PUERTO RICO

PROCESO PLEBISCITARIO 1989-1991

VOLUMEN II

Estudios relacionados con el estatus político de Puerto Rico

POLITICAL STATUS REFERENDUM 1989-1991

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Reports and Studies on The Puerto Rico Political Status and Related Issues

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NOTA INTRODUCTORIA

Con la publicación de esta amplia compilación de documentos, pretendemos poner a la disposición del público en general tantos textos como ha sido posible recopilar relacionados con los proyectos de ley radicados en el Congreso de los Estados Unidos con el objeto de convocar un plebiscito sobre el futuro de las relaciones políticas entre Puerto Rico y los Estados Unidos de América. Dichos proyectos fueron ampliamente debatidos en ambos países durante treinta meses entre enero de 1989 y junio de 1991.

Para darle un marco de referencia a esta colección, se reproducen los originales de los proyectos de ley radicados en el Senado y la Cámara de Representantes del Congreso. Dichos proyectos hubiesen autorizado la convocatoria de un plebiscito en que los ciudadanos de Puerto Rico hubieran decidido entre las tres opciones que han sido objeto de discusión en Puerto Rico a lo largo de este siglo, pero acompañadas de una definición específica de cada una y de unas disposiciones que permitieran que el resultado fuera autoejecutable en el plazo que el Congreso de los Estados Unidos determinara más razonable. Con este proceso, marcadamente diferente al que se inició en la década de los sesenta, se intentaba vertebrar el ejercicio del derecho a la autodeterminación por parte de nuestros conciudadanos y evitar que el Congreso de los Estados Unidos no atendiera el reclamo que le llegaría desde Puerto Rico una vez celebrado el plebiscito.

La documentación que genera un proceso político-constitucional de esta envergadura es tan abundante como copiosa. Por dicha razón, no reproducimos las transcripciones de las vistas públicas celebradas por las comisiones competentes del Senado y la Cámara de Representantes del Congreso de los Estados Unidos de América. Esas están disponibles al público hace ya varios meses.

Por lo tanto, nuestro propósito ha sido el de publicar aquellos documentos generados durante esos treinta meses que no han sido publicados por las comisiones congresionales. Creemos cumplir con la misión de facilitar la difusión pública de documentos que difícilmente hubiera podido hacerse por otras instituciones.

Advertimos al lector que algunos de los documentos no son del todo legibles dado que son copias o facsímiles de los originales. Sin embargo, hemos optado por reproducirlos tal y como obran en nuestro poder para evidenciar su autenticidad.

Esta compilación se divide entres partes:

- Correspondencia entre los líderes políticos de Puerto Rico y los Estados Unidos de América y documentos legislativos que incluyen los proyectos de ley radicados en el Senado y la Cámara de Representantes del Congreso de los Estados Unidos de América y los informes de las comisiones permanentes a las que fueron referidos dichos proyectos.

- Informes, dictámenes y monografías encomendados por el Congreso a la Oficina de Presupuesto del Congreso ("Congressional Budget Office"), el Servicio de Investigación Congresional de la Biblioteca del Congreso ("Congressional Research Service"); y estudios ordenados a asesores privados por los partidos políticos puertorriqueños sobre aspectos específicos de las relaciones entre Puerto Rico y los Estados Unidos de América.

- Estudios llevados a cabo en la Contraloría General de los Estados Unidos ("U.S. General Accounting Office") sobre disposiciones específicas de dichos proyectos de ley y otros asuntos directamente relacionados.

Cada una de estas partes se ha publicado en un tomo distinto. Cada tomo contiene la cronología de los hitos principales ocurridos durante esos treinta meses y otros datos de interés en la evolución del proceso plebiscitario. La cronología incluye una referencia al documento mencionado identificando el tomo y la página donde se encuentra en la recopilación. Los documentos en cada tomo aparecen por orden de fecha.

Con el deseo de alcanzar la objetividad y la neutralidad en la presentación de estos documentos, hemos optado por no hacer interpretaciones de los eventos ocurridos durante estos treinta meses, ni referencias a los acaecidos fuera de estas fechas. Quedará en manos de los historiadores, los juristas, los estudiosos de este tema y los ciudadanos interesados en el futuro de Puerto Rico, la tarea de interpretar el significado y la importancia de cada documento contenido en estos tomos.

En el discurso inaugural de su tercer mandato como gobernador del Estado Libre Asociado de Puerto Rico, el 2 de enero de 1989, Rafael Hernández Colón inició el proceso que intentamos aquí documentar. Por ello, le cabe a este texto encabezar esta compilación.

A partir de esa fecha, los acontecimientos generaron una gran cantidad de correspondencia entre los líderes políticos de Puerto Rico y de los Estados Unidos de América. Muchas de estas cartas ayudaron a moldear el debate que se da en el Congreso luego de la radicación de las primeras iniciativas legislativas. Cabe resaltar las comunicaciones conjuntas de los presidentes de los tres partidos políticos que mostraron una rara coincidencia de pareceres en el liderato político puertorriqueño que tantas veces se ha dividido en el pasado al terciar en el interminable debate sobre el futuro de nuestras relaciones políticas con los Estados Unidos de América.

Esta recopilación se ha hecho de la forma más exhaustiva posible e incluye todos los documentos disponibles al cierre de esta edición en su idioma original. Sin embargo, el lector (particularmente, el experto en este tema) encontrará inevitablemente errores de omisión. Rogamos del amable lector su indulgencia en vista de la enorme dificultad en identificar y obtener cada una de los documentos vertidos durante este complejo proceso.

Quisiéramos pensar que con esta publicación ayudamos y animamos a los interesados en la suerte de Puerto Rico y de los puertorriqueños a estudiar con detenimiento lo que aconteció durante treinta meses de singular importancia en la historia de nuestra querida patria.

José Roberto Martínez Ramírez
Director y Asesor Especial del Gobernador
Administración de Asuntos Federales de Puerto Rico

Diciembre 1992
Washington, D.C.

INTRODUCTION

With the publication of this comprehensive collection of documents, we attempt to make available to the general public as many texts as it was possible to compile in connection with the bills introduced in the United States Congress, which sought to convoke a referendum concerning the future of the political relationship between Puerto Rico and the United States of America. These bills were the object of ample debate in both countries during the thirty-month period between January 1989 and June 1991.

To provide a frame of reference for the collection, the original texts of the bills introduced in the Senate and the House of Representatives of the Congress of the United States of America are included. The purpose of these bills was to authorize a referendum to allow the citizens of Puerto Rico to decide among the three status options that have been the object of discussion during this century. The bills contained a specific definition of each option, as well as provisions to permit the result to be self-executing within the time period determined by the U.S. Congress to be the most reasonable for each option. This process, markedly different from that initiated in 1960s, was intended to provide the framework for the exercise of the right of self-determination by the people of Puerto Rico. It also was designed to preclude the possibility that the U.S. Congress would fail to act on the choice arrived at by the electorate in the referendum.

The documentation generated by such a political-constitutional process is copious and abundant. For this reason, the transcripts of the public hearings held by the standing committees of the Senate and House of Representatives of the United States Congress are not included. These transcripts are readily available to the public.

Accordingly, our goal has been to make available the documentary record of those thirty months, not necessarily contained or compiled in Congressional committee publications. Thus, making available those documents which would have proven more difficult for other institutions to compile.

Not all the documents are completely legible since some are copies or facsimile reproductions of the originals. Nevertheless, we have chosen to reproduce them as we received them in order to evidence their authenticity.

This compilation is divided into three main parts:

- Correspondence between the political leaders of Puerto Rico and the United States of America; legislative documents: bills introduced in the U.S. Senate and U.S. House of Representatives, the reports of the standing committees to which the bills were referred, and sections of the Congressional Record of the United States Congress containing remarks that were made in connection with the bills.

- Opinions, and papers requested by the U.S. Congress to the Congressional Budget Office (CBO) and the Congressional Research Service (CRS), and studies conducted by private groups at the request of Puerto Rican political parties concerning specific aspects of the relationship between Puerto Rico and the United States of America.

- Studies produced by the U.S. General Accounting Office (GAO) on specific provisions contained in the bills.

Each part constitutes a separate volume. Each volume contains the chronology of the main events as well as other dates of interest in the evolution of the referendum process. The chronology identifies the documents by referring to the volume and page where they are found in the collection. The documents in each volume appear in chronological order.

In the interest of maintaining neutrality and objectivity in the presentation of these documents, no attempt at interpretation was made, nor are there references to events outside this period. The work of interpreting the significance and importance of each document is left to the historians, lawyers, other students of the subject, and, in general, any person interested in the future of Puerto Rico.

In the inaugural address of January 2, 1989, with which he began his third term as Governor of the Commonwealth of Puerto Rico, Rafael Hernández-Colón initiated the process documented in this collection. Hence, the text of his speech heads the list of the documents assembled.

After that date, the process generated a great deal of correspondence between the political leaders of Puerto Rico and of the United States. Many of these letters helped to shape the debate in Congress and in Puerto Rico once the initial legislative measures were filed. Particularly noteworthy are the joint letters of the chairmen of the three Puerto Rican political parties which show an uncommon agreement within the Puerto Rican political leadership so often divided in the endless debate on the future of our political relationship with the United States of America.

This collection has been compiled in the broadest possible manner and includes all of the documents available as of the date of publication, in the language in which they were originally written. Nonetheless, the reader (particularly the expert in the subject) will inevitably discover some omissions. We beg the indulgence of the reader in light of the difficulty in identifying and obtaining a copy of each and every one of the documents originated by this complex process.

We hope that this publication helps spark the interest of those concerned about the future of Puerto Rico in a way that will lead them to understand what occurred during these thirty months of singular importance in the history of our beloved homeland.

Jose Roberto Martínez Ramírez
Director and Special Counsel to the Governor
Puerto Rico Federal Affairs Administration

December 1992
Washington, D.C.

CRONOLOGÍA DEL PROCESO PLEBISCITARIO SOBRE EL ESTATUS DE PUERTO RICO 1989-1991

1989

ENERO, 1989

2/enero - El gobernador Rafael Hernández Colón en su Mensaje Inaugural hace un llamado a una consulta sobre el estatus político de Puerto Rico señalando que "la inmensa mayoría de los puertorriqueños desea expresarse en torno al asunto de nuestro status político" e instando al Gobierno de los Estados Unidos a que manifieste su posición al respecto. [I, 1]

17/enero - Los presidentes de los principales partidos políticos de Puerto Rico, el gobernador Rafael Hernández Colón (PPD), Baltasar Corrada del Río (PNP) y Rubén Berríos Martínez (PIP), suscriben una carta conjunta al Presidente Bush y al liderato congresional para solicitar legislación para el referéndum "con la garantía de que la voluntad del pueblo, una vez expresada, será implantada mediante acción congresional". La carta fue enviada a los senadores George J. Mitchell, Bob Dole, J. Bennett Johnston y James McClure, y a los congresistas Jim Wright, Robert H. Michel, Morris K. Udall, Ron de Lugo y Robert Lagomarsino. [I, 17]

FEBRERO, 1989

9/febrero - El Presidente Bush insta al Congreso a tomar acción sobre el estatus político de Puerto Rico y declara su preferencia personal por la estadidad en su primer mensaje sobre el Estado de la Unión. [I,11]

14/febrero - El Gobernador Hernández Colón envía una carta al Presidente Bush en la que agradece su endoso al proceso de consulta y le insta a que se mantenga neutral y se abstenga de hacer campaña en favor de alguna fórmula en particular. [I, 15]

21/febrero - El Nuevo Día publica los siguientes resultados de la encuesta sobre status realizada por Yankelovich-Stanford Klapper and Associates: Estado Libre Asociado 45%; Estadidad 35%; Independencia 5%; indecisos 11%. La encuesta revela que el 78% del electorado favorece la celebración de un plebiscito.

26/febrero - El ex-gobernador Carlos Romero Barceló es electo presidente del Partido Nuevo Progresista (PNP) en asamblea en Guaynabo, luego de que el Alcalde de San Juan y candidato a la gobernación por el PNP en 1988, Baltasar Corrada del Río, renunciara a la posición a finales de enero.

27/febrero - El Senador J. Bennett Johnston, Presidente de la Comisión de Energía y Recursos Naturales del Senado, se reúne con los presidentes de los partidos políticos de Puerto Rico en San Juan para discutir la legislación federal para un referéndum sobre el estatus.

MARZO, 1989

9/marzo - Circula un memorando del Servicio de Investigaciones del Congreso (CRS) sobre la ciudadanía americana de los puertorriqueños redactado por John H. Killian, Especialista en Derecho Constitucional Americano de la Biblioteca del Congreso. Analiza cómo las garantías constitucionales de la ciudadanía americana posiblemente no aplicarían si Puerto Rico optase por la independencia.

Desata una fuerte y prolongada disputa en Puerto Rico sobre si la ciudadanía americana está constitucionalmente garantizada bajo el Estado Libre Asociado. [II, 81]

16/marzo - El senador J. Bennett Johnston anuncia desde el hemiciclo del Senado que pronto radicará legislación plebiscitaria. [I, 121]

25/marzo - Los senadores Johnston y McClure envían una carta al Presidente Bush para solicitar la ayuda de la Administración para lograr legislación plebiscitaria. La carta señala que la legislación debe ser aprobada en el Centésimo Primer Congreso si el plebiscito fuera a celebrarse antes de las elecciones generales de 1992, y solicita la designación de una agencia que represente a la Administración y de funcionarios contacto para trabajar con el Congreso en este asunto. [I, 19]

ABRIL, 1989

5/abril - El Senador Johnston presenta tres anteproyectos de ley sobre el plebiscito con distintos grados de detalle en las definiciones de cada fórmula: S.710, S.711, S.712. El liderato político de Puerto Rico mayormente favorece el S.712 que es autoejecutable y no requeriría legislación Congresional posterior. Los tres partidos políticos habrán de proponer las definiciones de sus respectivas fórmulas de estatus para la consideración de la Comisión de Energía y Recursos Naturales del Senado para el 9 de mayo. [I, 129]

30/abril - La Junta de Gobierno del Partido Popular Democrático aprueba una definición del Estado Libre Asociado Mejorado que propone (1) mayor autonomía en asuntos locales; (2) una política federal afín a las singularidades de Puerto Rico y orientada a acelerar el desarrollo social y económico de la Isla; (3) salvaguardar la identidad y cultura propia del pueblo de Puerto Rico; (4) un mecanismo para que Puerto Rico entre en acuerdos internacionales y (5) trato igual con los estados en los programas federales de asistencia social a los necesitados. [I, 31]

MAYO, 1989

3/mayo - El Partido Independentista Puertorriqueño presenta su definición de la independencia. Propone (1) el retiro completo de las fuerzas ---militares de los Estado Unidos--- de Puerto Rico; (2) ciudadanía dual (Estados Unidos-Puerto Rico) por 25 años; (3) acceso libre de los productos de Puerto Rico a los Estados Unidos por 20 años; (4) la extensión de la Sección 936 por 25 años; (5) extensión de los programas federales de asistencia social y otros pagos federales en bloque al gobierno de Puerto Rico por 20 años; y (6) soberanía total como una república independiente.

9/mayo - Fecha límite para los partidos políticos puertorriqueños somete sus definiciones de estatus bajo el S.712 a la Comisión de Energía y Recursos Naturales del Senado. El Partido Nuevo Progresista presenta su definición de estadidad para Puerto Rico, que incluye: (1) el español y el inglés como idiomas oficiales; (2) la extensión inmediata de todos los programas federales de asistencia; (3) exención decreciente de contribuciones federales durante los primeros 25 años de estadidad; (4) la extensión de la Sección 936 durante 25 años; (5) el derecho a votar por el Presidente; y (6) representación congresional completa.

JUNIO, 1989

1,2/junio - Se celebran vistas de la Comisión de Energía y Recursos Naturales del Senado para discutir las definiciones propuestas de los tres estatus; los presidentes de los tres partidos políticos puertorriqueños testifican en Washington, DC.

13/junio - Andrew Card, funcionario de la Casa Blanca, declara a la prensa de Puerto Rico que la Administración no creará el grupo de trabajo plebiscitario solicitado por los senadores Johnston y McClure.

16-17-19/junio - Vistas de la Comisión de Energía y Recursos Naturales del Senado en San Juan, Puerto Rico. Entre los participantes figuran líderes cívicos puertorriqueños, educadores y organizaciones independientes. Los senadores Johnston, McClure y Daniel Patrick Moynihan asisten a las vistas.

17/junio - La prensa de Puerto Rico informa que el senador Johnston no considera que el Estado Libre Asociado es una colonia y que "la ciudadanía americana de los puertorriqueños es irrevocable". Johnston añade que el informe del CRS del 9 de marzo sobre la ciudadanía americana "fue mal interpretado" en Puerto Rico ya que se refería al caso de la independencia y no al del Estado Libre Asociado.

22/junio - Se crea, mediante Orden Ejecutiva del Gobernador de Puerto Rico, el Comité de Diálogo sobre el Estatus Político de Puerto Rico por acuerdo entre los presidentes de los partidos de Puerto Rico con el propósito de proveer un foro para la discusión y solución de asuntos plebiscitarios. Se asignan fondos del Gobierno de Puerto Rico a los tres partidos. Los miembros del Comité de Diálogo son los presidentes de los tres partidos y sus representantes: José M. Berrocal por el PPD, Benny Frankie Cerezo por el PNP y Fernando Martín por el PIP. [I, 35]

23/junio - Una carta dirigida al Presidente Bush firmada por los senadores Johnston y McClure, Rafael Hernández Colón, Carlos Romero Barceló y Rubén Berríos Martínez solicita la cooperación inmediata de la Administración para acelerar la legislación plebiscitaria. [I, 44]

JULIO, 1989

11-13-14/julio - Vistas de la Comisión de Energía y Recursos Naturales del Senado sobre el S.712. Entre los deponentes comparecen funcionarios de los departamentos federales de Justicia, Defensa, Tesoro y Estado.

AGOSTO, 1989

2/agosto - La Comisión de Energía y Recursos Naturales del Senado aprueba el S.712 mediante votación de 11-8, luego de considerar el proyecto durante cuatro días. El proyecto provee para un plebiscito autoejecutable, basado en definiciones detalladas de cada fórmula de estatus. El proyecto S.712 es referido simultáneamente a las Comisiones de Finanzas y de Agricultura del Senado. Las propuestas originales de cada partido son alteradas sustancialmente. Al ELA no se le concede paridad en los programas federales de asistencia social y las propuestas de mayor gobierno propio son limitadas significativamente. A la independencia se le impone como condición la permanencia de las bases militares norteamericanas en la Isla, se reduce el período de transición económica, y se le limita sustancialmente la asistencia federal. A la definición de la estadidad se le elimina la referencia a idiomas oficiales; y la exención de contribuciones federales y la extensión de la Sección 936 queda limitada a los cinco primeros años de estadidad.

4/agosto - El senador Moynihan hace declaraciones sobre el S.712 ante el Senado en pleno. Plantea su preocupación sobre la dependencia en programas federales de beneficencia bajo la estadidad. Concluye, a base de dos nuevos informes del CRS, que "según informado por la Comisión de Energía y Recursos Naturales del Senado, la estadidad ofrece a los puertorriqueños la expectativa de beneficios inmediatos de asistencia social, pero de pérdidas económicas a largo plazo... en contraste, el Estado Libre Asociado promete incremento económico a largo plazo".

SEPTIEMBRE, 1989

6/septiembre - La Oficina de Presupuesto Congresional (CBO, por sus siglas en inglés) revela sus estimados de costo para el S.712. La estadidad costaría a los Estados Unidos más que cualquiera otra opción; su implantación bajo el S.712 requeriría desembolsos de más de $9,000 millones para el 1995 (el triple de los $3,600 millones estimados por la Comisión de Energía y Recursos Naturales inicialmente).

OCTUBRE, 1989

2/octubre - El Nuevo Día publica los resultados de una encuesta sobre el estatus realizada por Yankelovich-Stanford Klapper and Associates: Estadidad 41%, Estado Libre Asociado 37%, Independencia 4%, Indecisos 18%. Esta es la primera vez que se refleja una ventaja a la estadidad.

23/octubre - El senador Johnston envía una carta a los congresistas Morris Udall, Presidente de la Comisión del Interior y Asuntos Insulares de la Cámara, y Ron de Lugo, Presidente de la Subcomisión de Asuntos Insulares e Internacionales de la Cámara, en la que les insta a iniciar el proceso legislativo sobre el plebiscito en la Cámara sin esperar a la aprobación del proyecto del Senado. Johnston sugiere que para ahorrar tiempo, se radique S.712 en la Cámara y se celebren vistas en Puerto Rico en diciembre o enero. [

26/octubre - El congresista Robert Lagomarsino, líder de la minoría en la Subcomisión de Asuntos Insulares e Internacionales de la Cámara, radica un proyecto plebiscitario en la Cámara (HR 3536); esencialmente igual S.712 pero sin las disposiciones sobre contribuciones y gastos federales que incluye el del Senado. De Lugo rehúsa tomar acción sobre el proyecto debido a la falta de apoyo de los tres partidos políticos de Puerto Rico. [I, 242]

NOVIEMBRE, 1989

2/noviembre - La Oficina de Presupuesto Congresional (CBO) revela su revisión de los estimados de costo para el S.712 del 6 de septiembre. [I, 243]

6/noviembre - El congresista Udall responde a la carta del senador Johnston del 23 de octubre y expresa la oposición del liderato de la Cámara a la cláusula de autoejecución incluida en el S.712, citando específicamente las objeciones del Presidente de la Cámara al mecanismo del S.712. **puertorriqueños.**

8/noviembre - En una reunión-almuerzo en Washington del líder senatorial de la mayoría George Mitchell, el Presidente de la Comisión de Finanzas del Senado, Lloyd Bentsen, el senador Johnston y el senador Moynihan, con el Presidente del PPD, Rafael Hernández Colón, el Presidente del PNP, Carlos Romero Barceló, y el Presidente del PIP, Rubén Berríos Martínez. El liderato del Senado se compromete a llevar el proyecto de referéndum a votación en el hemiciclo en 1990.

9/noviembre - Se celebran las vistas de la Comisión de Agricultura del Senado sobre S.712. El gobernador Hernández Colón critica fuertemente el desbalance a favor de la estadidad en el S.712. Solicita paridad en los programas federales de asistencia social bajo el ELA.

14-15/noviembre - Se celebran vistas de la Comisión de Finanzas del Senado sobre las disposiciones de ingresos y egresos bajo el S.712. Entre los testigos comparecen los presidentes de los partidos políticos de Puerto Rico; Kenneth Gideon, Secretario Auxiliar del Tesoro para Política Contributiva; Shirley D. Peterson, Secretaria Auxiliar de Justicia de Estados Unidos - División de Contribuciones;

Laurence Tribe, Profesor de Derecho Constitucional de la Universidad de Harvard, y representantes del GAO, CRS y CBO.

16/noviembre - La Comisión de Finanzas del Senado solicita al CBO y al Comité Económico Conjunto (Joint Economic Committee) un estudio sobre el impacto económico de las tres fórmulas de estatus contenidas en el S.712.

1990

ENERO, 1990

30/enero - Linda G. Morra del GAO y Clay H. Welbourn del CRS informan a los miembros de la Comisión del Interior y Asuntos Insulares de la Cámara sobre el estatus político de Puerto Rico, seguido por presentaciones de los representantes de los tres partidos políticos de Puerto Rico ante el Comité de Diálogo sobre el Estatus.

FEBRERO, 1990

13/febrero - El Nuevo Día publica los resultados de la última encuesta sobre estatus realizada por Kaagan Research/Stanford Klapper Associates: Estadidad, 43%; Estado Libre Asociado, 36%; Independencia, 5%; indecisos, 16%.

26/febrero - El New York Times publica en su página op.ed. un artículo del gobernador Hernández Colón que hace énfasis en el impacto negativo, tanto cultural como económico, de la estadidad para la Isla.

MARZO, 1990

2/marzo - La Subcomisión de Asuntos Insulares de la Cámara celebra vistas en Washington sobre la posible legislación plebiscitaria. Los tres presidentes de los partidos políticos de Puerto Rico testifican.

8/marzo - El grupo KMPG Peat Marwick Policy Economics publica el estudio titulado "Impacto Económico y Fiscal de la Estadidad para Puerto Rico" (Economical and Fiscal Impact of Statehood for Puerto Rico) que concluye que la estadidad trastornaría dramáticamente la economía de Puerto Rico, aumentando el desempleo a un 40% (pérdida de 80,000-145,000 empleos) y produciéndole un déficit neto cumulativo al Gobierno Federal de $22,000 a $25,000 millones para el año 2000. [II, 305]

9-10-12/marzo - La Subcomisión de Asuntos Insulares de la Cámara celebra vistas en San Juan, Ponce y Mayagüez. A estas vistas, presididas por el congresista Ron de Lugo, asistieron los congresistas Robert Lagomarsino, James McClure Clarke, Richard Lehman, Ben Blaz, Eni Falaeomavaega y Jaime Fuster. Testificaron más de 80 deponentes entre los que figuraron educadores, políticos, comerciantes y líderes cívicos del país.

ABRIL, 1990

5/abril - El CBO publica el informe "Impactos económicos potenciales de cambios en el estatus de Puerto Rico bajo el S.712". Concluye que bajo la estadidad Puerto Rico sufriría una reducción en su producto nacional bruto de 10% a 15% para el año 2000, acompañada por una pérdida de entre 50,000 a 100,000 empleos en el sector privado. [II, 1]

24/abril - El Washington Post critica editorialmente el desbalance a favor de la estadidad en el S.712 y advierte que no hay tiempo suficiente para aprobar el proyecto.

26/abril - Se celebran las vistas de la Comisión de Finanzas del Senado sobre el S.712 en torno al informe del CBO. Testifican el director del CBO, Robert D. Reischauer; el Asesor sobre Contribuciones Internacionales del Tesoro, Philip Morrison; el Secretario Auxiliar del Departamento de Salud y Recursos Humanos, Martin Gerry; y el subdirector del CBO, Fred Ribe.

30/abril - El congresista de Lugo anuncia que radicará un proyecto plebiscitario en la Cámara dentro de "la próxima semana a diez días". Señala que el S.712 tiene "serios problemas" y anticipa que su proyecto no será autoejecutable.

MAYO, 1990

1/mayo - El gobernador Hernández Colón anuncia en San Juan que cualquier proyecto plebiscitario que no comprometa al Congreso con sus resultados es inaceptable.

9/mayo - El congresista de Lugo radica el HR 4765, un proyecto con definiciones generales de cada fórmula que establece un proceso en dos etapas con el requisito de una segunda ronda de legislación para implantar la fórmula ganadora. [I, 261]

14-17/mayo - Los señores Andrew Card, Subjefe de Operaciones de la Oficina del Presidente, y Chase Untermayer, Director de Personal del Presidente y Oficial Contacto para Asuntos de Puerto Rico, visitan la Isla y endosan la estadidad. Durante su reseñada estadía, participaron en actividades públicas en favor de la estadidad y aseguraron que, con el endoso del Presidente, la estadidad triunfaría. El señor Untermayer señaló "es tiempo de que la democracia llegue a Puerto Rico".

16/mayo - El gobernador Hernández Colón escribe al Presidente Bush para expresar su decepción ante el activismo pro-estadista de sus subalternos. Insta a la Administración Bush a permanecer neutral y evitar desbalancear el proceso plebiscitario, para que se pueda conducir "libre de interferencia y distorsión externa". [I, 48]

17/mayo - El delegado estadista al Comité de Diálogo Benny Frankie Cerezo hace público el memorando de Hex, Inc. "La Estadidad en Puerto Rico: una condición para un sólido desarrollo económico". Dicho memorando contradice los hallazgos del informe del CBO sobre el impacto adverso de la estadidad en la economía de Puerto Rico. [II, 437]

23/mayo - El presidente Bush responde a la carta del gobernador Hernández Colón del 16 de mayo expresando que él no considera que sus acciones o las de su personal sean "interferencia externa" y que su personal no se abstendrá de expresar sus opiniones. [I, 51]

31/mayo - Se publica el documento del CRS titulado "Impacto de la Estadidad en Puerto Rico sobre los instrumentos financieros puertorriqueños". El informe sostiene que la imposición de contribuciones federales y la derogación de la Sección 936 resultarían en mayores costos de financiamiento en Puerto Rico. También señala los problemas financieros que el gobierno estatal confrontaría con la aplicación de un nivel adicional de contribuciones bajo la estadidad, implicando que habría que reducir los servicios y empleos estatales. [II, 203]

JUNIO, 1990

25/junio - Se celebran vistas del Subcomité de Asuntos Insulares e Internacionales de la Cámara sobre el HR 4765 en Nueva York. Las vistas giran en torno a la enmienda presentada por el congresista José Serrano para extender el derecho a votar en el plebiscito a los puertorriqueños que residan en los estados de los Estados Unidos. El congresista Bill Richardson preside las vistas. Los congresistas Serrano, Bill Green, Charles Rangel y Jaime Fuster asisten a estas vistas, donde unos 40 testigos exigen el voto para los puertorriqueños ausentes.

28/junio - Se celebran vistas de la Subcomisión de Asuntos Insulares de la Cámara sobre el HR 4765 en Washington presididas por el Congresista Clarke. Los presidentes de los partidos políticos de Puerto Rico explican sus definiciones de estatus. Además testifica el Secretario Auxiliar de Justicia de los Estados Unidos, Stuart Gerson.

JULIO, 1990

10/julio - Miembros de la Subcomisión de Asuntos Insulares de la Cámara envían una carta al congresista de Lugo, presidente de la Subcomisión, para expresar apoyo a sus esfuerzos en favor del HR 4765 e indicar que están listos para aprobar el proyecto a base de las definiciones sometidas por los tres partidos. Dicha carta la firman los congresistas Fuster, Darden, Lewis, Blaz y Falaeomavaega. [I, 53]

25/julio - Día de la Constitución del ELA en Puerto Rico. Mensaje especial del gobernador Rafael Hernández Colón en la celebración del 38 aniversario de Estado Libre Asociado.

27/julio - Celebración del natalicio de José Celso Barbosa. El Secretario del Interior de los Estado Unidos, Manuel Luján, habla en un mitin pro-estadista en Bayamón y reafirma el compromiso de la administración Bush con la estadidad.

AGOSTO, 1990

1/agosto - La Comisión de Finanzas del Senado enmienda unánimemente el S.712 para balancear las disposiciones económicas de cada fórmula y hacerlas neutrales en términos de costos por un período de cinco años. La implantación de la estadidad se retrasa hasta 1996. Se concede trato igual en Programas de Asistencia Social al Estado Libre Asociado, sujeto a una contribución proporcional por parte del gobierno del ELA. La Comisión se abstiene de favorecer la aprobación del proyecto.

1/agosto - El gobernador Hernández Colón envía una carta al congresista Ron de Lugo para establecer la posición oficial del gobierno de Puerto Rico en favor del voto de los puertorriqueños no residentes en el plebiscito. El ex-gobernador Carlos Romero Barceló y Fernando Martín envían cartas para exponer la posición del PNP y PIP, respectivamente, sobre el asunto. [I, 55-56-58]

3/agosto - La Subcomisión de Asuntos Internacionales e Insulares de la Cámara aprueba el HR 4765 en votación de 10-0. El proyecto no incluye definiciones de las fórmulas, provee para un proceso en dos etapas que requiere legislación adicional posterior al referéndum. Las definiciones del estatus se anejan en el informe de la Comisión ("Informe 101-790, Parte 1"). [I, 452]

SEPTIEMBRE, 1990

19/sept. - La Comisión de Asuntos Insulares y de lo Interior de la Cámara aprueba el HR 4765 por votación de 37-1. El congresista Ron Marleene emite el único voto disidente. El proyecto autoriza el voto de puertorriqueños no residentes en la isla, sujeto a la aprobación de dos de los tres partidos de Puerto Rico.

OCTUBRE, 1990

2/octubre - La Comisión de Reglas de la Cámara recomienda unánimemente la consideración del HR 4765 por la Cámara en pleno. [I, 472]

4/octubre - Circula una carta firmada por 29 congresistas en la que solicitan a sus colega apoyo para el HR 4765 cuando se considere ante la Cámara en pleno. Entre los firmantes figuran los congresistas de Lugo, Lagomarsino, Udall, Fuster, Miller, Moakley, Rangel, Serrano y Green. [I, 61]

5/octubre - En una carta del presidente Bush al congresista de Lugo, éste felicita a su Subcomisión por aprobar legislación plebiscitaria e insta al "Congreso a tomar acción afirmativa y rápida sobre cualquier medida responsable que se plantee ante su consideración para lograr un plebiscito sobre el status político de Puerto Rico. Estoy listo para firmar tal legislación tan pronto llegue a mi escritorio." [I, 62]

10/octubre - La Cámara de Representantes aprueba el HR 4765, "Ley para la Autodeterminación de Puerto Rico", bajo el mecanismo parlamentario de suspensión de las reglas. [I, 479]

El senador Johnston anuncia desde el hemiciclo del Senado que el HR 4765 es inaceptable y señala que pospondrá los esfuerzos en el Senado hasta el próximo Congreso. [I, 477-478]

11/octubre - Los presidentes de los partidos políticos de Puerto Rico suscriben una carta conjunta al senador Johnston: "le instamos respetuosamente a que acepte el proyecto de la Cámara (HR 4765), con enmiendas". [I, 65]

15/octubre - El congresista Udall, en una carta al senador Johnston, resume el proceso que llevó al impasse a finales del 101o Congreso, reafirma la negativa de la Cámara a aceptar un proyecto autoejecutable, insiste en favorecer las definiciones generales sobre las detalladas, y advierte que la posposición hasta el próximo Congreso muy probablemente llevaría a un impasse similar. [I, 66]

18/octubre - Se emite una declaración conjunta de los líderes de los partidos de Puerto Rico para instar al Congreso y al Presidente a aprobar legislación plebiscitaria antes del cierre de la sesión, y solicitar reuniones inmediatas con el presidente Bush, con los congresistas Foley y de Lugo, y con los senadores Mitchell y Johnston. [I, 70]

22/octubre - El senador Johnston responde a la carta del congresista Udall del 15 de octubre. Lamenta que no se haya aprobado legislación durante el 101o Congreso y hace énfasis en su compromiso firme con este proceso señalando que su meta es trabajar rápidamente en el próximo Congreso para lograr un plebiscito en el 1991 o a comienzos de 1992. [I, 74]

25/octubre - Miembros de la Comisión de Agricultura del Senado envían una carta al senador Johnston en la que señala que lamentan la falta de tiempo para considerar el S.712 y anuncian la política pública de otorgar beneficios completos de asistencia nutricional federal bajo el Estado Libre Asociado. La carta está firmada por los senadores Patrick Leahy, Richard Lugar, David Pryor, Bob Dole, Tom Harkin, Thad Cochran, Max Baucus, Boschwitz, Christopher Bond y Mitch McConnell. [I-75]

25/octubre - Aparece el editorial del Washigton Post titulado "El Asunto de Puerto Rico" ("The Puerto Rico Question"). Insta al Senado a aceptar el proceso legislativo propuesto por la Cámara: "Un referéndum de menor alcance como el primer paso en un largo proceso ...(en el cual) el Congreso no se compromete, sino para mantener vivo un proceso que se acogería con entusiasmo si se estuviese dando en Europa Occidental o en las Bálticas. El senador Johnston debe reconsiderar."

25/octubre - Los líderes de los partidos políticos de Puerto Rico se reúnen con el senador Johnston en Washington para discutir el futuro de la legislación plebiscitaria. En conferencia de prensa conjunta, el senador Johnston expresa su compromiso de trabajar por que se apruebe legislación antes del 4 de julio. El gobernador Hernández Colón condiciona su aceptación de este itinerario de trabajo a recibir el endoso formal del PPD como partido de gobierno.

26/octubre - En una carta de miembros de la Cámara al senador Johnston le solicitan que reconsidere su decisión de posponer la legislación del referéndum hasta el 102o Congreso y que traiga el HR 4765 al Senado en pleno antes del final de la sesión. La firman los congresistas Ted Weiss, José Serrano, Charles Rangel, Bill Green, Gary Ackerman, Thomas Manton, Frank Horton, Benjamin Gilman, Robert Mrazek, James Scheuer, Major Owens, Eliot Engel, Amo Houghton. [I, 77]

NOVIEMBRE, 1990

6/nov. - Un editorial del New York Times titulado "Promesas Pálidas para Puerto Rico" reflexiona sobre el fracaso del Congreso en aprobar legislación plebiscitaria debido al impasse entre la Cámara y el Senado Federal. Señala que "Los puertorriqueños han aprendido a no perder el sueño ante las promesas de acción del Congreso".

13/nov. - En un mensaje televisado al pueblo de Puerto Rico, el gobernador Hernández Colón señala que para poder retomar el proceso legislativo sobre el estatus y lograr un plebiscito en 1992, el liderato congresional debe resolver las diferencias que derrotaron la legislación en el 101o Congreso tan pronto comience la sesión del 102o Congreso.

17/nov. - El Consejo General del PPD, reunido en Ponce, adopta una resolución para endosar la continuación de los esfuerzos plebiscitarios en 1991, si para el 19 de febrero de 1991 el liderato bipartita del Congreso acuerda un enfoque legislativo de consenso respecto al nivel de detalle de las definiciones de estatus y al mecanismo para la implantación de los resultados del plebiscito. De no satisfacerse estas condiciones, establece que el plebiscito debe celebrarse posterior a las elecciones generales de 1992. Solicita que las definiciones de las fórmulas de estatus sean de "igual dignidad política, no subordinadas al poder plenario del Congreso bajo la cláusula territorial de la Constitución".
[I, 79]

29/nov. - Los presidentes de los partidos políticos de Puerto Rico suscriben una carta conjunta al liderato congresional para exigir un acuerdo entre Cámara y Senado sobre un proyecto de consenso al comienzo de la sesión del 102o Congreso, de modo que el proyecto se pueda aprobar para el verano de 1991 y el plebiscito pueda celebrarse en otoño. [I, 86]

DICIEMBRE, 1990

3-6/dic. - Los senadores de la Comisión de Energía y Recursos Naturales Johnston, Wallop y Nickles visitan Puerto Rico. El senador Johnston discute el borrador de su nuevo proyecto plebiscitario con los presidentes de los partidos en Puerto Rico. El proyecto incluye tres definiciones detalladas (una versión enmendada del S.712, que incluye las enmiendas de la Comisión de Finanzas), pero no es autoejecutable.

30/dic. - Miembros del Partido Republicano en Puerto Rico, dirigidos por Luis A. Ferré, anuncian una campaña para recoger 300,000 firmas y probar la fortaleza del partido en Puerto Rico.

1991

ENERO, 1991

2/enero - El senador Johnston anuncia que radicará legislación plebiscitaria el 23 de enero y que celebrará vistas el 30 de enero.
3/enero - El congresista de Lugo radica su proyecto plebiscitario en la Cámara (HR 316) que es exactamente igual al HR 4765. El liderato republicano en la Cámara rehúsa auspiciar el proyecto a pesar de haberlo apoyado el año anterior. [I, 526]

30/enero - Se celebran vistas de la Comisión de Energía y Recursos Naturales del Senado sobre el S.244 en Washington con los presidentes de los tres partidos de Puerto Rico.

FEBRERO, 1991

7/febrero - Continúan las vistas de la Comisión de Energía y Recursos Naturales del Senado sobre el S.244 en Washington con los representantes de la Administración Bush.

20/febrero - La Comisión de Energía y Recursos Naturales del Senado se reúne formalmente para discutir el S.244. Se evidencia una fuerte oposición a la estadidad en los comentarios de varios senadores.

20/febrero - El Nuevo Día publica los resultados de la encuesta de Kaagan Research/Stanford Klapper Associates: Estado Libre Asociado 41%, Estadidad 39%, Independencia 5%.

26/febrero - Se recibe una carta en la cual el Presidente Bush insta al senador J. Bennett Johnston, Presidente de la Comisión de Energía y Recursos Naturales del Senado, a "tomar acción en favor de la celebración de ... un plebiscito".

27/febrero - El proyecto S.244 es derrotado en la Comisión de Energía y Recursos Naturales del Senado por un impasse de 10 a 10. Siete republicanos y tres demócratas votan en contra del proyecto aduciendo objeciones a la opción de la estadidad. Una enmienda alterna presentada por el senador Wallop en la cual se reconocería el derecho de Puerto Rico a la libre determinación mediante un plebiscito local también es derrotada.

MARZO, 1991

8/marzo - De Lugo declara ante la prensa norteamericana que a menos que el Senado actúe sobre el S.244, la Cámara no considerará el HR 316.

17/marzo - En una entrevista con la prensa puertorriqueña, el senador Johnston afirma que la legislación sobre el plebiscito está muerta en el 102o Congreso.

20/marzo - EL gobernador Hernández Colón concuerda con el senador Johnston en que no existen oportunidades de aprobar legislación plebiscitaria para celebrar una consulta en 1991.

A CHRONOLOGY OF THE PROCESS FOR A REFERENDUM ON THE STATUS OF PUERTO RICO 1989-1991

1989

JANUARY 1989

1/2 - In his Inaugural Address, Governor Rafael Hernández Colón calls for a political status referendum stating that "The vast majority of Puerto Ricans wish to express their view on our political status. The people wish to be consulted", and urging the Federal Government to make public its position regarding the issue. [I, 1]

1/17 - The presidents of Puerto Rico's principal political parties, Governor Hernández-Colón (PDP), Baltasar Corrada del Río (NPP), and Rubén Berríos-Martínez (PIP), sign a joint letter to President Bush and the Congressional leadership requesting referendum legislation "with the guarantee that the will of the people once expressed shall be implemented through an act of Congress." The letter is send to Senators George J. Mitchell, Bob Dole, J. Bennett Johnston and James McClure, and to Congressmen Jim Wright, Robert H. Michel, Morris Udall, Ron de Lugo, and Robert Lagomarsino. [I, 12]

FEBRUARY 1989

2/9 - President Bush urges Congress to act on Puerto Rico's political status and states his personal preference for statehood in his first State of the Union Address [I,11].

2/14 - In a letter to President Bush, Governor Hernández-Colón welcomes his endorsement of the referendum process and requests that he remains neutral and abstains from campaigning on behalf of any particular formula. [I, 15]

2/21 - *El Nuevo Día,* a Puerto Rico daily newspaper, publishes a Yankelovich-Stanford Klapper Associates status poll. Results: Commonwealth, 45%; Statehood, 35%; Independence, 5%; Undecided, 11%. The poll reveals that 78% of the electorate favors holding a plebiscite.

2/26 - Former Governor Carlos Romero-Barceló is elected President of the New Progressive Party (NPP) at an assembly in Guaynabo, after the former Mayor of San Juan and 1988 NPP gubernatorial candidate Baltasar Corrada del Río resigns from the post in late January.

2/27 - Senator J. Bennett Johnston, Chairman of the Senate Energy and Natural Resources Committee, meets with Puerto Rican party presidents in San Juan to discuss federal legislation for a status referendum.

MARCH 1989

3/9 - Release of a CRS memorandum on U.S. citizenship of Puerto Ricans subscribed by John H. Killian, senior specialist of American constitutional law of the Library of Congress. Report reviews juridical precedents on citizenship, and discusses how constitutional guarantees of citizenship would likely not apply should Puerto Rico opt for independence. Sparks bitter prolonged controversy in P.R. on whether U.S. citizenship is constitutionally guaranteed under Commonwealth. (The full Spanish translation of this report was published on *El Nuevo Día* and *El Mundo* on June 8, 1989.)
[II, 81]

3/16 - Senator J. Bennett Johnston announces that he would soon introduce referendum legislation in a statement delivered in the U.S. Senate floor. [I, 121]

3/25 - Senator Johnston and Senator McClure send a letter to President Bush requesting the administration's assistance for legislation on Puerto Rico's political status. The letter states that legislation must be approved in the 101st Congress if a plebiscite is to be held before the 1992 general elections and requests the designation of a lead agency and contact persons for Congress to work with on this matter.
[I, 19]

APRIL 1989

4/5 - Senator Johnston introduces three different referendum bills, S.710, S.711 and S.712, with varying degrees of specificity in the definitions of each formula. Puerto Rico's political leadership generally favors S.712, which is self-implementing and would not require further Congressional legislation. The three political parties are to submit proposed definitions of their respective status for consideration by the Senate Committee on Energy and Natural Resources by May 9th. [I, 129]

4/30 - The Governing Board of the Popular Democratic Party approves a definition of enhanced Commonwealth establishing: (1) broader self-government in local matters; (2) that Federal policies would take into account local conditions and seek to accelerate the Island's economic and social development; (3) safeguards for the distinct identity and culture of the Puerto Rican people; (4) a mechanism for Puerto Rico to enter in international agreements; and, (5) parity in federal assistance programs. [I, 30]

MAY 1989

5/3 - The Puerto Rican Independence Party presents its definition for independence. It establishes: (1) complete withdrawal of U.S. military forces from Puerto Rico; (2) dual (U.S.-Puerto Rican) citizenship for 25 years; (3) a 20-year transition period of open access for Puerto Rican products to the USA; (4) extension of Section 936 provisions for 25 years; (5) extension of federal social programs and transfers for 20 years as a block grant to the Puerto Rican government; and, (6) full sovereignty as an independent republic.

5/9 - The New Progressive Party subscribes its definition for Puerto Rican statehood including: (1) Spanish and English as official languages; (2) immediate and full extension of all federal social programs; (3) federal income tax exemption during the first 25 years of statehood; (4) extension of Section 936 for 25 years; (5) the right to vote for the President; and (6) full Congressional representation.

JUNE 1989

6/1-2 - Senate Energy and Natural Resources Committee hearings to discuss the proposed definitions of the three statuses; the three Puerto Rico party presidents testify in Washington.

6/13 - White House official Andrew Card states in Puerto Rican press that the Administration will not create the referendum working group requested by Senator Johnston and Senator McClure.

6/16-17-19 - Senate Energy and Natural Resources Committee field hearings in San Juan, Puerto Rico. Participants include Puerto Rican political and civic leaders, scholars, independent organizations. Senators Johnston, McClure and Moynihan attend the hearings.

6/17 - Puerto Rican press reports that Johnston does not consider Commonwealth a colony and that "the American citizenship of Puerto Ricans is irrevocable". Johnston adds that CRS report of March 9 on U.S. citizenship "was interpreted wrongly," as it only refers to independence, not to Commonwealth.

6/22 - The Dialogue Committee on Political Status is instituted by Executive Order of the Governor of Puerto Rico upon agreement by Puerto Rico party presidents. It is intended to provide a forum for the discussion and solution of referendum-related issues. The Government of Puerto Rico funds are allocated to the three parties. The membership consists of party presidents and their representatives: José M. Berrocal (PDP), Benny Frankie Cerezo (NPP), and Fernando Martín (PIP). [I, 35]

6/23 - A letter to President Bush is signed by Senators Johnston and McClure, Rafael Hernández-Colón, Carlos Romero-Barceló, and Rubén Berríos-Martínez requesting immediate cooperation from the Administration to advance THE referendum legislation. [I, 44]

JULY 1989

7/11,13,14 - Senate Energy and Natural Resources Committee hearings on S.712; witnesses include officials from the Justice, Defense, Treasury, and State Departments.

AUGUST 1989

8/2 - Senate Committee on Energy and Natural Resources favorably reports S.712, by a 11-8 vote after considering bill during four days of meetings. Bill provides for a self-executing referendum based on detailed definitions of each status formula. S.712 is jointly referred to the Senate committees on Finance and on Agriculture, Nutrition and Forestry. The original party proposals are substantially altered. Commonwealth is denied parity in federal assistance programs, and proposals for broader self-government are significantly curtailed. Independence is conditioned upon the permanence of U.S. military installations, the economic transition is shortened, and federal aid is substantially limited. Statehood definition is silent on official languages, and federal tax exemption and Section 936 is limited to first 5 years of statehood.

8/4 - Senator Moynihan in a statement on the Senate floor discusses S.712. He expresses concern with welfare dependence under statehood. On the basis of two new CRS reports, he concludes that "statehood [as reported by the Senate Energy Committee] offers Puerto Ricans the prospect of immediate social welfare benefits but long-term economic losses... By contrast, the Commonwealth promises long-term economic gains."

SEPTEMBER 1989

9/6 - The CBO reveals cost estimates for S.712: statehood would cost the U.S. more than any other option, its implementation under S.712 requiring outlays in excess of $9,000 million by 1995 (triple the original $3.6 billion estimated by Senate Energy and Natural Resources Committee).

OCTOBER 1989

10/2 - *El Nuevo Día,* , publishes Yankelovich-Stanford Klapper Associates status poll results: Statehood 41%, Commonwealth 37%, Independence 4%, Undecided 18%. It is the first report ever of a statehood lead in Puerto Rico.

10/23 - Senator Johnston writes a letter to Congressman Morris Udall, Chairman of the House Interior and Insular Affairs Committee, and Congressman Ron de Lugo, Chairman of the House Insular and International Affairs Subcommittee, urging them to initiate the referendum legislative process in the

House and not wait for passage of Senate bill. To save time, Senator Johnston suggests that S.712 be introduced in the House and hearings be held in P.R. in December or January.

10/26 - Congressman Robert Lagomarsino, Ranking Minority Member of the House Insular and International Affairs Subcommittee introduces status referendum bill in the House; essentially S.712 without the Senate Energy and Natural Resource Committee tax and spending provisions. Chairman de Lugo refuses to act on the bill due to lack of support by all three Puerto Rican political parties. [I, 242]

NOVEMBER 1989

11/2 - CBO reveals a revision of the cost estimates for S.712 disclosed on September 6, 1989. [I, 243]

11/6 - Udall letter to Johnston (response to 10/23/89 letter) expressing House objections to self-implementing legislation, and specifically citing Speaker' opposition to S. 712 mechanism. **He states that self-implementation may prompt moves to couple the issue of DC statehood to the Puerto Rico bill. He also alleges the lack of support to S.712 by three parties in Puerto Rico.**

11/8 - In a luncheon meeting in Washington between Senate Majority Leader George Mitchell, Chairman of the Finance Committee Lloyd Bentsen, Senator Johnston, Senator Moynihan, PDP President Hernández-Colón, NPP President Romero-Barceló, and PIP President Berríos-Martínez, the Senate leadership pledges a Senate vote on the referendum bill in 1990.

11/9 - Senate Agriculture Committee held hearings on S.712: Governor Hernández-Colón firmly criticizes S.712's front-loading of statehood. Requests parity in social programs under Commonwealth.

11/14-15 - Senate Finance Committee held hearings on revenue and spending provisions of S.712. Witnesses include: P.R. party presidents; Kenneth Gideon, Assistant Secretary of the Treasury for Tax Policy; Shirley D. Peterson, Assistant U.S. Attorney General, Tax Division; Constitutional Law Professor Laurence Tribe of Harvard, GAO, CRS and CBO.

11/16 - The Senate Finance Committee requests from the CBO and the Joint Economic Committee a study on the economic impact of the three status options in S.712.

1990

JANUARY 1990

1/30 - Linda G. Morra of GAO and Clay H. Welbourn of CRS conduct a briefing on Puerto Rico's political status for the members of the House Interior and Insular Affairs Committee, followed by presentations by the three Puerto Rican party representatives to the Dialogue Committee on Status.

FEBRUARY 1990

2/13 - *El Nuevo Día,* publishes Kaagan Research/Stanford Klapper Associates status poll. Results: Statehood, 43%; Commonwealth, 36%; Independence, 5%; Undecided, 16%.

2/26 - The New York Times op.ed. page features an article of Governor Hernández-Colón stressing statehood's negative economic and cultural impact on the Island.

MARCH 1990

3/2 - House Insular Affairs Subcommittee holds hearings in Washington on how to structure status referendum legislation. The three Puerto Rico party presidents testify.

3/8 - KMPG Peat Marwick Policy Economics Group releases a study on "Economic and Fiscal Impacts of Puerto Rican Statehood" which concludes that statehood would dramatically dislocate Puerto Rico's economy, hiking unemployment to 40% (a loss of 80,000 to 145,000 jobs) and resulting in a net cumulative deficit to the Federal Government of $22 billion to $25 billion by 2000. [II, 305]

3/9-10-12 - House Insular and International Affairs Subcommittee holds field hearings in San Juan, Ponce and Mayagüez. Chaired by Congressman Ron de Lugo and attended by Congressmen Robert Lagomarsino, James McClure Clarke, Richard Lehman, Ben Blaz, Eni Falaeomavaega, and Jaime Fuster. Over 80 witnesses, including scholars, and political, business, and civic leaders, testified.

APRIL 1990

4/5 - CBO releases a report on the "Potential Economic Impacts of Changes in Puerto Rico's Status under S.712" concluding that under statehood Puerto Rico would suffer a drop in GNP of 10-15% by the year 2000, accompanied by a loss of 50,000 to 100,000 jobs in the private sector. [II, 1]

4/24 - A Washington Post editorial criticizes S.712's front-loading of statehood and warns that the bill will not be approved because of the time limitation.

4/26 - Senate Finance Committee hearings on S.712, center on CBO report. CBO director Robert D. Reischauer, Treasury's international tax counsel Philip Morrison, Health and Human Resources Department Assistant Secretary Martin Gerry, and CBO economist Fred Ribe testify.

4/30 - Congressman de Lugo announces that he will file a referendum bill in the House within "the next week to ten days." He states that S.712 is in "deep trouble" and anticipates that his bill will not be self-implementing.

MAY 1990

5/1 - Governor Hernández-Colón announces in San Juan that any referendum bill that does not commit Congress to its results is unacceptable.

5/9 - Congressman de Lugo introduces H.R. 4765, a bill with general definitions and a two-step process requiring a second round of legislation to implement winning formula. [I, 261]

5/14-17 - In a visit to Puerto Rico, the Deputy Chief of Staff of the White House, Andrew Card, and the Director of Presidential Personnel and Liaison for Puerto Rico, Chase Untermeyer, support statehood. During their high-profile stay, they endorse public pro-statehood activities, and assured that, with the President's strong endorsement, statehood will win. Mr. Untermeyer states that "its about time that democracy reach here in Puerto Rico."

5/16 - Governor Hernández Colón writes a letter to President Bush expressing disappointment for the latter's pro-statehood activism. He urges the Bush administration to remain neutral and avoid tilting the referendum process, so that it can be conducted "free of outside interference and distortion." [I, 48]

5/17 - Statehood delegate to the Dialogue Committee Benny Frankie Cerezo makes public the Hex, Inc. memorandum on "Puerto Rican Statehood: A Condition for Solid Economic Development", which contradicts the findings of the CBO report about the adverse impact of statehood on the economy of Puerto Rico. [II, 437]

5/23 - President Bush replies to Governor Hernández-Colón's May 16 letter expressing that he does not consider his --nor his staff's-- actions "outside interference," and that his staff will not refrain from expressing its views. [I, 51]

5/31 - A CRS Brief on the "Impact of Puerto Rican Statehood on Puerto Rican Financial Instruments" is released. The brief sustains that the imposition of federal taxes and the repeal of Section 936 would probably result in higher borrowing costs for Puerto Rico. The study also points to the financial problems that the local government will face with the extension of an additional layer of taxation under statehood, implying a need for a reduction of government services and employment. [II, 203]

JUNE 1990

6/5 - A meeting of Congressmen de Lugo and Lagomarsino with the presidents of Puerto Rico's political parties is held in Washington, to receive the proposed definitions for their respective status formulae.

6/25 - The House Insular and International Affairs Subcommittee holds field hearings in New York on HR 4765. The hearings center on Congressman José Serrano's amendment to extend participation in the referendum to Puerto Ricans that reside in the United States. Congressman Bill Richardson chairs the Hearing. Congressmen José Serrano, Bill Green, Charles Rangel, and Jaime Fuster were present. Some 40 witnesses forcefully demand the so called "offshore vote."

6/28 - House Insular and International Affairs Subcommittee hearings on HR 4765 are held in Washington and chaired by James Clarke. The Puerto Rican party presidents explain their proposed status definitions. Assistant U.S. Attorney General Stuart Gerson also testifies.

JULY 1990

7/10 - A letter signed by Congressmen Fuster, Darden, Lewis, Blaz and Faleomavaega, all members of the House Insular and International Affairs Subcommittee to Chairman de Lugo supports his efforts on H.R. 4765 and states that the Subcommittee is ready to report out the bill with the definitions submitted by the three parties. [1, 53]

7/25 - Constitution Day in Puerto Rico. Special address by Governor Rafael Hernández-Colón on the celebration of the 38th anniversary of the Commonwealth.

7/27 - U.S. Interior Secretary Manuel Luján addresses a pro-statehood rally in Bayamón, Puerto Rico, reassuring statehood advocates of the Bush administration's commitment to their cause.

AUGUST 1990

8/1 - The Senate Finance Committee unanimously amends S.712 to establish a level playing field on the economic provisions of each formula and make them revenue-neutral over a 5-year period. Statehood delayed until 1996. Commonwealth granted parity on federal social programs, subject to an appropriate contribution by the commonwealth government. The Committee makes no recommendation on whether the bill as amended should be approved.

8/1 - Governor Hernández-Colón sends a letter to Congressman de Lugo responding to his inquiry on the Puerto Rico government official position regarding vote for non-resident Puerto Ricans. The Governor states that the Commonwealth government favors the inclusion of a provision in HR 4765 for such a vote.

8/3 - The House Insular and International Affairs Subcommittee approves HR 4765 by a 10-0 vote. The bill does not include definitions, provides for two-step process, requiring further legislation after the referendum. The status definitions are included in the House Interior and Insular Committee Report 101-790, Part 1. [I, 452]

SEPTEMBER 1990

9/19 - The House Interior and Insular Affairs Committee approves HR 4765 by a 37-1 vote. Republican Ron Marleene of Montana casts the sole dissenting vote. The bill authorizes "offshore vote" contingent upon agreement by two of P.R.'s three parties on its implementation.

OCTOBER 1990

10/2 - The House Rules Committee unanimously recommends HR 4765 for House floor consideration. [1, 472]

10/4 - A "Dear colleague" letter asking for floor support to HR 4765 is sent. Among the 29 signatures are those of Congressmen de Lugo, Lagomarsino, Udall, Fuster, Miller, Moakley, Rangel, Serrano, and Green. [I, 61]

10/5 - President Bush sends a letter to de Lugo commending his subcommittee for its efforts on producing legislation that will soon reach the House floor and urging "the entire Congress to act affirmatively and rapidly on whatever responsible measure comes before them to call for a referendum on Puerto Rico's political status. And I stand ready to sign such legislation when it reaches my desk." [I, 62]

10/10 - The House of Representatives approves HR 4765, "The Puerto Rico Self-determination Act," under suspension of the rules. Senator Johnston announces on the Senate floor that HR 4765 is unacceptable and states that he will defer the Senate referendum effort until the next Congress. [I, 477-478]

10/11 - Puerto Rican party presidents subscribe joint letter to Senator Johnston: "To facilitate the legislative process and assure legislation, we respectfully urge you to accept the House bill (HR 4765), with amendments." [I, 65]

10/15 - A letter from Congressman Udall to Senator Johnston reviews the process leading to the impasse at the end of the 101st Congress. He reinstates House unwillingness to accept a self-executing bill; insists on general definitions over detailed ones such as those in S.712; and warns that postponement to the next Congress will most surely lead to a similar impasse. [I, 66]

10/18 - A joint statement from Puerto Rico party leaders urging Congress and the President to pass referendum legislation before adjournment, and requesting urgent meetings with President Bush and with Congressmen Foley and de Lugo, and Senators Mitchell and Johnston. [I, 70]

10/22 - Senator Johnston responds to Congressman Udall's October 15 letter. He regrets failure to pass referendum legislation in 101st Congress and stresses "solid" commitment to the process; expresses goal of working promptly in the next Congress for a 1991 or early 1992 referendum. [I, 74]

10/25 - The Senate Agriculture, Nutrition and Forestry Committee sends a letter to Johnston regretting lack of time to mark-up S.712 and expressing a policy of full federal nutrition assistance benefits under Commonwealth. Signed by Senators Leahy, Lugar, Pryor, Dole, Harkin, Cochran, Baucus, Boschwitz, Bond, McConnell. [I, 75]

10/25 - The Washington Post publishes the editorial on "The Puerto Rico Question". It urges the Senate to accept the House legislative approach: "a less ambitious referendum as the first step in a longer process...[in which] Congress would not be committing itself, only keeping alive a process that in Eastern Europe or the Baltics it would be heartily endorsing. Sen. Johnston should reconsider."

10/25 - Puerto Rico party leaders meet in Senator Johnston's office to discuss future efforts to approve referendum legislation. In a joint conference, Senator Johnston expresses commitment to push for legislation by July 4th. Governor Hernández-Colón conditions the acceptance of timetable to PDP's endorsement as governing party.

10/26 - House members send a letter to Senator Johnston urging him to reconsider decision to postpone referendum legislation to the 102nd Congress, and to bring HR 4765 to the Senate floor before adjournment. The letter is signed by Congressmen Ted Weiss, José Serrano, Charles Rangel, Bill Green, Gary Ackerman, Thomas Manton, Frank Horton, Benjamin Gilman, Robert Mrazek, James Scheuer, Gerald Solomon, Major Owens, Eliot Engel, Amo Houghton. [I, 77]

NOVEMBER 1990

11/6 - The NY Times "Pallid Promises to Puerto Rico" editorial reflects on Congress' failure to approve referendum legislation because of the House/Senate impasse. It states that "Puerto Ricans have learned not to hold their breath when members of Congress promise action."

11/13 - Governor Hernández-Colón in a televised address to the people of Puerto Rico states that in order to restart the legislative process for a referendum before the 1992 elections, the Congressional leadership must resolve early on in the 102nd Congress the differences that derailed the legislation in the 101st Congress.

11/17 - The island-wide leadership of the PDP, assembled in Ponce, adopts a resolution endorsing the continuation of the referendum legislative efforts. It pledges to work toward a 1991 referendum if by February 19 the bipartisan leadership of House and Senate agree on a consensus legislative approach regarding the specificity of the status definitions and the mechanism of implementation of the referendum results. Otherwise, the referendum would be held after the 1992 general elections. It requests that the definitions of status formulae be "of equal political dignity and not subordinate to the plenary powers of Congress under the Territorial Clause."
[I, 79]

11/29 - The Puerto Rican party presidents sent a joint letter to Congressional leaders demanding House/Senate agreement on a consensus bill early during the 102nd Congress so that a bill be approved in the summer of 1991 and a referendum be held in the fall. It echoes the PDP referendum timetable adopted in Ponce. The letter is sent to Senators Mitchell, Dole, Bentsen, Johnston, Packwood, Wallop, and Congressmen Foley, Michel, de Lugo, Lagomarsino, Udall and Young. [I, 86]

DECEMBER 1990

12/3-6 - Senate Energy Committee Senators Johnston, Wallop and Nickles visit Puerto Rico. Senator Johnston discusses his new referendum draft bill with the three Puerto Rico party presidents. The draft bill includes detailed definitions (slightly amended version of S.712, including Senate Finance Committee amendments) but is not self-executing.

12/30 - Members of the Republican Party of Puerto Rico, led by former Governor Luis A. Ferré, announce a 300,000 affiliates registration drive to persuade U.S. Senators of the strength of the local GOP.

1991

JANUARY 1991

1/2 - Senator Johnston announces that he will introduce referendum legislation on January 23. Hearings will be held on January 30.

1/3 - De Lugo introduces a referendum bill in the House (HR 316). The bill is exactly the same as HR 4765. The House Republican leadership refuses to cosponsor bill, although it had done so in the previous Congress. [I, 526]

1/30 - Senate Energy and Natural Resources Committee hearings on S.244 were held. The three Puerto Rican party presidents testify.

FEBRUARY 1991

2/7 - The Senate Energy and Natural Resource Committee hearings on S. 244 continue with witnesses from the Administration testifying.

2/20 - The Senate Energy and Natural Resource Committee meets formally to discuss S. 244. Strong opposition against statehood is evident in the comments of various members.

2/20 - *El Nuevo Día,* publishes Kaagan Research/Stanford Klapper Associates status poll results: Commonwealth: 41%, Statehood: 39%, Independence: 5%.

2/26 - A letter by President Bush to Senator Bennett Johnston, Chairman of the Energy and Natural Resource Committee urging him "to act favorably on calling for... a referendum."
2/27 - The Senate Energy and Natural Resources Committee fails to pass S.244, a bill to provide for a referendum on the status of Puerto Rico by a 10 to 10 impasse. Seven Republicans and three Democrats voted against the bill, citing objections to the statehood option. A substitute presented by Senator Wallop that would have recognized Puerto Rico's right to self-determination through a local plebiscite is also defeated.

MARCH 1991

3/8 - Congressman de Lugo states to the Puerto Rican press that unless the Senate moves on S. 244 the house will not consider H.R. 316.

3/17 - In an interview with the Puerto Rican press, Senator Johnston states that the status referendum legislation is dead for the 102nd Congress.

3/20 - Governor Rafael Hernández Colón joins Senator Johnston in acknowledging that there are no chances for passage of referendum legislation so that a vote may be held in 1991.

CBO- Congressional Budget Office - Oficina de Presupuesto del Congreso
CRS- Congressional Research Service - Servicio de Investigación Congresional
GAO- U.S. General Accounting Office - Oficina de Contraloría General del Gobierno Federal
PIP- Puerto Rican Independence Party, *(Partido Independentista Puertorriqueño)*
NPP- New Progressive Party, *(Partido Nuevo Progresista)* pro-statehood party
PDP- Popular Democratic Party *(Partido Popular Democrático)*, pro-commonwealth party

NOTAS

CBO PAPERS

POTENTIAL ECONOMIC IMPACTS OF CHANGES IN PUERTO RICO'S STATUS UNDER S. 712

April 1990

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

NOTES

Puerto Rican fiscal years start on July 1 of the preceding calendar year.

U.S. fiscal years start on October 1 of the preceding calendar year.

Details in the text and tables of this report may not add to totals because of rounding.

Puerto Rican gross product is referred to as gross national product (GNP).

The provisions of S. 712 considered in this report are those contained in the bill as reported by the Senate Committee on Energy and Natural Resources.

Corporations in Puerto Rico that, if current status continues, would qualify under the provisions of Section 936 of the Internal Revenue Code are referred to throughout this report as "Section 936 corporations." This designation is used here for convenience, even though S. 712 stipulates that, for such firms, application of the provisions of Section 936 would be phased out under statehood and would be eliminated under independence.

PREFACE

Puerto Rico is scheduled to hold a referendum in the summer of 1991 to determine its future as a political entity: citizens will vote on whether to remain a commonwealth within the United States, to become a state of the Union, or to become an independent nation. A bill now pending in Congress, S. 712, would make the results of the referendum binding under specific legal and financial terms that are set out in the bill.

The Senate Finance Committee has requested that the Congressional Budget Office (CBO) study the important consequences that any of the three "status options" could have for Puerto Rico's economy. This paper presents the results of CBO's analysis. Matthew Salomon and John Sturrock of CBO's Fiscal Analysis Division prepared the paper under the direction of Frederick Ribe and Robert Dennis. Mark Booth wrote Appendix A, and he and Trevor Alleyne made important contributions at all stages of the analysis. Nick Dugan provided expert research assistance. Other individuals inside and outside CBO who made valuable comments include James Blum, Joseph Cordes, Harry Grubert, Robert Hartman, Hoe Ee Khor, Cory Leach, Rosemary Marcuss, Chuck Seagrave, James Tobin, and Bernard Wasow.

In preparing the paper, CBO consulted with representatives of the commonwealth, statehood, and independence parties in Puerto Rico. Consultations were held with Jose Berrocal, William Ocasio, and Jaime Capellá representing the commonwealth party, together with representatives of KPMG Peat Marwick, consultants to the party; with Benny Frankie Cerezo of the statehood party, together with representatives of Quick, Finan and Associates, consultants to the party; and with Manuel Rodriguez-Orellana, Francisco Catalá, Erick Negrón, and Pedro Parrilla, representing the independence party.

Sherry Snyder edited the paper, and Dorothy Kornegay and Verlinda Lewis typed the many drafts. Ms. Kornegay produced the final version.

Robert D. Reischauer
Director

April 1990

CONTENTS

SUMMARY OF CONCLUSIONS

A bill now before the Congress provides for a referendum in Puerto Rico scheduled for 1991 to determine the island's political status. In the referendum, voters in Puerto Rico would choose to become a state, to become an independent republic, or to remain a commonwealth within the United States (although with enhanced status). The Congressional Budget Office (CBO) has been asked to estimate how a change in Puerto Rico's status, if it were made under the stipulations of the current version of the bill (S. 712), would affect the island economy over the remainder of the decade.

As S. 712 defines them, the various status options could have important implications for Puerto Rico's economy, though the outcomes are hard to predict with confidence. Many of the most important economic implications of the changes in status are impossible to quantify with the usual economic methods, and this report makes no attempt to do so.

Those aspects of statehood under S. 712 that CBO is able to quantify may eventually bring about a significant reduction in the growth of the Puerto Rican economy. Increased federal transfers (less new taxes) would initially stimulate the economy. Later, however, statehood could lead to slower economic growth than would be expected under commonwealth status because statehood could reduce the growth of investment, output, and employment in the manufacturing sector. This reduction would be initiated because, under statehood, U.S. corporations operating in Puerto Rico would no longer enjoy tax advantages provided by Section 936 of the Internal Revenue Code.

The results would depend, in part, on the speed and degree with which U.S. corporations would slow the rate at which they invest on the island. They would also depend on the size of the Section 936 sector compared with the rest of the Puerto Rican economy. The possible scenarios that CBO investigated suggest that between 1992 and 2000, projected annual growth in Puerto Rico's real (inflation-adjusted) gross national product under statehood might be slower by about one to two percentage points than under current commonwealth status. These declines in growth are consistent with a reduction of between 10 percent and 15 percent in the level of Puerto Rico's gross national product (GNP) in the year 2000 from the levels that would otherwise be projected for that year. These reductions in the growth of real GNP would be accompanied by annual growth in employment about one-half to one percentage point slower than that projected under commonwealth status.

These figures should be regarded as rough guides to the magnitudes involved, not as precise estimates of the behavior of the Puerto Rican economy under statehood. They cannot take into account the unquantifiable gains from statehood, such as the effects of reduced uncertainty about Puerto Rico's future status and increased awareness of the opportunities that it offers. These effects, which generally would work to improve the economic outlook under statehood, may be significant, though CBO can give no estimate of their size.

If Puerto Rico became independent, the economic changes might be quite different but are even harder to predict. CBO has not attempted to prejudge how much direct investment Puerto Rico could attract under independence. If direct investment from outside were to remain at the levels projected under a continuation of commonwealth status, the reduction and eventual elimination of federal transfers

to Puerto Rico from baseline levels mandated by S. 712 would be likely to cause relatively small reductions in the growth of real GNP--on the order of 0.2 to 0.3 percentage point per year over the period from 1992 to 2000. In addition, an independent Puerto Rico would face interest rates on funds borrowed abroad that would be at least two percentage points higher than those it would pay under other status options. These changes may be accompanied by others, either positive or negative, that could potentially be larger, but CBO has not been able to quantify them. These possible changes include expansion in direct investment in Puerto Rico by countries other than the United States, reduced economic dependency among the Puerto Rican people, and complications in obtaining external finance for the balance of payments.

INTRODUCTION

The Congress is now considering a Senate bill, S. 712, that provides for and would recognize the results of a referendum in Puerto Rico scheduled for 1991 to determine the island's political status. In the referendum, voters in Puerto Rico would choose to enter the Union as a state, to become an independent republic, or to remain a commonwealth within the United States (although with enhanced status). If no majority is attained, even after a runoff, the island would retain its current commonwealth status. S. 712 would recognize the results of the referendum as binding, and partially specifies legal and financial arrangements under which any of the three status options--statehood, independence, or an enhanced version of the commonwealth arrangement--would be implemented. The Congressional Budget Office (CBO) has been asked to estimate how a change in Puerto Rico's status, if it were made under the stipulations of the current version of S. 712, would affect the island economy over the remainder of the decade.

As S. 712 defines them, the various status options could have important implications for Puerto Rico's economy, though the outcomes are hard to predict with confidence. Enhanced commonwealth status would establish procedures under which federal laws and regulations applying to Puerto Rico could be modified selectively in order to enhance the island's economic growth. At present, a heavy regulatory burden is imposed by many federal laws and regulations; some of these are inappropriate when applied to a developing region in a tropical and insular setting. Under S. 712, federal agencies would be required to be guided by a new federal policy of accelerating the island's economic development, taking local conditions into account. Proponents of enhanced commonwealth status argue that these changes could improve the current program for economic development of the island, which focuses primarily on expansion of tourism and of manufacturing. These activities are now encouraged by both Puerto Rican and federal tax law--the latter through provisions of Section 936 of the Internal Revenue Code, which effectively exempt from taxation a substantial part of the profits earned by U.S. corporations in Puerto Rico.

Enhanced commonwealth status could also lead to more favorable tariff treatment of Puerto Rico's exports and imports. Other countries would be encouraged to treat the island's exports favorably, while Puerto Rico would be given limited power to set tariffs on its imports in order to encourage the growth of particular local industries.

Promoters of enhanced commonwealth status argue further that it will lead to further expansion of direct investment in Puerto Rico's manufacturing industry. They point especially to the possibility of increased investment by corporations from outside the United States that might invest on the island as expansions of their mainland operations under the provisions of Section 936, through the intermediation of third countries, or through direct agreements with Puerto Rico under expanded powers of "tax sparing" that could be facilitated under the provisions of S. 712. Others argue, however, that there is no guarantee that Section 936 will remain in full force since efforts have been made to remove or amend it in the past.[1]

While it is difficult to measure the effects of these enhancements, they would inevitably increase Puerto Rico's ability to compete economically with other middle-income developing countries.

Statehood under S. 712 could bring more sweeping economic changes to the island, some of them potentially restrictive and others favorable. Statehood would entail losing the benefits of Section 936 tax provisions which, by all accounts, have been central to the island's rapid development as a manufacturing economy during the past 40 years. As in other states, the U.S. corporate tax would apply with full force in Puerto Rico. In addition, resident Puerto Rican individuals and firms would become subject to U.S. federal taxation, while certain federal transfer programs would be significantly expanded. The economic consequences of these aspects of statehood under S. 712 can be at least roughly quantified, and this report presents estimates of their effects.

Statehood could also have economic consequences that cannot be quantified but are nevertheless potentially quite important. Proponents argue that statehood would bring about fundamental changes in Puerto Rico's economic prospects, in part by ending the uncertainty about possible changes in the island's status that they feel has retarded its progress. Furthermore, they argue, statehood could end the ambiguous way in which Puerto Rico is perceived on the mainland, where it is commonly viewed as a foreign location even though it is part of the United States. As a result, supporters argue that statehood would bring increased recognition among outsiders of the opportunities for investment and tourism that the island offers. Proponents of statehood suggest that these consequences would be supplemented by a program of economic development focusing on tourism, agricultural development, and expansion of the island's manufacturing base.

Independence for Puerto Rico also carries the possibilities of both restraints on, and fundamental improvements in, the island's economic progress. Independence would necessarily remove Puerto Rico from the scope of Section 936. Moreover, S. 712 implies a gradual diminution (and elimination after 2000) of federal transfers to the island from the levels that would otherwise obtain, a fact with some worrisome implications for the island economy. In addition, some analysts are concerned that, like other developing countries in Latin America and elsewhere, the island might suffer from a shortage of external capital.

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1. Since the discussions leading up to the Tax Reform Act of 1976, the Treasury has repeatedly proposed scaling back Section 936 or replacing it with a partial credit for wages paid, arguing that it constitutes an inefficient subsidy for a developing region with excess labor.

But as an independent nation, Puerto Rico might offset, wholly or in part, the loss of tax incentives for direct investment by U.S. corporations and, in addition, may be better able to attract direct investment from third countries than the island has in the past. Moreover, proponents argue that independence offers a unique chance to wean the island of the debilitating effects of its dependence on federal grants and transfers, and to awaken a new economic spirit in its people.

In this analysis, CBO compares the economic effects of statehood and independence with those of continuing the current commonwealth status and its associated benefits. The report does not deal at length with the economic effects of the option of enhanced commonwealth status. While the provisions of enhanced commonwealth status may benefit the island, CBO is unable to quantify their effect. In any case, the overall economic difference between enhanced commonwealth and current status is likely to be relatively small. The economic impacts and ranges of uncertainty associated with either statehood or independence are clearly much larger than those associated with relatively minor changes in current status.

When dealing with statehood and independence, CBO has been able to estimate the magnitudes of only a few of the potential economic effects that were described above--the possible changes in manufacturing investment under statehood and the consequences of fiscal changes that are specified in S. 712 under either option. The other economic consequences of these options are largely in the realm of benefits that cannot be quantified by usual methods of economic analysis.

Because of the highly uncertain nature of future economic events in Puerto Rico, CBO can only outline a few reasonable possibilities among the many scenarios that could follow from either statehood or independence. The analysis is uncertain, in particular, because data are limited and because no economic model adequately represents the potential behavior of the U.S. corporations in Puerto Rico that would be affected by the complicated changes in tax provisions under either statehood or independence. CBO tries to deal with the quantifiable responses to a change in Puerto Rico's status by U.S. corporations and local firms and individuals, advances some plausible estimates of their reactions, and then spells out what their short-term implications for the wider island economy might be.

PUERTO RICO'S ECONOMIC DEVELOPMENT AND THE ROLE OF TAX PREFERENCES

Puerto has grown and industrialized rapidly since 1948. Among other factors, this growth is attributable to federal and Puerto Rican tax preferences for fixed investment, especially in the manufacturing sector, that have been jointly in effect since that year.[2] In 1921, the federal government enacted a tax exemption for

2. Puerto Rico's economic development is detailed in Department of the Treasury, *Operation and Effect of the Possessions Corporation System of Taxation: Sixth Report* (March 1989, processed); Puerto Rico Economic Development Association, Office of Economic Research, "An Analysis of the President's Tax Proposal to Repeal the Possessions Tax Credit in Section 936 of the U.S. Internal Revenue Code" (September 30, 1985, processed); and The Committee to Study Puerto Rico's Finances, "Report to the Governor" (December 11, 1975, processed).

qualifying income of "possessions corporations"--U.S. corporations operating in U.S. territorial possessions. This provision is now known, in amended form, as Section 936 of the Internal Revenue Code. In 1948, Puerto Rico enacted complementary legislation, the Industrial Incentives Act, that, among its provisions, largely exempted manufacturers' profits from taxation.

The federal legislation was amended most recently by the Tax Reform Act of 1986. In its present form, Section 936 effectively exempts from U.S. tax almost half the income arising from the active conduct of business of Section 936 corporations--U.S. corporations with 80 percent or more of their active income generated in Puerto Rico and no more than 25 percent of their income drawn from financial and other passive investments there.[3] In addition, all the passive income arising from qualified investments is free of federal tax.

Section 936 is essentially an example of "tax sparing"--sparing from tax all or part of income earned abroad and normally subject to tax without regard to tax paid abroad on that income. Many developed countries enter tax-sparing agreements with second countries (usually less developed countries) so that businesses from the first country pay no tax to the first country on income earned in the second country. As a matter of policy, the United States does not enter into such arrangements with other countries and has barred U.S. possessions from doing so.

Puerto Rico's Industrial Incentives Act also accords generous tax treatment, and the island's government has provided nontax incentives. Nominally, all corporate income is taxed at a top marginal rate of 42 percent under the Puerto Rican revenue code (a rate that is scheduled to fall to 35 percent in 1993), although a "flexible depreciation" provision reduces the effective tax bite in qualifying industries, including manufacturing. In addition, the Industrial Incentives Act allows manufacturing and export service firms to qualify for tax exemption of up to 90 percent of their operating income for a period of 10 to 25 years, depending on location. The act entirely exempts from income tax the interest earnings of specified financial assets in Puerto Rico. Profits of manufacturers generally are subject to a "tollgate" tax of 10 percent upon repatriation, unless certain conditions regarding the length of time the profits have been retained in Puerto Rico are met, in which case the tollgate tax rate is reduced to 5 percent. In recent years, the provisions of the Industrial Incentives Act have resulted in Section 936 corporations paying effective Puerto Rican tax rates of 5 percent or less, not including liabilities under the tollgate tax. (The federal and Puerto Rican tax provisions governing investments by affected firms are described more fully in Appendix A.) Tax preferences have been complemented with active promotion of economic development by providing infrastructure, facilities, and education and skill training of the work force.

With the federal and Puerto Rican tax preferences jointly in effect, the Puerto Rican economy underwent a dramatic change. While real GNP per capita initially

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3. These corporations are almost always organized as wholly owned U.S. subsidiaries of U.S. "parent" corporations. Formally, their profits are subject to tax, but a credit is given for the amount of tax owed. The effect is the same as if these profits were tax exempt. Section 936 also applies to qualifying U.S. corporations operating in other jurisdictions--American Samoa, Guam, the Commonwealth of the Northern Marianas, the Federated States of Micronesia, the Marshall Islands, and the Virgin Islands.

grew rapidly, conditions of excess labor have persisted, and net migration from the island has continued (see Table 1). The island economy was transformed from one based on agriculture to one based on manufacturing as well as government, construction, and services (see Table 2). Although labor-intensive sectors such as food, textiles, apparel, and leather goods, initially dominated the manufacturing sector, the pattern of expansion gradually shifted toward such relatively high-technology, capital-intensive activities as chemicals (including pharmaceuticals), machinery, electronics, electrical equipment, and scientific equipment (see Table 3). Both the gross product and labor income paid in the manufacturing sector grew substantially as shares of the respective totals for the economy as a whole, but a declining share of manufacturing income accrued to labor. The concomitant rise in the share of profit income in manufacturing largely reflected the fact that the high-technology enterprises earn substantial amounts of income from intangible assets, such as patents, trademarks, or trade names.

