tend to be smaller than most of the industrial projects they usually develop and marginal benefits may not be enough to compensate for the investment of resources.

Another alternative under consideration is to diversify into power generation. The firm has had experience in this type of project and is contemplating directing more of its efforts toward competing in this sector of the market. Because of the many manufacturing firms operating on the Island, demand for power is high, however, management is still uncertain about how the new changes in Section 936 will affect this section of the market. Taking into consideration that new investments may drop, they feel it is questionable as to whether or not additional power would be needed in Puerto Rico.

Besides expansion alternatives of their services to other sectors of the construction industry of the Island, Fluor Daniel Caribbean, is considering alternatives to expand their services outside of Puerto Rico. The company considers that potential for growth comes from some of the other Caribbean islands, and from countries in Central and South America. Although it is not a new concept for them, the company is considering to pursue this alternative more vigorously. One method to expand comes from what is known as the twin-plant concept. As explained in chapter 1, this concept is where the labor intensive portion of a firm's work is performed in a low labor cost country and the technical work is performed in the Puerto Rico or the U.S. subsidiary. Fluor Daniel's role would be to provide its engineering and construction services to the development of its clients' operations in the lower cost countries.

3.2.2 H.B. Zachry Co. (International)[113]

ENR ranks H.B. Zachry Co. as the 37th top U.S. contractor. With corporate headquarters in San Antonio, Texas, the company has concentrated its attention on construction in the U.S. Nevertheless, their services have expanded to some other countries worldwide. To efficiently maintain the quality of its services, the company is organized into regional offices. The regional offices provide support, special purchasing power, technical expertise in the latest safety procedures, construction equipment and finances to the temporary offices set up at the site of each project in its region. Table 3.8 provides a list of the regional offices.

Table 3.8 H.B. Zachry Regional Offices

Dallas Regional Office Heavy/Maintenance & Services	East Texas Regional Office Maintenance & Service
Houston regional Offices Maintenance & Service	San Antonio Regional Office Heavy Division
Corpus Christi Regional Office Maintenance & Service	Louisiana Regional Offices Process Division
Puerto Rico Regional Office	Middle East Regional Office

Similar to Fluor Daniel Caribbean Inc., H.B. Zachry International set up self supporting operations in Puerto Rico to take advantage of the many industrial projects which were developed in the Island as a result of Section 936 tax incentives.

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[113] This section is primarily based on an interview with Eng. Shafik B. Farid, District Manager, additional printed informadion given by the firm, and on Michele Czechowski's study: <u>Análisis Estratégico de H.B.Zachry.</u>

Eng. Shafik B. Farid is the district manager of H.B. Zachry in Puerto Rico. Although he is not Puerto Rican, he has been in the Island long enough to understand the significance and impact that Section 936 and the local investment incentives have on the Puerto Rican economy and the importance of 936 firms investments to the development of the construction industry.

3.2.2.1 Background Information

H.B. International have been operating in Puerto Rico for the past 27 years. In June of 1966, the Industrial Group landed in Puerto Rico to build some of the largest power plants on the Island. PREPA (Puerto Rico Electrical Power Authority) awarded to Zachry, the complete construction and erection of its electrical units three and four with a total value of $18 million. The projects were successfully finished in 1970, and they marked the establishment of the firm's operations on the Island. In 1969, the Zachry organization was awarded the contract for the construction of PREPA's units five and six with a total value of $24.5 millions. These projects enabled the company to become one of the most experienced in this field on the Island.

In 1974, Zachry expanded to the petrochemical industry by providing its services to Union Carbide. Inc. This company is still one of Zachry's clients. Later, in 1975 the company entered the pharmaceutical industry. The construction and maintenance of Baxter-Travenol Laboratories was the first of a list of pharmaceutical firms which have become part of H.B. Zachry (International) clientele.

As with other construction firms, 936 firms, especially pharmaceutical companies, have become the principal source of revenue for the Zachry organization. The elimination or implementation of major changes to Section 936 therefore becomes a major threat to its operations in Puerto Rico.

3.2.2.2. Services Provided

The company's experience has been accumulated through building petrochemical plants, pharmaceutical facilities, power plants and managing long-term maintenance contracts for many clients. To date it has expended over 25 million man-hours in construction, and over four million man-hours in maintenance.

Investment projects by 936 firms, primarily pharmaceutical companies, account for 75 percent of H.B. Zachry work. The rest (25 percent) is concentrated in PREPA's power plants. Its industrial work is basically composed of three types: new construction (30 percent), maintenance of facilities and equipment (20 percent), and rehabilitation of facilities to augment productivity and efficiency of operations (50 percent).

