

Lessons learned: explaining the political behavior of business.

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Experiential learning is one process by which companies adapt to political changes. This process is based on past corporate experiences in dealing with changes, company preferences and strategies and previous successes or failures. Since experiential learning is incremental, firms are not always able to respond quickly to shifts in the political environment.

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The political strategies of firms vary in response to changes in the political environment. Yet firms are not always quick to identify these changes even when they have clearly defined political preferences and these preferences remain constant over time. Firms' understanding of new political realities is shaped by past political experiences, and their choice of political strategy is guided by what they have learned from prior success or failure. The process by which firms learn is reconstructed here with a longitudinal account of the political battles surrounding the "possessions tax credit," one of the longest-lasting and most intricate U.S. tax breaks, between 1976 and 1993.

The prominence of business in contemporary politics has inspired continuing interest in explaining how particular firms develop strategies for maximizing their political influence. The leading studies of business behavior in the last forty years suggest that the strategies of firms vary in response to the political environment at the time. Bauer, Pool and Dexter suggested that business was not interested in the political process during late 1950s and early 1960s. Lindblom explained that business benefited from a privileged position in society that made extensive political activity unnecessary. In sharp contrast, most accounts of business in the 1970s and 1980s noted a marked increase in the level of political activity by firms in response to new political threats to their interests.(1)

Yet it is also clear from the patterns of firm behavior that even when firms have clear political preferences that remain constant over time, their political behavior may be inconsistent with the political environment of the moment. The inconsistency can be explained only by understanding how a firm's past experience shapes its decision to (1) rely on its structural power, (2) lobby in competition with other firms, or (3) engage in collective action with other firms. When their political interests are at risk, firms respond in the same way individuals do when faced with an uncertain environment: they rely on instinct. Firms' political instinct is based in turn on the lessons they have learned from their prior political successes and failures.

Illustrating the significance of this prior learning by business requires examining an issue that has been important to the same group of firms over a considerable period of time. Therefore, this article reconstructs the political battles surrounding one of the longest-lasting and most complex corporate tax breaks in the U.S. Internal Revenue Code--the tax credit granted to U.S. firms doing business in Puerto Rico. Until its repeal by Congress in 1996, this "possessions tax break" had been more important than foreign tax credits, tax deferrals, capital gains tax breaks, or investment tax credits in reducing the federal tax liability of most U.S. pharmaceutical and many U.S. electronics companies. Most of the firms studied here had been investing under the rules of the possessions tax credit for over 25 years, and efforts to reduce or eliminate it were recurrent elements of the tax policy debates in Washington.

The narrative reconstructs the political responses of pharmaceutical and electronics firms to U.S. government efforts to repeal the possessions tax credit during four critical tax policy controversies, those leading to the enactment of the Tax Reform Act of 1976, the Tax Equity and Fiscal Responsibility Act of 1982, the Tax Reform Act of 1986, and the Omnibus Budget Reconciliation Act of 1993. While the experiences of the firms involved in these battles are not meant to be taken as representative of the experiences of American businesses regarding all issues at each time, they do illustrate how learning from past experiences shapes the strategic choices of firms.

The empirical discussion reveals that the firms employed a variety of strategies in their efforts to protect the tax break. In 1976 they won by relying on implicit threats to cause unemployment. In 1982 they first relied on the same implicit threat, then engaged in fragmented lobbying, but still lost a significant portion of the break. In 1986 they organized for collective lobbying and won. In 1993 they initially engaged in collective lobbying, then engaged in fragmented lobbying and lost. While at first glance the behavior of the companies might appear random, a closer look reveals that their political strategies were a response to their success or failure during the preceding period as much as they were a response to the current political environment.

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The learning model presented here does not explain the behavior of all individual firms. Rather, it is based on the behavior of a critical mass of firms and highlights the tendency of individual firms to behave in a certain way when confronted with different political environments. In addition, while the focus of this study is on firm learning and on the shape of the political environment as the two most important factors affecting the political behavior of individual firms, it does not deny the relevance of other factors like the personal characteristics of firm executives and lobbyists.

The research draws on two sources, publicly available information--political action committee (PAC) contributions, congressional hearings, company annual and 10-k reports, and other documents--and over seventy semi-structured interviews. Interviewees included lobbyists for nine pharmaceutical, one biotechnology, one beverage and four electronics companies; eleven private consultants and tax lawyers all of whom had lobbied on behalf of various companies;(2) fifteen legislative aides and other congressional staff members; five lobbyists for the Puerto Rico-USA Foundation (PRUSA) and for the Pharmaceutical Manufacturers Association; seven White House and Treasury Department officials; nine Puerto Rican officials; anti six Washington-based journalists who covered the possessions tax credit debates. The first round of interviews was conducted in 1991-92; whenever possible, follow-up interviews were conducted during and just after the debates leading to adoption of the Budget Act of 1993. The interviews with lobbyists were designed to capture as closely as possible a picture of the firms' own rationales for the political strategies chosen and perceptions of how their behavior contributed to their successes and failures. Interviews were also supplemented with private reports and correspondence obtained from the interviewees. Unless otherwise noted, information was offered on the condition that it not be attributed.

I. Conventional Views

In the prevailing view of lobbying, corporations employ the same repertoire of tactical options to promote and protect their interests as other interest groups.(3) The dominant theoretical and empirical evidence suggests, however, that critical determinants of business influence are more precisely its structural power to cause unemployment, its decision to mobilize, and when it does, the extent to which its political effort is fragmented or united.(4) Firms are implicitly aware of these choices, especially since the explosion of organized interest activity over the last thirty years, because they share a common political past and culture. As Vogel points out, "the efforts of particular industries and firms to achieve their political objectives do not take place in isolation."(5) How firms decide which strategy to pursue among the existing alternatives is the central theme of this paper.

