Chapter 6

Investment

Job Creation Through Section 936

Section 936 of the Internal Revenue Code provides a mechanism for economic development in Puerto Rico. The law allows certain U.S. corporations that derive significant income from Puerto Rican business activities to obtain an exemption from U.S. taxes on such income. The law was designed to enhance Puerto Rico's attraction as a manufacturing site and to encourage employment-producing investments by U.S. corporations there. The Tax Reform Act of 1986 revised the qualifying criteria for U.S. corporations in order to encourage the conduct of a trade or business, rather than merely investments, to better achieve the objective of employment creation. The 1986 Act also expanded the tax benefits of Section 936 to include interest on loans for projects in Caribbean Basin Initiative countries. Section 936 funds on deposit in Puerto Rico can now also be used for loans at favorable interest rates to qualifying projects, including complementary (twin plant) and stand-alone operations. To qualify as a CBI beneficiary for this program, a country must enter into a Tax Information Exchange Agreement (TIEA) with the United States. This has proven to be a major obstacle for some countries.

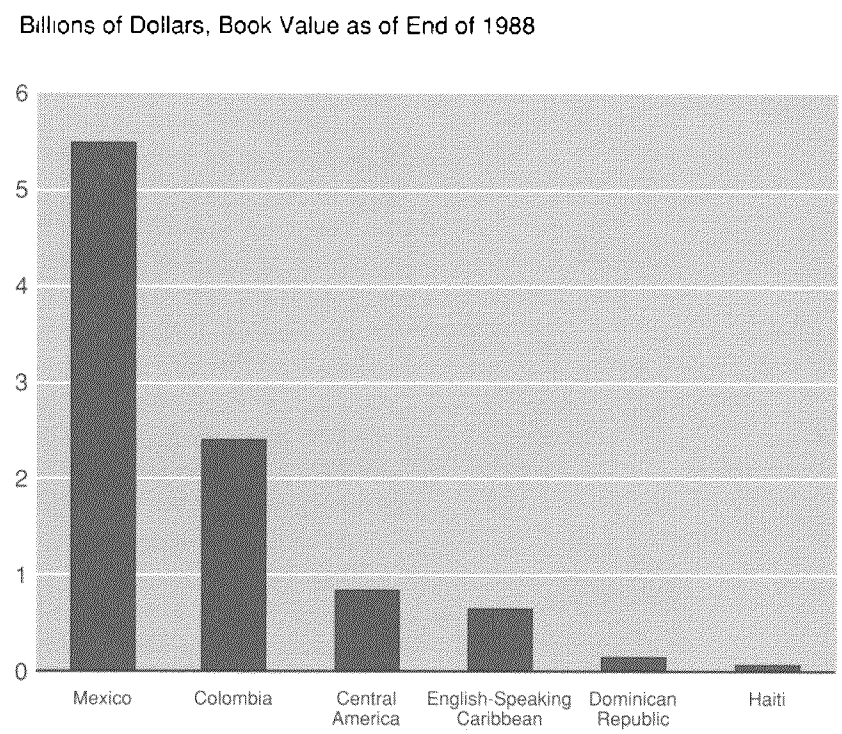
As a result of these tax incentives, the stock of Section 936 funds was approximately $15 billion in 1989 (including bank and other financial deposits and direct investment by U.S. corporations). These funds may be loaned at concessional interest rates (1% - 1 1/2% below normal international lending). The Section 936 Program has been an important development and job-creation tool for Puerto Rico.

Critics of the program cite its adverse fiscal impact on the U.S. tax base and its failure so far to provide significant employment creation in CBI countries. The U.S. Treasury Department adamantly opposes the program because it results in loss of substantial tax revenues. Limited use of 936 funds on deposit in Puerto Rico for other than a few capital-intensive projects in CBI countries has thwarted the program's employment-generating effect in sending countries.

Section 936 should be continued. Puerto Rico should remain its primary beneficiary, but efforts should be made to expand its employment-generating effect in CBI countries through greater utilization of 936 funds in labor-intensive operations in such countries.

Greater priority should be attached to using Section 936 funds for the development of national and region-wide markets. They should be used to a greater extent for the promotion of small businesses through the provision of credit, technical support and managerial assistance. To facilitate the flow of funds for these riskier investments, AID and the Overseas Private Investment Corporation

FIGURE 6 1
U.S. Direct Investment Position in Migrant-Sending Countries and Areas



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(OPIC) should be encouraged to provide guarantees for Section 936 loans to small businesses in migrant-sending CBI countries. (See Figure 6.1, p. 66.)