Growth slowed during the 1970s and early 1980s as a result of a variety of adverse developments. Federal tax legislation reduced the value of Section 936 provisions either indirectly by reducing the effective tax rate on mainland investment, or directly by subjecting to tax part of the income from intangible assets of Section 936 corporations. Such legislation included liberalized depreciation allowances in 1971, the sharp reductions in taxation of capital income in the 1980s, and provisions in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Tax Reform Act of 1986 (TRA) that exposed intangible income to tax.[1]

Factors other than taxes also slowed growth. As early as the 1950s, Puerto Rican wages were rising relative to those in the United States and elsewhere, so that Puerto Rico gradually lost its advantage in supplying unskilled labor at low wages. The negotiations to reduce U.S. (and Puerto Rico's) tariffs during the 1960s helped reduce another advantage because goods from foreign locations offering cost advantages relative to Puerto Rico could now enter the U.S. market at lower cost. During the 1970s and early 1980s, the world price of oil shot up, and recession and high real interest rates plagued the economy on the U.S. mainland.[2] High oil prices disadvantage Puerto Rico both because it imports all its oil products and because it generates virtually all its electricity from oil, implying high power costs for industrial users.

Most recently, the economy of Puerto Rico has presented a mixed picture of progress and problems. After a decade of slow growth, GNP per capita has grown at 3.6 percent since 1985, while the unemployment rate has fallen from its 1983 peak of 23.5 percent. Still, per capita income, though well above levels typical of the Caribbean and Latin America, is substantially below that of Mississippi, the U.S.

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1. The first major tax act of the 1980s, the Economic Recovery Tax Act of 1981 (ERTA), further liberalized depreciation allowances, but its provisions were partially scaled back by TEFRA in 1982. In 1986, TRA further restricted depreciation allowances, but also reduced the statutory corporate tax rate. The net effect in most cases was to raise slightly the effective tax rate on capital income from its level under TEFRA.

2. In March 1979, the Commonwealth Oil Refining Company (CORCO) filed for protection under federal bankruptcy laws. It had been the largest private corporation in Puerto Rico, but had lost its cost advantage when the federal oil import quota system was abolished.

TABLE 1. INDICATORS OF ECONOMIC CONDITIONS
(In percent for decade ending in year given, by Puerto Rican fiscal years)

	Average Annual Growth Rate of Real GNP Per Capita	Average Annual Net Emigration As a Percentage of Mid-decade Population	Average Annual Unemployment Rate
1950	4.0	n.a.	n.a.
1960	4.7	2.2	14.3
1970	5.5	0.8	11.5
1980	1.6	0.3	15.5
1989	1.5	0.9[a]	19.5

SOURCE: Puerto Rico Planning Board; Puerto Rico Department of Labor and Human Resources.

NOTE: n.a. = not available.

a. Data extend only through 1988.

TABLE 2. SECTORAL DISTRIBUTION OF EMPLOYMENT, PRODUCT, AND INCOME (In percent, by Puerto Rican fiscal years)

	Manufacturing	Agriculture	Government	Other	Total
		Employment (Industry share of total employment)[a]			
1940	7.0	44.7	2.5	45.8	100.0
1950	7.4	35.9	7.6	49.1	100.0
1960	13.4	22.8	11.4	52.4	100.0
1970	18.2	9.9	15.5	56.4	100.0
1980	18.5	5.0	24.4	52.1	100.0
1989	17.2	3.9	23.0	55.9	100.0
		Gross Domestic Product (Industry share of total GDP)			
1950	16.5	18.2	10.4	54.9	100.0
1960	21.7	9.7	11.1	57.5	100.0
1970	23.6	3.2	12.1	61.1	100.0
1980	36.8	2.6	13.1	47.5	100.0
1989	39.2	1.5	11.1	48.2	100.0
		Labor Income (Industry share of total labor income)			
1950	15.9	17.0	18.1	49.0	100.0
1960	19.4	7.6	18.8	54.2	100.0
1970	21.7	2.4	21.8	54.1	100.0
1980	23.0	2.3	26.3	48.4	100.0
1989	21.6	1.7	24.5	52.2	100.0
		Labor Income's Share of Net Industry Income[b]			
1950	69.4	44.2	100.0	51.9	58.4
1960	62.5	39.2	100.0	57.2	61.4
1970	63.5	37.6	100.0	58.4	65.0
1980	34.8	38.3	100.0	61.8	56.4
1989	26.7	44.9	100.0	57.6	49.9

SOURCE: Puerto Rico Planning Board.

a. Manufacturing in this panel excludes sugar refining and home needlework.

b. Last column in this panel represents labor income's share of total net domestic income.

TABLE 3. COMPONENTS OF NET MANUFACTURING INCOME IN PUERTO RICO (As a percentage of total, by Puerto Rican fiscal years)

	1950	1960	1970	1980	1989
Food and Tobacco	52.5	26.7	20.6	12.0	12.5
Textiles and Apparel	20.9	22.4	22.2	8.6	5.0
Chemicals and Machinery	9.2	22.2	31.4	62.6	73.6
Other Manufacturing	17.4	28.7	25.8	16.8	8.9

SOURCE: Puerto Rico Planning Board.

state with the lowest per capita income, and the unemployment rate, at about 14 percent, is very high by mainland standards. Moreover, many Puerto Ricans are not counted in the reported unemployment rate because participation in the labor force is only about 45 percent, well below the level on the mainland. Reported unemployment is also affected by the relatively high rate of migration from the island. Although net emigration varies from year to year, those leaving the island each year represent about 1 percent of the population.

Some observers have interpreted the prominent role of federal and commonwealth governments in Puerto Rican economic life as a high degree of dependence among Puerto Ricans. As Table 2 shows, employment by government has grown steadily since the 1940s. This growth was financed in part by federal transfers to the commonwealth government, and also by growing deficits in the commonwealth government's operating budget. Moreover, at 31 percent, the proportion of federal transfer payments in personal income is more than twice as high as the mainland average and half again as high as the five states with the highest combined proportion. The figure for Puerto Rico would be even higher--about 35 percent--if all federal entitlement programs were fully available to Puerto Ricans.

Many firms in labor-intensive sectors such as apparel and shoe manufacturing have been leaving the island for countries with lower wage rates. The remaining manufacturing firms are concentrated in capital-intensive sectors. Economists interpret this concentration in part as a reflection of the incentives for such production methods embodied in both the Section 936 tax provisions applicable to tangible corporate income, which they see as a subsidy to capital income, and of the wage levels in Puerto Rico, which are high relative to those in other Caribbean and Latin American countries.

Even more than its incentive to use capital-intensive methods, however, Section 936 also offers a unique opportunity for operations that generate income from intangible assets, such as patents or trademarks. By transferring such intangible assets to subsidiaries in low-tax jurisdictions, firms seek to have the costs of producing the intangible assets appear on the U.S. parent's books, where the tax deduction is valuable, and to have the income appear on the subsidiary's books, where the tax rate is low.

Some types of producers are particularly able to take advantage of such opportunities to shield income. These firms usually have high marketing costs (which generate marketing intangibles) or high research and development costs (which generate manufacturing intangibles) and produce a product that is easily transported and requires a mass-production stage in light industry. For this reason, Section 936 activity in Puerto Rico is dominated by firms in such industries as pharmaceuticals, electrical and electronic equipment, and scientific instruments. Many such firms have subsidiaries in a number of foreign locations. Determining the response of these firms to the loss of tax advantages under Section 936 is one of the principal analytical issues presented by the possibility of either statehood or independence.

While data necessary to determine the response to losing Section 936 are not publicly available, some measure of the problem is suggested by theory and by aggregate data. Theory suggests that firms will make investments in all feasible locations until the after-tax rates of return of the last investment in each location are all equal. This assumes that taxes are treated like other costs, so that tax advantages in a given location can offset nontax cost disadvantages. Removing those tax advantages would leave the location at a cost disadvantage for the marginal investment. Then investment in that location would be curtailed or assets relocated until after-tax rates of return in all locations are again equal for the last investment.

The first step in applying the theory is to determine the quantitative difference in after-tax rates of return that either statehood or independence would imply compared with alternative locations available to the firm. CBO has made rough estimates of the change in after-tax rates of return to investment in Puerto Rico under statehood using the reported before-tax returns shown in Table 4.[6]

Given that roughly one-half of reported profits in Puerto Rico are exempt from U.S. tax under commonwealth status but by 1998 would be fully taxable under statehood, the reported after-tax profit rate would fall by about 9 percentage points for the average Section 936 manufacturer and about 11 percentage points for firms in chemicals, electronics, and instruments--the group of industries that represents about three-quarters of Section 936 assets.[7]

For reference, these reductions in after-tax rates of return are roughly on the order of the levels of operating rates of return on the mainland, which are considered to represent the opportunity cost of holding capital. In principle, other things being equal, it would be profitable simply to abandon assets in Puerto Rico if higher after-tax returns elsewhere would more than cover this opportunity cost. But relocation is not costless, and there is no guarantee that higher after-tax returns are available elsewhere.

The relevant question becomes whether Section 936 firms can mitigate their losses under statehood by investing or locating elsewhere. CBO has neither the data nor resources to answer such a question precisely. Theory, however, suggests that mainland locations may again become competitive because locating in Puerto

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6. As discussed below, the levels of reported profit rates do not accurately reflect the productivity of tangible capital in Puerto Rico: rather, they largely reflect the incentive for corporations to allocate profits to their Section 936 subsidiaries, especially through the transfer of intangible assets. Nevertheless, changes in reported profit rates can be used strictly for comparison.

7. The calculations include the following assumptions: the effective Puerto Rican tax rate is 5 percent; the federal tax rate is 34 percent; the firm has no interest expense (borrowing by Section 936 firms is minimal because it is to the affiliated group's advantage to borrow on the mainland where tax deductibility of interest expense is valuable); the firm uses the "profit-split" method as most firms are expected to do under the provisions of the Tax Reform Act of 1986. This method allows the affiliated group to split its profits from Section 936 activity roughly equally between the subsidiary (paying no U.S. tax) and the parent (paying full U.S. tax). For a more complete explanation of this method, see Department of Treasury, *Sixth Report*, pp. 8-10.

TABLE 4. BEFORE-TAX OPERATING RATES OF RETURN FOR SELECTED INDUSTRIES, 1983

Industry	Before-Tax Operating Income As a Percentage of Operating Assets	
	Mainland Operations	Section 936 Corporations[a]
All Manufacturing	10.3	54.1
Food and Kindred Products	13.7	40.2
Chemicals and Related Products	10.1	72.1
Pharmaceuticals	18.7	77.5
Fabricated Metal Products	10.6	27.8
Machinery, Except Electrical	9.1	42.6
Electrical and Electronic Equipment	8.5	67.3
Instruments and Related Products	12.1	69.5

SOURCE: Department of the Treasury, Office of Tax Analysis.

NOTE: Operating income is defined as gross sales less cost of goods sold and less all other deductions except taxes, interest, and charitable contributions. Operating assets include net property, plant and equipment, inventories, and net accounts receivable.

a. Section 936 corporations included are those that did not elect to use the profit-split method. Such firms represented about 80 percent of Section 936 assets in Puerto Rico. Most of their income from intangible assets was likely to arise from manufacturing intangibles, rather than marketing intangibles.

Rico would no longer offer tax advantages that could outweigh any cost disadvantages. Moreover, low-tax foreign locations may offer attractive alternatives.

The U.S. tax treatment of income earned in a foreign location is more favorable than that accorded domestic income. Generally, U.S. tax is due on foreign-source profits not as they are earned but when they are returned to the U.S. parent, and a credit is provided for any foreign tax that has been paid on them. This deferral of tax reduces the effective U.S. tax rate for such income--the longer the profits remain abroad, the lower the effective U.S. tax rate. Given deferral, the effective tax rate is below the U.S. rate as long as the foreign tax rate is below the U.S. rate.

In principle, intangible income is subject to current, rather than deferred, taxation, but U.S. firms located abroad are expected to be able to shield a significant portion of intangible income from current tax.[8] The extent to which this is possible is speculative, depending on regulations that have not yet been issued, but most authorities expect that significant opportunities to shield such income from current tax will remain.

Given this tax treatment of foreign-source income, low-tax foreign locations could offer tax advantages over Puerto Rico under statehood. The exact advantage cannot be stated precisely, but rough calculations suggest that, other things being equal, over half the tax loss that statehood would imply might well be preserved by relocating to a low-tax foreign jurisdiction. Because an independent Puerto Rico could serve as a low-tax jurisdiction, it also follows that Puerto Rican independence would not entail the same tax costs as statehood.

Because of the loss of full Section 936 benefits under either statehood or independence, firms may reduce investment or relocate their operations entirely. The extent to which they would do either is hard to quantify, but historical data contain some evidence that tax benefits affect investment decisions by parents of Section 936 corporations. Figures on the number of jobs promised by Section 936 firms and other nonlocal companies show sharp declines in years when news of possible changes in Section 936 benefits was announced (see Figure 1). On two previous occasions, in 1982 and 1985-1986, anticipation of changes in Section 936 rules sharply reduced the number of new jobs promised (committed) by nonlocal firms (mostly Section 936 firms), while commitments of local firms changed little. Nonlocal commitments are once again sharply down during the current discussion of changing Puerto Rico's status. A decision to change status would probably reduce commitments and investment even further.

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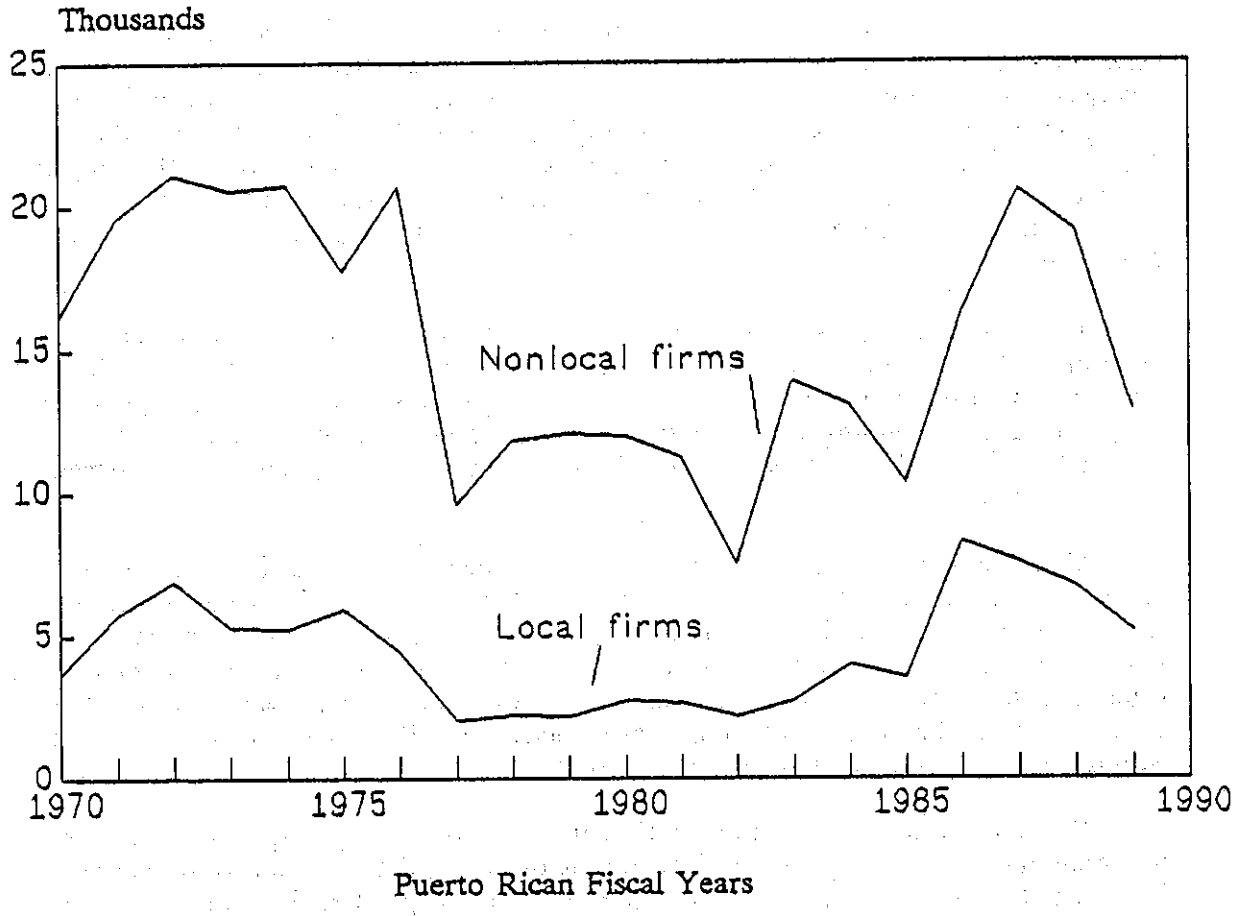
8. More formally, law requires that the foreign subsidiary make payments to the parent that reflect the market value of using the intangible asset during the year. This payment appears as income on the parent's books where it is subject to current federal tax. The ability to shield intangible income depends in part on being able to claim that the intangible asset properly belongs to the subsidiary, rather than the parent. It is easier to make such an argument in the case of manufacturing intangibles, which are used where the item is produced, than in the case of marketing intangibles, which are used where the item is marketed. Informal analysis suggests that most intangible income of Section 936 firms flows from manufacturing intangibles rather than marketing intangibles (see Department of Treasury, *Sixth Report*, pp. 61-64).

FIGURE 1. NEW JOB COMMITMENTS



SOURCE: Puerto Rico Economic Development Administration.

NOTE: New job commitments filed with the Puerto Rico Economic Development Administration by local and nonlocal (mainly Section 936) firms seeking partial exemption from Puerto Rican taxes.

Firms less likely to move existing assets and production to a new location than to reduce new investment because relocation involves costs that do not apply when considering possible locations for expanded production. As a result, such relocations may not happen very quickly even when they may be profitable in the long run. Beyond their fixed capital investments, going-concern operations in Puerto Rico have substantial investments in the training of their staff to carry out their operations. They have already organized supply and distribution networks, developed relations with local unions and government organizations and other institutions, and acquired an understanding of the local culture. These efforts were all made at substantial cost, a cost that would need to be incurred again if these firms moved to a new location. In addition, moving assets to a foreign location would entail paying tax on any capital gains that had accrued to the assets while in Puerto Rico.

The importance of considerations of cost differs considerably from industry to industry and from firm to firm. Some industries, such as apparel, are notoriously "footloose" and seem to move fairly readily to the location of least operating cost. Some firms in Puerto Rico have kept down their commitments by using space rented from the commonwealth government rather than buying their own buildings.[9] Nevertheless, it is possible that only a few firms would actually cease operations in Puerto Rico as a result of a change in status, and that the loss of current Section 936 firms would not greatly exceed normal attrition that occurs as firms pass through a life cycle.

Several arguments suggest that Section 936 corporations in Puerto Rico may not reduce their investment significantly if the island were to become a state, but CBO has not incorporated all of them into its analysis. In some cases, CBO was unconvinced by the logic or evidence, and in other cases full consideration of the arguments would have required an analysis far beyond CBO's time and resources. The main arguments considered here are the apparently high pre-tax rate of profit in existing Section 936 corporations, which seemingly insulates them from changes in taxation; the apparent lack of response of Section 936 investment to past changes in U.S. tax laws; and the possibility that Puerto Rico may have substantial nontax advantages that would continue to induce firms to locate there.

The Importance of High Profit Margins. The first argument is that Section 936 firms have strong profit margins that could withstand an increase in taxation without becoming unprofitable. In CBO's view, however, the apparent profitability of Section 936 corporations does not necessarily mean that they will be unaffected by loss of Section 936 tax benefits. Much of their reported pre-tax profitability might disappear under statehood because that profitability apparently reflects the use of corporate accounting conventions that are themselves stimulated by Section 936. As was shown in Table 4, reported pre-tax profits of Section 936 companies are indeed very high compared with mainland corporations in similar industries, which seems to suggest that they would remain profitable even when they pay U.S. tax. But these profit rates do not represent the profitability of many Puerto Rican operations from the point of view of parent corporations in the United States. Current tax law

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9. About two-thirds of the space used by firms in the textile, apparel, electronics and scientific instruments industries—which account for over one-fifth of Section 936 assets—is rented rather than owned.

provides a strong incentive for the parent corporation to find ways to take profits in Puerto Rico rather than on their own books. The accounts of these Section 936 companies thus reflect profits accruing from their ownership of intangible assets. These returns to intangible assets would continue to accrue to the parent corporation wherever production is located and thus do not, in the absence of tax considerations, affect the location of production.

The Apparent Lack of Response of Section 936 Investment to TEFRA. A second argument to the effect that manufacturing investment in Puerto Rico would continue strongly under statehood is based on the effect of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) on new job commitments by Section 936 firms. The argument is that tightened rules about the reporting of income on intangibles that were included in the act do not seem to have slowed the rate of growth of Section 936 firms. Indeed, new job commitments, especially those of nonlocal firms (mostly Section 936 firms), were higher after 1982 than before (see Figure 1).[10] CBO is not convinced by this line of argument because even though these tightened rules reduced the tax-planning incentive to locate in Puerto Rico, they did not eliminate it, as statehood would. Puerto Rico therefore kept a unique tax advantage over any alternative site even after the TEFRA changes. Moreover, it is difficult to infer what effect TEFRA had on Section 936 investment because the data reflect not only the effects of this tax change but also the influence of recovery from a recession that was very severe in the United States and even more severe in Puerto Rico. It is not possible to know what the growth of Section 936 activity would have been in the absence of TEFRA, so it is not clear how much weight to put on the relative strength of growth in Section 936 investment since TEFRA was passed.

Nontax Cost Advantages of Location in Puerto Rico. Another argument implying that Section 936 corporations might stay in Puerto Rico under statehood is that Puerto Rico may still offer cost advantages for Section 936 firms relative to other potential locations. Average manufacturing labor costs are lower in Puerto Rico than in any state of the Union, though until recently the minimum wage in Puerto Rico was the same as on the mainland. Manufacturing wages exceed those of most alternative low-tax locations, but this differential is at least partially offset by the relatively high skill and experience of the manufacturing labor force in Puerto Rico, and by the tariff protection in the U.S. market that Puerto Rico would enjoy under statehood as well as under commonwealth status. However, power costs, costs of compliance with federal safety and environmental regulations, and shipping costs (in part the result of the Jones Act requirement to use U.S. ships and crews) disadvantage Puerto Rico, but these disadvantages apply equally to a commonwealth and to a state of Puerto Rico.

CBO does not have the means to examine possible nontax cost advantages, and as a result has not taken them into account. Furthermore, theory suggests that firms locate investment so that tax advantages offset cost disadvantages. Removal of the Section 936 tax advantage should leave Puerto Rico at a cost disadvantage for

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10. Firms seeking partial exemption from Puerto Rican taxes file commitments with the Puerto Rico Economic Development Administration to create a certain number of jobs within a specified period. Tax exemptions, in principle, are conditional on meeting these commitments.

at least some firms. A full comparison of costs of production in Puerto Rico with those in other possible locations is far beyond CBO's capabilities. Such a study would have to include not only U.S. states and other Caribbean locations, but also Ireland, Latin American countries, and the newly industrializing countries of the Pacific. Which cost factors are most relevant differs by industry and even by what particular investment project is contemplated, so that general statements cannot be made or supported. For this reason, though CBO recognizes the importance in principle of directly comparing production costs in Puerto Rico with those in other locations, such comparisons cannot be the basis of this analysis.

POTENTIAL ECONOMIC IMPLICATIONS OF STATEHOOD

The Congressional Budget Office, like other analysts, has considered several consequences of statehood that might affect the course of the Puerto Rican economy during the next several years. These effects include:

- Slower growth in Puerto Rico's capacity to produce as a result of the possible reductions in the rate of investment by manufacturing corporations on the island stemming from the loss of Section 936 tax preferences;

- Changes in aggregate demand in Puerto Rico that result from several developments: changes in the net flow of funds (income-support payments, grants-in-aid, and tax payments) between the federal government and Puerto Rico; and reductions in investment on the island in response to loss of Section 936 tax preferences;

- Slower growth in the island's capacity to produce stemming from lower investment by businesses other than the Section 936 corporations, which would also experience increased costs because they would be liable for federal income taxes under statehood;

- Contraction of Puerto Rico's financial sector, which has benefited from tax incentives for financial investment on the island by Section 936 corporations--incentives that would no longer obtain under statehood;

- Possible changes in the tax and spending policies of the Puerto Rican government. Unless Puerto Rican taxes are reduced, the combination of federal and Puerto Rican income taxes would result in high income tax rates on the island. To avoid this, the Puerto Rican government might reduce both its taxes and expenditures--actions that could result in economic dislocation in the short term;

- Changes in the incentives to work in or migrate to or from Puerto Rico. Such changes are embodied in liberalized eligibility for federal income-support payments in Puerto Rico and the higher marginal tax rates in Puerto Rico stemming from liability for federal and Puerto Rican income taxes;

- Changes in the incentives for foreign countries to invest in Puerto Rico because, as a state, U.S. tax treaties would apply. In particular, income of West German firms would not be liable to German tax were they to operate in a state of Puerto Rico (although U.S. tax would apply); and

- Changes in perceptions of the island on the part of outsiders. A new perception of Puerto Rico may come about particularly as a result of a reduction in the uncertainty of its status, and perhaps through less of a perception on the United States mainland that Puerto Rico is a foreign location. Such a change in perception could bring greater awareness of opportunities for investment and tourism that the island could offer if it became a state.

Representatives of the statehood party have suggested that the state of Puerto Rico would reduce its state income tax rates from present levels and expand investment in the tourist industry. Lower income tax rates would be made possible by reducing expenditures on the provision of health care, recognizing that a greater share of health care could be supplied by the private sector and through federal programs. In addition, the state government might raise funds by divesting itself of public corporations.

While many of the economic consequences of statehood could be significant, CBO has been able to concentrate on the only two that are quantifiable: the reductions in the supply side of the economy stemming from a loss of Section 936 capital, and changes in aggregate demand from both changes in activity of Section 936 firms and changes in the net flow of funds with the federal government. CBO has focused on these effects because it could find little data permitting the quantification of the other consequences of statehood. While those consequences may be significant, there was little basis for estimating their magnitude.

Reductions in Investment Resulting from Loss of Section 936 Investment Benefits

One of the central economic consequences of any change in Puerto Rico's status follows from the loss of federal tax benefits under Section 936. If Puerto Rico elects statehood, S. 712 mandates that Section 936 be phased out in equal increments over five years beginning in 1994. A Section 936 firm would receive a credit against only 80 percent of its federal tax owed in 1994, 60 percent in 1995, 40 percent in 1996, 20 percent in 1997, and no credit thereafter.

As a result, the after-tax rate of return to Section 936 corporations located in Puerto Rico might fall below levels available on the mainland or in third countries. The drop in return could lead some firms to relocate their operations, while others might slow their investment in Puerto Rico without leaving. Firms that would otherwise have located in Puerto Rico may choose not to do so. Any of these outcomes would slow the growth of investment in Puerto Rico by these corporations, as well as the growth of their production, their exports, their imports of capital goods, and the income and employment that they generate in Puerto Rico.

If Section 936 firms slowed their investment, the impact on the Puerto Rican economy could be exacerbated by the reactions of other businesses and the state government of Puerto Rico. Many local businesses that supply Section 936 firms might reduce the growth of their production as a result of slowing activity in the Section 936 sector. Similarly, the growth of tax revenues to the state government might slow, and the government might then have to cut back its own expenditures and employment in order to maintain a balanced budget. Such cutbacks as a result of slowing economic growth are common among state governments on the mainland, which face constitutional requirements that their operating budgets remain in balance. Even in the absence of constitutional strictures, financial markets constrain the ability of state governments to run budget deficits without endangering their credit ratings. When state governments undergo such cutbacks, they at least temporarily accentuate the economic slowing that precipitated the budget-reduction measures. (The model CBO used for analysis, however, suggests that any slowing induced by budget reduction would be transient.)

Some of these effects could be offset, however, to the extent that uncertainty about Puerto Rico's future political status has deterred companies from investing there until now. Statehood could raise Puerto Rico's visibility as a place to locate for domestic producers. It could also eliminate any risk that was associated with its uncertain political status in the past. Thus, domestic or foreign firms looking for a secure, low-cost site of production within the United States could be attracted to Puerto Rico after statehood.

Changes in Net Federal Transfers to Puerto Rico

If Puerto Rico becomes a state, its fiscal relations with the federal government would change in several ways under S. 712:

- Puerto Rican residents would become fully eligible for the Food Stamp program, Medicaid, and Aid to Families with Dependent Children (AFDC);

- Puerto Rico would become eligible for Supplemental Security Income (though its eligibility for Aid to the Aged, Blind, and Disabled would end); and

- Puerto Rican individuals and firms would become liable for federal income and excise taxes (but individuals would also be eligible for the earned income tax credit).

CBO estimates that, in the absence of changes in economic behavior, payments from the U.S. government to Puerto Rico under entitlement programs could increase by $1.7 billion in fiscal year 1992, an amount that rises to $3 billion per year in fiscal year 1995 (see Table 5). In terms of the federal budget, these increased payments would be partially offset by higher taxes received from Puerto Rico, and from U.S.-based corporations as a result of their loss of Section 936 benefits.

TABLE 5. ESTIMATED FEDERAL OUTLAYS IN PUERTO RICO FOR CERTAIN ENTITLEMENT PROGRAMS (In billions of dollars, U.S. fiscal years)

Programs	1992	1993	1994	1995
Baseline Outlays	1.8	1.9	2.0	2.1
Increases Under Statehood				
Food Stamps	0.7	0.7	0.7	0.7
Medicaid	0.9	1.0	1.1	1.2
Medicare	0.1	0.1	0.1	0.1
Supplemental Security Income	0	0	0.6	0.9
Aid to Families with Dependent Children	a	a	0.1	0.1
Foster Care	a	a	a	a
Total Increase	1.7	1.8	2.6	3.0
Outlays Under Statehood	3.5	3.7	4.6	5.1

SOURCE: Congressional Budget Office.

a. Less than $50 million.

Increases in funding for social welfare programs and in marginal tax rates might reduce incentives to work, or to stay in Puerto Rico rather than migrate to the mainland. CBO has not taken these effects into account, however, in part because a significant portion of the increased welfare benefits goes to those unable to work, such as children, the elderly, and disabled people. Liberalized welfare benefits in Puerto Rico may also reduce an incentive to migrate to the mainland, partially offsetting the increased incentive to migrate that may come about as Puerto Ricans become liable for federal income taxes beginning in 1994, and as a result of the loss of Section 936 jobs. In any case, CBO has found no analysis of migration or labor supply in Puerto Rico on which to base a technical judgment of these effects on incentives to work or migrate, nor any source of data that would permit it to develop its own analysis in the time available.

Another economic implication of statehood under S. 712 stems from the fact that increased federal funding of entitlement programs in Puerto Rico would exceed the increases in tax payments received from residents and local corporations on the island. (Increased tax collections from Section 936 corporations, other things being equal, would also add to federal revenues, but this tax change would not lead to additional reductions in Puerto Rican aggregate demand because it would reduce incomes of mainlanders rather than islanders.) These increased net transfers would offset some of the loss in overall Puerto Rican demand for goods as a result of changes in the manufacturing sector, thereby mitigating the loss in Puerto Rican gross national product. CBO has also analyzed this effect using the formal econometric model that is described below.

CBO's Method of Estimation

As the above discussion points out, CBO's analysis of the possible economic consequences of statehood has concentrated on two particular changes: loss of Section 936 tax benefits for qualifying corporations; and increases in federal transfer payments to the island less increases in federal tax receipts from the island. CBO's analysis of the effects of these developments on the whole Puerto Rican economy consisted of three steps:

- Developing two alternative baseline projections of economic variables over the 1990-2000 period, assuming Puerto Rico's current commonwealth status;
- Deriving plausible responses of investment by Section 936 corporations to the loss of 936 tax benefits; and
- Estimating the consequences of these changes in investment and of the changes in net federal transfers to the island for such economic variables as GNP and unemployment, using an economic model.

Developing the Baseline Projections. The first step in estimating the effects of statehood on Puerto Rico's economy was to develop two alternative baseline projections of such economic variables as real GNP, investment, employment, and exports over the 1990-2000 period. These are not forecasts of the performance of

the economy under commonwealth status; CBO does not have the expertise to develop accurate projections of the most likely course of Puerto Rico's economy. Instead, the baselines represent mechanical projections of the course of the economy over the next decade based on recent historical trends. The projections serve as benchmarks against which the performance of the economy under the different status options can be expressed.

The baselines were constructed in the following manner. First, CBO found the growth trend of real GDP since 1973 using a statistical adjustment to remove the influence of business cycles.[11] These calculations imply that the trend growth rate in Puerto Rico since 1973 has been about 3.4 percent per year. Next, the variation from trend of actual growth in real GDP for successive 10-year periods starting in 1973 was found. CBO used this variation to determine bands around the trend that would include deviations above and below the trend rate of growth that are at all likely based on experience since 1973.[12] The upper band was then treated as the high-growth baseline and the lower band as the low-growth baseline. The optimistic baseline incorporates growth in real GDP of 4.4 percent per year, while the lower baseline involves growth of 2.4 percent.

CBO chose the year 1973, a cyclical peak, as a base year because it seems to separate a period of generally strong trend growth from one of slower average growth in subsequent years. This pattern applies in the United States and many other countries as well as in Puerto Rico. The results would have been virtually identical if 1979 (also a cyclical peak year) had been chosen as the base year instead.

In constructing each of the baseline projections, CBO assumed that Section 936 activity would grow 2.6 percentage points faster than the rest of the economy. This figure reflects the amount by which growth in the manufacturing sector has exceeded that of the economy as a whole since 1974. (Manufacturing is taken to be a proxy for Section 936, for which recent data are unavailable, but which is known to account for most manufacturing in Puerto Rico.) Since 1974, manufacturing output has grown on average about 3.7 percentage points faster than the rest of the economy, but the extraordinary differential in 1976 accounts for over 1

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11. In particular, CBO estimated a statistical equation relating the logarithm of real GNP to a constant and to the deviation of the unemployment rate in the United States from CBO's estimate of the structural ("nonaccelerating inflation") unemployment rate for the United States (an adequate measure of cyclical unemployment in Puerto Rico is not available). In addition, this regression equation contained five time trends: one covering the whole estimation period (1953-1989) and four others beginning in the years following successive peaks in Puerto Rico's business cycle: 1958, 1961, 1974, and 1980. In this manner, the equation was able to estimate changes between business cycles in the trend rate of growth in Puerto Rico's GNP. In making projections with the equation, the deviation in the unemployment rate from the structural rate was set equal to zero.

12. In making this calculation, CBO first estimated the standard deviation of a sample of estimates of the average rate of growth of real GNP over successive 10-year intervals beginning in 1974. The resulting estimate of the standard deviation was 0.5 percentage point. This estimate was used to generate the high and low baseline paths by adding two standard deviations to the projected trend growth rate to derive the optimistic baseline path, and by subtracting two standard deviations to derive the pessimistic baseline. If growth rates are distributed normally about the trend, this procedure would imply that there is only a 5 percent chance that growth would be either faster than CBO's optimistic baseline or slower than its pessimistic one.

percentage point of this total. Therefore, the figure of 2.6 percentage points was chosen.

These assumptions determine the characteristics of the high-growth and low-growth baseline paths. With real GDP growing at 4.4 percent per year on the high-growth baseline, real Section 936 output grows at 5.6 percent, while real growth in the rest of the economy proceeds at 3.0 percent. Similarly, real GDP grows at 2.4 percent per year on the low-growth baseline, with real output in the Section 936 sector growing at 3.6 percent and the real output in the rest of the economy growing at 1.0 percent.

The Response of Investment to Loss of Section 936 Benefits. CBO has been able to make only rough estimates about the crucial issue of how much and how fast affected corporations operating in Puerto Rico would reduce the scale of their operations once statehood eliminated the tax benefits under Section 936. In order to be sure how much Section 936 benefits currently contribute to the rates of investment in Puerto Rico and, hence, what would happen if they are removed, CBO would need to know more about the Section 936 companies--for example, which investments would have occurred even without special tax advantages, and which investments are made profitable for the parent corporation only by the special tax advantages. This information is unavailable.

CBO assumed that recent rates of attrition of Section 936 firms would continue under statehood, and that the remaining firms would invest only enough to offset depreciation and maintain their capital stock. (Attrition of Section 936 firms occurs on an ongoing basis, but is normally more than offset by expansion of existing firms and the entrance of new firms.) These investment changes would lead to a loss of between 37 percent and 47 percent of the capital and production of Section 936 corporations in the year 2000 compared with what it might be in that year under the current status. The smaller of these losses in capital is similar to an assumption of a 35 percent loss used by the U.S. Treasury.[13] While CBO makes no explicit assumption about events after 2000, the loss in Section 936 activity seems likely to be permanent.

The actual outcome under statehood could be better or worse than is implied by CBO's assumption. It could be better if investment by Section 936 firms is insensitive to tax considerations, so that removal of tax advantages would have little effect on investment. It could be worse if tax advantages are crucial to the profitability of locating in Puerto Rico (from the point of view of the parent corporation), so that the removal of these advantages leads firms not merely to halt growth in their commitment to Puerto Rico but even to pull back from existing investments.

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13. A loss of 25 percent was cited in testimony of Kenneth Gideon, Assistant Secretary of the Treasury, before the Senate Committee on Finance, November 14, 1989. This percentage, however, understates the movement of firms and their income out of Puerto Rico, because some of the income of relocated firms would be subject to U.S. tax. Private communications with the Treasury suggest that the underlying loss in Puerto Rico production and income was estimated at 35 percent.

Even current levels of activity of Section 936 corporations might not be maintained under statehood if tax advantages are crucial to the profitability to parent companies of current Section 936 operations. For reasons already discussed, CBO cannot accurately assess how likely such moves would be, as it does not know either how important tax considerations are to the Section 936 corporations, or in detail how other costs differ between locations.

CBO's Economic Model. CBO is charged with the task of estimating the implications for the overall Puerto Rican economy not only of the changes in corporate investment that have just been discussed, but also of changes in federal spending and taxes. It is impossible to estimate the combined effects of these separate developments without a model of the Puerto Rican economy. Even so, recent theoretical developments suggest that the results of econometric models must be used with extreme caution.[14] With this caveat in mind, CBO has used the results from a macroeconomic model that it developed for this study.[15] The model is described in Appendix B.

CBO's model concentrates on elaborating the demand side of the Puerto Rican economy, but also permits evaluation of some of the most important impacts of statehood on the supply side. It derives estimates of Puerto Rican GNP first by predicting how each of the components of aggregate demand (consumption, investment, government, and net exports), which--taken together--constitute GNP, will behave in a given year on the basis of assumed changes in variables external to the model. The components of demand are further influenced by the model's own subsequent predictions of changes in economic conditions that affect the components of aggregate demand. GNP is then determined by adding up the separate components of aggregate demand. The behavior of Puerto Rican employment is predicted chiefly on the basis of the evolution of overall GNP.

The model incorporates statistically estimated equations describing the behavior of Puerto Rican consumption and investment spending, as well as spending on merchandise imports and exports. Exports are determined largely on the basis of economic conditions on the U.S. mainland, which is by far the most important destination of Puerto Rico's exports. The behavior of the spending and taxes of Puerto Rico's government are predicted outside the model (treated as external variables).

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14. Many critiques of existing econometric models result from the advent of expectational analysis during the 1970s. Two of the most celebrated critiques are presented in Robert E. Lucas, "Econometric Policy Evaluation: A Critique," in K. Brunner and A. H. Meltzer, eds., *The Phillips Curve and Labor Markets*, Carnegie-Rochester Conference on Public Policy No. 1 (New York: North-Holland 1976); and Christopher Sims, "Macroeconomics and Reality," Econometrica (March 1980).

15. Existing models that helped guide CBO's work are described in Jorge Freyre, *El Modelo Económico de Puerto Rico* (San Juan: Inter American University Press, 1979); M. Dutta and V. Su, "An Econometric Model of Puerto Rico," *Review of Economic Studies* (July 1969), pp. 319-333; and Fernando Zalacaín, "Un Sistema de Modelos Económicos Para Puerto Rico," 1985 (processed).

Such a model differs from the input/output models that others have generally used to analyze the potential impacts of removing of Section 936 tax benefits.[16] CBO's model concentrates on predicting the magnitudes of the different components of total spending that make up GNP. It also, however, permits the consequences of such "supply-side" developments as a loss in productive capacity to be analyzed directly. As such, this model is adequate to the present task, which involves calculating the combined effects of two different implications of statehood: "supply-side" changes in the amount of capital (from Section 936 firms) located in Puerto Rico; and "demand-side" effects such as reductions in investment demand implied by loss of Section 936, and changes in consumer demand implied by changes in net federal transfers to the island.

This model permits analysis of the ultimate implications of these combined changes for such important overall economic conditions as national saving and the balance of payments. In all of these respects, models of the type that CBO used are more general than conventional input/output models. The "forward and backward linkages" that input/output models emphasize--linkages between activity in Section 936 corporations and other sectors of the Puerto Rican economy--are implicitly represented in the analysis provided by CBO's model.

Short-run models of the type that CBO has used have limitations, especially when it comes to representing the possible longer-term behavior of any economy. Such models take little account of the possibility that wages and other relative prices may change in response to shifts in unemployment and other developments, inducing resources to flow into new uses. (Input/output models also fail to address this issue.) Long-run models that emphasize flexible wages and other prices, for example, would suggest that unemployment would cause declining wages and expansion in productive sectors that absorbed idle workers as a result of their lower cost. Such models do not, however, necessarily reflect the likely short-term behavior of any economy, especially Puerto Rico's, where the federal minimum wage is thought to have helped restrict the downward flexibility of wages and where, as Tables 1 and 2 show, high levels of unemployment have not historically led quickly to shifts in the mix of employment.

Changes from Baseline. Changes from the baseline projections attributable to changes in Puerto Rico's status were computed by introducing several changes into the model representing the separate economic implications of statehood. Once all of the changes were introduced, the model was allowed to predict the combined effects of all of these changes. For each baseline path, CBO computed a separate solution of the model (a prediction of a set of overall economic effects) for the reduced rate of investment by Section 936 corporations resulting from loss of Section 936 tax benefits.

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16. See, for example, John R. Stewart and Theodore Lane, "An Analysis of the President's Tax Proposal to Repeal the Possessions Tax Credit in Section 936 of the U.S. Internal Revenue Code" (Puerto Rico Economic Development Administration: December, 1985); Angel L. Ruíz, "Impacto Intersectoral y Macroeconómico en la Economía de Puerto Rico de las Empresas Operando Bajo la Sección 936 del Codigo de Rentas Internas de Estados Unidos," January 29, 1988 (processed); and Fernando Zalacaín, "Un Analysis Preliminar de los Impactos Económicos del Proyecto de Ley S. 712 del Senado de Estados Unidos," September 1989 (unpublished).

In each solution, the slower growth in the economy's supply capacity as a result of lower investment by Section 936 corporations was first introduced by reducing investment from baseline levels. The path of the capital stock of Section 936 corporations was chosen by assuming that normal attrition of Section 936 firms would continue and that, beyond 1994, the remaining firms would invest only enough to maintain their capital stock. Based on information about attrition rates developed by the Puerto Rico Economic Development Administration, CBO judges that about 5 percent of Section 936 employment is lost each year by contraction or exit of existing Section 936 firms. But this employment loss occurs principally in sectors with relatively low amounts of capital per worker. Judging from the capital-to-worker ratios in the chemical industry (which includes pharmaceutical) and in the rest of the Section 936 sector, plant closings and reductions in usable capacity appear to reflect attrition of Section 936 capital at a rate of about 2.5 percent per year. As a result, the net capital stock of Section 936 corporations was assumed to fall at a rate of 2.5 percent per year under statehood. This assumption was implemented in the model by smoothly reducing gross investment of Section 936 below the baseline starting in 1992; after 1993, gross investment of Section 936 firms simply offsets depreciation of the capital stock of firms that remain.

The changes in investment and resulting percentage changes in capital stock differ according to how strongly Section 936 firms are assumed to grow in the baseline (under the current status). In the high-growth baseline, Section 936 capital grows at a rate of 7 percent, so that the 2.5 percent decline assumed under statehood represents a substantial loss relative to the baseline. By 2000, indeed, Section 936 capital stock under statehood would be about 47 percent lower than baseline levels, and gross investment would be reduced even more (see Table 6). Section 936 capital grows more slowly in the low-growth baseline, only 5 percent, so that statehood under those assumptions produces a smaller reduction in the Section 936 capital stock (37 percent) and a correspondingly smaller loss of gross investment.

Next, output (including exports) of Section 936 firms was assumed to fall from baseline levels in proportion to the previous year's reduction in capital. The reductions from baseline levels in investment and exports register as reductions from baseline levels of aggregate demand in the Puerto Rican economy.

The static increases in Puerto Rican income from baseline levels stemming from increased receipts of transfers (less tax payments) from the federal government--which work in CBO's model to <u>increase</u> aggregate demand--were incorporated by increasing disposable personal incomes and grants to the Puerto Rican government relative to their baseline levels by the amounts shown in Table 7. Those amounts exclude any increased collections from Section 936 corporations because they are effectively collected from mainland corporations and, therefore, do not affect aggregate demand in Puerto Rico. Some federal tax collections from Puerto Rican sources (excise taxes and customs duties) are currently "covered over"--returned to the Puerto Rican Treasury. These cover-overs will continue through 1998. Personal tax collections will be covered over through 1995. CBO has assumed that increases in tax collections that are covered over are redistributed to Puerto Rican entities, so that only tax collections net of cover-over affect aggregate demand.

TABLE 6. CBO'S ASSUMED CHANGES IN SECTION 936 GROSS INVESTMENT, CAPITAL, AND EXPORTS (In percent of baseline levels, Puerto Rican fiscal years)

Item Changed	1991	1992	1993	1994	1995	2000
High-Growth Baseline						
Section 936 Gross Investment	0	-26	-30	-56	-59	-73
Section 936 Capital	0	-4	-8	-15	-21	-47
Section 936 Exports	0	0	-4	-8	-15	-43
Low-Growth Baseline						
Section 936 Gross Investment	0	-26	-30	-47	-49	-62
Section 936 Capital	0	-3	-7	-12	-17	-37
Section 936 Exports	0	0	-3	-7	-12	-33

SOURCE: Congressional Budget Office.

TABLE 7. ASSUMED STATIC CHANGES IN FEDERAL EXPENDITURES AND REVENUES FROM LOCAL SOURCES AS A RESULT OF STATEHOOD (In millions of dollars, United States fiscal years)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Change in Total Spending	1,666	1,810	2,550	2,950	3,068	3,191	3,318	3,451	3,589
Change in Revenues from Local Sources[a]									
New excise taxes								395	414
Customs duties								163	171
Rum excise tax								265	268
Personal tax			163	10	539	739	773	809	846
Tax on local corporations					274	471	495	519	545
Total Change in Local Source Revenues			163	10	813	1,210	1,268	2,151	2,244
Change in Net Transfers to Puerto Rico	1,666	1,810	2,387	2,940	2,255	1,981	2,050	1,300	1,345

SOURCE: Congressional Budget Office; Department of Treasury.

NOTE: Revenue figures are expressed as net of cover-over–remission of federal collections to the Puerto Rican Treasury. The earned income tax credit is netted from personal tax, rather than appearing separately in expenditures. Beyond 1995, expenditure figures were assumed to grow at 4 percent per year. For more detail, see Congressional Budget Office, "Background Materials on the Costs of the Puerto Rico Status Referendum Act" (November 5, 1989, mimeo); and Testimony of Kenneth Gideon, Assistant Secretary of the Treasury, before the Senate Committee on Finance, November 14, 1989.

a. Excluding increased tax collections from Section 936 corporations.

The demand for imports was constrained to yield reasonable results. Specifically, CBO assumed that 60 percent of Section 936 investment is imported --a figure suggested by the direct and indirect import content of investment goods in Puerto Rico. In this view, imports can be decomposed into two parts: imports that satisfy Section 936 investment demand and those that satisfy all other demand as represented, implicitly or explicitly, by the workings of CBO's model. In the absence of such a restriction, imports of capital goods would fall by only 20 percent to 40 percent of the fall in Section 936 investment--an unreasonably low figure.

Simulation Results on Economic Implications of Statehood. Under the quantifiable assumptions discussed here, statehood for Puerto Rico seems likely to reduce the average growth rate of the island's income over the balance of the decade. Puerto Rico would probably enjoy a temporary surge in growth during an initial transition period, reflecting the provisions of S. 712 that would increase federal transfers to the island before the reductions in the growth of Section 936 investment would be fully felt. Given the various assumptions, however, average growth in output over the balance of the decade would be reduced by about one to two percentage points, and average growth in employment by about one-half to one percentage point (see Table 8). The figures on employment would translate into increases in the unemployment rate in 2000 of between four and seven percentage points if there were no influence of statehood on migration, and if there were no increase in employment stemming from other developments that have not been taken into account here. This increase represents a total of 50,000 to 100,000 more unemployed persons in 2000 than would otherwise have been the case. The shortfall in growth translates into lower real GNP than would otherwise have occurred--about 10 percent to 15 percent below baseline by 2000 (see Figure 2).

Although normal growth rates would eventually return as the disinvestment process runs its course, the accumulated loss of output and income below levels that would otherwise have obtained would remain.

There are three interesting features of the results beyond those already discussed. First, real GNP and GDP growth is affected more in the case of the high-growth baseline than in the case of the low-growth baseline. This occurs primarily because the growth of Section 936 capital is higher in the high-growth case, and therefore its curtailment reduces investment by more. Second, in both cases, growth in employment is not affected as much as growth in real GDP because much of the loss in output is concentrated in the Section 936 sector, for which a given level of output requires less than half as much employment as other output. Finally, growth in real exports is affected more than growth in output because Section 936 firms contribute a greater share to exports than to output.

POTENTIAL ECONOMIC IMPLICATIONS OF INDEPENDENCE

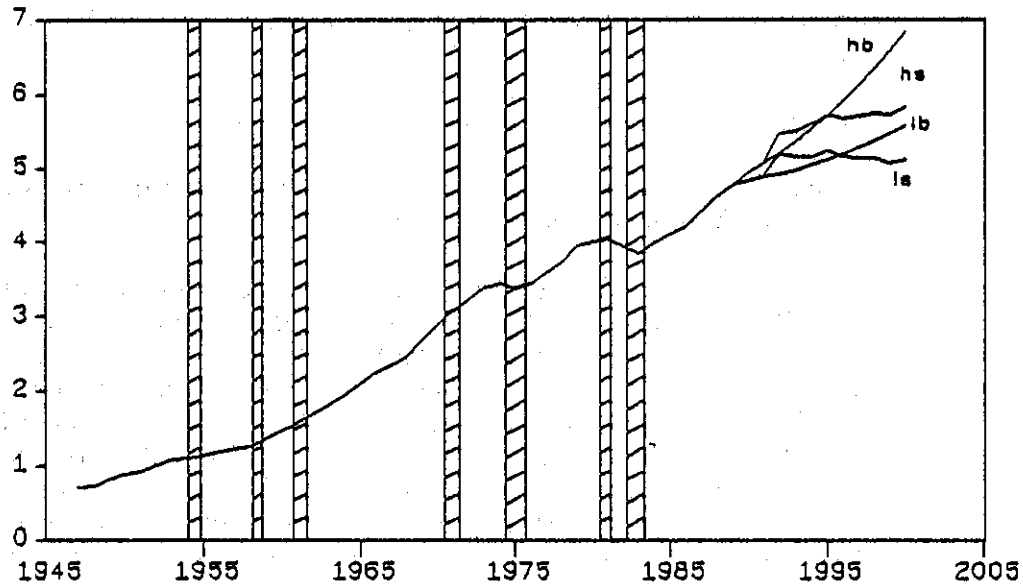
Only very rough estimates are possible when trying to predict how Puerto Rico's economy would fare after such a fundamental change in its character as independence from the United States. Any such estimates are even more uncertain than

TABLE 8. ILLUSTRATIVE EFFECTS OF STATEHOOD ON THE PUERTO RICAN ECONOMY (Difference from baseline of average annual growth rate, in percentage points)

	1992-1995	1996-2000	1992-2000
	High-Growth Baseline		
Real GNP	0.1	-3.3	-1.8
Real GDP	-0.4	-3.0	-1.9
Employment	0.1	-1.9	-1.0
Real Exports	-2.4	-4.5	-3.6
	Low-Growth Baseline		
Real GNP	0.7	-2.3	-1.0
Real GDP	0.1	-2.2	-1.2
Employment	0.5	-1.4	-0.6
Real Exports	-1.8	-3.0	-2.5

SOURCE: Congressional Budget Office.

FIGURE 2. ESTIMATED LEVELS OF REAL GNP UNDER STATEHOOD COMPARED WITH ALTERNATE BASELINE ASSUMPTIONS UNDER COMMONWEALTH STATUS (In billions of 1954 dollars)



Puerto Rican Fiscal Year

NOTES: Shaded areas represent recessions in the United States.

hs = statehood with high growth.
ls = statehood with low growth.
hb = baseline with high growth.
lb = baseline with low growth.

those associated with statehood. One can speculate, however, that independence could affect the economy in the short term in the following ways:

- Through changes in the tax status of corporate profits generated in Puerto Rico.

- Through changes in the net fiscal flows between Puerto Rico and the United States.

- Through changes in Puerto Rico's own fiscal policy.

- Through changes in monetary arrangements in Puerto Rico, such as possible institution of a new currency.

- Through changes in trade policy affecting commercial relations between Puerto Rico and other countries. Puerto Rico's exports to the United States would no longer automatically be free from tariff duties. S. 712 provides that an independent Puerto Rico would qualify for most-favored-nation status and states that the United States would wish to enter into a free trade association with the new republic. But the bill makes no commitments regarding actual tariff provisions. Tariff-free entry to the U.S. market would preserve an important cost advantage to Puerto Rico and greatly increase its ability to attract investment from abroad as a republic.

- Through changes in shipping costs to the U.S. mainland because U.S. shipping regulations would no longer apply. As an independent nation, Puerto Rico would no longer face the requirement that its shipments to U.S. markets be carried on vessels registered in the United States, which would reduce the cost of such operations.

- Through changes in the terms under which Puerto Rico can borrow on world financial markets. These changes might stem either from loss of access to tax-exempt financial markets in the United States or from changes in outsiders' willingness to lend to or invest in Puerto Rico. Willingness to invest in Puerto Rico will depend on outsiders' perceptions of Puerto Rico's political stability, economic policy, and future economic institutions.

- Through possible changes in attitudes on the part of Puerto Ricans themselves: on the one hand, they may respond to independence with still higher work effort, saving, and the like; on the other hand, they may demonstrate lack of confidence in the country's future by emigrating or sending their savings abroad.

Representatives of the independence party of Puerto Rico have described the policies that the government of an independent Puerto Rico might choose to carry out. In particular, the party has described the tax provisions that it believes would be effective in preventing losses of investment in the manufacturing sector. It also has suggested that it would be wise for Puerto Rico to create no monetary institu-

tions of its own during the first 10 years of independence, instead relying on the U.S. dollar as its currency.

The independence party representatives have also suggested that the government of an independent Puerto Rico might usefully institute a program of economic reforms involving such measures as selling unprofitable public enterprises, improving tax enforcement, increasing government investment, raising the productivity of public workers, and reducing the government work force. Such a government might also gradually reduce the dependence of some Puerto Ricans on government income-support payments by reducing the levels of such support in steps during the first years of independence.[17] The successful implementation of these types of reform is an extremely difficult and complex task, as indicated by the experiences of other developing countries over the past several years.

Of the many factors that might affect economic performance in Puerto Rico after independence, CBO has focused on three: the effects of the projected reduction in transfers from the U.S. government relative to the levels that would otherwise obtain; the possibilities for attracting direct foreign investment to the country; and the possible problems that the country might face in financing its balance of payments.

Changes in Net Federal Transfers to Puerto Rico

Compared with continued commonwealth status, under independence federal transfers to Puerto Rico would fall and federal revenues from local sources (as well as Section 936 firms) would rise. While some programs such as federal pension and veterans benefits would continue after independence, others such as Food Stamps, Medicare, Foster Care, Aid to Families with Dependent Children, and Supplemental Security Income would not. Instead, Puerto Rico would receive a federal block grant at a level equal to U.S. federal expenditures in Puerto Rico for such discontinued programs during the U.S. fiscal year in which independence is proclaimed. This grant would be paid annually to Puerto Rico through the ninth year following the certification of the referendum. The grant would be fixed in nominal terms, however, and would not allow for growth that would otherwise occur as a result of inflation or increased participation. Therefore the republic's annual income from this source would fall short of what Puerto Rico would receive under commonwealth status (see Table 9). In addition, Puerto Rico would lose the benefit of federal cover-overs, which currently protect it from liability for federal excises on rum. As a result, net payments to the U.S. Treasury for rum excises would increase after independence. The overall result is a significant reduction from projected baseline levels in net fiscal flows from the U. S. Treasury to Puerto Rico.

This shortfall can be expected to have two effects. One, which is discussed at greater length below, is that less financing through federal transfers will be available

17. Some analysts have pointed to the possibility that less dependence on income-support payments at levels close to those provided on the U.S. mainland might well increase private saving and other economic initiatives in Puerto Rico. See Bernard Wasow, "Dependent Growth in a Capital-Importing Economy: The Case of Puerto Rico," *Oxford Economic Papers*, vol. 30 (1978), pp.117-129.

TABLE 9. ASSUMED STATIC CHANGES IN FEDERAL EXPENDITURES AND REVENUES FROM LOCAL SOURCES AS A RESULT OF INDEPENDENCE (In millions of dollars, U.S. fiscal years)

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Change in Total Spending	0	0	-100	-300	-500	-600	-800	-1,000	-1,200
Change in Revenues from Local Sources (Rum excise tax)[a]	0	188	252	255	257	260	262	265	268
Change in Net Transfers to Puerto Rico	0	188	-352	-555	-757	-860	-1,062	-1,265	-1,468

SOURCE: Congressional Budget Office; Department of Treasury.

NOTE: Figures assume proclamation of independence occurs on January 1, 1993. For more detail, see Congressional Budget Office, "Background Materials on the Costs of the Puerto Rico Status Referendum Act" (November 5, 1989, processed); and Testimony of Kenneth Gideon, Assistant Secretary of the Treasury, before the Senate Committee on Finance, November 14, 1989.

a. Excluding increased tax collection from Section 936 corporations.

for any deficit in the current account of Puerto Rico's balance of payments. The other effect is that there will be less stimulation of aggregate demand from federal payments.

CBO has estimated the possible economic effects of these reductions in federal transfers using the CBO economic model that was described above. Compared with the same high- and low-growth baselines that were used in the analysis of statehood, growth in real GNP is projected to be slightly below the baseline projection--a shortfall amounting to 0.2 to 0.3 percentage point per year on average between 1992 and the year 2000.

Issues Affecting Direct Investment from Abroad

Several issues arise in assessing an independent Puerto Rico's potential for attracting investment from abroad. Under S. 712, Section 936 benefits would no longer be available to U.S. corporations. Puerto Rico could, however, offer several tax-related advantages that might effectively replace those available under its current status. First, the republic could offer the advantages of a low-tax foreign jurisdiction to U.S. firms. Further, the new nation would have the opportunity, unavailable under current status, to negotiate tax-sparing treaties making investments by corporations of third countries more attractive. Finally, the independence party of Puerto Rico has described a new set of provisions intended to duplicate the effects of Section 936.[18] According to their description, the scheme would involve levying a Puerto Rican tax on corporate profits at rates equal to those levied in the United States, and then returning the proceeds of the tax to manufacturing and other firms in the form of subsidies. Since affected United States corporations would have their U.S. tax liability reduced to zero through the foreign tax credit, and since all Puerto Rican tax would be rebated, companies could end up with little or no overall liability for tax.

Because the possibilities involved are largely unquantifiable, CBO is unable to provide numerical estimates of the extent to which an independent Puerto Rico might, on balance, gain or lose investment from abroad.

Other Issues Associated with External Finance in an Independent Puerto Rico

Although tax policies may provide continued incentives for foreign direct investment in an independent Puerto Rico, other issues may serve to deter such investment as well as the borrowing on foreign credit markets on which Puerto Rico has relied at times in the past. The island will rely heavily on both sources of "external finance" if it runs a significant deficit in the current account of its balance of payments, as the commonwealth has. A current-account deficit is inevitable for a country that, like Puerto Rico, generates little domestic saving but nevertheless carries out significant domestic investment. As Table 10 shows, Puerto Rico's deficit has historically arisen primarily because of large payments for factor services--

18. See Erick Negrón, "S. 712--Manufacturing Incentives Made Possible by the Foreign Tax Credit," unpublished memorandum, February 6, 1990.

TABLE 10. PUERTO RICO'S BALANCE OF PAYMENTS AND ITS FINANCING, 1980-1989
(In millions of dollars, by Puerto Rican fiscal years)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Current-Account Deficit	4,447	4,479	3,783	4,564	5,404	5,621	5,226	6,355	7,347	7,828
Deficit on Factor Services	3,586	4,007	4,350	4,529	5,311	5,647	6,347	7,108	8,115	8,548
Deficit on Merchandise and Non-factor Services	861	473	-567	34	93	-26	-1122	-754	-768	-720
Financing of Current-Account Deficit	4,447	4,479	3,783	4,564	5,404	5,621	5,226	6,355	7,347	7,828
Net transfers	3,252	3,345	3,515	3,561	3,590	3,706	3,833	3,741	3,879	3,913
U.S. government	3,021	3,126	3,249	3,240	3,232	3,389	3,503	3,354	3,456	3,556
Other	231	219	266	320	358	318	330	387	423	357
Net capital inflows	1,195	1,135	268	1,003	1,814	1,915	1,392	2,614	3,468	3,915
Section 936	2,048	2,215	577	1,306	1,001	4,050	1,011	n.a.	n.a.	n.a.
Other	-853	-1,080	-309	-303	813	-2,135	381	n.a.	n.a.	n.a.

SOURCE: Congressional Budget Office; Department of Treasury, Office of Tax Analysis; Puerto Rico Planning Board.

NOTE: n.a. = not available.

principally, dividends on Section 936 investment. Although the data on financing shown in the table are only suggestive, the financing of this deficit has apparently been accomplished primarily through two sources: large transfers from the U.S. government, and inflows of direct (Section 936) investment. Much of the remaining finance has apparently been derived through government borrowing in the United States, generally on the tax-exempt municipal bond market.

Potential difficulties in financing Puerto Rico's balance of payments stem from the fact that two of the major sources of finance in the past will be more restricted under independence. U.S. government transfers will gradually decline under S. 712 from the baseline levels that are projected in the absence of changes in Puerto Rico's status. Borrowing on U.S. credit markets, for its part, seems likely to be more costly at the least, and may be significantly curtailed.

In the event of independence, Puerto Rico may have more trouble using such borrowing and other measures to finance its balance of payments than it has in the past. At the very least, Puerto Rico would suffer a noticeable increase in borrowing costs because it would no longer have access to tax-exempt bond markets. CBO estimates that Puerto Rico would have to pay interest rates that would be at least two percentage points higher than at present. This is the difference between the tax-exempt rate that the island now pays and the rate that is paid by the few relatively low-risk developing countries, such as Thailand, that currently have access to bond markets in the United States. Even this outcome may not occur, however, if financial markets were sufficiently dubious of Puerto Rico's prospects. Indeed, most other Latin American countries have trouble borrowing abroad at any reasonable rate.

CBO contacted Wall Street institutions to ask how successfully an independent Puerto Rico could issue debt on open U.S. markets. Some were optimistic, but others took a cautious attitude, suggesting that the level of government debt would affect any bond rating and that the entire balance-of-payments picture would have to be assessed--especially the levels of investment income payments abroad compared with the rate of foreign direct investment inflows and the rate of growth of exports. The Wall Street analysts suggested that there would initially be questions about economic policies and institutions under independence that would require answers before an independent government on the island could have full access to world credit markets.

If no other means of finance are found, any "financing gap" in Puerto Rico's balance of payments is likely to cause a decline in economic activity in Puerto Rico. Unless fiscal policy measures are taken, the financing gap would cause a tightening in financial conditions on the island. If prices and wages in Puerto Rico were quite flexible, the financial outflow would cause prices to fall below the level they would otherwise take. Because of the minimum wage (which should be retained, according to independence representatives) and other restrictive policies, however, a decline in prices seems unlikely to occur quickly. The financing gap is more likely, therefore, to lead initially and for some time to increases in real Puerto Rican interest rates relative to those abroad, and to a contraction in domestic real output and income. Much the same restrictive effect would come about if Puerto Rico were to use fiscal restraint to keep its needs for external financing within the

available supply, rather than the passive monetary policy that has just been described.

Problems in financing the balance of payments could be reduced if the rest of the world were to step up its direct lending to Puerto Rico through multilateral institutions and commercial banks, but the financial environment in the world is not encouraging in this regard. In principle, the island economy could rely on multilateral institutions, such as the International Monetary Fund and the World Bank, as well as direct lending programs of commercial banks and the governments of industrial countries. Puerto Rico's admittance to the multilateral institutions could take some time, however, and such agencies are already hard pressed to meet the needs of other developing countries. The recent emergence of Eastern Europe has increased the number of developing countries needing finance from such multilateral institutions. Net new lending from commercial banks to similarly illiquid developing countries, in Latin America and elsewhere, has recently slowed to a virtual halt. Such lenders are likely in any case to be cautious in lending to Puerto Rico until they feel that uncertainties surrounding its economic policies, political stability, and financial system are removed. This leaves industrial governments as the most likely source of financing, with the United States the logical candidate for a lead role in any lending program.

A number of other factors could also work to alleviate Puerto Rico's difficulties in financing its balance of payments. Under independence, S. 712 specifies that tariff revenues collected by the U.S. government on imports transshipped to Puerto Rico will be rebated to the island government, providing a new flow of financing. Puerto Rico's terms of trade with the rest of the world would improve under independence because both shipping costs and nontariff restrictions on its trade with countries outside the United States would be reduced. As an emergency measure, the government would be free to restrict outflows of financial capital should such severe action be required.

CONCLUSIONS

S. 712 opens up the possibility of major political and economic change in Puerto Rico, especially if the referendum in 1991 results in a vote for independence or for statehood. Economic changes will result not only from changes in the fiscal relations between Puerto Rico and the mainland, but also, and much more importantly, from changes in the economic activity in Puerto Rico of firms that, under the current status, would benefit from Section 936 of the U.S. tax code. These effects, while extremely uncertain, lend themselves at least in principle to quantification. Other economic changes, such as increased recognition of opportunities in Puerto Rico, reduced economic dependence, or financing problems, are also likely to occur, but their importance is not easily quantified.

Fiscal relations between Puerto Rico and the federal government would change significantly with any change in status, according to the provisions of S. 712. Statehood would increase taxes paid by individuals and companies in Puerto Rico to the federal Treasury, but this increase would be more than offset by higher federal transfers to island residents and governments. As a result, net transfers (spending less taxes) to the island would be nearly $18 billion higher over the nine-

year period between 1992 and 2000, if no other economic changes took place. The net fiscal benefit from statehood would likely be permanent. Independence, on the other hand, would reduce net transfers from the federal government, by increasing amounts that add to nearly $7 billion over the eight-year period from 1993 to 2000. The annual fiscal loss to Puerto Rico would increase after 2000 as a result of the end of the block grant called for under S. 712.

While changes in fiscal relations with the federal government, taken alone, favor statehood over either independence or the current status, likely changes in the economic activity of firms that benefit from Section 936 under current status seem likely to worsen the economic outlook under statehood as compared with the other two options. Statehood would imply the eventual loss of Section 936 benefits. Under the current status, or under the "enhanced commonwealth" status described in S. 712, the tax advantages of Section 936 would continue (though Congress is free to repeal it at a later date). An independent Puerto Rico would not benefit from Section 936, but might be able to implement other tax provisions that might match the tax advantages currently available under Section 936.

The potential loss of investment under statehood is large, both absolutely and compared with the fiscal benefits of statehood to Puerto Rico. Under CBO's assumptions, statehood could reduce the growth rate of real GNP in Puerto Rico over the 1992-2000 period by between about one and two percentage points, depending on what is assumed about growth under the current status. These estimates reflect both the effect of higher net federal transfers--which work to increase real growth in the first few years of statehood--and the effects of the loss of investment and exports by Section 936 firms as compared with a current-status baseline in which both are growing.

Independence may also lead to large changes in investment, but these changes are not so easily anticipated as those under statehood, because an independent Puerto Rico may be able to construct a set of incentives--through a combination of tax-sparing treaties and local subsidies--that would approach the attractiveness of the current benefits under Section 936.

Other possible economic effects under independence are still more speculative. On the positive side, independence could lead to reduced dependence, improved tariff policies, reduced shipping costs, and other unquantifiable benefits. However, the access of an independent Puerto Rico to U.S. financial markets would be less advantageous than it is under the current status, or would be under statehood. At the very least, Puerto Rico would be likely to have to pay at least two percentage points more in interest than it currently does on its government debt. Another possibility, however, is that the new nation would have difficulty borrowing at any interest rate, as have other developing countries in recent years. This pessimistic outcome would be especially likely if direct investment in Puerto Rico were to be curtailed, thus leading both to lower growth in Puerto Rico's exports and to a smaller contribution from direct investment to financing the deficit in its balance of payments.

Because of the great importance of Section 936 to the island's economy, loss of its provisions will lead to major changes in its economic condition. The magnitude of these changes is, however, extremely uncertain and the analysis of the

changes contained in this paper, though they may be useful in the debate, cannot be regarded as definitive. As with any major political change, changes in the status of the island will require consideration of many factors beyond the strictly economic, and ultimately will be based on a leap of faith.

APPENDIX A

TAX PROVISIONS AFFECTING DIRECT INVESTMENT IN PUERTO RICO

U.S. corporations that do business in Puerto Rico are currently eligible for generous tax treatment from both governments. The generous tax treatment results from the interaction of the United States and Puerto Rican tax laws. In an effort to attract U.S. corporations to the commonwealth, Puerto Rico has designed tax incentives to take full advantage of the benefits made available under U.S. law.

This appendix will first examine the general U.S. tax rules and show how Section 936 of the tax code offers preferential treatment to U.S. corporations that operate in Puerto Rico. It will then examine Puerto Rico's tax rules and show how they interact with the U.S. rules to grant very generous overall tax benefits to U.S. corporations.

General U.S. Tax Rules on Corporate Income from Foreign Operations

The United States taxes corporations on their worldwide income, allowing tax credits for foreign taxes paid. These foreign tax credits are designed to avoid taxing the same income both in the foreign country and in the United States. As a result of these credits, the corporation typically pays the higher of the United States and the foreign income tax rate. (The top U.S. corporate income tax rate is 34 percent.) If the foreign tax rate is less than the U.S. rate, then the firm must make a tax payment to the United States as well as to the foreign government. For example, if the foreign tax rate is zero, then the United States taxes the income from the foreign source at the full U.S. tax rate. If the foreign tax rate exceeds the U.S. rate, generally the firm owes no tax to the United States on the income from the foreign source. In this case, the firm may be placed in an "excess credit" tax position, in which it has foreign tax credits that it is unable to use.

A U.S. corporation may organize (charter) a subsidiary corporation under the tax rules of another country, with the "parent" owning the stock of the subsidiary. The subsidiary's profits are subject to different tax rules that may yield some tax benefits but with an important restriction. The United States generally does not tax the active income of these foreign-chartered subsidiaries in the year the income is earned. (Active income is that earned from the business operations of the firm, not by financial investments.) Instead, the income is taxed by the United States only when it is returned (repatriated) to the parent company, generally in the form of a dividend payment. This treatment results in a deferral of U.S. tax. Corporate funds that would otherwise be subject to U.S. tax can instead be reinvested and earn income free from U.S. tax until repatriated. A restriction applies, however, to certain income, including financial investment income, earned in countries with low tax rates. Such financial income, largely interest and rental income, is attributed to the U.S. parent and taxed without deferral. This income is called "Subpart F income" after its location in the tax code (see United States tax code Sections 951-

964.) Note that the foreign tax credit for taxes paid in the foreign location may act to reduce or eliminate the U.S. tax on Subpart F income.

SECTION 936 AND ITS PREFERENTIAL TAX TREATMENT OF POSSESSIONS CORPORATION

Section 936 of the United States tax code establishes the preferential rules whereby certain corporations are exempt from U.S. tax on qualifying income generated in uerto Rico and other United States possessions. Section 936 establishes "tax sparing," in which the qualifying corporation owes no tax to the United States on its Puerto Rico income, regardless of the amount of taxes it pays to Puerto Rico. (Section 936 also applies to income generated from other U.S. possessions, but virtually all such activity occurs in Puerto Rico.)

A corporation that qualifies for these tax benefits is known as a Section 936 corporation, or a "possessions corporation." A Section 936 corporation is chartered in the United States and is almost always structured as a wholly owned subsidiary of a U.S. parent corporation. This arrangement is chosen because, in order to qualify for the tax benefits, at least 80 percent of the Section 936 corporation's gross income (income not reduced by expenses) must be earned from sources physically located within Puerto Rico. In addition, a Section 936 corporation must earn at least 75 percent of its income from active business operations, so that no more than 25 percent of its income can come from financial investment sources.

To qualify for the tax exemption in the United States, financial investment by Section 936 corporations must satisfy certain limitations of type and quantity. Not only must the financial income be less than 25 percent of the firm's total income, as described above, but the investments must be made in financial instruments located in Puerto Rico. In addition, the investment funds must be generated from active business in Puerto Rico. Financial income that passes these restrictions is known as Qualified Possessions Source Investment Income (QPSII.)

Income from intangible assets such as patents, trademarks, and trade names, transferred by a parent to its Section 936 subsidiary has received only partial tax exemption in the United States since 1982; this partial exemption is still preferential relative to general U.S. tax treatment of intangible transfers to subsidiaries operating in foreign countries. In an effort to reduce taxes, parent firms typically transfer to their Section 936 corporation the rights to certain intangibles, such as a drug patent. Before 1982, all of the Section 936 corporation's income from production in Puerto Rico that used the patent would be allocated on tax returns to the Section 936 corporation, making the income effectively tax-exempt in the United States. The research expenses that created the patent, however, would be generated in the United States and would reduce otherwise taxable U.S. income. The Congress considered these intangible transfers an abusive effort to avoid taxation, and in 1982 limited the amount of income from transferred intangibles that could be attributed for tax purposes to the Section 936 subsidiary. The treatment of intangible transfers to Section 936 corporations remains partly tax advantaged, however, relative to

general U.S. tax treatment of foreign transfers of intangibles (see United States tax code Sections 367 and 482).

Section 936 corporations and their parents can use several different tax accounting methods for the income arising from intangible transfers, but most will now use what is called the profit-split method.[1] Under this tax accounting method, generally half of the taxable income derived from the Puerto Rican operation is allocated to the Section 936 corporation, and the other half to the parent corporation. This method does not differentiate between types of intangibles, since it applies to production that uses both "marketing intangibles," such as trademarks and trade names, and "manufacturing intangibles," such as patents. Some part of the income from all intangibles, therefore, can be attributed to the Section 936 corporation and be tax exempt to the U.S. parent.

PUERTO RICO'S TAX RULES ON SECTION 936 CORPORATIONS

Puerto Rico's statutory corporate income tax rates currently are higher than the U.S. tax rates. In 1990, the statutory tax rates are between 22 percent and 42 percent, depending on the amount of income earned. According to legislation already in place, the top rate will fall to 35 percent by 1993, just above the top U.S. rate of 34 percent.

While Puerto Rico's statutory tax rate on Section 936 income is currently higher than that levied in the United States, Puerto Rico has legislated tax exemptions that dramatically reduce its effective tax rate on most Section 936 firms to near zero. Up to 90 percent of a Section 936 corporation's income earned within Puerto Rico is currently exempt from taxation, as long as the firm is engaged in manufacturing or export services. (Taken alone, this exemption would reduce the top 1990 tax rate from 42 percent to effectively as low as 4.2 percent.)

Puerto Rico's tax exemptions date back to the passage of the Industrial Tax Exemption Act of 1948, which was revised in 1953, 1963, 1978, and most recently in 1987. The exemptions are currently valid for 10 to 25 years, depending on the location of the plant and equipment; firms usually can expect extensions of the exemptions when they expire.[2]

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1. The cost-sharing method was widely used by firms with manufacturing intangibles until its benefits were curtailed sharply by the Tax Reform Act of 1986.

2. For a more complete discussion of the evolution of Puerto Rico's incentives through 1983, see the U.S. Department of Treasury, *The Operation and Effect of the Possessions Corporation System of Taxation, Fourth Report* (March 1983). For a more detailed discussion of the incentives as they were amended in 1987, see Joint Committee on Taxation, *Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence, and Enhanced Commonwealth Status* (S. 712, Puerto Rico Status Referendum Act) (JCS-19-89), November 14, 1989.

The effective corporate tax rate on Section 936 corporations may be reduced further by a tax incentive called flexible depreciation. Under Puerto Rico's tax depreciation system, manufacturing firms (and other favored industries) can depreciate as much of the value of their available property as desired in any year, without regard to the tax lifetime, as long as the depreciation deductions do not make taxable income negative. This tax incentive may not be valuable, however, to some firms that pay Puerto Rico's alternative minimum tax; the excess of flexible depreciation over straight-line depreciation is considered a tax preference for purposes of that tax.

Puerto Rico has also enacted tax incentives for Section 936 firms to reinvest their profits on the island. Puerto Rico taxes income of Section 936 firms when taken out of Puerto Rico, and it generally does not tax the interest earnings on funds invested in its financial instruments. Puerto Rico levies a tollgate tax on dividends of foreign corporations that are paid to a parent corporation. The tollgate tax on Section 936 firms is generally 10 percent, although it is reduced to 5 percent if they retain half of their earnings in specified Puerto Rico investments for five years. Furthermore, when Section 936 corporations earn income in Puerto Rico and keep it invested there in specified assets, Puerto Rico does not tax the earnings.

INTERACTION OF THE UNITED STATES AND PUERTO RICO TAX RULES ON SECTION 936 CORPORATIONS

Since Puerto Rico exempts only manufacturing and export service firms from the bulk of its income tax, virtually all Section 936 firms are of those types. Only a few Section 936 firms do not qualify for the Puerto Rico tax exemptions, and they pay full Puerto Rico taxes.

Section 936 corporations tend to retain a large share of their earnings in Puerto Rico, either invested in financial instruments or reinvested in plant and equipment, in order to gain the tax-advantaged return and avoid Puerto Rico's tollgate tax. Generally, these firms pay out dividends to their U.S. parents only to the extent necessary to avoid earning more than 25 percent of their income from these financial investments; otherwise, they would lose their Section 936 status. They must pay the tollgate tax on these dividend payments.

APPENDIX B

CBO'S ECONOMETRIC MODEL OF PUERTO RICO

A change in Puerto Rico's political status would have a significant direct economic impact on the island's economy. These direct effects would, in turn, trigger indirect economic effects that cannot be easily calculated without the use of a macroeconomic model. In order to calculate the macroeconomic consequences of a change in the island's political status, therefore, CBO developed an econometric model of Puerto Rico. This appendix describes the CBO model.

OVERVIEW OF THE MODEL

The CBO model is a small system of equations designed to achieve a single primary objective: to simulate the island's short-run economic response to changes in Puerto Rican export activity and net U.S. government income flows to the island. The structure of the model was chosen so as to meet this objective. This choice, however, also implies an important limitation on interpreting the reported model simulation results, a limitation that is discussed in a later section.

The Structure of the Model

The model describes the demand side of the Puerto Rican economy. Aggregate demand equals the sum of consumption, investment, and government and export demands minus imports. In the CBO model, each of these components of demand is in turn affected by movements in aggregate demand.[1] Thus, the model determines aggregate demand as the outcome of simultaneous interactions among aggregate activity levels and the components of demand and is commonly referred to by economists as a Keynesian income-expenditure system.

The model's behavior is strongly affected by the behavior of imports of capital services. Because Puerto Rico's economy is critically dependent on foreign-owned physical capital (in particular, operations owned by U.S. corporations), a substantial portion of income generated in Puerto Rico leaves the island economy.[2] This net outflow of "factor income" constitutes the difference between Puerto Rico's 1989 GDP of about $28 billion and its GNP of about $21 billion.

Outflows of factor income are the return on capital that finances the deficit in the Puerto Rican balance of payments. Thus, they are sensitive both to the size of the balance-of-payments deficit and to how much is financed by direct investment,

1. Consumption and investment by the Puerto Rican government are exogenous to the model.

2. The relevance of this fact to the design of econometric models for Puerto Rico is pointed out by Bernard Wasow, "Dependent Growth in a Capital-Importing Economy: The Case of Puerto Rico," *Oxford Economic Papers*, 30 (1978), p. 118.

which for reasons of tax planning described in the text has an exceptionally high recorded rate of return. Flows of factor income in turn affect how Puerto Rican income is related to its production. Because some of the income from production goes abroad, this factor limits the size of the domestic multiplier.

In constructing its model, CBO was guided by the earlier modeling efforts of others. The models that proved useful to the CBO research were Dutta-Su's model, published in 1969, and Freyre's model, published in 1979.[3]

While broadly similar in design to these two earlier models, the CBO model differs in two important respects, both of which are related to its more recent vintage:

- It includes the determination and consequences of net factor income flows in a critical way; and
- It is estimated through 1989, thereby encompassing the most recently available data.

A more detailed account of CBO's treatment of net factor income flows is given in the final section of this appendix.