Lindblom argues that business enjoys a privileged position in society through its ability to affect unemployment levels. Policymakers will be sensitive to the interests of business rather than risk an investment strike and the subsequent wrath of the electorate. Thus, in Lindblom's view, the implicit threat of unemployment is usually enough to "repress" policy decisions. There is no need for "explicit exchange with businessmen" because there is a "tacit understanding ... with respect to the conditions under which enterprises can or cannot profitably operate."(6) On many occasions, however, this implicit threat does not suffice to protect the interests of business. Policymakers cannot be expected to always be aware of exactly how a piece of legislation affects their constituents or exactly how many jobs in their districts could be affected.(7) Hence, business may decide to mobilize for political action individually or collectively to persuade policymakers of the connection between a particular policy proposal and the incentives it must have to invest.

Yet researchers disagree about the likelihood of mobilization. David Truman argued that interests mobilize rapidly and easily for political action to protect themselves against threats to their benefits. In contrast, Mancur Olson argued that individual firms or organizations are rational actors with strong incentives to free ride on the political actions of others. Therefore, he expects that mobilization will be difficult to initiate or sustain. However, he noted that collective action is possible when a few of the larger units are willing to shoulder the cost of the organization because they have a bigger stake in the outcome of policy.(8) Olson's expectation that U.S. business firms are more likely to form or join groups when they share political interests than are other economic interest like farmers or labor unions, has been confined empirically.(9)

The political structure of the U.S. state poses another obstacle to collective action by firms. At the federal level, the system of a divided government with administrative bureaucracies and specialized Congressional committees encourages firms to pursue their own narrow interests individually and continues to inhibit the development of a single business peak organization.(10) U.S. firms have become political actors in their own right and have set up their own offices in Washington to promote their particular interests.(11) But they also continue to support their trade and industry groups, organize on the basis of size, and join with other firms to form single-issue groups.

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The key to reconciling all three explanations of business political behavior--reliance on its structural power, fragmented lobbying, and collective action--is to adopt a comparative-historical perspective. The strategies of business vary not only over time and across issues, but throughout the political process as well. At each juncture, firms' political strategies respond to the current political environment but their behavior is guided by the lessons they have learned from prior political successes and failures.

II. Political Uncertainty and Business Learning

Research has shown that compared to other groups such as labor, which are concerned with a broad range of social issues, firms "stay close to their particular business."⁽¹²⁾ This does not mean, however, that the political preferences of firms are clearly identified. To begin with, firms may not be aware of the impact of general or particular political decisions on corporate profits. And even when firms are aware of the impact of politics on profitability, it does not follow that they know how to translate their interests into specific policy preferences.⁽¹³⁾ This paper goes a step further to argue that even when profits are clearly at stake and firms have strong policy preferences, their political strategies are not easily formulated due to the uncertainty of politics.

The political system is pervaded by uncertainty. Firms are uncertain about outcomes and about the means to achieve their interests.⁽¹⁴⁾ Emerging political issues and shifting government structures can disturb established relationships between business and government, and thereby contribute to the uncertainty of the political environment. At a minimum, to be effective firms' behavior has to respond to newly emerging issues. When new issues become part of the political agenda, their political structure shifts and policy subsystems may be destroyed.⁽¹⁵⁾ In such situations firms can find themselves losing influence unless they change their established political practices. While private interests take advantage of the multiple points of access characteristic of the U.S. government, the system is dynamic. State structures fluctuate between greater and lesser decentralization.⁽¹⁶⁾ Changes in the fundamental structure and rules of government bring about a shift in the structure of policymaking and, like the transformation of an issue, require business to adapt its political strategies and reassess its political alliances.⁽¹⁷⁾ Salient issues and government structures comprise the political environment to which business attempts to respond. Yet the political adaptation by business to a new political environment does not always occur when its interests are initially threatened. Rather, lessons learned from prior experiences determine how business will interpret the implications of a new political environment.

Knowledge from experience, "whether in tacit form or in formal rules," is recorded in an organization's memory and reflected in "standard operating procedures" that simplify experience.⁽¹⁸⁾ Experiential learning is relevant to our understanding of the political behavior of firms because corporations, like other institutions such as state and local governments, "have a continuing existence" and "can afford to wait longer than most individuals for the political results they need."⁽¹⁹⁾ Hence, firms are likely to accumulate experiences that may bias their political behavior in the future. Several empirical studies have found evidence of experiential learning. Martin has emphasized its importance in the health care debates of the early 1990s. She argues that corporate political preferences regarding health care reform were shaped by firms' membership in regional and national associations. "Companies plugged into national networks learned from their groups and peers, and collectively moved toward a political position." But Martin argues that these firms had become "disillusioned" with prior strategies of health care cost containment. Past experiences in the form of policy legacies made these firms more open to new policy alternatives.⁽²⁰⁾

In his study of the politicization of business in the 1970s and 1980s, Vogel argues that firms mobilized in response to prior political defeats and learned their political strategies from the environmental and consumer groups that fueled those defeats.⁽²¹⁾ In another study Martin suggests that the origins of business mobilization can actually be traced to the efforts of Presidents Kennedy and Johnson to build support for their legislative agendas. She argues that the experiences of CEOs in the 1960s were instrumental to the organization of the Business Roundtable in the 1970s.⁽²²⁾ In his survey of Fortune 500 corporations, Wilson found that the most important predictor of business political activity was not the perceived costs of regulation, but the size of a firm's federal contracts; in his view companies that receive government contracts had been educated as to the "practical importance of government in every-day commercial life."⁽²³⁾

Experiential learning affects perception as well as action. Firms are likely to believe that their behavior has influenced the outcome of policy even when it has not. As Scott explains, "We act and, at least sometimes, elicit a response from the environment, but whether the response is to our actions or completely independent of them is often difficult to determine. Thus, our 'learning' is often superstitious."⁽²⁴⁾ Superstitious or not, this learning serves as a prism through which firms

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evaluate new political threats and the potential effectiveness of different political strategies. As a result, experiential learning can affect firms in one of three ways. First, they will repeat past behavior when it is associated with past successes. As long as the political environment remains stable, such political behavior is likely to be effective. Second, what has been learned from past successes may also blind firms and prevent them from adapting to a new environment.(25) When new issues become politically salient, firms may fail to grasp their significance and the possible consequences of increased public scrutiny. Also, shifting government structures alter the balance of power within the government, but it takes time for firms to realize that they need to change their strategies and also seek new allies. On such occasions firms are said to "be taken by surprise"; they fail to recognize new threats at first because their understanding of reality is clouded by past successes. Here it is also important to emphasize that firms do not necessarily learn the right lessons from experience. When firms win in the political arena, what they learn is a "process" or "standard operating procedure" that may not be the most appropriate to repeat in the future. In such cases, firms will change their strategy only as the progress of the political process reveals that the old strategy is not working. Third, learning also occurs after failures.(26) Failures decrease the chance that businesses will repeat the same behavior; they are more likely to change their strategy in an effort to avoid another defeat.