The Co-Production Partnership

Mexican maquiladoras and Caribbean Basin offshore assembly operations are both manifestations of the globalization of the international economy. Pressures to maintain international competitiveness stemming from global marketing and production strategies have led multinational corporations from technologically advanced countries to establish co-production ventures with their own subsidiaries or independent firms in labor-abundant developing countries. Co-production arrangements today are truly global, with multinational corporations active in every major region of the world. Japan is a major user of such arrangements.

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Co-production strategies enable firms from industrialized countries to benefit from inexpensive labor in developing countries. They also help developing countries generate jobs and earn foreign exchange. Co-production provides an opportunity for technologically less advanced economies to modernize plants and to embark upon self-sustaining industrial development. Co-production incentives offered by developing countries are often geared to improving specific regions of such countries.

In Mexico, maquiladora operations originated in 1965 after the Bracero Program was terminated. The Border Industrialization Program was intended to attract investments to generate jobs for returning workers. Proximity to the U.S. market, lower Mexican wages, and favorable tariff treatment made the border area attractive for foreign investment. U.S. companies could send American-made components to plants on the Mexican side of the border for further processing, and then import the assembled goods paying duty only on the value added in Mexico.

Maquiladora output was at first destined exclusively to foreign markets, but Mexico later modified this requirement. Currently, up to 50 percent of maquiladora output can be marketed in Mexico. In 1989, maquiladoras accounted for over 15 percent of manufacturing jobs, earning 13 percent of all non-oil related foreign exchange. Almost all of the materials used in border maquiladoras are imported (98.5%), with the balance purchased locally. In the interior, about five percent of the material input is purchased locally. (This is a crucial difference with significant ramifications for the future development of the Mexican industrial sector.) The bulk of maquiladora exports are concentrated in electronics, electrical machinery and transportation equipment.

Box 6.1 - Forward and Backward Economic Linkages

The terminology of linkages was first used by the economist Albert Hirschman. It refers to spinoffs from one industry, activity, or service to others. This is best clarified by examples An automotive industry has backward linkages or spinoffs to producers of automotive parts and forward linkages to producers of gasoline or providers of maintenance services A producer of wheat requires seed and fertilizers (backward linkages) and sells his output to a miller (forward linkage), who in turn, sells his product to a baker (forward linkage) The semi-conductor is an input into computer production and the computer, in turn, has spawned an extensive industry for servicing and the development of software. These linkages can exist within a single firm when it is vertically integrated (for example, when the same company produces parts, assembles products, establishes marketing outlets, provides consumer financing for sales and then services its products), or may be spread widely among many firms

This network of relationships in an economy can be captured in an input-output matrix, a technique first developed by Wassily Leontiev. These matrices show which activities use different inputs and in turn trace their outputs through all other sectors National input-output matrices, some with great detail and others quite primitive, exist for many countries, including many studied in this Report.

Policy makers in developing countries frequently seek to maximize national linkages - or spinoffs - when they favor certain types of investment over others, although these judgments do not always turn out as predicted.

In the Caribbean Basin, the United States has fostered the development of free trade zones through trade preferences and special regional programs such as the CBI. Free trade zones (FTZs), hosted by over twenty countries in the Caribbean Basin, are essentially in-bond assembly operations that produce finished or semi-finished goods from largely imported components. Almost 90 percent of these products are apparel and electrical machinery. The proportion of domestic value-added is 31 percent, low compared to Mexico's 50 percent. (Domestic value added among Asian producers often exceeds 80 percent.) Furthermore, the overall employment impact of these activities remains limited due to their relatively small scale compared to the region's labor base.

Mexico, as it reforms its economy, is ideally positioned to gain from the type of co-production process that helped the newly industrialized Asian countries develop their economies. If Mexico is successful, today's assembly operations will evolve into a full-fledged manufacturing industry, enabling it to develop its own capability to generate technology Under such circumstances, production linkages will grow among Mexican firms and between them and foreign firms. (See Box 6.1, p. 68.) For the Central American and Caribbean countries, with smaller and far less developed economies than Mexico's, prospects are not as bright, but offshore assembly offers the opportunity to accelerate growth and increase employment.

Co-production assembly and manufacturing has had spectacular growth throughout the migrant-sending region. During 1989, 1,674 Mexican maquiladora firms employed over 430,000 workers, generating about $3 billion in foreign exchange. In the Caribbean Basin countries, offshore assembly activities accounted for close to

200,000 jobs, 112,000 of them in the Dominican Republic alone. The latter figure is proportionally greater than that created in Mexico by the maquiladoras.

Many foreign assembly plants are alleged to be sweatshops where poorly paid workers toil under exploitative conditions. By local standards, working conditions in foreign assembly operations are above the national average. In Mexico, maquiladora wages are about 25 percent over the average. Women workers predominate in these plants although, at least in Mexico, the share of male workers has been increasing.