The Model's Chief Structural Limitation

The CBO model's demand-oriented structure means it cannot directly explore many supply-side issues. For example, population is exogenous to the model, and labor supply plays no explicit role. Thus, the model provides no estimate of how economic changes are likely to affect either migration between Puerto Rico and the mainland, or labor force participation on the island. Moreover, prices in the CBO model are also exogenous and are used only to translate constant dollar into current dollar magnitudes and vice versa. These limitations imply that the aggregate supply curve in the CBO model is flat.

PROPERTIES OF THE INDIVIDUAL EQUATIONS

The CBO model consists of 74 equations, of which 19 are statistically estimated behavioral equations and the remaining 55 are identities. In addition, the model

3. See M.C. Dutta and V. Su, "An Econometric Model of Puerto Rico," *Review of Economic Studies*, 36(3) (July 1969), pp. 319-333; and Jorge Freyre, *El Modelo Economico de Puerto Rico* (San Juan: Inter-American University Press, 1979). A more recent model of Puerto Rico examined by CBO, while having a similar macroeconomic structure, also has an elaborate embedded interindustry structure; see F. Zalacain, "Un Sistema de Modelos Economicos Para Puerto Rico," 1985 (processed).

includes 38 exogenous variables.[4] This section presents the properties of the estimated equations for the components of aggregate demand and other income-side equations. A summary of the statistical fits for the estimated equations is given in Table B-1.

The Components of Aggregate Demand

Aggregate demand consists of six sectors--consumption, inventory investment, private fixed investment, government, exports, and imports.

Consumption. The consumption sector of the CBO model comprises four equations, for consumer durables, food, other nondurables, and services.

As can be seen from Table B-1, all the consumption equations fit the data relatively well. The normalized standard errors for this sector (rightmost column in Table B-1) are among the smallest in the model. The equations, each relating consumption to disposable income, differed only slightly in specification. With the exception of the equation for consumer durables, which was estimated under the assumption that consumers adjust their durable stocks gradually to an income-dependent target level, the consumption equations were related to a simple measure of permanent disposable income. Consumption of food was affected least by contemporaneous changes in income, and consumption of services seemed to have its own momentum, little affected by other variables.

The marginal propensity to consume (MPC) for each consumption category is given in the following table:

	MPC^{SR}	MPC^{LR}
CBO Model		
Durables	.1427	.2084
Food	.1193	.1193
Other Nondurables	.1183	.3066
Services	.2274	.2274
Total	.6077	.8617

4. In general, the model was estimated using annual data for the 1947-1989 period. The only exceptions were equations that required balance-of-payments data, which were only available to CBO for 1971 on. The data were taken from *Ingreso y Producto 1984*, Junta de Planificacion de Puerto Rico, May 1985; and *Informe Economico al Gobernador: Appendice Estadistico*, Junta de Planificacion de Puerto Rico, 1989.

TABLE B-1. SUMMARY OF MODEL GOODNESS-OF-FIT

Dependent Variable	Mnemonic	Adjusted R^2	Durbin Watson	Standard Deviation of Residual As a Percentage of Dependent Variable
Components of Real GNP				
Consumption				
Durables	CD54	.996	2.2	4.5
Food	CNFOOD54	.956	1.3	4.7
Other nondurables	CNOTH54	.991	1.1	4.4
Services[a]	CS54	.298	2.1	3.0
Inventory Investment	INV54CVH	.160	1.9	81.3
Private Fixed Investment				
Machinery	IM&EPRV54	.967	1.9	10.3
Structures	ICONPRV54	.928	1.5	16.4
Exports	EX54	.989	1.4	6.7
Imports				
Merchandise imports				
Consumer durables	MCD	.993	1.5	8.2
Food	MCNFOOD	.987	1.2	9.5
Other nondurables	MCNOTH	.989	1.7	11.6
Capital goods	MK	.957	1.1	19.2
Raw materials	MRAW	.988	1.1	8.8
Investment income outflows[a]	MYINV	.868	2.0	2.1
Other	MOTH	.988	1.4	4.3
Components of Income[a]				
Capital Depreciation	CCA	.688	2.6	4.5
Net Puerto Rican IBT	PRTX@SUB	.985	1.8	4.7
Wages and Salaries	WSD	.999	1.7	4.7
Nonlabor Net Income	YN@LABOR	.977	1.5	18.1

SOURCE: Congressional Budget Office.

NOTE: All equations were estimated using ordinary least squares.

a. Denotes that the equation was estimated in first differences.

Note that the short-run total MPC of 61 percent is considerably lower than the long-run MPC of 86 percent. These estimates for the total MPC are similar to Dutta-Su's estimates (59 percent in the short run and 87 percent in the long run).[5] In his model, Freyre does not distinguish between short- and long-run consumption effects. Freyre's total MPC of 83 percent is substantially larger than CBO's in the short run.

Inventory Investment. The inventory equation posits a gradual adjustment of real stocks to a long-term desired level which, in turn, depends upon real final sales. The equation implies a rather high long-run inventory-to-sales ratio of 52 percent and a rather low annual stock adjustment rate of 23 percent. As Table B-1 indicates, the inventory equation is the poorest fit in the model. Changes in the demand for real inventories, however, will have very little influence on the magnitude of economic effects of external shocks to Puerto Rico, since a rise in final sales leads to a short-term rise in inventory demands of only 12 percent of the increase in final sales.

Private Fixed Investment. The CBO model contains equations for private fixed investment in machinery and equipment, and in structures. Each of these equations has an "income-accelerator" specification relating real investment to lagged investment and the contemporaneous change in real GDP. The equations provide an adequate, though not exceptional, fit to the historical data (see Table B-1). The estimated equations suggest that the short-term (static) response of private fixed investment to a unit change in the level of real GDP is only 0.23.

Government. The government sector, consisting of a consumption and an investment component, is exogenous to the CBO model. This is a traditional approach used in many macroeconomic models such as those of the United States, but it contrasts sharply with Freyre's more elaborate treatment that relates government spending to taxes. Since CBO's main interest was in the fiscal relations between the island and the federal government, rather than in predicting the behavior of the island government, the traditional approach was followed. A treatment such as Freyre's would most likely have increased the predicted impact on the economy of shocks such as the loss of Section 936 investment.

Exports. Real exports are specified to depend upon the exogenously determined level of U.S. real GNP and lagged exports, and are thus effectively exogenous. The proportionate response in Puerto Rico's exports (in 1954 dollars) to a shock in U.S. real GNP (in 1982 dollars) is 0.37 in the short run and 1.59 in the long run. For the simulations reported in the text of this paper, exports were changed exogenously based on a side calculation of the loss in Section 936 activity.

Imports. The model distinguishes five categories of merchandise imports--consumer durables, food, other consumer nondurables, capital goods, and raw materials--in addition to outflows of investment income, and a final import class called "other" in

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5. The individual MPCs for equations in the CBO model differ somewhat more from those of Dutta-Su.

Table B-1. The model's import sector is estimated in current dollars because constant dollar figures are not available for components of imports.

The basic specification for the equations for merchandise imports relates each category of merchandise imports to a relevant demand variable. The determinants of the first three import categories are the corresponding current-dollar consumption expenditures. Imports of capital goods depend upon nominal fixed investment, while imports of raw materials depend upon current-dollar GDP.

The marginal propensities to import (MPI) for merchandise imports, which are listed below, indicate a rather high import response:

	MPI^{SR}	MPI^{LR}
Consumer Durables	.4696	.4696
Food	.3699	.3699
Other Nondurables	.1978	.1978
Capital Goods	.1362	.2927
Raw Materials	.3825	.3825

The final category of import demand, called "other" in Table B-1, consists largely of trade services and is determined by the aggregate volume of merchandise imports and a measure of non labor net income. This equation's dependence on merchandise imports (the coefficient is 0.11) adds to the model's overall import response.

Other Income-Side Equations

Most of the model's equations outside the demand relationships described above are identities. The four exceptions, discussed below, are capital depreciation, net Puerto Rican indirect business taxes, wage and salary disbursements, and nonlabor net income.

Capital Depreciation. The depreciation equation relates the change in depreciation to the contemporaneous level of current-dollar fixed investment (public and private). This specification was adopted because an official estimate of Puerto Rico's total net capital stock was not available. The equation fits reasonably well over the post-war period (see Table B-1) and implies that a unit change in investment stimulates a change of 0.03 in depreciation.

Net Puerto Rican Indirect Business Taxes. This equation relates indirect business taxes paid to the Puerto Rican government, less subsidies paid by the Puerto Rican government, to the level of durable and nondurable consumption expenditures. The equation fits fairly well (see Table B-1).

Wage and Salary Disbursements. Wages and salaries are assumed to be a fixed share of national income. While this assumption is somewhat unrealistic, it does not affect the macroeconomic behavior of the model.

Nonlabor Net Income. Nonlabor net income consists chiefly of profits of corporations and public enterprises, corporate profit tax receipts, and payments of interest by the Puerto Rican government. This time series is quite cyclical. The equation for nonlabor net income is estimated using a lagged independent variable (coefficient of 0.46) and national income minus wages and social insurance contributions (coefficient of 0.32).

THE EFFECT OF FACTOR INCOME FLOWS ON THE SIMULATION PROPERTIES OF THE MODEL

As was emphasized in the first section of this appendix, the flows of net service factor income play a critical role in CBO's model of the Puerto Rican economy and have a decisive effect on the model's simulation properties. The CBO model determines net factor income flows as the negative of Puerto Rico's outstanding net direct and indirect external liabilities multiplied by a rate of return, assumed equal to 10 percent in 1971.[6] Because of the size of the deficit in Puerto Rico's balance of payments, tracking these flows proved crucial to the behavior of the model.

Changes in factor income flows work to increase the effect on the Puerto Rican economy of reductions in exports. When exports fall, Puerto Rico's balance-of-payments deficit widens. Financing this deficit requires a capital inflow, which will earn a rate of return (assumed in the model to be 10 percent).[7] In subsequent years, this return must be paid in the form of interest and dividends out of income generated by current production. Thus, domestic incomes are reduced relative to domestic production--that is, GNP falls relative to GDP. Domestic consumption spending is thus reduced which in turn adds to the reduction in activity levels that started with the loss of exports.

Changes in flows of factor income, however, work to reduce the effect of changes in the fiscal policy of the island government. When the Puerto Rican government cuts its spending, for example, imports fall through the large import propensities described above, and the balance-of-payments deficit that has to be financed is reduced. Over a period of years, this effect reduces dividend and interest payments out of the island, and thus increases the proportion of income that is kept on the island--GNP rises relative to GDP. This increase in domestic income

6. Since adequate data on Puerto Rico's net external liabilities were not available to CBO, both the initial 1971 stock and rate of return were constructed so that this identity holds exactly.

7. The rate of return for direct investment by Section 936 firms is assumed to be 30 percent.

eventually offsets the impact on activity in Puerto Rico caused by the initial change in fiscal policy.

DOCUMENTATION FOR CBO'S MACROECONOMIC MODEL OF PUERTO RICO

ENDOGENOUS VARIABLES (74)

Stochastic (28)

CCA	CD54	CNFOOD54	CNOTH54	CS54
EX54	ICONPRV54	IM&EPRV54	INV54CH	MCD
MCNFOOD	MCNOTH	MK	MOTH	MRAW
MYINV	PCD	PCNFOOD	PCNOTH	PCS
PEX	PGC	PIFIX	PM@MYINV	PMYINV
PRTX@SUB	WSD	YN@LABOR		

Identities (46)

C	C54	CD	CNFOOD	CNOTH
CS	EX	EX@MSFI	EX@MSFI54	FEDTRP
FEDTW	GC	GDP	GDP54	GNP
GNP54	IFIX	IFIX54	INV54$	INVCH
M	M54	M@MYINV	NFEDTR	NIIP
NNP	PC	PEX@MSFI	PGDP	PGNP
PM	PRTW	PSF	SF	SF54
TCF	TP	TPF	TW	TX@SUB
UNEMPCH	YD	YD54	YN	YN@WSD
YP				

EXOGENOUS VARIABLES (38)

DUM7184	DUM7986	EX@MSFI54BASE	EX@MSFIBASE	FEDTRG
FEDTRO	FEDTRPBASE	GC54	GDP54BASE	GNPUS82
IG54	INV54CHBASE	INVCHBASE	NIIPBASE	NOTR
OTR&INT	PCDUS	PCNFOODUS	PCNOTHUS	PCOF
PCSUS	PEXUS	PGDPBUSHH	PIFIXUS	POP
RFEDTRP	RFEDTW	RNIIP	RPRTW	RTCF
RTP	RTPF	STAT	TCFADJ	TPFADJ
TWFADJ	UNEMPCOEFF	VBUS		

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ECONOMETRIC MODEL GLOSSARY

MNEMONIC	DESCRIPTION
C	Personal Consumption Expenditures: Total
C54	Personal Consumption Expenditures: Total (Millions of 1954 dollars)
CCA	Capital Consumption Allowance
CD	Consumer Durables
CD54	Consumer Durables (Millions of 1954 dollars)
CNFOOD	Consumer Nondurables, Food
CNFOOD54	Consumer Nondurables, Food (Millions of 1954 dollars)
CNOTH	Consumer Nondurables, Other
CNOTH54	Consumer Nondurables, Other (Millions of 1954 dollars)
CS	Consumer Services
CS54	Consumer Services (Millions of 1954 dollars)
DUM7184*	Dummy Variable (= 1 for 1971-1984, 0 otherwise)
DUM7986*	Dummy Variable (= 1 for 1979-1984, 0 otherwise)
EX	Exports of Goods & Services
EX54	Exports of Goods & Services (Millions of 1954 dollars)
EX@MSFI	Balance on Investment Income Flows (Exports Less Imports)
EX@MSFI54	Balance on Investment Income Flows (Exports Less Imports) (Millions of 1954 dollars)
EX@MSFIBASE*	Balance on Investment Income Flows (Exports Less Imports) , Base
EX@MSFI54BASE*	Balance on Investment Income Flows(Exports Less Imports) (Millions of 1954 dollars), Base
FEDTRG*	Federal Transfers to the Puerto Rico Government
FEDTRO*	Federal Transfers to Other
FEDTRP	Federal Transfers to Persons
FEDTRPBASE*	Federal Govt. Transfers to Persons , Base
FEDTW	SI Contributions to Federal Govt.
GC	Puerto Rico Government Consumption Expenditures
GC54*	Government Consumption Expenditures (Millions of 1954 dollars)
GDP	Gross Domestic Product
GDP54	Gross Domestic Product (Millions of 1954 dollars)
GDP54BASE*	Gross Domestic Product (Millions of 1954 dollars), Base
GNP	Gross National Product
GNP54	Gross National Product (Millions of 1954 dollars)
GNPUS82*	Gross National Product, United States (1982$)
ICONPRV54	Private Fixed Investment: Construction (Millions of 1954 dollars)
IFIX	Fixed Investment
IFIX54	Fixed Investment (Millions of 1954 dollars)
IG54*	Fixed Investment, Puerto Rico Government and Public Enterprises (Millions of 1954 dollars)
IM&EPRV54	Private Fixed Investment: Machinery & Equipment (Millions of 1954 dollars)
INV54$	Inventory Stock (Millions of 1954 dollars)
INV54CH	Inventory Change (Millions of 1954 dollars)
INV54CHBASE*	Inventory Change (Millions of 1954 dollars), Base
INVCH	Inventory Change
INVCHBASE*	Inventory Change, Base
M	Imports of Goods & Services
M54	Imports of Goods & Services (Millions of 1954 dollars)
M@MYINV	Imports of Goods & Services excl. Investment Income Flows

MNEMONIC	DESCRIPTION
MCD	Imports of Durable Consumer Goods
MCNFOOD	Imports of Food
MCNOTH	Imports of Other Nondurable Consumer Goods
MK	Imports of Capital Goods
MOTH	Other Imports
MRAW	Imports of Raw Materials
MYINV	Investment Income Outflows
NFEDTR	Net Federal Govt. Transfers
NIIP	Net Direct and Indirect Liabilities of Puerto Rico
NIIPBASE*	Net Direct and Indirect Liabilities of Puerto Rico , Base
NNP	Net National Product
NOTR*	Other Net Transfers
OTR&INT*	Other Transfers and Interest Paid
PC	Implicit Price Deflator for Total Consumer Expenditures (= 1 in 1954)
PCD	Implicit Price Deflator for Consumer Durable (= 1 in 1954)
PCDUS*	Implicit Price Deflator for Consumer Durables, U.S. (= 1 in 1982)
PCNFOOD	Implicit Price Deflator for Food Consumption (= 1 in 1954)
PCNFOODUS*	Implicit Price Deflator for Food Consumption, U.S. (= 1 in 1982)
PCNOTH	Implicit Price Deflator for Other Nondurable Consumption (= 1 in 1954)
PCNOTHUS*	Implict Price Deflator for Other Non-Durables, U.S. (= 1 in 1982
PCOF*	Average U.S. Refiners' Acquisition Cost of Imported Oil (Dollars per barrel)
PCS	Implicit Price Deflator for Services Consumption (= 1 in 1954)
PCSUS*	Implicit Price Deflator for Services Consumption, U.S. (= 1 in 1982
PEX	Implicit Price Deflator for Total Exports (= 1 in 1954)
PEXUS*	Implicit Price Deflator for U.S. Exports (= 1 in 1982
PEX@MSFI	Implicit Price Deflator for Net Investment Income Exports (= 1 in 1954)
PGC	Implicit Price Deflator for Government Consumption (= 1 in 1954)
PGDP	Implicit Price Deflator for GDP (= 1 in 1954)
PGDPBUSHHUS*	Implicit Price Deflator For Gross Domestic Product: Nonfarm, Nonhousing Business, U.S. (= 1 in 1982)
PGNP	Implicit Price Deflator for GNP (= 1 in 1954)
PIFIX	Implicit Price Deflator for Fixed Investment (= 1 in 1954)
PIFIXUS*	Implicit Price Deflator for Fixed Investment, U.S. (= 1 in 1982)
PM	Implicit Price Deflator for Total Imports (= 1 in 1954)
PM@MYINV	Implicit Price Deflator for Total Imports excl. Investment Income (= 1 in 1954)
PMYINV	Implicit Price Deflator for Investment Income (= 1 in 1954)
POP*	Population (thousands of persons)
PRTW	Social Insurance Contributions to Puerto Rico Govt.
PRTX@SUB	Puerto Rico Indirect Business Taxes Minus PR Govt. Subsidies
PSF	Implicit Price Deflator for Final Sales
RFEDTRP*	Marginal Federal Govt. Transfers to Persons Per Person Employed
RFEDTW*	Marginal Rate of SI Contributions to Federal Govt. Per Dollar of Wages
RNIIP*	Marginal Return On Direct and Indirect Investment in Puerto Rico
RPRTW*	Rate of Social Insurance Contributions to Puerto Rico Govt. Per Dollar of Wages
RTCF*	Marginal U.S. Corporate Income Tax Rate
RTP*	Marginal Personal Income Tax Rate

MNEMONIC	DESCRIPTION
RTPF*	Marginal U.S. Personal Income Tax Rate
SF	Final Sales
SF54	Final Sales (Millions of 1954 dollars)
STAT*	Statistical Discrepancy
TCF	U.S. Corporate Income Taxes
TCFADJ*	Adjustment to U.S. Corporate Income Taxes
TP	Personal Income Taxes
TPF	U.S. Personal Income Taxes
TPFADJ*	Adjustment to U.S. Personal Income Taxes
TW	Social Insurance Contributions
TWFADJ*	Adjustment to Social Insurance Contributions to Federal Govenment
TX@SUB	Indirect Business Taxes Minus Subsidies
UNEMPCH	Simulated Change in Unemployment (thousands of persons)
UNEMPCOEFF*	Coefficient in Unemployment Equation
VBUS*	Transfer Payments By Business
WSD	Wage & Salary Disbursements
YD	Disposable Personal Income
YD54	Disposable Personal Income (Millions of 1954 dollars)
YN	National Income
YN@LABOR	Undistributed Corporate & Public Enterprise Profits+Interest Received by Govt
YN@WSD	National Income Minus Wages & Salaries
YP	Personal Income

ECONOMETRIC MODEL EQUATION LISTING

C PCE: Total ($)
(Identity)

c

= cd+cnfood+cnoth+cs

C54 PCE: Total (1954$)
(Identity)

c54

= cd54+cnfood54+cnoth54+cs54

CCA Capital Depreciation ($)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

diff(cca)

= 0.03154 * ifix + 0.37161
(9.5510) (0.06961)

Sum Sq	19837.3	Std Err	22.2695	LHS Mean	39.3929
R Sq	0.6952	R Bar Sq	0.6876	F 1, 40	91.2224
D.W.(1)	2.5861	D.W.(2)	1.9198		

CCA=cca[-1]+??

CD PCE: Durables ($)
(Identity)

cd

= pcd*cd54

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CD54 PCE: Durables (1954$)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

cd54

= 0.31524 * cd54[-1] + 0.42905 * yd54 - 0.28637 * yd54[-1]
(2.80994) (10.6564) (7.16309)

- 83.3962
(5.82116)

Sum Sq	14041.0	Std Err	19.2224	LHS Mean	409.369
R Sq	0.9957	R Bar Sq	0.9953	F 3, 38	2908.37
D.W.(1)	2.2433	D.W.(2)	1.4768		
H	-1.5700				

CNFOOD PCE: Food ($)
(Identity)

cnfood

= pcnfood*cnfood54

CNFOOD54 PCE: Food (1954$)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

cnfood54/pop

= 0.11925 * yd54/pop + 0.09484
(29.9727) (26.3724)

Sum Sq	0.0033	Std Err	0.0090	LHS Mean	0.1942
R Sq	0.9574	R Bar Sq	0.9563	F 1, 40	898.365
D.W.(1)	1.2676	D.W.(2)	2.4873		

CNFOOD54=??*pop

CNOTH PCE: Other Nondurables ($)
(Identity)

cnoth

= pcnoth*cnoth54

CNOTH54 PCE: Other Nondurables (1954$)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

(cnoth54/pop)

= 0.61401 * (cnoth54/pop)[-1] + 0.11834 * (yd54/pop) - 0.00152
(3.64492) (2.40733) (0.33083)

Sum Sq	0.0040	Std Err	0.0101	LHS Mean	0.2379
R Sq	0.9912	R Bar Sq	0.9908	F 2, 39	2206.94
D.W.(1)	1.0508	D.W.(2)	1.3649		

CNOTH54=??*pop

CS PCE: Services ($)
(Identity)

cs

= pcs*cs54

CS54 PCE: Services (1954$)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

diff(cs54/pop)

= 0.22738 * diff(yd54/pop) + 0.00602
(4.29308) (3.06092)

Sum Sq	0.0031	Std Err	0.0088	LHS Mean	0.0121
R Sq	0.3154	R Bar Sq	0.2983	F 1, 40	18.4305
D.W.(1)	2.0644	D.W.(2)	2.2503		

CS54=cs54[-1]+(??*pop[-1])

EX Exports of Goods & Services ($)
(Identity)

ex

= pex*ex54

EX54 Exports of Goods & Services (1954$)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

ex54

= 0.76930 * ex54[-1] + 0.36665 * gnpus82 - 387.185
(6.83160) (2.59069) (2.48409)

Sum Sq	548911	Std Err	118.637	LHS Mean	1732.25
R Sq	0.9900	R Bar Sq	0.9895	F 2, 39	1926.97
D.W.(1)	1.4210	D.W.(2)	1.9942		
H	2.3396				

EX@MSFI Net Factor Income Exports ($)
(Identity)

ex@msfi

= ex@msfibase+(-rniip*(niip[-1]-niipbase[-1]))
EX@MSFI54 Net Factor Income Exports (54$)
(Identity)

ex@msfi54

= ex@msfi54base+(ex@msfi-ex@msfibase)/pgdp

FEDTRP Federal Govt. Transfers to Persons ($)
(Identity)

fedtrp

= fedtrpbase+rfedtrp*unempch

FEDTW SI Contributions to Federal Govt. ($)
(Identity)

fedtw

= rfedtw*wsd+twfadj

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GC Government Consumption Expenditures ($)
(Identity)

gc

= pgc*gc54

GDP Gross Domestic Product ($)
(Identity)

gdp

= gnp-ex@msfi

GDP54 Gross Domestic Product (1954$)
(Identity)

gdp54

= gnp54-ex@msfi54

GNP Gross National Product ($)
(Identity)

gnp

= sf+invch

GNP54 Gross National Product (1954$)
(Identity)

gnp54

= sf54+inv54ch

ICONPRV54 Private Fixed Investment: Construction (1954$)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

iconprv54

= 0.90511 * iconprv54[-1] + 0.07458 * diff(gdp54)
(20.8369) (1.94364)

- 17.4971 * dum7986 + 12.2321
(1.63000) (1.41189)

Sum Sq	27903.1	Std Err	27.0978	LHS Mean	159.336
R Sq	0.9330	R Bar Sq	0.9277	F 3, 38	176.329
D.W.(1)	1.5462	D.W.(2)	1.7225		
H	1.5323				

IFIX Fixed Investment ($)
(Identity)

ifix

= pifix*ifix54

IFIX54 Fixed Investment (1954$)
(Identity)

ifix54

= im&eprv54+iconprv54+ig54

IM&EPRV54 Private Fixed Investment: Machinery & Equipment (1954$)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

im&eprv54

= 0.94624 * im&eprv54[-1] + 0.15649 * diff(gdp54) - 3.21450
(27.5507) (5.85025) (0.57948)

Sum Sq	11939.3	Std Err	17.4967	LHS Mean	165.500
R Sq	0.9689	R Bar Sq	0.9673	F 2, 39	607.702
D.W.(1)	1.9004	D.W.(2)	1.2561		
H	-0.6068				

INV54$ Inventory Stock (1954$,proxy)
(Identity)

inv54$

= inv54$[-1]+inv54ch

INV54CH Inventory Change (1954$)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

inv54ch

= 0.12145 * sf54 - 0.23331 * inv54$[-1] - 79.3765
(2.59290) (2.40763) (1.80928)

Sum Sq 54916.8 Std Err 37.5250 LHS Mean 44.9667
R Sq 0.2007 R Bar Sq 0.1597 F 2, 39 4.8950
D.W.(1) 1.8930 D.W.(2) 2.5556

INVCH Inventory Change ($)
(Identity)

invch

= invchbase+psf*(inv54ch-inv54chbase)

M Imports of Goods & Services ($)
(Identity)

m

= m@myinv+myinv
M54 Imports of Goods & Services (1954$)
(Identity)

m54

= (m@myinv/pm@myinv)+(myinv/pmyinv)

M@MYINV Imports of Goods & Services excl MYINV ($)
(Identity)

m@myinv

= mcd+mcnfood+mcnoth+mk+mraw+moth

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MCD Imports of Durable Consumer Goods ($)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

mcd

= 0.46974 * cd - 5.80454
(78.7651) (0.82422)

Sum Sq	41253.0	Std Err	32.1143	LHS Mean	388.345
R Sq	0.9936	R Bar Sq	0.9934	F 1, 40	6203.96
D.W.(1)	1.5024	D.W.(2)	1.4600		

MCNFOOD Imports of Food ($)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

mcnfood

= 0.36980 * cnfood + 127.895 * dum7184 + 3.31245
(47.4786) (6.55390) (0.26016)

Sum Sq	111604	Std Err	53.4943	LHS Mean	549.771
R Sq	0.9879	R Bar Sq	0.9873	F 2, 39	1597.16
D.W.(1)	1.2337	D.W.(2)	1.7560		

MCNOTH Imports of Other Nondurable Consumer Goods ($)
Cochran-Orcutt
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

mcnoth

= 0.19783 * cnoth + 71.4741
(14.9594) (2.44221)

Sum Sq	41423.3	Std Err	32.5904	LHS Mean	379.867
R Sq	0.9899	R Bar Sq	0.9893	F 2, 39	1902.05
D.W.(1)	1.7239	D.W.(2)	2.0151		

MK Imports of Capital Goods ($)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

mk

= 0.53460 * mk[-1] + 0.13623 * ifix - 22.7961
(2.41922) (2.95558) (1.72070)

Sum Sq 118649 Std Err 55.1570 LHS Mean 279.476
R Sq 0.9589 R Bar Sq 0.9568 F 2, 39 455.006
D.W.(1) 1.0946 D.W.(2) 0.8579

MOTH Other Imports ($)
Ordinary Least Squares
ANNUAL data for 19 periods from 1971 to 1989
Date: 6 MAR 1990

moth

= 0.11186 * (mcd+mcnfood+mcnoth+mk+mraw) + 0.44125 * yn@labor
(10.2213) (5.73171)

+ 355.133
(7.25492)

Sum Sq 94171.6 Std Err 76.7185 LHS Mean 1663.13
R Sq 0.9893 R Bar Sq 0.9879 F 2, 16 736.855
D.W.(1) 1.3920 D.W.(2) 2.0986

MRAW Imports of Raw Materials ($)
Ordinary Least Squares
ANNUAL data for 29 periods from 1961 to 1989
Date: 6 MAR 1990

mraw

= 0.38246 * gdp + 32.4238 * pcof - 564.363
(29.9273) (3.57611) (4.82129)

Sum Sq 3504237 Std Err 367.122 LHS Mean 3998.45
R Sq 0.9889 R Bar Sq 0.9881 F 2, 26 1160.36
D.W.(1) 1.1006 D.W.(2) 1.5333

MYINV Investment Income Outflows ($)
Ordinary Least Squares
ANNUAL data for 18 periods from 1972 to 1989
Date: 6 MAR 1990

diff(myinv)

= - 1.03605 * diff(ex@msfi) + 71.9544
(10.6261) (1.49845)

Sum Sq 161587 Std Err 100.495 LHS Mean 515.811
R Sq 0.8759 R Bar Sq 0.8681 F 1, 16 112.914
D.W.(1) 2.0371 D.W.(2) 1.7627

MYINV=myinv[-1]+??

NFEDTR Net Federal Govt. Transfers ($)
(Identity)

nfedtr

= fedtrp+fedtrg-fedtw-fedtro-(tpf+tcf)

NIIP Net Direct and Indirect Liabilities of Puerto Rico
(Identity)

niip

= niip[-1]+(m-ex)-(nfedtr+notr)

NNP Net National Product ($)
(Identity)

nnp

= gnp-cca

PC Implicit Price Deflator for Consumption
(Identity)

pc

= c/c54

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PCD Implicit Price Deflator for Durable Consumption
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

pcd

```
 =   1.00000 * pcd[-1]*(pcdus/pcdus[-1]) + 0.00000
    (    NC)                        (    NC)
```

PCNFOOD Implicit Price Deflator for Food Consumption
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

pcnfood

```
 =   1.00000 * pcnfood[-1]*(pcnfoodus/pcnfoodus[-1]) + 0.00000
    (    NC)                              (    NC)
```

PCNOTH Implicit Price Deflator for Other Nondurable Consumption
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

pcnoth

```
 =   1.00000 * pcnoth[-1]*(pcnothus/pcnothus[-1]) + 0.00000
    (    NC)                              (    NC)
```

PCS Implicit Price Deflator for Services Consumption
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

pcs

```
 =   1.00000 * pcs[-1]*(pcsus/pcsus[-1]) + 0.00000
    (    NC)                        (    NC)
```

PEX Implicit Price Deflator for Total Exports
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

pex

= 1.00000 * pex[-1]*(pgdpbushhus/pgdpbushhus[-1]) + 0.00000
(NC) (NC)

PEX@MSFI Implicit Price Deflator for Net Factor Income Exports ($)
(Identity)

pex@msfi

= ex@msfi/ex@msfi54

PGC Implicit Price Deflator for Government Consumption
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

---

pgc

= 1.00000 * pgc[-1]*(pgdp/pgdp[-1]) + 0.00000
(NC) (NC)

PGDP Implicit Price Deflator for GDP
(Identity)

pgdp

= gdp/gdp54

PGNP Implicit Price Deflator for GNP
(Identity)

pgnp

= gnp/gnp54

PIFIX Implicit Price Deflator for Fixed Investment
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

---

pifix

```
 =   1.00000 * pifix[-1]*(pifixus/pifixus[-1]) + 0.00000
   (    NC)                                (    NC)
```

PM Implicit Price Deflator for Total Imports
(Identity)

pm

```
 = m/m54
```

PM@MYINV Implicit Price Deflator for Total Imports excl. MYINV
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

---

pm@myinv

```
 =   1.00000 * pm@myinv[-1]*(pexus/pexus[-1]) + 0.00000
   (    NC)                                (    NC)
```

PMYINV Implicit Price Deflator for MYINV
(imposed)
ANNUAL data for 43 periods from 1947 to 1989
Date: 6 MAR 1990

pmyinv

```
 =   1.00000 * pmyinv[-1]*(pex@msfi/pex@msfi[-1]) + 0.00000
   (    NC)                                (    NC)
```

PRTW SI Contributions to Puerto Rico Govt. ($)
(Identity)

prtw

```
 = rprtw*wsd
```

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PRTX@SUB Indirect Business Taxes Minus PR Govt.Subsidies ($)
Ordinary Least Squares
ANNUAL data for 19 periods from 1971 to 1989
Date: 6 MAR 1990

prtx@sub

= 0.15530 * (cd+cnfood+cnoth) + 13.5418
(34.5573) (0.40289)

Sum Sq	47112.5	Std Err	52.6433	LHS Mean	1097.49
R Sq	0.9860	R Bar Sq	0.9851	F 1, 17	1194.20
D.W.(1)	1.8036	D.W.(2)	2.8658		

PSF Implicit Price Deflator for Final Sales ($)
(Identity)

psf

= sf/sf54

SF Final Sales ($)
(Identity)

sf

= c+ifix+gc+(ex-m)

SF54 Final Sales (1954$)
(Identity)

sf54

= c54+ifix54+gc54+(ex54-m54)

TCF U.S. Corporate Income Taxes ($)
(Identity)

tcf

= rtcf*yn@labor+tcfadj

TP Personal Income Taxes ($)
(Identity)

tp

= rtp*yp+tpf
TPF U.S. Personal Income Taxes ($)
(Identity)

tpf

= rtpf*yp+tpfadj

TW Total SI Contributions
(Identity)

tw

= fedtw+prtw

TX@SUB Indirect Business Taxes Minus Subsidies ($)
(Identity)

tx@sub

= prtx@sub-fedtro

UNEMPCH Simulated Change in Unemployed Persons (thousands)
(Identity)

unempch

= -unempcoeff*(gdp54-gdp54base)
WSD Wage & Salary Disbursements ($)
Cochran-Orcutt
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

---

wsd

= 0.65638 * yn + 98.7980
(45.1982) (0.69384)

Sum Sq 269271 Std Err 83.0927 LHS Mean 3414.41
R Sq 0.9993 R Bar Sq 0.9993 F 2, 39 28696.0
D.W.(1) 1.7160 D.W.(2) 2.0254

YD Disposable Personal Income ($)
(Identity)

yd

= yp-tp

YD54 Disposable Personal Income (1954$)
(Identity)

yd54

= yd/pc

YN National Income ($)
(Identity)

yn

= nnp-(tx@sub+vbus+stat)

YN@LABOR Corp. & Public Ent. Profits + Interest Received by Govt ($)
Ordinary Least Squares
ANNUAL data for 42 periods from 1948 to 1989
Date: 6 MAR 1990

yn@labor

= 0.46010 * yn@labor[-1] + 0.32144 * (yn@wsd-tw) - 96.5457
(4.29666) (5.81505) (3.89840)

Sum Sq 234934 Std Err 77.6141 LHS Mean 418.669
R Sq 0.9784 R Bar Sq 0.9773 F 2, 39 883.355
D.W.(1) 1.4777 D.W.(2) 1.4290
H 2.3004

YN@WSD National Income Minus Wages & Salaries ($)
(Identity)

yn@wsd

= yn-wsd

YP Personal Income ($)
(Identity)

yp

= yn-(prtw+fedtw+yn@labor)+fedtrp+otr&int

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

March 9, 1989

TO : Honorable Bennett Johnston
Attention: Laura Hudson

FROM : American Law Division

SUBJECT : Discretion of Congress Respecting Citizenship Status of Puerto Ricans

This memorandum responds to your request for a brief discussion of the question whether Congress may be constitutionally constrained in decision-making with regard to the citizenship status of Puerto Ricans. The matter arises in the context of present proposals to afford Puerto Rico a choice through referendum of continuing commonwealth status, statehood, or independence. If the decision should be in favor of independence, what alteration could Congress constitutionally make with respect to United States citizenship of the residents of Puerto Rico?

In §7 of the Foraker Act, 31 Stat. 77 (1900), passed in the wake of the acquisition by the United States of Puerto Rico, Congress provided that all inhabitants of "Porto Rico," as it was then known, and their children born thereafter "shall be deemed and held to be citizens of Porto Rico, and as such entitled to the protection of the United States." Subsequently, by §5 of the Organic Act (Jones Act), 39 Stat. 953 (1917), "all citizens of Porto Rico ... are hereby declared, and shall be deemed and held to be, citizens of the United States." See 8 U.S.C. §1402(present law).

Although the original Constitution of 1789 contained several requirements of and provisions respecting citizenship, it nowhere defined who was or could be a citizen of the United States. By Article I, §8, cl. 4, Congress was empowered to "establish an uniform Rule of Naturalization," and pursuant to this power from the beginning provided not only for a naturalization process but also enacted a series of provisions determining what persons born outside the United States were to be citizens and what conditions if any they had to meet. 1 Stat. 103 (1790). But the omission in the Constitution of a definition of citizenship or of criteria for citizenship created a situation under which it was strenuously argued that national citizenship was derivative of citizenship under one of the States, an argument that culminated in the *Dred Scott* case. *Scott v. Sandford*, 19 How. (60 U.S.) 393 (1857). *Dred Scott* was reversed, first by the Civil Rights Act of 1866, 14 Stat. 27, and then by the first sentence of §1 of the Fourteenth Amendment. The Amendment provided: "All persons born

or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and the State wherein they reside."

That the first sentence of §1 of the Fourteenth Amendment comprehended more than a declaration of who was a citizen was determined by the Supreme Court in *Afroyim v. Rusk*, 387 U.S. 253 (1967), a controversial and divided decision in which the Court ruled that the Amendment withdrew from Congress the power to expatriate United States citizens against their will for any reason. See *Vance v. Terrazas*, 444 U.S. 252 (1980)(process for determining whether one has voluntarily renounced citizenship). Afroyim was a Polish national by birth, but he had acquired United States citizenship by naturalization. He had voted in a political election in Israel, and the Government attempted to revoke his citizenship under a statute which prescribed that penalty for voting in a foreign election.

If the *Afroyim* case applied to those persons made United States citizens by force of statute because of their Puerto Rican citizenship, then Congress might well lack the power statutorily to alter the citizenship status. We say "might," inasmuch as the situation in which Puerto Rico was granted independence could elicit a compelling argument excepting the case from the *Afroyim* rule. But it appears that *Afroyim* is inapplicable in the instance of Puerto Rico.

In *Rogers v. Bellei*, 401 U.S. 815 (1971), the Court had before it a challenge to an immigration law provision that requires one who acquired United States citizenship by virtue of having been born abroad to parents, one of whom is an American citizen, to reside in this country continuously for five years between the ages of 14 and 28. Forfeiture of citizenship is the price of failing to meet the residency requirement. Upholding the constitutionality of the provision, the Court, still divided, ruled that *Afroyim* was inapplicable because the claimant was not a "Fourteenth Amendment citizen" within the meaning of the first sentence, which defined citizens as those "born or naturalized *in* the United States."(Italics supplied). Because Bellei had been born *outside* the United States and naturalized *outside* the United States by statute, he did not meet the Fourteenth Amendment definition. Thus, the denaturalization provision, in order to be sustained, had only to be reasonable and not arbitrary.

The case law establishes that Puerto Rico, whatever its exact status and relationship to the United States is not itself *in* the United States. The reason this conclusion is possible owes to the decision of the *Insular Cases* following the acquisition of Puerto Rico and the Philippines. Those cases grappled with the difficult question whether "the Constitution follows the flag." That is, when the United States acquires territories or possessions, is the United States within the particular territory or possession bound by the Constitution in all respects? The cases held in the negative, but the reason for the result was for a time difficult to discern. In *De Lima v. Bidwell*, 182 U.S. 1 (1901), the Court ruled that Puerto Rico was not a "foreign country" after acquisition within the meaning of the United States tariff law. See also *Dooley v. United*

States, 182 U.S. 222 (1901)(authority to tax imports from United States into Puerto Rico ended when territory was ceded to the United States). *Downes v. Bidwell*, 182 U.S. 244 (1901), was the difficult case, in which, over four dissents and with no opinion of the Court by a majority of the Justices, it was determined that a discriminatory tax could be imposed on Puerto Rico despite the direction of Article I, §8, cl. 1 that "all Duties, Imposts and Excises shall be uniform throughout the United States."

One of the Justices in the majority simply took the position that nothing in the Constitution applied to any of the territories. Id., 285-286 (Justice Brown announcing the judgment of the Court). The other eight Justices disagreed, although they did not agree with each other. In a concurring opinion, Justice White, for himself and two other Justices with a third agreeing in substance, propounded a theory under which he found that Puerto Rico was not a part of "the United States" within the meaning of the uniformity clause. Id., 287. According to the theory, a territory becomes part of the United States only after it has been "incorporated" by congressional action, action that manifests an intention on the part of the political branches to set a territory upon a course of ultimate integration into the union of States. Those territories that Congress does not intend to admit into the union at some point in the future are not parts of "the United States" in the context of provisions limited in their application to "the United States." Id., 292, 299, 341-342. The concurrence specifically alluded to the difficulties which would accompany the inability of the United States to restrict the inhabitants of acquired territories from access to automatic citizenship in the United States if all the Constitution was applicable to the territories upon acquisition, an acknowledgment that absent incorporation the first sentence of §1 of the Fourtenth Amendment would have no effect. Id., 306, 313. He accepted that some provisions of the Constitution would apply to the island. Id., 293.

In *Dorr v. United States*, 195 U.S. 138 (1904), the Court ruled that the Constitution's jury trial provisions, Article III, §2, cl. 3; Sixth Amendment, did not apply to the Philippines. With only one Justice dissenting, the Court accepted Justice White's *Downes* concurrence and pointed to the fact that Congress had not "incorporated" the Islands. See also *Hawaii v. Mankichi*, 190 U.S. 197 (1903). Again, what provisions of the Constitution did apply was left uncertain. Then, in *Balzac v. Porto Rico*, 258 U.S. 298 (1922), a unanimous Court in an elaborate opinion by Chief Justice Taft considered whether a Sixth Amendment right to jury applied in the courts of Puerto Rico. Resolution of the question turned on whether Puerto Rico had been "incorporated" into the United States, the Court held, and it ruled that Congress had not done so. The fact that the Jones Act had extended United States citizenship to Puerto Ricans did not establish a showing of incorporation, nor did a variety of other enactments in that and other laws evidence an intent to put Puerto Rico on a course to eventual statehood.

The rule which emerges from these cases, as stated in Justice White's *Downes* concurrence, subsequently adopted by the Court, is that "whilst in an international sense Porto Rico was not a foreign country, since it was subject

to the sovereignty of and was owned by the United States, it was foreign to the United States in a domestic sense, because the island had not been incorporated into the United States, but was merely appurtenant thereto as a possession." *Downes*, supra, 258 U.S., 341-342. See *Balzac*, supra, 258 U.S., 305 (*Downes* and *Dorr* settled that neither the Philippines nor Puerto Rico "was territory which had been incorporated in the Union or become a part of the United States, as distinguished from merely belonging to it"), 313 ("we find no features in the Organic Act ... from which we can infer the purpose of Congress to incorporate Porto Rico into the United States with the consequences which would follow").

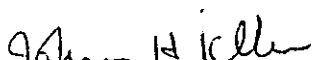
It is true that some Justices have since questioned the vitality of the *Insular Cases*. See *Reid v. Covert*, 354 U.S. 1, 14 (1957)(plurality opinion of Justice Black). But in *Torres v. Puerto Rico*, 442 U.S. 465, 469-470 (1979), the history and the cases are recited with approval of the analysis, while four concurring Justices would have limited the "old cases" to their "particular historical context." Id., 474, 475. On the other hand, the concurrence was expressly concerned with the application of the Bill of Rights to Puerto Rico. In that regard, the recent cases do apply certain Bill of Rights guarantees to the Commonwealth. See *Calero-Toledo v. Pearson Yacht Leasing Co.*, 416 U.S. 663 (1974)(due process clause applies, but Court does not decide whether the Fifth or Fourteenth Amendment is relevant provision); *Examining Board v. Flores de Otero*, 426 U.S. 572 (1976)(equal protection guarantee of either the Fifth or Fourteenth Amendment); *Califano v. Torres*, 435 U.S. 1, 4 n. 6 (1978)(assuming constitutional right to travel applies). In *Balzac*, supra, 258 U.S., 314, the Court assumed that the First Amendment speech and press guarantees applied. On the other hand, in *Torres v. Puerto Rico*, supra, the majority of the Justices reached the conclusion that the Fourth Amendment's search and seizure guarantee applied on the basis that Congress in its governing legislation had always acted on the premise that the Amendment could be applied to Puerto Rico without danger to national interests or the risk of unfairness.

But care must be taken when considering the impact of the recent judicial debates on the *Insular Cases* to remember that those decisions did not question the application of any of the Constitution's provisions; rather, the Court assumed that certain "fundamental" guarantees did apply. The more recent debate reflects the division within the Court on the "fundamentality" of most of the provisions of the Bill of Rights. Nothing said in these cases need be taken as questioning the theory regarding "incorporation" of a territory or possession into "the United States." In that perspective, then, the limitation of the first sentence of §1 of the Fourteenth Amendment would not restrain Congress' discretion in legislating about the citizenship status of Puerto Rico.

Of course, some Puerto Ricans do have "Fourteenth Amendment citizenship." That is, those who were born *in* the United States are within the meaning of §1 and are therefore constitutional citizens from birth. Cf. *United States v. Wong Kim Ark*, 169 U.S. 649 (1898). As to them, either dual

citizenship or some treaty provision requiring some choice might be alternatives. In any event, the relative numbers of persons involved will be small.

You also inquired with regard to the citizenship status of residents of the Philippines. Under §4 of the Organic Act, 32 Stat. 691, 692 (1902), Congress provided that all residents of the Philippines and their subsequently born children should be deemed to be "citizens of the Philippine Islands" entitled to the protection of the United States. As noted above, *Dorr v. United States*, supra, held that the Philippines was an unincorporated territory. In §8 of the Philippine Independence Act, 48 Stat. 456, 462 (1934), the Philippines was treated as a foreign country for many purposes. Filipino citizens were treated as aliens for immigration purposes; United States foreign service officers assigned to the Philippines were treated as if stationed in a foreign country. See *Hooven v. Evatt*, 325 U.S. 652, 677-678, 692 (1944). There was, thus, no comparable citizenship issue upon independence.



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May 22, 1989

TO : Honorable Bennett Johnston
Attention: Laura Hudson

FROM : American Law Division

SUBJECT : Limitation of Certain Corporate Expenditures in Proposed Puerto Rico Referendum

This memorandum responds to your inquiry with respect to the constitutional validity of a proposal to limit, in the proposed referendum to be held in Puerto Rico on the future status of the Commonwealth, expenditures in the referendum by corporations which receive benefits under § 936 of the Internal Revenue Code.

As you note, there is a body of Supreme Court precedent protecting corporate political expenditures under the First Amendment speech clause. The essential question is whether the First Amendment applies in full in Puerto Rico so that such a limitation would be governed by these precedents.

In this memorandum, we set forth applicable principles which we believe support three conclusions. First, the First Amendment is one of the fundamental constitutional provisions which fully apply to Puerto Rico, whether the agency imposing limitations be the government of Puerto Rico or the government of the United States. Second, despite the case law which seemingly denies any legislative power to curb corporate political spending on ballot issue questions, the most recent precedent and the possible divisions of the Justices in this decision and in some earlier cases suggest that the possibility of limitations is not truly foreclosed. Third, while limitation may be possible generally, the proposal you describe would be constitutionally suspect nonetheless, because it would run afoul of the principle that permissible government regulation or limitation of expression must be content neutral.

Application of First Amendment to Puerto Rico

Upon the acquisition of Puerto Rico from Spain by the Treaty of Paris (30 Stat. 1754) following the Spanish-American War, an acrimonious debate developed in the United States about governing the territory and the extent to which the Constitution applied in Puerto Rico and to which it limited Congress in making provision for the Island under its power to make rules and regulations respecting territorial possessions under Article IV, § 2, cl. 2.

Over a series of cases, collectively known as the *Insular Cases*, the Supreme Court formulated the theory of incorporated and unincorporated territories. Unincorporated territories were those as to which Congress had not, or had not yet, evinced an intention to set on the route to statehood. In unincorporated territories, the Constitution did not apply in full. See esp. *Downes v. Bidwell*, 182 U.S. 244 (1901); *Dorr v. United States*, 195 U.S. 138 (1904); *Balzac v. Porto Rico*, 258 U.S. 298 (1922).

Nevertheless, the Court cautioned that the people of Puerto Rico, even though then aliens, were within the jurisdiction of the United States for purposes of the Constitution's fundamental guarantees of individual rights. Thus, Justice Brown, announcing the Court's judgment in *Downes*, said: "Whatever may be finally decided by the American people as to the *status* of these islands and their inhabitants - whether they shall be introduced into the sisterhood of States or be permitted to form independent governments - it does not follow that, in the meantime, awaiting that decision, the people are in the matter of personal rights unprotected by the provisions of our Constitution, and subject to the merely arbitrary control of Congress. Even if regarded as aliens, they are entitled under the principles of the Constitution to be protected in life, liberty and property." Supra, 182 U.S., 283 (emphasis in original). See also id., 290-291 (Justices White, Shiras, and McKenna, concurring: "As Congress in governing the territories is subject to the Constitution, it results that all the limitations of the Constitution which are applicable to Congress in exercising this authority necessarily limit its power on this subject."); 294-295 ("Undoubtedly, there are general prohibitions in the Constitution in favor of the liberty and property of the citizen which are not mere regulations as to the form and manner in which a conceded power may be exercised, but which are an absolute denial of all authority under any circumstances or conditions to do particular acts. In the nature of things, limitations of this character cannot be under any circumstances transcended, because of the complete absence of power. . . . [This distinction] has in effect been conceded, even by those who most strenuously insisted on the erroneous principle that the Constitution did not apply to Congress in legislating for the territories, and was not operative in such districts of [the] country.").

When, in the Organic Act of 1917 (Jones Act), Congress made citizens of Puerto Rico also citizens of the United States, § 5, 39 Stat. 953, the question was litigated whether Puerto Rico was now incorporated into the United States, and in *Balzac*, supra, the answer was in the negative. But in holding that a right to trial by jury was not such a fundamental right that it applied to an unincorporated territory, a unanimous Court, speaking through Chief Justice Taft, reiterated that the Constitution, in regard to certain basic provisions, did govern Congress' power to legislate for the Island and did constrain the governmental activity of the Puerto Rican government. "The Constitution of the United States is in force in Porto Rico as it is wherever and whenever the sovereign power of [the United States] is exerted. This has not only been admitted but emphasized by this court in all its authoritative expressions upon the issues arising in the *Insular Cases* . . . . The Constitution, however, contains grants of power and limitations which in the

nature of things are not always and everywhere applicable, and the real issue in the *Insular Cases* was not whether the Constitution extended to the Philippines or Porto Rico when we went there, but which of its provisions were applicable by way of limitations upon the exercise of executive and legislative power in dealing with new conditions and requirements. The guaranties of certain fundamental personal rights declared in the Constitution, as for instance that no person could be deprived of life, liberty or property without due process of law, had from the beginning full application in the Philippines and Porto Rico . . . ." Id., 258 U.S., 312-313.

Historically, the record of United States - Puerto Rican relations reveals that both Congress and the Supreme Court have had a shared role in the determination of what rights of a constitutional nature the residents of Puerto Rico may assert. *Examining Board v. Flores de Otero*, 426 U.S. 572, 590 (1976). Thus, in § 2 of the Jones Act, 39 Stat. 951, Congress provided for Puerto Rico a bill of rights, which remained in effect until 1952, guaranteeing nearly all the personal rights found in the United States Constitution.[1] In 1947, Congress, in adopting legislation providing for popular election of the governor, declared that "[t]he rights, privileges, and immunities of citizens of the United States shall be respected in Puerto Rico to the same extent as though Puerto Rico were a State of the Union . . . ." 61 Stat. 772, § 2, 48 U.S.C. § 737. Responding to demands for greater autonomy for Puerto Rico, Congress in 1950, 64 Stat. 319, 48 U.S.C. § 731b, offered in the "nature of a compact" to "the people of Puerto Rico" an authorization to draft their own constitution, which was to "provide a republican form of government and ... [to] include a bill of rights." Congress thereafter approved the constitution drafted and approved by Puerto Ricans, imposing a condition that any amendment or revision of it be consistent with "the applicable provisions of the Constitution of the United States." 66 Stat. 327 (1952). The constitution of Puerto Rico was proclaimed to be in effect on July 25, 1952. See 48 U.S.C. § 731d note.

Similarly, the Court has largely been expansive with respect to the coverage of Puerto Rico by at least the personal guarantees of the Constitution under the *Downes-Dorr-Balzac* formula.[2] Protection from

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[1] Only two major exceptions existed: the right under the Fifth Amendment to indictment by grand jury and the right under the Sixth and Seventh Amendments to a jury trial. See *Balzac*, supra, 258 U.S., 306.

[2] The vitality of the *Insular Cases* has been questioned by some Justices. See *Torres v. Puerto Rico*, supra, 442 U.S., 474, 475 (Justice Brennan concurring, joined by three other Justices). In *Reid v. Covert*, 354 U.S. 1, 14 (1957)(plurality opinion), Justice Black denied that any principle of inoperativeness of the Constitution anywhere the Government of the United States acts could exist. The *Insular Cases* had been central to the Court's holding the year previous to this in *Kinsella v. Krueger*, 351 U.S. 470 (1956), and *Reid v. Covert*, 351 U.S. 487 (1956), that the Constitution applied with

deprivation of life, liberty, or property without due process of law was recognized in *Downes* and *Balzac*, as the quotations above evince, and this application has been reasserted. *Calero-Toledo v. Pearson Yacht Leasing Co.*, 416 U.S. 663 (1974); *Examining Board v. Flores de Otero*, supra, 426 U.S., 600-601. The guarantee of equal protection similarly reaches Puerto Rico. Ibid; *Harris v. Rosario*, 446 U.S. 651 (1980). Fourth Amendment protections from unreasonable searches and seizures apply. *Torres v. Puerto Rico*, 442 U.S. 465 (1979). In *Califano v. Torres*, 435 U.S. 1, 4 n. 6 (1978), the Court assumed that a protected right to travel applied.

More important, for purposes of this memorandum, in *Balzac*, supra, 258 U.S., 314, the Court assumed that the First Amendment speech and press guarantees applied, an assumption since confirmed. *Posadas de Puerto Rico Assocs. v. Tourism Co.*, 478 U.S. 328, 331 n. 1 (1986)("We have *held* that Puerto Rico is subject to the First Amendment Speech Clause[.]")(citing *Balzac*; emphasis supplied). In *Rodriguez v. Popular Democratic Party*, 457 U.S. 1, 7-8 (1982), the Court observed that "[i]t is not disputed that the fundamental protections of the United States Constitution extend to the inhabitants of Puerto Rico. . . . We thus think it clear that the voting rights of Puerto Rico citizens are constitutionally protected to the same extent as those of all other citizens of the United States."

This last pronouncement is particularly important in considering the validity of the proposal to limit corporate expenditures. It is important because the Constitution itself does not directly confer electoral rights.[3] Rather, the

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full force only within the United States and incorporated territories and that civilian dependents of servicemen could be tried for capital crimes by courts-martial overseas. On petitions for rehearing, the Court overturned these holdings in the second *Reid v. Covert* opinion, although with no opinion of the Court concurred in by a majority of the Justices. The principle was extended to civilian dependents overseas charged with noncapital crimes in *Kinsella v. United States ex rel. Singleton*, 361 U.S. 234 (1960), and to civilian employees overseas of the military charged with either capital or noncapital crimes. *Grisham v. Hagan*, 361 U.S. 278 (1960); *McElroy v. United States ex rel. Guagliardo*, 361 U.S. 281 (1960). Some tension between these decisions and the *Insular Cases* exists, but the Court has yet to harmonize the two lines of precedents. In *Torres*, supra, 469-470, the Court recited the history of the *Insular Cases* without mentioning *Reid v. Covert*, while in *Examining Board*, supra, 426 U.S., 600, the Court cited *Reid v. Covert* for the proposition that it "reaffirmed and strengthened" the principle of the *Insular Cases* that fundamental guarantees of the Constitution applied to Puerto Rico.

[3] Although the right to vote for Members of Congress is derived from the Constitution, *United States v. Classic*, 313 U.S. 299, 314-315 (1941), and Congress is thus empowered to legislate to protect this right of suffrage from both official and private abridgment, *Buckley v. Valeo*, 424 U.S. 1, 13 n. 16 (1976); see also *Ex parte Yarbrough*, 110 U.S. 651 (1884)(power of Congress

First Amendment, usually in combination with the equal protection clause, has provided the basis for the judicial development of a protected right of political association to advance political beliefs and principles. E.g., *Kusper v. Pontikes*, 414 U.S. 51, 56-57 (1973); *Tashjian v. Republican Party of Conn.*, 479 U.S. 208, 213-217 (1986); *Eu v. San Francisco County Democratic Central Com.*, 109 S.Ct. 1013, 1019-1023 (1989). Moreover, the limitations on governmental regulation of or barring of expenditures in elections, including corporate expenditures, flow from the Court's construction of speech and associational rights.

Most of the decided cases have to do with the application of the United States Constitution to actions of the government of Puerto Rico, and it is true that no congressional provision directed to Puerto Rico has been struck down. But the necessary construction of the language of the cited cases is that those constitutional guarantees that do apply to Puerto Rico limit equally Puerto Rican and United States action. The earlier cases, as recurrence to the quotations set out above reveal, expressly speak of limits on congressional discretion. Nothing in the more recent cases suggests a deviation from that understanding.

Thus, in *Califano v. Torres*, supra, and *Harris v. Rosario*, supra, the Court sustained, respectively, provisions of the Social Security Act making benefits for aged, blind, and disabled persons payable only to residents of the United States and giving less assistance to Puerto Rico under AFDC than to the States. In both instances, responding to right to travel and equal protection challenges, the Court sustained the congressional decisions, emphasizing especially in *Rosario*, the congressional power under the territories clause. Article IV, § 3, cl. 2. But the principal foundation of both decisions was that the nature of federal spending programs gave Congress

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to legislate to protect integrity of presidential elections); *Burroughs and Cannon v. United States*, 290 U.S. 534 (1934)(same), the Constitution confers on the States the power to determine voter qualifications, Article I, § 2, cl. 1; Article II, § 1, cl. 2; Seventeenth Amendment, § 1, and to regulate the times, places, and manner of choosing Members of Congress and presidential electors. Article I, § 4; Article II, § 1, cl. 2. The Constitution "does not confer the right of suffrage upon any one," *Minor v. Happersett*, 21 Wall. (88 U.S.) 162, 178 (1875), and "the right to vote, *per se*, is not a constitutionally protected right." *San Antonio Ind. School Dist. v. Rodriguez*, 411 U.S. 1, 35 n. 78 (1973). However, when electoral systems are established, the Constitution denies government the power to deny voting rights on the basis of race, sex, or age above 18 years old, Fifteenth, Seventeenth, and Twenty-sixth Amendments, and the equal protection clause bars many other classifications that impair voting rights. E.g., *Reynolds v. Sims*, 377 U.S. 533 (1964)(equally populated voting districts); *Kramer v. Union Free School Dist.*, 395 U.S. 621 (1969)(property qualifications). The right to participate in the electoral system is also protected by the First Amendment's speech/association guarantee which is relevant to this memorandum and which is dealt with in the text.

broad discretion in treating different recipients differently so long as a rational basis exists. Under the rational basis standard, Congress' discretion within the United States and among United States resident recipients and potential recipients, barring classification on the basis of such impermissible factors as race, sex, or illegitimacy, is just as broad as the discretion exercised in *Torres* and *Rosario*. E.g., *Mathews v. DeCastro*, 429 U.S. 181 (1976); *Califano v. Boles*, 443 U.S. 282 (1979).

Possible to cite as a case indicating greater congressional discretion is *Torres v. Puerto Rico*, supra. In that case, the challenge was to a statute of Puerto Rico authorizing police to search, without a warrant or probable cause, the baggage of any person arriving in Puerto Rico from the United States. In deciding that the Fourth Amendment search and seizure provision applied to Puerto Rico, the Court looked to the record of legislative enactment of a search and seizure provision from 1917 to 1952, the requirement by Congress that the constitution authorized in 1950 should contain a bill of rights, and congressional approval of the constitution in 1952 with the language of the Fourth Amendment included. This background was relevant, the Court stated, although Congress had generally left it to the Court to determine what constitutional guarantees applied in Puerto Rico, "because the limitation on the application of the Constitution in unincorporated territories is based in part on the need to preserve Congress' ability to govern such possessions, and may be overruled by Congress, a legislative determination that a constitutional provision practically and beneficially may be implemented in a territory is entitled to great weight." Id., 442 U.S., 470. It was thus possible for the Court to conclude, on the basis of the record of congressional action, "that the Fourth Amendment's restrictions on searches and seizures may be applied to Puerto Rico without danger to national interests or risk of unfairness." Ibid.

Of this mode of analysis, several things may need brief mention.

First, four Justices refused to adhere to it, denying the vitality of the *Insular Cases* to Bill of Rights questions, at least, but five Justices did join the opinion. It remains the only case applying this analysis.

Second, it is perhaps significant that the issue was the application of the Fourth Amendment. Without digressing to a discussion of the Court's treatment of search and seizure issues, it bears noting that the Court under Chief Justices Burger and Rehnquist has generally placed a very low value upon this constitutional guarantee.

Third, however one may view the mode of analysis in the case, it does contain an ambiguous reference which must be considered when evaluating congressional power to legislate with respect to Puerto Rico. It will be observed that, in the quotation above, the Court says Congress may overrule certain decisions on the application of the Constitution to Puerto Rico. Actually, in context, the Court appears to say that a Court decision that a constitutional guarantee *does not* apply may be set aside. The paragraph in

which the quoted language appears begins by noting that Congress may by statute make constitutional provisions applicable to territories in which they would not otherwise be controlling, simply as a matter of legislative grace. Citing *Mullaney v. Anderson*, 342 U.S. 415, 419-420 (1952)(congressional extension of privileges and immunities clause to territory of Alaska). Cf. *Barnard v. Thorstenn*, 109 S.Ct. 1294, 1299 (1989)(congressional extension of privileges and immunities clause to Virgin Islands). Then, the Court observes that Congress has generally left it up to the Court to decide what constitutional provisions apply. It then sets out the quoted language to the effect that "limitations on the application of the Constitution" are based in part on the need to preserve congressional discretion. Thus, the "may be overruled by Congress" phrase must be limited to judicial decisions holding that certain provisions *do not* apply, so that prior congressional determinations that it is practical and beneficial to apply a constitutional provision to an unincorporated corporated are for those reasons "entitled to great weight." There is hence nothing in the passage to indicate the Court is saying that judicial decisions that certain constitutional provisions *do* apply may be overruled by Congress.

It appears, therefore, that Congress could not make an independent determination that a Bill of Rights provision deemed fundamental and applied to Puerto Rico by the Court was in actuality not fundamental and not applicable.

Because Puerto Rico itself might have discretion under a referendum provision to make certain regulations, it may be useful briefly to consider whether it might have somewhat more discretion than Congress would have to limit the pertinent corporate expenditures. The Court has enunciated no standard by which, for purposes of Puerto Rico, it determines which constitutional guarantees are so fundamental that they apply in the island. The early cases merely spoke of those "immunities [which] are indispensable to a free government," *Downes v. Bidwell*, supra, 282-283 (opinion of Justice Brown), or "restrictions of so fundamental a nature that they cannot be transgressed," id., 291 (Justice White concurring), or of "certain fundamental rights declared in the Constitution." *Balzac*, supra, 312. But there is a parallelism here with those cases in which the Court has been asked to apply certain of the Bill of Rights to the States through the due process clause of the Fourteenth Amendment. For a long period of time the Court declined to apply most of the Bill of Rights, holding that only those rights which are "fundamental" or "implicit in the concept of ordered liberty" were applicable. *Palko v. Connecticut*, 302 U.S. 319, 325 (1937). See *Twining v. New Jersey*, 211 U.S. 78, 99 (1908); *Gitlow v. New York*, 268 U.S. 652, 666 (1925). In fact, the Court sometimes observed the parallel. In *Dowdell v. United States*, 221 U.S. 325, 332 (1911), the Court, holding that there was no requirement of indictment by grand jury in the Philippines, cited *Hurtado v. California*, 110 U.S. 516 (1884), which found that indictment by grand jury was not mandated under due process of law for the States. The lower federal courts with jurisdiction over Puerto Rico, thus, generally assumed that the tests for application to the States and application to Puerto Rico of the Bill of Rights

were essentially identical. E.g., *Montalvo v. Colon*, 377 F. Supp. 1332, 1338-1341 (D.P.R. 1974)(three-judge court); *Mora v. Mejias*, 206 F.2d 377 (1st Cir. 1953).

Since the 1960s, the Court has largely applied most of the Bill of Rights to the States. The process involved not a renunciation of the fundamental rights formula but a redefinition of it. Rights previously found not to be fundamental in the sense in which the Court used the word were now deemed fundamental and applicable to the States. Earlier, the Court had asked whether a civilized system of criminal justice could be imagined that did not accord the particular procedural or substantive safeguard. E.g., *Palko v. Connecticut*, supra, 302 U.S., 325. The present approach is to ascertain whether a particular guarantee is fundamental in the light of the system existent in the United States, e.g., *Duncan v. Louisiana*, 391 U.S. 145, 149 n. 14 (1968), which can make a substantial difference. *Duncan* held that the Sixth Amendment right to trial by jury applied to the States, as compared to the 1922 *Balzac* holding that denial of a jury trial in Puerto Rico was constitutional.[4]

That the Court may have conflated the two different inquiries is evidenced by its practice in recent years of expressly declining to decide whether the constitutional provision which it is construing applies to Puerto Rico directly - i.e., the First Amendment itself governs - or applies to Puerto Rico through the due process clause of the Fourteenth Amendment, the method of constraining the States. *Calero-Toledo*, supra, 416 U.S., 668 n. 5; *Examining Board*, 426 U.S., 600, 601; *Torres v. Puerto Rico*, supra, 442 U.S., 471; *Rodriguez v. Popular Democratic Party*, supra, 457 U.S., 7 n. 6; *Posadas*, 478 U.S., 328 n. 1. The conceptual difficulties with maintaining that it is the Fourteenth Amendment which limits Puerto Rico should be obvious. That Amendment plainly provides that "no State" may do the proscribed things. While the Court has observed in *Examining Board*, supra, 426 U.S., 594, that Congress by entering into the Commonwealth compact intended "to accord to Puerto Rico the degree of autonomy and independence normally associated with States of the Union," and in *Rodriguez*, supra, 457 U.S., 8, that "Puerto Rico, like a State, is an autonomous political entity, '"sovereign over matters not ruled by the Constitution."'"(quoting *Calero-Toledo*, supra, 673, quoting *Mora v. Mejias*, supra, 115 F. Supp., 612). But, although Puerto Rico may be a "state" in the sense of being an organized government, it is not a "State" in the sense of a member of the Union. *Examining Board*, supra, 426 U.S., 606 (Justice Rehnquist dissenting); *United States v. Lopez Andino*, 831 F.2d 1164, 1172 (1st Cir. 1987)(Judge Torruella concurring); see also *Puerto Rico v. Shell Co.*, 302 U.S. 253 (1937)(double jeopardy clause would prevent prosecutions

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[4] On the other hand, as noted above, *Balzac* did indicate that the First Amendment speech and press clauses applied in Puerto Rico, while the speech clause was not applied to the States until *Gitlow v. New York*, supra, in 1925, and the press clause was not applied until *Near v. Minnesota ex rel. Olson*, 283 U.S. 697, 701 (1931).

for same offense by United States and Puerto Rico because of lack of dual sovereignty), cited with approval in *Waller v. Florida*, 397 U.S. 387, 393 & n. 5 (1970). See also *Puerto Rico v. Branstad*, 483 U.S. 219, 229-230 (1987)(applicability of extradition clause to Puerto Rico); id., 231 (Justice Scalia concurring). And the Court has expressly held that Congress may legislate for Puerto Rico under the territories clause, *Harris v. Rosario*, supra, 446 U.S., 651-652; *Califano v. Torres*, supra, 435 U.S., 3 n. 4, a result contrary to any statehood conception.

In any event, however, even if it is the Fourteenth Amendment through which the First Amendment applies to Puerto Rico, the precedents are clear that constitutional provisions applied to the States through the due process clause mean the same thing as they mean when directly applicable. E.g., *First National Bank of Boston v. Bellotti*, 435 U.S. 765, 780 n. 16 (1978); *Malloy v. Hogan*, 378 U.S. 1, 10-11 (1964). Thus, whatever the result of the debate summarized here, the First Amendment would inhibit both the National Government and Puerto Rico to the same degree in attempting to limit corporate expenditures.[5]

First Amendment Protection of Corporate Expenditures

Regulation of campaign finance - contributions and expenditures - first began to receive extended constitutional analysis in *Buckley v. Valeo*, 424 U.S. 1 (1975).[6] Central to the *Buckley* decision was the conclusion of the Court that campaign funding was speech, rather than conduct intermixed with communication, so that the dependence of communication on the expenditure of money did not reduce the "exacting scrutiny" that the judiciary must apply to governmental regulation. Id., 16-17. Different results were achieved by differing majorities of the Justices in sustaining parts of the 1971 Federal

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[5] To be sure, *Posadas*, supra, 478 U.S. 328, represents a departure by the Court from its line of cases developing First Amendment protection for commercial speech, not in the enunciation of standards but in the application of those standards. But nothing in the opinion of the Court suggests that it was the particularity of the First Amendment's scope in Puerto Rico that explains the departure. Rather, it appears that it was the subject matter at issue - advertising of casino gambling - that resulted in a coalition of previous commercial-speech dissenters and some majority Justices to join in the five-to-four opinion.

[6] Earlier cases involving limitations contained in the Federal Corrupt Practices Act of 1925 had primarily concerned statutory interpretation, although the Court was express that some interpretations were adopted to avoid constitutional problems that would otherwise arise. *Pipefitters Local 562 v. United States*, 407 U.S. 385 (1972); *United States v. UAW*, 352 U.S. 567 (1957); *United States v. CIO*, 335 U.S. 106 (1948).

Election Campaign Act, as amended,[7] and in voiding other parts. Sustained were disclosure provisions, id., 60-84, limitations on contributions from groups and individuals, id., 23-38, and public funding of presidential elections. Id., 85-109. Invalidated were limitations upon overall campaign expenditures, id., 54-59, independent expenditures made on behalf of candidates, id., 39-51, and the expenditure of a candidate's personal wealth. Id., 51-54.

Enunciated in *Buckley* were three principles or conclusion with bearings on the proposed limitation of corporate expenditures in the Puerto Rican referendum. We will note these, indicate their application in subsequent cases, and then detail the modification of them more recently.

First, the Court distinguished between expenditures and contributions, which explains in part why limitations on the former were voided while limitations on the latter prevailed. Thus, "[a] restriction on the amount of money a person or group can spend on political communication during a campaign necessarily reduces the quantity of expression by restricting the number of issues discussed, the depth of their exploration, and the size of the audience reached." Id., 19. The Act's spending limitations represented "substantial rather than merely theoretical restraints on the quantity and diversity of political speech."[8] Ibid. On the other hand, a limit on contributions "entails only a marginal restriction upon the contributor's ability to engage in free communication" because a contribution is only "a general expression of support for the candidate and his views" and the amount of the contribution does not increase the expression appreciably. A limitation on contributions "involves little direct restraint" on a contributor's expression and does not limit his "freedom to discuss candidates and issues." Id., 21.[9]

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[7] P.L. 92-225, 86 Stat. 3, as amended by the Federal Election Campaign Act Amendments of 1974, P.L. 93-443, 88 Stat. 1263, 2 U.S.C. § 431 *et seq.*, and various revenue law provisions of 1971, 1972, and 1974.

[8] The Court did indicate that expenditure limitations would be valid if applied only to candidates accepting public subsidies, id., 57 n. 65, and subsequently without opinion sustained such a limitation applied to presidential candidates accepting subsidies. *RNC v. FEC*, 487 F.Supp. 280 (S.D.N.Y)(three-judge court), *affd. per curiam*, 445 U.S. 955 (1980).

[9] Three Justices in *Buckley* did not agree with the expenditure-contribution dichotomy. Id., 241 (Chief Justice Burger), 261 (Justice White), and 290 (Justice Blackmun). But Chief Justice Burger and Justice Blackmun would have voided the contribution limits as well as the spending limits, whereas Justice White would have sustained both. Justice Marshall has since stated his views that the distinction "has no constitutional significance," *FEC v. NCPAC*, 470 U.S. 480, 518, 519 (1985), and would sustain both kinds of limits.

Second, the prevention of corruption or the appearance of corruption was the only basis the Court would accept as justification for the congressional limitation on expression involved in contribution and expenditure limitations. In this respect, this justification was sufficient to validate the contribution limits. Id., 26-28. But the Court did not believe the expenditure limits were necessary to eliminate corruption or the appearance of corruption nor did it believe they served that purpose. Id., 45-48, 53. More important was the narrow construction the Court gave to the concept of corruption. Although its concept was not limited to actual bribery, id, 27-28, the Court was concerned with the giving of contributions "to secure political *quid pro quo*'s from current and potential office holders," and the "appearance of [such] corruption stemming from public awareness of the opportunities for abuse". Id., 26, 27. Thus, the corruption rationale extended to improper influence on or with the candidate and not improper effects upon the election, and the evil to be prevented was the effectuation of some kind of arrangement, a *quid pro quo*.[10]

Third, parallel to the congressional concern with corruption, more broadly construed than by the Court, was a desire to equalize access to and influence upon the electoral process. Flatly rejecting the equalization rationale as an impermissible justification for limiting political speech, the Court said that "the concept that government may restrict the speech of some elements of our society in order to enhance the relative voice of others is wholly foreign to the First Amendment . . . . The First Amendment's protection against governmental abridgment of free expression cannot properly be made to depend on a person's financial ability to engage in public discussion." Id., 48-49. See also id., 54 (speaking of the limit on the candidate's use of his own money), 56-57 (overall campaign expenditure ceilings).

Application of these principles to corporate political spending was effected in *First National Bank of Boston v. Bellotti*, 435 U.S. 765 (1978), although the result was closer than in *Buckley*. Challenged before the Court was a state statute that barred corporations from making expenditures to influence the vote on any referendum question, other than one materially affecting the property, business, or assets of a corporation. The statute specifically provided that no question related to the taxation of the income, property, or transactions of individuals could be deemed so to affect a corporation, and it was with respect to such a ballot question that the case was brought. In an opinion by Justice Powell, the Court avoided deciding whether corporations have a distinctive protected First Amendment right of expression, holding instead that political speech is at the apex of expression protected by the First Amendment for many purposes and the societal interest in free expression surmounts the question of the identity of the speaker. Id., 775-783. Because the statute was a governmental limitation on speech, it had to be justified by a compelling interest, and the Court found none. Prevention of corruption was not a viable basis, because in the absence of candidates there could be no such

[10] See also *FEC v. NCPAC*, supra, 470 U.S., 497; *California Medical Assn. v. FEC*, 453 U.S. 182, 195 (1981).

danger. With regard to the broader threat of "undue influence" on the electorate, the Court, recalling its *Buckley* language, rejected any permissible governmental interest in limiting corporate influence in elections. "To be sure, corporate advertising may influence the outcome of the vote; this would be its purpose. But the fact that advocacy may persuade the electorate is hardly a reason to suppress it." Id., 790. "Moreover, the people in our democracy are entrusted with the responsibility for judging and evaluating the relative merits of conflicting arguments. They may consider, in making their judgment, the source and credibility of the advocate. But if there be any danger that the people cannot evaluate the information and arguments advanced by appellants, it is a danger contemplated by the Framers of the First Amendment." Id., 791-792. Finally, the Court considered as a justification for the statute the protection of stockholders, doubting its permissibility, but finding it not served, in any event; the statute did not reach other political activity stockholders might object to, i.e., lobbying, and even if stockholders unanimously favor a prohibited corporate expenditure, the statute barred it. Id., 792-795.

Dissenting, then-Justice Rehnquist argued that as an artificial creation a corporation organized under the laws of a State could do essentially only what the State chose to permit it to do. Thus, limitations on such political expenditures as Massachusetts had provided raised no First Amendment problem. Id., 822. Justice White, joined in dissent by Justices Brennan and Marshall, conceded that the First Amendment protected corporate speech, but he argued that such expression is "subject to restrictions which individual expression is not." Id., 802, 804. The First Amendment, in his view, is intended to facilitate individual "self-expression, self-realization and self-fulfillment." Id., 804-805. Because corporate speech fails to serve these interests, he concluded that "[i]deas which are not a product of individual choice are entitled to less First Amendment protection." Id., 807. Thus, the fact that corporations are "in a position to control vast amounts of economic power which may, if not regulated, dominate not only the economy but also the very heart of our democracy, the electoral process," gave the States a legitimate interest in preventing institutions which have amassed great wealth "from using that wealth to acquire an unfair advantage in the political process." Id., 809.

In *Citizens Against Rent Control v. City of Berkeley*, 454 U.S. 290 (1981), the Court, with only Justice White dissenting, id., 303, struck down a city ordinance limiting to $250 the amount any person could contribute to committees formed to support or oppose ballot propositions. Although the ordinance involved a contribution ceiling rather than an expenditure limit, and thus implicated the dichotomy created in *Buckley*, the Court found no basis for sustaining it. First, it continued to reject the equalization rationale as it had done in *Bellotti* and *Buckley*. Id., 295-296. Second, and more important, the Court found the corruption rationale of *Buckley* inapplicable to a referendum election; there was no danger of the Court's concept of corruption arising in an election without candidates. Id., 296-299.

Although intervening decisions suggested that the Court might be withdrawing somewhat from its position on campaign finance reform constitutionality,[11] a seven-to-two Court majority in *FEC v. NCPAC*, 470 U.S. 480 (1985), invalidated a provision of the statute governing subsidies to presidential candidates, under which it was unlawful for independent political action committees to expend more than $1,000 to further the election of any presidential candidate who had accepted public subsidies. As noted above, the Court had previously invalidated spending limits imposed on a candidate's use of his own funds, independent expenditures on behalf of a candidate, and on overall campaign expenditures, but it had sustained spending limitations imposed on a candidate accepting public funds. Both of the organizational PACs before the Court in *NCPAC* were corporations, but Justice Rehnquist, speaking for the Court, noted that the statutory prohibition applied to any entity, whether incorporated or not, and went on to invalidate the restriction as overbroad when applied to large and small PACs and to corporate and unincorporated sponsors of PACs and as violating the First Amendment in any event because the limitation on expression rights could not be justified. Supra, 470 U.S., 496, 500-501. Reiterated was the principle "that preventing corruption or the appearance of corruption are the *only* legitimate and compelling government interests thus far identified for restricting campaign finances." Id., 496-497 (emphasis supplied).

Stressing that the average contribution to the two PACs before it was a modest amount and that PACs afforded persons of modest means the opportunity to join together to promote political goals, the Court could discern no danger of corruption. That is, corruption as "a subversion of the political process. Elected officials are influenced to act contrary to their obligations of office by the prospect of financial gain to themselves or infusions of money into their campaigns. The hallmark of corruption is the financial *quid pro quo*: dollars for political favors." Id., 497. However, the overwhelming number of contributions to PACs were small in amount and were not coordinated with the candidate's campaign. Because of the amassing of amounts to be spend by an organized PAC, it was alleged that the potential for corruption existed, but the Court did not see it. "It is of course hypothetically possible here . . . that candidates may take notice of and reward those responsible for PAC expenditures by giving official favors to the latter in exchange for the supporting messages. But here . . . the absence of prearrangement and coordination undermines the value of the expenditure to the candidate, and thereby alleviates the danger that expenditures will be given as a *quid pro quo* for improper commitments from the candidate." Id., 498. The fact that a candidate might independently alter positions or take actions because of the

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[11] *FEC v. NRWC*, 459 U.S. 197 (1982), was a contributions case rather than one involving expenditures. Its importance is discussed infra, p. 15-16. See also *Common Cause v. Schmitt*, 455 U.S. 129 (1982), *summarily affg.*, 512 F.Supp. 489 (D.D.C. 1981).

message conveyed to him by such independent spending did not accord with the Court's conception of "corruption." Ibid.[12]

Much scholarly commentary has been directed to the Court's utilization of the First Amendment to oversee, and to invalidate some of, the regulation of campaign finance,[13] and, more broadly, the Court's interpretation of the First Amendment in the context of corporate political funding and commercial speech has excited considerable controversy in the journals.[14] But, while the

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[12] Justices White and Marshall dissented, id., 502, 518, the former continuing his long-standing position and the latter announcing his conversion to validation of both contribution and expenditure limitations as a means of achieving equal access to the political process and of avoiding corruption. Id., 521.