This view of the process by which firms formulate their political strategies is consistent with the current view of lobbying. Nowadays "much of what is called lobbying involves . . . simply gathering information on what an immensely complex, and cross-pressured government is doing or may do in the future."(27) But Feldman and March caution that there are two types of information gathering. They argue that while it might be appealing to assume that "information gathered for use in a decision will be used in making that decision," the fact is that "individuals and organizations ... gather information and do not use it,... ask for reports and do not read them [and] act first and receive requested information later." Hence, while there is a great deal of information gathering, most of it is done in a "surveillance mode" rather than a "decision mode."(28) Their findings suggest that the effectiveness of firms in keeping track of information pertinent to their interests must be distinguished from their propensity to take the time to reevaluate the suitability of past strategies, especially if they perceive their past behavior to have been a success.(29) Only when they lose in the political arena on an issue that continues to be of importance to them will firms take time away from other activities and critically evaluate their past behavior.(30)

Table 1 illustrates the relative impact of learning and the two main features of the political environment, salient issues and government structures, on the political behavior of firms. Analyzing their political behavior throughout the political process requires distinguishing between an initial phase a and an adaptive phase b. Firms' response to new political threats to their interests during the initial phase a of the political process at time t is a factor of their experiences at t-1. If the firms' prior experience was a political success they are likely to repeat their past behavior unreflectively and automatically. If the political environment at t is the same as the political environment at t-1, firms will have no reason to change their strategy. They will continue to behave in the same way during the adaptive phase b of the political process, and learning will be reinforced. If the political environment is different at time t, firms may find that their strategy is not working as effectively as before and that their behavior needs to change. At this point firms are likely to employ their default strategy, which generally means that they will fragment and pursue divided lobbying. If firms' prior experience is perceived as a failure, they will not repeat their earlier behavior at time t. Firms will experiment with a new political strategy at time t, assuming that the political environment they had perceived at time t-1 remains relevant. If the political environment at t is the same as the political environment at t-1 then firms will continue to pursue the experimental strategy. New learning occurs if firms discover that the new strategy is effective. If the political environment at time t is different from what it had been at t-1, firms will find that their experimental strategy is not working and they will once again adopt their default strategy.

Table 1. The Political Process and Business Behavior

POLITICAL OUTCOME AT t-1	PHASE A INITIAL RESPONSE	POLITICAL ENVIRONMENT
Success	Automatic Response	[PE.sub.t] = [PE.sub.t-1] [PE.sub.t] [not equal to] [PE.sub.t-1]
Failure	Experimental Response	[PE.sub.t] = [PE.sub.t-1] [PE.sub.t] [not equal to] [PE.sub.t-1]
POLITICAL	PHASE B	

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OUTCOME AT t-1	ADAPTIVE RESPONSE
Success	Old Learning Reinforced Default Strategy
Failure	Experimental New Learning Default Strategy

The model outlined in Table 1 predicts that the behavior of firms in the first phase of the political process at time t will be either a repetition or a rejection of their past political strategy, depending on whether it produced success or a failure, independently of the present political environment. Moreover, the model indicates that when the political environment at t is different from the political environment at t-1, firms will employ their default strategy, divided lobbying. When past experiences do not provide information useful to firms, divided lobbying will always be the strategy of choice because firms are essentially competitors.

III. Four Tax Break Battles

Dozens of Fortune 500 corporations, including most of the largest U.S. pharmaceutical and electronics companies, make up the industrial landscape of Puerto Rico. Many of these firms have been attracted to Puerto Rico by the possessions tax break. This tax provision was originally enacted in 1921 at the behest of U.S. businessmen in the Philippines, and it excluded from U.S. taxation all foreign income of individuals and corporations deriving a substantial portion of their income from business within the U.S. possessions.(31) In 1946 the Puerto Rican legislature matched the 100 percent federal tax exemption (Section 931) with a 100 percent local exemption. U.S. investors rapidly took notice and contributed to the substantial economic growth enjoyed by Puerto Ricans in the two decades after 1948.(32) The combination of Section 931 and the Puerto Rican exemption made the island the only offshore location where U.S. firms could enjoy the permanent forgiveness (as opposed to a deferral) of their federal tax liabilities.(33)

The relative importance of taxes for manufacturing operations varies considerably across industries and business activities. Since 1975 pharmaceutical and electronics firms were attracted to Puerto Rico despite rising labor costs because their low manufacturing costs relative to research and development costs make taxes one of the most important considerations.(34) The possessions tax break allowed these firms to reduce their U.S. tax liability by placing production of their patented products in Puerto Rico and aggressively using transfer pricing practices to enhance their tax-free profits on the island. The island affiliate sold the finished product to the parent at an inflated price and the parent would then sell it to its distributors for the same price. The parent corporation would retain most of the costs of researching and developing this new product, enabling it to further offset its tax liability in the U.S. Conditions in Puerto Rico were unique because U.S. firms were also able to repatriate their Puerto Rican profits tax-free upon liquidation. Nowhere else in the world could they invest free of home and host country taxation.