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There has been considerable debate about the extent to which Mexican maquiladoras and offshore assembly operations in the Caribbean Basin affect employment levels in the United States. Organized labor argues that the foreign gains come at the expense of American workers. Representatives of industry and most economic analysts, on the other hand, conclude that were it not for this accessibility to lower-priced labor, U.S. job losses would be much greater. Indeed, they argue, foreign assembly of domestically-produced components helps U.S. companies remain competitive. In the absence of this low-wage option, U.S. production costs would be so high that entire U.S. manufacturing operations would have to relocate abroad. Assembly operations in these countries, they say, are likely to continue even if preferential tariffs were eliminated.

Regardless of one's views on these issues, increased economic interdependence suggests that growth in foreign assembly carries its own momentum. The assembly sector is essential to the economic well-being and even the political stability of Mexico and Caribbean Basin nations. In order to maximize the benefits accruing from maquiladora activities, Mexico must persevere in its efforts to integrate the maquiladora industry more fully into the national economy by increasing the value added to maquiladora products and marketing more of them in Mexico.

Facilitating the location of maquiladoras in the interior of Mexico will accelerate this process. **The United States should support Mexican requests to international financial institutions for funds to improve infrastructure in interior Mexican locations capable of hosting maquiladora activities.**

Mexico and the United States should continue jointly to address some of the more volatile issues arising from maquiladoras, such as those concerning the environment. Worker rights in the maquiladoras constitute a genuine concern of organized labor in both countries. The Commission strongly urges the two governments, and the governments of other migrant-sending countries, to be vigilant about protection of worker rights and labor standards in maquiladora and other assembly operations. Techniques should be explored to ensure that the fruits of development are equitably distributed, for example, through profit-sharing plans and Employee Stock Option Plans.*

There are a number of impediments to the further growth of free trade zones in the Caribbean Basin. Poor infrastructure (e.g., insufficient electric power) in many countries hampers FTZ development, as do excessive bureaucratic requirements, low worker skill levels, and continued reluctance by some countries to sign Tax Information Exchange Agreements. In the United States, numerous import restrictions weaken legislative initiatives aimed at promoting economic growth and political stability in the Caribbean region. Some, such as rules of origin, are designed to prevent non-CBI countries from using the CBI as an export platform. Others respond to the legitimate concerns of organized labor about job losses at home

Legislation which bars the U.S. Agency for International Development (AID) from providing assistance for investment in the manufacture of goods which compete with U.S. products often preclude viable development projects in migrant-sending countries. Another important constraint to the export potential of migrant-sending countries is the allocation of U S. import quotas on products such as textiles and apparel on the basis of historical precedent instead of current U.S priorities. This favors already established suppliers, particularly the newly industrialized East Asian countries. **Quota allocations for these products should be progressively shifted in favor of Mexico and CBI countries.** This would significantly expand employment in sending countries while having minimal effects on East Asian and other advanced developing countries

A question of considerable interest to the Commission is whether border maquiladoras contribute to unauthorized immigration by bringing potential migrants closer to the United States. The evidence is not conclusive. Some research suggests that they do not, finding that maquiladoras generally—but especially those in the interior—tend to reduce undocumented migratory flows by providing domestic employment options. Results of more tentative studies reach the opposite conclusion that, even in the interior, emigration is facilitated by exposure to a maquiladora environment.

Another issue of concern to the Commission is the extent to which the border maquiladora industry can be used to promote the prosperity of U.S. border communities, which include some of the poorest in the country. Evidence suggests that U.S. border com-

* Employee Stock Option Plans (ESOPs) permit workers to purchase shares in the companies in which they are employed

munities are helped, for example, by retail sales to Mexicans and provision of other services to maquiladoras. However, total costs and benefits are difficult to quantify precisely.

Technology

The acquisition of modernizing technology which accompanies foreign direct investment is essential to development. Technology transfer and adaptation require not only a hospitable climate for foreign direct investment in migrant-sending countries, but adequate protection of intellectual property through patents, trademarks and other safeguards. University training is another major avenue for the transfer of technology and the creation of an environment in which domestic innovation can occur

Increased foreign direct investment can do more for technological development in migrant-sending countries than any other measure. **Migrant-sending countries should encourage technological modernization by strengthening and assuring intellectual property protection and by removing existing impediments to investment.**

Beyond this, U.S. agencies should support increased in-country university and secondary education in science and technology in conjunction with initiatives to establish centers for the adaptation of technology to local needs. These activities should include cooperative programs between U.S. and migrant-sending country universities and the provision of up-to-date scientific textbooks and teaching materials.

Modern technology can be used to enhance international trade by providing information about marketing opportunities abroad, particularly in migrant-sending countries with poor communications networks. For example, the Organization of American States—with support from AID and other donors—has instituted a computer network service to provide buyers and sellers with information about market opportunities. Innovative efforts of this kind should be encouraged.