[13] Among the most useful commentary is Nicholson, *The Supreme Court's Meandering Path in Campaign Finance Regulation and What It Portends for Future Reform*, 3 J. L. & POL. 509 (1987); Nicholson, *Basic Principles or Theoretical Tangles: Analyzing the Constitutionality of Government Regulation of Campaign Finance*, 38 CASE W. RES. L. REV. 589 (1988); BeVier, *Money and Politics: A Perspective on the First Amendment and Campaign Finance Reform*, 73 CALIF. L. REV. 609 (1982); Wright, *Politics and the Constitution: Is Money Speech?*, 85 YALE L. J. 1001 (1976); Wright, *Money and the Pollution of Politics: Is the First Amendment an Obstacle to Political Equality?*, 82 COLUM. L. REV. 609 (1982); Powe, *Mass Speech and the Newer First Amendment*, 1982 SUP. CT. REV. 243. Especially with respect to corporate spending and referenda, see Lowenstein, *Campaign Spending and Ballot Propositions: Recent Experience, Public Choice Theory and the First Amendment*, 29 U. C. L. A. L. REV. 505 (1982); Brudney, *Business Corporations and Shareholder's Rights Under the First Amendment*, 91 YALE L. J. 235 (1981); Shockley, *Direct Democracy, Campaign Finance, and the Courts: Can Corruption, Undue Influence and Declining Voter Confidence Be Found?*, 3 U. MIAMI L. REV. 377 (1985).

[14] Beginning with *Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council*, 425 U.S. 748 (1976), the Court has broadly extended a somewhat diluted First Amendment protection to commercial speech, primarily but not exclusively by and on behalf of corporations. See, e.g., *Consolidated Edison Co. v. PSC*, 447 U.S. 530 (1980); *Central Hudson Gas & Electric Corp. v. PSC*, 447 U.S. 557 (1980); *Pacific Gas & Electric Co. v. PUC*, 475 U.S. 1 (1986). But compare *Posadas de Puerto Rico Assocs. v. Tourism Co.*, 478 U.S. 328 (1986). On the commentary, see Jackson & Jeffries, *Commercial Speech: Economic Due Process and the First Amendment*, 65 VA. L. REV. 1 (1979); Shiffrin, *The First Amendment and Economic Regulation: Away from a General Theory of the First Amendment*, 78 NW. U. L. REV. 1212 (1983). For one effort to develop a counter theory, see Fiss, *Free Speech and Social Structure*, 71 IOWA L. REV. 1405 (1986), and Fiss, *Why the State?*, 100 HARV.

case law strongly suggests that your proposal with respect to limiting certain corporate expenditures in the Puerto Rican referendum would run afoul of the First Amendment, there are some signs, by no means negligible, that a balance may be shifting on the question in the Supreme Court.

First indications of some degree of change are to be found in *FEC v. NRWC*, 459 U.S. 197 (1982), which preceded the *NCPAC* decision, with the latter decision reflecting both recognition of and denial of change. *NRWC* concerned a provision of federal law that restricted the persons subject to solicitation by corporate, union, and trade association PACs. Corporations with shareholders or members may solicit those persons for contributions to their PACs, and corporate PACs may also solicit their executive and administrative personnel and their families. 2 U.S.C. § 441b(b)(4). The National Right to Work Committee was an ideological corporation, rather than the business corporation before the Court in *Bellotti* and some other cases. It had only administrative and executive personnel to solicit, having no shareholders or members, and it contended that under the First Amendment it must be allowed to solicit those in the public who had indicated some interests in its policies or it could not function. But, unanimously, the Court upheld the statute as applied to NRWC.

Significantly, Justice Rehnquist's opinion for the Court followed a modified line of reasoning he had put forward in his *Bellotti* dissent, now more like Justice White's dissent in that case. He observed that proponents of the restrictive statute had adduced two purposes justifying it. "The first purpose . . . is to ensure that substantial aggregations of wealth amassed by the special advantages which go with the corporate form of organization should not be converted into political 'war chests' which could be used to incur political debts from legislators who are aided by the contributions. . . . The second purpose . . . is to protect the individuals who have paid money into a corporation or union for purposes other than the support of candidates from having that money used to support political candidates to whom they may be opposed. . . . We agree . . . that *these* purposes are sufficient to justify the regulation at issue." Id., 207-208 (emphasis supplied).

Although the opinion deals only with the first purpose, it does so more in the sense of undue influence rather than the *quid pro quo* idea of corruption the Court had used previously and was to use again in *NCPAC*. "The statute reflects a legislative judgment that the special characteristics of the corporate structure require particularly careful regulation. . . . [W]e [will not] second-guess a legislative determination as to the need for prophylactic measures where corruption is the evil feared." Id., 209-210.

The reason the second purpose is not discussed in the opinion is that it was irrelevant to the corporation before the Court. It had no shareholders or

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L. REV. 781 (1987), criticized in Powe, *Scholarship and Markets*, 56 G. W. L. REV. 172 (1987).

members. The people who contributed to it agreed with its purposes. Thus, the insertion of clear dictum, especially combined with Court approval of "these" purposes, the two set out, as sufficient justification for the regulation, seemed intended to signal a departure from language in prior opinions casting doubt on the shareholder/member protection rationale.[15] That intention seems as well to lie in the basis said to distinguish *NRWC* from NCPAC in the latter case. Justice Rehnquist said that *NRWC* "turned on the special treatment historically accorded corporations. In return for the special advantages that the State confers on the corporate form, individuals acting jointly through corporations forgo some of the rights they have as individuals." Supra, 470 U.S., 495. Thus, the fact that *NRWC* was a contributions cases, rather than an expenditures case, and contribution restrictions are scrutinized less severely than spending limitations, seems to have counted less than the corporate form of organization did.

Expenditures independently made on behalf of political candidates constituted the issue in *FEC v. Massachusetts Citizens for Life*, 479 U.S. 238 (1986), a five-to-four decision invalidating, as applied to the contestant, a corporation organized purely for ideological purposes, the provision of 2 U.S.C. § 441b, prohibiting corporations from using funds from their treasuries to make an expenditure "in connection with" an election for federal office. Corporations desiring to make political expenditures may do so by organizing a separate, segregated fund for a PAC to receive contributions. Thus, for your purposes, it is important to note that the case did involve expenditures in connection with a political candidate, rather than a ballot question, but the Court's language in the course of deciding the case is instructive.

What is important about *Massachusetts Citizens for Life* is not that the law was voided as to it but that the Court rather expansively explained why the statute could be applied to business corporations. Thus, looking for the compelling governmental interest that would justify the infringement of First Amendment interests occasioned by the statutory bar, the Court discerned two.

First, there was a "concern over the corrosive influence of concentrated corporate wealth" that bespoke the importance of "protect[ing] the integrity of the marketplace of political ideas." Id., 257. Ascription of meaning to this concern revealed that to the *Massachusetts Citizens for Life* Court the issue was not corruption in the *quid pro quo* sense, but it was the impairment of the political process itself. The effect on the process rather than the effect on candidates or office holders was critical. "Direct corporate spending on political activity raises the prospect that resources amassed in the economic marketplace may be used to provide an unfair advantage in the political marketplace. Political 'free trade' does not necessarily require that all who participate in the political marketplace do so with exactly equal resources. . . . Relative availability of funds is after all a rough barometer of public

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[15] *First National Bank of Boston v. Bellotti*, supra, 435 U.S., 794 n. 34; *Cort v. Ash*, 422 U.S. 66, 80, 81 n. 13 (1975).

support. The resources in the treasury of a business corporation, however, are not an indicator of popular support for the corporation's political ideas. They reflect instead the economically motivated decisions of investors and customers." Id., 257-258. The ability to form a segregated fund to support a PAC entitled a corporation to reflect the strength of its political convictions. Thus, Congress acted out of "concern not about use of the corporate form *per se*, but about the potential for unfair deployment of wealth for political purposes." Id., 259.

This justification reflects both a sense of unfair influence and a measure of the concern for equalization that *Buckley* and *Bellotti* had supposedly consigned to the unacceptable. In any event, the Court said, the justification did not apply to Massachusetts Citizens for Life because the organization was not a business corporation and the only funds it had did reflect the popularity of its political position. Ibid. But the implication for regulation of business corporations is clear.

Second, the legislative concern for "dissenting stockholder[s] and union member[s]" who might not want their money used by corporations (or unions in the relevant instance) for purposes they might not support was a legitimate one supporting limitations. People contribute investment funds for economic gain and may well not support the use of the money for political ends. Because individuals may depend on the corporations for income or jobs, it is not sufficient to tell them they can take the money out. Id., 260. This argument was almost identical to the one made by Justice White in dissent in *Bellotti*. Supra, 435 U.S., 812-820. Nevertheless, the Court asserted, the justification did not apply to Massachusetts Citizens for Life, because contributors gave it their money not to earn income but to support its well-known ideological aims. Id., 479 U.S., 261.

The significance of *Massachusetts Citizens for Life* can be immense in the context of the permissible regulation of corporate political spending, but the Court has been inconsistent enough in this area to justify caution.[16] But, if

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[16] Application of the Court's dicta in this case will be tested in *Michigan State Chamber of Commerce v. Austin*, 856 F.2d 783 (6th Cir. 1988), *prob. juris. noted*, 88-1569 (May 1, 1989)(to be argued and decided next Term), in which the lower court utilized *Massachusetts Citizens for Life* to invalidate a bar on any incorporated entity making direct or indirect expenditures to or on behalf of a candidate for state office, except from a separate, segregated fund established for that purpose and accepting voluntary contributions. The contestant in *Austin* is comprised of about 8,000 members, 75% of which are business corporations. The *Massachusetts Citizens for Life* Court listed "three features essential to our holding" in explaining how the organization was different from entities which may be closely regulated; one was that it was not established by a business corporation and did not accept contributions from corporations, supra, 479 U.S., 263-264, a standard the Chamber of Commerce in *Austin* does not meet. Unlike your situation, however, this case, too,

the views expressed prevail, the language, which, like the language in *NRWC* is dicta, does afford the rationale for a judicial departure from the standards established in *Buckley* and *Bellotti* with respect to limitations on corporate expenditures in all elections, including ballot question elections.[17]

There seems little doubt that the Court intended, by its resort to a much broader rationale than it needed to have used to exempt the nonbusiness corporation before it from the burdensome regulations at issue, to signal a change in course. Much of the opinion, instead of explaining why Massachusetts Citizens for Life should be exempt, concentrates on explaining why government can regulate political speech by business corporations. In so doing, it drew on two complementary reasons. It moved away from a narrow conception of corruption and focussed rather on "the corrosive influence of concentrated corporate wealth." Id., 257. The argument is that businesses' economic power, combined with legal advantages conferred by the state, such as preferential tax treatment and limited liability, "may make a corporation a formidable political presence, even though the power of the corporation may be no reflection of the power of its ideas." Id., 258. Government has a legitimate interest in protecting the "marketplace of ideas" from the distortions caused by corporate speech that few individuals may endorse. Id., 259. *Leading Cases*, op. cit., n. 17, 208.

This emphasis upon the special status of the corporation and the effects of the conferral of benefits by state incorporation parallels the view of Chief Justice Rehnquist that the very fact that a corporation has benefited from a

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involves expenditures in a political candidate election. It is no doubt the situation that the Court's language will have some bearing on your problem, but decision will probably come too late to be instructive in drafting a provision.

[17] See Nicholson, op. cit., n. 13, 38 CASE W. RES. L. REV., 604-606; *The Supreme Court - Leading Cases*, 101 HARV. L. REV. 119, 199-209 (1987). In the Court's most recent case involving a ballot question election, *Meyer v. Grant*, 108 S.Ct. 1886 (1988), the Court unanimously struck down a state statute that prevented those circulating petitions to get a question on the ballot from using paid circulators. The Court observed that petition circulators invariably engaged in political speech by attempting to persuade individuals to sign the petitions. Denial of the right to pay circulators thus burdened the ability of some to place before citizens questions they regarded as important. The State's asserted interests were found to be insufficiently strong, i.e., the fear of corruption in the process could be addressed in less severe ways, and the Court denied it was permissible for the State to attempt "to mute the voices of those who can afford to pay petition circulators." Id., 1894 n. 7 (citing *Buckley* and *Bellotti*). The plaintiffs were all individuals, except for what was apparently an incorporated, ideological association, so that the case does not directly undermine the conclusions in the text about corporate interests.

state charter makes it subject to quite extensive regulation, even in the speech area, which he regards as fictitious in any event. Id., 479 U.S., 267 (dissenting). See also *Pacific Gas & Electric Co. v. PUC*, 475 U.S. 1, 33 (1986)(dissenting). It is important to note that while *Massachusetts Citizens for Life* was a five-to-four decision, and one of the majority, Justice Powell, has retired, the dissenters did not object to the congressional limitation of corporate spending at all; in fact, they wished to apply the limitations to the ideological corporate entity before the Court as well. Thus, not only did Chief Justice Rehnquist and Justice White reiterate their long-standing positions, they were joined by Justices Blackmun and Stevens in broad views, id., 479 U.S., 26 (dissenting), but Justice Brennan, in writing the majority opinion, was joined not only by a fellow *Bellotti* dissenter, Justice Marshall, but by Justices Scalia and O'Connor as well.

Additionally, the reiterated statement of the legitimacy of the concern for the corporate dissenter who may not wish his funds used for political purposes is important as a basis for limitation.

Several caveats must be noted, however. First, these recent cases all involved the utilization of corporate funds in some way in candidate elections. It will be remembered that in *Bellotti* and *Berkeley* the Court was sure the absence of a candidate removed the danger of corruption and thus the justification for legislative action. But, the emphasis in the more recent cases about the undue influence of corporate money, the amount of which bears no relationship to the popularity of the cause promoted or attacked, applies just as well to ballot question elections as to candidate elections, and the matter of the dissenting investor or shareholder may be just as serious, regardless of the nature of the election.

Second, the recent cases involved *limitations of* rather than a *bar on* corporate expenditures. *Bellotti* concerned, of course, a complete foreclosure of any opportunity for political speech in the areas marked off, and *Berkeley* involved a limitation on contributions, a quite low ceiling in fact. The federal law involved in *Massachusetts Citizens for Life*, in *NCPAC*, and in *NRWC* banned expenditures from corporate treasuries but did permit the establishment of separated, segregated funds to receive contribution and to make expenditures. It is thus possible that the principles to be derived from the cases would justify not a total ban on corporate spending in a Puerto Rican referendum but only a requirement that a separate, segregated fund be used for such expenditures.

Professor Nicholson, however, one of the more prolific scholars in the area of campaign finance reform, argues that *Massachusetts Citizens for Life* does in fact justify more than this form of regulation. She argues that the rationales of the case "have particular significance in those elections because corporations have played a large, and some believe, determinative role in many instances. Indeed, there is much stronger evidence of domination by corporations in ballot measure elections than in candidate elections. Given the ability of corporations to raise very large sums through PACs, it seems

unlikely that a PAC requirement would solve the problem." Op. cit., n. 13, 38 CASE W. RES. L. REV., 604 (footnote citations omitted). Because voters tend to distrust advertisements associated with certain corporations, she continues, such entities prefer to contribute to committees with innocuous sounding names. "Thus, the most effective reform would be limitations on contributions. Certainly such an approach is paternalistic . . . . Despite the anti-paternalism language in *Bellotti*, the emphasis in *Massachusetts Citizens for Life* on preventing the effect of concentrated wealth in the electoral process lends constitutional support to statutory limitations on contributions from business corporations in ballot measure elections." Ibid. The overruling of *Berkeley* would be required to sustain this form of regulation, of course, as she recognizes.

Too, this kind of regulation could draw some strength from the Court's distinction between contributions and expenditures, which, however, may be a declining doctrine in this Court. See *Massachusetts Citizens for Life*, supra, 479 U.S., 270 (Chief Justice Rehnquist dissenting)("The distinction between contributions and independent expenditures is not a line separating black from white.").

Third, it must also be remembered that the ban on expenditures in *Bellotti* was not on all corporate expenditures in ballot question elections. Rather, corporations could not spend except on questions "materially affecting any of the property, business or assets of the corporation," with the statute excluding some issues that might otherwise have fallen within this standard. *Bellotti*, supra, 435 U.S., 767-768 (quoting statute). The state courts assumed that permitting a corporation to express itself on an issue materially affecting it, with some exceptions, adequately protected whatever expression rights corporations have. Id., 771-773 (describing state court holding). Because of the Supreme Court's view of the protection accorded political speech, even when it is by a corporate "speaker," it pretermitted this not unimportant question. Id., 772 n. 6, 777 & n. 13, 783 (commercial speech protected not so much because it pertains to seller's business but because of it societal value), 784-785. It may well be that should the Court withdraw from its *Bellotti* views, if in fact it has not already withdrawn, it might nonetheless find that a ban on corporate expenditures, or a limitation through regulation of contributions, would be invalid in the case of denials to a corporation of the ability to represent its business interests, the reasons for its existence after all, in the political arena. Acceptance, therefore, of the view set forth above that the language of the most recent cases constitutes a major shift in direction does not necessarily get your proposal out beyond the constitutional shoals.

On the other hand, it is certainly possible to shape arguments that justify substantial limitations on or bans on corporate expenditures in ballot question elections. Spending from corporate treasuries still raises the danger of abridgment of dissenting shareholders' interests. The fact that the corporate leadership believes that the entity's economic interests are at stake on a particular question does not necessarily mean that all who have bought into the business for reasons of gain would agree, or, even if they do agree, that

they would necessarily believe either that those economic interests should be protected or that corporate funds should be used in that pursuit.

With respect to "the corrosive influence of concentrated corporate wealth," the fact that a corporation's economic interests are or may be affected by a ballot question does not necessarily reduce the concern government might feel, whether the funds come from corporate treasuries or from a separate PAC. The question that might concern corporate beneficiaries of favored tax treatment in any Puerto Rican referendum would be one not of a substantial threat to corporate existence or some similar issue but rather whether certain public subsidies through tax treatment, which were enacted for broad public interest reasons, not simply to benefit corporations, should be retained. It might well be reasonable for government to conclude that, on questions affecting corporate self-interest, it should restrict corporate spending power, in order to prevent undue influence in an election, to equalize access to electoral resources, or to favor a disinterested public debate on the issue. But compare *Meyer v. Grant*, 108 S.Ct. 1886, 1893-1894 (1988).

In any event, as formulated in your request, the proposal would probably fall victim to another judicial doctrine in the First Amendment area, the bar on content regulation.

The Content Neutrality Requirement

Even in instances in which governmental regulation of or bans on expression are permissible, government may not exercise its discretion by basing regulation or bans on the *content* of the expression. That is, it may not choose which speech it prefers and which it does not for this purpose. Thus, in *Police Dept. of Chicago v. Mosley*, 408 U.S. 92 (1972), and *Carey v. Brown*, 447 U.S. 455 (1980), the Court declined to assess the validity of governmental restrictions on picketing, respectively, school buildings and residences, because the restrictions excepted labor union picketing. Government could not prefer the views of one entity, labor unions, while suppressing the views of all others. In *Boos v. Barry*, 108 S.Ct. 1157 (1988), the Court found impermissibly content oriented a statute in the District of Columbia that banned picketing and placarding within 500 feet of a foreign embassy, if the signs carried tended to bring the foreign government into "public odium" or "public disrepute." The restriction was based *only* on the content of the speech and could not be justified. See also *Pacific Gas & Electric Co. v. PUC*, 475 U.S. 1, 12-16 (1986); *Regan v. Time, Inc.*, 468 U.S. 641, 648-649 (1984); *Consolidated Edison Co. v. PSC*, 447 U.S. 530, 536-537 (1980). See generally Stone, *Content Regulation and the First Amendment*, 25 WM. & MARY L. REV. 189 (1983). "In the realm of protected speech, the legislature is constitutionally disqualified from dictating the subjects about which persons may speak and the speakers who may address a public issue. . . . Especially where, as here, the legislature's suppression of speech suggests an attempt to give one side of a debatable public question an advantage in expressing its views to the

people, the First Amendment is plainly offended." *Bellotti*, supra, 435 U.S., 785-786.[18]

If it is decided to proceed with a limitation on corporate expenditures, or some other form of regulation, a considerable constitutional question would be removed if the limitation were not imposed on only one group of corporations, those benefiting under one particular section of the Tax Code.

Conclusion

It is thus concluded that the Supreme Court's standards with respect to First Amendment protections of political speech, including corporate speech, applies to Puerto Rico, whether restraints are enacted by the government of the United States or the government of Puerto Rico. Further, it is possible to draw from recent cases indications that the Court may be withdrawing from the position of according corporate political speech as much constitutional protection as that speech has hitherto enjoyed. Even if this trend proves to be the case, however, a restriction would have to be drafted more broadly than the one suggested in your request.

Johnny H. Killian
Senior Specialist
American Constitutional Law

[18] One may note that then-Justice Rehnquist was willing to sustain the ban in *Bellotti*, even if the legislature's motive was to muzzle corporations on a particular issue, i.e., the imposition of a personal income tax. Id., 826-827 n. 6.

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May 30, 1989

TO : Honorable Bennett Johnston
Attention: Laura Hudson

FROM : American Law Division

SUBJECT : Validity of Congressional Deviation from Uniformity Requirement of Federal Taxation Respecting Puerto Rico in the Event of Statehood

This memorandum responds to your inquiry whether Congress might have some discretion under the Constitution to vary federal taxes in and respecting Puerto Rico, should Puerto Rico be admitted to statehood following the upcoming proposed referendum. We do not attempt to evaluate, except in passing in certain instances, the numbers and degrees of special, nonuniform treatment of Puerto Rico or Puerto Rican interests contained in federal tax and customs laws. It is sufficient to note that special provisions are made, and the uniformity requirement would be implicated as soon as Puerto Rico is admitted to statehood.

The relevant provisions of the Constitution are:

> The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises . . . but all Duties, Imposts and Excises shall be uniform throughout the United States[.] Article I, § 8, cl. 1.
>
> Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union[.] . . . The actual Enumeration shall be made within three Years after the first Meeting of the Congress of the United States, and within every subsequent Term of ten Years, in such Manner as they shall by Law direct. Article I, § 2, cl. 3.
>
> No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census of Enumeration herein before directed to be taken. Article I, § 9, cl. 4.
>
> No Preference shall be given by any Regulation of Commerce or Revenue to the Ports of one State over those of another[.] Article I, § 9, cl. 5.

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration. Sixteenth Amendment.

In *Downes v. Bidwell*, 182 U.S. 244 (1901), there were challenged provisions of the Foraker Act, which imposed a duty on goods imported to the mainland from Puerto Rico. There was no comparable duty on shipments from one State to another, and the Court had decided in *De Lima v. Bidwell*, 182 U.S. 1 (1901), that the Island was no longer a "foreign country." Thus, the Court assumed that if Puerto Rico were part of the United States, the duty would be unconstitutional under the uniformity clause or under the port preference clause. *Downes*, supra, 182 U.S., 249. See also id., 292 (Justice White concurring). But the Court held, as clarified and refined by subsequent Court adoption of Justice White's concurrence, that as an unincorporated territory, Puerto Rico was not part of the United States for purposes of either clause. But see also *Binns v. United States*, 194 U.S. 486 (1904)(sustaining license taxes, imposed by Congress but applicable only in Alaska, an *incorporated* territory, where revenues were paid into the general fund of the Treasury and did not exceed or even equal the total cost of maintaining the territorial government). Because the contested provisions in *Downes* applied specifically to goods originating in Puerto Rico, §§ 2, 3, 31 Stat. 77 (1900), it might be concluded that the case, though the assumption is dictum, would bring all special tax provisions specifically tailored to Puerto Rico into conflict with the uniformity clause.

Indeed, the overwhelming precedent with respect to the uniformity clause has been to the effect that, while it does not require Congress to ignore special circumstances, it does obligate Congress to legislate on the basis of geographic uniformity, in other words, couch laws in nongeographic terms. E.g., *Knowlton v. Moore*, 178 U.S. 41, 83-110 (1900). However, in the most recent decision, and the case law is in any event of notable paucity, the Court held that Congress could, having ascertained the existence of a geographically isolated problem, a special circumstance, frame tax legislation in express geographic terms. *United States v. Ptasynski*, 462 U.S. 74 (1983). While the case may be justly criticized as draining the uniformity clause of its content, the unanimous decision does afford a basis for Congress to take into account Puerto Rico's special circumstances, by express geographic designation, in structuring tax legislation respecting it, should it be admitted as a State.

That the net windfall profit tax revenues from the inception of the law through the end of the fiscal year in which the litigation was being conducted were in excess of $26 billion and the estimated net during the following five years was approximately $50 billion[1] no doubt created that "hydraulic

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[1] See *Jurisdictional Statement* of the Appellant United States, *United States v. Ptasynski*, supra, 82-1066, p. 8.

pressure," in Justice Holmes' words, that "makes what previously was clear seem doubtful, and before which even well settled principles of law will bend." *Northern Securities Co. v. United States*, 193 U.S. 197, 401 (1904)(dissenting). But, nonetheless, *Ptasynski* is now the latest precedent and will doubtless guide the Court in future decisions. The most serious imponderable is whether the Court, having departed from what had been a previous, seemingly settled course of interpretation - not squarely, of course, it never having decided on the merits an express geographic tax classification case - will now seek to cabin the latest precedent through a narrow reading or to apply it through the usual incorporation of its standards into future litigation.

Before treating the question whether the uniformity clause would permit a geographically-identified deviation from a general, indirect tax, we should briefly digress to consider what taxes are direct and which indirect, because upon that issue may turn an indication of the magnitude of the exception Congress might seek to make. The Constitution divides the taxes which Congress is authorized to impose into two classes: (1) direct taxes, which must be apportioned among the States on the basis of their respective populations, and (2) indirect taxes, which need not be apportioned but must be levied uniformly throughout the country.[2] *Steward Machine Co. v. Davis*, 301 U.S. 548, 581 (1937); *Brushaber v. Union Pacific R. Co.*, 240 U.S. 1, 12-13 (1916). The Court has generally assumed that the uniformity clause applies to all taxes that are not "direct" within the meaning of the apportionment clause. E.g., *Knowlton v. Moore*, supra, 178 U.S., 83; *Nicol v. Ames*, 173 U.S. 509, 515 (1899). This formulation did not allow the Court, however, ease in deciding what a "direct" tax is, a definition which the cases proved to be quite elusive.

In the contrived case of *Hylton v. United States*, 3 Dall. (3 U.S.) 171 (1796),[3] it was argued that a fixed yearly tax on carriages used for the conveyance of persons was a direct tax and invalid because not apportioned. Out of the separate opinions of the participating Justices there emerged the rule which applied for almost 100 years: direct taxes contemplated by the Constitution were two and only two, to wit, a capitation or poll tax and a tax on land. No other tax was capable of being apportioned. Utilizing this rule, the Court in *Springer v. United States*, 102 U.S. 586 (1881), sustained a

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[2] Actually, as will be noted from the language of the Constitution, "taxes" appear to be distinguished from "duties, imposts and excises." But the Court commonly treats the two classes as equally constituting "taxes," *Knowlton v. Moore*, supra, 178 U.S., 88 (discussing "the classes of taxes termed duties, imposts and excises"); *United States v. Ptasynski*, supra, 462 U.S., 80 (referring to duties, imposts, and excises as "indirect taxes"), and, inasmuch as we conclude that income taxes are "indirect taxes" for purposes of the uniformity requirement, semantic clarity would seem to require the utilization of the word "tax" for both classes.

[3] See D. CURRIE, THE CONSTITUTION in the SUPREME COURT - The FIRST HUNDRED YEARS, 1789-1888 (1985), 31-37.

federal income tax law, the first in our history, imposed in 1864 as a Civil War measure. See also *Pacific Ins. Co. v. Soule*, 7 Wall. (74 U.S.) 433 (1869); *Veazie Bank v. Fenno*, 8 Wall. (75 U.S.) 533 (1869); *Scholey v. Rew*, 23 Wall. (90 U.S.) 331 (1875).

Demise of this rule occurred in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, *modified on rehearing*, 158 U.S. 601 (1895), which invalidated the 1894 federal income tax law. Act of August 27, 1894, ch. 349, §§ 27-37, 28 Stat. 509, 553-560. The first decision struck down the tax as applied to income from real property and from state or municipal bonds,[4] and the second invalidated the tax on the income from certain personal property, such as stocks and bonds. The Court found that a tax on income from property was effectively one on the property itself, id., 157 U.S., 580-581; 158 U.S., 627-628, and was thus a direct tax, invalid because not apportioned. But taxes on incomes from other classes of property than real estate and invested personal property, that is, income from "professions, trades, employments, or vocations," id., 158 U.S., 637, were indirect and valid, although the Court, applying a severability rule, found that Congress would not have levied the remaining tax on earned income had it known it could not have enacted the entire measure and thus voided the entire act.

Distinctions thereafter became difficult as the Court sustained progressive inheritance taxes, *Knowlton v. Moore*, supra, taxes on sales at exchanges or boards of trade, *Nicol v. Ames*, supra, and levies on the net income of corporations as excises. *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911). But the necessity for such distinctions disappeared when Congress proposed and the States ratified the Sixteenth Amendment, empowering Congress to "lay and collect taxes on incomes . . . , without regard to any census or enumeration." By the language of the Amendment, it could have been read as accepting the Court's judgment that certain income taxes are direct, simply removing the apportionment requirement. Adverting to the difficulties that could still arise both in interpretation and in the fact of the existence of a class of taxes that neither need be apportioned nor made uniform, the Court decided rather that the effect of the Amendment was to restore the understanding of income taxes as in all cases indirect.

Thus, in *Brushaber v. Union Pacific R. Co.* supra, 240 U.S., 18-19, the Court stated that the Amendment "forbids the application to [income] taxes of the rule applied in the *Pollock Case* by which alone such taxes were removed from the great class of excises, duties, and imposts . . . and were placed under the other or direct class." And in *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112-113 (1916), the Court reiterated that "the Sixteenth Amendment conferred no new power of taxation but simply prohibited the previous complete and plenary power of income taxation possessed by Congress from the beginning from being taken out of the category of indirect

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[4] As to the state and municipal bond portion of the decision, see *South Carolina v. Baker*, 108 S.Ct. 1355, 1362-1368 (1988).

taxation to which it inherently belonged and being placed in the category of direct taxation subject to apportionment . . . ."

Income taxes, therefore, are indirect taxes, and, like other duties, imposts, and excises, must be levied with regard for the uniformity requirement. The special provisions now accorded residents of Puerto Rico in excluding from gross income earnings derived from sources within Puerto Rico, 26 U.S.C. § 933(1), and see 26 U.S.C. § 933(2), as well as other income rules, see especially 26 U.S.C. § 936, must be evaluated in light of this conclusion.

It is evident from the Journal and the recorded debates of the Constitutional Convention that while the Framers were anxious to give to the National Government the power to act upon national problems, with the power to levy taxes and the power to regulate interstate commerce being two principal authorizations toward this end, they were also concerned with the possible abuse of power. The prospect of a faction of Congress acting to the detriment of one or more of the States gave rise to several provisions in the Constitution, namely, the requirement of apportionment of direct taxes, the requirement of uniformity of indirect taxes, and restrictions against discriminating commercial regulations contained in the port preference prohibition. See *Knowlton v. Moore*, supra, 178 U.S., 95-106 (setting out the consideration of these provisions not only in the Convention but in the Continental Congress as well). The safeguards of a ban on port preference either through regulation or taxation and a uniformity requirement for indirect taxes were contained in consecutive clauses. 2 M. FARRAND, THE RECORDS of the FEDERAL CONVENTION of 1787 (rev. ed. 1937), 417-418, 434, 437, 473. This collocation of the clauses shows the substantially similar meaning to be ascribed to the two provisions,[5] but for reasons not explained in the records, they were separated into their present location by the Committee on Style in the act of arranging the Constitution. Id., 614. As is well known, the charge of the Committee on Style was to arrange the Constitution and not to alter meanings previously adopted.

The two most important cases prior to *Ptasynski* which discuss the meaning of the uniformity clause are the *Head Money Cases*, 112 U.S. 580

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[5] In *Knowlton*, supra, 178 U.S., 104, the Court referred to the two as having "absolutely the same significance," and see id., 86-87, 106, but this is not quite right. The port preference clause applies to discrimination or preferential treatment both by taxation and by regulation; the bar is to preference, however, along state lines, rather than between or among ports. *Louisiana PSC v. Texas & New Orleans R. Co.*, 284 U.S. 125, 131 (1931). The uniformity clause contains no limitation as to States or state lines. See infra, p. 11.

(1884), and *Knowlton v. Moore*, supra, 178 U.S., 83-110.[6] In the former case, a federal law imposed a charge on the carrier of each alien coming by sea from a foreign port to any American port. The purpose of the charge was to raise funds for administering the immigration laws and for aiding immigrants who found themselves in distress after arrival. Among the challenges to the statute was that the charge did not apply to aliens who arrived over the inland borders and thus failed the uniformity requirement in that it applied only in those areas of the country where seaports were located. The Court found that the charge was not a tax but was instead a regulation of commerce, to which the uniformity clause did not apply, but it also discussed why, even if the charge were considered to be a tax, the uniformity clause was complied with.

"The tax is uniform when it operates with the same force and effect in every place where the subject of it is found. The tax in this case, which, as far as it can be called a tax, is an excise duty on the business of bringing passengers from foreign countries into this, by ocean navigation, is uniform and operates precisely alike in every port of the United States where such passengers can be landed. . . . [The law] does not apply to passengers arriving in this country by railroad or other inland mode of conveyance. But the law applies to all *ports* alike, and evidently gives no preference to one over another, but is uniform in its operation in all ports of the United States. It may be added that the evil to be remedied by this legislation has no existence on our inland borders, and immigration in that quarter needed no such regulation." Id., 112 U.S., 594-595(emphasis by Court).

Thus, the Court did not demand "[p]erfect uniformity and perfect equality of taxation." Id., 595. It was geographic uniformity that was demanded, not some chimerical conception of equality in all respects. "The uniformity here prescribed has reference to the various localities in which the tax is intended to operate. . . . Is the tax on tobacco void, because in many of the States no tobacco is raised or manufactured? Is the tax on distilled spirits void, because a few States pay three-fourths of the revenue arising from it?" Id., 594. It was "substantial uniformity," taking into account differences throughout the country, that was required. Id., 595.

Knowlton remains the most thorough consideration of the meaning of the uniformity clause, containing a lengthy exposition of the movement in the

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[6] In addition to these cases, the uniformity clause is discussed to some extent in the *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 156-161 (1974); *Fernandez v. Wiener*, 326 U.S. 340, 359-361 (1945); *Riggs v. Del Drago*, 317 U.S. 95, 102 (1942); *Phillips v. Commissioner*, 283 U.S. 589, 602 (1931); *Poe v. Seaborn*, 282 U.S. 101, 117-118 (1930); *Bromley v. McCaughn*, 280 U.S. 124, 138 (1929); *Florida v. Mellon*, 273 U.S. 12, 17 (1927); *LaBelle Iron Works v. United States*, 256 U.S. 377, 392-393 (1921); *Billings v. United States*, 232 U.S. 261, 282 (1914); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 158-159 (1911); *Nicol v. Ames*, 173 U.S. 509, 520-523 (1899).

Continental Congress and the Convention for taxing and commerce regulation powers in a national Congress and the safeguards to be attached thereto. From this review, the Court ascertained that its conclusion in *Head Money* had been correct, that is, the purpose of the clause was to prevent Congress from favoring one State or region over another. Supra, 178 U.S., 95-106.

Attacked before the Court was a statute that included an inheritance tax, which exempted small legacies and taxed larger ones at progressive rates. Act of June 13, 1898, ch. 448, §§ 29, 30, 30 Stat. 448, 464. After rejecting an argument that the tax was direct and void because not apportioned, the Court considered a claim that the inheritance tax violated the uniformity clause because it did not operate in precisely the same manner on all individuals or all property. Id., 178 U.S., 83-84. This standard the Court termed the requirement of "intrinsic uniformity," that taxes must be "equal and uniform." Id., 84. The narrower standard, the one adopted by the Court, was one of geographic uniformity. Id., 85. The clause "simply requires that whatever plan or method Congress adopts for laying the tax in question, the same plan and the same method must be made operative throughout the United States; that is to say, that wherever a subject is taxed anywhere, the same must be taxed everywhere throughout the United States, and at the same rate." Id., 84.

Advanced were three reasons the Court thought uniformity referred only to geographical uniformity. First, the language of the clause suggested the more limited meaning. If "uniform" meant "equal and uniform" in the broader sense argued for, that is, taxes must affect every person or all property identically, then nothing would be added by the phrase "throughout the United States" in the clause. But the phrase did have meaning if it was taken to qualify the word "uniform" by giving it a geographic conception. This reading comported with the canon of construction that effect be given to each word of the Constitution. Id., 87.

Second, to give the broad construction to the clause would be to place outside the federal taxing power a wide range of subjects, inasmuch as indirect taxes would rarely affect everyone equally, since few, if any, taxable goods and services are produced or consumed equally by everyone. On the other hand, direct taxes were those most suitable and adaptable to some kind of "intrinsic" uniformity, but they are not governed by a uniformity requirement, only the apportionment mandate. The broader construction thus imputed to the framers a conscious decision to apply a restraint to certain forms of taxes where the restraint was less appropriate and not to apply it to forms where it was very appropriate. But giving the uniformity clause a geographic construction avoided this anomaly and harmonized the two clauses relating to apportionment and uniformity. Id., 87-89.

Third, the Court undertook an historical review which convinced it that the practice in England and in the American colonies and States was devoid of any evidence of the existence of any "intrinsic" uniformity idea with respect to indirect taxes. Id., 89-95. Continuing, it recounted the history of the Continental Congress and the Convention as it related to the uniformity issue

and found convincing the evidence that geographical uniformity was all that was in anyone's mind. Id., 95-106. In particular, it noted that one version of the port preference clause referred to the Committee on Detail had required that duties, imposts, and excises laid by Congress for the maintenance of ports be "uniform and equal." But, as noted, the version reported and thereafter maintained in the taxing clause required only uniformity. Id., 103-104. See 2 M. FARRAND, op. cit., 418, 434, 437.

Having determined that geographic uniformity was the necessary condition, the Court found it satisfied by the tax before it. It was particularly argued that the variety of state testamentary and intestacy laws throughout the nation made the application of the tax rates vary widely and thus not be uniform. Acknowledging that the law would have different impacts in different States, the Court denied that this made any difference. "The proposition in substance assumes that the objects taxed by duties, imposts and excises must be found in uniform quantities and conditions in the respective States, otherwise the tax levied on them will not be uniform throughout the United States. But what the Constitution commands is the imposition of a tax by the rule of geographical uniformity, not that in order to levy such a tax objects must be selected which exist uniformly in the several States." Id., 178 U.S., 108.[7]

These two cases, then, and the cases which followed them without significant analysis, established at least two propositions. Uniformity was satisfied so long as the subjects of the taxation were not specified in geographic terms, even though the effects of taxation were uneven, because of the varying distribution of the subjects. That is, a tax on tobacco was uniform, in the *Head Money Cases* example, even though the impact fell upon only a few States, while a tax on "tobacco in the State of Maryland" would at least be suspect and probably invalid, inasmuch as other States had tobacco crops. Similarly, Congress could take into account localized problems or evils and legislate about them in tax terms, even though as a general matter there existed in other places like subjects which could be taxed. Again, in terms of the *Head Money Cases*, the fact that aliens might enter the United States across inland borders, from Mexico and Canada, and their crossing or their carriage could be taxed, did not prevent Congress from identifying the problem as the entry at sea ports and impose the tax uniformly on sea port entries. Considerable congressional discretion was available.

But what was to be the rule if Congress, seeing a problem that required different treatment in a tax law, expressly defined the object of the taxing power in geographic terms? All the cases appeared to suggest, if not say, that

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[7] On the same principle in construction of the uniformity requirement in the bankruptcy clause, see *Hanover National Bank v. Moyses*, 186 U.S. 181, 188-190 (1902); *Stellwagen v. Clum*, 245 U.S. 605, 613-615 (1918); *Vanston Bondholders Protective Com. v. Green*, 329 U.S. 156, 172-173 (1946)(Justice Frankfurter concurring). See also infra, p. 10.

a geographic classification would deny uniformity. This issue came before the Court in *Ptasynski*. Contested was the Crude Oil Windfall Profit Tax Act of 1980, P. L. 96-223, 94 Stat. 229 (codified as amended at 26 U.S.C. §§ 4986-4998, and scattered other sections of title 26). The law imposed an excise tax on the production of domestic crude oil, utilizing a variety of criteria to divide into several classes oil to be taxed at various rates or to be exempted altogether. The challenged provision created a class of "exempt Alaskan oil," 26 U.S.C. §§ 4991(b), 4994(e), which did not actually encompass all oil produced in Alaska, but rather only oil from most areas north of the Arctic Circle. Less than 20% of current Alaskan production was exempt.[8] *United States v. Ptasynski*, supra, 462 U.S., 77-78. "The exemption . . . reflects Congress' considered judgment that unique climatic and geographic conditions require that oil produced from this exempt area be treated as a separate class of oil." Id., 78.[9]

Unanimously sustaining the exemption, the Court laid down two standards. It read *Head Money* and *Knowlton* as establishing that the uniformity clause is fully satisfied so long as Congress does not employ geographic definitions in defining the subject of the tax, permitting great discretion in distinguishing between similar classes. Id., 82, 84, 86. It may be doubted that those cases stand for a proposition this broad. Certainly, Congress could employ a definition formally free of geographic terms but couched so as to pinpoint such a classification. The earlier cases simply announce that the clause requires geographic uniformity, without elaborating the degree of judicial scrutiny of such classifications. In any event, the *Ptasynski* Court so read the cases.

Turning then to the issue whether the uniformity clause absolutely prohibits Congress from defining the class of objects to be taxed in geographic terms, the Court concluded that it did not. "The Uniformity Clause gives Congress wide latitude in deciding what to tax and does not prohibit it from considering geographically isolated problems. . . . But where Congress does choose to frame a tax in geographic terms, we will examine the classification closely to see if there is actual geographical discrimination." Id., 84-85.

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[8] That some Alaskan oil was taxed and some was exempt did not at all affect the analysis in *Ptasynski*, illustrating the point earlier made that the uniformity clause is not dependent in its effect upon the lack of uniformity being related or unrelated to state lines. See supra, p. 5, n. 5.

[9] Prior to the enactment of the tax, price controls were in effect for oil, and these regulations treated the northern Alaska oil as a separate class also. The commerce clause, the basis for the controls, unlike the indirect tax authority, is not constrained by a uniformity requirement. E.g., *Hodel v. Indiana*, 452 U.S. 314, 323-324 (1981); *Railway Labor Executives' Assn. v. Gibbons*, 455 U.S. 457, 468-469 (1982).

In considering the question, the Court looked to adjudication under the bankruptcy clause, which also has a uniformity clause.[10] The *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 158-161 (1974), upheld against a uniformity clause challenge a statute that had been enacted to facilitate the reorganization of eight major railroads in the northeast and midwest regions of the country. "The uniformity provision," said the Court, "does not deny Congress power to take into account differences that exist between different parts of the country, and to fashion legislation to resolve geographically isolated problems. . . . The national rail transportation crisis that produced the Rail Act centered in the problems of the rail carriers operating in the region defined by the Act, and these were the problems Congress addressed. No railroad reorganization proceeding, within the meaning of the Rail Act, was pending outside that defined region on the effective date of the Act or during the 180-day period following the statute's effective date. Thus the Rail Act in fact operates uniformly upon all bankrupt railroads then operating in the United States and uniformly with respect to all creditors of each of these railroads." Id., 159-160.[11]

Thus, the *Ptasynski* Court read the railroad case as establishing that Congress may permissibly legislate to address "geographically isolated problems." Supra, 462 U.S., 84. And, without expressly establishing that the uniformity mandate of the tax clause and that of the bankruptcy clause mean the same thing, the Court held that Congress may frame tax legislation in "geographic terms" in order to deal with such problems, subject to judicial scrutiny to make sure it is not actually discriminating. Id., 85. Briefly reviewing Congress' action, the Court concluded that the legislature had "ample evidence" to justify, "based on neutral factors," favorable treatment for the class of Alaskan oil. The Court discerned no congressional intent either to benefit Alaska or to cause detriment to other oil-producing States for any reason prohibited by the uniformity clause. Id., 85-86.

It therefore appears that Congress, if it should admit Puerto Rico as a State, would find it constitutionally permissible, at least for some time, to provide special tax treatment couched solely in geographic terms, that is, expressly applicable to Puerto Rico, provided only that it undertake to make the record that each special provision addresses a particular, perhaps uniquely, Puerto Rican problem. These problems, it seems safe to say, would

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[10] "The Congress shall have Power . . . To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States[.]" Article I, § 8, cl 4. See also supra, p. 8, n. 7.

[11] A congressional enactment to provide for the particular problems of one bankrupt railroad was voided under the uniformity clause in *Railway Labor Executives' Assn. v. Gibbons*, 455 U.S. 457 (1982). The *Ptasynski* Court distinguished *Gibbons*, saying that, unlike the law in that case, the Alaska provision did deal with a geographically isolated problem. Supra, 462 U.S., 85 n. 14.

predominantly if not solely relate to the different levels of standards of living and economic conditions existing there. It also seems safe to say that it would not be hard to find areas within other States of the Union, perhaps entire States, that evidence similar problems of economics. Nonetheless, the lesson of *Ptasynski* is that it was irrelevant that the production of oil in other regions and States might have also encountered severe and difficult, and therefore costly, problems. Perhaps, then, it is not a case of uniqueness in identifying the problem of one State. It could be permissible for Congress in defining the "subject" to be taxed to establish that it is responding to the unique problem of the transition to statehood that Puerto Rico would be undergoing.

Perhaps, it is sufficient to show that Congress does not intend to engage in "actual geographic discrimination," id., 85, does not intend to confer "an undue preference," id., 86, in its treatment of special problems. *Ptasynski* is ambiguous, leaving much in doubt, but it does provide Congress room for the exercise of discretion. That is, in the *Rail Cases*, although the classification was in geographic terms alone, the Court, in addition to emphasizing that Congress was addressing a particular geographic problem, noted that, inasmuch as no other rail line in another region was in bankruptcy during the relevant period, the act did "in fact" operate uniformly. No such conclusion was possible in *Ptasynski*. Other oil production had similar conditions of costly production, though, to be sure, not the same climatic conditions, so that there was a lack of uniformity in fact. But the response of the Court was to deferentially scrutinize Congress' reasons for the exemption and to approve the classification as permissible. The fact that statehood transition, at least, is unique may afford Congress all the basis for classification it needs.

We have included the port preference clause in this memorandum, not only because in its drafting it was so associated with the uniformity clause as to furnish guidance to the meaning of the uniformity clause, but because in providing special revenue measures for Puerto Rico, as a statehood transition measure, it would be possible for Congress to violate that clause. Special customs duties or similar provisions might create a discrimination between Puerto Rico and other States. *Pennsylvania v. Wheeling & Belmont Bridge Co.*, 18 How. (59 U.S.) 421, 435 (1855)("What is forbidden is, not discrimination between individual ports within the same or different States, but discrimination between States: and if so, in order to bring this case within the prohibition, it is necessary to show not merely discrimination between Pittsburgh and Wheeling, but discrimination between the ports of Virginia and those of Pennsylvania."). And the port preference clause applies to regulations of commerce also, not only tax laws, so that some care must be taken. But what the clause reaches is not incidental results as benefits or discriminations but direct, intended classifications which have such results. *Louisiana PSC v. Texas & New Orleans R. Co.*, supra, 284 U.S., 131; *South Carolina v. Georgia*, 93 U.S. 4, 13 (1876).

The association of the two clauses in drafting and in the Court's jurisprudence would likely lead the Court to construe the port preference clause in the same lenient manner as it now construes the uniformity clause, thus permitting Congress some discretion in providing for a Puerto Rican statehood transition period. But we must emphasize that the case law in this regard is lacking.

Nothing in *Ptasynski*, similarly, guides judgment with respect to the length of the period in which Puerto Rico could be specially treated. Notice may be taken that with respect to Alaska and Hawaii, when they were admitted as States, Congress amended the tax law to permit them to continue to enjoy an exemption they had as territories from an air transportation tax, based on geographic remoteness, an exemption they continue to enjoy today, 30 and 29 years later. 26 U.S.C. § 4262(c)(1). One may assume that the Court would be as deferential to a congressional determination with respect to the length of the period as it would be to the necessity of special treatment itself.

You asked expressly about the provisions of 26 U.S.C. § 7652(e), under which the revenues collected on rum imported into the United States from Puerto Rico are covered into the treasury of Puerto Rico, less the estimated amount necessary for payment of refunds and drawbacks. You ask whether this treatment could continue indefinitely.

Unlike the tax clause, the spending clause contains no limitation upon Congress' discretion, save that it be for the public welfare. The payment of these funds into the Puerto Rican treasury after their collection as taxes is an exercise of the spending power. See *Cincinnati Soap Co. v. United States*, 301 U.S. 308 (1937)(proceeds from processing tax on coconut oil of Philippine production segregated and paid into Philippine treasury). Great deference is judicially accorded Congress' decision that a spending program furthers the general welfare, *Helvering v. Davis*, 301 U.S. 619, 640, 645 (1937), and the Court has suggested that the question whether a spending program is for the general welfare may not be judicially reviewable. *Buckley v. Valeo*, 424 U.S. 1, 90-91 (1976). Resolution of this question would appear to be one solely within Congress' discretion.

It thus appears that Congress would be enabled, despite the uniformity clause, as well, probably, as the port preference clause, to treat Puerto Rico differently for tax purposes than other States were treated for purposes of a transition. A study of past transitional measures adopted upon the admission of new States might well bring to light historical examples upon which Congress could rely both for guidance and support.

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Washington, D.C. 20540

August 1, 1989

TO : Honorable Daniel P. Moynihan
Attention: Ed Lopez

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SUBJECT : **Effects of the Proposal for a Referendum on the Status of Puerto Rico**

In response to your request, this memorandum presents an analysis of the effect on selected social welfare programs of alternative outcomes of a referendum on the status of Puerto Rico. The alternatives are (1) statehood, (2) independence, or (3) "enhanced" commonwealth status. Our analysis is based on Senator Johnston's and Senator McClure's amendment in the nature of a substitute to S. 712 as of July 27, 1989.

The important findings of our review of how social welfare programs would be affected by a change in Puerto Rico's status are:

- Under statehood, extension of the earned income tax credit to Puerto Rico, where it is not currently available, could be a significant new program expenditure, potentially covering up to 65 percent of all families with children in Puerto Rico;

- Under statehood, replacing the nutrition assistance block grant with the food stamp program, including open-ended funding, (a) would greatly reduce Puerto Rico's program design flexibility, and (b) could expand the caseload and program costs by one-third or more;

- Under statehood, replacing the program of aid to the aged, blind, or disabled with the supplemental security income program and open-ended funding would significantly expand the eligible population in Puerto Rico, increase benefits to recipients by as much as 10-fold and, consequently, greatly increase Federal costs;

- Under statehood, the cap on medicaid funds that currently applies to Puerto Rico would be removed and a more generous Federal matching formula would be used. As a result, Federal spending for medicaid in Puerto Rico could more than double. In addition, Puerto Rico would become subject to new requirements for furnishing more extensive coverage to some classes of individuals while cutting off coverage to others, and Puerto Rico would no longer be able to restrict medicaid providers to public facilities.

- Under independence the following issues would arise concerning the social security system: (1) if social security beneficiaries in Puerto Rico continued to receive payments from the U.S. system, but the contributions of workers that formerly went to the U.S. system instead were credited to the new Puerto Rican system, Puerto Rico would benefit at the expense of the U.S. social security system; (2) eventually, the new Puerto Rican system probably would have to provide lower benefits or have a higher rate of taxation than under the current arrangement (Puerto Rico now receives approximately 50 percent more in benefits than it pays in social security taxes).

This memo is organized as follows: First is a brief description of our understanding of each of the alternatives for the status of Puerto Rico as included in substitute S. 712, with specific reference to the operation of various social welfare programs; second are data on the demographic and economic characteristics of the population of Puerto Rico and relevant comparisons with data for the States; third is a description of how selected programs operate in the 50 States, how those programs currently operate in Puerto Rico, what the effect of a change in the status of Puerto Rico would be on each program, and important program policy issues that would arise from a change in status.

As agreed in discussions with your staff, the programs covered in our analysis are:

Please note that we do not attempt definitive cost or budget estimates, although we discuss issues concerning the general implications of the alternatives for cost and coverage of the population.

Alternatives for the Status of Puerto Rico, as Proposed in Substitute S. 712

Statehood

Puerto Rico would become a State equal in standing with the 50 States. All laws and programs operating in the 50 States would operate in Puerto Rico on the same terms and according to the same rules and regulations that apply in the other States. Where there is precedent for variation in program operations in individual States, such as eligibility and benefit criteria for certain programs in Alaska and Hawaii, those precedents might be considered in establishing such a program in Puerto Rico. One exception is made that would allow, until October 1, 1997, the continuation of the nutrition assistance block grant instead of the food stamp program.

Independence

Puerto Rico would become a separate and sovereign nation, although any person with U.S. citizenship would retain that citizenship. Presumably, the final legislation will provide for a transition period during which Federal spending in Puerto Rico would be replaced with a consolidated aid package that would be paid for several years after the proclamation of independence. Once Puerto Rico is fully independent, no program available to U.S. citizens who reside in the States or territories would be available to residents of Puerto Rico, whether or not U.S. citizens. A special task force would be appointed to deal with transition issues for the old-age, survivors, and disability insurance program (social security) and medicare.

Enhanced Commonwealth Status

Puerto Rico's commonwealth status would be somewhat altered. Federal grant-in-aid programs, with specific exceptions for programs that provide payments to individuals, could be consolidated and subjected to reduced application and reporting requirements. The funds could be used for the purposes of any of the programs included in the consolidation, and matching fund requirements could be waived by the Federal administering agency.

Income and Demographic Characteristics in Puerto Rico

Tables 1 and 2 illustrate how the income and household characteristics of the population in Puerto Rico compare to the U.S. population as a whole and to a State. (Mississippi is used in this comparison.) The data were tabulated from the 1980 decennial census. Even though the data are 10 years

old, the characteristics of the populations in the different jurisdictions probably have not changed substantially in relation to each other.[1]

The data show that the average family is significantly larger in Puerto Rico than in the States (4.01 persons per family compared with 3.27 persons), and the median age in Puerto Rico is 4.5 years younger than in the States, reflecting a greater number of children per family. A slightly higher proportion of children in Puerto Rico live in single, female-headed families than do those in the United States, but a higher proportion live in two-parent families than do in Mississippi. The elderly in Puerto Rico are more likely to live in a family unit than are the elderly in the United States, which also increases the average family size.

Income in Puerto Rico is significantly lower than in any of the 50 States, which is an important consideration for evaluating the potential effects of extending open-ended, means-tested transfer programs there. Measured against the poverty threshold that applies in the States, in 1979 the incidence of poverty was six times greater in Puerto Rico than in the United States as a whole; 58.1 percent of families in Puerto Rico fell below the poverty threshold compared with 18.9 percent in Mississippi and 9.6 percent in the United States as a whole. The median family income in Puerto Rico in 1979 was less than 30 percent of the U.S. median and was 40 percent of that in Mississippi, which had the lowest income of the 50 States. The median annual earnings of men in Puerto Rico who worked at any time during 1979 were 54 percent of the median earnings of men in Mississippi, and 41 percent of the earnings of men in the total United States. The poverty rate among the elderly is substantially higher in Puerto Rico than in the States. Only 8.1 percent of elderly persons in the States live in families with incomes below poverty, but in Puerto Rico nearly 60 percent of the elderly live in poor families.

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[1]The definition of a family is two or more persons related by blood, marriage, or adoption living together; "unrelated individuals" are single persons living alone or with others to whom they are not related by blood, marriage, or adoption. The term "household" includes families, single individuals living alone, and two or more unrelated individuals living together as one household unit.

TABLE 1. Selected Data on the Income and Demographic Characteristics of the Populations of Puerto Rico, Mississippi, and the United States--1980

	Puerto Rico	Mississippi	United States
Households	904,151	861,418	86,573,717
Families	757,645	645,453	59,190,133
Unrelated individuals	146,506	215,965	27,383,584
Persons	3,176,743	2,455,065	220,845,766
Persons in families	3,035,777	2,239,100	193,462,182
Percent of persons in families	95.6%	91.2%	87.6%
Percent of family households	83.8%	74.9%	68.4%
Average household size	3.65	2.97	2.74
Average family size	4.01	3.47	3.27
Age distribution (percent)			
Persons under 16	33.9%	28.7%	24.8%
Persons age 16 to 64	58.2%	60.0%	64.3%
Persons age 65+	7.9%	11.3%	10.9%
Median age (years)	25.5	29.2	30.0
Family status: children (percent)			
In male-present families	82.1%	77.8%	82.9%
In single female-headed families	17.9%	22.2%	17.1%
Family status: persons 65+ (percent)			
In families	80.8%	69.1%	68.0%
Unrelated individuals	19.2%	30.9%	32.0%
Family income			
Median income	$5,923	$14,591	$19,917
Mean income	$8,271	$17,645	$23,092
Families with children			
Median income	$6,080	$15,812	$20,375
Mean income	$8,553	$18,225	$23,551
Married-couple families with children			
Median income	$6,743	$18,210	$22,816
Mean income	$9,153	$20,474	$25,735

See note on following page.

TABLE 1. Selected Data on the Income and Demographic Characteristics of the Populations of Puerto Rico, Mississippi, and the United States--1980--Continued

	Puerto Rico	Mississippi	United States
Single householder with children			
Median income	$3,210	$7,117	$8,819
Mean income	$4,436	$8,715	$10,943
Families with householder 65+			
Median income	$4,294	$8,138	$12,295
Mean income	$6,349	$11,797	$16,831
Income of unrelated individuals			
Median	$1,853	$3,961	$6,695
Mean	$3,417	$6,386	$9,282
Unrelated individuals 65+			
Median income	$1,840	$3,200	$4,752
Mean income	$2,495	$5,000	$7,142
Median annual earnings			
Males 15+	$5,394	$9,943	$13,172
Females 15+	$5,082	$5,487	$6,285
Poverty status			
Families below poverty (percent)	58.1%	18.9%	9.6%
Persons below poverty (percent)	62.4%	12.4%	23.9%
Children below poverty	69.5%	30.4%	16.0%
In male-present families	66.2%	20.9%	9.4%
In single female-headed families	84.1%	63.7%	47.8%
Persons 65+ below poverty	63.8%	34.3%	14.8%
In families	59.1%	24.7%	8.1%
Unrelated individuals	83.6%	55.7%	29.2%
Median poverty income deficit for:			
Families below poverty	$3,887	$2,610	$2,574
Unrelated individuals below poverty	$2,481	$1,332	$1,538
Persons 65+	$1,806	$ 921	$ 843

Note: Income and poverty data are for 1979.

Source: Table prepared by the Congressional Research Service (CRS). Data derived from the U.S. Bureau of the Census. 1980 Decennial Census. Detailed Population Characteristics, v. 1, chapter D.

TABLE 2. Distribution of Gross Annual Family Income: United States, Mississippi, and Puerto Rico--1980

	No. of families	Percent of families by income				
		<$5,000	$5,000-9,999	$10,000-14,999	$15,000-24,999	$25,000+
U.S.	59,190,133	7.3%	13.1%	14.7%	29.4%	35.4%
Mississippi	645,453	13.5	19.9	17.9	27.5	21.3
Puerto Rico	757,145	43.4	28.4	13.3	10.3	4.6

Source: CRS tabulations from the 1980 Decennial Census.

TABLE 3. Labor Force Participation in the United States and Puerto Rico--1987

	United States	Puerto Rico
Total civilian labor force participation rate (persons 16+)	65.6%	44.1%
Males	76.2	59.7
Females	56.0	30.4
Unemployment rate	6.2	16.8

Source: *Statistical Abstract*, 1989, tables 622, 623, and 1389.

Table 3 shows that in 1987 the labor force participation rate in Puerto Rico was lower than in the United States as a whole: 44.1 percent of the population age 16 and over was in the labor force in Puerto Rico, compared with 65.6 percent in the United States. During that year the unemployment rate in Puerto Rico was well above that in the United States, 16.8 percent compared with 6.2 percent respectively.

Altogether, the data for Puerto Rico portray a population that is very different from that of the States. The major differences in the income distribution indicate that, should Puerto Rico become a State, applying the welfare program eligibility and benefit criteria that pertain in the 50 States could extend those benefits to a very large portion of the Island's population. The programs that would have the greatest impact if extended to Puerto Rico are food stamps, SSI, and the EITC, for which benefits are nationally uniform and are not set by the States. Although a detailed economic analysis of the effects of Puerto Rican statehood or enhancement of its commonwealth status on the distribution of personal income there is not undertaken in this memo, the data indicate that the introduction of welfare benefits at levels equal to those in the States could have important consequences for the Island's economy.

The Effects of the Referendum Alternatives on Social Welfare Programs

Following is a description of the implications of statehood, independence, and enhanced commonwealth status on various social welfare programs. Each program discussion includes a description of how the program operates now in the 50 States, how it operates in Puerto Rico, and the implications for program operations and scope under the alternatives proposed for referendum.

AID TO FAMILIES WITH DEPENDENT CHILDREN (AFDC)

THE CURRENT PROGRAM IN THE STATES

Eligibility and Benefits in the 50 States and the District of Columbia

Aid to families with dependent children (AFDC) is the major cash welfare program for needy children and their families. The AFDC program offers Federal funds to help pay State costs of providing cash payments to needy children (and their needy parents or other caretakers) who are under age 18 (or at State option, 19, if the child is still in high school or training); living in the home of a parent or specified relative; and deprived of parental support or care because of the death, continued absence from the home, or physical or mental incapacity of a parent, or, at State option, until FY 1991 (FY 1993 for the outlying areas), when it becomes a mandatory component of AFDC, the unemployment of the principal wage earner.

In FY 1987, 98 percent of AFDC children had two living parents (almost half of whom were unwed) but 87 percent lived with one parent, usually the mother. Only 11.4 percent of the children were in two-parent families (7.9 percent in families with an unemployed parent, 3.5 percent with an incapacitated parent).

States define "need," set their own benefit levels, establish (within Federal limitations) income and resource limits, and administer the program or supervise its administration. All States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands operate an AFDC program. American Samoa, effective October 1, 1988, has the authority to operate an AFDC program, but as of spring 1989 had not chosen to do so. To qualify for AFDC, a family must have a dependent child, countable income below the State's payment standard and countable resources below the State's resource limit; if able-bodied and without a preschool child, the parent must register for work or training. (Under the Family Support Act, all States must adopt a new job opportunities and basic skills (JOBS) training program by October 1, 1990; States generally are required to enroll all parents with children under age 3 in their education, work, or training activities if resources permit.) Benefits vary by family size; in January 1989, monthly AFDC payments to a three-person family with no countable income ranged in the 48 contiguous States from $118 in Alabama to $665 in Suffolk County, New York. The Federal countable resource limit is $1,000 per family. Some major resources, however, such as the home in which the family is living and up to $1,500 in equity value of a car (less in two States), are not counted as resources. The average monthly benefit paid in FY 1988 was $370 per family.

Participation

In FY 1988, 10.9 million persons in 3.7 million families were enrolled in the AFDC program in the 50 States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands. AFDC children totaled 7.3 million, 11.5 percent of the U.S. child population.

Funding and Expenditures

In the 50 States and the District of Columbia, the Federal Government pays at least 50 percent of each State's AFDC benefit payments, and 50 percent for most administrative costs in all States. Federal matching for AFDC benefits varies among States and, within limits, is inversely related to State per capita income. The Federal share of a State's AFDC payments is determined by the matching formula specified for medicaid in Title XIX of the Social Security Act. The share of AFDC benefits paid by Federal funds ranges in FY 1989 from 50 percent to 79.8 percent (Mississippi), and unlimited matching funds are authorized. For the outlying areas, Guam, Puerto Rico, and the Virgin Islands, 75 percent Federal matching is provided, but the law imposes a ceiling on Federal funds.

In FY 1988, total AFDC program costs for the 50 States, the District of Columbia, and the outlying areas amounted to almost $19 billion, of which 88 percent, $16.6 billion, was spent on benefit payments and the rest on administrative costs. The Federal Government paid nearly 55 percent, $9.1 billion, of AFDC benefit expenditures.

THE CURRENT PROGRAM IN PUERTO RICO

Eligibility and Benefits in Puerto Rico

Under the AFDC program, the Commonwealth of Puerto Rico is considered a "State." Thus, generally the categorical, income, and resource eligibility criteria described above apply. However, the new law requiring all States to offer AFDC (for at least part of the year) to two-parent families in which the principal earner is unemployed does not take effect in Puerto Rico until October 1, 1992, 2 years later than in the 50 States and the District of Columbia.

In FY 1987, 98 percent of AFDC children in Puerto Rico had two living parents (about 40 percent of whom were unwed), but 75 percent lived with only one parent, usually the mother. More than one-fifth of the children were in two-parent families with an incapacitated parent. Puerto Rico did not offer AFDC for unemployed parents.

Puerto Rico's maximum AFDC benefit varies by family size, and for a three-person family is $90 per month (this amount assumes an average rent

payment of $20 per month). This is $28 below the lowest maximum payment in the 50 States (Alabama). The average payment among families of all sizes in FY 1988 was $101 per month, compared with $370 among the States.

Participation

In FY 1988, 177,360 persons in nearly 55,000 families in Puerto Rico received AFDC benefits. In 1980, a total of 117,669 Puerto Rican children received AFDC, 9.6 percent of the Island's child population (more recent percentage data are unavailable).

Funding and Expenditures

The major difference between Puerto Rico and the other "States" is the way its AFDC program is funded. The 50 States and the District of Columbia receive open-ended funding, with a minimum Federal matching rate for benefits of 50 percent and a maximum Federal match of 83 percent. In contrast, as noted before, Puerto Rico and the other outlying areas are subject to a "cap" on Federal funding for several programs grouped together. The Federal Government pays 75 percent of Puerto Rico's AFDC benefit payments and several other social welfare benefits up to a specified limit. Section 1108 of the Social Security Act places an annual limit of $82 million ($72 million before FY 1989) on the sum available to Puerto Rico for matching funds to help fund AFDC, emergency assistance, aid to the aged, blind, or disabled, and foster care and adoption assistance. The Act provides that Puerto Rico may use funds not expended within the section 1108 cap for its Title XX social services program. (In effect, this Title XX provision generally allows Puerto Rico to always receive the amount of the Federal cap.)

In FY 1988, total AFDC benefit payments in Puerto Rico amounted to $66.7 million (qualifying Puerto Rico for $50 million in 75 percent Federal matching funds).

IMPLICATIONS OF STATEHOOD

If Puerto Rico were to be treated like the 50 States and the District of Columbia in terms of its AFDC funding, the cap on Federal funding would be removed, and its Federal matching rate would be raised from the 75 percent rate to the maximum permitted in law, 83 percent. This is because Puerto Rico's 1987 per capita income ($4,997) was less than one-third that of the United States ($15,481). These relationships, under the existing formula, would qualify Puerto Rico for the maximum matching rate.

According to data from the Department of Health and Human Services, total FY 1987 benefit payments in Puerto Rico for AFDC ($66.4 million), emergency assistance ($207,000), and aid to the aged, blind, or disabled ($17.2

million) totaled $83.8 million, qualifying Puerto Rico for maximum matching funds (at a 75 percent rate) of $62.86 million. In addition, administrative costs for AFDC totaled $14.1 million, qualifying Puerto Rico (at a 50 percent rate) for matching funds of $7.05 million. Data are not available on expenditures in Puerto Rico on foster care and adoption assistance, but the Administration has indicated that Puerto Rico does not receive funding under the Title IV-E foster care and adoption assistance programs. It appears that Puerto Rico in FY 1987 did not use the full $72 million available in that year for the programs listed above, in which case it could apply the rest to its Title XX social services program. It is unclear how Puerto Rico would respond to open-ended benefit funding for AFDC at an 83 percent matching rate. By spending somewhat *less* money Puerto Rico could maintain existing program levels.

IMPLICATIONS OF INDEPENDENCE

Puerto Rico as an independent nation would not be eligible to participate in the AFDC program. Presumably, Federal AFDC funds would be included in the consolidated aid package that would be paid to Puerto Rico for several years after the proclamation of independence.

The Family Support Administration estimated that in FY 1988 the Federal Government reimbursed Puerto Rico $52.3 million for AFDC benefit payments, $92,561 for emergency assistance payments (also part of Title IV-A of the Social Security Act), and about $7.2 million for administration and training costs, for a total of approximately $59.6 million related to families and children. These figures reflect adjustments for previous claims. (An additional amount was reimbursed in FY 1988 for cash aid to the aged, blind, or disabled. See next section.)

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

Section 407 of the substitute S. 712 provides for the consolidation of certain "grant-in-aid" programs. Because the law referred to in section 407 excludes "direct payments to classes of individuals," the provision presumably would not apply to the AFDC program, which makes grants *to* States *for* payments to classes of individuals. If commonwealth status prevailed, the existing AFDC program would continue (unchanged) in Puerto Rico.

SUPPLEMENTAL SECURITY INCOME (SSI)

THE CURRENT PROGRAM IN THE STATES

Eligibility and Benefits in the 50 States, the District of Columbia, and the Northern Mariana Islands

The supplemental security income (SSI) program is a Federal program administered by the Social Security Administration that guarantees a minimum level of cash income to needy aged, blind, and disabled persons. To qualify for SSI payments, a person must satisfy the program criteria for age, blindness, or disability. The aged are defined as persons 65 years and older. Blind individuals are those with 20/200 vision or less with the use of a correcting lens in the person's better eye, or those with tunnel vision of 20 degrees or less. Disabled individuals are those unable to engage in any substantial gainful activity (SGA) by reason of a medically determined physical or mental impairment expected to result in death or that has lasted or can be expected to last, for a continuous period of at least 12 months. In addition, to be considered "disabled," a child under age 18 must have an impairment of "comparable severity" with that of an adult. SSI law is contained in (the second) Title XVI of the Social Security Act.

In 1989, individuals and couples are determined to be eligible for a Federal SSI payment if their countable income does not exceed $368 per month for an individual living independently or $553 for a couple living independently. Benefit levels are adjusted for price inflation at the same time and by the same percentage as social security benefits. Countable income is subtracted from the Federal SSI guarantee (and State supplementary payment, if available) to determine SSI eligibility and benefit amount.

Under the SSI program, $20 of monthly income from virtually any source (such as social security benefits, but not need-tested income such as veterans' pensions) is disregarded in determining eligibility and benefit amount. In addition, the first $65 of monthly earned income plus one-half of remaining earnings are disregarded. Thus, the income level at which Federal SSI eligibility ends for an individual (i.e., the "breakeven" amount) is $388 if the person has only unearned income, and $821 per month if the person has only earned income. (The corresponding figures for a couple are $573 and $1,191.) In effect, this means that the marginal benefit-reduction rate is 50 percent for earned income and 100 percent for unearned income.

About 42 percent of SSI recipients receive a State supplement. Currently, 26 States and the District of Columbia supplement the Federal guarantee for individuals living independently, by monthly amounts ranging from $2 to $384 (Connecticut). Most States provide supplements for recipients in group living arrangements.

To determine eligibility and benefits the SSI program generally takes into account all types of income, including earned, unearned, and support and maintenance furnished in cash or in kind. However, Congress recognized that many aged, blind, or disabled individuals live with relatives or friends, making it difficult to determine the exact value of the support and maintenance furnished in kind. Thus, if an SSI applicant or recipient is "living in another person's household and receiving support and maintenance in-kind from such person," the value of such in-kind assistance is presumed to equal one-third of the Federal SSI benefit standard. The maximum Federal SSI benefit payable to such individual or couple is two-thirds of the Federal SSI guarantee level.

Eligibility for SSI is restricted to qualified persons who have countable assets of not more than $2,000, or not more than $3,000 in the case of qualified couples. In determining assets, a number of items are excluded. Totally disregarded is the individual's home; and, within "reasonable" limits set by the Secretary of the Department of Health and Human Services these assets are disregarded: household goods, personal effects, an automobile, and a burial space for the individual, spouse, and members of the immediate family.

The income of an ineligible spouse who lives with an adult SSI applicant or recipient is considered in determining the eligibility and amount of payment to the individual. Similarly, part of the income of the parents of a disabled or blind child under the age of 18 is counted as available to the child and used in determining his SSI benefit amount, if any. Further, an individual's resources are deemed to include those of his ineligible spouse (with whom he lives) or in the case of a child under the age of 18, those of his parents with whom he lives. In 1987, there were 41,200 spouse-to-spouse and 22,500 parent-to-child cases in which deeming reduced the benefit; these figures do not include the cases in which individuals were made ineligible because of the deeming provisions.

In addition to the categorical requirements and income and resource rules, to receive SSI a person must be a citizen of the United States or an alien who is lawfully admitted to the United States; live in the United States or the Northern Mariana Islands; apply for all other benefits to which he is entitled; and if he is disabled, accept vocational rehabilitation services if they are offered.

The Commonwealth of Northern Mariana Islands is the only outlying U.S. area with the SSI program. The Northern Marianas Covenant (P.L. 94-241) was signed into law in March 1976. It changed the status of the Northern Mariana Islands from a part of the United Nations Trust Territory of the Pacific administered by the United States to that of a full U.S. Commonwealth. Terms of the covenant extended SSI to the new Commonwealth on the same terms as in the 50 States and the District of Columbia, effective in 1978. Congress has never passed proposals to extend

the SSI program to the other U.S. Commonwealth (Puerto Rico) or the other U.S. outlying areas of Guam, American Samoa, and the Virgin Islands.

The SSI program, which began operations in 1974, replaced the matching-grant programs of old-age assistance, aid to the blind, and aid to the permanently and totally disabled in the 50 States and the District of Columbia.

Participation

It is estimated that nearly 4.5 million persons will receive SSI benefits in FY 1989; 2.0 million persons aged 65 or older (almost 7 percent of the U.S. aged population) and 2.5 million blind or disabled persons, approximately 290,000 of whom are estimated to be children. In September 1988, the average monthly SSI payment was $259; the average monthly Federal SSI payment was $226, and the average amount of State supplementation was $122.

Funding and Expenditures

Federal SSI benefits and the cost of administering the program are financed from general funds from the Treasury. The Social Security Administration also administers the payment of State-financed State supplementary SSI payments for 26 States and the District of Columbia. These administrative costs are paid by general funds from the Treasury.

In FY 1989 it is estimated that the Federal Government will pay 77 percent of total SSI program costs ($14.7 billion) and the States, 23 percent. In FY 1988, the SSI program cost the Federal Government $11.4 billion. Ninety-two percent of this amount was spent on Federal SSI benefit payments and the rest was spent on administrative costs, beneficiary services, and demonstration projects.

THE CURRENT PROGRAM IN PUERTO RICO

Eligibility and Benefits of Aid to the Aged, Blind, or Disabled in Puerto Rico

The SSI program is not available in Puerto Rico. Instead, Puerto Rico operates an assistance program of aid to the aged, blind, or disabled (AABD) under Title XVI of the Social Security Act. As with AFDC, the Commonwealth of Puerto Rico sets eligibility requirements (within Federal guidelines) and benefit levels. The Federal Government provides a grant to the Commonwealth to meet a share of the program's cost.

Aged persons are defined as those age 65 and older. The definition for blindness is virtually the same as that used for the SSI program; there is no age requirement for blind persons (i.e., blind children always have been eligible for benefits under both programs). Disability is defined by Puerto Rico, but is restricted to those age 18 or older.

To qualify for assistance in Puerto Rico, an aged, blind, or disabled person must have countable resources of no more than $2,000 and countable income of less than the maximum benefit, which equals $32 per month plus 50 percent of actual shelter costs. If shelter costs are assumed to be $20 monthly (reported by Administration officials as the average amount paid for rent by welfare recipients), the income level at which an individual with no other income would no longer qualify for adult assistance payments is $42 per month. In FY 1987, the average monthly benefit was approximately $36.

Under the AABD program not all earned income is counted. In the case of an aged or disabled person the law says that of the first $80 per month of earned income, the State agency *may* disregard not more than $20 plus one-half of the remainder. Thus, the breakeven level for an aged or disabled AABD recipient who has only earned income is $92 per month (assumes shelter costs of $20 per month). In the case of a blind AABD recipient, the State agency *must* disregard the first $85 per month of earned income plus one-half of remaining earnings. Thus, the breakeven level for a blind AABD recipient who has only earned income is $169 per month (assumes shelter costs of $20 per month). In effect, this means that (1) 100 percent of unearned income is counted in determining the AABD benefit amount, (2) the marginal benefit-reduction rate is 100 percent for the income of aged or disabled persons, and (3) the marginal benefit-reduction rate is 50 percent for the earned income of blind persons.

Participation

In FY 1987, 40,323 persons in Puerto Rico received AABD assistance payments: 16,297 aged persons, 278 blind persons, and 23,748 disabled persons. (In 1980, the most recent year with age data, about 8 percent of aged Puerto Ricans received AABD payments.)

Funding and Expenditures

Puerto Rico and the other outlying areas are subject to a "cap" on Federal funding. The Federal Government pays 75 percent of Puerto Rico's assistance payments to aged, blind, or disabled persons up to a specified limit (which must also cover the Federal share of costs of various other social welfare programs.) The Social Security Act places an annual limit of $82 million in FY 1989 and years thereafter on the sum available to Puerto Rico for matching payments to help fund programs of aid to families with dependent

children, emergency assistance, aid to the aged, blind, or disabled, and foster care and adoption assistance.

In FY 1987, total AABD assistance payments in Puerto Rico amounted to $17.2 million (qualifying Puerto Rico for a maximum of $12.9 million in Federal matching funds).

IMPLICATIONS OF STATEHOOD

If Puerto Rico were treated like the 50 States, the District of Columbia, and the Northern Mariana Islands, the Social Security Administration would extend the Federal SSI program to it, at 100 percent Federal expense. SSI then would replace AABD, providing much larger benefits, and much higher eligibility limits. Furthermore, the SSI program would cover disabled children, excluded from the AABD program.

The Federal SSI guarantee to an individual currently is $368 per month. In Puerto Rico the maximum money payment to a needy aged, blind, or disabled person in 1987 under the adult assistance programs was $32 per month plus 50 percent of actual shelter costs. A jump of this magnitude in benefit amounts undoubtedly would vastly expand the eligible population. The exact scope is unknown. However, when SSI replaced the cash welfare programs to aged, blind, or disabled persons in the States, the number of recipients rose nationwide by more than one-third. From 1973, the last year of the old cash welfare programs for aged, blind, or disabled persons, to 1975, the second year of the SSI program, 19 States had increases of more than 50 percent in the number of cash recipients (numbers more than doubled in 5 States).

Puerto Rico no longer would have to pay the 25 percent matching rate required under the AABD program. It is unknown how Puerto Rico would use such released funds. But, because the Federal SSI guarantee is relatively high (equal to 88 percent of per capita income in Puerto Rico), it is virtually certain that these funds would not be used to supplement the Federal SSI guarantee. Because statehood would require Puerto Rico to give automatic eligibility for medicaid to SSI recipients, funds would be needed for the expanded population eligible for medicaid (although many might already have medicaid coverage as medically needy persons).

IMPLICATIONS OF INDEPENDENCE

Puerto Rico as an independent nation would not be eligible for Federal funds under the AABD or the SSI program. Presumably, Federal funds used for AABD would be included in the consolidated aid package that would be paid to Puerto Rico for several years after the proclamation of independence. Based on data from the Family Support Administration, it is estimated that

in FY 1988 the Federal Government reimbursed Puerto Rico $13.2 million for the cost of its program for needy aged, blind, or disabled persons.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

Section 407 of the substitute S. 712 provides for the consolidation of certain "grant-in-aid" programs. Because the law referred to in section 407 excludes "direct payments to classes of individuals," the provision would not apply to the AABD program. If commonwealth status prevailed, the existing program for needy aged, blind, or disabled persons would continue (unchanged) in Puerto Rico.

NUTRITION ASSISTANCE UNDER THE FOOD STAMP ACT

THE CURRENT PROGRAM IN THE STATES

The Food Stamp Program

Overview

The Food Stamp Act authorizes a food stamp program to increase the food purchasing power of needy households by granting them monthly allotments of food stamp coupons. With limited variations for Alaska and Hawaii, it operates under nationally uniform Federal rules.[2] Federal funds pay for the full cost of benefits and a bit more than half of total costs for administration, with no effective limit.[3]

Administration

Virtually all rules governing program operations are established by the Federal Government, and program operations and participation by food concerns accepting food stamp coupons are subject to extensive oversight by the U.S. Department of Agriculture's Food and Nutrition Service. Day-to-day administration (determination of eligibility and issuance of benefits) is the responsibility of State welfare agencies, following Federal rules.

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[2]The regular food stamp program also operates in the District of Columbia, Guam, and the Virgin Islands, although more liberal benefit rules apply in Guam and the Virgin Islands.

Under the terms of the 1976 Covenant with the Commonwealth of the Northern Mariana Islands and implementing legislation, a variant of the food stamp program was negotiated with the Commonwealth and began operations in 1982. The Northern Marianas' program differs from the regular food stamp program primarily in that: (1) it is funded entirely by Federal money (benefits and administration), up to a maximum annual grant of $3.7 million; (2) a portion of each household's food stamp allotment (25 percent) must be used to purchase locally produced food (coupons for local food items are differentiated by color); (3) maximum monthly benefits are about 20 percent higher than those in the regular food stamp program; and (4) income eligibility limits are about half those in the regular program.

[3]Although specific annual appropriation levels are authorized by the Food Stamp Act, they have never operated to actually limit necessary appropriations.