Table 2 shows the tax savings in the possessions for a sample of companies in 1975. The U.S. statutory tax rate was 48 percent, but as the table illustrates, the 931 provision enabled some firms to reduce their U.S. tax burden by 10, 20 and even 30 percentage points. Note that G.D. Searle was able to reduce its tax liability by 33.6 percentage points in 1975. This translated into a 70 percent reduction of the company's federal income tax liability. For almost all of these companies, the possessions tax break was the most important source of reduction in their federal tax liability. For example, in 1975 Eli Lilly reduced its federal tax liability by \$4 million using the investment tax credit and by \$17.3 million using the possessions tax credit. For some companies, Puerto Rican tax-free earnings represented more than a third of consolidated worldwide earnings. In the case of Eli Lilly and G. D. Searle, two of the companies taken to Tax Court by the IRS in the 1970s, their profits-to-sales ratios in Puerto Rico exceeded 100 percent compared to no more than 30 percent on the mainland.(35)

Table 2. Tax Savings Under the Possessions Tax Break in Percentage Points

	1975	1980	1985
Abbott Laboratories	12.6(*)	11.8(*)	-
American Hospital Supply	3.5	12.5(*)	-
Baxter Laboratories	22.3(*)	25.7(*)	-
Bristol Myers (Squibb)	-	-	-

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Carter-Wallace	-	22.5(*)	7.4(*)
Digital Equipment	7.6(*)		
Eli Lilly	6.0	4.2	8.0
Johnson & Johnson	2.5	5.0	11.0(*)
Medtronics	-	21.7(*)	30.0(*)
Merck	4.5	4.4	6.9(*)
Motorola	8.2(*)		
Schering Plough	14.0(*)	19.0(*)	15.2(*)
G. D. Searle	33.6(*)	22.8(*)	-
Smithkline	21.7(*)	17.5(*)	17.6(*)
Squibb	12.7	22.5(*)	-
Upjohn	-	20.0(*)	14.7(*)
U.S. Surgical	-	-	10.7
Westinghouse Electric	-	14.0(*)	11.1(*)
Federal Statutory Tax Rate	48%	46%	46%

1990 1992

Abbott Laboratories	-	-
American Hospital Supply	-	-
Baxter Laboratories	-	-
Bristol Myers (Squibb)	5.6(*)	8.7(*)
Carter-Wallace	5.8(*)	5.6(*)
Digital Equipment		
Eli Lilly	5.1(*)	7.0(*)
Johnson & Johnson	9.1(*)	-
Medtronics	9.1(*)	8.5(*)
Merck	4.3(*)	5.1(*)
Motorola		
Schering Plough	8.4(*)	6.8(*)
G. D. Searle	-	-
Smithkline	-	-
Squibb	-	-
Upjohn	9.1(*)	11.0(*)
U.S. Surgical	7.8(*)	12.9(*)
Westinghouse Electric	-	-
Federal Statutory Tax Rate	34%	34%

(-) information not available or no tax savings reported.

(*) Indicates that the possessions tax break was the most important factor reducing federal taxes.

Sources: Tax Notes and 10-k reports (1975, 1980, 1985, 1990, 1992).

Note: The 10-k reports, filed with the U.S. Securities Exchange Commission, require companies to indicate which tax provisions reduced their U.S. tax liability by more than 2.4 percent. However, not all companies break down their tax savings by country or statute. General Electric, for example, combines its tax breaks savings and places them under "miscellaneous."

The Tax Reform Act of 1976

In the early 1970s, U.S. labor began to argue that multinationals exported jobs, transferred U.S. technology to low-wage countries, and were nothing more than "a device for escaping the full burden of U.S. corporate taxes."⁽³⁶⁾ As a result of labor's denunciations, the taxation of foreign income of U.S. multinationals became a dominant political issue. And in early 1973, when the chairman of the House Ways and Means Committee, Wilbur Mills (Democrat, Arkansas) began hearings on tax reform, he decided to engage in an unprecedented review of foreign-source income.⁽³⁷⁾ The latter also included a review of the possessions tax break. In May 1973, during the markup of tax reform, the staff at Treasury, who since the 1960s had been trying to control what they perceived to be the transfer pricing "abuses" of the companies, lobbied to limit the tax benefits of investing under the rules of Section 931. As a result, the committee decided to tax the repatriated income of the companies' subsidiaries in Puerto Rico. For all practical purposes, the proposal eliminated one of the most important incentives of the federal tax break.

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Upon learning about the proposals, Puerto Rican officials asked the Committee for a hearing.(38) In their presentations they explained that Puerto Rico's industrial incentives program had been devised to work with U.S. tax laws and argued that U.S. firms would stop investing on the island if they could no longer repatriate their earnings free of federal taxes. Puerto Rican officials also made the economic well-being of Puerto Rico a "local" issue for Committee members by arguing that if the tax benefits were curtailed, 90,000 to 100,000 Puerto Ricans would migrate to the U.S. every year, most of them taking residence in New York City, Chicago, and Philadelphia. Finally, Puerto Rican officials pointed out that their island was the sixth largest customer of mainland products, generating 168,000 jobs in the United States. These jobs would be lost if Section 931 were "modified."(39) Reacting to the testimony of Puerto Rican officials, Mills said:

I have said on many occasions that sometimes there is a loophole in the law that you cannot fully close or eliminate without creating more problems in the process of doing so than you have as a result of the loop hole. This is, in my opinion, an example of what I have been talking about. As far as I am concerned, I am willing to forget it.(40)

No one questioned whether or not the implied threat of unemployment in Puerto Rico was real or not. In addition, tax breaks were the only alternative considered. As Lindblom would predict, policymakers were aware of the incentives business needs to invest. And since the domestic economic situation on the mainland had started to improve, labor's protectionist arguments also lost their credibility."(41) Mills could concentrate on promoting what he thought was good public policy.(42) This meant helping Puerto Rico's democracy by promoting its economic development with American capital. There is no evidence to suggest that Mills's decision was challenged by other committee members. Indeed, Mills's control over the committee and its revenue legislation is legendary; his "word [came] close to being law."(43) Though Mills was no longer the committee chair by the time the House finally voted to pass the Tax Reform Act in 1975, his influence continued to be strong. When Al Ullman (Democrat, Oregon) became the new chairman of the committee in January 1975, he was under pressure to get tax reform enacted, not to change the version of the act that Mills had left behind. Hence, when the committee began deliberations in mid-1975, Ullman adopted Mills's version of the possessions tax credit.(44)

In one respect the Mills version made it more attractive for U.S. companies to do business in Puerto Rico. Under the new version, now Section 936, U.S. firms continued to receive a 100 percent tax credit and were also able to repatriate their income from island subsidiaries tax-free at any time.(45) No longer did U.S. firms have to liquidate their Puerto Rican operations to repatriate their island profits free of federal tax.

