

September 2, 2016
Senator Orrin Hatch
Chairperson
Congressional Task Force on
Economic Growth in Puerto Rico
U.S. Congress
Washington, DC

Dear Chairman Hatch & Task Force Members:

Thank you for the opportunity for the Private Sector Coalition of Puerto Rico to respond to the request of the Task Force for ideas and recommendations regarding the need to restore economic growth, create meaningful and well-paying jobs, stop out migration, and ensure efficient and low cost energy. The Coalition represents thirty major employers; composed by trade and business organizations that generate practically all private sector jobs. The private sector is also the primary source of local tax revenue.

We note from a historical perspective that Federal Policy has driven the economy of Puerto Rico since the 1920's. When this policy has been withdrawn, as when Section 936 was repealed, our economy has suffered, and when it has been in place, it has grown and provided job opportunities and better wages for workers. We note that these historical policies have created a very unique manufacturing intensive economy where today direct and indirect manufacturing employment represents one-half of our GDP and serves as our primary taxpayer.

Our proposals will additionally provide the Commonwealth Government with increased tax revenue needed to deal with its debt obligations, and act as a powerful tool to stop the migratory process from the Island. Our recommendations to the Task Force are the following:

1. Adoption of the Growth Proposal designed to jumpstart our important manufacturing sector and the economic ecosystem that surrounds it.
2. Creating the correct institutional framework that will foster the growth of the aerospace industry in Puerto Rico.
3. Stimulating local industry by creating the conditions for equal access to federal procurement through set asides that permit firms in Puerto Rico to effectively compete at the national level.
4. Creating the adequate institutional framework for Puerto Rico to lower its high electricity costs.
5. Providing for parity in Federal Medicaid and Medicare treatment for Puerto Rico and direct the Centers for Medicaid and Medicare Services (CMS) to reform the Wage Index and use of the SSI in formulas which impact Medicare reimbursements for our hospitals, doctors and clinics.

6. Expanding a payroll tax holiday proposal by Chairman Hatch this past December to include private sector employers as well as employees as a tool to inject capital into the private economy.

Growth Proposal

The private Sector Coalition's proposal seeks to provide Puerto Rico with an instrument that will improve its competitive advantage compared to its foreign competition and enable it to retain and attract manufacturing investment in a manner consistent with tax reform objectives. It is the Congress' stated objective to address indefinite deferral of taxes and foster repatriation of funds held by U.S. corporations abroad. Moving from a worldwide taxation regime to a territorial taxation regime has been identified by the key policymakers as an appropriate way of achieving this. What is being proposed is, essentially, that by adopting the Growth Proposal the Congress treat Puerto Rico as the first step of this concept.

The proposal entails exempting 85% of dividend income from federal income tax and the remaining 15% to be taxed at 50% of the federal corporate income tax rate. The income exempted must be Puerto Rico source income (Section 864). By approving the measure, the Federal Government would achieve the double objective of stimulating the return of funds held abroad because of the attractive tax environment and, at the same time, stimulating investment in Puerto Rico in order to generate Puerto Rico source income. In order to implement the measure a number of Sections of the Internal Revenue Code need to be amended, including Section 864, but also Sections 245, 901, 904 and 933A and 959 in order to implement the measure.

The Growth Proposal described above would be beneficial for both Puerto Rico and the United States Treasury since it would provide an incentive to repatriate funds and promote investment in Puerto Rico that would otherwise be directed to foreign countries. It complies with the statements made by Members of Congress that remedies for Puerto Rico's fiscal situation cannot generate additional cost to the U.S. tax payers because we used mandatory repatriation as our pay-for. It is also in line with statements made by many in Congress that eliminating Section 936 of the U.S. Internal Revenue Code had a very negative impact on the Puerto Rican economy, evidenced by the fact that the manufacturing sector has lost 90,000 jobs since 1996 when it had 165,000 employees.

The Coalition also notes that the Sec. 199 Domestic Production Activities Deduction for activities in Puerto Rico expires at the end of this Calendar and needs extension. This provision is important to a number of our employers who are organized as Domestic Corporations. We also urge its extension as it is a permanent provision for Domestic Corporations operating elsewhere in the United States and these companies should not be treated differently.