Funding

Federal funding covers: (1) Federal administrative expenses for personnel, printing food stamp coupons, and oversight of welfare agency and food store operations, (2) the full cost of benefits, (3) half of day-to-day administrative expenses incurred by State agencies, (4) 75 percent of State agencies' costs for developing expanded computer capability, (5) 75 percent of costs incurred by States for fraud investigation and prosecution,[4] and (6) the full cost of implementing the systematic alien verification for entitlements (SAVE) program (procedures for using the Immigration and Naturalization Service to verify the immigration status of alien welfare applicants). In addition, the Federal Government pays the major portion of the cost of carrying out employment and training programs for food stamp recipients: each State receives a formula share of $75 million a year for basic operating costs, plus half of any operating expenses above those covered by the basic grant and half the cost of support services to participants (e.g., transportation and child care).

States are responsible for their share of food stamp administrative expenses (50 or 25 percent, depending on the type of expense) and, under the food stamp "quality control" system, are liable for fiscal sanctions if they have very high rates of erroneous eligibility and benefit determinations.

In FY 1989, Federal food stamp spending for the States is expected to total $12.9 billion. State costs are anticipated to be about $1.1 billion.

Eligibility for Assistance

In the food stamp program, households are determined eligible for aid under generally uniform provisions established in the Food Stamp Act.

- *Income.* Most eligible households must have basic (gross) monthly income at or below 130 percent of the Federal poverty levels.[5] At present, the gross income limit for a four-person household is $1,263 a month. Almost all cash income received by a household is included when judging gross income eligibility.

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[4]States also may retain a portion of improperly issued benefits they recover (other than those caused by welfare agency error).

[5]The "poverty levels" used for food stamp eligibility determinations in Alaska and Hawaii are higher than those used for other jurisdictions, by 25 and 15 percent, respectively. Although the requirement for gross income at or below 130 percent of Federal poverty levels is the basic income test, households with elderly or disabled members are subject to a more liberal test based on their counted (net) income (after reduction for various household expenses).

- *Assets.* Liquid assets of eligible households are limited to $2,000, or $3,000 for households with elderly members. Counted liquid assets do not include the value of the household's residence, business assets, a portion of the fair market value of any vehicle, and a number of other items.

- *Employment and training requirements.* Nonworking able-bodied adults not caring for young children or enrolled in another program's work initiative must participate in State-designed employment and training programs in order to maintain their food stamp eligibility.

- *Categorical rules.* Two classes of households are automatically eligible for food stamp assistance: those composed entirely of AFDC or SSI recipients. In certain other cases, households or individuals are automatically ineligible: households with members on strike, households where the head of household has voluntarily quit a job, postsecondary students (unless they are working or caring for a young child), illegal or temporarily resident aliens, persons living in institutional settings (except for specifically approved group living arrangements such as drug addiction programs and shelters for the homeless or battered women and children), and boarders (unless they apply together with the household providing board).

Between 18 and 19 million persons a month now participate in the food stamp program in the States, about 8 percent of the U.S. population.

Benefits

Eligible households receive monthly food stamp coupon allotments. These coupons are normally used to purchase food in participating stores and redeemed for dollars through banks and the Federal Reserve System, although they may be used to obtain prepared meals in some cases (e.g., in elderly nutrition projects, in shelters for the homeless) and nonfood items in other instances (e.g., hunting and fishing equipment in remote areas of Alaska). Allotments depend on a household's size, its counted (net) monthly income, and the program's maximum monthly benefit levels.

Food stamp maximum benefits are equal to an amount slightly higher than the cost of the U.S. Department of Agriculture's lowest estimate of the cost of an adequate diet, the "Thrifty Food Plan," adjusted for household size and indexed annually for food price inflation. They are standard for the 48 contiguous States, but significantly higher in Alaska and Hawaii (reflecting special surveys indicating substantially higher food prices). At present, the maximum monthly allotment for a four-person household is $300 in the 48 contiguous States, $382-$592 in Alaska (varying among urban and remote rural areas), and $457 in Hawaii.

Recipients' actual monthly benefits are calculated by subtracting 30 percent of their *counted (net)* monthly income from the maximum benefit for

their household size. Food stamps then make up the difference between their expected contribution to food expenses (30 percent of counted income) and the amount judged sufficient to buy an adequate low-cost diet (the maximum benefit). Monthly food stamp benefits in the States now average $52 per person.

An important part of determining a household's benefits is the calculation of its counted income. When determining counted monthly income, basic (gross) income is *reduced* by applying a series of "deductions," including a "standard" deduction, specific deductions for certain living expenses (e.g., excessively high shelter costs), and a deduction for taxes and work expenses (20 percent of any earnings). These deductions average a bit over $200 a month, making the average household's counted income for food stamp benefit purposes about half its gross income.

Program Options

While the Food Stamp Act varies some eligibility and benefit rules for Alaska and Hawaii (higher income eligibility limits, maximum benefits, and allowable deductions), it allows States to make very few departures from Federal rules. States are permitted to operate "outreach" programs, vary specifically listed administrative rules (e.g., how changes in household circumstances are to be reported), and disregard a portion of child support payments in counting income (at their own cost). They also make most decisions as to the design of employment and training programs. Other variations can be achieved only as demonstration projects.

THE CURRENT PROGRAM IN PUERTO RICO

Nutrition Assistance in Puerto Rico[6]

Overview

The Food Stamp Act provides money for nutrition assistance in Puerto Rico under rules very different from those applied to the States. From early 1975 through June 1982, the regular food stamp program operated in the Commonwealth, albeit with some variations from standard rules.[7] Puerto

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[6]With the exception of the food stamp program, all federally supported nutrition assistance (e.g., the school lunch program, the special supplemental food program for women, infants, and children) are available to Puerto Rico as with any State.

[7]Although 1971 legislation allowed the Commonwealth to operate the food stamp program in virtually the same manner as any State, Puerto Rico (along with other areas of the country) chose instead to distribute surplus Federal agricultural commodities to the needy until that option was removed.

Rico's food stamp program offered lower maximum benefits (about 5 percent less than in the 48 contiguous States, based on a special survey of food costs) and more limited income deductions (about half those in the regular program); however, income eligibility was based on the same Federal poverty levels used in the 48 States. At its peak, it assisted over 1.8 million persons each month, nearly 60 percent of the Commonwealth's population at the time, at an annual Federal cost of some $900 million. However, 1981 amendments to the Food Stamp Act directed that traditional food stamp assistance in the Commonwealth be ended and replaced with an annual "block grant" of Federal funds provided under the authority of the Food Stamp Act, effective July 1982. Today, the Food Stamp Act block grant to Puerto Rico represents about one-fifth of all Federal transfers to individuals in the Commonwealth and between 5 and 6 percent of personal income.[8]

Section 19 of the Food Stamp Act requires that the Federal Government pay Puerto Rico an annual grant, out of appropriations under the Act, to support the costs of nutrition assistance in the Commonwealth. Puerto Rico is given rein to design its own initiatives for nutrition assistance to needy persons, without reference to the Federal rules of the food stamp program. It has chosen to use this flexibility to establish a Nutrition Assistance Program (NAP) that differs significantly from the food stamp program. There are virtually no "strings" attached to the grant, other than a requirement that Puerto Rico share in the cost of administration, and the Commonwealth uses funds provided under the block grant both for its NAP and other activities (a cattle tick eradication project and wage subsidies to employers hiring NAP recipients).

Authorization of Federal funding for Puerto Rico under the Food Stamp Act expires September 30, 1990. Continuation of aid and the terms of that aid will be before Congress next year.

Administration

All rules governing operations using block grant funds are established by the Commonwealth. Although it must submit annual plans to the U.S. Department of Agriculture for approval, there are, for all practical purposes, no specific provisions of law that the Department can use to disapprove a plan. The Federal role is limited to approval of the Commonwealth's plan and the provision of funds.

Funding

Federal funds cover costs for carrying out any program(s) of nutrition assistance designed by the Commonwealth. However, to qualify for Federal

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[8]Commonwealth of Puerto Rico. Junta De Planificacion De Puerto Rico. *Informe Economico Al Gobernador 1987* and *Informe Preliminar De La Economia De Puerto Rico 1988.*

money Puerto Rico must pay half of any administrative expenses it incurs, and total Federal support is limited to amounts specified in the Food Stamp Act (the annual block grants).

When originally enacted, the annual block grant was set at $825 million, with no provision for adjustment; this was a substantial reduction from the previous level of Federal support under the food stamp program and prevailed through FY 1986. In 1985 legislation, the annual grant amount was increased to: $852.75 million for FY 1987, $879.75 million for 1988, $908.25 million for 1989, and $936.75 million for 1990.[9]

Puerto Rico receives no special Federal cost-sharing for development of computer capability, fraud investigation and prosecution, employment and training activities, or carrying out a SAVE program. The Commonwealth is not liable for fiscal sanctions under the food stamp quality control system.

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[9]With the exception of FY 1986 (when the grant was subject to a $5 million reduction under the terms of the "Gramm-Rudman-Hollings" law) and FY 1988 (when $.5 million less than the earmarked amount was made available), the full amount established in the Act has been appropriated.

TABLE 4. Food Stamp Act Expenditures in Puerto Rico: Current Dollars
(in millions)

Fiscal year	Benefits[b]	Administration[a] Federal	Administration[a] Commonwealth	Administration[a] Total
1979	$748	$26	$26	$800
1980	825	25	25	875
1981	879	27	27	933
1982[c]	870	27	27	924
1983	801	23	23	847
1984	803	22	22	847
1985	804	21	21	846
1986[d]	795	25	25	845
1987	827	26	26	879
1988 (estimated)[d]	853	26	26	905

[a]Adminstrative costs shared equally between the Federal Government and the Commonwealth, both under the terms of the regular food stamp program (through June 1982) and under the Commonwealth's limited nutrition assistance block grant (from July 1982 onward).

[b]Benefits federally funded under the terms of the regular food stamp program (through June 1982), and under the limited nutrition assistance block grant (from July 1982 onward). Benefit figures include spending (e.g., $8.6 million in FY 1988) on special agriculture projects allowed under the terms of the block grant.

[c]In July 1982, the regular food stamp program was replaced with the Commonwealth's nutrition assistance program, funded by a Federal block grant and the Commonwealth's share of administrative costs.

[d]In FY 1986, the normal $825 million nutrition assistance block grant was subject to a $5 million reduction in available funding under the terms of the "Gramm-Rudman-Hollings" law. In FY 1988, $0.5 million less than the earmarked block grant amount was actually appropriated.

Note: The Food Stamp Act earmarks specific amounts for Puerto Rico: $206.5 million in FY 1982, $825 million a year in FY 1983-1986, $852.75 million in FY 1987, $879.75 million in FY 1988, $908.25 million in FY 1989, and $936.75 million in FY 1990.

Source: Budget documents prepared by the U.S. Department of Agriculture, Food and Nutrition Service.

TABLE 5. Food Stamp Act Expenditures in Puerto Rico: Constant Dollars[a]
(in millions)

Fiscal year	Benefits	Administration		
		Federal	Common-wealth	Total
1979	$1,029	$36	$36	$1,101
1980	1,030	31	31	1,092
1981	998	31	31	1,060
1982	958	29	29	1,016
1983	879	25	25	929
1984	856	23	23	902
1985	854	22	22	898
1986	837	26	26	889
1987	854	27	27	908
1988 (estimated)	853	26	26	905

[a]Benefit spending has been adjusted for inflation, to constant FY 1988 dollars, by using the "food at home" component of the Consumer Price Index for All Families in Puerto Rico, as compiled by the Commonwealth's Department of Labor and Human Resources in its monthly *Informe Estadistico*. Administrative spending has been adjusted for inflation, to constant FY 1988 dollars, by using the overall Consumer Price Index for All Families in Puerto Rico. For adjustments prior to January 1980, the Consumer Price Index for All Wage Earners in Puerto Rico was used.

Note: See notes for table 4.

Eligibility for Assistance

Under Puerto Rico's NAP, eligibility rules are *simpler and significantly more restrictive* than in the food stamp program. Income eligibility is based solely on basic (gross) monthly income, and limits are set at levels approximately half those now applied under the food stamp program in the 48 contiguous States (e.g., $667 vs. $1,263 a month for a four-person household). The liquid assets eligibility standard also is set well below the food stamp standard: $1,000 for all households. Income and asset eligibility standards have not changed since the advent of the NAP, while food stamp income limits are indexed for inflation and asset standards have been raised by legislation. Categorical eligibility rules are generally not used.

Approximately 1.4 million persons a month receive benefits under the NAP, representing some 43 percent of the Commonwealth's population.

Benefits

Benefits in the NAP are issued monthly and calculated in much the same manner as in the food stamp program. However, they are issued in *cash* (checks), are slightly lower than average food stamp allotments, and can vary significantly from month to month even when household circumstances do not change.

To keep NAP costs within the annual block grant amount without adjusting eligibility criteria, Puerto Rico has chosen to vary maximum benefit levels monthly if necessary, and, as a result, the benefits participating households receive can differ from month to month. For example, in FY 1988, maximum monthly benefits for a four-person household varied from a high of $277 to a low of $233.[10] The expenditure of all block grant funds each year is ensured through the issuance of a 13th "bonus" benefit check in September.

Although maximum benefit levels are changeable and noticeably below those in the food stamp program, benefit determinations are similar in other respects. Households' benefits are calculated by subtracting 30 percent of counted monthly income from the applicable maximum benefit level. And, the counted income used to establish benefits is substantially less than each household's gross income: i.e., it is reduced by applying a series of deductions comparable to, although somewhat smaller than, those used in the food stamp program.

Because of substantially lower incomes in the Commonwealth (recipients are more likely to receive something close to the maximum benefit), NAP monthly average benefits are only slightly below the U.S. average food stamp benefit: in FY 1988, $49 vs. $50 per person. In effect, the Commonwealth has chosen to live within the amounts provided by the block grant primarily by freezing eligibility standards thereby reducing participation, rather than substantially reducing benefits. In 1988, the NAP provided $844 million in benefits; this represented an amount equal to approximately 20 percent of all personal consumption food expenditures in the Commonwealth.[11]

Program Options

Under the law governing Puerto Rico's block grant, virtually unlimited program design options are available. At present, the Commonwealth is exercising this flexibility primarily by providing NAP benefits in cash, and

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[10]Maximum monthly food stamp benefits in the 48 contiguous States were $290 in FY 1988.

[11]See footnote 8.

using approximately $10 million a year to fund a cattle tick eradication project. It has also recently begun a pilot project using $15 million of its block grant funds to provide wage subsidies to certain employers hiring NAP recipients.

IMPLICATIONS OF STATEHOOD

Overview

Section 213 of the substitute S. 712 requires that, on admission, the food stamp program apply to Puerto Rico as with any State. It also *allows* the Secretary of Agriculture, with the consent and agreement of the Governor of Puerto Rico, to "continue to obligate the amount of funds for which Puerto Rico becomes eligible under the food stamp program as a block grant rather than as coupons as a pilot program until October 1, 1997 unless otherwise provided by Congress."

With its admission, Puerto Rico would become a State under the food stamp program (see below for a specific discussion of the likely implications). Or, *presumably*, it could continue to receive a block grant of Federal funds, through September 1997, based on the likely cost of a food stamp program in the Puerto Rico.[12] Continuation of the block grant form of aid would hinge on agreement by both the Secretary of Agriculture and the Governor of Puerto Rico. As such, it is not clear what the *terms* of the grant would be (i.e., whether Puerto Rico would continue to have the program design flexibility it now has and to what extent it might be required to share costs). The *size* of such a demonstration project grant would appear to depend on annual *estimates* of the Federal cost-share of running a full-fledged food stamp program in the Commonwealth. But, given the substantial differences between Puerto Rico's NAP and the food stamp program, this estimating procedure would be very difficult and, at least initially, costly.

Puerto Rico's inclusion as a State under the Food Stamp Act is not simply a matter of added Federal costs. While it would bring on a large increase in Federal moneys to the Commonwealth, it also would require that Puerto Rico operate its nutrition assistance program under the full panoply of Federal food stamp rules, thereby removing the important program design options it now enjoys. Moreover, because benefits would be issued in food stamp coupons, a sizable portion of Puerto Ricans' personal income would be *required* to be spent on food purchases, with uncertain effects on the Commonwealth's economy.

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[12]The language of section 213 is a bit unclear in this respect since Puerto Rico (or any State) does not become "eligible" for any funds under the food stamp program, other than an entitlement to administrative cost-sharing amounts. *Recipients* become eligible.

Administration

With extension of the food stamp program to Puerto Rico, substantial administrative changes would be in store both for the Commonwealth and the Federal Government. Puerto Rico would be subject to a wide range of Federal administrative rules and some new administrative costs. Puerto Rico's NAP generally operates under procedures for determining eligibility and issuing benefits that are simpler, and less costly, than would be the case under the food stamp program. At the least, new rules for processing applications, verifying eligibility factors, issuing benefits as coupon allotments rather than checks, operating employment and training programs, and quality control surveys would add significantly to administrative costs.[13] Puerto Rico's administration of the program might also come under much closer scrutiny than other States because of a provision in the Food Stamp Act requiring special audits by the U.S. Department of Agriculture's Inspector General whenever a State's food stamp caseload exceeds 60 percent of its population; this provision was almost triggered under Puerto Rico's pre-1982 food stamp program.

From the Federal perspective, statehood would bring on new administrative involvement related to printing and redeeming coupons and oversight of food stores and welfare agency operations.

Funding

Treating Puerto Rico as a State in the food stamp program would remove the current block grant limit on Federal financial support for nutrition assistance, and Federal funding would increase to cover whatever benefits were issued, a little over half of the Commonwealth's administrative costs, and new Federal expenses. Using experience under the pre-1982 food stamp program in Puerto Rico as a guide, annual Federal spending could increase by $300 million, or more, because of increased participation, higher benefits, and larger administrative costs. On the other hand, Puerto Rico would become liable to the Federal Government for quality control sanctions if its rate of erroneous eligibility and benefit determinations exceeded food stamp program "tolerance" levels.

Eligibility for Assistance

Possibly the most important change would be a substantial increase in the number of people eligible for, and presumably choosing to participate in, the new food stamp program. It is not unlikely that participation would grow by almost one-third to pre-1982 levels, adding some 400,000 persons to the caseload. Financial eligibility limits would be double those under the NAP,

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[13]The U.S. Department of Agriculture's evaluation of the conversion to the NAP found an 18 percent reduction in administrative expenses. A portion of this reduction was due to a reduced caseload.

rising to 130 percent of the standard Federal poverty levels and approaching average family income in the Commonwealth. In the alternative, a separate set of food stamp income eligibility limits *could* be established for Puerto Rico, on the theory that the income poverty levels (on which food stamp eligibility standards are based) should reflect any *substantial* differences in living costs, as is now done for Alaska and Hawaii. These limits would probably be lower than those applied in the 48 contiguous States, but developing a separate set of poverty levels for Puerto Rico would not be a simple task and would raise a host of serious issues as to equity and whether the standard poverty levels used in the 48 States should be recalibrated and varied within the 48 States.

Imposition of those food stamp eligibility rules that are more restrictive than under the NAP (e.g., some categorical rules) probably would have little effect, and the availability of new cash welfare assistance (e.g., the SSI program) if Puerto Rico becomes a State would only increase food stamp participation because of rules making most cash welfare recipients automatically eligible for food stamps.

Benefits

All benefits under Puerto Rico's food stamp program would have to be issued in coupons rather than cash. However, it is not clear what benefit *levels* would be, although they would be noticeably higher than under the NAP.

Under the most probable scenario, the standard maximum benefit and income deduction levels established for the 48 contiguous States would become those used in Puerto Rico. Maximum benefits in the NAP are, on average, roughly 15 percent lower than in the 48 States; income deduction levels are similarly smaller.

In a second scenario, special lower benefit and deduction levels, closer to those under the NAP, *could* be set for Puerto Rico, just as higher benefit and deduction levels are set for Alaska and Hawaii and as was the case when the food stamp program operated in Puerto Rico prior to the NAP. Pre-1982 maximum food stamp benefits in the Commonwealth were about 5 percent smaller than in the 48 States and deduction levels were about half.

In either case, average benefits would rise sharply, surpassing benefit levels in the rest of the country.

Other Considerations

Under the Food Stamp Act, States are not allowed to collect sales taxes on food stamp purchases if they wish to operate the food stamp program. To the extent Puerto Rico collects sales taxes on purchases now made with cash provided under the NAP, it would lose revenues.

Food stamps in Puerto Rico would both affect and be affected by other welfare program consequences of statehood. To some degree the new infusion of food stamp assistance might encourage Puerto Rico to hold down, or not embark on, expansion of its AFDC program, despite new Federal cost-sharing offered it as a State. Extension of the SSI program to Puerto Rico would limit additional food stamp costs because this new income to likely food stamp recipients would reduce their food stamp benefits.

Conversion to the NAP cash grants brought on an estimated 1-8 percent reduction in aggregate food expenditures.[14] And it would appear that conversion back to food stamp coupons usable only for food would increase food spending noticeably, might tie up an unacceptably high proportion of the Commonwealth's income in food purchases, and could have distorting effects on Puerto Rico's economy.

IMPLICATIONS OF INDEPENDENCE

Puerto Rico as an independent nation would not be eligible for Federal funds under the nutrition assistance block grant or the food stamp program. Presumably, Federal funds used for the block grant would be included in the consolidated aid package that would be paid to Puerto Rico for several years after the proclamation of independence.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

Section 407 of the substitute S. 712 provides that certain Federal grant-in-aid programs may be consolidated with others. The Food Stamp Act block grant to Puerto Rico would be not be covered by this provision. It is among those excluded because they are used to make "direct payments to classes of individuals." Instead, the Food Stamp Act's treatment of Puerto Rico would be left to future decisions by Congress, whether they be to continue the block grant approach or bring Puerto Rico back into the food stamp program.

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[14]The evaluation from which this estimate is drawn indicates that the "true" effect is probably closer to the lower end of this range.

SOCIAL SECURITY

THE CURRENT PROGRAM IN THE STATES

Program Description

Social security--the old-age, survivors, and disability insurance (OASDI) program--provides monthly benefits to retired and disabled workers and to their dependents and survivors. A worker gains eligibility for OASDI benefits through employment that is covered by the social security system. Employees of State and local governments are covered on a voluntary group basis.

Social security taxes are levied on covered employment and the revenues are credited to special trust funds. These trust funds are debited for payment of monthly benefits and administrative expenses of the program. Benefits are paid as a "earned right"--free from any test of need--and are loosely based of the level of career earnings covered by social security.

Cost and Recipients

Benefit payments in 1989 are expected to total $231 billion. There are approximately 38 million current social security beneficiaries.

THE CURRENT PROGRAM IN PUERTO RICO

Program Description

Basically, social security coverage and eligibility rules apply to Puerto Rico as they do to the United States generally. The Social Security Act generally defines a "State" and the "United States" to include Puerto Rico, as well as the Virgin Islands, Guam, the District of Columbia, and American Samoa. Employees of the Government of the Commonwealth of Puerto Rico, who are treated the same as "State" employees, participate in social security.

An exception to the general applicability of benefits is what are called "special age-72 benefits," sometimes called "Prouty" benefits. These are special benefits, paid out of general revenues, for individuals (men who attained age 72 before 1972 and women who attained age 72 before 1970) who have worked in covered employment for less than the amount of time otherwise required. The law restricts these benefits to residents "of the 50 States," the Northern Mariana Islands, and the District of Columbia.

Cost and Participants

In 1987, the last year for which there are data, Puerto Rico had 553,000 social security beneficiaries. Their average monthly benefit was $303.80, compared to a national average of $488.10. In the aggregate, residents of Puerto Rico received $1.775 billion in social security benefit payments. The last year for which we have data on workers is 1985. In that year, 1,135,000 workers and their employers paid $1.1 billion in social security taxes (in the same year Puerto Rican residents received $1.64 billion in benefits).

IMPLICATIONS OF STATEHOOD

Basically, statehood would bring no change from current law. However, special age-72 benefits might be extended to the few individuals who would be eligible if "the 50 States" were interpreted to include *all* States.

IMPLICATIONS OF INDEPENDENCE

Clearly, establishing a new social security system and designing a transition from the current arrangement would be a major and fundamental undertaking. We know of no precedent that would pertain to this proposal. The nature of social security, as an "earned right" program that bases both the eligibility for benefits and their level on career earnings, would complicate the switch-over to a replacement system.

The substitute S. 712 requires the Joint Transition Commission to establish a Task Force on Social Security to negotiate agreements necessary for the coordination of the U.S. social security system with a similar system to be established in Puerto Rico. In the meantime, the bill stipulates that provisions of the U.S. social security program would continue to apply for 5 years after the referendum is certified. Similarly, "rights" of workers who are fully insured under the U.S. social security program as of 5 years after this certification are to be "protected."

The meaning of these provisions is unclear. For example, the nature of the "rights" to be retained by fully insured workers is uncertain. Are these rights to receive the same type and level of benefits as had already been earned under the U.S. social security program, or to receive what they would have if they had remained in the U.S. program? Conceivably they could be simply the earnings credits earned under the U.S. system, transferred to the new Puerto Rican system. More important, it is unclear which system will pay these benefits. The task force apparently will have the discretion and bear the onus to resolve these and many other issues.

The wording that the Puerto Rican system should be "similar" to that of the U.S. may be a constraint, however. If it were construed that the new system must be virtually identical to the U.S. social security system, transition

problems might be minimized, but there is a serious question whether an identical design would be suitable for Puerto Rico. For example, copying the current U.S. system's financing arrangements and benefit levels would probably be impractical. As shown above, Puerto Rico now receives approximately 50 percent more in benefits than it pays in social security taxes. This "subsidy" from the rest of the country presumably is caused by the redistributive features of social security, primarily its progressive benefit formula that replaces a higher proportion of earnings for low-income workers. Eventually, the new Puerto Rican system probably would have to provide lower benefits or have a higher rate of taxation than under the current arrangement.

Financing implications make the method of transition from one system to another very sensitive. One scenario could be to continue payments from the U.S. social security program to all *beneficiaries* residing in Puerto Rico who were enrolled before independence. For workers, their credit for social security-covered employment might be transferred to a new Puerto Rican social security system, but from which system their payment of benefits would come is problematic. The Puerto Rican system could pay entirely for their benefits, or for only the proportion of the earnings career covered by it. Under either scenario, Puerto Rico would receive the advantage that social insurance systems usually have at their beginning--many workers contributing to support few beneficiaries, resulting in either low tax rates or surpluses in the initial years. This advantage would occur at the expense of the U.S. social security system, as it would lose all the tax revenue from Puerto Rico while continuing to pay benefits. Over time, however, this advantage would fade away as more and more benefit payments would made by the Puerto Rican system. Eventually, when nearly all benefits would be paid out of the Puerto Rican program, the level of benefits would either have to be curtailed or taxes raised (assuming a pay-as-you-go system and rough balance between income and outgo).

An alternative approach could be similar to the way "totalization" agreements work with other countries. Under this scenario, benefits would be paid by the social security system under which most of an individual's work occurred.

Although Puerto Rico may receive a windfall from such approaches, eventually it would have to confront the structural imbalance its social security system would have if its financing arrangements and benefits levels were similar to the current U.S. program. As mentioned above, whatever the design of the new Puerto Rican system, eventually it probably would have to provide lower benefits or cost more than under the current arrangement.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

Enhanced commonwealth status for Puerto Rico would bring no apparent change from current law.

MEDICAID

THE CURRENT PROGRAM IN THE STATES

Medicaid, authorized by Title XIX of the Social Security Act, is a Federal-State matching program providing medical assistance to low-income persons. Each State designs and administers its own medicaid program, setting eligibility and coverage standards within broad Federal guidelines. Thus, there is considerable variation among the States in terms of eligibility requirements, range of services offered, limitations placed on those services, and reimbursement policies.

Program Description

Financing

The Federal share of expenditures for medicaid services in the States is tied to a formula inversely related to the square of a State's per capita income. For FY 1989, the Federal matching percentages range from 50 percent to 79.8 percent; no State may receive more than 83 percent. The matching rate for administrative costs is generally 50 percent for all States, with higher matching available for certain management and control activities. The remaining costs of the program are paid by the State; in some States local governments also contribute.

Eligibility

All States must cover the *categorically needy*. These include all persons receiving AFDC and, in most States, persons receiving SSI. Thirty-nine States and other jurisdictions also provide medicaid to the *medically needy*. These are persons whose income or resources exceed the standards for the cash assistance programs but who meet a separate medically needy financial standard established by the State and also meet the nonfinancial standards for categorical eligibility (such as age, disability, or being a member of a family with dependent children). Finally, Congress has recently extended medicaid coverage to certain *target populations*, using eligibility standards that are not directly linked to those used in the cash assistance programs. The Medicare Catastrophic Coverage Act of 1988 (P.L. 100-360) requires States to phase in coverage of pregnant women, infants under 1 year old, and aged and disabled persons eligible for medicare with family incomes below 100 percent of the Federal poverty income guidelines. (Required coverage for the aged and disabled is restricted to medicare premiums and cost-sharing amounts and prescription drugs up to the new medicare drug deductible.)

Services

All States must cover a minimum set of services under medicaid and may offer additional services. For the categorically needy, the State must provide inpatient and outpatient hospital services, physician services, laboratory and X-ray, family planning, skilled nursing facility (SNF) services for those over age 21, and home health care for persons entitled to SNF care. The State must also provide early and periodic screening, diagnosis, and treatment (EPSDT), a preventive health program for persons under 21. Optional services include care in intermediate care facilities (ICFs), as well as such ancillary services as prescription drugs, dental care, and eyeglasses. Beneficiaries generally must be allowed to obtain services from any qualified provider.

Administration

Although each State administers its own medicaid program, there are some basic administrative standards with which States must comply. States are required to maintain a medicaid quality control (QC) system, which reviews the accuracy of eligibility determinations. Federal funding may be reduced if the State makes excessive errors in determining medicaid eligibility. Most States are also required to operate a medicaid management information system (MMIS), a standard claims processing and reporting system.

Cost and Participation

Medicaid will serve a projected 25 million low-income persons in FY 1989. Estimated total expenditures for medicaid during FY 1989 are $61 billion, of which the Federal share is $34 billion.

THE CURRENT PROGRAM IN PUERTO RICO

Program Description

The medicaid program in Puerto Rico operates under special Federal funding rules and is exempt from certain requirements relating to eligibility, service coverage, and program administration.

Financing

The Federal share in medicaid expenditures in Puerto Rico and other territories is fixed at 50 percent. Total Federal funding is subject to a cap: $76.2 million in FY 1989, and $79 million in FY 1990 and later years. As a result of the cap, Federal funds made up only 40 percent of program costs in FY 1986.

Eligibility

Puerto Rico is exempt from the new requirement that States phase in coverage of pregnant women and infants. On the other hand, Puerto Rico has been permitted to establish medically needy income standards above the maximum ordinarily allowed. A State's medically needy standard may not exceed 133-1/3 percent of the State's maximum AFDC payment amount for a family of the same size. In Puerto Rico, with a maximum AFDC payment of $90 per month, this would mean a medically needy income standard of $1,440 per year for a family of three. Instead, Puerto Rico's standard for a family of three in 1986 was $5,700. (There does not appear to be any statutory authority for this exception.) The medically needy accounted for 48 percent of Puerto Rico's medicaid beneficiaries in FY 1987, as opposed to 14 percent in the rest of the Nation.

Puerto Rico is also exempt from the requirement that it phase in coverage of medicare premiums and cost-sharing amounts for aged and disabled persons with incomes up to 100 percent of poverty. Puerto Rico could, at its option, pay premiums and cost-sharing for medicare beneficiaries who meet its current medicaid income and resource standards. However, it has opted not to do so. Possibly as a result, 35 percent of medicare Part A enrollees did not have Part B coverage in 1987.

Services

Puerto Rico is exempt from the requirement that beneficiaries be allowed to obtain services from any qualified provider. All services are provided through public hospitals and clinics. Medicaid in Puerto Rico thus does not operate as a conventional insurance program, paying claims for specific services furnished to particular eligible individuals. Payment amounts to the participating public facilities are based on the facilities' budgets, with the medicaid share determined by comparing a sample of provider treatment records to medicaid eligibility listings.

Puerto Rico does not claim Federal financial participation for SNF, family planning, or home health services. These are mandatory services and are nominally included in Puerto Rico's State plan for medical assistance. Health Care Financing Administration (HCFA) officials are not certain they are actually being furnished.

Administration

Puerto Rico is exempt by statute from several rules relating to program administration. It is not subject to financial penalties under the medicaid QC system, nor is it required to operate an MMIS. As a result of these waivers, Puerto Rico is not subject to two of the basic control mechanisms used by the Federal Government in overseeing State medicaid programs. The absence of QC penalties has meant that there is no Federal review of the accuracy of eligibility determinations. (Puerto Rico does operate its own

internal QC system, which has found eligibility errors in 20 to 30 percent of the cases reviewed.) The absence of an MMIS has meant that reliable information about program operations is unavailable.

Cost and Participation

In FY 1987, 1.7 million persons in Puerto Rico, or about half the population, were estimated to have received medicaid benefits. Total expenditures were an estimated $160 million, of which $63.4 million was covered by Federal payments. These figures may include expenditures for persons who do not qualify for medicaid under Federal rules.

IMPLICATIONS OF STATEHOOD

Medicaid in Puerto Rico would change dramatically in the event of statehood. Federal funding could more than double. At the same time, Puerto Rico would become subject to the minimum requirements, restrictions, and program control mechanisms applicable to the States. The current system, under which medicaid amounts to a transfer of funds to public facilities, would be replaced by a system in which public and private providers would file claims for specific services to specific beneficiaries.

The following program changes would occur if Puerto Rico were treated like other States for medicaid purposes.

Financing

The cap on medicaid matching funds for Puerto Rico would be removed, and the Federal funding percentage would be computed under the current formula, which increases funding for States with lower per capita incomes. Puerto Rico's percentage would almost certainly be the maximum 83 percent permitted by law, as its median income is half that of the poorest State.[15] As a result of open-ended funding at a much higher matching rate, Federal funding would more than double from its FY 1987 level of 39.6 percent.

Eligibility

Puerto Rico would be subject to the new requirement that States phase in coverage of pregnant women and infants with incomes up to 100 percent of poverty. In addition, if its SSI payment levels were raised to the national standard, it would be required to furnish medicaid to any newly eligible SSI

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[15]If there were no 83 percent maximum, a State whose per capita income was half the national average would receive 88.75 percent matching. A State whose per capita income was one-third the national average (the situation of Puerto Rico) would receive 95 percent matching.

beneficiaries (many of these persons may already be covered as medically needy). On the other hand, Puerto Rico could no longer use a medically needy income standard in excess of 133-1/3 percent of maximum AFDC payments. Unless its AFDC standards were increased significantly, many families with children could lose coverage. (The potential trade-offs here might change if Congress were to enact current proposals permitting or mandating coverage of children with higher family income levels.)

For all aged and disabled persons below poverty currently eligible for medicare, Puerto Rico would be required to pay the medicare Part B premium, deductibles, and coinsurance, as well as provide prescription drugs up to the catastrophic deductible limit. Puerto Rico also would be required to pay the Part A premium for any persons who are over age 65, have incomes below the poverty level, and are not automatically eligible for Part A because they are not insured under the social security system.

Services

Puerto Rico would be subject to the requirement that beneficiaries be allowed to obtain services from any qualified provider. Unlike the other associated territories, Puerto Rico has a substantial private medical care sector. For example, 30 percent of community hospital beds in 1987 were in private nonprofit facilities; another 34 percent were in proprietary hospitals. This is a higher proportion of privately owned beds than prevails in some States, such as Louisiana, Mississippi, or Oklahoma. Statehood could, then, mean a substantial shift in funds towards the private sector. One consequence might be that the public facilities would be less able to subsidize care for those low-income populations that would continue to be excluded from the medicaid program.

Medicaid law does permit waivers of the "freedom-of-choice" requirement to allow States to establish selective contracting systems. California and Illinois currently have such waivers, under which nonemergency hospital services are available only through specified contract providers. However, these providers are selected on the basis of price competition. It is not clear that current law would permit a system in which only public providers could participate.

Puerto Rico also would be required to make available the mandatory services that, while nominally covered under its current State plan, may not actually be available. These include SNF services, home health care, and family planning.

Administration

Puerto Rico would be subject to penalties under the medicaid QC system and would be required to operate an MMIS. These changes could result in a more rigorous eligibility application process and would also require the State

to screen claims from providers, to insure that payment was made only for covered services to eligible individuals.

Implications for Scope and Cost of Program

In summary, statehood would bring an influx of new dollars to Puerto Rico's medicaid program. This benefit would be offset by requirements that Puerto Rico furnish more extensive coverage to some classes of individuals while cutting off coverage to some others. Medicaid funds might be shifted from public to private providers. Finally, stricter bureaucratic requirements could create barriers to access for many eligible persons.

IMPLICATIONS OF INDEPENDENCE

Puerto Rico as an independent nation would not be eligible for Federal funds under the medicaid program. Presumably, Federal medicaid funds would be included in the consolidated aid package that would be provided to Puerto Rico for several years after the proclamation of independence.

Puerto Ricans who were U.S. citizens at the time of independence would retain U.S. citizenship in addition to Puerto Rican citizenship and have all the rights of U.S. citizens. This raises the question of whether Puerto Ricans might enter the United States in order to obtain medicaid coverage for health care services.

A dual citizen residing in the United States could qualify for medicaid if he or she met all the requirements for medicaid in the State in which he or she resided. A State may not require that applicants reside in the State for any minimum period before receiving medicaid. A person who enters the State with the intention of making it his or her permanent residence may receive medicaid benefits from that State at once. On the other hand, a person who enters the State expressly to obtain medical care is not eligible in that State. Thus, a resident of Puerto Rico who moved permanently to New York, or who declared the intention of remaining permanently, could qualify for New York medicaid. A person who went directly from Puerto Rico to a New York nursing home or hospital would not be eligible.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

Under enhanced commonwealth status, Puerto Rico would be eligible for the grant consolidation option provided by section 501 of P.L. 95-134, which permits any department or agency to use simplified application and reporting procedures and waive matching funds requirements for assistance to "Insular Areas." Medicaid would be eligible for this treatment. It is a grant-in-aid program and does not make direct payments to classes of individuals. (A program which makes direct payments to individuals is not eligible for the simplified treatment.)

Implications for Scope and Cost of Program

Medicaid in Puerto Rico is already operating under simplified administrative procedures. Because of the cap on Federal funding, the Commonwealth is providing matching funds well in excess of the amount required by law. It is not clear that use of the section 501 option would make any real difference in medicaid operations or costs.

MEDICARE

THE CURRENT PROGRAM IN THE STATES

Program Description

Medicare provides health insurance protection for aged and disabled individuals. The program covers hospital services, physician services, and other medical services for all of those eligible, regardless of income. Medicare has two parts: hospital insurance (Part A) and supplementary medical insurance (SMI) (Part B).

Part A of medicare covers inpatient hospital care. In some cases, it also covers short-term skilled nursing facility care after a hospital stay, home health agency visits, and hospice care. Part A is financed chiefly from hospital insurance payroll taxes. A small number of persons over age 65 are not entitled to medicare because they are not eligible for social security or railroad retirement benefits; these persons may enroll under Part A by paying a monthly premium.

Medicare pays for inpatient hospital services according to a prospective payment system (PPS). Under this system, each medicare patient is classified according to his or her medical condition into diagnosis-related groups (DRGs). Hospitals are paid a predetermined rate for each patient treated within a given DRG. Hospitals with costs below the payment rate are allowed to keep the surplus, while hospitals with costs above the payment rates must absorb the loss.

Part B is a voluntary program; individuals must enroll and pay a premium to receive benefits. All persons entitled to Part A and all persons over age 65 are eligible to enroll. The program covers the services of physicians, outpatient hospital care, laboratory and X-ray services, and other related medical services and supplies. The program is financed by beneficiary premiums and general revenues. The monthly premium ($27.90 plus $4 for catastrophic coverage in 1989) accounts for about 25 percent of program costs. Medicare generally pays 80 percent of the reasonable charges for covered services, after the beneficiary has met the $75 annual deductible. The beneficiary is liable for 20 percent of the reasonable charge, an amount known as coinsurance. Beneficiaries with sufficient taxable income are also subject to a supplemental premium collected through the Federal income tax system.

Cost and Participation

Medicare outlays for FY 1989 are estimated to be $86.9 billion ($98.6 billion in outlays, offset by $11.7 billion in premiums and collections).

THE CURRENT PROGRAM IN PUERTO RICO

Program Description

For medicare purposes, Puerto Rico is treated like any State, with two exceptions.

First, hospitals in Puerto Rico are reimbursed for inpatient services under a special prospective payment system (PPS) distinct from the PPS used for hospitals in the States. The standard medicare PPS establishes three basic national hospital payment rates, for hospitals in large urban areas, other urban areas, and rural areas. These basic rates are adjusted through a wage index to reflect relative labor costs in different areas. For each case, the applicable adjusted rate is multiplied by a weighting factor reflecting the classification of the case into one of 477 DRGs. The product represents the basic DRG payment for the case.[16]

Puerto Rico's system works essentially the same way, except that separate large urban, other urban, and rural rates are established for Puerto Rico hospitals. These represent a blend of an average national rate (25 percent) and rates based on historical costs for Puerto Rico hospitals alone (75 percent). The FY 1989 blended rate for hospitals in San Juan is 29 percent lower than the rate that would apply in a mainland city of the same size with the same relative wage levels.[17]

Second, because Puerto Ricans do not pay Federal income tax, they do not pay the supplemental income-related premium established by the Medicare Catastrophic Coverage Act of 1988 (P.L. 100-360). They do pay the flat rate catastrophic premiums established by the Act, but at lower rates than citizens of the States.

Cost and Participation

In 1987, 406,000 Puerto Ricans were enrolled in medicare Part A, and 263,000 were enrolled in Part B. Data on medicare expenditures by residence of the beneficiary are not available.

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[16]This payment may be further adjusted for cases with very high costs or long stays (outliers); additional payments are made to teaching hospitals and those treating a disproportionate share of low-income patients.

[17]This estimate applies the San Juan wage index of .5369 to the labor-related components of the blended and national rates respectively. Before the wage adjustment, the Puerto Rico and national rates are $2,641.64 and $3,215.17, 21 percent apart. The gap widens after the wage adjustment because a higher proportion of the Puerto Rico rate is considered to be labor-related.

IMPLICATIONS OF STATEHOOD

Inpatient Hospital Reimbursement

The substitute version of S. 712 provides that, after statehood, medicare would operate the same way in Puerto Rico as in other States.

Under statehood, Puerto Rico hospitals would be paid under the national PPS. Revenues would rise by something less than the current 29 percent differential, because the inclusion of Puerto Rico in the averages on which the national rates are based would reduce those rates for all hospitals. Still, Puerto Rico hospitals would be paid considerably more, relative to their costs, than hospitals in the States. However, the substitute version of S. 712 also provides that "reimbursements under medicare shall not exceed the actual cost of providing equivalent health care to the levels of care provided in the several contiguous States." This provision is ambiguous. It is not clear whether the restriction is on individual payments to providers for each patient treated or on the aggregate amount of payments to all providers in Puerto Rico. If the restriction applied to individual payments, the effect would be a system under which a hospital would receive the lesser of its actual costs for a given case or the national PPS rate for that case. This would probably result in financial losses for hospitals.[18] If the restriction applied to aggregate payments, the effect would be to maintain the current system of separate rates based on historic Puerto Rico costs. (An alternative way of achieving the same goal would be to provide that the provisions of section 1886(d)(9) of the Social Security Act would continue in effect after statehood.)

Part B Enrollment

One feature of Puerto Rico's medicaid program has an indirect effect on eligibility for medicare benefits. Other States' medicaid programs pay medicare premiums and cost-sharing for low-income aged and disabled persons; Puerto Rico's does not. This may have contributed to the fact that in Puerto Rico enrollment under Part B is 35 percent lower than under Part A. If Puerto Rico were a State, it would be required to pay Part B premiums for all medicare beneficiaries with incomes below 100 percent of poverty. This could mean Part B eligibility for most of the 140,000 Part A eligibles not currently enrolled under Part B.

Catastrophic Premiums

As statehood would mean imposition of standard U.S. income tax rules, medicare beneficiaries who had Federal tax liability would be liable for the

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[18]The effect would be similar to that of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 payment limitations in effect before the adoption of PPS, under which hospitals could suffer a loss but never realize a profit.

income-based catastrophic supplemental premium.[19] Relatively few beneficiaries would be affected. However, the flat rate catastrophic premiums would also be charged at the rates prevailing in the States, rather than at the special lower rates established for Puerto Rico. This would have an impact on the medicaid program, which probably would be paying the premiums for most beneficiaries.

Implications for Scope and Cost of Program

The major impact of statehood would be a significant increase in the number of Part B enrollees, resulting in added costs for both the Federal and Puerto Rican governments. Depending on the interpretation of the restriction on hospital payments, Part A costs could be reduced or remain the same.

IMPLICATIONS OF INDEPENDENCE

The substitute version of S. 712 provides that, in the event of independence, the Joint Transition Commission will establish a task force to negotiate the coordination of medicare and a similar system to be established by Puerto Rico. At the same time, the bill includes medicare among the programs for which Federal funding would be replaced by a categorical grant to Puerto Rico for 9 years after the referendum. The grant amount would be based on an estimate of "the total amount of grants, programs, and services, including Medicare, provided by the Federal Government in Puerto Rico."

The amount "provided" by the Federal Government for medicare could be defined broadly to mean the total annual outlays for covered services, including outlays from the medicare trust funds. More narrowly, the amount "provided" could mean the Federal general fund contribution to Part B costs (approximately 75 percent). The first meaning is difficult to reconcile with the provision for ongoing coordination between medicare and a similar system to be established by the new nation. This coordination is presumably required in order to protect the vested rights of Puerto Ricans who have contributed to the Part A trust fund. Replacement of total medicare expenditures by a short-term categorical grant would not address this issue. For the purpose of the following discussion, it will be assumed that the second, narrower meaning is intended: that only the Federal general fund contribution to Part B would be replaced by a temporary grant. In this scheme, Part B (the pay-as-you-go component of medicare) would be wholly replaced by a Puerto Rican system immediately after independence, with temporary continuation of U.S. support. The transition between Part A (the vested social insurance component of medicare) and a Puerto Rican system would be more gradual.

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[19]These payments, like other income tax receipts, would be returned to Puerto Rico in the form of a transitional statehood grant through 1995.

The Part A transition would present some of the same issues raised elsewhere in this memorandum with respect to social security. As with social security, there appear to be at least three basic transition options:

- The portion of the Part A trust fund attributable to Puerto Rican contributions would be turned over to the new system, which would provide benefits to both current medicare beneficiaries and to insured persons not yet receiving benefits.

- Current beneficiaries would continue to be covered by medicare, while contributions for those not yet covered would be transferred to the new Puerto Rico program.

- Current beneficiaries would continue to be covered by medicare, while responsibility for those not yet covered would be established under a "totalization" approach. That is, an individual would be enrolled in either the U.S. or the Puerto Rico system, depending on which system the individual had contributed to for the greater part of his or her working life.

The first approach could create an immediate financial problem for the new Puerto Rican system if this system provided a level of benefits comparable to those available under medicare. As with social security, medicare benefits paid in Puerto Rico are probably in excess of the contributions made by lower-income Puerto Rican workers. The benefits for current enrollees are subsidized from the contributions made by higher-paid workers in the States. This subsidy would be lost after independence.

The second two approaches both involve continued direct entitlement to medicare for current beneficiaries. These approaches are complicated by the fact that medicare provides health benefits instead of simple cash payments.

Under current law, medicare does not pay for services outside the United States and its possessions. This rule could be changed to allow continued coverage for current beneficiaries in Puerto Rico. The effect, however, would be that Puerto Rican hospitals, physicians, and other providers would be subject to extensive regulation by an agency of a foreign country. Strictly speaking, medicare does not regulate providers; it sets forth conditions under which it will purchase services rendered to its enrollees. In this sense, HCFA rules affecting Puerto Rico providers would be no different from the specifications any other agency might impose in buying goods or services from a foreign supplier. Still, medicare regulations (especially certification requirements) can have such a pervasive impact on their providers that their continued imposition could be perceived as compromising Puerto Rican independence.

An alternative is to pay Puerto Rico to furnish continued coverage to current medicare beneficiaries, presumably under the same system it would develop for vested future beneficiaries. Although the structure of this system

cannot be predicted, it is not certain that Puerto Rico would choose to operate one health care system for medicare beneficiaries and another for the rest of its citizens. It might instead choose to treat its medicare payments as one funding source for a general national health care system. This might have two consequences. First, the vested "right" to medicare might be replaced by access to a health care system of public hospitals and clinics comparable to that currently available to Puerto Rico's medicaid population. Second, the entire Puerto Rican national system might be disproportionately dependent on the U.S. contribution for a small sector of its enrolled population. As the current medicare population died off, other funding sources would have to be found.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

Enhanced commonwealth status would bring no apparent change from current law.

UNEMPLOYMENT COMPENSATION

THE CURRENT PROGRAM IN THE STATES

The unemployment compensation (UC) system provides short-term income assistance to unemployed workers through a State-operated system created by Federal tax incentives. The Federal Unemployment Tax Act (FUTA) and Titles III, IX, and XII of the Social Security Act provide the framework for the system. Its major objectives are to: (1) provide temporary relief through partial wage replacement for unemployed workers who demonstrate a strong labor force attachment; and (2) help stabilize the national economy automatically by increasing net public spending during recessions and increasing taxation during periods of economic growth.

The Federal-State structure of UC places responsibility on the States for program details based on broad Federal guidelines. State laws determine individual eligibility, benefit amount, benefit duration, and disqualification provisions. Federal law requires State programs to cover certain types of employment.

Benefits are funded by State payroll taxes on employers. State tax revenue funds the payment of regular UC benefits and half of the extended benefits (EB) program. State UC laws determine the tax structure of the program, and States collect the revenue from employers. This revenue is deposited with the U.S. Treasury and credited to individual State accounts within the Unemployment Trust Fund. It is counted as Federal revenue in the budget. Funds are made available to States as needed for benefit payments, and the State accounts are charged for this Federal reimbursement of their benefit expenditures.

The FUTA imposes a 6.2-percent gross Federal tax rate on employers for the first $7,000 in wages paid to each covered employee. In States with federally approved programs and no outstanding Federal loans for the program, employers are given a tax credit reduction of up to 5.4 percentage points against the 6.2-percent tax liability. Thus, employers pay a net FUTA tax rate of 0.8 percent. FUTA tax revenue is used to fund the administrative costs of UC, the Federal half of EB, and loans to State programs that become insolvent.

The system covers about 85 percent of all employed persons in 53 "State" programs (the 50 States plus the District of Columbia, Puerto Rico, and the Virgin Islands). During FY 1989, the U.S. Department of Labor estimates that $13.6 billion will be paid to 6.9 million beneficiaries and that benefits will average $148 weekly.

THE CURRENT PROGRAM IN PUERTO RICO

The UC program in Puerto Rico operates on the same legal basis as the programs in the States. Puerto Rico's UC program has several unusual characteristics. For example, while the regular benefit period can last up to 26 weeks in most States, Puerto Rico has a 20-week period. Most States set an employer's tax rate based on the firm's experience with unemployment, but Puerto Rico does not use this "experience-rating" approach to taxation. Puerto Rico's maximum weekly benefit amount of $110 is the lowest in the system.

During the first calendar quarter of 1989, Puerto Rico had an unemployment rate of 14.7 percent, higher than that of any State. There were 31,000 UC beneficiaries in Puerto Rico during the quarter, and the cost of their benefits during the 3 months was $23.4 million.

IMPLICATIONS OF STATEHOOD

Since Puerto Rico already operates a UC program on the same basis as the States, no change in the existing program would be needed should Puerto Rico become a State.

IMPLICATIONS OF INDEPENDENCE

If Puerto Rico should become independent, the UC program would no longer exist as a component of the Federal-State system. However, there would be several issues to resolve with respect to a transfer of program assets to Puerto Rico and the rights of current beneficiaries and covered employees. The pending legislation as drafted is silent on these transitional issues.

First, Puerto Rico has credits in its Unemployment Trust Fund account for revenues collected from Puerto Rican employers against which charges for benefit payments have not yet been levied. As of March 31, 1989, Puerto Rico's account balance was $448.4 million. An independent Puerto Rico would probably ask that this balance, reduced by any further benefit payments that might be made after independence for entitlements earned before independence, be paid by the United States to the Republic of Puerto Rico.

Second, FUTA revenues are held in reserve in three Federal trust fund accounts to pay future administrative costs, EB payments, and loans to State programs. An independent Puerto Rico could argue that it should receive its share of these reserves since it would have no future claim against these accounts. Puerto Rico's share would presumably be determined by the proportion of national FUTA revenues that were collected from Puerto Rican employers over the months prior to independence. As of March 31, 1989, FUTA reserves totaled $8.2 billion. Puerto Rico's share of FUTA revenue collections was 0.6 percent during FY 1987.

A final independence issue concerns entitlement of the Puerto Rican unemployed to benefits. Benefits could be continued after independence for the unemployed already in beneficiary status. Also, new benefit claims could be allowed for persons who became unemployed after independence, but only for job loss associated with a base period of employment that occurred before independence. Puerto Rico's base period is the first four of the last five completed calendar quarters before the claim filing date. Benefits paid after independence would be charged against Puerto Rico's trust fund account.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

The proposed referendum does not call for any change in the status of the UC system in Puerto Rico under commonwealth status. Presumably, UC could not be included in a consolidated block grant since it provides direct payments to individuals.

EARNED INCOME TAX CREDIT

THE CURRENT PROGRAM IN THE STATES

The earned income tax credit (EITC) is a refundable tax credit authorized under the U.S. Internal Revenue Code as a part of the individual income tax. Eligible tax filers may use these credits to reduce their Federal income tax liability. If a filer's credit entitlement exceeds tax liability, the balance of the credit amount is "refunded," or paid directly, to the filer by means of a check from the U.S. Treasury. An individual who anticipates being eligible for EITC can have the employer take it into account in determining tax withholding from wages. Anticipated eligibility for an EITC refund can result in an increased pay check (i.e., negative tax withholding) for employees who take advantage of the withholding process.

To be eligible for EITC, a filing unit must have earned income and a dependent child residing in the household. The credit is currently worth 14 percent of the first $6,500 of yearly family earnings. The $910 maximum credit is reduced by 10 cents for each dollar of adjusted gross income (AGI) over $10,240. Thus, the credit phases out for families with AGI of $19,340 or more.

The EITC first took effect in 1975. The credit amount and phaseout income level have been increased several times since the original enactment and are now adjusted annually for price inflation. Credits earned in 1989, and generally paid in 1990, are projected to total $5.4 billion. They will go to 9.8 million families, or about one-third of all U.S. families with children.

Legislation to expand EITC is pending before Congress. The Senate has passed legislation (S. 5), and the House Ways and Means Committee is marking up a bill. Since President Bush is supporting this type of legislation, it is possible that EITC will be expanded by the 101st Congress.

THE CURRENT PROGRAM IN PUERTO RICO

The EITC generally is not available to families in Puerto Rico. Persons living in Puerto Rico year-round are exempt from Federal income taxes and pay only the Puerto Rican income tax. They are ineligible for EITC because their income is exempt from the U.S. tax system. Puerto Ricans with U.S. earnings who reside part-time in the States and file U.S. tax returns also are ineligible for EITC because EITC is available only for persons whose tax returns cover a 12-month period. (However, U.S. Government employees residing in Puerto Rico are subject to the U.S. income tax, and some are eligible for EITC.)

Puerto Rico has begun a demonstration of a wage subsidy using funds from the nutrition assistance program. This subsidy, intended to encourage

low-income family heads to work, will pay 25 percent of the Federal minimum wage for up to 40 hours of work per week. While similar to the EITC, this demonstration project will spend only $14 million in FY 1989, a small fraction of the potential cost of EITC in Puerto Rico.

IMPLICATIONS OF STATEHOOD

Puerto Rican statehood would bring its residents under the U.S. income tax. Thus, eligibility for EITC would be available to all working Puerto Ricans parents with dependent children who meet the income test.

The impact of this eligibility extension on the cost of EITC to the Federal Government and on the Puerto Rican economy could be substantial. The most recent individual income data for Puerto Rico are from the last decennial census and thus are dated. However, a conservative estimate of how many Puerto Rican families would have been covered in 1979 had today's EITC been available to them at the same real dollar levels shows that about 295,000 families would have been eligible. This group would have amounted to 65 percent of all Puerto Rican families with children in that year. If Puerto Rican families would have had an average credit similar to that for the United States as a whole ($552), the cost of these benefits would have been $163 million in today's dollars, which would raise the total cost of EITC for 1989 by 3 percent. These additional cash payments would not be taken into account in determining AFDC benefit amounts for families under that program under a law that takes effect October 1, 1989. EITC payments would also be ignored in most cases in the determination of benefit amounts under Puerto Rico's nutrition assistance program.

IMPLICATIONS OF INDEPENDENCE

The EITC would not be available in Puerto Rico under independence. Although Puerto Rican residents could elect U.S. citizenship at the time of independence, the denial of EITC eligibility to Federal tax filers who exclude income earned in a U.S. possession or a foreign country would continue to apply, thereby eliminating Puerto Rican residents from EITC.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

The proposed enhancement of commonwealth status would not affect the U.S. tax code. Thus, EITC would continue to be unavailable to Puerto Ricans.

MATERNAL AND CHILD HEALTH SERVICES BLOCK GRANT

THE CURRENT PROGRAM IN THE STATES

Program Description

The maternal and child health (MCH) services block grant, authorized under Title V of the Social Security Act, provides grants to each State and insular area to meet a broad range of health services, including preventive, primary care, and habilitative services, to mothers and children. Funds are allocated among the States on a percentage formula based on the FY 1981 funding levels for the programs that were combined into the block grant when it was created in FY 1982. In addition, 15 percent of the funds appropriated for the block grant each year are set-aside for special projects of regional and national significance (SPRANS) in the categories of research, training, hemophilia, genetic diseases, and maternal and child health improvement, including infant mortality and efforts relating to children with special health care needs.

States determine eligibility criteria for MCH services. The law provides that block grant funds are to be used to assure access of mothers and children, "particularly those with low income or limited access to health services," to quality health services. Low-income mothers and children are those with family income below 100 percent of Federal poverty guidelines. States determine the level of services provided under the block grant, including prenatal care, well-child care, dental care, immunization, family planning, and vision and hearing screening services. Services may also include inpatient services for children with special health care needs, screening services for lead-based paint poisoning, and counseling for parents of sudden infant death syndrome victims. In order to receive their MCH block grant allocations, States are required to match each $4 in Federal funds with $3 of their own.

Program Operation

In FY 1989, a total of $554,268,000 was appropriated for the MCH block grant. Of this amount, $465,293,000 was allocated in grants to the States, and $88,975,000 was distributed in SPRANS project grants to 490 grantees. The MCH program does not have the authority to collect uniform data from the States on the number of program recipients, although some States do submit such information in annual reports on program operation.

THE CURRENT PROGRAM IN PUERTO RICO

Program Description

For the purposes of the MCH block grant, Puerto Rico is treated as a State, and the program operates as in the 50 States. The program is administered by Puerto Rico's Department of Health.

Program Operation

In FY 1987, the most recent year for which such data are available, Puerto Rico received an MCH allocation of $11.5 million. For this, it was required to spend $8.6 million in matching funds, but it actually spent $14.4 million of its own funds on its MCH program.[20] In FY 1987, the Puerto Rico MCH program served 40,717 prenatal patients through 237,756 clinic visits. That year the program also served 8,881 postpartum patients. A total of 46,127 infants, 39,876 preschool children, and 57,586 school-age children and adolescents received comprehensive health services. Neonatal intensive care was provided for 499 infants, and 18,867 children with special health care needs received services through 123,000 health visits. In addition, 42,676 women received family planning services.[21]

IMPLICATIONS OF STATEHOOD

Since Puerto Rico is treated as a State for purposes of the MCH block grant, a change in the Commonwealth's status to a State apparently would have no effect on this program.

IMPLICATIONS OF INDEPENDENCE

Puerto Rico as an independent nation would not be eligible for a share of the MCH block grant as currently authorized. Presumably, Federal MCH funds would be included in the aid package that would be provided to Puerto Rico to replace Federal funds for several years after the proclamation of independence.

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[20]FY 1987 program expenditure data are from: Public Health Foundation. *Public Health Agencies 1989: An Inventory of Programs and Block Grant Expenditures*. Washington, 1989.

[21]Information on clients served obtained in telephone conversation July 24, 1989, with spokesman of Division of Maternal and Child Health, Health Resources and Services Administration, U.S. Department of Health and Human Services.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

Section 407 of the substitute S. 712 provides, under enhanced commonwealth status, for the consolidation in any fiscal year or years of certain Federal grant-in-aid programs available to Puerto Rico, with certain exceptions. The consolidated grant would be at least equal to the sum of grants to which the Commonwealth would otherwise be entitled under the separate programs. The consolidated grant would be for the programs and purposes authorized under *any* of the grants consolidated, but the Commonwealth would determine how the funds should be allocated. Regulations would be published covering the application and reporting process, and the Federal administering authority would be required to waive any requirements for matching funds.

Enhanced commonwealth status and the resulting consolidation of grants-in-aid could have implications for the MCH block grant. This provision does not specifically exclude the MCH block grant, so, presumably, Puerto Rico *could* (but would not be required to) request the funds under this program be included in a consolidated grant. In such a case, Puerto Rico would receive the same amount of funds it would otherwise be eligible to receive under the MCH block grant, but could use these funds for other purposes. The possible elimination of separate application and report requirements could reduce administrative costs to the Commonwealth and make more funds available for program services. The elimination of requirements for matching funds could allow the Commonwealth to reduce its own spending for maternal and child health services activities. As seen above, Puerto Rico currently spends more of its own funds for such activities than is required by the matching provisions of the MCH block grant authorizing legislation.

TITLE IV-B CHILD WELFARE SERVICES

THE CURRENT PROGRAM IN THE STATES

The child welfare services program provides 75 percent Federal matching grants to States for a variety of services intended to protect the welfare of children. The services are to address problems that could result in neglect, abuse, exploitation or delinquency of children; prevent the unnecessary separation of children from their families and restore them to their families when possible; place children in adoptive homes if restoration is not possible; and assure adequate foster care when children cannot be returned home or placed for adoption.

The FY 1989 appropriation for child welfare services is $246.7 million. These funds are allotted to States according to a formula that takes into account the size of the State's population that is under age 21 and the ratio of per capita income in the State to per capita income in all the States and territories. States with lower per capita incomes have higher per capita allotment percentages than States with higher per capita incomes, although a minimum is set for higher income States and a maximum applies to low-income States. States (including Puerto Rico) receive their share of funds appropriated in excess of $141 million only if they have implemented specified protections for children in foster care. There are minimal reporting requirements under the program and there are no reliable national or State data on the use of funds, including services provided or persons served.

THE CURRENT PROGRAM IN PUERTO RICO

Puerto Rico is considered a State for the purposes of this program. Funding is allocated on the basis of the population under age 21, but the allotment percentage for Puerto Rico is set at the maximum allotment level rather than on the basis of actual per capita income. In addition, Puerto Rico is not eligible for a share of funds appropriated in excess of $141 million because it has not implemented the specified protections for children in foster care. In FY 1989, Puerto Rico received $6.5 million under this program.[22] Information on the use of funds under this program is not available.

IMPLICATIONS OF STATEHOOD

Puerto Rico would receive funds on the same basis as other States under this option. This would mean that Puerto Rico's allotment percentage would be based on actual per capita income rather than being assumed to be at the

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[22]U.S. Department of Health and Human Services, Office of Human Development Services, Administration on Children, Youth and Families.

cap. However, Puerto Rico's allotment percentage (and funding under the Title IV-B program) would remain the same based on its current per capita income. Per capita annual income in Puerto Rico is estimated to be less than one-third the U.S. per capita income.[23] The allotment for Puerto Rico could not increase on the basis of statehood, because its allotment percentage already is the highest permitted under the law.

IMPLICATIONS OF INDEPENDENCE

Puerto Rico as an independent nation would not be eligible for Federal funds under Title IV-B. Presumably, funding for the Title IV-B program would be included in the aid package to replace Federal programs provided to Puerto Rico for several years after the proclamation of independence.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

The substitute S. 712 would allow Federal agencies to consolidate grants made to Puerto Rico (other than those used for direct payments to classes of individuals) to minimize application and reporting requirements. The consolidated grant could be used for the purposes authorized under any of the consolidated programs. The grant amount would be at least equal to the sum of grants to which the Commonwealth would otherwise be entitled. Presumably, the administering authority would waive the requirements for matching funds. The Title IV-B program is not specifically treated as an exception under the bill. Hence, Puerto Rico presumably *could* (but would not be required to) request that the funds under this program be included in a consolidated grant. In this case, Puerto Rico would receive the same amount of funds it received under Title IV-B (e.g., $6.5 million) but could use these funds for other purposes. (It could also use other funds for child welfare.) Incentives to consolidate the child welfare services program with others would include reductions in paperwork requirements (the elimination of multiple applications and reporting) and the possibility that the matching funds requirement would be lifted. If the consolidation of Title IV-B were not requested, Puerto Rico presumably would continue to receive funds as outlined under current law.

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[23]Estimated by the Bureau of Economic Analysis, U.S. Department of Commerce.

TITLE IV-E FOSTER CARE AND ADOPTION ASSISTANCE

THE CURRENT PROGRAM IN THE STATES

The Title IV-E foster care program provides open-ended Federal matching funds to States for maintenance payments made for AFDC-eligible children in foster care. The program is required of all States participating in AFDC (all States do). The Federal matching rate for a given State is that State's medicaid matching rate, which averages about 53 percent nationally. States may also claim open-ended Federal matching (50 percent) for their administrative costs and (75 percent) for training costs. States have up to 2 years to make claims for expenditures under the IV-E foster care program; thus, the actual funding for FY 1988 and FY 1989 is still in flux. The FY 1989 appropriation for foster care is $1.023 billion (which includes funds for prior years' expenses). The Administration estimates the FY 1989 costs for the IV-E foster care program to be $1.03 billion. It is estimated that 123,000 children participated in the program on an average monthly basis in FY 1988.

The Title IV-E adoption assistance program provides Federal matching payments to States for adoption assistance payments made to parents who adopt AFDC- or SSI-eligible children with special needs; and for the one-time adoption expenses of parents of special needs children whether or not they are AFDC- or SSI-eligible. The Federal matching rate for the open-ended adoption assistance payments for a given State is that State's medicaid matching rate. States may also claim open-ended Federal matching for their administrative costs (50 percent) and for their training costs (75 percent). States may claim up to 50 percent Federal matching for the one-time adoption expenses, up to a maximum of $2,000 total for each placement. As in the Title IV-E foster care program, States have up to 2 years to make claims for expenditures under the adoption assistance program; thus, the actual funding for FY 1988 and FY 1989 is still in flux. The FY 1989 appropriation for the adoption assistance program is $111.7 million (which includes money for prior years' expenditures). The Department of Health and Human Services estimates the FY 1989 costs for the IV-E adoption assistance payments to be $111.7 million. It is estimated that the average monthly number of children participating in the program in FY 1989 was 38,000.

THE CURRENT PROGRAM IN PUERTO RICO

The Administration indicates that Puerto Rico does not currently receive funding under the Title IV-E programs, although it is included in the definition of State and would presumably be eligible for funds within the section 1108 cap as described in this memo under the Title IV-A AFDC program. As noted in that description, Puerto Rico is eligible for up to $82 million in FY 1989 for total expenditures under several programs including Titles IV-A and IV-E.

IMPLICATIONS OF STATEHOOD

Effective on the date of admission to statehood, Puerto Rico would receive funds on the same basis as other States. If, like the other States, Puerto Rico were not subject to the cap on expenditures for programs specified under section 1108, it would be more likely to claim reimbursement for its foster care and adoption expenses under Title IV-E. As noted above, these are generally open-ended reimbursements for the costs of serving eligible children, based on the State's medicaid matching rate.

IMPLICATIONS OF INDEPENDENCE

Puerto Rico as an independent nation would not be eligible for Federal funds under the Title IV-E program. Presumably, all Title IV-E funds would be included in the consolidated aid package provided to Puerto Rico for several years after the proclamation of independence.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

This option would allow Federal agencies to consolidate grants made to Puerto Rico, *other than those for direct payments to classes of individuals.* Because the Title IV-E foster care and adoption assistance programs provide funding for direct payments to classes of individuals, they probably could not be consolidated under this option. However, this could be subject to legal interpretation. Currently, Puerto Rico does not receive funds under these programs.

TITLE XX SOCIAL SERVICES BLOCK GRANTS

THE CURRENT PROGRAM IN THE STATES

Title XX is an appropriated entitlement that provides Federal funds as block grants to States to support a variety of social services, with no State matching required. Funds are allotted to States on the basis of their share of total population in the 50 States and the District of Columbia. There are minimal reporting requirements under the program and there are no reliable national or State data on how funds are spent, including services provided or persons served. However, annual preliminary plans submitted by the States indicate the range of services provided. In FY 1987, the service category provided by the largest number of States was home-based services (including homemaker and home health services), followed by day care for children; protective or emergency services for children; employment, education and training services; and protective and emergency services for adults. A variety of other services were also provided. The FY 1989 appropriation for the Title XX program is $2.7 billion.

THE CURRENT PROGRAM IN PUERTO RICO

Puerto Rico's annual allotment of Title XX funds is based on the ratio of the funds Puerto Rico received in FY 1981 to total Title XX funds. In addition, Puerto Rico may use funds for the Title XX program that are not expended within the cap specified under section 1108 (described in the section of this memo on Title IV-A AFDC). The FY 1989 allotment under Title XX for Puerto Rico is $14 million. Puerto Rico reported that it planned to use its Title XX funds in FY 1987 for case management; counseling; day care for children and adults; disabled services; employment, education and training services; home-based services; residential care and treatment; and social support services.

IMPLICATIONS OF STATEHOOD

The substitute S. 712 provides that Title XX would operate in Puerto Rico as it currently does in the 50 States. If Puerto Rico received Title XX funds under the same formula that applies to other States--on the basis of population--its Title XX funding would be likely to increase substantially. For example, the State of Connecticut, which has a population roughly equivalent in size to Puerto Rico, receives $36 million in Title XX funds in FY 1989, compared with Puerto Rico's allotment of $14 million. Presumably, the additional funds that might be available for Title XX under the cap specified in section 1108 would not be available under this option.

IMPLICATIONS OF INDEPENDENCE

Puerto Rico as an independent nation would not be eligible for Federal funds under Title XX. Presumably, Federal Title XX funds would be included in the consolidated aid package that would be provided to Puerto Rico for several years after the proclamation of independence.

IMPLICATIONS OF ENHANCED COMMONWEALTH STATUS

The substitute S. 712 would apply the provisions of P.L. 95-134, relating to consolidation of Federal grant programs, to Puerto Rico. These provisions currently apply to the Virgin Islands, Guam, American Samoa, the Trust Territories of the Pacific Islands, and the Northern Marianas. P.L. 95-134 allows Federal agencies to consolidate grants available to these insular areas in response to a single application. If Puerto Rico were brought under this legislation, it could receive consolidated grants from Federal agencies equal to the sum of grants to which it would otherwise be entitled from that agency. The consolidated grant would be for the programs and purposes authorized under *any* of the grants being consolidated, but the Commonwealth would determine how the funds should be allocated. Regulations would be published covering the application and reporting processes. Presumably, the administering authority would waive the requirements for matching funds. The Title XX program is not treated as an exception under the bill. Hence, Puerto Rico presumably *could* (but would not be required to) request that funds under this program be included in a consolidated grant from the Department of Health and Human Services. In this case, Puerto Rico would receive the same amount of funds it would otherwise be eligible to receive under Title XX, but could use these funds for other purposes. One possible incentive to consolidate the program with others would be the reduction in paperwork required in the application and reporting processes, although the paperwork burden of Title XX currently is minimal. It is uncertain how the additional funds that might be available for Title XX under the section 1108 cap would be affected by this option.

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THE POLITICAL STATUS OF PUERTO RICO: ISSUES FOR WELFARE PROGRAMS

Statement of
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Education and Public Welfare Division
Congressional Research Service
Library of Congress

Before the
Committee on Finance
U.S. Senate

November 15, 1989

MR. CHAIRMAN, my name is Carolyn Merck. I am a legislative analyst with the Congressional Research Service (CRS). The purpose of my testimony today is to describe how welfare programs and recipients might be affected by a change in Puerto Rico's status. My statement is largely drawn from a report CRS prepared last summer at Senator Moynihan's request.

I would like to preface my testimony by saying that I will not address program costs or budget effects, as the Congressional Budget Office is charged with the responsibility of providing such estimates for the Congress.

In order to keep my statement brief, I will discuss only the most significant changes that would occur if Statehood were to be chosen in the referendum. However, most welfare programs would be unaffected by the enhanced Commonwealth option, and, under independence, welfare programs would no longer be the responsibility of the U.S. Government.[1]

If Statehood were to be the outcome of the referendum, the Earned Income Tax Credit (EITC), and the Supplemental Security Income (SSI) and Food Stamp programs would undergo the most significant changes in scope. These programs have federally financed, nationally uniform eligibility and benefit criteria and are generally geared to serve a population whose income is low relative to mainland U.S. incomes. Because incomes in Puerto Rico are far below those of even the poorest state, the eligibility levels for these programs would occur at a point below which a large segment of the Island's population would fall.[2]

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[1]Under independence, many issues pertaining to the social security retirement program would have to be resolved by a special transition commission, including credits for work performed under the U.S. system and which nation's program would pay for the benefits according to what formula. At least in the short run, there could be increased costs to the United States if it continued to pay Puerto Rican beneficiaries but no longer collected payroll taxes from Puerto Rican workers and employers.

[2]According to 1980 census data, the median family income in the United States was nearly $20,000; in Mississippi, the poorest State, it was $14,600, but in Puerto Rico it was only $6,000. Using the income standard that defines poverty in the States, in 1980, 9.6 percent of families in the United States fell below poverty. In Mississippi about 20 percent of families were poor, and in Puerto Rico 58 percent fell below the U.S. poverty line.

EARNED INCOME TAX CREDIT

The Earned Income Tax Credit (EITC) is a refundable tax credit for households with earned income and dependent children. It is not available in Puerto Rico because it is part of the U.S. income tax system. However, upon implementation of the Federal income tax in the State of Puerto Rico, this program would be extended to all working Puerto Rican parents with adjusted gross incomes below $19,340.

Given the distribution of family income in Puerto Rico, a rough estimate shows that in 1979 almost two-thirds of all Puerto Rican families with children would have been eligible for the EITC if it had been available then at today's real dollar levels.

SUPPLEMENTAL SECURITY INCOME

The Supplemental Security Income (SSI) program, which is not available in Puerto Rico, provides federally financed, nationally uniform monthly cash assistance to low-income elderly, blind, and disabled persons.

Instead of SSI, the Commonwealth operates a program of Aid to the Aged, Blind and Disabled (AABD) according to locally determined eligibility and benefit criteria. Federal funds going to Puerto Rico for AABD are subject to an annual cap, and the Commonwealth is required to pay 25 percent of benefit costs.[3]

Under Statehood, SSI would replace the AABD program at 100 percent Federal expense, and the cap on Federal funds would be removed. Income eligibility and maximum benefit levels would increase from $32 monthly (for those with no other income and no shelter costs) to $368 monthly (about $245 if they lived in another's household). A jump of this magnitude undoubtedly would expand the population eligible, increase payments to program participants 8- to 11-fold, and could potentially affect persons other than SSI recipients. The elderly in Puerto Rico tend to live in extended households, and a large increase in the income of one household member might create a work disincentive for other household members.

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[3]Federal funds for AABD are combined with funding for Aid to Families with Dependent Children (AFDC), emergency assistance, and foster care and adoption assistance. In 1989, Federal funds are capped at $82 million. In 1987, AABD payments in Puerto Rico totaled $17.2 million (Federal plus Puerto Rican funds).

THE FOOD STAMP PROGRAM

Although the Food Stamp program is not under the jurisdiction of this committee, its counterpart, the nutrition assistance program (NAP), is the linchpin of Puerto Rico's welfare system. The NAP provides more money and affects more people in the Commonwealth (about 43 percent of the population) than all other means-tested welfare programs put together.

Statehood would require the extension of the regular Food Stamp program to Puerto Rico with four major consequences:

- Benefits would have to be issued in food stamp coupons rather than cash, requiring implementation of redemption procedures and monitoring of food store operations;
- The number of recipients could increase by 400,000 persons, to well over half the population;
- Benefits to participants would rise significantly, by at least 20 percent; and
- Puerto Rico would lose the very substantial flexibility it now has to design its major cash welfare program as it sees fit, without the panoply of Federal food stamp rules that States must follow.

Overall, this increase in income to a large segment of the Island's population in the form of coupons earmarked for food could create distortions of uncertain dimensions in food markets and the economy in general.

AID TO FAMILIES WITH DEPENDENT CHILDREN

Puerto Rico decides benefit levels and eligibility criteria for the Aid to Families with Dependent Children (AFDC) program, as do the States. However, unlike the program in the States, funding is subject to a cap, and Puerto Rico is required to pay 25 percent of benefit costs. AFDC covers only about 5 percent of the population and, thus, is much smaller in scope than the NAP or, potentially, the Food Stamp program.

If Puerto Rico were to become a State, the cap on Federal funding would be removed, and the Federal Government's share of benefit costs would rise from 75 percent to 83 percent. However, it is unclear how Puerto Rico would respond to open-ended funding for AFDC at an 83 percent matching rate. By spending somewhat *less* money, Puerto Rico could maintain existing benefit levels. Because the Food Stamp program would be available to a broader population and would offer higher benefit levels at no cost to Puerto Rico, there would appear to be little reason for Puerto Rico to expand its AFDC program.

MEDICAID

The Medicaid program is available in Puerto Rico under current law, but it functions under vastly different rules from those that prevail in the States. Medicaid funding in Puerto Rico is capped, and the Commonwealth must pay half of program costs. Under Statehood, the cap on Federal funds for Medicaid would be removed, and the Federal share of costs would rise from 50 percent to 83 percent. As a result, Federal spending for Medicaid in Puerto Rico could more than double.

In addition, Puerto Rico would become subject to new requirements for furnishing more extensive coverage to some classes of individuals (pregnant women and infants in families with incomes up to 100 percent of the Federal poverty line), while cutting off coverage to others (persons with incomes over 133-1/3 percent of the AFDC payment level).[4] Also, Puerto Rico would no longer be permitted to restrict Medicaid providers to public hospitals and clinics.

CONCLUSION

In conclusion, under the Statehood option for Puerto Rico, a sharp rise in welfare benefits could dramatically reconfigure the outline of the Island's income distribution. While, on the one hand, this could have salutary effects on the living standards of many low-income people, the effect on labor force participation and work disincentives in an economy in which unemployment is already very high (14.5 percent) is an issue of serious concern.[5]

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[4]Puerto Rico provides medical services financed by Medicaid to persons with incomes up to five times the AFDC payment level ($5,700 for a three-person family in 1986).

[5]In 1987 the labor force participation rate (persons age 16 and over) was 44.1 percent: 59.7 percent for males and 30.4 percent for females.

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

December 29, 1989

TO :

FROM : Bette Taylor
Analyst in American National Government
Government Division

SUBJECT : Treatment of Language in Instances of Admission to Statehood

This memorandum was prepared in response to your request for an analysis of how language was treated when new States were admitted to the Union. The analysis that follows deals with how the language issue was treated in the statehood deliberations for Louisiana, Oklahoma, New Mexico and Arizona.

These four States, which had large groups of non-English speaking residents, were admitted to the Union with language conditions in their enabling acts.[1] Louisiana's enabling act mandated that its laws, records and proceedings be conducted and preserved in the language of the U.S. government—the word "English" was not used. Oklahoma's enabling act dictated that all public schools be conducted in English. Both Arizona's and New Mexico's enabling acts contained identical language creating a public school system to be conducted in English as well as prescribing English literacy qualifications for State legislators. Additionally, the New Mexico constitution directed that all laws passed after statehood be printed in both English and Spanish for a period of twenty years. A brief historical synopsis describing the admission of these States follows.

Louisiana

The Louisiana territory, a large portion of whose population spoke French or Spanish, was ceded to the United States by France under the terms of the Louisiana Purchase, which was ratified by Congress in 1803. In 1911, Louisiana's territorial legislature petitioned Congress for admission to the Union. This move was opposed by some in Congress as being both

[1] United States General Accounting Office. *Puerto Rico's Political Future: A Divisive Issue With Many Dimensions.* GGD 81-48, March, 1981., p. 91.

unconstitutional and unwise. Opponents of statehood contended that the admission of new States might set an unhealthy precedent that would threaten the privilege and autonomy of the existing States.[2] But the Treaty with France had provided for assimilation of the new territory into the Nation by the creation of a number of States as soon as possible. The Supreme Court later upheld the majority's view as to the constitutionality of Louisiana's admission.[3]

When Louisiana was admitted in 1812 as the 18th State, its enabling act provided that:

> . . . the laws which [Louisiana] may pass shall be promulgated, and its records of every description shall be preserved, and its judicial and legislative written proceedings conducted, *in the language in which the laws and the judicial and legislative proceedings of the United States are now published and conducted.*[4]

Oklahoma

Statehood was advocated by many in the territory of Oklahoma in the early 1890s, but several factors complicated this picture. For one, the territory had a large number of Indians, and their political position under a new State was unclear. There were also two "statehood" movements; one supported the establishment of one State and an alternative movement looked to create two States. It was thought that Oklahoma alone would make a Republican state but that with the addition of Indian Territory it would be Democratic.[5]

Several conventions were held to consider statehood in both territories (Oklahoma and the Indian Territory) after 1890. In the Indian territory, the convention showed considerable opposition to statehood. One proposal from

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[2] Arguably, a far more important factor in the statehood deliberations was the feeling that Louisiana might vote for the majority Republican-Democrat ticket rather than that of the Federalists. Huddle, Frank P. Admissions of New States. *Editorial Research Reports*. v. 1, Mar. 20, 1946. p. 192.