Most of the company's work is performed by direct-hire employees, with the exception of selected specialties that are subcontracted. Zachry possesses the management expertise and craftsmen to execute a comprehensive range of work: site preparation, concrete placement, structural steel, pipe fabrication and installation, electric power wiring, equipment erection, boiler erection, turbine generator erection, process-vessel and line installation, alloy welding, high voltage substation installation, thermal installation and painting.

Another resource the firm has to offer its clients is construction equipment. Zachry owns a large fleet of construction equipment operated exclusively on its projects. By owning its own fleet, the company is able to keep costs down, thereby passing the savings to clients.

H.B. Zachry has developed an in-house computerized system for effective materials management. Large projects using this system have experienced less than one percent surplus at job completion. Its experience in CPM scheduling, cost control and other management systems provides the company with the historical data and insight needed to create mutually beneficial contracts. The contracting approach is flexible. Although they are accustomed to working on lump sum contracts, various projects with cost-plus contracts have been successfully developed. Unlike Fluor Daniel Caribbean, its strongest competitor, HBZI specializes only in construction work and management. It does not offer in-house design services. The design process is done separately and depending on the type and size of the project, it is either design by a local firm or a U.S. based firm.

For HBZI, the most important advantage it holds over competition is its excellent reputation which have been strengthened by cooperating with clients in every possible way to achieve budget and schedule constraints, and to successful completed 100 percent of their projects. The satisfaction of clients is evidently felt by the company because over 70 percent of annual volume is repeat business.

3.2.2.3. HBZI and Section 936

Like every construction company in existence on the Island, HBZI has gone through the cyclical behavior of the market, once Section 936 benefits become a center of dispute. The impact of the 1992-93 disputes are no different from the previous ones. The effects of the disputes are noticeable in the employment and revenues of the company. In 1992, HBZI employed approximately 650 workers. By the beginning of 1993 this number was reduced to 250 employees. The company eliminated many of its laborers positions and maintained most of the management staff. Revenues in 1992 were approximately $45 million. In 1993 the firm expect them to decrease to $30 million. Mr. Farid explained that his company has had to make some adjustments, mainly in employment, to compensate for the expected loss of revenues. Nevertheless, he feels optimistic on the outcome of Section 936 and foresees that by 1994 the market will return to normal behavior and that the revenues of the company will increase.

Although the debate of Section 936 have created uncertainty among industrial firms, there are some companies such as Abbot, Merck Sharp and Dohme, and Upjohn that have not stopped their investments. However, there are other big firms such as Johnson & Johnson, Schering and Bristol Myers that have stopped completely their expansion projects.

Mr. Farid explained that the companies that halted their projects might be following one of two strategies. Either they mean to leave the Island if Section 936 benefits are eliminated or largely modified, or they are making a tactical move by creating pressure on the local government so it fights harder with the Federal Government to keep Section 936 as much as possible the way it is now. Mr. Farid was inclined to think it was the second strategy.

He believes that whatever decision is made on Section 936, the status of the economy will not suffer as much as many tend to believe. Although some companies might leave, the majority will stay. For him it does not sound reasonable that a company that has invested millions of dollars will leave their investments behind just because instead of making for example a 30 percent profit, they will make a 20 percent profit under the new regulation.

Mr. Farid sees Section 936 benefits as a "habit" which has been acquired by many companies, and that they do not want to let go. However, there is absolutely nothing unusual in not having the full benefits of Section 936 and having to pay taxes. As an example he stated that firms have to pay full taxes in the U.S. and they have production operations there. With the upcoming changes, companies will have to pay some taxes, but there still will be profits. In the event that there are no profits, then there are no taxes to be paid. Nevertheless, there have always been large profits.

To his understanding, the latest proposal for modification of Section 936 currently being debated by the U.S. Congress, seems reasonable. As discussed in Chapter I, the proposal gives two options to industries from which they have to choose. Firms basically have to decide between a 60 percent tax credit on total revenues or a 90 percent wage credit.

The first option, although less than the current 100 percent credit, is still attractive to keep firms on the Island and spur new investments. He explained that because 936 firms were not paying taxes before it is natural for them to react against modifications. However, the fact remains that firms will have to pay taxes but these will not be detrimental enough to damage the economy as many tend to believe. Firms with a small group of workers and high revenues will be inclined to choose this option. On the other hand, the wage credit proposal will mainly be considered by those firms with a larger group of workers, specifically labor intensive firms. What makes the option attractive for this type of firm is that the credit is based on gross wages. Gross wages or gross payroll is defined as the summation of the payroll and the payroll burden. The payroll burden is composed of benefits to the employees paid by the employer. These include social security, unemployment benefits and health plans among others which vary with the benefit policies offered by firm. These costs may amount to 40 percent of payroll, therefore, the 90 percent gross wage credit proves to be more than the payroll itself.[114]

No matter the option that firms decide to choose, they still prove to be attractive for firms to maintain operations on the island and to attract others. A final decision on the extent of the modifications has not been made yet but it seems that if further changes are going to take place they seem to decrease the tax burden, therefore making the options just mentioned more attractive.