Aerospace

Puerto Rico's manufacturing and advanced services sector has been augmented by the addition of the aerospace industry. Its growth in Puerto Rico, where a number of well-known names in the industry have already begun operations, is due to the concurrence of two factors. One is the fact that Homeland Security legislation and the International Traffic in Arms Regulation (ITAR) require that certain engineering jobs and manufacturing operations be performed within the U.S. mainland, and second, the fact that Puerto Rico has an ample supply of highly competent engineers.

Among the firms already established in Puerto Rico are Honeywell, Pratt & Whitney, Lockheed Martin, Hamilton Sundstrand, Axon Group, Lufthansa Technik and Florida Turbine. We also note the many graduates of Puerto Rico's engineering schools are now NASA engineers.

This is an instance in which federal legislation has been essential in the development of a major economic sector in Puerto Rico, with benefits to both the U.S. and the Island. Our proposal to the Task Force does not necessitate changes in the legislation, but rather that it assumes a proactive role in stimulating U.S. firms and federal initiatives to take advantage of the many favorable conditions that Puerto Rico offers the aerospace and defense industries, including those aspects related to transportation and space exploration. Ideally, what we would want the Task Force to promote is the adoption of a public policy at the federal level aimed at stimulating the development of the aerospace industry in Puerto Rico. The rationale for this is that locating new operations in the Island will not only advance our local development objectives but will benefit the defense establishment in the U.S. since Puerto Rico operations are highly cost effective. The spillovers from the industry are major inducements for other high value added activities - not covered by federal legislation and could thus locate anywhere - to locate in the Island and employ American citizens.

Procurement access and set aside

Federal legislation applied by the General Services Administration already incorporates a number of set asides for various groups, including minorities and minority owned businesses. What is suggested is amending the Federal Acquisition Regulations in order to provide the framework for improved access to federal procurement by Puerto Rico firms that qualify under the SBA Final Rule and other sections of legislation related to the operation of the SBA. This includes those sections that are directly related to the operations of the GSA. Although PROMESA includes a Section that permits the Puerto Rico Government's procurement to be carried out through the GSA, a set aside for Puerto Rico based manufacturing and service activities, and addresses the need to strengthen locally owned firms through improved access to federal procurements. Parallel to this effort, the Government of Puerto

Rico will adopt legislation that will stimulate local purchases by both the local Government and multinationals established on the Island.

What is needed from the Task Force is a commitment to evaluate all procurement related legislation and regulations in the Federal Government so that access of Puerto Rican firms to federal procurements is improved. At present, because of certain restrictions limiting such purchases to firms located in the continental U.S. (CONUS), access is denied. The objective is for the federal Government to relax this restriction and consider Puerto Rico, currently excluded due to CONUS restrictions, as an eligible location, and thus increase its purchases from locally owned firms in Puerto Rico that meet SBA criteria. This measure could apply to all other territories.

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In addition, we request the Task Force to recommend establishing a provision for the following 15 years that would set aside 3% of federal contracts and use of federal funds on the Island for legitimate businesses registered in the Puerto Rico State Department as of June 30, 2016 that are also registered in SAM. We note that the legislative response to the Katrina disaster provided for a set aside to provide opportunities for businesses struggling to recover. Our recommendation is to follow this model.

Energy Initiatives

PROMESA's Title V, *Puerto Rico Infrastructure Revitalization*, includes mechanisms to accelerate the permitting and define potential energy infrastructure projects "whose approval, consideration, permitting, and implementation shall be expedited and streamlined..." such as: "(i) reduce reliance on oil for electric generation in Puerto Rico; (ii) improve performance of energy infrastructure and overall energy efficiency; (iii) expedite the diversification and conversion of fuel sources for electric generation from oil to natural gas and renewables...; (iv) promote the development and utilization of energy sources found on Puerto Rico; (v) contribute to transitioning to privatized generation capacities...; (vi) support the Energy Commission of Puerto Rico in the achievement of its goal of reducing energy costs and ensuring affordable energy rates for consumers and business; or (vii) achieve in whole or in part the recommendations, if feasible, of the study in section 505 (d) of this title (St

udy of Electrical Rates) to the extent such study is completed and not inconsistent with studies or plans otherwise required under Puerto Rico laws.”

The Private Sector Coalition notes that Puerto Rico suffers electricity rates of 2-3 times the national average. We believe it is essential for Puerto Rico’s future competitiveness we make the necessary changes so our electric energy system operate at very high levels of efficiency that would make it possible to produce and distribute electricity at low costs. Although other key infrastructures also need improvement, electricity is our priority concern at the moment. US electric energy costs for all sectors when we take the averages for October 2015, were 10.34¢/kwh while in Puerto Rico they were at 19.66¢/kwh, almost twice that of the US. Once global oil prices return to historical levels, we may see electricity costs at 3 to 4 times the U.S. average.