[3] Huddle, Admission of New States, p. 192.

[4] 2 Stat. 641-643; February 20, 1811. Emphasis added.

[5] Tansill, William R. The States after the Original Thirteen: Sketches of the Circumstances incident to their Admission. Legislative Research Service. Washington. March 3, 1954. p. 26. Also see Foreman, Grant. *A History of Oklahoma*. Norman, Okla., University of Oklahoma Press, 1942. pp. 310-316.

the Indian territory would have established the new state of "Sequoyah." However, no hearings were held on the Senate and House bills containing dual States for Oklahoma, because the prevailing sentiment was strongly in favor of a unified State.[6]

Because of the large number of American Indians inhabiting the new State, Oklahoma's enabling act provided that:

> Provisions shall be made for the establishment and maintenance of a system of public schools, which shall be open to all the children of said State and free from sectarian control; and said schools shall always be conducted in English: *Provided*, That nothing herein shall preclude the teaching of other languages in said public schools . . . .[7]

New Mexico and Arizona

The movement for the admission of New Mexico and Arizona as States began many years before admission was achieved. As early as 1873, advocates for New Mexico statehood argued that the territory's increasing wealth and population and the maturity of its civilization (many centuries old) should qualify for statehood. Perhaps more important was the fact that the Treaty of Guadalupe-Hidalgo, by which New Mexico had been transferred to the United States, obligated eventual statehood. Opponents were quick to point out that nearly all the area's population was Spanish-speaking and that these people could neither speak English nor read or write in their own language. Nevertheless, in May 1874, a statehood bill for New Mexico passed the House by a decisive majority. In the next session, the legislation was amended and passed by the Senate, but the amended version was not accepted by the House. During the remainder of the nineteenth century and the early years of the twentieth century, the statehood movement (either for one State or for both) continued unabated. In 1905-6 a bill to combine the two territories into one State was defeated.[8]

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[6] Tansill, p. 26.

[7] 34 Stat. 267-278; June 16, 1906.

[8] Tansill, p. 27. Also see Oberholtzer, Ellis Paxson. *A History of the United States Since the Civil War*. 5 vol. New York. The Macmillan Co., 1936. v. 3, p. 370-1; v. 4, p. 661; v. 5 p. 332, and Coan, Charles F. *A History of New Mexico*. Chicago and New York, The American Historical Society, 1925. 3 vol. v. 1, p. 410-15.

After more than fifty bills on statehood for New Mexico and Arizona were considered by the Congress over a span of 35 years, enabling acts for both territories were passed June 20, 1910.[9]

Both these enabling acts mandated that school instruction be conducted English and that the State legislators be proficient in English. The following is an excerpt from New Mexico's enabling act:

> . . . provision[s] shall be made for the establishment and maintenance of a system of public schools, which shall be open to all the children of said State and free from sectarian control, and that said schools shall always be conducted in English . . . that the ability to read, write, speak and understand the English language sufficiently well to conduct the duties of the office without the aid of an interpreter shall be a necessary qualification for all State officers and members of the State legislature.[10]

Arizona's enabling act contained identical language.[11]

Furthermore, New Mexico's constitution explicitly safeguarded the rights of Spanish-speaking residents by mandating that, after admission to statehood, all laws passed subsequently be printed in both English and Spanish for a period of twenty years. The following language remains as part of the current constitution of New Mexico:

> For the first twenty years after this constitution goes into effect all laws passed by the legislature shall be published in both the English and Spanish languages and thereafter such publication shall be made as the legislature may provide.[12]

I trust that this information meets your needs. If I can be of further assistance, please call me at 707-5351.

BAT/rla

[9] Ibid.

[10] 36 Stat. 557; June 20, 1910.

[11] 36 Stat. 568; June 20, 1910.

[12] New Mexico Statutes: Art. XX, Sec. 12.

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AMERICAN LAW DIVISION
MEMORANDUM

May 4, 1990

SUBJECT: Congressional Authority Under the United States Constitution to Extend Voting Rights for a Federally Mandated Plebiscite in Puerto Rico to All Individuals Who Were Born Subject to the Jurisdiction of Puerto Rico

AUTHOR: Kenneth R. Thomas

This memorandum addresses the issue of whether the United States Congress is authorized under the United States Constitution to extend voting rights for a federally-mandated plebiscite, which will determine whether Puerto Rico should become a state, remain a commonwealth, or become independent, to individuals who were born subject to the jurisdiction of Puerto Rico and who are United States citizens.

It should be noted that the proposal under suggestion may significantly expand the pool of eligible voters for this plebiscite beyond those person who are currently eligible to vote in Puerto Rican elections.[1] Puerto Rico, like

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[1] For an individual to be a qualified elector in Puerto Rico, he must fulfill five qualifications, which are set forth below.

1) He must be a citizen of the United States.

2) He must be a citizen of Puerto Rico. Citizens of Puerto Rico include those persons born in Puerto Rico and subject to the jurisdiction of Puerto Rico; and those United States citizens who acquire domicile in Puerto Rico. 1 L.P.R.A. §7 (1984). Puerto Rican law requires that citizens in either category must maintain their domicile in Puerto Rico in order to retain their citizenship. *See* Fiddler v. Secretary of Treasury, 85 P.R.R. 302 (1962).

3) He must be domiciled in Puerto Rico. Domicile is the place in which a person is considered to be settled for certain legal purposes. 25 Am. Jur. 2d Domicil §1 (1966). Although the concept is related to a person's residence, they are not necessarily the same. A person may have several residences, but can only have one domicile. *Id.* at §2. Generally, the requirement of domicile is that a person both has some physical "residence" in a location, and that this presence is coupled with an intent to stay in that location for the indefinite future. The concept of domicile, however, does not exclude the possibility of long absences from a location, such as for military leave, educational or business purposes. *Id.* at §31.

4) He must be eighteen years of age.

most territories and states, allows "absentee" voting for Puerto Rican citizens who are registered to vote but who are unavoidably absent from the territory on the day of the election.[2] However, if a Puerto Rican citizen changes his "domicile" to a different state, he will lose his citizenship.[3] Thus, the proposal would allow individuals who were not currently citizens in Puerto Rico, but who were born subject to the jurisdiction of Puerto Rico, to vote in the plebiscite.

Puerto Rico is currently in a commonwealth relationship with the United States.[4] Although the application of specific provisions of the United States Constitution to Puerto Rico is a matter of some complexity, it has long been held by federal courts that Puerto Rico is subject to the legislative authority of the United States Congress.[5] The power of Congress to legislate regarding Puerto Rico would appear to arise from a number of legal bases: 1) the congressional authority under Article IV of the Constitution to legislate regarding territories;[6] 2) constitutional authorities under Article I of the Constitution, such as the power to regulate commerce;[7] and 3) the inherent power which the United States possesses incident to its sovereignty over Puerto Rico.[8]

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5) He must not be otherwise legally disqualified from voting.

See 16 L.P.R.A. §3053 (1984).

There may be an exception to Puerto Rico's requirement of establishing domicile to acquire voting rights. Federal law requires that territories and states allow overseas United States citizens to vote for federal officials in the various territories and states. 42 U.S.C. §1973ff-1 (1989). This would appear to apply whether or not these overseas citizens are officially domiciled in that state. *See supra* note 12.

2 16 L.P.R.A. §3238 (1984).

3 *See supra* note 1.

4 A. Leibowitz, *Defining Status: A Comprehensive Analysis of United States Territorial Relations* 127 (1989). The United States Constitution, under Article IV of the Constitution, only sets forth two categories of political entities which make up the United States - "territories" and "states". Although some argue that a commonwealth status confers more political autonomy than that which is conferred upon a territory, it is not clear that the Supreme Court or the federal circuit courts have found this enhanced relationship to represent a limit to the United States' authority over Puerto Rico. *Id.* at 47-49.

5 *See*, e.g., Downes v. Bidwell, 182 U.S. 244 (1901); A. Leibowitz, *supra* note 4, at 21.

6 U.S. Const. Article IV, §3, cl. 2. Congress has dominion, sovereignty, and full legislative authority over the national and local affairs of territories. United States v. Oregon, 295 U.S. 1, 28 (1935). *See* A. Leibowitz, *supra* note 4, at 10.

7 U.S. Const., Art. I, §8, cl. 3. *See* A. Leibowitz, *supra* note 4, at 16.

8 *See* National Bank v. Yankton, 101 U.S. 129, 132-33 (1880); A. Leibowitz, *supra* note 1, at 14.

The above cited powers would appear to establish a sufficient constitutional basis for the Congress to mandate a plebiscite for Puerto Rico to determine what political status is desired by the populace.[9] As an adjunct to this power, it would appear necessary for the Congress to establish voting requirements for such a plebiscite. Although the Congress may not exercise its authority in such a way as would violate other constitutional protections, there would appear to be no constitutional requirement that the Congress set the plebiscite voting qualifications to parallel present Puerto Rican election laws. The question thus arises as to what precisely constitutional limitations there are on how such voting qualifications could be established.

It should be noted that the proposal in question does not appear to contemplate discriminating among citizens of Puerto Rico, which might raise equal protection concerns.[10] In addition, such legislation should not discriminate against a suspect class, such as, for instance, a law which restricted voting to only persons living on the mainland, as opposed to overseas U.S. citizens.[11] The legislation might also need to be drafted so that there would be no Puerto Rican citizens who were ineligible to vote in the plebiscite, while similarly-situated non-residents outside of Puerto Rico would become so eligible.[12] Rather, it is assumed that the proposals would even-handedly extend voting rights in the plebiscite to all individuals who are not citizens of Puerto Rico, but who were born subject to the jurisdiction of Puerto Rico.[13]

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[9] In fact, the United States has previously mandated a plebiscite related to the admission of other territories to statehood. *See supra* note 14.

[10] For example, excessive residency requirements imposed upon individuals which restrict their right to vote have been held unconstitutional as discriminatory against those individuals who are exercising their right to travel. Shapiro v. Thompson, 393 U.S. 618, 629-631 (1969).

[11] For example, legislation setting forth voting rights for the Puerto Rican plebiscite might violate the constitution if it unreasonably discriminated against a suspect class. The Due Process clause of the Fifth Amendment has been interpreted to offer the same protections to victims of federal discrimination as are provided for victims of state discrimination under the Equal Protection Clause of the Fourteenth Amendment. Buckley v. Valeo, 424 U.S. 1, 93 (1976).

[12] For example, such legislation should extend those voter disqualifications which currently apply to Puerto Rican voters, such as mental incompetency, to those former residents or descendants of residents or former residents who are allowed to vote in the plebiscite.

[13] There does not appear to be a substantial argument that such an extension of voting rights would be a violation of the Fourteenth Amendment Equal Protection Clause under the cases disallowing unequally populated voting districts. *See* Baker v. Carr, 369 U.S. 186 (1962). Generally, this line of cases prohibits the maintenance of state voting districts which are so disparate in population that an individual's vote is substantially diluted when compared with the votes of citizens living in other parts of the state. Reynolds v. Simms, 377 U.S. 533, 568 (1964). In the instant case, however, there appears to be no equal protection argument, as no individual voter's vote has any more or less effect than the vote of another.

Congress can differentiate between non-suspect classes of individuals if it has a rational basis to believe that to do so would fulfill a governmental purpose.[14] Extending the plebiscite to individuals who were born in Puerto Rico would appear to fulfill a rational governmental purpose of determining which political status for Puerto Rico is preferred by United States citizens with cultural or political ties to Puerto Rico. Given the above limitations, there does not appear to be any significant constitutional argument which would prohibit Congress from so modifying Puerto Rico's voter qualifications; in fact, Congress has exercised similar power in the context of federal elections.[15]

There do not, however, appear to be directly relevant examples of legislation in which the United States Congress has extended the voting qualifications for a statehood plebiscite beyond the citizens of a territory.[16] There have been plebiscites in certain United States territories in which citizens of the territory who were living outside of the territory were allowed to vote in the plebiscite.[17] However, the voting requirements established for

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[14] *See* Delaware Tribal Business Committee v. Weeks, 430 U.S. 73, 85-86 (1976) (congressional restriction of funds, awarded pursuant to a treaty claim, to specific tribes not a violation of the Due Process Clause of the Fifth Amendment).

[15] A relevant example of Congress' power in this context involves Congress' authority to expand the voting requirements set out by each state and territory for federal elections. The United States Congress has provided overseas citizens voting rights by directing states and territories, including Puerto Rico, to provide such citizens absentee voting rights for federal elections. 42 U.S.C. §1973ff-1 (1989). Although these overseas citizens may not have all the indicia which a state generally requires for an absentee ballot, such as domicile in the state, the federal legislation compels states and territories to accept their votes. *Id.* Arguably, if Congress can expand the voting qualifications in all states and territories for the election of federal officials to include non-domiciled individuals, then it has the power to expand the voting qualifications for a single plebiscite concerning a territory's federal status to accept non-domiciled citizens.

[16] There appear to have been three federally-mandated plebiscite in the United States territories addressing the question of statehood. The voting qualifications appear to have been restricted to those voters who were qualified to vote under the laws of the respective territories. *See* An Act to enable the people of Oklahoma and of the Indian Territory to form a constitution and State government and be admitted into the Union on an equal footing with the original States; and to enable the people of New Mexico and of Arizona to form a constitution and State government and be admitted into the Union on an equal footing with the original States, ch. 3335, 34 Stat. 278 (1906); An Act to provide for the admission of the State of Hawaii, 73 Stat. 4, 7 (1959); An Act to provide for the admission of the State of Alaska , 72 Stat. 339, 343 (1958).

[17] *See* A. Ranny, H. Penniman, *Democracy in the Islands: The Micronesian Plebiscites of 1983*, 23-50 (1985)(Palau plebiscite extended to all citizens); *Id.* at 68 (Federated States of Micronesia plebiscite extended to all citizens). One such plebiscite, which took place in the Republic of Palau, involved, among other things, whether or not Palau would enter into a Compact of Free Association with the United States. This plebiscite, however, would not appear to be a direct analogy to the proposals being made regarding Puerto Rico. The citizens of Palau are not United States citizens, and do not lose their Palau citizenship if they are residing elsewhere. *Id.* at 38. In the Palau plebiscite, every citizen who was eighteen years old or older was allowed to vote. *Id.* at 39. Thus, non-domiciled citizens of Palau were allowed to vote in the plebiscite unless they had renounced their citizenship of Palau for some other country, such

these plebiscites were not imposed by federal legislation, but were established by the local territorial legislature.[18] Thus, the constitutional authority of the United States to impose voting requirements and any constitutional limitations on the federal government to do so were not at issue.

Kenneth R. Thomas
Legislative Attorney

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as the United States. *Id.* at 41. Puerto Ricans, however, are United States citizens, and may lose their Puerto Rican citizenship by changing their domicile to a place outside of Puerto Rico. *See supra* note 1. Thus, the Palau example is most similar to the citizens of a nation who are living abroad being able to vote in national elections. The Puerto Rican example, however, would be more akin to having allowed an individual who had once been a citizen of the territory of Arizona to have voted in the plebiscite for Arizona statehood, *see supra* note 14, even though he was no longer a citizen of that territory.

[18] *Id.* at 38

Congressional Research Service
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Washington, D.C. 20540

May 15, 1990

TO: Honorable Ron De Lugo

FROM: Bette A. Alberts
Government Division

SUBJECT: Puerto Rico Culture

This memorandum is in response to your question on the culture of Puerto Rico (see enclosed copy of your letter of March 15, 1990). The other questions you posed about Puerto Rico in your letter were assigned to the Congressional Research Service's Economic's Division. Answers to all these questions were sent under separate cover. Specifically, you requested information about: 1) how many Puerto Ricans know and use English; 2) what, if any, problems exist in the teaching of English in Puerto Rico; and 3) what has the U.S. policy to date been, if any, regarding the "Americanization" of Puerto Rico?

Facility of English Use in Puerto Rico

According to the U.S. Census as of 1980, about 42 percent of the population has some English proficiency. Specifically, out of 2,805,444 persons, 541,160 (19%) could speak English easily, 643,873 (23%) could speak English with difficulty and 1,620,411 (58%) were unable to speak English. Slightly less than half of those unable to speak English were 25 years of age and over (802,515).[1]

[1] U.S. Bureau of the Census. *1980 Census of Population*. General Social and Economic Characteristics: Puerto Rico. Place of Birth, Citizenship, Immigration, Ability to Speak Spanish and English, and Literacy. PC80-1-C53A Puerto Rico. Washington, Government Printing Office., [1984]. p. 24.

Problems in Teaching English in Puerto Rico

Question two concerned the problems, if any, that exist in the teaching of English in Puerto Rico. In order put this question into perspective, it is important to know understand how present language policies evolved in Puerto Rico.

Since 1900 there has been no consistent practice with respect to the language of instruction in Puerto Rico schools. In 1900, Spanish was the language of instruction at the elementary level, while English was the language at the secondary level. In 1905, English became the medium of instruction in all grades. In 1916, the policy changed again with Spanish being taught in the lower grades and English from the sixth grade through high school. In 1934 the language of instruction continued to be Spanish at the elementary level with English at the high school level, but time devoted to English in school doubled to 90 minutes in grades seven and eight. President Franklin D. Roosevelt stated in 1937 that Puerto Rico should become bilingual and, in 1942, the policy changed to further emphasize bilingual instruction.[2] Roosevelt directed his Education Commissioner "to make Puerto Ricans good North American citizens". This involved intensifying English language courses in Puerto Rico public schools in the middle 1940s.[3]

Emphasizing English, even in a bilingual context, however, still caused considerable controversy. Since 1948, Spanish has been the language of instruction of public schools with English taught at all levels beginning with the first grade.[4]

English fluency "as the native tongue has long been associated with the opportunity for social and economic advancement," so that contemporary American society prizes monolingualism, rather than bilingualism, or

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[2] United States General Accounting Office. *Puerto Rico's Political Future: A Divisive Issue With Many Dimensions*. Washington, D.C. March 2, 1981. GGD-81-48. p. 89-90.

[3] Maldonado-Denis, Manuel. *Puerto Rico: a Socio-Historic Interpretation*. Vintage Books, Random House, New York, 1972. p. 133-34.

[4] United States General Accounting Office. *Puerto Rico's Political Future: A Divisive Issue With Many Dimensions*. p. 90. See also: United States General Accounting Office. *Puerto Rico: Information for Status Deliberations*. GAO-HRD-90-70BR. Washington, D.C., March 1990. p. 25-26.

multilingualism.[5] A goal of the United States educational system has been to stress "native language loyalty" to promote assimilation into American society. Education also involves transmitting the "culture of a society".[6]

More recently, the Federal Government has come to realize that English remains and will be a peripheral language in Puerto Rican schools. In 1959, Congress made English a foreign language in Puerto Rico, thereby increasing availability for English language instruction under the National Defence Education Act.[7]

The emphasis of educating children in two languages has taken on increased importance since the end of World War II due to the migration of so many Puerto Ricans, and their families, to the mainland and back to Puerto Rico. At the beginning of the 1980's it was estimated that one out of three Puerto Ricans lived on the U.S. mainland.[8] Current population estimates indicate that the ratio of mainland to island Puerto Ricans is 2-5. Because of the migratory cycle between the mainland and the island, some observers of Puerto Rico contend that the language policies for Puerto Ricans both on the mainland and the island bear re-examination, i.e., the need for bilingual proficiency is greater because of this cycle.[9]

In 1986, the Puerto Rican Secretary of Education testified as to the importance of English as " a vehicle of cultural and economic interchange" in Puerto Rico. He also indicated there was a shortage of qualified English teachers on the island; and that a sizable percentage of them had not been board certified.[10]

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[5] Cafferty, Pastora San Juan and Rivera-Martinez, Carmen. *The Politics of Language: The Dilemma of Bilingual Education for Puerto Ricans*. Westview Press, Boulder, Colorado, 1981. p. 4.

[6] *Ibid.*, p. 9.

[7] Epstein, Erwin H. *Politics and Language in Puerto Rico*. Scarecrow Press, Metuchen, New Jersey, 1970. p. 145.

[8] Cafferty, p. 47.

[9] *Ibid.*

[10] U.S. Congress. House. Committee on Interior and Insular Affairs. *Hearings on the Puerto Rican Economy*. May 20, 1986. 99th Congress, 2nd session. Statement of the Secretary of Education Regarding the Teaching of English as a Second Language in Puerto Rico.

Americanization of Puerto Rico

Question three asked about U.S. policy, if any, toward the "Americanization" of Puerto Rico. Your staff defined this term primarily in terms of policy on usage of English, which has already been addressed in the previous sections. Beyond efforts to encourage the teaching of English in Puerto Rican schools we are aware of no Federal Government policies that could be interpreted as constituting an official "Americanization" policy.

If you have any questions, I can be reached at 707-5351.

BAA/rla

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Memorandum May 31, 1990

TO : House Committee on Interior and Insular Affairs
Attention: Virginia Sablan

FROM : David L. Brumbaugh
Analyst in Public Finance
Economics Division

SUBJECT : Impact of Puerto Rican Statehood on Puerto Rican Financial Instruments

This memorandum responds to your request for an analysis of the impact Puerto Rican statehood might have on public- and private-sector financial instruments issued in Puerto Rico. As noted in our previous conversations, however, we do not have sufficient information to go beyond this analysis and assess the potential impact of statehood on Puerto Rico's construction industry.

Puerto Rico's current status as a commonwealth carries with it a number of factors that bear on borrowing and lending in Puerto Rico. Chief among these are the Federal income tax exemption that is accorded income from investment in Puerto Rico and the exemption of Puerto Rican residents from Federal individual income taxes. Under statehood, these exemptions would ultimately end, which could have the following effects on Puerto Rican financial instruments. First, the applicability of Federal taxes to Puerto Rico may reduce the ability of the Puerto Rican government to raise its own revenue. As a consequence of its reduced revenue-raising capacity, the borrowing costs of the Puerto Rican government could accordingly increase unless the government takes counter-measures (such as reducing its level of borrowing) to offset upwards pressure on borrowing costs. Second, according to some analyses, the repeal of section 936 would slow economic growth in Puerto Rico. This would generally increase the riskiness of lending to Puerto Rican borrowers (both public and private), which would drive up interest costs.

We should point out, however, that this analysis is fraught with uncertainty, and some have disputed whether the developments that would drive up borrowing costs would actually occur. For example, supporters of statehood for Puerto Rico have argued that statehood would benefit rather than harm Puerto Rico's economy. If this is true, the costs faced by at

least some private-sector borrowers in Puerto Rico could fall under statehood.

Congress is currently considering legislation that would put before the residents of Puerto Rico a referendum to decide among three options for Puerto Rico's future political status: statehood, continued commonwealth status, or independence. A bill (S. 712) providing for the referendum has been reported by the Senate Committee on Energy and Natural Resources. The analysis here uses the statehood provisions outlined in S. 712 to assess the possible impact of statehood.

The Possessions Tax Credit and Borrowing Costs

The possessions tax credit (or section 936 as it is sometimes called, after the relevant section of the U.S. Internal Revenue Code) grants U.S. corporations a tax exemption for income from active business operations in Puerto Rico and the possessions. While income from investment in financial instruments issued in Puerto Rico does not receive the same blanket exemption that benefits business income, certain types of income from financial investment -- called qualified possessions source investment income, or QPSII -- is tax exempt like business income. Specifically, income from financial investment is exempt under section 936 as long as the investment is undertaken in Puerto Rico itself and the underlying investment funds were derived from the active conduct of a business in Puerto Rico. At the same time, however, at least 85 percent of a corporation's income must be from the active conduct of a business in the possessions, or it will fail to qualify for the possessions tax credit altogether.

S. 712 would phase out the possessions tax credit over a four-year period beginning in 1994 (roughly two years after statehood's implementation in October 1991). The end of section 936 could have an indirect effect on borrowing costs in Puerto Rico through its impact on the Puerto Rican economy in general. According to a recent study by the U.S. Congressional Budget Office (CBO), the removal of the tax benefit for investment in Puerto Rico would reduce the aftertax return available from Puerto Rican business investment. Accordingly, some firms would reduce their investment in Puerto Rico from levels they would otherwise undertake. Puerto Rico's economic growth would slow according to CBO's analysis; CBO estimates that by the year 2000 Puerto Rico's real Gross Product would be from 10 to 15 percent lower under statehood than under current law.[1]

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[1]U.S. Congressional Budget Office. *Potential Economic Impacts of Changes in Puerto Rico's Status under S. 712.* Washington, 1990. p. 21.

Slower economic growth in Puerto Rico would probably lead to higher borrowing costs for at least some Puerto Rican borrowers -- specifically, those whose own economic health is dependent on economic conditions within Puerto Rico. For example, the profitability of a firm whose product is sold primarily within Puerto Rico might well be adversely affected by slower Puerto Rican economic growth. Consequently, the firm might be evaluated as a poorer credit risk under statehood. Lenders would accordingly charge the firm a higher interest rate and the firm's borrowing costs might therefore increase.[2]

At the same time, however, some borrowers in Puerto Rico might be relatively insulated from disturbances in Puerto Rico's economy. Indeed, a firm that exports to the mainland United States might actually benefit from slower economic growth in Puerto Rico. For example, in the face of reduced demand for labor, the firm's wage bill might fall. The borrowing costs of such insulated firms would probably not be greatly affected by repeal of the possessions tax credit.

A more direct potential impact of statehood would be from loss of the section 936 tax exemption for QPSII, although at least one recent analysis suggests the impact would be small. With current law's tax exemption, investments that generate QPSII provide their owners with a higher aftertax return than they would otherwise earn. Accordingly, under certain market conditions, investors are willing to accept a lower before-tax interest rate on investments that generate QPSII. To the extent that financial intermediaries in Puerto Rico pass on this lower interest rate to borrowers, it might reduce borrowing costs in Puerto Rico. And to the extent the demand for investment funds in Puerto Rico is responsive to reductions in borrowing costs, investment is increased.

But if the demand for investment funds in Puerto Rico is relatively unresponsive to changes in borrowing costs, reduced interest costs may lead to little increase in investment in Puerto Rico, and, by implication, the impact of statehood's removal of the QPSII exemption would likewise be small. Indeed, a recent analysis by the U.S. Treasury Department found little relation between the QPSII provisions and the level of investment in Puerto Rico. The Treasury analysis sought to gauge the magnitude of the impact of QPSII by looking at net inflows of capital to Puerto and the level of real investment in Puerto Rico. The Treasury study found little relation between capital inflows and real investment on the one hand and QPSII on

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[2]Note that this analysis assumes that Puerto Rican borrowers must compete for funds with borrowers outside of Puerto Rico. Thus, it is assumed that a reduction of demand for funds within Puerto Rico (a reduction that would be brought about by a slower Puerto Rican economy) would not reduce the interest rate lenders charge at each level of risk. This is a reasonable assumption given Puerto Rico's open economy.

the other, suggesting that the QPSII provisions do not have a strong impact on investment in Puerto Rico.[3]

In contrast to this analysis, supporters of the possessions tax credit have argued that the presence of QPSII investment in Puerto Rico does stimulate investment in Puerto Rico. In support of this conclusion, a study prepared for the Puerto Rico U.S.A. Foundation by Nathan Associates states that interest rates on QPSII funds are between 65 percent and 85 percent of interest rates on Eurodollar deposits. The study also found that the relatively low interest rate paid on QPSII investments was at least partly passed on to borrowers in the form of lower borrowing costs.[4] But even if the Nathan study's data on interest rates is accurate, it does not necessarily mean that QPSII funds have increased investment in Puerto Rico. Again, the magnitude of the impact on investment depends on the

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[3]The Treasury analysis of QPSII is contained in its most recent report on the possession tax credit. See: U.S. Department of the Treasury. *The Operation and Effect of the Possessions Corporation System of Taxation: Sixth Report*. Washington, U.S. Govt. Print. Off. 1989. p. 73-85.

Some of the forces at work behind the findings contained in Treasury's analysis can be seen if the exemption for QPSII funds is modelled as an import subsidy provided by the Federal Government. The subsidy increases the aftertax return mainland firms can obtain by providing imported capital to Puerto Rican investors. In terms of economic jargon, the supply of capital imports shifts downwards. As a consequence, the quantity of capital imported into Puerto Rico increases, but interest rates that Puerto Rican investors are willing to pay also falls. As a consequence of the decline in interest rates they can obtain in Puerto Rico, Puerto Rican savers export a part of their savings to financial markets outside of Puerto Rico -- an outflow which at least partly offsets the increase in imported capital. The extent to which investment increases (i.e., the extent to which increased capital imports outweigh increased capital exports) depends on the responsiveness of Puerto Rican borrowers to the decline in interest rates.

When modeled this way, Puerto Rico generally gains from the subsidy, although there are some losers. Those who gain include borrowers who benefit from reduced interest costs and -- to the extent that the subsidy is not passed on to borrowers -- financial intermediaries that use QPSII provisions of section 936. Puerto Rican savers with sufficient financial expertise to shift funds out of Puerto Rico do not lose from the measure. However, those Puerto Rican savers who are not able to invest in mainland financial markets lose because their savings generate reduced interest payments. Losers outside of Puerto Rico include the United States Treasury, which incurs a loss in tax revenue.

[4]Robert A. Nathan Associates, Inc. *Section 936 and Economic Development in Puerto Rico*. Prepared for the Puerto Rico, U.S.A. Foundation. 1987. p. 44-52.

responsiveness of Puerto Rico's demand for investment to changes in the interest rate.

Statehood and Borrowing Costs Faced by Puerto Rico's Government

The borrowing costs of Puerto Rico's government might register some of the impact of statehood's repeal of section 936. First, the government of Puerto Rico has issued regulations designed to ensure that QPSII funds are invested within Puerto Rico itself; among the requirements set forth is one that requires banks that accept QPSII deposits to invest a certain portion of their available funds in two types of obligations issued by the Puerto Rican government: obligations that are not exempt from Federal income taxes or obligations issued by Puerto Rico's Government Development Bank.[5] This requirement probably increases the demand for these particular types of Puerto Rican government bonds and hence probably also reduces the government's borrowing costs. Statehood's repeal of section 936 may thus increase the costs of this type of borrowing by the Puerto Rican government. However, since regulations require only a fraction of bank assets need be invested in government obligations, and since the range of obligations that would be affected is limited, the magnitude of this effect is open to question.

Repeal of section 936 may also affect the borrowing costs of the Puerto Rican government through its general impact on Puerto Rico's economy. According to numerous sources, general economic conditions within a borrowing jurisdiction are an important criterion for agencies that rate the creditworthiness of State and local bonds.[6] Thus, to the extent that repeal of section 936 reduces economic growth in Puerto Rico, it may increase the perceived riskiness of Puerto Rican government obligations and increase borrowing costs for the Puerto Rican government.

Beyond the consequences of the possession tax credit's repeal, statehood's changes in taxes might affect Puerto Rico's borrowing costs in a number of other ways. For example, unlike the obligations of State and

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[5]Specifically, 15 percent of the bank assets (loans) supported by QPSII-generating deposits must consist of the two types of government obligations in question. For a more detailed description of Puerto Rico's regulations on QPSII deposits, see: U.S. Department of the Treasury. *Operation and Effect of the Possessions Corporation System of Taxation: Sixth Report*. p. 73-85.

[6]See, for example: Lamb, Robert, and Stephen P. Rappaport. *Municipal Bonds: the Comprehensive Review of Tax-Exempt Securities and Public Finance*. New York, McGraw-Hill. 1980. p. 58-60; and Feldstein, Sylvan G. and Frank J. Fabrozzi. *The Dow Jones-Irwin Guide to Municipal Bonds*. Homewood Ill., Dow Jones-Irwin. 1987. p. 250.

local governments, bonds issued by the government of Puerto Rico are exempt under Federal law from income taxes levied by the fifty States.[7] While S. 712's statehood provisions do not explicitly end this exemption, some have argued that under statehood, provisions that would accord Puerto Rico special tax treatment would violate the Uniformity clause of the U.S. Constitution. If this is indeed the case, or if the exemption from State taxes is subsequently repealed, Puerto Rico might have to pay a higher interest rate on its bonds in order to attract investors.

A larger increase in borrowing costs might occur if the Puerto Rican government finds its ability to raise revenue constrained under statehood. Under current law, residents of Puerto Rico are exempt from Federal individual income taxes. In addition, neither Federal corporate income taxes nor Federal excise taxes apply in Puerto Rico. At the same time, however, the level of Puerto Rico's own taxes exceeds the level that is imposed by the U.S. States. Under statehood, however, Puerto Rico's Federal tax exemptions would ultimately come to an end and in order to avoid a relatively high combined State and Federal tax burden on its residents, the State government of Puerto Rico may be forced to reduce its own level of taxation.

Along with general economic conditions, a State's ability to raise tax revenue is an important factor in evaluating the creditworthiness of a borrowing State. Puerto Rico's reduced ability to raise tax revenue under statehood may thus increase the risk premium associated with Puerto Rican obligations and -- at each level of borrowing -- may drive up the borrowing costs of the Puerto Rican government. It might also be pointed out, however, that creditworthiness is also heavily dependent on the level of debt an issuing government carries. Puerto Rico might thus be able to avoid higher borrowing costs by reducing its borrowing.

We should note, finally, that a large portion of the government of Puerto Rico's borrowing is done by Puerto Rico's government-owned public corporations, such as the Puerto Rico Electric Power Authority and the Puerto Rico Telephone Authority. The bonds issued by these agencies are generally revenue bonds: bonds supported by the revenues of the corporations in question rather than tax and other revenues of the Commonwealth government. Thus, the portion of Puerto Rico's borrowing that is conducted by these agencies would probably not be greatly affected by the decline in Puerto Rico's tax revenues.

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[7]The exemption is provided by title 48 of the U.S. Code, section 745. Like State and local bonds, obligations of the Puerto Rican government are exempt from Federal taxes under current law.

Conclusions

The analysis here provides a glimpse of two of the most important economic issues related to Puerto Rico's possible statehood. One issue is statehood's ultimate repeal of the possessions tax credit. The possible economic effect of that repeal on Puerto Rico's economy has become one of the most hotly debated topics related to Puerto Rico's status. Would the end of section 936 slow Puerto Rico's economic growth dramatically, as statehood's opponents contend? Or would any adverse impact be outweighed by the increased tourism and investor confidence that statehood's supporters maintain would also occur under statehood?[8] It is important to note that part of the adverse effect of statehood on borrowing costs identified in the foregoing analysis is contingent on the repeal of section 936 significantly slowing Puerto Rico's economic growth -- an outcome that is less than certain.

The second broad issued that is touched by the analysis here is that of statehood's potential impact on the role of Puerto Rico's government. As described in the foregoing analysis, if statehood reduces the ability of the Puerto Rican government to raise its own tax revenue, Puerto Rico may opt to scale back its borrowing in order to avoid higher borrowing costs. And as a consequence of its reduced ability to raise its own funds -- either through borrowing or by other means -- the government of Puerto Rico may be forced to scale back its expenditures and reduce its size.

Under statehood, however, Federal transfers to Puerto Rico would increase, chiefly in form of increased outlays under food stamps, Medicaid, Supplemental Security Income, and Medicare.[9] Thus, even if the government of Puerto Rico does shrink under statehood, the role of government in the abstract may well increase under statehood, at least in terms of combined Federal and State outlays. At the same time, however, the precise form that government spending takes and the types of programs on which government funds are spent may change. This is because the portion of total government spending controlled by the government of Puerto Rico may well shrink, while the fraction controlled by the Federal Government may expand.

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[8]For additional information on the debate surrounding section 936 and statehood, see: U.S. Library of Congress. Congressional Research Service. *Puerto Rico's Status Options and Federal Taxes*. Issue Brief No. IB90086, by David L. Brumbaugh. Washington, 1990. 11 p. A copy of this issue brief is attached, for your perusal.

[9]U.S. Congressional Budget Office. *Potential Economic Impacts of Changes in Puerto Rico's Status under S. 712*. p. 14.

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CRS Issue Brief

Puerto Rico's Status Options and Federal Taxes

Updated August 14, 1990

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Congressional Research Service • The Library of Congress

CONTENTS

Puerto Rico's Status Options and Federal Taxes

SUMMARY

Federal taxation of income earned in the Commonwealth of Puerto Rico is currently different from taxation of income earned in the 50 States. Year-round residents of Puerto Rico are subject to Puerto Rico's individual income tax rather than the Federal income tax. And U.S. firms that invest in Puerto Rico can exempt their Puerto Rican-source business income from Federal taxes by using the possessions tax credit (also known as "section 936") -- a provision of the Federal tax code aimed at stimulating investment in Puerto Rico.

Legislation has been introduced in the 101st Congress under which Puerto Rico would hold a referendum to determine its future relationship with the United States. The status options would be to remain a Commonwealth linked to the United States, to become a U.S. State, or to become an independent country. Under one bill -- H.R. 4765 -- only the general principles embodied by each option are set forth. However, another proposal -- contained in S. 712 and H.R. 3536 -- details the form each status would take. Under the statehood and independence options of this proposal, Federal taxation of Puerto Rico would change substantially. The possible impact of these tax changes has become a major issue in the debate over Puerto Rico's status.

Under both the statehood and independence options of S. 712 and H.R. 3536, the possessions tax credit would ultimately end, although the credit would be phased out only gradually under statehood. Under statehood, mainland firms investing in Puerto Rico would ultimately be fully taxable. Under independence, mainland firms could use the same Federal tax benefit (called "deferral") currently available for U.S. investment in foreign countries. The deferral benefit, however, is not as generous as the possessions tax credit. A lively part of the debate over taxes centers on the effectiveness of the possessions tax credit in stimulating economic growth in Puerto Rico. Is the continued existence of the credit vital to the economic future of Puerto Rico, as advocates of continued commonwealth status argue? Or does it promote dependence on the mainland United States, and engender distorted, unbalanced growth, as its critics maintain?

Under statehood, Federal individual income taxes would apply to residents of Puerto Rico for the first time. The impact of this change on total tax burdens in Puerto Rico is uncertain and depends on whether Puerto Rico would alter its own individual income tax to accommodate the Federal tax. Opponents of statehood have argued that new Federal taxes would threaten the fiscal flexibility of the Puerto Rican government, forcing either large cutbacks in government employment (if Puerto Rican taxes are reduced) or a high total tax burden in Puerto Rico (if Puerto Rico does not reduce its taxes).

Another important issue is the budgetary impact of a change in Puerto Rico's status. There is general agreement that either statehood or independence would eventually increase Federal tax revenues -- a consequence of the end of the possessions tax credit and the tax exemption for individuals. In the case of the statehood option there is disagreement over whether increased Federal revenues would outweigh the increase in Federal outlays that would result from the treatment of Puerto Rico as a State under Federal entitlement programs.

ISSUE DEFINITION

Under current law, Federal individual income taxes do not apply to residents of Puerto Rico; instead, Puerto Rico levies its own income tax which resembles a national-level tax more closely than a State tax. For corporations, section 936 of the U.S. Internal Revenue Code (the possessions tax credit) exempts U.S. corporations from Federal income taxes on business income earned in Puerto Rico. Puerto Rico's tax status, however, may soon change. Congress is currently considering legislation that provides for Puerto Rico to conduct a referendum on whether to become a State, an independent nation, or to continue its Commonwealth status. Taxes are an important issue in consideration of the measure, since Puerto Rico's current tax status is contingent on its status as a Commonwealth rather than a State or independent nation. This brief considers the impact changes in Puerto Rico's tax status would have on Puerto Rico.

BACKGROUND AND ANALYSIS

Normally, the United States taxes the worldwide income of individuals who are U.S. citizens. While individuals born in Puerto Rico are U.S. citizens, Puerto Ricans have largely been exempt from Federal individual income taxes since 1919. Section 933 of the U.S. Internal Revenue Code provides that year-round residents of Puerto Rico are exempt from Federal income taxes on income earned from sources within Puerto Rico. While this leaves income earned by Puerto Ricans within the United States or in foreign countries subject to Federal taxes, it is clear that the bulk of their income is exempt from the Federal individual income tax.

While Puerto Ricans are exempt from Federal taxes, the level of Puerto Rico's own income tax is more akin to a national-level tax than a State income tax -- at least in terms of its statutory rates. Puerto Rico's statutory tax rates are generally higher than Federal tax rates, and Puerto Rico's standard deduction and individual exemption amounts are lower than those permitted by the Federal Government. In a very general sense, then, the effect of Federal and Puerto Rican tax laws is to substitute Puerto Rico's own income tax for the Federal income tax in the case of residents of Puerto Rico.

We should also note, however, that according to some measures, the aggregate burden of Puerto Rico's individual income tax is lower than that of the Federal tax. For Puerto Rico's fiscal year 1987, for example, collections from Puerto Rico's individual income tax amounted to only 5.5% of personal income and 5.2% of Puerto Rico's gross product. For the same period, Federal income taxes claimed 10.4% of U.S. personal income and constituted 8.7% of the U.S. gross national product. A principal reason for the apparent paradox of Puerto Rico's high rates and low aggregate burden is Puerto Rico's low level of income compared with the mainland United States. Another possible explanation is differences in tax administration and compliance.

Current Law: The Possessions Tax Credit

Just as important as individual taxes is the special Federal corporate tax provision that applies to Puerto Rico, the possessions tax credit (also known as "section 936," after the relevant section of the tax code). Under its provisions, U.S. corporations are permitted a credit against Federal income taxes generally equal to their Federal tax liability on income from business operations in a possession. Thus, while the tax benefit is in the form of a credit, it has the same effect as a tax exemption for business income earned in the possessions. In addition, the section 936 exemption extends beyond active business income to certain kinds of income from passive investment. Income from financial investment is tax-exempt as long as the investment is undertaken in Puerto Rico and is generated by investment of funds derived from business operations in the possessions. Also, the total amount of passive investment income a corporation can earn and still qualify for the possessions tax credit is limited to 25% of total income. The government of Puerto Rico has instituted regulations designed to ensure that eligible passive investment is actually used to fund investments within Puerto Rico.

The tax exemption for possessions-source income originated in 1921 as a measure designed to make U.S. firms operating in the possessions more competitive with foreign firms. Initially, the primary concern of Congress was the Philippines, then a U.S. possession. In the years immediately following World War II, however, the government of Puerto Rico devised a development strategy ("Operation Bootstrap") that relied heavily on the Federal tax exemption. Puerto Rico's plan was to use imported investment (chiefly from the mainland United States) as an engine of economic growth. Together with Puerto Rico's own tax benefits, relatively low labor costs, and its location within U.S. tariff barriers, the Federal tax exemption was used as one of the primary means of attracting U.S. investment to Puerto Rico. For its part, Congress has subsequently linked section 936 with Puerto Rico explicitly, making the provision of a tax incentive for investment in the possessions the stated purpose of the possessions tax credit.

The tax advantage the possessions tax credit establishes over mainland investment is clear. Its tax exemption provides a significant benefit compared to investment in the 50 States -- investment which is generally subject to the Federal corporate income tax. But section 936 also provides favorable Federal tax treatment compared to investment in foreign countries. The U.S. tax system provides a tax incentive to invest in low-tax foreign countries in the form of the so-called "deferral principle." Under deferral, corporations chartered in foreign countries are generally not subject to U.S. taxes. Thus, U.S. firms can indefinitely defer U.S. taxes on foreign income by conducting their foreign operations through subsidiary corporations chartered abroad: as long as the foreign-source income is reinvested abroad, it escapes U.S. taxation. The deferral tax benefit, however, is only temporary; foreign-source income is ultimately subject to U.S. taxes when it is repatriated to the United States. In contrast, section 936 provides a permanent tax exemption; income from Puerto Rican business operations is not subject to Federal taxes even when it is repatriated to the mainland.

Under current law, corporations chartered in Puerto Rico are considered foreign corporations for Federal tax purposes. The deferral tax benefit as well as the

possessions tax credit is therefore available for investment in Puerto Rico. However, the two benefits cannot be used simultaneously, and despite the availability of deferral, most mainland firms investing in Puerto Rico utilize the possessions tax credit.

The cost of the possessions tax credit in terms of foregone tax collections has been estimated at $1.9 billion for FY1989.

Current Law: Federal Excise Taxes

Federal excise taxes generally do not apply to items produced in Puerto Rico unless they are shipped to the mainland United States. While Puerto Rican goods shipped to the mainland are subject to the same Federal excise taxes as mainland goods, the revenues from taxes on Puerto Rican items are rebated or "covered over" from the U.S. Treasury to the Treasury of Puerto Rico.

A special set of rules applies to rum and distilled spirits. First, excise taxes on distilled spirits are not covered over to Puerto Rico except for taxes on rum. Second, while the Federal excise tax on rum is currently $12.50 per proof-gallon, only $10.50 per proof-gallon is covered over to Puerto Rico. Finally, excise taxes on any rum imported to the United States is covered-over, regardless of the country of origin. The revenue from foreign rum, however, is shared between Puerto Rico and the U.S. Virgin Islands.

In FY1989, excise tax cover-overs to Puerto Rico amounted to $272 million.

Federal Taxes under Statehood

As noted above, one referendum proposal (H.R. 4765) specifies only the general principles embodied by each status option. However, S. 712, a bill reported by the Senate Committee on Energy and Natural Resources provides a detailed description of each status option, including the form of Federal taxes. (H.R. 3536 is a nearly identical bill introduced in the House.) S. 712 provides for a referendum to be held on June 4, 1991. Implementation of the option selected by the voters would begin Oct. 1, 1991.

Under S. 712's statehood option, the Federal individual and corporate income taxes would ultimately apply to Puerto Rico in full; section 933's exemption for individuals and section 936's corporate exemption would eventually cease to apply. As a transitional measure, however, neither individual nor corporate taxes would apply until Jan. 1, 1994. At that time, individuals residing in Puerto Rico would become fully subject to Federal income taxes.

Section 936, however, would be phased out gradually over 4 years. The corporate tax exemption would be reduced to 80% for 1994, 60% for 1995, 40% for 1996, 20% for 1997, and would not apply thereafter.

Federal excise taxes would apply immediately upon Puerto Rico's admission as a State. However, the current cover-over of excise tax revenues would continue,

along with the cover-over of excise taxes newly extended to Puerto Rico. The bill sets no ending date for the cover-over of revenues, and explicitly provides that no legislation will terminate the cover-over until after Oct. 1, 1998.

As a "transitional statehood grant," all revenue produced by the application of Federal income taxes to Puerto Rico would likewise be covered-over to the government of Puerto Rico. The rebate of income taxes, however, would apply to 1994 and 1995 only.

Federal Taxes Under Independence

Under S. 712's independence option, Puerto Rico would be treated as a foreign country for Federal tax purposes immediately upon the island's independence. For corporations, the bill would repeal the section 936 tax benefit immediately; no transitional phaseout would apply. At the same time, however, the deferral principle's tax benefit would continue to be available as it is in foreign countries and as it is in Puerto Rico now under current law.

The treatment of individuals is more ambiguous. While the United States normally does not tax residents of foreign countries on any but U.S.-source income, residents of Puerto Rico may well be subject to U.S. individual income taxes after independence. The reason is citizenship: the United States asserts the jurisdiction to tax its citizens on their worldwide income, and under S. 712 residents of Puerto Rico who are currently U.S. citizens (as most are) would retain their citizenship. Since S. 712 would apparently also repeal section 933's tax exemption for Puerto Rico, some residents of Puerto Rico may be subject to Federal taxes under independence.

Several provisions of the Internal Revenue Code might mitigate the application of individual income taxes to Puerto Rico. One is the foreign earned income exclusion, under which U.S. citizens working abroad can exclude up to $70,000 from Federal taxes. To claim the exclusion, however, an individual must file a tax return. Another possible mitigating factor is the U.S. foreign tax credit, under which foreign (in this case, Puerto Rican) taxes can be credited against U.S. taxes. Again, however, a return must be filed. Thus, under independence many Puerto Ricans who do not now file Federal tax returns may be required to do so (assuming they retain their U.S. citizenship).

Under independence, U.S. Federal excise taxes would continue to apply to Puerto Rican goods shipped to the United States and goods sold in an independent Puerto Rico would, of course, be exempt. In contrast to the statehood option the cover over of excise taxes to Puerto Rico would end.

Federal Taxes under the Commonwealth Option

Under the option of S. 712 that would continue Puerto Rico's Commonwealth status, the basic individual, corporate, and excise tax arrangements that currently exist would continue.

There are, however, some differences. For example, S. 712's commonwealth option would give Puerto Rico the right to negotiate its own international agreements as authorized by the President of the United States and consistent with the laws and international obligations of the United States. It has been suggested that this provision may allow Puerto Rico to negotiate its own tax treaties with foreign countries. In particular, Puerto Rico may be able to reach so-called "tax sparing" agreements under which foreign countries would not tax the Puerto Rican-source earnings of their firms in a way that would negate tax incentives provided by Puerto Rico or the United States. The effect of such tax-sparing agreements would, in some cases, be to provide the equivalent of the possessions tax credit to foreign-owned firms as well as U.S. firms.

The U.S. Treasury Department opposes providing Puerto Rico with the ability to negotiate independent tax treaties, arguing that it would "significantly complicate the negotiations of United States and quite possibly undermine several existing conventions."

The Possessions Tax Credit Issue

A crucial tax issue related to Puerto Rico's status is the possessions tax credit. As described above, the credit's tax exemption would ultimately be replaced under statehood by full corporate taxation. Under independence, firms could use the deferral principle -- a less powerful tax incentive. The impact of these possible changes on Puerto Rico's economy has been the focus of a lively debate.

Given its importance, a brief bit of background information on the role of the tax credit in Puerto Rico's economy is useful. The credit's most basic and general effect is beyond dispute: it increases the aftertax return to investment in Puerto Rico compared with other locations and thus poses an incentive for mainland firms to establish operations in Puerto Rico. What is open to debate is exactly how powerful an investment incentive section 936 is, and thus the extent to which firms would scale back their Puerto Rican operations if the possessions credit were to be repealed.

Most analyses agree that the possessions tax credit played a large role in the transformation of Puerto Rico's economy during the 1950s and 1960s from one based largely on agriculture to an economy with a substantial manufacturing sector. The transformation was characterized by large inflows of capital from the mainland United States and by prodigious economic growth. Since the early 1970s, however, Puerto Rican economic growth has been more sporadic. Also, the composition of Puerto Rico's industry has shifted from the labor-intensive operations that characterized the early post war period to more capital-intensive, high-technology firms. At the same time, unemployment reported in Puerto Rico has remained high by mainland standards throughout the post war era, leading some to question the effectiveness of section 936 as an employment-generating measure.

Advocates of continued Commonwealth status for Puerto Rico argue that section 936 tax benefit is still the foundation of Puerto Rico's economy. They argue that

when both the direct and indirect effects of section 936 are counted, the possessions tax credit accounts for about one-half of Puerto Rico's private sector employment. If section 936 were to be repealed, it is argued that a substantial portion of the mainland firms operating in Puerto Rico would relocate to either the mainland United States or to foreign countries, resulting in a massive increase in unemployment in Puerto Rico.

Criticisms of the possessions tax credit by statehood and independence advocates focus on Puerto Rico's persistently high unemployment rate and a per capita income level that remains radically lower than that of the poorest U.S. States. For example, some have argued that the credit's investment incentive is strongest for capital-intensive firms whose employment-generating capacity is limited. As long as section 936 exists, these critics say, it will distort Puerto Rico's economy, preventing a more balanced type of growth that would generate more employment.

Statehood advocates argue that, as a State, Puerto Rico would provide a more stable and certain investment climate than exists under Commonwealth status. They point to the economic growth that occurred in Hawaii after statehood as a promise of what would occur in Puerto Rico. Independence advocates point out that the deferral tax benefit (described above) would continue to be available after independence; they argue that deferral would permit Puerto Rico to offer investment incentives comparable in magnitude to the current possessions tax credit. At the same time, they argue that Puerto Rico would be more free to diversify its capital and export markets.

Recent independent analyses of section 936 are few. The U.S. Treasury Department has issued a series of statutorily mandated reports on the operation and effect of the possessions tax credit. The Treasury analyses have tended to focus on the cost-effectiveness of section 936, with cost measured in terms of foregone tax collections by the U.S. Treasury, and effectiveness measured in terms of employment. Each report (the most recent appeared in March 1989) has compared the total tax benefits received by possessions corporations (firms using the possessions tax credit) to the compensation paid to persons directly employed by the firms. Each report has concluded that total tax benefits under section 936 exceed compensation paid to employees by possessions corporations.

The Treasury Department concluded that an important reason for section 936's large revenue cost was a particular feature in the design of the tax credit that permitted some firms to use section 936 to shelter mainland-source income from taxes as well as income actually earned in the possessions. The sheltering activity was apparently particularly feasible for firms with large investments in intangible assets such as patents. However, in 1982, and again in 1986, Congress passed new restrictions on the possessions tax credit designed to limit such use of the credit. Indeed, in its latest report on section 936, the Treasury reached a preliminary conclusion that the legislated restrictions may be dampening the revenue cost of the tax credit. Still, the report estimates that in 1983 (the latest year for which the estimate is made) the revenue cost of the possessions tax credit was 125% of employee compensation.

Concern with the cost effectiveness of the possessions tax credit led the Reagan Administration to include a proposal for its modification as part of the

Administration's broad tax reform that proposed in 1985. In its reform proposal, the Treasury Department argued that the impact of the current tax credit on employment is restricted because it stimulates employment only as a byproduct of its investment stimulus. The Treasury Department proposed that the current credit be replaced by a so-called "wage credit" that would provide a direct tax benefit for employment. (The wage credit was not adopted as part of the tax reform program that was ultimately enacted as the Tax Reform Act of 1986.)

The Treasury reports do not directly address the role of section 936 in the context of statehood or independence. The Congressional Budget Office (CBO), however, recently published an assessment of the economic impact of statehood; one of the chief changes considered by CBO was statehood's repeal of section 936. According to the CBO analysis, the economic impact of statehood would be quite large, and one of the chief reasons would be the repeal of the possessions tax credit. By the year 2000, CBO concluded, assets of firms currently using section 936 would decline by 37% to 47%. The decline in investment, in turn, would be instrumental in a decline in real gross national product (GNP) of between 10% and 15% from levels that would occur under Commonwealth status. At the same time, CBO estimated that unemployment would increase by between 4 and 7 percentage points, representing a total of from 50,000 to 100,000 additional unemployed persons.

As large as CBO's estimated effects are, they are not as large as estimates made by studies cited by Commonwealth proponents. For example, a recent study by the KPMG Peat Marwick consulting firm concluded that 80,000-145,000 private sector jobs would be lost under statehood; 31% to 72% of the assets of possessions corporations would leave Puerto Rico.

Statehood proponents, in contrast, have argued that the number of manufacturing jobs in Puerto Rico would not necessarily decline if section 936 were eliminated. In the first place, they argue that even without the possessions tax credit, Puerto Rico would retain labor and other cost advantages over the mainland. Further, they say that Puerto Rican-owned manufacturing firms would replace departing mainland-owned firms.

Statehood proponents have also pointed out that the CBO study does not assess the possibility of statehood having a positive impact on investment from the mainland as a consequence of factors such as increased confidence in Puerto Rico as an investment location. They also note that the CBO results assume that section 936 will remain in effect indefinitely if Puerto Rico remains a Commonwealth, and argue that there is no guarantee that Congress will not repeal or amend the tax benefit in the future even under Commonwealth status.

Individual Income Tax Issues

As noted above, the statutory rates of Puerto Rico's own individual income tax are higher than those of the Federal income tax; its standard deduction and exemption amounts are smaller than the similar Federal allowances. Nonetheless, the change that would occur in a typical Puerto Rican's income tax liability under statehood is impossible to predict with certainty. The outcome depends heavily on

whether Puerto Rico's government would reduce Puerto Rico's tax rates or otherwise modify its own tax structure to accommodate the Federal income tax under statehood.

Commonwealth supporters have argued that the imposition of Federal income taxes on Puerto Rico would significantly reduce Puerto Rico's fiscal flexibility. If Puerto Rico did not reduce its own personal income taxes under statehood, they argue that the combined Federal and State tax burden would be extremely high. On the other hand, if Puerto Rico did reduce its own taxes, it is argued that the State government would be forced to make large reductions in expenditures and government employment. Since the Puerto Rican government accounts for a large portion of total employment in Puerto Rico, unemployment would increase accordingly.

The amount of pressure on the government of Puerto Rico to reduce its tax rates would depend on the number of Puerto Rican residents who would actually incur Federal individual income tax liabilities. The low income levels that exist in Puerto Rico suggest that large numbers of Puerto Ricans would fall below the taxable threshold for Federal tax purposes. Even though Puerto Rico's tax rates are higher than those of the Federal tax, and despite the smaller personal exemption amounts provided by Puerto Rico's tax laws, Puerto Ricans pay considerably less of their personal income in income taxes than do mainland residents.

Statehood supporters have also argued that the presence of a large government sector in Puerto Rico is a hindrance to economic development. They maintain that even if Puerto Rico is forced to scale back the size of its government, that result may not be undesirable.

Impact on Federal Tax Revenues

Because statehood would ultimately terminate the possessions tax credit and because Puerto Rico would become subject to Federal individual income and excise taxes, there would probably be an increase in Federal tax revenues under statehood. The precise amount of the revenue increase is heavily dependent, however, on economic variables that are uncertain. For example: how many corporations that currently use the possessions tax credit would relocate in foreign countries and beyond U.S. tax jurisdiction? What would be the nature of economic growth under statehood?

Under independence, there would be a larger near-term revenue gain than under statehood because of the delayed implementation of Federal tax laws under the statehood option. In the long run, however, independence would not increase Federal revenues to the same extent as statehood. While some possessions corporations would probably relocate to the United States (and thus become taxable), individual income taxes would not fully apply to an independent Puerto Rico and Federal excise taxes would not apply.

The CBO analysis described above contained estimates of the increase in Federal revenues that would occur under statehood. In FY1994 -- the first year Federal taxes would be applicable under S. 712 -- CBO estimates that Federal revenue would increase by $163 million, net of rebates to the government of Puerto Rico. By

FY2000 -- when section 936 is fully repealed and cover overs are assumed to no longer apply -- the estimated annual revenue gain would increase to $2.2 billion.

Of course, tax revenues are only one side of the budget; Federal outlays in Puerto Rico would increase under statehood because programs such as Supplemental Security Income and Food Stamps would be fully extended to Puerto Rico. While a discussion of the impact of a change in Puerto Rico's status on Federal outlays is beyond the scope of this memorandum, we should note that CBO has estimated that increases in outlays under statehood would outweigh increases in Federal revenue. According to CBO, statehood would increase Federal spending by an estimated $2.6 billion in FY1994 and by an estimated $3.6 billion in FY 2000. Thus, according to CBO estimates, statehood would impose a net cost of $2.4 billion on the Federal treasury in FY1994 and $1.3 billion in FY2000. Over its first 9 years, CBO estimates that the cumulative net cost of statehood to the Federal treasury would be $17.7 billion.

Other estimates differ. For example, the U.S. Treasury Department has estimated that the cumulative tax revenue gain over statehood's first 9 years would be $25.3 billion -- a figure several billion dollars larger than CBO's estimate. And the Senate Committee on Energy and Natural Resources has estimated that the net budgetary impact of statehood (revenue gains minus increases in outlays) would be positive in the long run, increasing revenues by a cumulative total of $12.9 billion more than outlays over statehood's first 9 years. A large reason for the difference between the Committee's estimate and CBO's is smaller assumed increases in outlays on the part of the Committee.

LEGISLATION

H.R. 3536 (Lagomarsino)

Puerto Rico Status Referendum Act. Requires an island-wide referendum to be held in Puerto Rico in which voters will be presented a choice of three status options: (1) statehood; (2) independence; or (3) commonwealth. Introduced Oct. 26, 1989; referred to more than one committee.

H.R. 4765 (de Lugo)

Puerto Rico Self-Determination Act. Authorizes appropriations for conducting a political status referendum in Puerto Rico and for legislation implementing the selected status. Introduced May 9, 1990; referred to more than one committee.

S. 710 (Johnston)

Requires a referendum to be held in Puerto Rico in which voters will have a choice of three status options: (1) statehood; (2) independence; or (3) enhanced commonwealth in permanent union. Introduced Apr. 5, 1989; referred to Committee on Energy and Natural Resources.

S. 711 (Johnston)

Requires a referendum to be held in Puerto Rico in which voters will have a choice of three status options: (1) statehood; (2) independence; or (3) commonwealth. Introduced Apr 5, 1989; referred to Committee on Energy and Natural Resources.

S. 712 (Johnston)

Requires an islandwide referendum to be held in Puerto Rico in which voters will be presented a choice of three status options: (1) statehood; (2) independence; or (3) commonwealth. Introduced Apr. 5, 1989; referred to more than one committee. Reported by Committee on Energy and Natural Resources, amended, Sept. 6, 1989 (S.Rept. 101-120). Hearings held by Committee on Agriculture Nov. 9, 1989. Hearings held by Committee on Finance Nov. 15, 1989; Apr. 26, 1990.

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CRS Report 88-200 E

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CRS Report for Congress

Statehood for Puerto Rico: The Effect on Social Welfare Programs

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Congressional Research Service • The Library of Congress

STATEHOOD FOR PUERTO RICO: THE EFFECT ON SOCIAL WELFARE PROGRAMS

SUMMARY

Puerto Rico, a U.S. possession since 1898, gained commonwealth status in 1952. However, a central issue in Puerto Rican politics has been whether this political status should be changed. Three major options are statehood, independence, or a revised form of commonwealth.

The 101st Congress considered legislation authorizing a referendum in Puerto Rico about its political status. Although that legislation did not pass the Congress, interest in revision of Puerto Rico's status continues. Throughout congressional consideration of the referendum legislation in 1989 and 1990, the statehood option received extensive scrutiny and debate. Much of the debate focused on how social welfare programs applicable in the 50 States would affect Puerto Rico's population, which differs significantly from that of the mainland United States in terms of income and demographic characteristics.

The important effects of Puerto Rican statehood on major social welfare programs are:

- The existing program of aid to families with dependent children (AFDC) would be unlikely to change substantially, but Puerto Rico would be eligible for increased Federal funding for the program.

- Extension of the earned income tax credit (EITC) to Puerto Rico, where it is not now available because the Federal income tax system does not operate there, would bring significant new benefits and Federal expenditures; potentially, the EITC could cover 65 percent of all Puerto Rican families with children.

- Replacing the current nutrition assistance "block grant" with the regular food stamp program could increase the caseload and program costs by one-third or more and would eliminate Puerto Rico's flexibility to design its own program.

- Replacing the existing programs of aid to the aged, blind, and disabled (AABD) with the supplemental security income (SSI) program could greatly expand the recipient population in Puerto Rico, increase benefits to recipients by as much as tenfold, and, consequently lead to much larger Federal costs.

- Removal of the existing cap on Federal medicaid funding for Puerto Rico and a more generous Federal matching formula could more than double Federal medicaid spending for Puerto Rico. As a State, Puerto Rico would become subject to requirements for more extensive coverage for some classes of individuals, but would have to end services to some others; it could no longer restrict medicaid providers to public facilities.

- Questions would remain as to whether "special" welfare eligibility and benefit rules should be applied in Puerto Rico (or any State) in recognition of differences in income, living costs, and demographics.

CONTRIBUTORS

The following members of the Education and Public Welfare Division of the Congressional Research Service (CRS) contributed to this report:

Carolyn L. Merck	Coordinator; Demographic data; Precedents for interstate differences
Melvina Ford	Medicaid; Maternal and child health block grant
Celinda Franco	Medicare
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Joe Richardson	Food stamps/nutrition assistance block grant
Carmen Solomon	Aid to families with dependent children; Supplemental security income/aid to the aged, blind, or disabled
Karen Spar	Title IV-B child welfare services; Title IV-E foster care and adoption assistance; Title XX social services
Jim Storey	Earned income tax credit; Unemployment compensation

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STATEHOOD FOR PUERTO RICO: THE EFFECT ON SOCIAL WELFARE PROGRAMS

INTRODUCTION

Puerto Rico, a U.S. possession since 1898, gained commonwealth status in 1952. However, a central issue in Puerto Rican politics has been whether this political status should be changed, replaced by statehood, independence or a revised form of commonwealth.

The 101st Congress considered two bills authorizing a political status referendum in Puerto Rico (S. 712 and H.R. 4765). The Senate bill comprehensively defined the three status options on which the vote would have been based and the terms under which each would have been implemented. The bill sought to make each of the three options "neutral" with regard to the net effect on the U.S. budget deficit and to make certain program benefits to residents of the Island comparable under each status option. In addition, the bill would have been "self-implementing," that is, once the status was decided by a majority of voters in Puerto Rico, no further congressional action would have been needed to permit that status to go into effect.

The House version was much briefer and was not self-implementing. It called for a three-step process. First, a vote would have taken place in Puerto Rico among the three status options as *general principles*, without definition of the terms under which each would be implemented. Second, if one of the status options had achieved a majority of the vote, Congress would have drafted legislation specifying how that status would be implemented. Third, if that legislation had been enacted, it would have been submitted to the people of Puerto Rico for ratification. If ratified, the House version would have become effective in 1992.

The House passed its version of the bill by voice vote on October 10, 1990, but S. 712 never reached the Senate floor. Senator J. Bennett Johnston, chairman of the Senate Committee on Energy and Natural Resources (the committee with jurisdiction over territorial affairs) pledged to submit new legislation in the 102d Congress.[1]

Throughout consideration of the referendum legislation in the 101st Congress, the statehood option received extensive scrutiny and debate. Statehood would require substantial changes in the fiscal relationship between Puerto Rico and the U.S. Government with regard to several important social

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[1]For a general review of the issue of Puerto Rico's political status and the legislation proposed in the 101st Congress, see U.S. Library of Congress. Congressional Research Service. *Puerto Rico: Political Status Options*. Issue Brief No. IB89065, by Bette A. Alberts, Nov. 14, 1990 (continually updated). Washington, 1990.

welfare programs, the personal income tax system, and preferential corporate tax treatment for U.S. companies operating in Puerto Rico.

This report presents a general analysis of how selected social welfare programs would be affected if statehood were the outcome of the referendum. It addresses statehood in a generic sense and not as specifically provided for in any bill. It does not address the enhanced commonwealth or independence options because they are wholly dependent on legislative specification. Finally, the report does not address tax issues.[2]

Because eligibility for most social welfare programs is determined on the basis of income and family structure, the report first presents data on the demographic and economic characteristics of the population of Puerto Rico and relevant comparisons with data for the States. Second is a description of how selected programs operate in the 50 States, how those programs currently operate in Puerto Rico, what the effect of statehood for Puerto Rico would be on each program, and important program policy issues that would arise from a change to statehood. Third is a review of the precedents for establishing different program eligibility and benefit criteria for individual states under programs that are otherwise nationally uniform.

The programs covered in this report are:[3]

- Aid to families with dependent children (AFDC)
- Supplemental security income (SSI) and the Puerto Rico counterpart, aid to the aged, blind, or disabled (AABD)
- Food stamps and the Puerto Rico counterpart, the nutrition assistance block grant
- Social security retirement, disability, and survivor benefits
- Medicaid
- Medicare
- Unemployment compensation (UC)
- Earned income tax credit (EITC)
- Maternal and child health (MCH) block grant
- Title IV-B child welfare services
- Title IV-E foster care and adoption assistance
- Title XX social services

This report does not attempt definitive cost or budget estimates, although it discusses issues concerning the general implications of statehood for program costs and coverage of the population.

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[2]For information on how statehood could affect corporate and individual taxes, see U.S. Library of Congress. Congressional Research Service. *Puerto Rico's Options and Federal Taxes.* Issue Brief No. IB90086, by David L. Brumbaugh, Aug. 14, 1990 (archived). Washington, 1990.

[3]All of these programs are authorized under the Social Security Act, with the exception of the food stamp and nutrition assistance programs.

PART 1. INCOME AND DEMOGRAPHIC CHARACTERISTICS

Tables 1 and 2 compare the income and household characteristics of the populations in Puerto Rico, the U.S. as a whole, and Mississippi, the State with the lowest per capita income. The data were tabulated from the 1980 decennial census. Even though the data are 10 years old, the characteristics of the populations in the different jurisdictions probably have not changed substantially in relation to each other.[4]

The data show that the average family is significantly larger in Puerto Rico than in the States (4.01 persons per family compared with 3.27 persons), and the median age in Puerto Rico is 4.5 years younger than in the States, reflecting a greater number of children per family. A slightly higher proportion of children in Puerto Rico live in single, female-headed families than do those in the United States, but a higher proportion live in two-parent families than do in Mississippi. The elderly in Puerto Rico are more likely to live in a family unit than are the elderly in the United States, which also increases the average family size.

Income in Puerto Rico is significantly lower than in any of the 50 States, which is an important consideration for evaluating the potential effects of extending open-ended, means-tested transfer programs there. Measured against the Census Bureau's uniform poverty threshold, the incidence of poverty in 1979 was six times greater in Puerto Rico than in the United States as a whole; 58.1 percent of families in Puerto Rico fell below the poverty threshold, compared with 18.9 percent in Mississippi and 9.6 percent in the United States as a whole. The median family income in Puerto Rico in 1979 was less than 30 percent of the U.S. median and was 40 percent of that in Mississippi, which had the lowest income of the 50 States. The median annual earnings of men in Puerto Rico who worked at any time during 1979 were 54 percent of the median earnings of men in Mississippi, and 41 percent of the earnings of men in the total United States. The poverty rate among the elderly is substantially higher in Puerto Rico than in the States. Only 8.1 percent of elderly persons in the States live in families with incomes below poverty, but in Puerto Rico nearly 60 percent of the elderly live in poor families.

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[4]The definition of a family is two or more persons related by blood, marriage, or adoption living together; "unrelated individuals" are single persons living alone or with others to whom they are not related by blood, marriage, or adoption. The term "household" includes families, single individuals living alone, and two or more unrelated individuals living together as one household unit.

TABLE 1. Selected Data on the Income and Demographic Characteristics of the Populations of Puerto Rico, Mississippi, and the United States--1980

	Puerto Rico	Mississippi	United States
Households	904,151	861,418	86,573,717
Families	757,645	645,453	59,190,133
Unrelated individuals	146,506	215,965	27,383,584
Persons	3,176,743	2,455,065	220,845,766
Persons in families	3,035,777	2,239,100	193,462,182
Percent of persons in families	95.6%	91.2%	87.6%
Percent of family households	83.8%	74.9%	68.4%
Average household size	3.65	2.97	2.74
Average family size	4.01	3.47	3.27
Age distribution (percent)			
Persons under 16	33.9%	28.7%	24.8%
Persons age 16 to 64	58.2%	60.0%	64.3%
Persons age 65+	7.9%	11.3%	10.9%
Median age (years)	25.5	29.2	30.0
Family status: children (percent)			
In male-present families	82.1%	77.8%	82.9%
In single female-headed families	17.9%	22.2%	17.1%
Family status: persons 65+ (percent)			
In families	80.8%	69.1%	68.0%
Unrelated individuals	19.2%	30.9%	32.0%
Family income			
Median income	$5,923	$14,591	$19,917
Mean income	$8,271	$17,645	$23,092
Families with children			
Median income	$6,080	$15,812	$20,375
Mean income	$8,553	$18,225	$23,551
Married-couple families with children			
Median income	$6,743	$18,210	$22,816
Mean income	$9,153	$20,474	$25,735

See note on following page.

TABLE 1. Selected Data on the Income and Demographic Characteristics of the Populations of Puerto Rico, Mississippi, and the United States--1980--Continued

	Puerto Rico	Mississippi	United States
Single householder with children			
Median income	$3,210	$7,117	$8,819
Mean income	$4,436	$8,715	$10,943
Families with householder 65+			
Median income	$4,294	$8,138	$12,295
Mean income	$6,349	$11,797	$16,831
Income of unrelated individuals			
Median	$1,853	$3,961	$6,695
Mean	$3,417	$6,386	$9,282
Unrelated individuals 65+			
Median income	$1,840	$3,200	$4,752
Mean income	$2,495	$5,000	$7,142
Median annual earnings			
Males 15+	$5,394	$9,943	$13,172
Females 15+	$5,082	$5,487	$6,285
Poverty status			
Families below poverty (percent)	58.1%	18.9%	9.6%
Persons below poverty (percent)	62.4%	23.9%	12.4%
Children below poverty	69.5%	30.4%	16.0%
In male-present families	66.2%	20.9%	9.4%
In single female-headed families	84.1%	63.7%	47.8%
Persons 65+ below poverty	63.8%	34.3%	14.8%
In families	59.1%	24.7%	8.1%
Unrelated individuals	83.6%	55.7%	29.2%
Median poverty income deficit for:			
Families below poverty	$3,887	$2,610	$2,574
Unrelated individuals below poverty	$2,481	$1,332	$1,538
Persons 65+	$1,806	$ 921	$ 843

NOTE: Income and poverty data are for 1979.

Source: Table prepared by the Congressional Research Service (CRS). Data derived from the U.S. Bureau of the Census. 1980 Decennial Census. Detailed Population Characteristics, v. 1, chapter D.

TABLE 2. Distribution of Gross Annual Family Income: United States, Mississippi, and Puerto Rico--1980

	No. of families	Percent of families by income <$5,000	$5,000-9,999	$10,000-14,999	$15,000-24,999	$25,000+
United States	59,190,133	7.3%	13.1%	14.7%	29.4%	35.4%
Mississippi	645,453	13.5	19.9	17.9	27.5	21.3
Puerto Rico	757,145	43.4	28.4	13.3	10.3	4.6

Source: CRS tabulations from the 1980 Decennial Census.

TABLE 3. Labor Force Participation in the United States and Puerto Rico--1988

	United States	Puerto Rico
Total civilian labor force participation rate (persons 16+)	65.9%	45.6%
Males	76.2	61.3
Females	56.6	32.0
Unemployment rate (Sept. 1990)	5.7	14.5

Source: *Statistical Abstract*, 1990, tables 628 and 1424.

Table 3 shows that in 1988 the labor force participation rate in Puerto Rico was lower than in the United States as a whole: 45.6 percent of the population age 16 and over was in the labor force in Puerto Rico, compared with 65.9 percent in the United States. As of September 1990, the unemployment rate in Puerto Rico was 14.5 percent, compared with 5.7 percent in the 50 States.

Altogether, the data for Puerto Rico portray a population that is very different from that of the States. The major differences in the income distributions indicate that, should Puerto Rico become a State, applying the welfare program eligibility and benefit criteria that pertain in the 50 States could extend those benefits to a very large portion of the Island's population. The programs that would have the greatest impact if extended to Puerto Rico are food stamps, SSI, and the EITC, for which benefits are nationally uniform and are not set by the States. Although this report does not undertake a detailed economic analysis of the effects of Puerto Rican statehood or enhancement of its commonwealth status on the distribution of personal income there, the data indicate that the introduction of welfare benefits at levels equal to those in the States could have important consequences for the Island's economy.

PART 2. THE EFFECTS OF STATEHOOD ON SOCIAL WELFARE PROGRAMS

Under statehood, it is assumed that Puerto Rico would become a State equal in standing with the 50 States. All laws and programs operating in the 50 States would operate in Puerto Rico on the same terms and according to the same rules and regulations as in the other States. Where there is precedent for variation in program operations in individual States, such as eligibility and benefit criteria for certain programs in Alaska and Hawaii, those precedents might be considered in establishing those programs in Puerto Rico (see Part 3, Precedents for Interstate Differences in National Social Welfare Program Rules).

Following is a description of various social welfare programs. Each program discussion includes a description of how the program operates now in the 50 States, how it operates in Puerto Rico, and the implications for program operations and scope should statehood be the outcome of the referendum.

AID TO FAMILIES WITH DEPENDENT CHILDREN (AFDC)

The Program in the States

Eligibility and Benefits in the 50 States and the District of Columbia

Aid to families with dependent children (AFDC) is the major cash welfare program for needy children and their families. The AFDC program offers Federal funds to help pay State costs of providing cash payments to needy children (and their needy parents or other caretakers) who are under age 18 (or at State option, 19, if the child is still in high school or in vocational or technical training); living in the home of a parent or specified relative; and deprived of parental support or care because of the death, continued absence from the home, unemployment of the principal wage earner,[5] or physical or mental incapacity of a parent.

In FY 1988, 98 percent of AFDC children had two living parents (a little more than half of whom were unwed), but 87 percent lived with one parent, usually the mother. Only 10.2 percent of the children were in two-parent families (6.5 percent in families with an unemployed parent, 3.7 percent with an incapacitated parent).

States define "need," set their own benefit levels, establish (within Federal limitations) income and resource limits, and administer the program or supervise its administration. All States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands operate an AFDC program. American Samoa, effective

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[5]Eligibility for AFDC based on the unemployment of the principal wage earner became a mandatory component of the program on October 1, 1990 (it will become a mandatory component of the AFDC programs in the outlying areas on October 1, 1992).

October 1, 1988, has the authority to operate an AFDC program, but as of fall 1990 had not chosen to do so. To qualify for AFDC, a family must have a dependent child, countable income below the State's payment standard and countable resources below the State's resource limit; if able-bodied and with a child age 3 or over, the parent must participate in the State's job opportunities and basic skills (JOBS) training program. Benefits vary by family size; in July 1990, monthly AFDC payments to a three-person family with no countable income ranged in the 48 contiguous States from $118 in Alabama to $703 in Suffolk County, New York. The Federal countable resource limit is $1,000 per family. Some major resources, however, such as the home in which the family is living and up to $1,500 in equity value of a car (less in two States), are not counted as resources. The average monthly benefit paid in FY 1990 was $388 per family.

In FY 1991, a matching grant program for child care became effective. State AFDC agencies may use these funds to provide child care to any low income working family not receiving AFDC that might become eligible for AFDC in the absence of child care.

Participation

In FY 1990, a monthly average of 11.4 million persons in 4.0 million families were enrolled in the AFDC program in the 50 States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands. AFDC children totaled 7.7 million, 12 percent of the U.S. child population.

Funding and Expenditures

In the 50 States and the District of Columbia, the Federal Government pays at least 50 percent of each State's AFDC benefit payments, and 50 percent for most administrative costs in all States. Federal matching for AFDC benefits varies among States and, within limits, is inversely related to State per capita income. The Federal share of a State's AFDC payments is determined by the matching formula specified for medicaid in Title XIX of the Social Security Act. The share of AFDC benefits paid by Federal funds ranges in FY 1991 from 50 percent to 79.9 percent (Mississippi), and unlimited matching funds are authorized. For the outlying areas, Guam, Puerto Rico, and the Virgin Islands, 75 percent Federal matching is provided, but the law imposes a ceiling on Federal funds.

In FY 1989, total AFDC program costs for the 50 States, the District of Columbia, and the outlying areas amounted to $19.6 billion, of which 88 percent, $17.2 billion, was spent on benefit payments and the rest on administrative costs. The Federal Government paid nearly 55 percent, $9.4 billion, of AFDC benefit expenditures.

The Program in Puerto Rico

Eligibility and Benefits in Puerto Rico

Under the AFDC program, the Commonwealth of Puerto Rico is considered a "State." Thus, generally the categorical, income, and resource eligibility criteria described above apply. However, the 1988 law requiring all States to offer AFDC (for at least part of the year) to two-parent families in which the principal earner is unemployed does not take effect in Puerto Rico until October 1, 1992, 2 years later than in the 50 States and the District of Columbia.

In FY 1988, 97 percent of AFDC children in Puerto Rico had two living parents (40 percent of whom were unwed), but 74 percent lived with only one parent, usually the mother. More than one-fifth of the children were in two-parent families with an incapacitated parent. Puerto Rico did not offer AFDC to the children of needy unemployed parents.

Puerto Rico's maximum AFDC benefit varies by family size, and for a three-person family is $90 per month (this amount assumes an average rent payment of $20 per month). This is $28 below the lowest maximum payment in the 50 States (Alabama). The average payment among families of all sizes in FY 1988 was $102 per month, compared with $381 among the States.

Participation

In FY 1989, 185,346 persons in nearly 58,000 families in Puerto Rico received AFDC benefits (including 126,471 children). In FY 1980, a total of 117,669 Puerto Rican children received AFDC, 9.6 percent of the Island's child population (more recent percentage data are unavailable).

Funding and Expenditures

The major difference between Puerto Rico and the other "States" is the way its AFDC program is funded. The 50 States and the District of Columbia receive open-ended funding, with a minimum Federal matching rate for benefits of 50 percent and a maximum Federal match of 83 percent. In contrast, as noted before, Puerto Rico and the other outlying areas are subject to a "cap" on Federal funding for several programs grouped together. The Federal Government pays 75 percent of Puerto Rico's AFDC benefit payments and several other social welfare benefits up to a specified limit. Section 1108 of the Social Security Act places an annual limit of $82 million ($72 million before FY 1989) on the sum available to Puerto Rico for matching funds to help fund AFDC, emergency assistance, aid to the aged, blind, or disabled, and foster care and adoption assistance. The Act provides that Puerto Rico may use funds not expended within the section 1108 cap for its Title XX social services program. (In effect, this Title XX provision generally allows Puerto Rico to always receive the maximum amount of authorized Federal funds.)

In FY 1989, total AFDC benefit payments in Puerto Rico amounted to $70.6 million (qualifying Puerto Rico for $52.9 million in 75 percent Federal matching funds).

Implications of Statehood

If Puerto Rico were to be treated like the 50 States and the District of Columbia in terms of its AFDC funding, the cap on Federal funding would be removed, and its Federal matching rate would be raised from the 75 percent rate to the maximum permitted in law, 83 percent. This is because per capita income in Puerto Rico for the fiscal year ending June 30, 1989, was $5,266, less than one-third that of the United States ($16,116 in 1988). These relationships, under the existing formula, would qualify Puerto Rico for the maximum matching rate.