In spite of having a clear interest in the preservation of the possessions tax break, U.S. firms never became openly involved in the political process. Rather, U.S. firms relied on the threat of unemployment in Puerto Rico, probably because they had never needed to mobilize for political action regarding this issue. The strategy proved effective because issues relating to the taxation of U.S. multinationals had ceased to dominate the political climate, and because the centralization of the political process allowed the polemic over the tax break to be resolved in relative obscurity.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)

The experiences of pharmaceutical and electronics firms during the TEFRA debates is one instance when learning from an earlier success prevented business from reacting effectively when faced with a new political environment.

At this time, the redefinition of tax issues combined with new government structures required the companies to bring their political strategies up to date to respond to a new political environment. But when the controversy over the possessions tax credit erupted, pharmaceuticals and electronics, based on what they had learned in 1976, unreflectively relied on their implicit power to cause unemployment. As the policy process progressed firms realized that the political environment had changed and that they could not rely on their structural power alone to protect their interests. The firms tried to form a coalition, but found it impossible to pursue a common political strategy. Their political fragmentation only weakened the potential effectiveness of their political mobilization.

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In 1981, concern over continuing Treasury Department attacks on the possessions tax credit led Puerto Rican administrators to begin a series of meetings with the tax directors of U.S. firms.⁽⁴⁶⁾ During the meetings, the pharmaceutical companies said that they were not interested in a compromise with Treasury, and maintained that they would not invest in Puerto Rico if Section 936 were modified in any way. In turn, electronics companies were resentful of the pharmaceutical firms. They argued that the uncertain investment climate resulted from the Treasury's view that pharmaceuticals were abusing the tax law. Electronics believed that they should not be penalized for the activities of the pharmaceuticals. In spite of their differences, however, both industry groups expected that the implicit threat of unemployment in Puerto Rico and migration to the mainland would persuade Treasury to leave Section 936 alone. By mid-1982, however, this scenario would change and yet the companies would continue to rely on their structural power until the elimination of the tax break seemed all but inevitable.

In early 1982, the Reagan administration was becoming painfully aware that "there was not enough money in the economy to pay the government's enormous bills and also finance a recovery by the private sector."⁽⁴⁷⁾ In May the Senate Finance Committee chairman, Robert Dole (Republican, Kansas), presented a list of proposals for deficit reduction to the Committee Republicans.

The Republican caucus agreed to amend Section 936 to impose taxes on all of the income generated by the transfer of intangibles (patents and the like) from a U.S. parent to an island affiliate. This amendment meant eliminating the main incentive 936 offered to most of the firms. The Republicans presented their bill to the committee Democrats in July and, according to a Treasury official present at this meeting, there was still no evidence that the companies had decided to mobilize even though they knew that the issue had become part of the legislative agenda. In turn, Senator Dole was so adamant that the proposal be enacted that it became known as the "Dole amendment."

It was only when the bill came out of committee that the companies decided to mobilize. They realized that the strategy of relying on their implicit power to cause unemployment had neither prevented Section 936 from becoming a legislative issue nor persuaded the Senate to drop the Dole amendment from the bill. But influencing the policy process on the Hill in 1982 was a very different undertaking from what it had been in the early 1970s. In 1973, the only legislator whose opinion had really mattered was that of Chairman Mills. After the Congressional reforms of the 1970s, however, the power of committee chairs was diluted. To secure a simple majority a lobbyist now needed 18 votes in the Ways and Means Committee alone, because its membership had grown from 25 to 35. Six subcommittees were also created, and the staff grew from 24 in 1970 to 90 in 1982. The Senate Finance Committee's staff also grew from 16 in 1970 to 55 in 1982.⁴⁸ Overall, the task of lobbying Congress became more complicated, but also indispensable for the companies, as the number of legislators and staff who had to be influenced multiplied.

The companies tried to adapt to the new political environment by joining forces in a loose coalition with other companies and the government of Puerto Rico. But it was clear from the start that the coalitional effort would be weak. Puerto Rican officials wanted to compromise with members of Congress. Electronics companies also believed that some sort of compromise might be needed to prevent a complete repeal of Section 936. Pharmaceutical firms felt, however, that they could prevent changes to Section 936 without giving up any of their benefits. A Puerto Rican official explained, "we believed that there were limits to what Congress could do for us" whereas "pharmaceuticals--individually--were used to getting their own way."

Ultimately, Puerto Rican officials and a few of the U.S. firms tentatively agreed (over the opposition of other companies) to try to get Treasury to accept two regulatory alternatives that the Puerto Rican government had drafted.⁽⁴⁹⁾ It was a very shaky agreement and a very weak alliance both among the firms themselves and between the firms and the government of Puerto Rico. According to an industry lobbyist, infighting was such that the Pharmaceutical Manufacturers Association could not take a position on the issue. Individual companies felt that, given the opportunity, any one of them would try to cut its own deal at the expense of the others.

Nevertheless, the companies needed to give members of Congress reasons to support their interests--especially when the connection between U.S. investment in Puerto Rico and the members' local interests was not evident. The firms devised their arguments to fit the particular interests of the members. To those legislators sensitive to the interests of Puerto Rico, U.S. firms argued that, contrary to what the Treasury thought, they were an indispensable tool for the economic development of the island. However, as a pharmaceutical lobbyist explained, the companies soon realized most members of Congress believed that "we should be helping the people in Alabama, not Puerto Rico." The vast majority of

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legislators, both Republican and Democrats, were most sensitive to the argument that what hurt the companies' Puerto Rican affiliates also affected the companies' ability to protect the jobs of constituents employed in their affiliates on the mainland. A number of "pro-business" Republicans believed firms should be provided with strong incentives to invest. Luckily for the companies, a few powerful legislators, including Senator Daniel Patrick Moynihan (Democrat, New York) and Congressman Charles Rangel (Democrat, New York), were interested in protecting the wellbeing of both their constituents on the mainland and Puerto Ricans living in Puerto Rico. The threat of Puerto Ricans migrating to the mainland was also emphasized by the companies.