One point that Mr. Farid believes has not been fully discussed by 936 firms and the government of the Island is the fact that productivity is very high in Puerto Rico. By his own experience and in discussion with managers of many industrial firms, he asserts that the labor force of the Island is very productive and competent. Many firms on the Island would confirm that once an initial training period is over, production rates are among the highest in the world. Although wages on the Island are somewhat lower than in the U.S. they are high compared to many countries were firms have similar types of operations. Relative high wages on the Island exist primarily due to the fact that the federal minimum wage regulation applies to Puerto Rico. This reduces the notion of cheap labor and supports the fact that besides the 936 benefits, many firms bring their operation to Puerto Rico to take advantage of its productive labor market. One reason why this quality has not been given enough attention by firms is that they might not want to deviate the attention of those deciding the future of Section 936 from the impact 936 benefits have on their operations.

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[114] Gross payroll= payroll + payroll burden= 100% + 40%= 140%. Therefore 90% wage credit equals 0.9(140%)= 126%

HBZI's district manager is optimistic of the decision that will be made in the near future. Although, the economy of the Island is going through a period of uncertainty, once a decision is made it will return to normal. Mr. Farid believes that next year HBZI will have as much work as last year. What is hurting the market is the fear of the unknown where no one knows with certainty what is going to happen. Therefore, firms as well as individuals are being careful with their money and do not want to invest until they find out what is going to happen.

One piece of advice recommended by Mr. Farid for the construction industry in particular, is to reduce costs. HBZI is following this strategy to cope with the downturn in the market and will continue to do so until the Section 936 debate is over. The adjustment are temporary; and once a decision is made, investments will increase and consequently new projects will follow which will need the services provided by the construction industry of the Island.

3.2.2.4 Growth Alternatives

HBZI will keep providing its services to the industries which have in the past provided the bulk of its revenues, namely, pharmaceuticals, petrochemicals and power plants. The company is confident that its reputation in the field of construction can help them increase their share on the market. The firm is planning to utilize its marketing department to attain its goal. HBZ's marketing department, located in its headquarters in Texas, will be responsible for establishing contact with U.S base firms that have operations in Puerto Rico. Communication will permit HBZ to obtain information on the investments projects these firms may have planned for their subsidiaries in

Puerto Rico. This strategy can provide a competitive advantage for the firm, especially over the locally-based construction firms.

To increase the volume of contracts with PREPA, HBZI is considering to help this entity seek solutions for additional power generation capacity. The firm plans to invest capital in investigative studies which will concentrate on finding methods to obtain more energy and to improve the existing technology. By working together with PREPA, HBZI will be able to offer improved services in repair, renovation and maintenance of the existing and forthcoming power plants on the Island, therefore ensuring its position as a leader in this market in Puerto Rico.

Other markets in which HBZI is showing interest to expand its services are road construction and tourism projects, mainly hotels. The government of Puerto Rico recognizes the necessity to improve and expand its infrastructure to be able to maintain growth of the economy. This entails, among other things, the improvement and maintenance of roads and highways. With $593 million in 1993 and $352 million in 1994 in proposed local funds, plus a not yet disclosed amount of eligible federal funds, this section of the construction market presents a possible alternative for diversification.[115]

Tourism is also a market which will be developed with more attention. Million of visitors come to the Island each year to enjoy the Island's beaches and historic sites. In addition, because of the many U.S. firms located in Puerto Rico, managers of the U.S. and many other countries of the world come to the Island for business. This inflow of people has become an important source of revenue for many, including construction firms. Hotel's expansions and the

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[115] Yadira Valdivia, Newspaper: El Nuevo Día, "Revés en la construcción", March 20,1993, p.35

establishment of new ones are projects which HZBI is considering to expand into.

3.2.3 Case Studies Wrap up

The case studies demonstrated the significant impact Section 936, mainly 936 firms' investments, has on the construction industry of Puerto Rico. Both companies, like many others, with renowned worldwide services, have set up important operations in this small tropical island; and there is no doubt that Section 936 has been responsible for this trend.

The periods when Section 936 have been under fire, clearly shows that the reaction of 936 firms to withhold investments affects the development and growth of the construction industry. Although some construction firms feel more threaten than others, all of them support the actions by the local government and other entities (ex. PRUSA) to uphold the benefits provided by the Section. Through organizations such as the A.G.C., construction and engineering firms concentrate and focus their support to defend Section 936. They realize that by working together with the other supporters, they are protecting their major source of revenues.