According to data from the Department of Health and Human Services, total FY 1989 benefit payments in Puerto Rico for AFDC ($70.6 million), emergency assistance ($119,000), and aid to the aged, blind, or disabled ($19.2 million) totaled $89.9 million, qualifying Puerto Rico for maximum matching funds (at a 75 percent rate) of $67.4 million. In addition, administrative costs for AFDC totaled $15.6 million, qualifying Puerto Rico (at a 50 percent rate) for matching funds of $7.8 million. Data are not available on expenditures in Puerto Rico on foster care and adoption assistance, but the Administration has indicated that Puerto Rico does not receive funding under the Title IV-E foster care and adoption assistance programs. It appears that Puerto Rico in FY 1989 did not use the full $82 million available in that year for the programs listed above, in which case it could apply the rest to its Title XX social services program. If Puerto Rico were to become a State, it is unclear how it would respond to open-ended Federal benefit funding for AFDC at an 83 percent matching rate. By spending somewhat *less* local money Puerto Rico could maintain existing program levels.

SUPPLEMENTAL SECURITY INCOME (SSI)

The Program in the States

Eligibility and Benefits in the 50 States, the District of Columbia, and the Northern Mariana Islands

The supplemental security income (SSI) program is a Federal program administered by the Social Security Administration that guarantees a minimum level of cash income to needy aged, blind, and disabled persons. To qualify for SSI payments, a person must satisfy the program criteria for age, blindness, or disability. The aged are defined as persons 65 years and older. Blind individuals are those with 20/200 vision or less with the use of a correcting lens in the person's better eye, or those with tunnel vision of 20 degrees or less. Disabled individuals are those unable to engage in any substantial gainful activity (SGA) by reason of a medically determined physical or mental impairment expected to result in death or that has lasted or can be expected to last, for a continuous

period of at least 12 months. In addition, to be considered "disabled," a child under age 18 must have an impairment of "comparable severity" with that of an adult. SSI law is contained in (the second) Title XVI of the Social Security Act.

In 1991, individuals and couples are determined to be eligible for a Federal SSI payment if their countable income does not exceed $407 per month for an individual living independently or $610 for a couple living independently. Benefit levels are adjusted for price inflation at the same time and by the same percentage as social security benefits. Countable income is subtracted from the Federal SSI guarantee (and State supplementary payment, if available) to determine SSI eligibility and benefit amount.

Under the SSI program, $20 of monthly income from virtually any source (such as social security benefits, but not need-tested income such as veterans' pensions) is disregarded in determining eligibility and benefit amount. In addition, the first $65 of monthly earned income plus one-half of remaining earnings are disregarded. Thus, the income level at which Federal SSI eligibility ends for an individual (i.e., the "breakeven" amount) is $427 if the person has only unearned income, and $899 per month if the person has only earned income. (The corresponding figures for a couple are $680 and $1,305.) In effect, this means that the marginal benefit-reduction rate is 50 percent for earned income and 100 percent for unearned income.

About 42 percent of SSI recipients receive a State supplement. Currently, 26 States and the District of Columbia supplement the Federal guarantee for individuals living independently, by monthly amounts ranging from $2 to $366 (Connecticut). Most States provide supplements for recipients in group living arrangements.

To determine eligibility and benefits the SSI program generally takes into account all types of income, including earned, unearned, and support and maintenance furnished in cash or in kind. However, Congress recognized that many aged, blind, or disabled individuals live with relatives or friends and that it is difficult to determine the exact value of the non-cash support and maintenance these persons receive. Thus, if an SSI applicant or recipient is "living in another person's household and receiving support and maintenance in-kind from such person," the value of that in-kind assistance is presumed to equal one-third of the Federal SSI benefit standard. In these cases, the maximum Federal SSI benefit couple is two-thirds of the Federal SSI guarantee level.

Eligibility for SSI is restricted to qualified persons who have countable assets of not more than $2,000, or not more than $3,000 in the case of qualified couples. In determining assets, a number of items are excluded. Totally disregarded is the individual's home; and, within "reasonable" limits set by the Secretary of the Department of Health and Human Services these assets are disregarded: household goods, personal effects, an automobile, and a burial space for the individual, spouse, and members of the immediate family.

The income of an ineligible spouse who lives with an adult SSI applicant or recipient is considered in determining the eligibility and amount of payment to the individual. Similarly, part of the income of the parents of a disabled or blind child under the age of 18 is counted as available to the child and used in determining his SSI benefit amount, if any. Further, an individual's resources are deemed to include those of his ineligible spouse (with whom he lives) or in the case of a child under the age of 18, those of his parents with whom he lives. In 1989, there were 44,900 spouse-to-spouse and 26,100 parent-to-child cases in which deeming reduced the benefit; these figures do not include the cases in which individuals were made ineligible because of the deeming provisions.

In addition to the categorical requirements and income and resource rules, to receive SSI a person must be a citizen of the United States or an alien who is lawfully admitted to the United States; live in the United States or the Northern Mariana Islands; apply for all other benefits to which he is entitled; and if he is disabled, accept vocational rehabilitation services if they are offered.

The Commonwealth of Northern Mariana Islands is the only outlying U.S. area with the SSI program. The Northern Marianas Covenant (P.L. 94-241) was signed into law in March 1976. It changed the status of the Northern Mariana Islands from a part of the United Nations Trust Territory of the Pacific administered by the United States to that of a full U.S. Commonwealth. Terms of the covenant extended SSI to the new Commonwealth on the same terms as in the 50 States and the District of Columbia, effective in 1978. Congress has never passed proposals to extend the SSI program to the other U.S. Commonwealth (Puerto Rico) or the other U.S. outlying areas of Guam, American Samoa, and the Virgin Islands.

The SSI program, which began operations in 1974, replaced the matching-grant programs of old-age assistance, aid to the blind, and aid to the permanently and totally disabled in the 50 States and the District of Columbia.

Participation

An estimated 4.6 million persons received SSI benefits in FY 1990; 2.0 million persons aged 65 or older (almost 7 percent of the U.S. aged population) and 2.6 million blind or disabled persons, approximately 301,000 of whom are estimated to be children. In March 1990, the average monthly SSI payment was $290; the average monthly Federal SSI payment was $253, and the average amount of State supplementation was $136.

Funding and Expenditures

Federal SSI benefits and the cost of administering the program are financed from general funds of the Treasury. The Social Security Administration also administers the payment of State-financed State supplementary SSI payments for 26 States and the District of Columbia. These administrative costs are paid by general funds from the Treasury.

In FY 1990 it was estimated that the Federal Government would pay 81 percent of total SSI program costs ($15.4 billion) and the States, 19 percent. In FY 1990, the SSI program cost the Federal Government $12.5 billion. Ninety-one percent of this amount was spent on Federal SSI benefit payments and the rest was spent on administrative costs, beneficiary services, and demonstration projects.

The Program in Puerto Rico

Eligibility and Benefits of Aid to the Aged, Blind, or Disabled in Puerto Rico

The SSI program is not available in Puerto Rico. Instead, Puerto Rico operates an assistance program of aid to the aged, blind, or disabled (AABD) under Title XVI of the Social Security Act. As with AFDC, the Commonwealth of Puerto Rico sets eligibility requirements (within Federal guidelines) and benefit levels. The Federal Government provides a grant to the Commonwealth to meet a share of the program's cost.

Aged persons are defined as those age 65 and older. The definition for blindness is virtually the same as that used for the SSI program; there is no age requirement for blind persons (i.e., blind children always have been eligible for benefits under both programs). Disability is defined by Puerto Rico, but the program is restricted to those age 18 or older.

To qualify for assistance in Puerto Rico, an aged, blind, or disabled person must have countable resources of no more than $2,000 and countable income of less than the maximum benefit, which equals $32 per month plus 50 percent of actual shelter costs. If shelter costs are assumed to be $20 monthly (reported by Administration officials as the average amount paid for rent by welfare recipients), the income level at which an individual with no other income would no longer qualify for adult assistance payments is $42 per month. In FY 1987, the average monthly benefit was approximately $36.

Under the AABD program not all earned income is counted. In the case of an aged or disabled person the law says that of the first $80 per month of earned income, the State agency *may* disregard not more than $20 plus one-half of the remainder. Thus, the breakeven level for an aged or disabled AABD recipient who has only earned income is $92 per month (assumes shelter costs of $20 per month). In the case of a blind AABD recipient, the State agency *must* disregard the first $85 per month of earned income plus one-half of remaining earnings. Thus, the breakeven level for a blind AABD recipient who has only earned income is $169 per month (assumes shelter costs of $20 per month). In effect, this means that (1) 100 percent of unearned income is counted in determining the AABD benefit amount, (2) the marginal benefit-reduction rate is 100 percent for the income of aged or disabled persons, and (3) the marginal benefit-reduction rate is 50 percent for the earned income of blind persons.

Participation

In FY 1989, 40,813 persons in Puerto Rico received AABD assistance payments: 16,166 aged persons, 278 blind persons, and 24,369 disabled persons. (In 1980, the most recent year with age data, about 8 percent of aged Puerto Ricans received AABD payments.)

Funding and Expenditures

Puerto Rico and the other outlying areas are subject to a "cap" on Federal funding. The Federal Government pays 75 percent of Puerto Rico's assistance payments to aged, blind, or disabled persons up to a specified limit (which also must cover the Federal share of costs of various other social welfare programs.) The Social Security Act places an annual limit of $82 million in FY 1989 and years thereafter on the sum available to Puerto Rico for matching payments to help fund programs of aid to families with dependent children, emergency assistance, aid to the aged, blind, or disabled, and foster care and adoption assistance.

In FY 1989, total AABD assistance payments in Puerto Rico amounted to $19.2 million (qualifying Puerto Rico for a maximum of $14.4 million in Federal matching funds).

Implications of Statehood

If Puerto Rico were treated like the 50 States, the District of Columbia, and the Northern Mariana Islands, the Social Security Administration would extend the Federal SSI program to it, at 100 percent Federal expense. SSI then would replace AABD, presumably providing much larger benefits, and much higher eligibility limits. Furthermore, the SSI program would cover disabled children, excluded from the AABD program.

The Federal SSI guarantee to an individual currently is $407 per month. In Puerto Rico the maximum money payment to a needy aged, blind, or disabled person in FY 1989 under the adult assistance programs is $32 per month plus 50 percent of actual shelter costs. A jump of this magnitude in benefit amounts undoubtedly would vastly expand the eligible population. The exact scope is unknown. However, when SSI replaced the cash welfare programs to aged, blind, or disabled persons in the States, the number of recipients rose nationwide by more than one-third. From 1973, the last year of the old cash welfare programs for aged, blind, or disabled persons, to 1975, the second year of the SSI program, 19 States had increases of more than 50 percent in the number of cash recipients (numbers more than doubled in 5 States).

During consideration of S. 712 in the 101st Congress, the Senate Finance Committee, which has jurisdiction over the SSI program, was concerned about the magnitude of the potential benefit increase in Puerto Rico, and the Committee proposed to limit SSI eligibility and benefits in all States to 50 percent of a State's per capita income. This limitation would have affected

Puerto Rico alone, since in all other States, including Mississippi (which has the lowest per capita income of the 50 States), 50 percent of per capita income is greater than the SSI eligibility and benefit levels.

Under statehood, Puerto Rico no longer would have to pay the 25 percent matching rate required under the AABD program. It is unknown how Puerto Rico would use such released funds. But, because the Federal SSI guarantee is relatively high compared with per capita income (equal to 88 percent of per capita income in 1989), it is virtually certain that these funds would not be used to supplement the Federal SSI guarantee. Because statehood would require Puerto Rico to give automatic eligibility for medicaid to SSI recipients, funds would be needed for the expanded population eligible for medicaid (although many might already have medicaid coverage as medically needy persons).

NUTRITION ASSISTANCE UNDER THE FOOD STAMP ACT

The Food Stamp Program in the States

Overview

The Food Stamp Act authorizes a food stamp program to increase the food purchasing power of needy households by granting them monthly allotments of food stamp coupons. With limited variations for Alaska and Hawaii (eligibility and benefit levels are higher), it operates under nationally uniform Federal rules.[6] Federal funds pay for the full cost of benefits and a bit more than half of total costs for administration.

Administration

Virtually all rules governing program operations are established by the Federal Government, and program operations and participation by food concerns and financial institutions accepting food stamp coupons are subject to extensive oversight by the U.S. Department of Agriculture's Food and Nutrition Service.

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[6]The regular food stamp program also operates in the District of Columbia, Guam, and the Virgin Islands, although somewhat more liberal benefit rules apply in Guam and the Virgin Islands.

Under the terms of the 1976 Covenant with the Commonwealth of the Northern Mariana Islands and implementing legislation, a variant of the food stamp program was negotiated with the Commonwealth and began operations in 1982. The Northern Marianas' program differs from the regular food stamp program primarily in that: (1) it is funded entirely by Federal money (benefits and administration), up to a maximum annual grant of $3.7 million; (2) a portion of each household's food stamp allotment (25 percent) must be used to purchase locally produced food (coupons for local food items are differentiated by color); (3) maximum monthly benefits are about 20 percent higher than those in the regular food stamp program; and (4) income eligibility limits are about half those in the regular program.

Day-to-day administration (determining eligibility and issuing benefits) is the responsibility of State welfare agencies, following generally standard Federal rules.

Funding

Federal funding covers: (1) Federal administrative expenses for personnel, printing and redeeming food stamp coupons, and oversight of welfare agency and food store operations, (2) the full cost of benefits, (3) half of day-to-day administrative expenses incurred by State agencies,[7] (4) 75 percent of State agencies' costs for developing expanded computer capability,[8] (5) 75 percent of costs incurred by States for fraud investigation and prosecution,[9] and (6) the full cost of implementing the systematic alien verification for entitlements (SAVE) program (procedures for using the Immigration and Naturalization Service to verify the immigration status of alien welfare applicants). In addition, the Federal Government pays the major portion of the cost of carrying out employment and training programs for food stamp recipients: each State receives a formula share of $75 million a year for basic operating costs, plus half of any operating expenses above those covered by the basic grant and half the cost of support services to participants (e.g., transportation and child care).

States are responsible for their share of food stamp administrative expenses (50 or 25 percent, depending on the type of expense) and, under the food stamp "quality control" system, are liable for fiscal sanctions if they have very high rates of erroneous eligibility and benefit determinations.

In FY 1990, Federal food stamp spending for the States totaled an estimated $15.6 billion; State costs were approximately $1.1 billion. Federal appropriations for FY 1991 (excluding Puerto Rico) are $18.1 billion, $823 million of which is to be held in "reserve" and made available only if specifically requested by the Administration to meet unanticipated needs.

Eligibility for Assistance

Applicant households are determined eligible for aid under generally uniform provisions established in the Food Stamp Act.

- *Income.* Most eligible households must have basic (gross) monthly income at or below 130 percent of the annually adjusted Federal

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[7]Increased to 60 percent if the State has very low rates of erroneous eligibility and benefit determinations.

[8]Reduced to 63 percent beginning in FY 1992.

[9]States also may retain a portion of improperly issued benefits they recover (other than those caused by welfare agency error).

poverty income guidelines.[10] At present, the gross income limit for a four-person household is $1,376 a month. Almost all cash income received by a household is included when judging income eligibility.

- *Assets.* Liquid assets of eligible households are limited to $2,000, or $3,000 for households with elderly members. Counted liquid assets do not include the value of the household's residence, business assets, a *portion* of the fair market value of any vehicle, and some other items.

- *Employment and training requirements.* Nonworking able-bodied adults not caring for young children or enrolled in another program's work initiative must accept appropriate job offers and, if assigned, participate in State-designed employment and training programs in order to maintain their food stamp eligibility.

- *Categorical rules.* Two classes of households are automatically eligible for food stamp assistance: those composed entirely of AFDC or SSI recipients. In certain other cases, households or individuals are automatically ineligible: households with members on strike, households where the head of household has voluntarily quit a job, most postsecondary students (unless they are working, in a training program, or caring for a young child), illegal or temporarily resident aliens, persons living in institutional settings (except for specifically approved group living arrangements such as drug addiction programs and shelters for the homeless or battered women and children), and boarders (unless they apply together with the household providing board).

About 20 million persons a month now participate in the food stamp program in the States, nearly 8 percent of the U.S. population.

Benefits

Eligible households receive monthly food stamp coupon allotments.[11] These coupons are normally used to purchase food in participating stores and redeemed by the stores for dollars through banks and the Federal Reserve System, although they may be used to obtain prepared meals in some cases (e.g.,

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[10]The poverty income guidelines used for food stamp eligibility determinations in Alaska and Hawaii are higher than those used for other jurisdictions, by 25 and 15 percent, respectively. Although the requirement for gross income at or below 130 percent of Federal poverty levels is the basic income test, households with elderly or disabled members are subject to a more liberal test based on their counted (net) income (after reduction for various household expenses), a test that other households must meet *in addition* to the generally more stringent gross income test.

[11]Although benefits in the form of coupons are the rule, a few demonstration projects offer benefits in cash or through "electronic benefit transfer" systems.

in elderly nutrition projects) and nonfood items in other instances (e.g., hunting and fishing equipment in remote areas of Alaska). Allotments depend on a household's size, its counted (net) monthly income, and the program's maximum monthly benefit levels.

Food stamp maximum benefits are equal to an amount slightly (3 percent) higher than the cost of the U.S. Department of Agriculture's lowest estimate of the cost of an adequate diet, the "Thrifty Food Plan," adjusted for household size and indexed annually for food price inflation. They are standard for the 48 contiguous States, but significantly higher in Alaska and Hawaii (reflecting special surveys indicating substantially higher food prices). At present, the maximum monthly allotment for a four-person household is $352 in the 48 contiguous States, $459-$713 in Alaska (varying among urban and remote rural areas), and $574 in Hawaii.

Recipients' actual monthly benefits are calculated by subtracting 30 percent of their *counted (net)* monthly income from the maximum benefit for their household size. Food stamps then make up the difference between their expected contribution to food expenses (30 percent of counted income) and the amount judged sufficient to buy an adequate low-cost diet (the maximum benefit). Monthly food stamp benefits in the States now average over $60 per person.

An important part of determining a household's benefits is the calculation of its counted income. When determining counted monthly income, basic (gross) cash income is *reduced* by applying a series of "deductions," including a "standard" deduction, specific deductions for certain living expenses (e.g., excessively high shelter costs), and a deduction for taxes and work expenses (20 percent of any earnings). These deductions total to a bit over $200 a month on average, making the "typical" household's counted income for food stamp benefit purposes a little more than half its gross income.

Program Options

While the Food Stamp Act varies some eligibility and benefit rules for Alaska and Hawaii (higher income eligibility limits, maximum benefits, and allowable deductions), it allows States to make very few departures from Federal rules. States are permitted to operate "outreach" programs, vary specifically listed administrative rules (e.g., how changes in household circumstances are to be reported), disregard a portion of child support payments in counting income (at their own cost), and determine coupon issuance systems. They also make most decisions as to the design of employment and training programs. Other variations can be achieved only as demonstration projects.

The Nutrition Assistance Program in Puerto Rico[12]

Overview

The Food Stamp Act provides money for nutrition assistance in Puerto Rico under rules very different from those applied to the States. From early 1975 through June 1982, the regular food stamp program operated in the Commonwealth, albeit with some variations from standard rules.[13] Puerto Rico's food stamp program offered lower maximum benefits (about 5 percent less than in the 48 contiguous States, based on a special survey of food costs) and more limited income deductions (about half those in the regular program); however, income eligibility was based on the same Federal poverty levels used in the 48 States. At its peak, it assisted over 1.8 million persons each month, nearly 60 percent of the Commonwealth's population at the time, at an annual Federal cost of some $900 million. However, 1981 amendments to the Food Stamp Act directed that traditional food stamp assistance in the Commonwealth be ended and replaced with an annual "block grant" of Federal funds provided under the authority of the Food Stamp Act, effective July 1982. Today, the Food Stamp Act block grant to Puerto Rico represents about one-fifth of all Federal transfers to individuals in the Commonwealth, 5 percent of personal income, and an amount equal to approximately 20 percent of all personal consumption food expenditures.[14]

Section 19 of the Food Stamp Act requires that the Federal Government pay Puerto Rico an annual grant, out of appropriations under the Act, to support the costs of nutrition assistance in the Commonwealth. Puerto Rico is given rein to design its own initiatives for nutrition assistance to needy persons, without reference to the Federal rules of the food stamp program. It has chosen to use this flexibility to establish a Nutrition Assistance Program (NAP) that differs significantly from the food stamp program. There are virtually no "strings" attached to the grant, other than a requirement that Puerto Rico share in the cost of administration, and the Commonwealth uses funds provided under

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[12]With the exception of the food stamp program, all federally supported nutrition assistance (e.g., the school lunch program, the special supplemental food program for women, infants, and children) are available to Puerto Rico as with any State.

[13]Although 1971 legislation allowed the Commonwealth to operate a food stamp program, Puerto Rico (along with many other areas of the country) chose instead to distribute surplus Federal agricultural commodities to the needy until that option was removed.

[14]Commonwealth of Puerto Rico. Junta De Planificacion De Puerto Rico. *Informe Economico Al Gobernador 1987* and *Informe Preliminar De La Economia De Puerto Rico 1988*, as confirmed by later reports.

the block grant both for its NAP and other activities (a cattle tick eradication project and wage subsidies to some employers hiring NAP recipients).[15]

As recently reauthorized in the Food, Agriculture, Conservation, and Trade Act of 1990 (P.L. 101-624), required Federal funding for Puerto Rico's Food Stamp Act block grant expires September 30, 1995.

Administration

All rules governing operations using block grant funds are established by the Commonwealth. Although it must submit annual plans to the U.S. Department of Agriculture for approval, there are, for all practical purposes, no specific provisions of law that the Department can use to disapprove a plan. The Federal role is restricted to approval of the Commonwealth's plan, the provision of funds, and limited oversight to ensure program integrity.

Funding

Federal funds cover costs for carrying out any program(s) of nutrition assistance designed by the Commonwealth. However, to qualify for Federal money Puerto Rico must pay half of any administrative expenses it incurs, and total Federal support is limited to amounts specified in the Food Stamp Act (the annual block grants).

When originally enacted, the block grant amount was set at $825 million a year, with no provision for adjustment over time. This was a substantial reduction from the previous level of Federal support under the food stamp program and prevailed through FY 1986. In 1985 legislation, the annual grant was increased to: $852.75 million (FY 1987), $879.75 million (FY 1988), $908.25 million (FY 1989), and $936.75 million (FY 1990). The 1990 act reauthorizing food stamp appropriations through FY 1995 (P.L. 101-624) sets Puerto Rico's annual grant at: $974 billion (FY 1991), $1.013 billion (FY 1992), $1.051 billion (FY 1993), $1.091 billion (FY 1994), and $1.133 billion (FY 1995).[16] With the exception of FY 1986 (when the grant was subject to a $5 million reduction under the terms of the "Gramm-Rudman-Hollings" law) and FY 1988 (when $.5 million less than the earmarked amount was made available by the agriculture

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[15]Puerto Rico recently has begun a limited wage subsidy initiative using funds from its block grant (about $1 million in FY 1990). This subsidy, intended to encourage low-income family heads to work, pays 25 percent of the Federal minimum wage for up to 40 hours of work per week. The cattle tick eradication project, accounting for approximately $10 million a year, is directed toward the enhancement of livestock productivity through the island-wide eradication of ticks.

[16]In general, the higher dollar amounts beginning in FY 1987 were arrived at by increasing the $825 million original grant by Congressional Budget Office inflation estimates.

appropriations act because of an across-the-board percentage cut in all agriculture appropriations), the full amount established in the Food Stamp Act has been provided each year.

Puerto Rico receives no special Federal cost-sharing for development of computer capability, fraud investigation and prosecution, employment and training activities, or carrying out a SAVE program. The Commonwealth is not liable for fiscal sanctions under the food stamp quality control system.

TABLE 4. Food Stamp Act Expenditures in Puerto Rico: Current Dollars
(in millions)

Fiscal year	Benefits[b]	Administration[a] Federal	Administration[a] Commonwealth	Total
1979	$748	$26	$26	$800
1980	825	25	25	875
1981	879	27	27	933
1982[c]	870	27	27	924
1983	801	23	23	847
1984	803	22	22	847
1985	804	21	21	846
1986[d]	795	25	25	845
1987	827	26	26	879
1988[d]	853	26	26	905
1989	883	25	25	933

[a]Adminstrative costs shared equally between the Federal Government and the Commonwealth, both under the terms of the regular food stamp program (through June 1982) and under the Commonwealth's limited nutrition assistance block grant (from July 1982 onward).

[b]Benefits federally funded under the terms of the regular food stamp program (through June 1982), and under the limited nutrition assistance block grant (from July 1982 onward). Benefit figures include spending (e.g., $9.6 million in FY 1989) on special agriculture projects allowed under the terms of the block grant.

[c]In July 1982, the regular food stamp program was replaced with the Commonwealth's nutrition assistance program, funded by a Federal block grant and the Commonwealth's share of administrative costs.

[d]In FY 1986, the normal $825 million nutrition assistance block grant was subject to a $5 million reduction in available funding under the terms of the "Gramm-Rudman-Hollings" law. In FY 1988, $0.5 million less than the earmarked block grant amount was actually appropriated.

NOTE: The Food Stamp Act earmarked specific amounts for Puerto Rico: $206.5 million in FY 1982, $825 million a year in FY 1983-1986, $852.75 million in FY 1987, $879.75 million in FY 1988, and $908.25 million in FY 1989.

Source: Budget documents prepared by the U.S. Department of Agriculture, Food and Nutrition Service.

TABLE 5. Food Stamp Act Expenditures in Puerto Rico: Constant Dollars[a]
(in millions)

Fiscal year	Benefits	Administration		Total
		Federal	Common-wealth	
1979	$1,087	$37	$37	$1,162
1980	1,087	32	32	1,152
1981	1,053	32	32	1,117
1982	1,012	30	30	1,072
1983	929	26	26	980
1984	904	24	24	952
1985	901	23	23	947
1986	883	27	27	938
1987	902	28	28	957
1988	901	27	27	955
1989	883	25	25	933

[a]Benefit spending has been adjusted for inflation, to constant FY 1989 dollars, by using the "food at home" component of the Consumer Price Index for All Families in Puerto Rico, as compiled by the Commonwealth's Department of Labor and Human Resources in its monthly *Informe Estadistico*. Administrative spending has been adjusted for inflation, to constant FY 1989 dollars, by using the overall Consumer Price Index for All Families in Puerto Rico. For adjustments prior to January 1980, the Consumer Price Index for All Wage Earners in Puerto Rico was used.

NOTE: See notes for table 4.

Eligibility for Assistance

Under Puerto Rico's NAP, eligibility rules are *simpler and significantly more restrictive* than in the food stamp program. Income eligibility is based solely on basic (gross) monthly income, and limits are set at levels just under half those now applied under the food stamp program in the 48 contiguous States (e.g., $667 vs. $1,376 a month for a four-person household). The liquid assets eligibility standard also is set well below the food stamp standard: $1,000 for all households. Income and asset eligibility standards have not changed since the advent of the NAP, while food stamp income limits are indexed for inflation, and asset standards have been liberalized by legislation. Categorical eligibility rules generally are not used.

Approximately 1.45 million persons a month in 450,000 households receive benefits under the NAP. Average monthly participation has held relatively steady at between 1.4 and 1.5 million persons since 1984, with NAP recipients representing some 44 percent of the Commonwealth's population.

Benefits

Benefits in the NAP are issued monthly and calculated in much the same manner as in the food stamp program. However, they are issued in *cash* (checks), are slightly lower than average food stamp allotments, and can vary significantly from month to month even when household circumstances do not change.

To keep NAP costs within the annual block grant amount without adjusting eligibility criteria, Puerto Rico has chosen to vary maximum benefit levels monthly if necessary, and as a result, the benefits participating households receive can differ from month to month. For example, in recent years (FY 1988-1990), maximum monthly benefits for a four-person household have ranged from about $230 to $280 a month.[17] The expenditure of all block grant funds each year is ensured through the issuance of a 13th "bonus" benefit check in September.

Although maximum benefit levels are changeable and noticeably below those in the food stamp program, benefit determination procedures are similar (although simpler) in other respects. Households' benefits are calculated by subtracting 30 percent of counted monthly cash income from the applicable maximum monthly benefit. And, the counted income used to establish benefit amounts is substantially less than each household's gross income: i.e., gross income is reduced to counted income by applying a limited series of deductions comparable to, although smaller than, those used in the food stamp program.

Because of their substantially lower incomes, recipients are more likely to receive something closer to the maximum benefit for their household size, and NAP monthly average benefits have not lagged far behind average U.S. average food stamp benefits--$50 vs. $52 per person in FY 1989--despite the fact that *maximum* NAP benefits are significantly lower, on average 20-25 percent. On the other hand, because NAP recipient households in Puerto Rico are often larger than food stamp households in the States, typical NAP *households* have received benefits that are significantly higher than in the regular food stamp program ($159 vs. $135 in FY 1989). In effect, Puerto Rico has attempted to live within the amounts provided by the block grant primarily by freezing eligibility standards, thereby controlling participation, and placed less emphasis on reducing benefits beyond the basic reductions made necessary by the size of the original block grant.

However, the gap between NAP and food stamp benefits is likely to widen, unless NAP enrollment is reduced to allow for higher benefits. Under the terms of the recent reauthorization of the block grant, Puerto Rico will receive annual increases equal to *estimates of inflation* through FY 1995, roughly 4 percent a year. Maximum food stamp benefits, on the other hand, will be increased for *actual* inflation, *plus* a 3-percent add-on.

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[17]Comparable maximum monthly food stamp benefits in the 48 contiguous States increased from $290 in FY 1988 to $331 in FY 1990.

Program Options

Under the law governing Puerto Rico's block grant, virtually unlimited program design options are available. At present, the Commonwealth is exercising this flexibility primarily by providing NAP benefits in cash, using approximately $10 million a year to fund a cattle tick eradication project, and spending $1 million of its block grant funds to provide wage subsidies to certain employers hiring NAP recipients.

Implications of Statehood

Overview

Unless special provisions were adopted, Puerto Rico's inclusion as a State under the Food Stamp Act would end the NAP and replace it with the regular food stamp program as it operates in the 48 contiguous States (and the District of Columbia), thereby greatly increasing enrollment, benefits, and costs (both to Puerto Rico and the Federal Government). However, the changeover would not be simply a matter of added costs from new benefits, a larger caseload, and added administrative responsibilities. Because Puerto Rico would be required to operate its nutrition assistance program under the full panoply of Federal food stamp rules, important program design options Puerto Rico now enjoys would be terminated. And, because benefits would be issued in food stamp coupons, a sizable portion of Puerto Ricans' personal income would be required to be spent on food purchases, with uncertain effects on the Island's economy.

Administration

With extension of the food stamp program to Puerto Rico, substantial administrative changes would be in store both for the Commonwealth and the Federal Government. Puerto Rico would be subject to a wide range of Federal administrative rules and some new administrative costs. Puerto Rico's NAP generally operates under procedures for determining eligibility and issuing benefits that are simpler, and less costly, than would be the case under the food stamp program. At the least, new rules for processing applications, verifying eligibility factors, issuing benefits as coupon allotments rather than checks, operating employment and training programs, and quality control surveys would add significantly to administrative costs.[18] Puerto Rico's administration of the program might also come under much closer scrutiny than other States because of a provision in the Food Stamp Act requiring special audits by the U.S. Department of Agriculture's Inspector General whenever a State's food stamp caseload exceeds 60 percent of its population; this provision was almost triggered under Puerto Rico's pre-1982 food stamp program.

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[18]The U.S. Department of Agriculture's evaluation of the conversion to the NAP found an 18 percent reduction in administrative expenses. A portion of this reduction was due to a reduced caseload.

From the Federal perspective, statehood would bring on significant new administrative activity related to printing and redeeming coupons and oversight of food stores and welfare agency operations.

Funding

Treating Puerto Rico as a State in the food stamp program would remove the current block grant limit on Federal financial support for nutrition assistance, and Federal funding would increase to cover whatever benefits were issued, a little over half of the Commonwealth's administrative costs, and new Federal expenses. Using experience under the pre-1982 food stamp program in Puerto Rico as a guide, annual Federal spending could increase by $500 million, or more, because of increased participation, higher benefits, and larger administrative costs. On the other hand, Puerto Rico would become liable to the Federal Government for limited quality control sanctions if its rate of erroneous eligibility and benefit determinations exceeded food stamp program "tolerance" levels and would have to return to the Federal Government the majority of any improperly issued benefits that were recouped.

Eligibility for Assistance

Possibly the most important change resulting from statehood would be a substantial increase in the number of people eligible for, and presumably choosing to participate in, the "new" food stamp program. It is not unlikely that participation would grow by almost one-third to pre-1982 levels, adding some 400,000 persons to the monthly caseload. Unless special provisions were enacted, financial eligibility limits would be more than double those under the NAP, rising to 130 percent of the standard Federal poverty levels and approaching 80 percent of average family income in the Commonwealth. Imposition of those food stamp eligibility rules that are more restrictive than those of the NAP (e.g., some categorical rules) probably would have little effect, and the availability of new cash welfare assistance (e.g., the SSI program) under statehood would increase food stamp participation because of rules making most cash welfare recipients automatically eligible for food stamps.

Benefits

All benefits under Puerto Rico's food stamp program would have to be issued in coupons rather than cash. Without specific amendments to the Food Stamp Act, the standard maximum benefit and income deduction levels established for the 48 contiguous States would become those used in Puerto Rico. Maximum benefits in the NAP are, on average, over 20 percent lower than in the 48 States, and income deductions are similarly smaller. As a result, average benefits would rise sharply, by at least 20 percent, surpassing typical benefits in the rest of the country.

Other Considerations

Under the Food Stamp Act, States are not allowed to collect sales taxes on food stamp purchases if they wish to operate the food stamp program. To the extent Puerto Rico collects sales taxes on purchases now made with cash provided under the NAP, it would lose revenues.

Food stamps in Puerto Rico would both affect and be affected by other welfare program consequences of statehood. To some degree the new infusion of food stamp assistance might encourage Puerto Rico to hold down, or not embark on, expansion of its AFDC program, despite new Federal cost-sharing offered it as a State. Extension of the SSI program to Puerto Rico would limit additional food stamp costs because this new income to likely food stamp recipients would reduce their food stamp benefits.

Federal funding for Puerto Rico's cattle tick eradication project and wage subsidies to employers would be eliminated, and Puerto Rico would be required to establish an employment and training program for food stamp recipients.

Conversion to the NAP cash grants brought on an estimated 1-8 percent reduction in aggregate food expenditures.[19] And it would appear that conversion back to food stamp coupons usable only for food would increase food spending noticeably, might tie up an unacceptably high proportion of the Commonwealth's income in food purchases, and could have distorting effects on Puerto Rico's economy.

SOCIAL SECURITY

The Program in the States

Program Description

Social security--the old-age, survivors, and disability insurance (OASDI) program--provides monthly benefits to retired and disabled workers and to their dependents and survivors. A worker gains eligibility for OASDI benefits through employment that is covered by the social security system. Employees of State and local governments are covered on a voluntary group basis.

Social security taxes are levied on covered employment and the revenues are credited to special trust funds. These trust funds are debited for payment of monthly benefits and administrative expenses of the program. Benefits are paid as a "earned right"--free from any test of need--and are loosely based of the level of career earnings covered by social security.

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[19]The evaluation from which this estimate is drawn indicates that the "true" effect is probably closer to the lower end of this range.

Cost and Recipients

Benefit payments in FY 1991 are expected to total $267 billion. There are approximately 40 million current social security beneficiaries.

The Program in Puerto Rico

Program Description

Basically, social security coverage and eligibility rules apply to Puerto Rico as they do to the United States generally. The Social Security Act generally defines a "State" and the "United States" to include Puerto Rico, as well as the Virgin Islands, Guam, the District of Columbia, and American Samoa. Employees of the Government of the Commonwealth of Puerto Rico, who are treated the same as "State" employees, participate in social security.

An exception to the general applicability of benefits is what are called "special age-72 benefits," sometimes called "Prouty" benefits. These are special benefits, paid out of general revenues, for individuals (men who attained age 72 before 1972 and women who attained age 72 before 1970) who have worked in covered employment for less than the amount of time otherwise required. The law restricts these benefits to residents "of the 50 States," the Northern Mariana Islands, and the District of Columbia.

Cost and Participants

In 1988, the last year for which there are data, Puerto Rico had 557,000 social security beneficiaries. Their average monthly retirement benefit was $341.20, compared to a national average of $536.90. In the aggregate, residents of Puerto Rico received $1.89 billion in social security benefit payments. The last year for which we have data on workers is 1986. In that year, 1,198,000 workers and their employers paid $1.20 billion in social security taxes (in the same year Puerto Rican residents received $1.72 billion in benefits).

Implications of Statehood

In general, statehood would bring no change from current law. However, special age-72 benefits might be extended to the few individuals who would be eligible if "the 50 States" were interpreted to include *all* States.

MEDICAID

The Program in the States

Medicaid, authorized by Title XIX of the Social Security Act, is a Federal-State matching program providing medical assistance to low-income persons. Each State designs and administers its own medicaid program, setting eligibility and coverage standards within broad Federal guidelines. Thus, there is considerable variation among the States in terms of eligibility requirements,

range of services offered, limitations placed on those services, and reimbursement policies.

Financing

The Federal share of expenditures for medicaid services in the States is tied to a formula inversely related to the square of a State's per capita income. For FY 1991, the Federal matching percentages range from 50 percent to 79.9 percent; no State may receive more than 83 percent. The matching rate for administrative costs is generally 50 percent for all States, with higher matching available for certain management and control activities. The remaining costs of the program are paid by the State; in some States local governments also contribute.

Eligibility

All States must cover the *categorically needy*. These include all persons receiving AFDC and, in most States, persons receiving SSI. Thirty-nine States and other jurisdictions also provide medicaid to the *medically needy*. These are persons whose income or resources exceed the standards for the cash assistance programs but who meet a separate medically needy financial standard established by the State and also meet the nonfinancial standards for categorical eligibility (such as age, disability, or being a member of a family with dependent children). Finally, Congress has recently extended medicaid coverage to certain *target populations*, using eligibility standards that are not directly linked to those used in the cash assistance programs. The Medicare Catastrophic Coverage Act of 1988 (P.L. 100-360) required States to pay medicare premiums, deductibles, and coinsurance for aged and disabled persons eligible for medicare with family incomes below 100 percent of poverty. The Omnibus Budget Reconciliation Act of 1990 (OBRA 90) requires States to pay medicare premiums for medicare beneficiaries with incomes below 110 percent of the poverty level by January 1, 1993, and with incomes below 120 percent of the poverty level by January 1, 1995. OBRA 1989 (P.L. 101-239) requires States to cover pregnant women and children up to age 6 with family incomes below 133 percent of the Federal poverty level, effective April 1, 1990. OBRA 90 (P.L. 101-508) requires States to phase in coverage of children under age 19, born after September 30, 1983, with family incomes below 100 percent of poverty. Thus, children will be eligible in annual cohorts so that all eligible children up to age 19 will be covered by the year 2002.

Services

All States must cover a minimum set of services under medicaid and may offer additional services. For the categorically needy, the State must provide inpatient and outpatient hospital services, physician services, laboratory and X-ray, family planning, nursing facility services for those over age 21, home health care for persons entitled to services in nursing facilities, and ambulatory services furnished by a federally qualified health center (FQHC). OBRA 89 defines FQHC as a center receiving a grant under section 329, 330, or 340 of the

Public Health Service Act, or a center determined to meet the requirements for such a grant. The State must also provide early and periodic screening, diagnosis, and treatment (EPSDT), a preventive health program for persons under 21. Optional services include care in intermediate care facilities (ICFs), as well as such ancillary services as prescription drugs, dental care, and eyeglasses. Beneficiaries generally must be allowed to obtain services from any qualified provider.

Administration

Although each State administers its own medicaid program, there are some basic administrative standards with which States must comply. States are required to maintain a medicaid quality control (QC) system which reviews the accuracy of eligibility determinations. Federal funding may be reduced if the State makes excessive errors in determining medicaid eligibility. Most States are also required to operate a medicaid management information system (MMIS), a standard claims processing and reporting system.

Cost and Participation

Medicaid served an estimated 26 million low-income persons in FY 1990. Total expenditures for medicaid during FY 1990 were an estimated $72 billion, of which the Federal share was $41 billion.

The Program in Puerto Rico

The medicaid program in Puerto Rico operates under special Federal funding rules and is exempt from certain requirements relating to eligibility, service coverage, and program administration.

Financing

The Federal share in medicaid expenditures in Puerto Rico and other territories is fixed at 50 percent. Total Federal funding is subject to a cap of $79 million in FY 1990 and later years. As a result of the cap, Federal funds make up less than 50 percent of program costs.

Eligibility

Puerto Rico is exempt from the new requirements for coverage of pregnant women and children. On the other hand, Puerto Rico has been permitted to establish medically needy income standards above the maximum ordinarily allowed. A State's medically needy standard may not exceed 133-1/3 percent of the State's maximum AFDC payment amount for a family of the same size. In Puerto Rico, with a maximum AFDC payment of $90 per month, this would mean a medically needy income standard of $1,440 per year for a family of three. Instead, Puerto Rico's standard for a family of three is $5,700. (There does not appear to be any statutory authority for this exception.) The medically needy

account for 48 percent of Puerto Rico's medicaid beneficiaries, as opposed to 14 percent in the rest of the Nation.

Puerto Rico is also exempt from the requirement that it phase in coverage of medicare premiums and cost-sharing amounts for aged and disabled persons. Puerto Rico could, at its option, pay premiums and cost-sharing for medicare beneficiaries who meet its current medicaid income and resource standards. However, it has opted not to do so. Possibly as a result, 35 percent of medicare Part A enrollees do not have Part B coverage.

Services

Puerto Rico is exempt from the requirement that beneficiaries be allowed to obtain services from any qualified provider. All services are provided through public hospitals and clinics. Medicaid in Puerto Rico thus does not operate as a conventional insurance program, paying claims for specific services furnished to particular eligible individuals. Payment amounts to the participating public facilities are based on the facilities' budgets, with the medicaid share determined by comparing a sample of provider treatment records to medicaid eligibility listings.

Puerto Rico does not claim Federal financial participation for nursing facility, family planning, or home health services. These are mandatory services and are nominally included in Puerto Rico's State plan for medical assistance. Health Care Financing Administration (HCFA) officials are not certain they are actually being furnished.

Administration

Puerto Rico is exempt by statute from several rules relating to program administration. It is not subject to financial penalties under the medicaid QC system, nor is it required to operate an MMIS. As a result of these waivers, Puerto Rico is not subject to two of the basic control mechanisms used by the Federal Government in overseeing State medicaid programs. The absence of QC penalties has meant that there is no Federal review of the accuracy of eligibility determinations. (Puerto Rico does operate its own internal QC system, which has found eligibility errors in 20 to 30 percent of the cases reviewed.) The absence of an MMIS has meant that reliable information about program operations is unavailable.

Cost and Participation

Between July 1989 and June 1990, 1.2 million persons in Puerto Rico were estimated to have received medicaid benefits. Total expenditures were an

estimated $381 million. These figures may include expenditures for persons who do not qualify for medicaid under Federal rules.[20]

Implications of Statehood

Medicaid in Puerto Rico would change dramatically in the event of statehood. Federal funding could more than double. At the same time, Puerto Rico would become subject to the minimum requirements, restrictions, and program control mechanisms applicable to the States. The current system, under which medicaid amounts to a transfer of funds to public facilities, would be replaced by a system in which public and private providers would file claims for specific services to specific beneficiaries.

The following program changes would occur if Puerto Rico were treated like other States for medicaid purposes.

Financing

The cap on medicaid matching funds for Puerto Rico would be removed, and the Federal funding percentage would be computed under the current formula, which increases funding for States with lower per capita incomes. Puerto Rico's percentage would almost certainly be the maximum 83 percent permitted by law, as its median income is half that of the poorest State.[21] As a result of open-ended funding at a much higher matching rate, Federal funding for the Puerto Rico medicaid program could be over $300 million.

Eligibility

Puerto Rico would be subject to the requirements that States cover pregnant women, infants, and children up to age 6 with family incomes up to 133 percent of the poverty level, and phase in coverage of children born after September 30, 1983, with incomes up to 100 percent of poverty. In addition, if its SSI payment levels were raised to the national standard, it would be required to furnish medicaid to any newly eligible SSI beneficiaries (many of these persons may already be covered as medically needy). On the other hand, Puerto Rico could no longer use a medically needy income standard in excess of 133-1/3 percent of maximum AFDC payments. Unless its AFDC standards were increased significantly, some families with children could lose coverage.

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[20]Data obtained in telephone conversation with spokesperson in the Region II office of the Health Care Financing Administration, Department of Health and Human Services, November 27, 1990.

[21]If there were no 83 percent maximum, a State whose per capita income was half the national average would receive 88.75 percent matching. A State whose per capita income was one-third the national average (the situation of Puerto Rico) would receive 95 percent matching.

For all aged and disabled persons below poverty currently eligible for medicare, Puerto Rico would be required to pay the medicare Part B premium, deductibles, and coinsurance, as well as phase in payment of medicare premiums for beneficiaries with higher incomes. Puerto Rico also would be required to pay the Part A premium for any persons who are over age 65, have incomes below the poverty level, and are not automatically eligible for Part A because they are not insured under the social security system.

Services

Puerto Rico would be subject to the requirement that beneficiaries be allowed to obtain services from any qualified provider. Unlike the other associated territories, Puerto Rico has a substantial private medical care sector. For example, 30 percent of community hospital beds in 1987 were in private nonprofit facilities; another 34 percent were in proprietary hospitals. This is a higher proportion of privately owned beds than prevails in some States, such as Louisiana, Mississippi, or Oklahoma. Statehood could, then, mean a substantial shift in funds towards the private sector. One consequence might be that the public facilities would be less able to subsidize care for those low-income populations that would continue to be excluded from the medicaid program.

Medicaid law does permit waivers of the "freedom-of-choice" requirement to allow States to establish selective contracting systems. California and Illinois currently have such waivers, under which nonemergency hospital services are available only through specified contract providers. However, these providers are selected on the basis of price competition. It is not clear that current law would permit a system in which only public providers could participate.

Puerto Rico also would be required to make available the mandatory services that, while nominally covered under its current State plan, may not actually be available. These include services in nursing facilities, home health care, and family planning.

Administration

Puerto Rico would be subject to penalties under the medicaid QC system and would be required to operate an MMIS. These changes could result in a more rigorous eligibility application process and would also require the State to screen claims from providers, to insure that payment was made only for covered services to eligible individuals.

Implications for Scope and Cost of Program

In summary, statehood would bring an influx of new dollars to Puerto Rico's medicaid program. This benefit would be offset by requirements that Puerto Rico furnish more extensive coverage to some classes of individuals while cutting off coverage to some others. Medicaid funds might be shifted from public to private providers. Finally, stricter bureaucratic requirements could create barriers to access for many eligible persons.

MEDICARE

The Program in the States

Program Description

Medicare provides health insurance protection for aged and disabled individuals. The program covers hospital services, physician services, and other medical services for all of those eligible, regardless of income. Medicare has two parts: hospital insurance (Part A) and supplementary medical insurance (SMI) (Part B).

Part A of medicare covers inpatient hospital care. In some cases, it also covers short-term skilled nursing facility care after a hospital stay, home health agency visits, and hospice care. Part A is financed chiefly from hospital insurance payroll taxes. A small number of persons over age 65 are not entitled to medicare because they are not eligible for social security or railroad retirement benefits; these persons may enroll under Part A by paying a monthly premium.

Medicare pays for inpatient hospital services according to a prospective payment system (PPS). Under this system, each medicare patient is classified according to his or her medical condition into diagnosis-related groups (DRGs). Hospitals are paid a predetermined rate for each patient treated within a given DRG. Hospitals with costs below the payment rate are allowed to keep the surplus, while hospitals with costs above the payment rates must absorb the loss.

Part B is a voluntary program; individuals must enroll and pay a premium to receive benefits. All persons entitled to Part A and all persons over age 65 are eligible to enroll. The program covers the services of physicians, outpatient hospital care, laboratory and X-ray services, and other related medical services and supplies. The program is financed by beneficiary premiums and general revenues. The monthly premium ($29.90 in 1991) accounts for about 25 percent of program costs. Medicare generally pays 80 percent of the reasonable charges for covered services, after the beneficiary has met the $75 annual deductible. The beneficiary is liable for 20 percent of the reasonable charge, an amount known as coinsurance.

The Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, established a new payment system for medicare's payment of physician services. Under the provisions of P.L. 101-239, payments are to be made using a fee schedule based on a relative value scale (RVS), a method for valuing individual services in relationship to each other. The law provides for a transition to the fee schedule over the 1992-1996 period.

Cost and Participation

Medicare outlays for FY 1990 are estimated to be $95.7 billion ($107.2 billion in gross outlays, offset by $11.5 billion in beneficiary premium payments).

The Program in Puerto Rico

Program Description

For medicare purposes, Puerto Rico is treated like any State, with one exception.

First, hospitals in Puerto Rico are reimbursed for inpatient services under a special prospective payment system (PPS) distinct from the PPS used for hospitals in the States. The standard medicare PPS establishes three basic national hospital payment rates, for hospitals in large urban areas, other urban areas, and rural areas. These basic rates are adjusted through a wage index to reflect relative labor costs in different areas. For each case, the applicable adjusted rate is multiplied by a weighting factor reflecting the classification of the case into one of 477 DRGs. The product represents the basic DRG payment for the case.[22]

Puerto Rico's system works essentially the same way, except that separate large urban, other urban, and rural rates are established for Puerto Rico hospitals. These represent a blend of an average national rate (25 percent) and rates based on historical costs for Puerto Rico hospitals alone (75 percent).

Cost and Participation

In 1989, 420,747 Puerto Ricans were enrolled in medicare Part A, and 273,733 were enrolled in Part B. Data on medicare expenditures by residence of the beneficiary are not available.

Implications of Statehood

Inpatient Hospital Reimbursement

Under statehood, Puerto Rico hospitals would be paid under the national PPS. Revenues would rise by something less than the current payment differential, because the inclusion of Puerto Rico in the averages on which the national rates are based would reduce those rates for all hospitals. Still, Puerto Rico hospitals would be paid considerably more, relative to their costs, than hospitals in the States.

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[22]This payment may be further adjusted for cases with very high costs or long stays (outliers); additional payments are made to teaching hospitals and those treating a disproportionate share of low-income patients.

Part B Enrollment

One feature of Puerto Rico's medicaid program has an indirect effect on eligibility for medicare benefits. Other States' medicaid programs pay medicare premiums and cost-sharing for low-income aged and disabled persons; Puerto Rico's does not. This may have contributed to the fact that in Puerto Rico enrollment under Part B is 35 percent lower than under Part A. If Puerto Rico were a State, it would be required to pay Part B premiums for all medicare beneficiaries with incomes below 100 percent of poverty. This could mean Part B eligibility for most of the 147,000 Part A eligibles not currently enrolled under Part B.

Implications for Scope and Cost of Program

The major impact of statehood would be a significant increase in the number of Part B enrollees, resulting in added costs for both the Federal and Puerto Rican governments. Part A costs could increase or remain the same, depending on how hospital payment rates for Puerto Rico are established.

UNEMPLOYMENT COMPENSATION

The Program in the States

The unemployment compensation (UC) system provides short-term income assistance to unemployed workers through a State-operated system created by Federal tax incentives. The Federal Unemployment Tax Act (FUTA) and Titles III, IX, and XII of the Social Security Act provide the framework for the system. Its major objectives are to: (1) provide temporary relief through partial wage replacement for unemployed workers who demonstrate a strong labor force attachment; and (2) help stabilize the national economy automatically by increasing net public spending during recessions and increasing taxation during periods of economic growth.

The Federal-State structure of UC places responsibility on the States for program details based on broad Federal guidelines. State laws determine individual eligibility, benefit amount, benefit duration, and disqualification provisions. Federal law requires State programs to cover certain types of employment.

Benefits are funded by State payroll taxes on employers. State tax revenue funds the payment of regular UC benefits and half of the extended benefits (EB) program. State UC laws determine the tax structure of the program, and States collect the revenue from employers. This revenue is deposited with the U.S. Treasury and credited to individual State accounts within the Unemployment Trust Fund. It is counted as Federal revenue in the budget. Funds are made available to States as needed for benefit payments, and the State accounts are charged for this Federal reimbursement of their benefit expenditures.

The FUTA imposes a 6.2-percent gross Federal tax rate on employers for the first $7,000 in wages paid to each covered employee. In States with federally approved programs and no outstanding Federal loans for the program, employers are given a tax credit reduction of up to 5.4 percentage points against the 6.2-percent tax liability. Thus, employers pay a net FUTA tax rate of 0.8 percent. FUTA tax revenue is used to fund the administrative costs of UC, the Federal half of EB, and loans to State programs that become insolvent.

The system covers about 85 percent of all employed persons in 53 "State" programs (the 50 States plus the District of Columbia, Puerto Rico, and the Virgin Islands). During FY 1991, the U.S. Department of Labor estimates that $18.8 billion will be paid to 8.4 million beneficiaries and that benefits will average $161 weekly.

The Program in Puerto Rico

The UC program in Puerto Rico operates on the same legal basis as the programs in the States. Puerto Rico's UC program has several unusual characteristics. For example, while the regular benefit period can last up to 26 weeks in most States, Puerto Rico has a 20-week period. Most States set an employer's tax rate based on the firm's experience with unemployment, but Puerto Rico does not use this "experience-rating" approach to taxation. Puerto Rico's maximum weekly benefit amount of $120 is less than that of all but one of the States' programs.

During the second calendar quarter of 1990, Puerto Rico had an unemployment rate of 13.5 percent, higher than that of any State. There were 41,200 UC beneficiaries in Puerto Rico during the quarter, and the cost of their benefits during the 3 months was $29.0 million.

Implications of Statehood

Since Puerto Rico already operates a UC program on the same basis as the States, no change in the existing program would be needed should Puerto Rico become a State.

EARNED INCOME TAX CREDIT

The Program in the States

The earned income tax credit (EITC) is a refundable tax credit authorized under the U.S. Internal Revenue Code as a part of the individual income tax. Eligible tax filers may use these credits to reduce their Federal income tax liability. If a filer's credit entitlement exceeds tax liability, the balance of the credit amount is "refunded," or paid directly, to the filer by means of a check from the U.S. Treasury. An individual who anticipates being eligible for EITC can have the employer take it into account in determining tax withholding from wages. Anticipated eligibility for an EITC refund can result in an increased pay

check (i.e., negative tax withholding) for employees who take advantage of the withholding process.

To be eligible for EITC, a filing unit must have earned income and a dependent child residing in the household. In 1991 the credit is worth 16.7 percent of the first $7,140 of yearly family earnings for a family with one child who is at least age 1. The $1,192 maximum credit is reduced by 11.93 cents for each dollar of adjusted gross income (AGI) over $11,250. Thus, the credit phases out for families with AGI of $21,242 or more. (If the child is under age 1, an extra credit of $357 is paid, but the phaseout point is the same.)

For a family with two or more children (neither under age 1), the 1991 credit rate is 17.3 percent. The maximum credit of $1,235 phases out over the same income range at a rate of 12.36 cents per dollar of AGI over $11,250. (Again, extra credit is paid for a child under 1).

The EITC first took effect in 1975. The credit amount and phaseout income level have been increased several times since the original enactment and are now adjusted annually for price inflation. Credits earned in 1990, and generally paid in 1991, are projected to total $5.9 billion. They will go to 10.3 million families, or about one-third of all U.S. families with children.

The Omnibus Budget and Reconciliation Act (OBRA) of 1990 increased EITC benefits beginning in January 1991. These increases will be phased in from 1991 through 1994. The credit rate will rise to 23 percent in 1994, and a higher rate (25 percent) will then apply for families with two or more children. Beginning in 1991, families with a child under age 1 receive a bonus credit of 5.0 percent of earnings. A new refundable credit to offset part of the cost of children's health insurance also began in 1991, set at 6.0 percent of the earnings level subject to EITC.

The Program in Puerto Rico

The EITC generally is not available to families in Puerto Rico. Persons living in Puerto Rico year-round are exempt from Federal income taxes and pay only the Puerto Rican income tax. They are ineligible for EITC because their income is exempt from the U.S. tax system. Puerto Ricans with U.S. earnings who reside part-time in the States and file U.S. tax returns also are ineligible for EITC because EITC is available only for persons whose tax returns cover a 12-month period. (However, U.S. Government employees residing in Puerto Rico are subject to the U.S. income tax, and some are eligible for EITC.)

Implications of Statehood

Puerto Rican statehood would bring its residents under the U.S. income tax. Thus, eligibility for EITC would be available to all working Puerto Rican parents with dependent children who meet the income test.

The impact of this eligibility extension on the cost of EITC to the Federal Government and on the Puerto Rican economy would be substantial. Individual income data for Puerto Rico are from the 1980 decennial census and thus are dated. However, a conservative estimate of how many Puerto Rican families would have been covered in 1979 had 1990's EITC been available to them at the same real dollar levels shows that about 295,000 families would have been eligible. This group would have amounted to 65 percent of all Puerto Rican families with children in that year. If Puerto Rican families had received an average credit similar to that for the United States as a whole ($567), the cost of these benefits would have been $167 million in today's dollars, which would have raised the total cost of EITC for 1990 by 3 percent. These additional cash payments would not be taken into account in determining AFDC benefit amounts for families under that program. EITC payments would also be ignored in most cases in the determination of benefit amounts under Puerto Rico's nutrition assistance program.

The expansion of EITC enacted in OBRA of 1990 will clearly raise the cost of these credits in Puerto Rico above the estimate for the 1990 law. The pool of eligible families remains the same, but the larger credit amounts will increase the cost per family.

MATERNAL AND CHILD HEALTH SERVICES BLOCK GRANT

The Program in the States

Program Description

The maternal and child health services block grant (MCH), authorized under Title V of the Social Security Act, provides grants to each State and insular area for a variety of health programs for mothers and children, including prenatal care and preventive care to low-income individuals, and rehabilitation services for blind and disabled individuals under age 16. Funds are allocated among grantees on a percentage formula based on the grantee's allotment in FY 1983. Fifteen percent of the funds appropriated for the block grant each year are set aside for special projects of regional and national significance (SPRANS) in categories that include research, training, dissemination of information, and testing for genetic disorders. The remaining 85 percent is available for block grants. Whenever the amount appropriated for a fiscal year exceeds $600 million, there is an additional set-aside of 12.75 percent of the excess. This additional set-aside is used for initiatives which may include case management, home visiting, or integrated service delivery for maternal and child health.

To receive an MCH grant, a State must submit an application containing a statewide needs assessment, a plan for meeting the needs identified in the assessment, and a description of how MCH grant funds will be used to meet the needs. State plans for meeting the needs must be consistent with national health objectives. The law provides that States must use at least 30 percent of their allotments for preventive and primary care services for children, and at least 30 percent for community-based care for children with special health care

needs unless the State demonstrates an extraordinary unmet need in one area. Not more than 10 percent of a State's allocation may be used for administrative costs. States are required to match each $4 in Federal funds with $3 of their own, and maintain the level of funding that the State provided for maternal and child health programs in FY 1989.

States determine eligibility criteria for MCH services, although the law provides for targeting some services to mothers and children with family incomes below 100 percent of Federal poverty guidelines.

Program Operation

For FY 1991, $587 million was appropriated for the MCH block grant. Information on the number of individuals served and the types of services provided under the block grant is incomplete. The Omnibus Budget Reconciliation Act of 1989 requires States to submit annual reports on standardized forms for fiscal years beginning with FY 1991.

The Program in Puerto Rico

Program Description

For the purposes of the MCH block grant, Puerto Rico is treated as a State, and the program operates as in the 50 States. The program is administered by Puerto Rico's Department of Health.

Program Operation

For FY 1991, Puerto Rico's MCH allotment is $14,467,207. In FY 1990, Puerto Rico received $13,637,494 in MCH funds and was required to spend $10,693,850 of its own money for maternal and child health programs. Puerto Rico may have spent an unreported amount in excess of the 75 percent required match. The MCH program in Puerto Rico is the primary payer for ambulatory care for medically indigent children. In 1989, 17,000 children with special health care needs received services through the MCH program. Recent information on other services is not available at this time; at present there is no mechanism for reporting from local health departments to the central health department in Puerto Rico.[23]

Implications of Statehood

Since Puerto Rico is treated as a State for purposes of the MCH block grant, a change in the Commonwealth's status to a State apparently would have no effect on this program.

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[23]Data obtained in telephone conversation November 26, 1990, with spokesperson of Region II office of Public Health Service, U.S. Department of Health and Human Services.

TITLE IV-B CHILD WELFARE SERVICES

The Program in the States

The child welfare services program provides 75 percent Federal matching grants to States for a variety of services intended to protect the welfare of children. The services are to address problems that could result in neglect, abuse, exploitation or delinquency of children; prevent the unnecessary separation of children from their families and restore them to their families when possible; place children in adoptive homes if restoration is not possible; and assure adequate foster care when children cannot be returned home or placed for adoption.

The FY 1990 appropriation for child welfare services is $252.6 million. The FY 1991 appropriation is $273.3 million, which includes $27.4 million appropriated to Title IV-E foster care but transferred to Title IV-B child welfare services. These funds are allotted to States according to a formula that takes into account the size of the State's population that is under age 21 and the ratio of per capita income in the State to per capita income in all the States and territories. States with lower per capita incomes have higher per capita allotment percentages than States with higher per capita incomes, although a minimum is set for higher income States and a maximum applies to low-income States. States (including Puerto Rico) receive their share of funds appropriated in excess of $141 million only if they have implemented specified protections for children in foster care. There are minimal reporting requirements under the program and there are no reliable national or State data on the use of funds, including services provided or persons served.

The Program in Puerto Rico

Puerto Rico is considered a State for the purposes of this program. Funding is allocated on the basis of the population under age 21, but the allotment percentage for Puerto Rico is set at the maximum allotment level rather than on the basis of actual per capita income. In addition, Puerto Rico is not eligible for a share of funds appropriated in excess of $141 million because it has not implemented the specified protections for children in foster care. In FY 1990, Puerto Rico received $6.5 million under this program.[24] Information on the use of funds under this program is not available.

Implications of Statehood

Presumably under statehood, Puerto Rico would receive funds on the same basis as other States. This would mean that Puerto Rico's allotment percentage would be based on actual per capita income rather than being assumed to be at the cap. However, Puerto Rico's allotment percentage (and funding under the Title IV-B program) would remain the same based on its current per capita

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[24]U.S. Department of Health and Human Services, Office of Human Development Services, FY 1991 appropriations justifications.

income. Per capita annual income in Puerto Rico is estimated to be less than one-third the U.S. per capita income.[25] The allotment for Puerto Rico could not increase on the basis of statehood, because its allotment percentage already is the highest permitted under the law.

TITLE IV-E FOSTER CARE AND ADOPTION ASSISTANCE

The Program in the States

The Title IV-E foster care program provides open-ended Federal matching funds to States for maintenance payments made for AFDC-eligible children in foster care. The program is required of all States participating in AFDC (all States do). The Federal matching rate for a given State is that State's medicaid matching rate, which averages about 53 percent nationally. States may also claim open-ended Federal matching (50 percent) for their administrative costs and (75 percent) for training costs. States have up to 2 years to make claims for expenditures under the IV-E foster care program; thus, the actual funding for FY 1990 and FY 1991 is still in flux. The FY 1990 appropriation for foster care was $1.2 billion. The 1991 appropriation for foster care is $1.8 billion, plus an additional $521 million which has been appropriated for prior year claims. It is estimated that 205,187 children will participate in the program on an average monthly basis in FY 1991.

The Title IV-E adoption assistance program provides Federal matching payments to States for adoption assistance payments made to parents who adopt AFDC- or SSI-eligible children with special needs; and for the one-time adoption expenses of parents of special needs children whether or not they are AFDC- or SSI-eligible. The Federal matching rate for the open-ended adoption assistance payments for a given State is that State's medicaid matching rate. States may also claim open-ended Federal matching for their administrative costs (50 percent) and for their training costs (75 percent). States may claim up to 50 percent Federal matching for the one-time adoption expenses, up to a maximum of $2,000 total for each placement. As in the Title IV-E foster care program, States have up to 2 years to make claims for expenditures under the adoption assistance program; thus, the actual funding for FY 1990 and FY 1991 is still in flux. The FY 1990 appropriation for the adoption assistance program was $124.9 million, and the FY 1991 appropriation is $189.8 million. It is estimated that the average monthly number of children participating in the program in FY 1991 will be 52,000.

The Program in Puerto Rico

The Administration indicates that Puerto Rico does not currently receive funding under the Title IV-E programs, although it is included in the definition of State and would presumably be eligible for funds within the section 1108 cap as described in this report under the Title IV-A AFDC program. As noted in

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[25]Estimated by the Bureau of Economic Analysis, U.S. Department of Commerce.

that description, Puerto Rico is eligible for up to $82 million in FY 1989 and years thereafter for total expenditures under several programs including Titles IV-A and IV-E.

Implications of Statehood

Effective on the date of admission to statehood, Puerto Rico would receive funds on the same basis as other States. If, like the other States, Puerto Rico were not subject to the cap on expenditures for programs specified under section 1108, it would be more likely to claim reimbursement for its foster care and adoption expenses under Title IV-E. As noted above, these are generally open-ended reimbursements for the costs of serving eligible children, based on the State's medicaid matching rate.

TITLE XX SOCIAL SERVICES BLOCK GRANTS

The Program in the States

Title XX is an appropriated entitlement that provides Federal funds as block grants to States to support a variety of social services, with no State matching required. Funds are allotted to States on the basis of their share of total population in the 50 States and the District of Columbia. There are minimal reporting requirements under the program and there are no reliable national or State data on how funds are spent, including services provided or persons served. However, annual preliminary plans submitted by the States indicate the range of services provided. In FY 1988, the service category provided by the largest number of States was day care for children, followed by home-based services (including homemaker and home health services); special services for the disabled; protective or emergency services for children; and protective and emergency services for adults. A variety of other services were also provided. The FY 1991 appropriation for the Title XX program is $2.8 billion.

The Program in Puerto Rico

Puerto Rico's annual allotment of Title XX funds is based on the ratio of the funds Puerto Rico received in FY 1981 to total Title XX funds. In addition, Puerto Rico may use funds for the Title XX program that are not expended within the cap specified under section 1108 (described in the section of this memo on Title IV-A AFDC). The FY 1991 allotment under Title XX for Puerto Rico is $14.5 million. Puerto Rico reported that it planned to use its Title XX funds in FY 1987 for case management; counseling; day care for children and adults; disabled services; employment, education and training services; home-based services; residential care and treatment; and social support services.

Implications of Statehood

Presumably, under statehood, Title XX would operate in Puerto Rico as it currently does in the 50 States. If Puerto Rico received Title XX funds under

the same formula that applies to other States--on the basis of population--its Title XX funding would be likely to increase substantially. For example, the State of Connecticut, which has a population roughly equivalent in size to Puerto Rico, receives almost $37 million in Title XX funds in FY 1991, compared with Puerto Rico's allotment of $14.5 million. Presumably, the additional funds that might be available for Title XX under the cap specified in section 1108 would not be available under this option.

PART 3. PRECEDENT FOR INTERSTATE DIFFERENCES IN NATIONAL SOCIAL WELFARE PROGRAM RULES

An issue sometimes raised regarding statehood for Puerto Rico is whether the income eligibility and benefit criteria that govern certain social welfare programs in the other States would be appropriate in Puerto Rico. Because personal incomes in Puerto Rico are significantly lower than in the States, and because Federal welfare programs with nationally uniform eligibility rules were designed to apply to the low-income segment of the income distribution in the existing States, application of those criteria in Puerto Rico could result in payment of certain welfare program benefits to people in middle-income brackets of the Puerto Rican income distribution. For example, census data from 1980 (the most recent available) show that the median annual family income in the 50 States was $19,917; in Puerto Rico it was $5,923. Using the Federal Government's poverty definition that applies in the States, 9.6 percent of all families in those States were poor; by that same standard, 58.1 percent of families in Puerto Rico were classified as poor.

The major exceptions from uniform national standards for certain social welfare program eligibility rules pertain to Alaska and Hawaii for programs that base eligibility on the Federal poverty income guidelines. (See appendix for a description of Federal programs that base eligibility on the poverty guidelines.) In addition, under the medicare program's prospective payment system for inpatient hospital services, the nonlabor component of the "standardized amounts" (the base rates on which payments for "diagnosis related groups" (DRGs) are based) are higher in Alaska and Hawaii. The objective of the separate guidelines and the higher medicare payment standards in those two States is to accommodate areas in which living costs and, presumably, incomes, are *higher* than in the other States. However, there is no precedent for setting *lower* eligibility or benefit levels where living costs might be presumed to be lower than in other States.

The poverty income guidelines in Alaska are 25 percent higher than in the 48 States, and in Hawaii they are 15 percent higher. These special guidelines were established in the middle 1960s, when the Office of Economic Opportunity (OEO) adapted the Census Bureau's poverty threshold for determining eligibility for OEO programs.[26] The OEO made adjustments based on special pay rates calculated by the Civil Service Commission (now the Office of Personnel Management (OPM)) for Federal employees stationed in outlying areas, which was the only index then available representing differing geographic living costs, and it continues to be the basis for the poverty line adjustments. In addition, the medicare program uses this index to determine its special payment rates in Alaska and Hawaii.

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[26]For *counting* the number of poor persons, and for all other statistical purposes, one uniform set of poverty *thresholds* is used in all parts of the United States *and* its outlying areas. These thresholds, established by the Census Bureau, are different from the poverty guidelines (but are the starting point for calculating the guidelines).

The OPM determines the pay adjustment index for each outlying area by comparing costs for certain categories of expenses representing consumer spending patterns of average-income Federal employees in the Washington, D.C., metropolitan area with the cost of those items in the outlying areas.[27] The consumption patterns of Washington, D.C., workers include items that are more costly in Puerto Rico, resulting in Federal pay rates in Puerto Rico that are 10 percent *higher* than in the 48 contiguous States.

Although OPM currently calculates special pay rates for Federal employees stationed in Puerto Rico, the poverty guidelines used in Puerto Rico have never been adjusted for determining eligibility for U.S. social welfare programs there, and medicare does not adjust the nonlabor component of the "standardized amounts" for Puerto Rico (although the *labor* component is *lower* than in any State because it is based on Puerto Rican labor rates). Thus, even though there is a precedent for establishing certain social welfare program eligibility rules differently in Alaska and Hawaii, many believe that the basis on which those rules are determined is not appropriate for Puerto Rico, and some suggest that any special rules or rates established for Puerto Rico should be based on a thorough, nationwide review of poverty definitions and program rules.

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[27]By law, these special pay adjustments may be used only for areas that are *not* part of the contiguous 48 States.

APPENDIX: PROGRAMS USING THE FEDERAL POVERTY INCOME GUIDELINES TO DETERMINE ELIGIBILITY

Because the Federal poverty income guidelines include a special adjustment for Alaska and Hawaii, programs using the poverty guidelines have different standards in those States. The poverty income guidelines in Alaska are 25 percent higher than in the 48 contiguous States, and in Hawaii they are 15 percent higher.

The major Federal programs that base eligibility on the poverty income guidelines, or a multiple of those guidelines, are:

- Food stamps
- Child nutrition programs
- Medicaid
- Job Training Partnership Act programs
- Community services block grant
- Community service employment program for older Americans
- Foster grandparents and the senior companion program
- Head start
- Maternal and child health services block grant
- Community health centers
- Migrant health centers
- Legal services
- Low-income home energy assistance
- Weatherization assistance

Food Stamps

Eligibility for the food stamp program in the States is restricted to households with gross incomes at or below 130 percent of the Federal poverty income guidelines.

Child Nutrition Programs

For most child nutrition programs there is an income test for free or reduced-price food. The school lunch and school breakfast programs offer *free* meals to children with family incomes at or below 130 percent of the poverty income guidelines and *reduced-priced* meals to those with incomes between 130 percent and 185 percent of poverty. The summer food service program for children offers *free* meals and snacks in areas where at least half of the children meet income limits for reduced-price lunches. States may set income eligibility limits for the special supplemental food program for women, infants and children (WIC) anywhere from 100 percent to 185 percent of poverty.

Medicaid

State medicaid programs are required to phase in coverage of pregnant women, infants under 1 year old, and aged and disabled persons eligible for

medicare who are members of a family with income at or below 100 percent of the poverty income guidelines. They are permitted to cover older children with family incomes at or below 100 percent of poverty, and may establish an income standard as high as 185 percent of poverty for pregnant women and infants. Effective April 1, 1990. States are required to extend medicaid coverage to pregnant women, infants, and children up to age 6 with family incomes up to 133 percent of the Federal poverty guidelines. OBRA 90 (P.L. 101-508) requires States to phase in coverage of children under age 19, born after September 30, 1983, with family incomes below 100 percent of poverty. Thus, children will be eligible in annual cohorts so that all eligible children up to age 19 will be covered by the year 2002.

Job Training Partnership Act

To qualify as an economically disadvantaged participant in the programs authorized under this legislation, individuals may have incomes no higher than 100 percent of the poverty income guidelines, or 70 percent of the Labor Department's lower living standard income level. Separate lower living standard income levels are established for Alaska, Hawaii, and Guam.

Community Services Block Grant

Federal law generally restricts eligibility for participation in this program to individuals with incomes at or below 100 percent of the poverty income guidelines, but gives States the option of covering persons with incomes up to 125 percent of poverty. This program comprises the vestiges of the original OEO community action programs.

Community Service Employment Program for Older Americans

Eligibility for participation in this program is restricted to individuals with incomes at or below 125 percent of the poverty income guidelines. The community service employment program subsidizes part-time jobs in community service activities for unemployed, low-income persons aged 55 and older.

Foster Grandparents and the Senior Companion Program

Eligibility for participation in these programs is restricted to persons with incomes at or below 125 percent of the poverty income guidelines, or 100 percent of those guidelines plus the amount, if any, by which the State supplements the Federal SSI program guarantee level. Foster grandparents provides funds to local sponsoring agencies to support volunteer activities by low-income persons aged 60 and older on behalf of children with disabilities. The senior companion program provides funds to local agencies to support volunteer activities by low-income persons aged 60 and over on behalf of vulnerable older persons.

Head Start

Eligibility for participation in the head start program is restricted to children in families with incomes at or below 100 percent of the poverty income guidelines, except that 10 percent of enrolled children may be from higher income families. In addition, head start funds are allocated to States on the basis of a formula that includes the number of children in families with income below the poverty guidelines. Thus, the higher poverty guidelines in Alaska and Hawaii affect the head start funds available to those States as well as the income limits for participants.

Maternal and Child Health Services Block Grant, Community Health Centers, and Migrant Health Centers

Free health services may be provided for persons with family incomes at or below 100 percent of the poverty income guidelines.

Legal Services

Free legal services for noncriminal proceedings may be provided for persons with incomes at or below 125 percent of the poverty income guidelines. In certain circumstances, services may be provided to those with income between 125 percent and 150 percent of the poverty guidelines.

Low-Income Home Energy Assistance

The income eligibility criteria for energy assistance are set by the States, although the law specifies that benefits be restricted to households with incomes at or below 150 percent of the poverty income guidelines, or 60 percent of the State median income.

Weatherization Assistance

Eligibility for this program is restricted to individuals with incomes at or below 125 percent of the poverty income guidelines.

PUERTO RICO STATUS OPTIONS: EFFECTS ON TRADE, AND TRADE-RELATED REVENUES

PUERTO RICO STATUS OPTIONS: EFFECTS ON TRADE, AND TRADE-RELATED REVENUES

Changes in Puerto Rico's political status will to some extent affect Puerto Rico's external trade (with the US as well as with third countries). These changes are not likely to bring about major shifts in the volume, value, or composition of Puerto Rico's trade. They will, however, result in changes in the collection and allocation of trade-related fiscal revenues.

Under present law, Puerto Rico receives certain revenues from fiscal charges collected on trade by the United States, which would normally be covered into the U.S. Treasury. Depending on the status option that will eventually be adopted, these "cover overs" of U.S. collections of trade-related fiscal charges into the treasury of Puerto Rico will be substantially reduced or eliminated altogether, and the monies now transferred to Puerto Rico will, for the most part, remain in the U.S. Treasury.

In this way, the anticipated additional social expenditures in Puerto Rico will be in part compensated for by additional revenues to the U.S. Treasury, in accordance with the already mentioned principle that the Puerto Rico status legislation should be deficit-neutral.

This handout contains brief descriptions of the present status of the relevant U.S. statutory provisions, the situations as they would be changed by the provisions of the three status options of S. 712, 101st Congress, as reported by the Senate Finance Committee, and a synoptic table comparing the four situations.

PRESENT STATUS

1. Trade and tariffs

Puerto Rico - part of U.S. customs territory:
-- US-PR trade - domestic
-- all trade and tariff laws that apply in US apply in PR
-- customs duties: none on trade between US and PR either way; US tariffs on imports into PR from 3d countries; in 3d countries, imports from PR subject to same duties as imports from US;

Special: under CBERA, PR-produced value (materials, direct cost of production) can be cumulated toward minimum CBERA-value requirement for duty-free status (35%) (in addition to 15% US value)

2. Other trade-related fiscal levies

-- US excise taxes on PR products sold in US
-- **no** US excise taxes on US products sold in PR (but subject to PR taxes)
-- PR duty on coffee imports into PR (from US or elsewhere)

3. Revenues from trade-related fiscal levies that are "covered over" into, or collected by, PR Treasury

-- US customs duties collected in PR
-- US excise taxes on all US imports of rum (shared with VI 88%-12%), but covered over at no more than $10.50/pfg (now collected at $12.50/pfg)
-- US excise taxes collected on PR products sold in US:
  -- distilled spirits, provided that at least 92% of alcohol content is rum (shared with VI, and amount not over $10.50/pfg)
  -- other products, provided that at least 50% of value is PR materials and direct cost of processing in PR
-- PR excise taxes on US products sold in PR
-- PR duty on coffee imports

ENHANCED COMMONWEALTH
(improved present situation with deficit neutrality)

1. Trade and tariffs (no change from present status)

Puerto Rico - part of U.S. customs territory:
-- US-PR trade - domestic
-- all trade and tariff laws that apply in US apply in PR
-- customs duties: none on trade between US and PR either way; US tariffs on imports into PR from 3d countries; in 3d countries, imports from PR subject to same duties as imports from US;

Special: under CBERA, PR-produced value (materials, direct cost of production) can be cumulated toward minimum CBERA-value requirement for duty-free status (35%) (in addition to 15% US value)

2. Other trade-related fiscal levies (no change from present status)

-- US excise taxes on PR products sold in US
-- **no** US excise taxes on US products sold in PR (but subject to PR taxes)
-- PR duty on coffee imports into PR (from US or elsewhere)

3. Revenues from trade-related fiscal levies that are "covered over" into, or collected by, PR Treasury (some changes from present status)

A **phasing down** (not out) in 4 equal annual stages of "cover-overs" of
-- US customs duties collected in PR
-- US excise taxes on all US imports of rum
-- US excise taxes collected on PR products (distilled spirits, other products) sold in US

The amount of the reduction would be in direct relation to increases in US social program spending in PR, and in inverse relation to increases in Federal tax revenues due to changes in section 936, but would have a fixed-dollar floor.

No change in collection of
-- PR excise taxes on US products sold in PR
-- PR duty on coffee imports

STATEHOOD
(equality of treatment of States)

1. Trade and tariffs (one change from present status)

Change: Cumulation of PR-produced value toward minimum value requirement for duty-free status under CBERA repealed 4 years after admission as State (but could be included in the US 15% share).

No changes:
Puerto Rico - part of U.S. customs territory:
-- US-PR trade - domestic
-- all trade and tariff laws that apply in US apply in PR
-- customs duties: none on trade between US and PR either way; US tariffs on imports into PR from 3d countries; in 3d countries, imports from PR subject to same duties as imports from US

2. Other trade-related fiscal levies (substantial changes)

Changes:
-- US excise taxes applied to all products (local, US, and 3d country's) sold in PR as of date of admission
-- PR duty on coffee imports phased out over 4-years

3. Revenues from trade-related fiscal levies that are "covered over" into or collected by PR Treasury (substantial changes)

Changes:
A **phasing out** in 4 equal annual stages of PR revenues from
-- US customs duties collected in PR
-- US excise taxes on all US imports of rum
-- US excise taxes collected on PR products (distilled spirits, other products) sold in US.
-- PR import duty on coffee

INDEPENDENCE
(absence of U.S. jurisdiction)

1. Trade and tariffs (substantial changes)

PR ceases to be part of US customs territory, hence,
-- trade between US and PR is *foreign* trade; that means:
-- PR has its own trade and tariff laws
-- US imports from PR are dutiable at MFN rates,
but
---- PR's eligibility for CBERA is authorized (but PR must also be designated a CBERA beneficiary)
---- 5-year authority is granted for negotiating a US-PR trade agreement, incl. FTA
---- PR's eligibility for US GSP (if needed) is possible (although not specifically authorized)
-- PR's imports from US are dutiable at PR MFN rates, **except** if bilateral FTA agreement is concluded

-- PR's imports from 3d countries are dutiable at PR MFN rates
-- PR's exports to 3d countries are dutiable at those countries' MFN rates, **but** PR could (and probably would) qualify for their GSP

-- cumulation of PR-produced value for minimum value requirement for duty-free status under CBERA not authorized as of date of independence (unless PR is designated CBERA beneficiary).