In spite of their lobbying the companies could not prevent the Dole amendment from passing in the Senate. On 28 July, the Ways and Means Committee members voted to go straight to conference with the Senate. This gave Section 936 supporters only a few weeks to make their case and now to an even larger number of members and staff. But rather than join forces, the companies became more hostile to one another and more determined to advocate their own particular deals. A lobbyist from a pharmaceutical company explained:

My client is the [company's] tax division in New York. The committee can say I want 100 million dollars from 936. There are five different ways to do it, and I know which one is the least painful to my company. ... There are tons of ways to raise the money, and that is when you have your deals being cut. I always tell the staff [on the Hill], "if I am going to be killed can I choose the weapon?"

In the end, Rep. Rangel was credited with "saving" Section 936. In the words of one lobbyist, "Dole got rolled" and 936 "got traded for something totally unrelated." The Senate got something, and Rangel got the committee to replace the Dole Amendment with the Puerto Rico-Treasury compromise. The latter, however, would become law rather than remain the administrative compromise that the firms had wanted.

The companies were not happy with this outcome. Though Section 936 had been preserved, its benefits had been curtailed. TEFRA signified that for the first time there would be explicit statutory guidelines for the allocation of intangibles to an island affiliate, which meant that the companies could no longer use transfer pricing to avoid taxes as effectively. Both the increased saliency of tax breaks and the decentralization of Congress contributed greatly to the companies' defeat, but by all accounts the companies believed that their strategy was to blame. As one pharmaceutical lobbyist explained,

In '82, industry and the government of Puerto Rico were not very well organized: it was a mess and you are trying to convince members [of Congress] to keep a 100 percent tax exemption and that was made more difficult by the inability of industry and Puerto Rico to work together.

Divided lobbying, however, was the default strategy adopted by the companies when they realized that relying on the implicit threat to cause unemployment, the strategy that had worked so well in 1976, would no longer suffice to protect their interests.

The Tax Reform Act of 1986

Interviews with company representatives suggest that pharmaceutical and electronics firms learned three things from TEFRA: (1) they must pay more attention to the political aspects of Section 936, (2) the threat of unemployment would not be enough to protect the tax law from congressional tinkering, (3) their failure to pursue a united political strategy was the

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main reason their benefits had been curtailed. Based on this knowledge, the companies decided to experiment with a unified political response. The clearest evidence of this change in strategy was the establishment of a formal organization, the Puerto Rico-U.S.A. Foundation (PRUSA), with the sole purpose of providing collective protection to Section 936.

Not all of the companies involved in the process in 1982 learned the same lessons at the same time. however. Some of the electronics firms learned quickly, and established ,an ad hoc coordinating group before PRUSA was formally organized in early 1984. Also not all of the companies that ultimately joined PRUSA were involved in its creation. Rather, a small group of firms, among them Motorola. Westinghouse. American Home Products, Baxter International. and Squibb. got together initially and conceived the organization. They hired a law firm to handle their affairs and to solicit other companies. Peter Holmes from General Electric's Washington office was brought in to coordinate PRUSA's lobbying operation and expand its membership. PRUSA contacted over 200 potential members: by the time the next political attack on Section 936 materialized it had more than 50 dues-paying members and was ready to take on the challenge.

In November 1984. Treasury unveiled "Treasury I," a tax reform proposal for "Fairness. Simplicity. and Economic Growth," which contained a provision repealing Section 936. Ronald Pearlman (Assistant Secretary for Tax Policy) explained. "our initial judgment was not a 936 prejudice." He continued,

Our initial attitude was that the tax code is not the place for economic incentives. The goal should be to tax income at the lowest possible rate and still have government revenues. We asked ourselves, "what kind of tax policy is best for the nation, not just Puerto Rico?"(50)

Once PRUSA and its member companies heard about "Treasury I," they began to execute their new experimental strategy for the protection of Section 936. Unlike in 1982, the companies did not wait until the issue reached Congress to mobilize. Holmes explains, "We directed our educational operation to those who were going to make the ultimate decision [and these] were members of Congress."(51)

On 28 May 1985, the White House sent its tax package to Congress. It was now up to the Chairman of the House Ways and Means Committee, Dan Rostenkowski (Democrat, Illinois), to keep the reform effort alive. PRUSA felt it already had the votes to protect Section 936, but Rostenkowski's position on the tax law was not clear. However, according to Rangel's aide, "Rostenkowski needed 19 votes, and he asked the members `what do you need to vote for this bill.'" Among other things, Congressman Rangel chose to protect Section 936 in exchange for his support for tax reform. Rostenkowski then divided the committee into task forces; he gave each task force a specific amount of dollars that they had to come up with in tax revenues and assigned them a staff to help draft their proposals. Not surprisingly, Section 936 was assigned to Rangel's task force. According to Holmes, "Rostenkowski told Rangel `I need \$300 million from 936 in five years.'"(52) The chairman left to Rangel's discretion how to come up with that amount and Rangel turned to the companies for advice.

PRUSA negotiated how to come up with the \$300 million with David H. Brockway, chief of staff to the Joint Committee of Taxation. Brockway and the company lobbyists both said that negotiations over Section 936 went smoothly because the companies were committed to their united front. From the beginning the companies empowered PRUSA to negotiate on their behalf, no company broke ranks or tried to get its own deal enacted. In the end, the committee proposed only minimal changes to Section 936. By the end of July, Rostenkowski announced publicly that there existed a consensus among his committee members for the maintenance of Section 936.(53) The Senate version of the tax bill adopted the House version of Section 936 and President Reagan signed the Tax Reform Act on 22 October 1986.