Chapter 4. Conclusions and Recommendations

During the time this thesis was written, Section 936 was involved in a process of evaluation by the Government of the United States, namely Congress. It is expected that if everything goes well, a final decision on the future of Section 936 will be made in the next couple of months.

Since the beginning of the Clinton Administration, Section 936 has been receiving a lot of attention from the mass media. This has created awareness and concerns among the different labor groups from Puerto Rico. They primarily fear that the elimination or modifications of Section 936 will negatively affect the future of their jobs. As explained in Chapter 1, it is estimated that close to one-third of Puerto Rico's labor force is employed directly or indirectly by the production activities of the 936 firms. However, the effects are without a doubt extended to all sectors of the Puerto Rican economy; hence, practically every Puerto Rican to some degree or another is affected by the impact of Section 936 on the economy of the Island.

Nevertheless, Puerto Rico is not the only one that benefits from Section 936. The United States, although less noticeable, also benefits. The tax benefits of Section 936, by increasing the companies' cash flow, have permitted the investment of additional resources in research and development; therefore, promoting the U.S. leadership against strong foreign competitors primarily in the science and technological industries.

Trading activities between Puerto Rico and the United States also have a positive impact on employment in the United states. It is estimated that the Island's total annual purchases of U.S. goods have created more than 100,000 jobs on the Mainland.

An important benefit to the U.S. is that Section 936, by helping stabilizing the economy of Puerto Rico and other Caribbean nations, provide the U.S. with a measure of tranquillity among its neighbors. Therefore, Section 936 can be viewed as a key bulwark for peace.

Like many other sectors of the economy of Puerto Rico, the construction industry is recipient of the benefits provided by Section 936. The benefits to the construction industry are primarily focused in two ways. First, the thesis discussed the availability of low cost 936 deposits for the issue of interim and permanent construction loans. Local regulations dictate financial institutions to make 936 funds available to activities in sectors which are considered critical to stimulate growth and development of the economy of Puerto Rico. The construction industry is considered one of these sectors. By offering 936 funds for projects' financing, the construction industry is provided a source of low cost funds which promotes the development of construction projects throughout the Island.

The optimal purpose of 936 interim construction loans is to transfer the savings in the project pricing to the projects' users. However, it is common practice for developers to keep the benefits for additional profit. Although it occurs in almost every sector of the construction industry, the housing sector was analyzed because the practice is most frequently noticed in this sector of the industry.

Bankers as well as developers are responsible for this action. A combination of more defined and controlled regulations by the local governmental agencies, and a support of the banking and development sector can help eliminate the inefficiencies in the handling and uses of 936 funds for interim project financing.

In contrast, permanent financing or mortgage loans issued with 936 deposits has been an activity developed to a high degree of efficiency where many on the Island, especially those who need it, have benefited. In the housing sector in particular, there are more than 250,000 mortgages, or more than 60 percent of total mortgages in Puerto Rico serviced by the Mortgage Bankers Association, whose holders have benefited by the low cost source of funds.[116]

The second impact on the construction industry brought by Section 936 is derived by the settlement of operations by U.S. firms on the Island. Investments in construction by 936 corporations have had a tremendous impact in terms of output, employment, and income. It is estimated than more than 80 percent of construction investments in the manufacturing sector is attributed to 936 firms; hence, Section 936's influence in the growth an development of the construction industry is undeniably important.

The demand for engineering and construction services spurred by the proliferation of industrial projects in Puerto Rico had caused the establishment of many construction firms, locally-based and U.S.-based, on the Island. Using the case study approach, the influence that 936 firms projects had over the performance of construction firms was investigated and demonstrated. The periods when Section 936 was under evaluation caused an almost complete halt in investments by 936 corporations; consequently created an atmosphere of uncertainty which practically affected the whole economy. The case studies clearly showed that during these periods, the construction firms' revenues decreased dramatically; therefore, enhancing the visibility of the linkage that exists between Section 936 and its impact on the construction

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[116] A.G.C,The Impact of Section 936 on Puerto Rico's Economy and Construction Sector, Prepared by Estudios Técnicos,p.33

industry. To counterattack this trend and compete in the market, firms are opting to diversify their services, not only in other sectors of the construction industry but also to other Caribbean nations.

The actual revisions to Section 936 are expected to end soon, and although changes are expected, it seems that they will not be strong enough to affect heavily the economy of the Island. Many believe that the modifications to come will be reasonable enough to not only keep the already settled firms, but also to continue attracting new ones. Nevertheless, whatever the changes made, the most important and critical step should be to ensure that the current discussions for modifications are the last to be made. This is heavily supported by the detrimental effects on the economy of the Island brought by the uncertainties created every time Section 936 becomes a center of dispute. Needless to say, after the current discussions, Section 936 should be remain untouched until the political status of the Island changes; however, this is a topic for another thesis.

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