The Coalition believes that the best option for addressing Puerto Rico’s sky high electricity costs is to extend the authority of the Federal Energy Regulatory Commission’s (FERC) to review and regulate electricity generated by the government run monopoly, the Puerto Rico Electric Power Authority (PREPA). Congress must enact legislation to permit FERC’s intervention in Puerto Rico.

Lifting Statutory caps on Medicaid and Reform the Medicare Reimbursement Formulas

The Coalition recommends providing full parity under Federal health care program treatment for Puerto Rico and for the lifting of the statutory cap on Federal Medicaid funding for Puerto Rico. We also note that if this issue is not addressed in the coming fiscal year, Puerto Rico is likely to face another serious crisis that will result from the exhaustion of an allocation of extra funding provided by Congress as an alternative to lifting the cap in 2010. When the “Medicaid Cliff” occurs in 2017, Puerto Rico will lose 75% of its Federal Medicaid funds with crippling results on its low income population and health care providers. It is pertinent to mention that, according to the U.S. Census Bureau, 46% of the population in Puerto Rico is at or below the poverty line.

In tandem, we urge Congress to work with the Centers for Medicaid and Medicare Services (CMS) to use its flexibility under its administrative authority to reform the Medicare Wage Index used for Puerto Rico and the use of the SSI that directly provide disparate treatment of Medicare reimbursements for our hospital, doctors and the Medicare Advantage Program. We question why SSI days have been used in the formula by CMS when residents of Puerto Rico are not eligible for SSI. We note these changes will directly benefit local residents as the viability of the health system strengthens.

Through 2009, Puerto Rico's Medicaid cap was only \$260.4 million a year and the FMAP was just 50 percent. In 2010, Congress enacted the Patient Protection and Affordable Care Act (ACA). Rather than simply removing the cap, the legislation instead provided \$6.4 billion in additional "temporary" Medicaid funding for Puerto Rico. This funding was to be drawn down by the territory beginning with the fourth quarter of Fiscal Year 2011 and with the hope that these funds would last until the end of Fiscal Year 2019. However, these projections turned out to be incorrect and CMS now projects they will be exhausted as early as July of 2017 but certainly during the local government's FY 18 budget year, beginning on July 1, 2017.

Puerto Rico now receives \$1.1 to \$1.3 billion a year in combined federal Medicaid funding. This is a major improvement but only temporary and is far less than Puerto Rico would receive if parity were achieved. Oregon, with roughly the same population as Puerto Rico, and a much lower poverty level, receives \$5 billion a year in Federal Medicaid funding. The District of Columbia received \$1.8 Billion in Federal Medicaid funds in FY 14 with a population one-fifth the size of Puerto Rico's.

During this Congress, H.R. 2635 and S. 1961, submitted by Cong. Pierluisi and Senator Schumer offered a solution by providing the territories with state-like treatment under Medicaid within well-defined parameters. Our recommendation is for Congress to lift the cap on Federal reimbursement under Medicaid for Puerto Rico, as called for in H.R. 2635 and S. 1961, under consideration by Congress. At a minimum, Congress should prevent the impending "Medicaid Cliff" and ensure stable and adequate Medicaid funding for Puerto Rico into the foreseeable future.

Payroll Tax Holiday

A six-year, 50% reduction in the social security tax for workers, employers and the self-employed in Puerto Rico is hereby proposed to raise the take-home pay of workers and reduce operating costs for businesses, thus helping to stabilize the island's economy during the implementation of PROMESA's fiscal adjustment program. The payroll tax holiday would provide a much needed stimulus to the local economy on both the demand side and the supply side. In addition, it would soften the short- and medium-term effects of the fiscal adjustment program on nearly one million American workers and thousands of private American businesses in the territory.

According to official data from the Puerto Rico Planning Board's Economic Report to the Governor, social security taxes paid by Puerto Rico's workers amounted to \$1,326 million in fiscal year 2015. In the same year, employers paid \$1,292 million as their share of the social security tax, for a combined contribution of \$2,618 million. The annual average for the five fiscal years in the 2011-2015 period was \$1,281 million paid by workers and \$1,273

million contributed by employers, for a total average annual contribution to the Social Security System of \$2,554 million by Puerto Rico's residents.