PRUSA was one of the few business groups that did not emerge as losers from the tax reform process in 1986. In the words of Brockway, "when you think of what we cut back in investments in the states, and given the Treasury reports, the fact that 936 survived is just amazing."(54) But a closer look at the process reveals that, contrary to the experiences of other industries, the subsystem that developed between pharmaceutical and electronics firms and Rep. Rangel after 1982 survived the political upheaval of 1986. As a member of the committee whose vote Rostenkowski needed, Rangel was willing and able to protect the tax break from broad criticism and lobby other members on the companies' behalf. The

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companies contributed effectively to the protection of their tax interests by preparing early to engage in an aggressive lobbying campaign that was characterized by a high degree of unity. Their political strategy was not formulated as a response to the political environment in 1986, however. Rather, it was based on the lessons the companies had learned from their political experiences in 1982.

The Omnibus Budget Reconciliation Act of 1993 (OBRA)

The companies' success in 1986 explains why they initially pursued a common political strategy when President Clinton proposed the elimination of Section 936 as part of his first budget proposal to Congress. Before the budget proposal was sent to Congress, pharmaceuticals had been under constant attack for their drug prices and their tax benefits in Puerto Rico. Given this new political environment, it is surprising that the electronics and other more labor-intensive companies remained in a coalition with the pharmaceuticals for as long as they did. The initial reaction of the entire membership of PRUSA, however, was an automatic response guided by the lessons they had learned from their experiences in 1986. The companies' subsequent fragmentation was the default strategy adopted by the electronics and other labor-intensive companies once they realized that the coalition strategy was not working as well as it had in 1986.

Senator David Pryor (Democrat, Arkansas) had been after the pharmaceuticals since the early 1990s. In March 1992, he proposed the "Prescription Drug Containment Act." According to a White House official close to the issue, "Senator Pryor felt that the drug industry was gouging the elderly and was also getting support from the Federal government in the form of Section 936." Hence, his proposal would have negated Section 936 benefits to drug companies that raised their prescription drug prices higher than the level of inflation. Pharmaceutical companies were able to fend-off this attack, but the Senator continued to target the companies' tax-free profits.

In May 1992, a GAO report requested by Senator Pryor revealed that for some companies the Section 936 tax savings per employee amounted to more than \$70,000. For example, in 1989 Pfizer had 500 employees in Puerto Rico, paid them an average salary of about \$25,000, and enjoyed federal tax savings per employee of about \$156,400.⁽⁵⁵⁾ According to an aide to Senator Lloyd Bentsen (Democrat, Texas) then Chair of the Senate Finance Committee, the Senator and others who had traditionally been "sympathetic towards the Commonwealth of Puerto Rico and very sympathetic of Section 936" were "shocked" by the level of benefits. Then, in September 1992, during a major health care speech at the Merck Pharmaceuticals headquarters, Presidential candidate Clinton endorsed "Senator Pryor's proposal to end special breaks for companies that do not keep the cost of traditional, already established drugs with inflation."⁽⁵⁶⁾ But in the end, it would be deficit reduction that enabled the staff at the Treasury Department to target Section 936 for elimination.

Of all of the promises made by Clinton during the campaign, cutting the deficit in half by the end of the first term became the most important, and it was up to the Treasury to come up with the tax revenue. A member of the Treasury staff working on the international tax provisions explains that by 1993 the possessions tax break was among the top five largest corporate tax expenditures, hence "it was inevitable that 936 would be on the table." In addition, he says that the staff felt a general animosity towards the pharmaceuticals and they sought to "exploit the latent split in the ranks of the companies." To take advantage of this potential rift, the staff began to work on a proposal that would hurt the capital-intensive pharmaceuticals more than it would hurt the electronics and other labor-intensive firms. They invited all of the companies to come and tell them how the proposal would hurt them. Not surprisingly, none of the pharmaceuticals wanted to negotiate. But while some of the more labor-intensive companies were in contact with the Treasury staff, none of the companies disassociated themselves from the coalition and "the most intensive lobbying was done by PRUSA." The behavior of the companies is remarkable given the tainted reputation of the drug companies and the fact that the newly elected Governor of Puerto Rico was also lukewarm in his defense of Section 936. But as one company representative explained, "we were united at the beginning because it was the strategy that had worked before." That is, the response that had been successful in 1986 was being automatically invoked by the companies to deal with a new political environment.

In February 1993 the Administration unveiled its "Deficit Reduction Plan." It proposed to eliminate the 100 percent credit on income under Section 936 and replace it with a 65 percent credit on wages paid. There was no doubt that the proposal was meant to hurt the capital-intensive pharmaceutical companies more than it would hurt the labor-intensive companies. For months, however, the companies continued to maintain a united front and PRUSA even offered its own alternative to the Administration's proposal. Undoubtedly, the companies' unity was under considerable strain as they were forced for the first time to lobby an unsympathetic Puerto Rican Administration at the same time that they lobbied the Clinton

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Administration and the U.S. Congress. In addition, their traditional ally, Congressman Rangel, claimed that he was unable to mount a credible defense of Section 936 in the face of the equivocal behavior of the Puerto Rican leadership.

In May 1993, as the Ways and Means Committee was coming close to a vote and it seemed inevitable that its members were going to adopt the President's plan unchanged, the first public break with PRUSA materialized. Allergan, a manufacturer of eye care products with two plants in Puerto Rico, began to circulate a proposal that provided for an enhanced wage credit only, even though pharmaceuticals preferred the existing income credit. A few days later, the committee voted to adopt the President's proposal unchanged. As the battle moved to the Senate, the companies' united front began to deteriorate more rapidly. Labor intensive companies began to meet on their own and with the Puerto Rican Administration. Lobbyists from PRUSA and capital-intensive firms were not invited to these meetings. By July, the National Journal was reporting that the controversy over Section 936 "had Washington lobbyists ringing their cash registers" as more and more individual companies began to hire their own separate lobbying firms.(57)

During the battle in the Senate Finance Committee, Senator Bill Bradley (Democrat, New Jersey) negotiated a compromise with Senator Pryor on behalf of the pharmaceuticals. Senator Bradley had supported the elimination of the income credit in 1986, but he had faced a tough re-election battle in 1990. He now felt that he had to be more responsive to the demands of the pharmaceuticals, which are one of the largest employers in New Jersey. Accordingly, Senator Bradley refused to allow the elimination of the income credit. In the end, the Conference Committee adopted the Senate's version of Section 936. The new provision contained both a considerably reduced income credit and a new wage credit. The wage credit was equal to 60 percent of wages and fringe benefits. The income credit was to be phased down from 100 percent to 40 percent by 1998.