A 50% payroll tax holiday would mean about \$640 million annually in additional take-home pay for Puerto Rican workers, equivalent to a 2.3% pay raise, and an immediate period, these savings would add up to a substantial injection to aggregate demand and a significant supply-side stimulus via lower production costs. The payroll tax holiday will have a much needed immediate impact on Puerto Rican workers and businesses.

Why our Proposals Matter

Puerto Rico, as the members of the Task Force are well aware, has gone through a prolonged and deep economic contraction since 2006. The consequences of this contraction are all so well known, a serious fiscal crisis that made PROMESA inevitable and the out migration of close to 500,000 persons since 2000, mainly to Florida, but also to Texas, Illinois, New York and other states. Unless we put in place measures to stimulate growth this migration will almost certainly continue and perhaps accelerate. It will also make resolving the fiscal crisis very difficult if not impossible. In this context it is relevant to mention that the cost to the federal Government of new migration from Puerto Rico is substantially higher than it is should they remain in Puerto Rico. These costs include increased Medicare funding as well as increased Medicaid costs and increases in other federal social programs.

When drafting the recommendations, the Coalition applied seven tests to the proposals. These are job creation, cost to the federal government, impact on access to financial markets, short and medium term economic impacts, impacts on Puerto Rico's fiscal income, spillovers to other sectors and impact on economic growth.

Although all individually have significant positives, including that of curtailing the migratory process, together the impact will be much greater. Approval of all six will provide even larger benefits from the synergies present, making possible an even greater impact and could, in effect, create conditions that put a stop to out-migration by generating economic growth and job creation.

The Coalition is cognizant of the fact that the Growth Proposal, our highest priority, will not have immediate impacts on employment. This is why the energy, set aside, payroll tax holiday and aerospace proposals were developed, since they will have a short term, much needed impact on economic activity and job creation. Initial and preliminary estimates suggest that putting in place all six proposals will generate on the order of 150,000 jobs over a five year period. In the case of the Medicaid and Medicare parity, our proposal will provide stability to the 85,000 individuals working in jobs directly related to the health system and address an important quality of life factor when it comes to employee retention. As mentioned, there are synergies among the six proposals that make this possible. Dealing with

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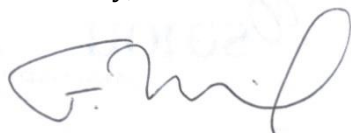
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h the high cost of energy will improve local firms' competitiveness and the Island's attractiveness for external investment. This will, of course, augment the potential for expansion of aerospace and other advanced, high value added sectors that generate significant spillovers that benefit other manufacturing and non-manufacturing activities.

The proposals were selected precisely because of the synergies involved and is the reason why all six need to be implemented. Each one, as previously mentioned, will be beneficial if adopted by itself, but the impact on job creation and sustained growth will be substantially increased when all six are adopted. The health system is a key component of Puerto Rico's social infrastructure, increasingly recognized as a key determinant of a jurisdiction's competitiveness. Although not specifically included as one of the Coalition's proposals, achieving an efficient and less costly maritime and air transportation cargo system are a core concern for the Coalition, with or without the Jones Act restrictions.

The Private Sector Coalition's proposals can be implemented with the changes in federal legislation and regulations suggested and can provide the needed stimulus for renewed economic growth and improved quality of life for the 3.4 million American citizens residing in the Island. The Coalition's proposals can be additionally supported by data that can be made available to the Task Force. We are available to meet with the Task Force to further discuss our recommendations and provide additional details concerning each one. The Coalition will be available to support the Task Force in advancing Puerto Rico's economic development in the coming months, as it prepares its final report.

Sincerely,



Dr. Francisco N. Montalvo Fiol,
Coordinator
Puerto Rico Private Sector Coalition

Puerto Rico Private Sector Coalition Members:



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Manufacturers
Association



Puerto Rico
Chamber of Commerce



Puerto Rico
Society of CPA



Puerto Rico
Farm Bureau



Professional College of
Engineers and
Land Surveyors of Puerto
Rico



Puerto Rico Chamber of
Marketing, Industry,
and Distribution of Food
(MIDA)



Puerto Rico Products
Association



Southern Puerto Rico
Chamber of Commerce



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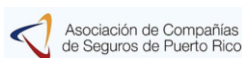
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