None of the companies was happy with the political outcome or the political strategy. Pharmaceuticals were only able to salvage part of their income credit and the labor-intensive companies felt that the final version of the wage credit was not as good as it could have been. Whether or not a different political strategy by the companies would have led to a different outcome is hard to tell. Yet it is clear that Treasury had wanted to favor the labor-intensive firms at the expense of the pharmaceuticals. This suggests that if labor-intensive firms had lobbied for their own proposal early on, they could have succeeded in protecting their interests more effectively. For the purposes of this study, however, it is most significant that when faced with a fluid and uncertain political environment the companies initially responded unreflectively. Consistent with the learning view, they relied on the same united front and nonnegotiation stance that had met with political success in 1986. The labor-intensive firms did not reflect on how they were being hurt by their association with the drug companies; and the latter refused to negotiate with the Treasury staff or the Ways and Means Committee. In the words of one pharmaceutical lobbyist, "if [we] had ascertained the political situation, [we] would have behaved differently." He continued, "experienced political operatives misjudged the situation [because] we always try to fight the last war."

IV. The Dynamics of Experiential Learning

The sequence of business efforts to preserve a valued tax break examined in this article demonstrates the importance of experiential learning in determining business firms' political behavior. It shows very clearly how prior experiences influence the choice of current political strategies. Yet it also shows that firms cannot rely on experiential learning as their sole source of guidance; firms, like other political actors, must remain flexible to detect significant changes in the political context and alter strategy accordingly.

Successive debates about changing or abolishing the possessions tax credit between 1976 and 1993 reveal the strong influence of past success and past failure on business firms' political strategies. Success encourages maintaining the strategy that worked before. This is most clearly shown in firms' responses in 1976, 1982, and 1993. During the first challenge to the possessions tax credit, firms relied on their structural power, their ability to affect the economy and with it the political context in which politicians compete for popular support. This strategy succeeded with both the U.S. Congress and the government of Puerto Rico; most of the explicit lobbying on the issue in that period was done by Puerto Rican officials anxious to maintain the tax credit lest Puerto Rican growth slow down. The companies relied on this strategy probably because they had no memory of ever having the need to mobilize for the political protection of the possessions tax credit. In 1982, prior success made the companies slow to realize that reliance on structural power would not suffice to protect their policy interests. The success of the joint lobbying effort in 1986 led the electronics and other non-pharmaceutical firms to continue that strategy in 1993 even though they would have been better off had they de-linked from the pharmaceutical firms, whose great benefits from the possessions tax break and steep price increases

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had made them subjects of strong political attack. The impact of failure is most evident in 1986. Here, experiential learning suggested that business needed a new strategy. The firms concluded almost as soon as the 1982 debates ended that the "default" option of uncoordinated individual lobbying would not suffice. Instead they developed a strategy based on joint lobbying by a cross-sectoral coalition of major firms working through a common lobbying organization, the Puerto Rico-USA Foundation.

The contrast between successful development of a joint strategy in 1986 and the scrambles of individual lobbying that developed after previously successful strategies were clearly failing in 1982 and 1993 shows how difficult it is to change strategies in mid-debate. It is significant that the firms looked back on their experience more quickly and comprehensively after the 1982 debate ended; doing so gave them time to prepare before the next round of policy battle took place. In both 1982 and 1993, the dimensions, if not the fact, of the political attack on the possessions tax credit seem to have taken the firms by surprise. The political context had changed with consequences unanticipated by the firms, and they had to scramble to keep up. In 1986 the political context had not changed as significantly; this allowed a strategy drawn up ahead of time to be successful once the policy debate was renewed.

Experiential learning has a particularly clear impact on the strategic choices of firms: past successes increase the attractiveness of already-selected strategies while past failures have the opposite effect. And while learning is not the sole factor affecting firms' political success, political outcomes depend on how well or poorly their perception of the political context matches the actual context in which they implement their strategy. As the sequence of debates over the possessions tax credit shows, firms may find it difficult to secure their political preferences even when they know what they want because they are unable to alter their strategy in response to a changed political context quickly enough. In the absence of an agreement on anything else, firms fall back on an individualized strategy of lobbying for their own interests without paying much regard to the interests of firms as a group. While this "default mode" is effective in many instances, it is inappropriate often enough that a simple shift into default mode whenever another strategy is obviously failing will not be productive.

Because it is confined to one issue, this study cannot answer the questions of whether firms generalize to other issues from their experience in any particular political battle. In spite of the evidence suggesting that different issues are characterized by different policymaking structures, many researchers treat firms as if one issue determines their political behavior across the board.(58) Yet more detailed research on the political behavior of private entities suggests that strategies on any one issue are formulated in relation to strategies being pursued on others.(59) This study provides evidence only of a rather indirect effect. The company lobbyists and executives interviewed rarely invoked their experiences on other issues when discussing their strategies regarding the possessions tax break. If anything, the need to pay attention to other issues as well contributed to the firms' tendency to rely on past experiences when selecting the strategies for the possessions tax credit debates. This is consistent with previous findings that no matter whether the Washington office is large or small there is considerable issue specialization among business firms' Washington representatives.(60)

The distinctiveness of the possessions tax credit means that this research cannot not address the extent to which bridges of common concern created by issue overlap may facilitate the transfer of learning.(61) For multiple issues that are not highly differentiated, learning might be more easily transferred from one issue to another and the strategic learning scenarios are likely to be more complicated than for highly specialized issues. Also, learning can be transferred between firms when they belong to the same trade association, or share a particular issue niche, interlocking directorate or alliance.(62) Yet even within these networks, an individual firm's disposition to learn from the specific experiences of others will also be a factor of its own immediate experiences of political success and failure.(63) For example, a few of the firms who became PRUSA members had not participated in the political activities of 1982, but they did share in the political defeat.

Experiential learning is not a complete explanation of business firms' political success or failure. It does, however, explain much about the dynamics of their strategic choices and provides a key to understanding the processes by which firms repeat or change their strategies in light of experiences in the political arena.

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