2. Other trade-related fiscal levies (no effective changes)

-- US excise taxes on PR products sold in US
-- PR duty on coffee imports (as part of new PR tariff law)

3. Revenues from trade-related fiscal levies (substantial changes)

Changes:
"Cover-overs" into PR Treasury:
-- US customs duties *cease* (no longer collected in PR, hence, no cover-over), **but** replaced by PR customs duties
-- US excise taxes on rum imports *cease*
-- US excise taxes on PR products sold in US *phased out* over 4 years.

No change: PR duty on coffee imports (if it remains in new PR tariff law) continues to be collected by PR.

U.S.-PUERTO RICO TRADE RELATIONS: PRESENT, AND UNDER THE THREE STATUS OPTIONS

(as proposed by S. 712, 101st Congress)

Status	Present	Enhanced com'w'lth	Statehood	Independence
Nature of US-PR trade	domestic	domestic	domestic	foreign
Applicable trade and tariff laws	U.S.	U.S.	U.S.	Puerto Rico
Duties on imports: U.S. from P.R.	none	none	none	US MFN; possibly CBERA[a]; FTA[b]
P.R. from U.S.	none	none	none	PR MFN; possibly FTA[b]
P.R. from 3d ctry	U.S.	U.S.	U.S.	P.R.
3d ctry from P.R.	3d ctry MFN	3d ctry MFN	3d ctry MFN	3d ctry MFN; possibly GSP[c]
P.R. value counted as CBERA value	yes	yes	no[d]	yes[a]
U.S. excise tax on: imports from P.R. US products in PR	yes no	yes yes	yes yes	yes n/a
P.R. duty on coffee	yes	yes	phased out[e]	yes
Trade related fiscal revenues to P.R.:				
U.S. customs duties collected in P.R.	yes	phased **down**[e]	phased **out**[e]	no
U.S. excise taxes on: all imports of rum PR rum sold in US PR goods sold in US	yes yes yes	phased **down**[e] - do -	phased **out**[e] - do -	no no no
P.R. duty on coffee	yes	yes	phased **out**[e]	yes

[a]If Puerto Rico is designated CBERA beneficiary by the President.

[b]The President will have a 5-year authority to conclude a FTA agreement with Puerto Rico.

[c]If designated GSP beneficiary by 3d country.

[d]Repealed after 4 years; thereafter P.R. value will qualify as U.S. value.

[e]In 4 equal annual stages.

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WELFARE AND TAXES UNDER ALTERNATIVE STATUS OPTIONS FOR PUERTO RICO

by

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ISSUES REGARDING THE MAJOR WELFARE PROGRAMS UNDER ALTERNATIVE STATUS OPTIONS FOR PUERTO RICO

I. Economic arguments for alternative status options

II. Comparison of demographic characteristics and income in Puerto Rico and the U.S.

- A. Age and income
- B. Income distributions
- C. Labor force participation

III. Current status of the major welfare programs in Puerto Rico and the States

- A. Aid to the Aged, Blind and Disabled in Puerto Rico; Supplemental Security Income in the States
- B. Nutrition Assistance Program in Puerto Rico; Food stamps in the States
- C. Earned Income Tax Credit in the States
- D. Medicaid in Puerto Rico and the States
- E. Aid to Families with Dependent Children in Puerto Rico and the States

IV. Issues regarding the major welfare programs under alternative status options

- A. Welfare dependency
- B. Program costs
  - 1. Increased costs
  - 2. Offsetting tax receipts
    - a. Personal income tax (statehood)
    - b. Excise taxes
    - c. Duties
    - d. Tax on local corporations (statehood)
    - e. "Section 936" U.S. corporate possessions tax credit

FAMILY CHARACTERISTICS AND INCOME IN PUERTO RICO AND THE 50 STATES & D.C. (1980 CENSUS DATA)

	Puerto Rico	50 States & D.C.
Avg. family size	4.01	3.27
Age distribution		
Persons under 16	34%	25%
Persons 16-64	58%	64%
Persons 65+	8%	11%
Median age (years)	25.5	30.0
Median annual family income	$5,923*	$19,917
Median annual earnings		
Males age 15+	$5,394	$13,172
Females age 15+	$5,082	$ 6,682
Persons below poverty[1]	62.4%	12.4%
Persons age 65+ below poverty	63.8%	14.8%
Persons age 65+ living with families	80.8%	68.0%

** Estimated update based on data supplied by the Puerto Rico Planning Board: 1989 median family income = $9,015 in Puerto Rico. Median family income in the 50 States and D.C. in 1989 was $34,210.*

[1] The poverty threshold for a four-person household in 1980 was $8,414. In 1989 it was $12,675.

DISTRIBUTION OF ANNUAL FAMILY INCOME (1980 CENSUS DATA)

	Percent of Families by Income				
	< $5,000	$5,000-9,999	$10,000 14,999	$15,000 24,999	$25,000+
U.S.	7.3%	13.1%	14.7%	29.4%	35.4%
Puerto Rico	43.4	28.4	13.3	10.3	4.6

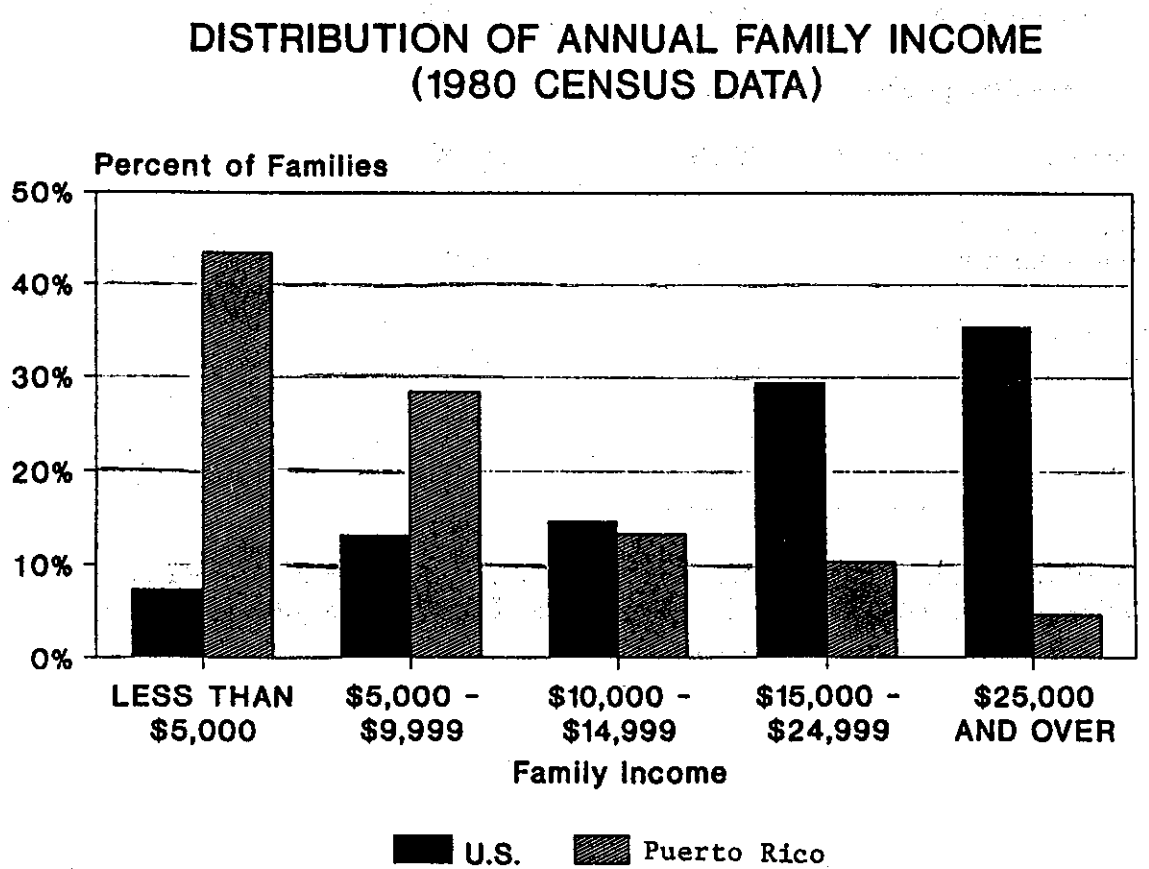

Figure prepared by CRS.

LABOR FORCE PARTICIPATION RATES IN THE 50 STATES & D.C. AND PUERTO RICO

	50 States	Puerto Rico
Total civilian labor force participation rate (1988)	65.9%	45.6%
Males 15+	76.2%	61.3%
Females 15+	56.0%	32.0%
Unemployment rate (October, 1990)	5.4%	14.8%

MAJOR SOCIAL WELFARE PROGRAMS IN THE 50 STATES AND D.C.

Programs providing benefits in cash or cash equivalent

Aid to Families with Dependent Children
Supplemental Security Income
Food Stamps
Earned Income Tax Credit
Unemployment Compensations
Social Security Retirement and Disability

Programs providing or paying for medical care

Medicaid
Medicare
Maternal and Child Health Block Grants

Programs providing food

School Lunch and Breakfast
Women, Infants and Children
Commodity assistance to school food programs
Summer Food Program
Nutrition education programs
Child Care Food Program

Social Services

Title IV-B Child Welfare Services
Title IV-E Foster Care and Adoption Services
Title XX Social Services Block Grants

Treatment of Certain Social Welfare Programs in Puerto Rico

Programs treating Puerto Rico as a State:

- Unemployment compensation
- Social security retirement and disability
- Several special food programs funded through the Department of Agriculture, including: WIC; commodity assistance to school food programs; summer food program; various nutrition education programs.
- Maternal and child health block grant

Programs treating Puerto Rico as a State, but with special rules:

- Aid to families with dependent children (AFDC)
  (A special, limited funding formula combining AFDC, AABD, emergency assistance and foster care and adoption assistance applies to Puerto Rico)
- Title IV-B child welfare services
  (A special funding formula applies to Puerto Rico, but statehood would not change the amount of funding because it currently receives the maximum Federal percentage for any State)
- Title IV-E foster care and adoption assistance
  (Puerto Rico does not claim funds for this program)
- Title XX social services block grants
  (A special funding formula applies to Puerto Rico, resulting in more limited funding than if it were a State)
- Medicaid
  (A special funding formula resulting in lower Federal matching applies to Puerto Rico, but special program rules expand eligibility)
- Medicare
  (A special formula resulting in lower reimbursement rates for in-patient hospital care applies to Puerto Rico)
- School lunch and school breakfast
  (Special program rules resulting in expanded eligibility apply in Puerto Rico)
- Child care food programs
  (special program rules resulting in more generous funding apply to Puerto Rico)

Major programs unavailable in the Commonwealth of Puerto Rico:

- Supplemental security income (SSI)
  (Puerto Rico provides aid the aged, blind or disabled)
- Food stamps
  (Puerto Rico receives a Federal block grant for nutrition assistance)
- Earned income tax credit (EITC)

DESIGN FEATURES OF MAJOR WELFARE PROGRAMS

	Puerto Rico	50 States & D.C.
AABD/SSI		
(one person)		
max. income and benefit levels	$32/mo. $384/yr.	$407/mo. $4,884/yr.
funding	75% Fed., capped	100% Fed., open
eligibility criteria	set by Puerto Rico Gov.	nationally uniform
NAP/Food stamps		
(four persons)		
max. income	$667/mo. $8,004/yr.	$1,376/mo. $16,512/yr.
max. benefit	$280/mo.[2] $3,360/yr.[4]	$352/mo.[3] $4,224/yr.
funding	100% Fed., capped	100% Fed., open
eligibility criteria	set by Puerto Rico Gov.	nationally uniform
EITC		
(2 or more children)		
max. income for max credit	no program	$ 7,140- $11,250
max. annual credit	" "	$1,235
max. annual income	" "	$21,242
funding	" "	100% Fed., open
eligibility criteria	" "	nationally uniform

[2]This was the maximum payable to a four-person household in 1990.

[3]This amount applies in the 48 contiguous States.

[4]Annual benefits are approximate estimates for the program in Puerto Rico. Annual benefits may not be 12 times a monthly benefit because benefit levels may change from month-to-month.

Medicaid		
max. income	527.8% of max. AFDC payment ($90/mo. three persons)	133.3% of State AFDC payment
funding	50% Fed., capped	50-83% Fed., open
eligibility criteria	special rules for P.R	State determined, with some limits
AFDC		
Max. income & benefit (three persons)	$90/mo. $1,080/yr.	State determined
funding	75% Fed., capped	50-83% Fed., open
eligibility criteria	set by Puerto Rico Gov.	State determined

Treatment of Certain Social Welfare Programs Under Alternative Status Options Provided in S. 712

	Statehood Admission to statehood Jan. 1, 1996; programs phased in 1992-1995	**Enhanced commonwealth** Fully effective Jan. 1, 1996; programs phased in 1992-1995	**Independence** Effective upon proclamation
AABD/SSI	AABD repealed. Full SSI program: Amendment will change eligibility and benefit maximum to 50% of per capita income (from $36/mo. to about $220) 100% open-ended Federal funding.	AABD continued: Eligibility and benefits gradually increased from $36/mo. to about $220 (50% of per cap. income). 50%-50% matching and open-ended Federal funding.	Not applicable
NAP/food stamps	NAP repealed. Full food stamp program: Food stamp eligibility and benefits may be changed by Congress.	To be designed by agreement between USDA and the government of Puerto Rico.	Not applicable
Medicaid	Full medicaid program: Same rules as all other States; expanded care providers, reduced eligibility levels.	Current medicaid program: 50%-50% matching and open-ended Federal funding.	Not applicable
AFDC/foster care	Current AFDC program continued, but with 83% Federal matching; open-ended funding. Full foster care program.	Current AFDC program continued; foster care available. 50%-50% matching and open-ended Federal funding.	Not applicable
EITC	Full EITC as part of the personal income tax system.	Not applicable	Not applicable

NOTE: Under the statehood option deficit-neutrality rules apply during 4-year transition period. Under enhanced commonwealth, permanent rules call for deficit-neutrality.

FUNDING FOR SOCIAL WELFARE PROGRAMS IN PUERTO RICO UNDER THE ALTERNATIVES IN S. 712

Program	Current funding	Statehood	Commonwealth
AFDC	75% Federal, capped	83% Federal, open-ended	50% Federal, open ended
AABD/SSI	75% Federal, capped	100% Federal, open-ended	50% Federal, open-ended
NAP/ Food Stamps	100% Federal, capped	100% Federal open-ended	to be determined
Medicaid	50% Federal, capped	83% Federal, open-ended	50% Federal, open-ended
EITC	Not applicable	100% Federal, open-ended	Not applicable

STATEHOOD:
ESTIMATED INCREASE IN FEDERAL SOCIAL WELFARE SPENDING
AND FEDERAL REVENUES UNDER S. 712 IN 2000
(in millions of dollars)

Increase in welfare spending over current law	$3,589
Increase in revenues from local sources	
New excise taxes	414
Customs duties	171
Rum excise tax	268
Personal income tax	846
Puerto Rico corporations	545
Total new Federal revenue from local sources	2,244
Increase in welfare spending over new local revenues	1,345
Revenues from repeal of "936" possessions tax credit	3,944

Source: Congressional Budget Office and Department of Treasury

Effect of the Statehood Option on the Federal Budget Based on Administration's Estimates and Projections of Federal Tax Revenue Gains and Outlay Increases

	Fiscal Year ($ Billions)								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Tax Revenue Gains**	*	.1	.7	1.2	2.7	3.8	4.6	5.1	5.4
Outlay Increases***	.8	.9	1.4	2.2	2.6	3.0	3.3	3.7	4.1
Increases in Surplus (+) or Deficit (-)	-.7	-.8	-.7	-1.0	+.1	+.8	+1.3	+1.4	+1.3

* Less than $50 million gain

** Revenue gains estimated by Office of Tax Analysis, Department of the Treasury

*** Outlay increases estimated by Departments of Health and Human Services and Agriculture

NOTE: Estimates as of April, 1990. The estimates do not reflect the "deficit neutrality" requirement of the Senate Finance Committee's amendments.

ECONOMIC AND FISCAL IMPACTS OF PUERTO RICAN STATEHOOD

Prepared for:

Governor of Puerto Rico

By:

The Policy Economics Group
KPMG Peat Marwick

February 1990

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EXECUTIVE SUMMARY

Congress is considering legislation to facilitate a political status choice by the people of Puerto Rico. To this end, the Senate Energy Committee reported S.712, the "Puerto Rico Status Referendum Act," which would sponsor a plebiscite for the summer of 1991. The purpose of the plebiscite is to determine whether Puerto Rico will become a state of the Union, an independent country or enhance the existing commonwealth relationship with the United States.

The Policy Economics Group of KPMG Peat Marwick was commissioned by the Governor of Puerto Rico to analyze the effects of the Statehood option on the Puerto Rican economy and on the revenues and expenditures of both the U.S. and the Puerto Rican governments.

- Statehood would have several direct effects on the Puerto Rican economy. First, corporations established under Section 936 of the Internal Revenue Code would be able to significantly increase their after-tax return by abandoning their existing operations and relocating in tax-favored locations in the Caribbean, Europe, or the Pacific rim. In addition, expansion by current 936 companies and the formation of new 936 companies would be sharply curtailed, if not eliminated. Seventy-two percent or more of the operating income of 936 companies would be subject to relocation.

  Second, as companies choose to move off the Island, either to the mainland or elsewhere, the Puerto Rican economy would be seriously affected. This would increase unemployment in Puerto Rico and reduce wages throughout the economy. Between 80,000 and 145,000 private sector jobs could be lost under statehood -- increasing the unemployment rate to nearly 30 percent.

  Third, under statehood Puerto Rico residents would be eligible to fully participate in all Federal outlay programs. The extension of Federal transfer programs would mitigate some of the negative economic impact of relocation and the imposition of Federal taxes, but aggregate demand in Puerto Rico in 2000 would decrease between $0.2 billion and $2.3

billion.

- The statehood option has major budgetary implications for the U.S. government, affecting both revenues and expenditures. The extension of Federal transfer programs would increase Federal outlays by about $36 billion from 1992 through 2000. This is accompanied by an increase in Federal revenues that would partially offset these costs. Depending on the extent of the relocation of companies, Puerto Rican Statehood would have a net cumulative cost to the U.S. Government of between $22 billion and $25 billion during the same period.

- Similarly, statehood would cause a major budget dilemma for Puerto Rico. To balance expenditures for present services, Puerto Rico would not be able to lower its taxes despite the burden of full U.S. taxes. If Puerto Rico chose to reduce its individual income tax rates to align them with tax rates facing residents in the U.S., the cost to the Puerto Rican Government would be about $8 billion from 1992 through 2000. To place the deficit problem in perspective, balancing the budget after the transition period solely through a cut-back in public sector services would require a lay-off of about 90 thousand employees or about 40 percent of total government employment.

The results demonstrate that under statehood, the Puerto Rican economy would experience a major economic transformation. The economy would lose a significant component of its industrial base because of the relocation of 936 and foreign-owned corporations. The public sector would be forced to cut back services and employment to retain competitive levels of taxation. Industrial production, capital accumulation, and both private and public sector employment would be replaced, in part, by transfers from the Federal government.

The remainder of this executive summary describes the assumptions and methodology used in the analysis.

Present Status and the Tax Relationship Between Puerto Rico and the U.S.

The Commonwealth of Puerto Rico was created in 1952 when its people adopted their own constitution pursuant to Public Law 600, passed by the U.S. Congress in 1950. Congress approved the Puerto Rican constitution in 1952 and since that time Puerto Rico has elected its own officials and exercised substantial control over internal affairs.

Since 1901, Puerto Rico has benefitted from fiscal autonomy as the tax uniformity clause of the U.S. Constitution does not apply. Under these arrangements, Puerto Rican individuals and corporations do not pay U.S. federal income taxes. As the study points out, they pay very substantial Puerto Rican taxes. Indeed, on a per capita basis, income taxes are higher than federal income taxes at the margin and on average.

Other key parts of the present tax arrangements date back to the Foraker Act of 1900, the first organic statute dealing with Puerto Rico following its cession to the United States by the Treaty of Paris after the Spanish American War. Thus Puerto Rico is within the U.S. customs' zone and U.S. tariffs apply in Puerto Rico, but all duties collected on imports into Puerto Rico are returned ("covered over") to the Puerto Rican Treasury. The same is true of U.S. excise taxes imposed upon Puerto Rican products shipped to the U.S. mainland. Presently, this relates almost exclusively to Puerto Rican rum shipments to the U.S.

Section 936 Benefits and Puerto Rico's Economic Development

Under Puerto Rico's unique Commonwealth status, Congress has been free to fashion special tax treatments to foster the Island's economic development. The most important tax provision fueling Puerto Rican economic growth has been Section 936 of the Internal Revenue Code, and its predecessor Section 931. Section 936 permits U.S. corporations doing business in Puerto Rico a tax credit equal to the U.S. tax on their active trade or business income from the Island, plus a restricted amount of income from their Puerto Rican financial investments. To qualify for Section 936 benefits generally, a U.S. corporation must undertake substantial manufacturing or other similar activities in Puerto Rico that generate at least 75 percent of the corporation's total income.

The Puerto Rican economy has undergone a dramatic transformation over the past forty years. Puerto Rico has developed from a primarily agricultural economy in 1950 to one driven by export-led manufacturing. The manufacturing sectors share of total output increased from 17 percent in 1950 to 40 percent in 1988. This transformation was the combined result of the Puerto Rico government policy of attracting and developing

manufacturing investment through tax incentives coupled with federal tax benefits available through Section 931, and after 1976, Section 936. The results have been dramatic. Per capita income is now $5,127, the highest in the Caribbean Basin, but still one-half of the lowest income state in the Union.

Section 936 has been crucial to attracting thousands of new manufacturing jobs, particularly in the pharmaceutical, electronics and other similar high technology industries, during the late 1970's and 1980's. To make certain that the tax benefits enjoyed by these taxpayers are not excessive, Congress in 1982 and again in 1986 enacted limitations to the amount of income that Section 936 corporations can allocate to their Puerto Rico operations. Notwithstanding these limitations, Section 936 currently provides Puerto Rico the opportunity to compete with alternative sites for new investment.

Applicability of U.S. Benefit and Welfare Programs

As a Commonwealth, Puerto Rico is not automatically included in federal spending programs addressed to the states. Certain programs apply fully, others in a limited or modified degree, and some not at all. Puerto Rico participates fully in Social Security and Medicare. However, Puerto Rico is given a limited block grant in lieu of participation in the Food Stamps program, and its citizens receive a lower level of benefits than other U.S. citizens under Aid to the Aged, Blind and Disabled (AABD), Medicaid and other programs.

The S.712 Provisions

S.712 is designed to allow the people of Puerto Rico to have a meaningful opportunity to select their political status. This means providing the details of transition and any permanent understandings between the United States and an independent republic of Puerto Rico in the case of the Independence option. With respect to the Statehood option, Congress must deal with the transition issues caused by the loss of the special tax provisions now applicable to the Commonwealth of Puerto Rico and deal with implementation of new and expanded welfare programs. In the case of Commonwealth, an effort is made to more clearly define the Commonwealth relationship and provide greater autonomy with respect to the applicability of Federal legislation and regulations to Puerto Rico, as well as with respect to trade, transportation and communication.

In devising transition measures for the Statehood option, S.712 provides that full federal benefit payments would commence in 1992 (following the plebiscite in 1991), with the exception of SSI, which would become effective in 1994. While Puerto Ricans would

thus begin receiving substantial federal benefits almost immediately, the associated costs of Statehood would be postponed. Federal income taxes would not apply until 1994, and would be returned to Puerto Rico in 1994 and 1995. The Section 936 tax credits would be phased out over five years beginning in 1994. Moreover, as a Statehood "grant," all revenues from custom duties in Puerto Rican rum, excise taxes and new excise taxes in Puerto Rico would be returned to the Puerto Rican government.

KPMG Peat Marwick Approach and Methodology

This study computes the individual and corporate taxes that would be paid under statehood. The report demonstrates that the tax increases accompanying Statehood would likely have a very significant negative effect on the Puerto Rican economy. Not incorporating these dynamic effects would drastically understate the Federal and Puerto Rican budgetary costs of statehood. Based on a comprehensive data base of all actual corporate and individual income tax returns, KPMG Peat Marwick is able to estimate the effect of statehood on the after-tax returns of companies operating in Puerto Rico. The clear effect of Statehood with its removal, either immediately or over time, of the Section 936 tax exemptions would be to substantially increase the tax cost of operations in Puerto Rico. The critical issue for determining the effect on the Puerto Rican economy is the extent to which existing operations relocate and future investment is curtailed.

Business Relocation

Business location decisions are affected by a number of factors: land costs, labor costs, environmental and regulatory costs, transportation costs, taxes, tariffs and other trade barriers, costs of raw materials and finished products, and non-economic factors such as relative political stability. The desirability of Puerto Rico under statehood relative to the mainland and alternative foreign sites is based on the net effects of all such factors.

Most Puerto Rican products are shipped to the United States either as intermediate products or ultimate consumption and its geographic location is a unique shipping cost disadvantage. Shipments between Puerto Rico and the United States must be in U.S. flag ships which generally are far more expensive than foreign flag ships which haul most goods to American ports from foreign destinations. This disadvantage has tended to be offset by exemptions from Puerto Rican and U.S. taxes. Labor costs in Puerto Rico are lower on average than on the mainland but higher than in most alternative foreign sites in the Caribbean and the Pacific rim. The costs of compliance with environmental and OSHA regulations puts Puerto Rico at a competitive disadvantage vis-a-vis most foreign locations.

It is not possible to replicate all of these factors which influence decisions concerning location, to enter, stay, or leave. It is possible, however, to analyze, in the case of Puerto Rico, the bottom-line effects of increased taxes resulting from a move to Statehood and to compare the resulting bottom-line to the available in alternative sites.

While it is not possible to know for each individual firm, the rate of return differential that would be required to induce the firm to relocate or invest elsewhere, this study analyzes two cases: A differential in the after-tax return of 5 percentage points, and 11 percentage points. The logical way to think about the results displayed is that those firms incurring the higher immediate reductions in returns, particularly where the percentage reduction exceeds their cost of capital, would be the first to leave Puerto Rico and relocate in a more conducive tax atmosphere. Firms suffering a return reduction approximately equal to their cost of capital, for which the 11 percent case is thought to be a current surrogate, would have no economic rationale for remaining in Puerto Rico even in the short-run and, depending on the balance of other factors, would have motivation to leave.

The 5 percent reduction case is most relevant to the longer term and to potential new entrants to Puerto Rico. Few firms would choose Puerto Rico over a foreign location or perhaps a U.S. location when its after-tax return would be 5 percent less than in another foreign location. The practical judgment here would be that only those firms which would find offsetting advantages to location in Puerto Rico would decide to do so.

The Puerto Rican economy is very dependent on Section 936 companies. Presently, Section 936 companies account for 94.4 percent of the operating income and 78.6 percent of the operating assets in the manufacturing sector in Puerto Rico. In four leading industries--apparel and other textile products, pharmaceuticals, machinery and instruments--Section 936 companies account for almost the entire activity. The response of 936 companies to the tax structure under statehood would clearly take several years. The adjustment would be a combination of current 936 companies relocating and curtailing expansion as well as the curtailment of the formations of new 936 companies. The exact timing of this adjustment can not be known with certainty.

The estimates below show the effect on the Puerto Rican manufacturing sector at 1992 levels assuming the adjustment process is complete.

Long Run Effect of Statehood on the Puerto Rican Manufacturing Sector: 1992 Levels (Percent of 936 and Foreign Owned Company Activity)

Relocation Threshold	Percent of Firms	Percent of Operating Assets	Percent of Operating Income
5 Percentage Points	-67%	-72%	-105%
11 Percentage Points	-31%	-31%	-72%

In the 11 percent case, firms would relocate representing 71.7 percent of operating income. And in the longer term hurdle rate test, the 5 percent case, virtually all of Puerto Rico's operating income represented by 936 companies would relocate or not chose Puerto Rico a site for future investment.

This loss in economic activity has a dramatic effect on employment and wages. As shown below, the job loss, taking account of both direct and first order indirect effects, is estimated to range between 79,500 and 145,000 jobs. The related aggregate wages range from $1.4 billion annually under the 11 percent case to $2.6 billion under the 5 percent case.

Estimated Employment and Wage Effects of Relocation Resulting from the Adoption of Statehood under Alternative Rate of Return Thresholds: 1992 Levels

	Employment (thousands)	Wages (billions of dollars)
5% Relocation	-145	-2.6
11% Relocation	-80	-1.4

Source: KPMG Peat Marwick

The Effect on Income Tax Levels

Under statehood, federal income taxes would be layered on an already high level of Puerto Rican taxes. As shown below, the average personal tax rate would increase from 10.3 percent to 16.1 percent, and the average marginal rate will increase from 25.8 percent from 40.4 percent.

Combined Federal and Puerto Rican Tax Rate Experienced by Residents Before and After the Adoption of Statehood in 1992

Federal AGI Class	Average Tax Rate Before Statehood	Average Tax Rate After Statehood	Marginal Tax Rate Before Statehood	Marginal Tax Rate After Statehood
Less than $5,0000	0.5	-1.0	0.0	-4.0
5,000 to 8,000	1.4	-.06	7.0	9.3
8,000 to 12,500	3.3	2.0	10.8	12.8
12,500 to 17,000	5.4	6.9	12.9	28.0
17,000 to 25,000	7.1	11.4	14.2	31.2
25,000 to 35,000	9.3	15.8	20.2	34.3
35,000 to 50,000	12.7	20.6	26.9	39.5
50,000 to 100,000	17.9	27.5	31.9	48.3
More than 100,000	23.1	38.7	30.7	53.4
All Taxpayers	10.3	16.1	25.8	40.4

Note: Under current law, i.e. before the adoption of statehood, Puerto Rican residents generally incur no federal income tax.

Effect on the Puerto Rican Financial Sector

Statehood would also have a significant effect on the Puerto Rican financial sector. As a result of Section 936 and the Puerto Rican tax on repatriations to U.S. (tollgate tax), bank deposits have increased significantly; currently 40 percent of all bank deposits are 936 funds. Under Statehood, Section 936 and the Puerto Rican tollgate tax would be repealed, the first for reasons of the Tax Uniformity clause, and the second for reasons of the Interstate Commerce clause. There would thus be no reason for 936 funds to remain in Puerto Rico; they would be repatriated to the mainland, and the Puerto Rico financial sector, which has experienced dramatic growth, would have to reduce services and employment.

Federal Transfer Payments to Puerto Rico

Under statehood, Federal transfer programs would also be fully extended to all Puerto Rican residents and would provide increased support in the areas of health, nutrition, child care, and old-age assistance. The three programs exhibiting the largest increases would be Medicaid, Food Stamps and Supplemental Security Income. The cumulative increase in Federal transfers would be about $17 billion for Medicaid, about $8 billion for Food Stamps, and about $7 billion for Supplemental Security Income. Total Federal spending in transfer programs for the period would be about $36 billion.

The Effect of Statehood on U.S. Government Receipts and Outlays

Under statehood, Puerto Rican residents would be subject to the full tax system facing U.S. residents and would be eligible for all U.S. outlay programs. Table 1 and table 2 show the effect of statehood on federal tax revenues under the 11 percentage point and 5 percentage point assumptions, respectively. Under both scenarios, revenues increase dramatically in the first few years as the Section 936 credit is being phase-out. Over the nine year period, treasury revenues would increase by about $28.5 billion before accounting for the decline in economic activity induced by statehood. Under the 11 percentage point scenario slightly less than 30 percent of the "static" effect is offset by the reduction in economic activity for a net of about $20.2 billion. Under the 5 percentage point case, nearly 40 percent of the static effect is offset for a net gain of about $17.4 billion.

Table 3 and table 4 show the effect on federal outlays. The estimates are shown with and without the effect of the decline in economic activity and include the cover-over of tax revenues that would occur during the transition years. Total outlays during the

period would be about $41.8 billion under the 11 percentage point case and $42.6 billion under the 5 percentage point case.

Table 5 summarizes the federal budget implications under the two scenarios. The cumulative increase in the federal deficit is $21.5 billion under the 11 percentage point case and $25.2 billion under the 5 percentage point case. Under either scenario, after the first partial fiscal year of 1992, the deficit to the Federal government would increase by over $2 billion each year.

Table 1

The Effect of Statehood on U.S. Government Revenues:
11 Percentage Point Relocation Scenario
(Millions of dollars)

Source	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Corporation Income Tax										
Excluding Economic Effects	-	-	634	1377	1971	2672	3495	4053	4418	18,620
Economic Effects	-	-	-140	-400	-711	-1080	-1515	-1801	-1981	-7,628
Net	-	-	494	977	1260	1592	1980	2252	2437	10,992
Individual Income Tax										
Excluding Economic Effects	-	-	651	962	1010	1061	1114	1169	1228	7,195
Economic Effects	-	-	-17	-43	-73	-105	-140	-155	-164	-697
Net	-	-	634	919	937	956	974	1014	1064	6,498
Excise Taxes										
Excluding Economic Effects	174	268	281	295	310	325	342	359	377	2,731
Economic Effects	-	-	-	-	-	-	-	-	-	-
Net	174	268	281	295	310	325	342	359	377	2,731
Grand Total										
Excluding Economic Effects	174	268	1566	2634	3291	4058	4951	5581	6023	28,546
Economic Effects	-	-	-157	-443	-784	-1185	-1655	-1956	-2145	8,325
Net	174	268	1409	2191	2507	2873	3296	3625	3878	20,221

Table 2

The Effect of Statehood on U.S. Government Revenues:
5 Percentage Point Relocation Scenario
(Millions of dollars)

Source	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Corporation Income Tax										
Excluding Economic Effects	-	-	634	1377	1971	2672	3495	4053	4418	18,620
Economic Effects	-	-	-187	-536	-951	-1445	-2026	-2410	-2649	-10,204
Net	-	-	447	841	1020	1227	1469	1643	1769	8,416
Individual Income Tax										
Excluding Economic Effects	-	-	651	962	1010	1061	1114	1169	1228	7,195
Economic Effects	-	-	-24	-62	-102	-147	-197	-219	-231	-982
Net	-	-	627	900	908	914	917	950	997	6,213
Excise Taxes										
Excluding Economic Effects	174	268	281	295	310	325	342	359	377	2,731
Economic Effects	-	-	-	-	-	-	-	-	-	-
Net	174	268	281	295	310	325	342	359	377	2,731
Grand Total										
Excluding Economic Effects	174	268	1566	2634	3291	4058	4951	5581	6023	28,546
Economic Effects	-	-	-211	-598	-1053	-1592	-2223	-2629	-2880	-11,186
Net	174	268	1355	2036	2238	2466	2728	2952	3143	17,360

Table 3

The Effect of Statehood on U.S. Government Outlays
11 Percentage Point Relocation Scenario
(Millions of dollars)

Item	Fiscal Year 1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Extension of Outlay Programs to Puerto Rico Residents:										
Food Stamps	615	858	729	706	741	779	817	858	901	7,004
Medicaid	946	1460	1577	1703	1839	1987	2145	2317	2502	16,476
Medicare	46	70	76	82	88	96	103	111	120	792
Supplemental Security Income (SSI)	0	0	600	900	944	992	1041	1093	1148	6,718
Aid to Families with Dependent Children (AFDC)	51	141	208	219	230	241	253	266	279	1,888
Foster Care	2	3	3	3	4	4	4	4	4	31
Earned Income Credit	0	0	12	243	255	268	281	295	310	1,664
Total, Excluding Economic Effects	1660	2532	3205	3856	4101	4367	4644	4944	5264	34,573
Economic Effects:										
Food Stamps	0	0	0	31	78	128	185	246	274	942
Medicaid	0	0	0	25	68	118	175	241	279	906
AFDC	0	0	0	7	19	32	47	63	72	240
Cover-Over of Tax Revenues in Transition Years	174	268	1290	1847	843	325	342	359	377	5,825
Total Outlays	1834	2800	4495	5766	5109	4970	5393	5853	6266	42,486

Table 4

The Effect of Statehood on U.S. Government Outlays
5 Percentage Point Relocation Scenario
(Millions of dollars)

Item	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Extension of Outlay Programs to Puerto Rico Residents:										
Food Stamps	615	858	729	706	741	779	817	858	901	7,004
Medicaid	946	1460	1577	1703	1839	1987	2145	2317	2502	16,476
Medicare	46	70	76	82	88	96	103	111	120	792
Supplemental Security Income (SSI)	0	0	600	900	944	992	1041	1093	1148	6,718
Aid to Families with Dependent Children (AFDC)	51	141	208	219	230	241	253	266	279	1,888
Foster Care	2	3	3	3	4	4	4	4	4	31
Earned Income Credit	0	0	12	243	255	268	281	295	310	1,664
Total, Excluding Economic Effects	1660	2532	3205	3856	4101	4367	4644	4944	5264	34,573
Economic Effects:										
Food Stamps	0	0	0	45	113	181	267	355	396	1,357
Medicaid	0	0	0	37	98	171	252	347	402	1,307
AFDC	0	0	0	10	28	46	68	91	104	347
Cover-Over of Tax Revenues in Transition Years	174	268	1268	1794	823	325	342	359	377	5730
Total Outlays	1834	2800	4473	5742	5163	5090	5573	6096	6543	43314

Table 5

Summary of the Effect of Statehood on U.S. Tax Revenues and Outlays Under Alternative Relocation Scenarios (Millions of dollars)

	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
11 Percentage Point Case										
Revenues	174	268	1409	2191	2507	2873	3296	3625	3878	20221
Outlays	1834	2800	4495	5766	5109	4970	5393	5853	6266	42486
Increase in Surplus (+) or Deficit (-)	-1660	-2532	-3086	-3575	-2602	-2097	-2097	-2228	-2388	-22265
5 Percentage Point Case										
Revenues	174	268	1355	2036	2238	2466	2728	2952	3143	17360
Outlays	1834	2800	4473	5742	5163	5090	5573	6096	6543	43314
Increase in Surplus (+) or Deficit (-)	-1660	-2532	-3118	-3706	-2925	-2624	-2845	-3144	-3400	-25954

The Effect of Statehood on The Puerto Rican Budget

Statehood would have a very negative effect on Puerto Rico's fiscal situation. Statehood would reduce tax revenues in Puerto Rico in four ways. First, the tollgate tax that currently applies to repatriations to the U.S. from Section 936 companies would be repealed. Second, as corporations relocate, income, and therefore tax revenue paid under the current Puerto Rican income tax, would be reduced. Third, as corporations relocate and unemployment increases and wages and personal incomes decline, Puerto Rico would experience a reduction in tax revenues from the individual income tax. Finally, financial institutions which would be adversely affected would be down-sized and pay much lower taxes.

In addition to the loss in tax revenues from the loss in economic activity, Puerto Rico would face very difficult fiscal choices. The combined federal and Puerto Rican tax rates would be much higher than those facing U.S. residents and there would be considerable pressure to lower their rates to be better aligned with other states. However, Puerto Rico would face long term deficits under statehood that may require increasing tax rates. Any tax rate reduction would further exacerbate the fiscal position and would necessarily require a significant increase in other tax revenues or massive reduction in government services and employment.

Table 6 and table 7 summarizes the effect of statehood on the Puerto Rican budget under the 11 percent point and 5 percentage point scenarios.

In total, over the nine years, Puerto Rican tax revenues would decline by about $5 billion. This would be partially offset by a reduction in outlays of $1.5 billion. The outlay reduction would result primarily in the health care area as federal programs are substituted. This would result in a net deficit of about $3.6 billion. However, the $5 billion cover-over of federal taxes during the transition period would more than offset the deficit, leaving Puerto Rico with a net surplus of $1.4 billion over the period. It is important to note, however that there would be a net deficit in each of the last four years of the period as the cover-over ends. Indeed, in less than two years after the forecast period, the cumulative total would turn negative.

As indicated above, one important issue that Puerto Rico would face is the extremely high tax rates facing its residents. If Puerto Rico reduced its tax rates to the average state rates in the U.S., Puerto Rico would experience a net deficit in all but one year of the forecast period for a cumulative deficit of about $7 billion. Balancing the budget after the transition period solely through a cut-back in public sector services would require a lay-off of about 90 thousand employees or about 40 percent of total government employment.

Table 6

Summary of the Effect of Statehood on Puerto Rico Tax Revenues and Outlays: 11 Percentage Point Relocation Scenario (Millions of dollars)

	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Revenue (Excluding cover-over of taxes)	-94	-190	-248	-376	-514	-677	-865	-1001	-1071	-5036
Outlays	-81	-160	-166	-170	-173	-175	-177	-176	-186	-1464
Increase in Surplus (+) or Deficit (-) (Excluding cover-over of taxes)	-13	-30	-82	-206	-341	-502	-688	-825	-885	-3572
Cover-over of Taxes	117	265	1011	1836	1117	322	338	355	373	5734
Increase in Surplus (+) of Deficit (-) (Including cover-over of taxes)	104	235	929	1630	776	-180	-350	-470	-512	2162
Reduction in Individual Income Taxes	-392	-892	-936	-983	-1032	-1084	-1138	-1195	-1255	-8907
Net Effect	-288	-657	-7	647	-256	-1264	-1488	-1665	-1767	-6745

Table 7
Summary of the Effect of Statehood on Puerto Rico Tax Revenues and Outlays:
5 Percentage Point Relocation Scenario
(Millions of dollars)

	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
Revenues (Excluding cover-over of taxes)	-94	-190	-277	-467	-632	-921	-1200	-1401	-1500	-6682
Outlays	-81	-160	-166	-166	-160	-150	-139	-125	-124	-1271
Increase in Surplus (+) or Deficit (-) (Excluding cover-over of taxes)	-13	-30	-111	-301	-472	-771	-1061	-1276	-1376	-5411
Cover-over of Taxes	117	265	996	1791	1089	322	338	355	373	5646
Increase in Surplus (+) of Deficit (-) (Including cover-over of taxes)	104	235	885	1490	617	-449	-723	-1276	-1376	235
Reduction in Individual Income Taxes	-344	-782	-821	-862	-906	-951	-998	-1048	-1101	-7813
Net Effect	-240	-547	64	628	-289	-1400	-1721	-2324	-2477	-7578

INTRODUCTION AND BACKGROUND

This report presents results of the study of the fiscal impacts of statehood for Puerto Rico both on Puerto Rico and the U.S. Government. The study was prepared for the Governor of Puerto Rico by the Policy Economics Group of KPMG Peat Marwick.

On September 26, 1989 the Senate Committee on Energy and Natural Resources reported the Puerto Rico Status Referendum Act (S.712) that provides for a referendum to be held on June 4, 1991. The purpose of the referendum will be to determine whether Puerto Rico is to become a state of the Union, an independent country, or to enhance the commonwealth relationship with the United States. The issue of the appropriate political status for Puerto Rico is extremely complex and far-reaching. It involves not only issues of political choice, but of the broad impacts on the Puerto Rican economy.

Statehood would have several direct effects on the Puerto Rican economy. First, since 1901 Puerto Rico has enjoyed full fiscal and tax autonomy - Federal individual and corporation taxes do not apply in Puerto Rico. The loss of this tax autonomy under Statehood, particularly the taxation of corporations now exempt would significantly increase tax burdens for these corporations. In many cases, these corporations would be able to increase their after-tax return by abandoning their existing operations and relocating elsewhere in tax-favored locations in the Caribbean, Europe, or the Pacific rim. In addition, expansion by current 936 companies and the formation of new 936 companies would be sharply curtailed, if not eliminated.

Second, as companies choose to move off the Island, either to the mainland or elsewhere, the Puerto Rican economy would be seriously affected. This would increase unemployment in Puerto Rico and reduce wages throughout the economy.

Third, the combined Federal and Puerto Rico tax rates would be out of line relative to the other states. If Puerto Rico decided to lower its taxes to the level of the other states, it would also have to reduce expenditures. Lower government spending would increase unemployment, exacerbating the reduction in economic activity. Finally, increased U.S. Government outlays for entitlement programs and transitional grants would help mitigate the effect of the reduction in economic activity in Puerto Rico.

In order to understand the complexities of the effects of statehood, one should be familiar with the history of the Puerto Rican economy and the Puerto Rico Status Referendum Act. The following sections provide a brief background.

The Puerto Rican Economy

The Puerto Rican economy has undergone a dramatic transformation over the past forty years. Puerto Rico has developed from a primarily agricultural economy in 1950 to one with a strong industrial base. The manufacturing sector's share of total output increased from 17 percent in 1950 to 40 percent in 1988. During the same period, agriculture's share of total output decreased from 18 percent to less than 2 percent. This transformation was the result of the Puerto Rican Government policy of attracting and developing manufacturing investment. As a key component of this development strategy the Government offered tax incentives to companies establishing manufacturing operations in Puerto Rico. Section 931 of the Internal Revenue Code (Section 936 after 1976) also provided incentives to U.S. corporations to establish in Puerto Rico. Real Gross National Product increased at an average annual rate of 6.0 percent between 1950 and 1970, compared to a 3.5 percent increase for the U.S. economy during the period.

Since 1970, the composition of manufacturing output developed from labor intensive to more capital intensive industries. With the gradual extension of the Federal minimum wage to Puerto Rico during this period, real wages increased and the economy began losing labor intensive investment to lower wage countries. During this period, the economy was also seriously affected by the recession of 1982. Real GNP decreased by 3.6 percent in 1982 and by 2.1 percent in 1983. The unemployment rate increased to its highest level at 23.5 percent in 1983. The economy has recovered since 1983. Real GNP and employment have increased by 5.5 and 4.3 percent annually, respectively. The unemployment rate decreased to 15.9 percent in 1988, the lowest level since 1975.

Puerto Rico's current economic structure is illustrated in Table 1. Manufacturing output in 1988 was $10.2 billion, accounting for 40 percent of the total gross domestic product and 18 percent of employment in the economy. The trade, services, and government sectors, contributing only 35 percent of total output, accounted for 65 percent of total employment. The government sector[1], the largest employment sector with 201,000 workers, accounted for 23 percent of total employment.

Puerto Rico's economic development in recent years has produced a level of output substantially higher than most other

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[1]The government sector in Puerto Rico includes municipal employees. Unlike state governments, the Commonwealth government performs many functions fulfilled by local governments and public utilities in the United States.

Table 1
Puerto Rican Gross Domestic Product (GDP) and Employment by Major Industrial Sector for Fiscal Year 1988

	GDP (Millions of dollars)	Percent of total	Employment (Thousands)	Percent of total
Agriculture	405	1.6	32	3.7
Contract construction and mining	490	1.9	48	5.5
Manufacturing	10,230	40.0	157	18.0
Transportation and public utilities	2,091	8.2	50	5.7
Trade	3,743	14.6	173	19.8
Finance, insurance, and real estate	3,301	12.9	30	3.4
Services	2,387	9.3	182	20.8
Government	2,903	11.4	201	23.0
TOTAL	25,567[a]	100.0	873	100.0

Source: Commonwealth of Puerto Rico, Economic Report to the Governor, 1989.

[a]Detail does not add to total due to statistical discrepancy.

Caribbean economies. Puerto Rico's 1985 GNP per capita of $4,519 was almost five times higher than the per capita GNP of Jamaica ($940) and almost six times higher than that of the Dominican Republic ($790). However, while per capita income in Puerto Rico is considerably higher than most economies in the region, it would rank last among the United States.

Table 2 compares two measures of income in Puerto Rico to those in selected U.S. states. Personal income and average manufacturing wages are illustrated for several high and low income states and for Puerto Rico. Annual per capita personal income in Puerto Rico is considerably lower than any state. Indeed, it is 54 percent lower than the lowest income state, and 69 percent lower than the national average. Similarly, the average manufacturing wage rate in Puerto Rico is 29 percent lower than the lowest state, and 46 percent lower than the national average. While these statistics demonstrate that under statehood Puerto Rico would have the lowest income of the states, the Puerto Rican economy has in fact improved substantially in recent years, in large part because of the federal and Puerto Rican tax incentives offered.

Table 3 compares revenues by source for Puerto Rico with U.S. state and local governments. Puerto Rico relies heavily on income taxes. Individual and corporate income taxes account for 62 percent of Puerto Rican tax revenues, while state and local governments receive only 28 percent of their tax revenues from income taxes. On the other hand, property taxes represent only 6 percent of total taxes in Puerto Rico, compared to 30 percent for all other states. Perhaps more important than the distribution of revenues is the difference in the overall level of taxation between Puerto Rico and the States. As a share of GDP, total state and local tax revenues were 15 percent in Puerto Rico but only 11 percent in the states of the Union.

The Puerto Rico Status Referendum Act (S. 712)

S. 712 as reported by the Senate Committee on Energy and Natural Resources provides for a referendum to be held on June 4, 1991. The result of the referendum will decide the political status of Puerto Rico. Voters will choose whether Puerto Rico should become a state, an independent country, or enhanced Commonwealth association with the United States. Should the majority elect statehood, Puerto Rico would become the 51st state of the United States on January 1, 1992.

Effective the date of admission, all federal taxes and entitlement programs would apply to the state of Puerto Rico in the same manner as they apply to all other states, with certain exceptions. These special provisions outlined in the bill are

Table 2

Personal Income per capita and Average Manufacturing Wages for Selected States

	Personal Income per capita in 1988	Average Manufacturing Hourly Wage Rate in 1985
Alaska	$19,079	$12.19
Delaware	$17,661	$9.86
Florida	$16,603	$7.86
Hawaii	$16,753	$8.65
Mississippi	$11,116	$7.22
New Jersey	$21,994	$9.86
New York	$19,305	$9.67
Rhode Island	$16,892	$7.59
North Carolina	$14,304	$7.29
Puerto Rico	$5,157	$5.15
United States	$16,487	$9.53

Source: U.S. Department of Commerce, Survey of Current Business, August, 1989.
U.S. Bureau of Labor Statistics, Employment and Earnings

Table 3

Tax Revenue Source Comparison between Puerto Rico and All U.S. State and Local Governments[a]
(in percent)

Revenue Source	Puerto Rico in 1989[b]	State & local governments in 1987[c]
Individual income tax	29	22
Corporate income tax	33	6
Sales and Excise taxes	31	36
Property tax	5	30
Other taxes	2	6
TOTAL	100	100

Source: Commonwealth of Puerto Rico, Budget, 1989-1990.
Bureau of the Census, Government Finances in 1986-87.

[a]Excludes sales of goods and services.

[b]Amounts for 1989 are estimated. Includes municipalities.

[c]Includes local governments and the District of Columbia.

divided into three main categories: income taxes, excise taxes, and entitlement programs.

Income Taxes. Current tax rules applicable to taxpayers in Puerto Rico would continue until January 1, 1994. Effective that date, all federal income tax laws would apply to Puerto Rico with one exception. The credit allowed under Section 936 of the Internal Revenue Code would be phased out over 5 years beginning on January 1, 1994. Corporations would receive 80 percent of the credit in tax year 1994, 60 percent in tax year 1995, 40 percent in tax year 1996, 20 percent in tax year 1997, and no credit thereafter. As a transitional grant to assist the new state in minimizing the impact of statehood on revenues, the Federal government would transfer to the Treasury of Puerto Rico all revenues from the application of the Federal tax laws in 1994 and 1995 on the taxpayers of the state of Puerto Rico.

Excise Taxes. Effective on the date of admission, all federal excise taxes not applicable to the Commonwealth of Puerto Rico would apply in the same manner as they apply to the other fifty states. As a transitional grant, the revenues derived from the extension of federal excise taxes to Puerto Rico would be transferred to the Treasury of Puerto Rico until at least October 1, 1998. Furthermore, the current payment to the Puerto Rican Treasury of collections from customs duties and alcohol excise taxes would be continued until at least October 1, 1998.

Entitlement Programs. Beginning on January 1, 1992, all entitlement programs would apply to the state of Puerto Rico except for the Supplemental Security Income Program. In order to enable the Department of Health and Human Services to properly establish the program administration, the program would not begin until January 1, 1994.

Preliminary estimates of the effect of statehood have been publicly released by the Congressional Budget Office (CBO) and the U.S. Treasury Department. CBO, along with certain Executive Branch agencies, has the responsibility of determining the impact on U.S. government outlays of statehood while the Treasury Department is primarily responsible for estimating the revenue impact of statehood. As one might expect, in an issue as complicated as this, these estimates will change as the issues become more clearly understood and as new data become available. The methodology and detailed estimates of revenues and outlays as prepared by CBO and Treasury are shown in Appendix D. Through the period 1992-1998, their estimates yield a cumulative budget cost of about $6.6 billion.

The remainder of this report is divided into three sections. Section I provides estimates of the effect of statehood on the Puerto Rican economy. One consequence of statehood is that Section 936 tax benefits would be repealed and would greatly increase the

tax burden of these corporations. Given the availability of tax-favored alternative locations, many of these companies may relocate. Once these companies relocate to alternative sites, employment, wages, income and tax revenue would be significantly affected in Puerto Rico.

Section II presents our estimates of the effect of statehood on the tax revenues and expenditures of the U.S. Government. The revenue estimates are divided by source of tax. Separate estimates are shown for the corporate income tax, the individual income tax and excise taxes. Estimates of the effect on Federal expenditures rely principally on work prepared by the Congressional Budget Office and our consultation with economists with the Commonwealth of Puerto Rico.

The estimates in this section incorporate the effect of changes in the Puerto Rican economy as a result of statehood. As firms relocate and the Puerto Rican economy contracts, the increased tax collection of the U.S. Treasury Department would be reduced. Similarly, estimates of the effect of statehood on Federal government outlays include the effect of unemployment and income loss from the relocation of firms out of Puerto Rico in Puerto Rico. As unemployment increases and incomes are reduced, government outlays on food stamps and other income maintenance programs would increase.

The final section of the report shows the impact of statehood on Puerto Rican tax revenues and outlays. To the extent that statehood and in particular the imposition of U.S. taxes on Puerto Rican companies and the repeal of Section 936 causes relocation of companies outside of Puerto Rico, corporate income tax revenues and individual income tax revenues would be reduced. This reduction in revenues would place the Puerto Rican fiscal system in a very tenuous position. On one hand, Puerto Rico would be faced with a declining economy and a significant reduction in revenues but, on the other hand, it may need to decrease tax rates to be competitive with other states and countries.

SECTION I

THE EFFECT OF STATEHOOD ON THE PUERTO RICAN ECONOMY

The Puerto Rican economy would experience widespread changes following the adoption of statehood. The imposition of U.S. taxes on Puerto Rican residents and the increased eligibility of Puerto Rican residents for U.S. entitlement programs would have major effects on the growth and distribution of Puerto Rican national income.

The imposition of U.S. taxes on Puerto Rican residents would have two main components. First, the special incentives granted to U.S. companies operating in Puerto Rico would be repealed, inducing the relocation of many of these operations and reduction of new investment, with the resulting loss in income and employment on the island. Relocation would significantly reduce the economy's manufacturing output and employment. Second, the additional Federal Government taxes paid by Puerto Rican residents would be a large drain on their disposable income and a deterioration of their standard of living.

In this section, the effect of these changes on the Puerto Rican economy is estimated. The section is divided into six parts, as described below. The models and data bases used in analyzing the effects of statehood on the Puerto Rican economy are briefly described in the first part of this section. A more extensive discussion has been included in Appendix A. The second part describes current federal tax incentives and some of the implications of the prospective changes in the tax system. The reminder of this part quantifies these effects and discusses the potential impact on business location decisions.

The effect of statehood on the business sector is discussed in the third part, with particular emphasis on the effects of repealing Section 936 of the U.S. Internal Revenue Code. Without the tax benefits available under Section 936, many corporations would relocate their activities in other countries offering advantages similar to those otherwise available in Puerto Rico. The relocation can occur in three ways: 1) existing 936 companies may abandon their existing plants; 2) existing companies may curtail or abandon plans to expand their Puerto Rican operations or; 3) U.S. companies may abandon plans to start new 936 companies in Puerto Rico.

The fourth part describes the effect of statehood on individuals. Under statehood, the combined effect of U.S. individual income tax rates with the current Puerto Rican tax

system results in a tax burden that substantially exceeds that imposed on the residents of any other state.

The fifth part analyzes the impact on the Puerto Rican financial sector which is heavily dependent on the financial assets of 936 companies retained in Puerto Rico. The last part discusses the impact of statehood on the Puerto Rican economy from a different perspective -- the effect on the aggregate demand or disposable income of Puerto Rican residents.

Data Bases and Computer Simulation Model

The analysis in this report is primarily based on a computerized system of Puerto Rican tax returns and two highly detailed models of the Commonwealth's and the U.S. Government's Internal Revenue Code and regulations. Corporation and individual income tax models are used to calculate tax payments using data bases from actual corporation, partnership, and individual income tax returns filed with the Commonwealth for the 1984 tax year. Following is a brief description of the structure of these models and data bases. A more detailed description is included in Appendix A.

Data Bases

Two major data bases are used for the estimates in this report. The first is a file of all corporation and partnership income tax returns filed in Puerto Rico in 1984. The second data base is a sample of all individual and partnership returns filed with the Puerto Rican Treasury Department in 1984. These data bases provide the best information available on the income and expenses reported by Puerto Rican taxpayers. The files were prepared as part of an annual review by the Department of the Treasury of the Commonwealth of Puerto Rico to enable them to assess and monitor the tax collections of the Commonwealth. These data files were used by the Commonwealth in estimating and analyzing the impact of their own Tax Reform Act enacted in 1987.

Each data base has been adjusted to reflect a forecast of the level of economic activity in Puerto Rico in 1992. The forecast used for this purpose was provided by the Puerto Rico Planning Board. Additional information was derived from the IAU-Wharton model of the Puerto Rican economy. This forecast is provided in Appendix A.

Computer Models

The corporate and individual income tax models are essentially straight-forward income tax calculators that include a decision-making capability. They are designed to replicate the procedures

used by each taxpayer to fill out their tax return. Unlike estimating methods that rely on aggregate information, this approach allows the models to choose among allowable alternative methods of reporting income and deductions, such as itemizing or using the standard deduction. They also force taxes to be calculated according to certain statutory rules, such as those required under the corporate alternative minimum tax, where each taxpayer must pay the greater of regular tax or alternative minimum tax liability.

Current Laws: Internal Revenue Code Section 936

Understanding Section 936 is fundamental to understanding the impact of statehood on the Puerto Rican economy. U.S. corporations are generally subject to U.S. tax on their worldwide income. Under Section 936 of the Internal Revenue Code, however, a U.S. corporation (a "936 corporation") conducting business operations in Puerto Rico receives a credit sufficient to eliminate its U.S. tax on the income allocable to its Puerto Rican business operations and certain Puerto Rican financial investments. As an economic development incentive, the Puerto Rican Government provides tax exemption grants to most of these same corporations, thereby substantially reducing their Puerto Rican corporate tax. A large number of U.S. companies have established 936 companies to manufacture products sold predominantly into the U.S. market, although an increasing proportion of the products are manufactured for sale to European and other export markets. A significant number of foreign corporations also have established 936 corporations (or non-U.S. corporations that are also eligible for Puerto Rican tax incentives) to manufacture products for sale into the U.S. market.

The Internal Revenue Code specifies three methods for determining the income allocable to 936 corporations for U.S. income tax purposes. Any 936 corporation can compute its income on a "cost plus" basis (i.e., manufacturing costs plus a reasonable return). Alternatively, companies meeting a test of significant business presence in Puerto Rico can elect to compute their income under either the "cost sharing method" or the "profit split method." Most of the income of 936 corporations is earned by corporations that elect one of these latter two methods.

Cost Sharing Method

Prior to the 1986 Tax Reform Act income was allocated to Puerto Rico under the cost sharing method by applying the normal U.S. arm's length requirements (under Code Section 482) for the pricing of products, purchased components, materials, etc. under three specified requirements and assumptions. The 936 corporation was required to make a cost sharing payment to its U.S. affiliates

to pay for a share of the research and development expenses of its affiliates. The precise share of total R&D in a particular product area that was to be paid was determined by the proportion of total sales revenues of the U.S. affiliated group plus the 936 corporation that were attributable to products manufactured in whole or part in Puerto Rico. Under the cost sharing method, this cost sharing payment by statute entitled the 936 corporation to be treated as owner of any technology or other similar intangibles related to the manufacture of the products ("manufacturing intangibles"). At the same time the statute specified that the U.S. affiliates -- and not the 936 corporation -- were generally to be treated as owner of any marketing or other similar intangibles ("non-manufacturing intangibles") related to the product. Thus, the price charged by a 936 corporation to any affiliate (U.S. or foreign) for products manufactured in Puerto Rico had to be determined under U.S. arm's length standards assuming the 936 corporation could earn all income attributable to manufacturing intangibles (less the cost-sharing payment) but no income attributable to non-manufacturing intangibles.

The 1986 Tax Reform Act continued but modified the cost sharing method in two ways. First, it requires that the cost sharing payment be increased in all cases to 110 percent of the amount calculated as described above. Second, it specified that where a larger payment would result, the amount of the payment is to be determined as the amount of royalty payment that would be required under 1986 Act rules applicable generally to related party licenses of manufacturing intangibles (the "super-royalty rules"). The principles for determining the amount of royalty payment required under these super-royalty rules are largely left to regulations, which have not yet been issued.

Profit Split Method

Taxpayers not electing the cost sharing method generally utilize the profit split method. As modified by the 1986 Act, that method allocates to the 936 corporation one-half of the combined taxable income of the 936 corporation and all U.S. affiliates participating in the manufacture and sales of products produced in Puerto Rico. This combined taxable income is computed, however, after subtracting as an expense 120 percent of the cost sharing payment calculated under the cost sharing method as it applied prior to the 1986 Act. Thus, 936 corporations electing profit split are allocated one-half of the income (net of 120 percent of the specified cost sharing payment) from the manufacturing and sale of products, including any income attributable to the marketing effort and intangibles of U.S. affiliates related to the product.

Taxpayers electing profit split can choose to apply that election only to sales into the U.S. market, thus treating sales into foreign markets under the cost sharing method. Because the

profit split method does not permit the income of foreign affiliates to be taken into account in determining the profit to be split, most 936 corporations that sell exported products through affiliated foreign marketing corporations elect to apply the profit split method only to sales into the U.S. market.

U.S. taxpayers establishing 936 corporations and electing the cost sharing or profit split methods receive tax benefits that are generally comparable to those which can be earned under U.S. law by foreign affiliates of U.S. companies conducting comparable activities in another jurisdiction. Earnings of a foreign affiliate manufacturing in a low or no-tax foreign jurisdiction are directly exempt from U.S. tax.[1] The amount of income that a corporation can earn is determined under U.S. (section 482) arm's length rules, including the super-royalty rules as they apply to manufacturing and marketing intangibles. These rules are thus the same as are applied to 936 corporations electing the cost sharing method after the 1986 Act with two notable exceptions. First, the cost sharing payment determined under the cost sharing method can exceed the super-royalty payment in some cases, resulting in a larger cost to a 936 corporation than to a foreign affiliate. Second, the super-royalty payment required of a foreign affiliate is generally treated as foreign source income to the recipient U.S. affiliate, which is thus eligible for the U.S. foreign tax credit, while the cost sharing or super-royalty payment of a 936 corporation is by statute treated as U.S. source income, which is not eligible for the U.S. foreign tax credit. Given these two exceptions, 936 corporations electing cost sharing generally receive on a current basis U.S. tax benefits that are at best equal to but not in excess of that received by foreign incorporated affiliates conducting comparable operations outside the U.S.

A 936 corporation electing the profit split method determines its income on a basis entirely separate from that of comparable foreign affiliates. Since 936 corporations can elect cost sharing and receive benefits that are generally comparable to (or somewhat less than) that of a foreign affiliate, it is reasonable to assume that most 936 corporations electing profit split expect to allocate to Puerto Rico income that is at least comparable to that of the foreign affiliate. However, a foreign affiliate will have a substantial expense in determining its income -- the super-royalty -- that will generally generate foreign source income eligible for U.S. foreign tax credit. Thus, it is likely on an overall basis

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[1]The discussion does not give weight to the fact that a foreign affiliate cannot necessarily repatriate its low taxed earnings to the U.S. (e.g., as a dividend) without a payment of U.S. tax, while a 936 corporation can, because most U.S. corporations owning foreign affiliates have discovered that the economic cost of not repatriating their income is low.

that the tax benefits of profit split for a 936 corporation will be comparable to the tax benefits available to a foreign affiliate.

Section 936 and the Puerto Rican Business Sector

On balance, Section 936 provides Puerto Rico manufacturing operations a substantial tax advantage over operations in the United States. Moreover, these advantages make Puerto Rico competitive with foreign countries that provide their own tax incentive programs for U.S. company manufacturing operations.

These incentives have clearly contributed to the growth in the Puerto Rican economy since 1976. By 1989 total direct employment by 936 corporations reached 112,000 jobs. In addition to the impact of Section 936 on the manufacturing sector, 936 corporations have greatly strengthened the financial sector, accounting for 40% of all bank deposits.

In addition to the effect on direct employment, 936 corporations are responsible for the creation of thousands of indirect jobs. These 936 corporations require a variety of raw materials and services. While some goods and services are provided by foreign suppliers and other 936 companies, local purchases have led to the establishment and growth of many new businesses in Puerto Rico with resulting increases in employment and the island's tax base.

Fundamental to reaching an understanding of the potential impact of statehood on the Puerto Rico economy is determining its impact on the 936 company sector on the island. The dominance of these 936 corporations in the Puerto Rican economy is difficult to understate. As shown in Table I-1 the nearly five hundred 936 corporations account for 94.4 percent of the operating income and 78.6 percent of the operating assets in the manufacturing sector. The operating income of four industries: apparel and other textile products, pharmaceutical, machinery (including electrical & electronic equipment), and instruments, is almost entirely accounted for by 936 companies.

The potential for the relocation of these companies can best be measured by determining the impact of the elimination of Section

Table I-1
Estimates of Section 936 and Foreign-Owned Manufacturing Corporations in 1992: Manufacturing Industry Distribution and Financial Characteristics
(Dollar amounts in millions)

Industry	Corporations		Operating Income		Operating Assets	
	Number	Percent	Amount	Percent	Amount	Percent
Food & Kindred Products	29	12.2	708	86.8	838	50.5
Apparel & Other Textile Products	81	34.0	183	97.2	410	37.0
Pharmaceutical	59	75.6	3,546	98.4	5,336	96.7
Other Chemicals	30	29.7	261	81.7	2,799	89.9
Electrical & Electronic Equip.	118	62.1	1,199	97.9	2,849	98.3
Instruments	59	73.8	560	99.3	850	97.7
Other Manufacturing	121	20.1	488	76.3	1,410	43.2
TOTAL	497	32.5	6,945	94.4	14,490	78.6

Note: Percentages refer to 936 firms as a share of Puerto Rican firms in the industry.

936 on the after-tax rate of return of 936 corporations.[2] The after-tax rate of return for all manufacturing companies would decline by 9.8 percentage points, or 23.2 percent, under statehood.

These averages mask the variance in the effect on individual firms. Table I-2 shows a distribution of firms by the size of their reduction in the after-tax rate of return. Sixty-five companies, accounting for 20.5 percent of net income, would experience a reduction of more than 30 percentage points. One hundred seventy-five companies, with a combined total of 62.6 percent of net income, would experience a reduction in their rate of return of more than 15 percentage points.

Relocation Effects

International business location decisions depend upon several factors, including political stability, wage rates, availability of labor and raw materials, financing arrangements, and infrastructure, such as utility and transportation systems. In addition, a major consideration is taxes. This part of the report analyzes how statehood, including the repeal of Section 936, would affect the level of business activity in Puerto Rico.

This analysis is necessarily limited to the companies that are currently operating in Puerto Rico, but implicit in the analysis is that newly formed 936 companies and current 936 companies that are expanding their operations in Puerto Rico would be affected in the same way as the existing operations of current 936 companies. Existing 936 corporations will therefore be considered as representative of all potential 936 investment in Puerto Rico. If, for example, two thirds of the current level of 936 activity would relocate after statehood, then two thirds of the new investment

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[2]The after-tax rate of return is computed using a methodology similar to the method the Treasury Department used to compute before-tax income in The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report, March 1989. The rate of return equals operating income divided by operating assets. Operating income is defined as gross sales less cost of goods sold and all other deductions except taxes, interest, and charitable contributions. Operating assets includes net property, plant, and equipment, inventories, and net accounts receivable. The after-tax rate of return computation reduces operating income by Puerto Rican and federal income taxes paid.

Table I-2

Variation in Change in After-Tax Rate of Return for 936 and Foreign-Owned Corporations if Statehood is Adopted
(Dollar amounts in millions)

Reduction in Rate of Return	Number of Firms	Net Income Amount	Net Income Percent
Less than 3 percentage points	108	6	.1
3.0 to 4.9 percentage points	57	412	4.6
5.0 to 7.9 percentage points	90	591	6.7
8.0 to 9.9 percentage points	47	744	8.4
10.0 to 14.9 percentage points	87	1,571	17.7
15.0 to 19.9 percentage points	54	1,838	20.7
20.0 to 24.9 percentage points	34	1,522	17.1
25.0 to 29.9 percentage points	22	383	4.3
30.0 or more percentage points	65	1,820	20.5
TOTAL	564	8,886	100.0

SOURCE: KPMG Peat Marwick estimate

(new 936 companies or expansion of existing companies) would also locate outside Puerto Rico.

There are two separate issues that need to be addressed. The first issue is the extent to which, in the long run, economic activity would be reduced in Puerto Rico as a result of statehood. The second issue is the time frame over which this reduction would occur.

On the first issue -- the extent of the long run decline in economic activity -- this study analyzes the impact of the change in the tax structure accompanying statehood on the after-tax rates of return of all existing 936 companies and compares this return to returns available in alternative sites.

As discussed later in this section, estimates are made under three alternative assumptions concerning the rate of return differential required for a firm to choose the alternative site over Puerto Rico. One assumption is that the required rate of return would be 5 percentage points higher in the alternative site, a second is that the required return would be 11 percentage points higher, and the third that the required rate of return would be higher by 15 percentage points.

The second issue is the timing of the relocation of these companies and the path along which the adjustment to the new tax structure occurs. One possibility is that the firms currently operating in Puerto Rico immediately abandon their operations and relocate elsewhere. The 11 and 15 percentage point relocation scenarios are investigated as indicators of the speed of adjustment of the relocation of these existing firms.

An alternative possibility is that current 936 companies curtail future investment in Puerto Rico and locate this investment elsewhere, so that the relocation of these companies would occur over a longer period of time as their current productive capacity depreciates and is abandoned incrementally. The adjustment process also would include companies that are not currently operating in Puerto Rico. These companies would have started a new 936 company in Puerto Rico had current law been continued, but faced with statehood may decide to continue producing in the U.S. or to locate in some other country.

The adjustment process is clearly very complex and would be a mixture of these three effects. For simplicity, it is assumed that the adjustment would occur rateably over five years starting in 1994. For some operations, the adjustment would take longer and for others the process would begin even before 1994.

The "relocation" effect thus does not refer solely to firms currently operating in Puerto Rico that would abandon their operations. The relocation effect also includes new investment by existing companies and by newly formed 936 companies. The relocation effect also includes the impact on new investment by existing companies and by newly formed 936 companies. The analysis, however, does not include relocation effects for Puerto Rican owned companies. With higher after-tax costs and lower income resulting from combined federal and state taxes under statehood, Puerto Rican companies may face competitive pressures from U.S. and foreign firms leading them to relocate, and/or to reduce output, income, employment and tax payments. Further analysis would be required to evaluate the magnitude of this effect.

The decision to relocate existing operations or to place new investment in an alternative site outside of Puerto Rico is driven by the after-tax rate of return. The rate of return could be higher outside of Puerto Rico for three reasons. First, if the country is one of several tax havens or if it offers incentives to relocating firms, the local tax rate would be low. Second, because the U.S. taxes the operating income of a foreign based subsidiary of a domestic firm only when the income is repatriated, the firm could defer the tax on its operating income by keeping its dividend payments at a minimum. Third many jurisdictions offer incentives, such as tax holidays, to relocating firms.

On the other hand, not all companies with a tax advantage in an alternative site will elect to relocate or place new investment on that site. As mentioned above, there are numerous non-tax factors that also affect business location decisions. Indeed, there are clearly some major non-tax advantages and disadvantages that Puerto Rico has in relation to foreign countries. The desirability of Puerto Rico under Statehood relative to the mainland and alternative foreign sites is difficult to precisely determine.

Most Puerto Rican products are shipped to the United States for ultimate consumption and its geographic location is a unique shipping cost disadavantage. Shipments between Puerto Rico and the United States must be in U.S. flag ships which generally are far more expensive than foreign flag ships which haul most goods to American ports from foreign destinations. This disadvantage has tended to be offset by exemptions from Puerto Rican and U.S. taxes. Labor costs in Puerto Rico are lower on average than on the mainland, but higher than most alternative foreign sites in the Caribbean and the Pacific rim. On the other hand, its proximity to the U.S. mainland, its political stability, and the fact that it uses the U.S. dollar as its currency are clear advantages.

On balance, the reduced taxes and resulting higher after-tax rate of return available in the alternative site must be enough to offset the non-tax advantages, if any, of locating in Puerto Rico. Determining the importance of the non-tax factors is problematic, especially since the importance varies considerably across companies. For some companies the required increase in the after-tax return may be only one percent, whereas other companies may require an increase of 15 or 20 percentage points. For purposes of this analysis, we selected three thresholds -- 5, 11 and 15 percentage points. If a company's return in an alternative site is higher than in Puerto Rico by at least the threshold amount, it is assumed that non-tax advantages, if any, are exceeded and the firm would relocate or place any new investment outside of Puerto Rico.

It is not possible to replicate all of the factors that influence decisions concerning location, to enter, stay, or leave. It is possible, however, to analyze in the case of Puerto Rico, the bottom-line effects of increased taxes resulting from a move to Statehood and to compare the resulting bottom-line to that available in alternative sites.

While it is not possible to know for each individual firm the rate of return differential that would be required to induce the firm to relocate or invest elsewhere, this study analyzes three cases: A differential in the after-tax return of 5 percentage points, 11 percentage points and 15 percentage points. The logical way to think about the results displayed is that those firms incurring the higher immediate reductions in returns, particularly where the percentage reduction exceeds their cost of capital, would be the first to leave Puerto Rico and relocate in a more conducive tax atmosphere. Firms suffering a return reduction approximately equal to their costs of capital, for which the 11 percent case is thought to be a current surrogate, would have no apparent reason to remain in Puerto Rico and, depending on the balance of other factors, would have motivation to leave.

The 5 percent reduction case is most relevant to the longer term and to potential new entrants to Puerto Rico. Few firms would choose Puerto Rico over a foreign location or perhaps U.S. location when its after-tax return would be 5 percent less than in another foreign location. The practical judgment here would be that only those firms which would find offsetting advantages to location in Puerto Rico would decide to do so.

The corporate model and data base for Puerto Rico have been used to estimate which firms would relocate. The after-tax rate of return has been calculated under the combined federal and Puerto Rican tax systems as they would apply under statehood, and then recalculated under the tax structures available in alternative sites. The change in the after-tax rate of return is due solely

to changes in tax liability. The receipts and expenses of each company and, therefore, the before-tax rate of return, is assumed to be the same in Puerto Rico and in the alternative sites. This is clearly an oversimplification since capital and labor costs could vary substantially among different sites, with some having higher or lower costs relative to Puerto Rico.

Two tax computations are made for each firm. First, the combined federal and Puerto Rican tax liability for firms remaining in Puerto Rico is computed. Puerto Rican tax liability is computed under current Puerto Rico tax law incorporating all the special exemptions and deductions allowed to each company. Federal tax liability is then computed under U.S. tax law which would allow a deduction for taxes paid to the Puerto Rican government and has very different rules for the measurement of taxable income.

The second step is to compute the tax liability at alternative sites. Unlike the very detailed computations made of the combined federal and Puerto Rican taxes, the alternative site calculations are necessarily approximations since specific alternative sites were not selected. The taxes owed to the taxing jurisdiction in the alternative sites are assumed to be five percent of net income which is the average tax rate currently paid by 936 companies to Puerto Rico.[3]

The determination of the total tax liability of the firms at the alternative site is further complicated by the super royalty rules in the U.S. tax code. In effect, even if the firm operates in the alternative site, some of its income would still be taxable in the U.S. Under the super royalty provision of the Federal Tax Reform Act of 1986, companies are required to pay a royalty to a parent company for the use of intangible assets (patents, etc.) that is commensurate with the income produced by the asset. The exact interpretation of this provision is very controversial and final regulations have not yet been issued by the IRS.

Section 936 companies using the cost-sharing method are subject to the super royalty rule. However, most 936 companies will elect the profit-split method, under which companies are deemed to be in compliance with the Super Royalty rules if their total profit (after making a cost sharing payment) is split 50/50 with the parent. Thus, the issue for relocation is how much additional income, if any, would be taxed in the U.S. above the current 50/50 split. To be conservative, it was assumed in the tax computations that an additional third of the remaining intangible income would be taxed in the U.S. even if the firm relocated to an alternative site.

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[3]Excluding the tollgate tax.

To summarize, a firm remaining in Puerto Rico after statehood would pay U.S. taxes on all of its tangible and intangible income. The tax advantage from relocation is that the firm could defer (until repatriation) its tax payment on all its manufacturing income and about one-third of its intangible income. The remaining two-thirds of its intangible income would be taxed currently under the super royalty rules.

The increase in the rate of return available in an alternative site for each firm is then compared to a specific threshold to determine whether the firm will relocate. As explained above, three thresholds have been modeled: 5 percentage points, 11 percentage points, and 15 percentage points.

Table I-3 through Table I-5 show the operating assets and operating income of the firms that could improve their returns in an alternative site by more than 5 percent, 11 percent and 15 percent, respectively. Of the 497 Section 936 manufacturing corporations, 101 firms could improve their return by more than 15 percentage points. The number of firms increases to 153 at 11 percent and 333 under 5 percent. The critical measure of the magnitude of the effect on the Puerto Rican economy is the percent of income that could be "lost" to other sites. The "lost" income increases from 44 percent under the 15 percentage point threshold to 105 percent under the 5 percentage point threshold.

The remainder of this report will present the revenue estimates for the 5 and 11 percentage point scenarios. The 15 percentage point scenario, while relevant in some firm's very short-run relocation decision, would not be the binding threshhold for longer term decisions. Since this analysis extends to the medium and longer-term investment decisions from 1992 to 2000, it will focus on the 5 and 11 percentage point scenarios.

Table I-6 shows the employment and wage effects of the 5 percentage point and 11 percentage point relocation scenarios. These estimates include estimates of both the direct and indirect effects of relocation. The direct effect is a measure of the reduction in employment and wages attributable solely to the relocating 936 and foreign owned corporations. Estimates of the indirect effect include only the reduction in employment and wages of firms supplying 936 and foreign owned corporations.

The direct effect of relocation would be the loss of between 47,000 and 84,500 jobs and $1,060 million to $1,880 million in wages. When the first order indirect effects are included, the total job loss increases to a range of 79,500 to 145,000, with a corresponding reduction in wages between $1,435 million and $2,580 million.

Table I-3

Estimated Relocation of Section 936 and Foreign-Owned Manufacturing Corporations in 1992: Manufacturing Industry Distribution and Financial Characteristics With Relocation Assumed to Occur When the Rate of Return in the Alternative Site is More than 5 Percentage Points Higher than Under Statehood
(Dollar amounts in millions)

Industry	Firms		Operating Assets		Operating Income	
	Number	Percent	Amount	Percent	Amount	Percent
Food & Kindred Products	14	48.3	733	87.5	448	63.3
Apparel & Other Textile Products	51	63.0	289	70.5	165	90.2
Pharmaceutical	46	78.0	4,472	83.8	3,337	94.1
Other Chemicals	18	60.0	599	21.4	382	146.4
Electrical & Electronic Equip.	91	77.1	2,512	88.2	1,957	163.2
Instruments	40	67.8	730	85.9	531	94.8
Other Manufacturing	73	60.3	742	52.7	460	94.3
TOTAL	333	67.0	10,396	71.7	7,280	104.8

Note: Percentages refer to share of total 936 and foreign-owned corporations.

Table I-4

Estimated Relocation of Section 936 and Foreign-Owned Manufacturing Corporations in 1992: Manufacturing Industry Distribution and Financial Characteristics With Relocation Assumed to Occur When the Rate of Return in the Alternative Site is More than 11 Percentage Points Higher than Under Statehood
(Dollar amounts in millions)

Industry	Firms		Operating Assets		Operating Income	
	Number	Percent	Amount	Percent	Amount	Percent
Food & Kindred Products	8	27.6	275	32.8	211	29.8
Apparel & Other Textile Products	18	22.2	65	15.9	91	49.7
Pharmaceutical	20	33.9	2,071	38.8	2,402	67.7
Other Chemicals	9	30.0	232	8.3	325	124.5
Electrical & Electronic Equip.	52	44.1	1,353	47.5	1,492	124.4
Instruments	20	33.9	213	25.1	282	50.4
Other Manufacturing	26	21.5	232	16.5	177	36.3
TOTAL	153	30.8	4,441	30.6	4,980	71.7

Note: Percentages refer to share of total 936 and foreign-owned corporations.

Table I-5

Estimated Relocation of Section 936 and Foreign-Owned Manufacturing Corporations in 1992: Manufacturing Industry Distribution and Financial Characteristics With Relocation Assumed to Occur When the Rate of Return in the Alternative Site is More than 15 Percentage Points Higher than Under Statehood
(Dollar amounts in millions)

Industry	Firms		Operating Assets		Operating Income	
	Number	Percent	Amount	Percent	Amount	Percent
Food & Kindred Products	4	13.8	109	13.0	104	14.7
Apparel & Other Textile Products	11	13.6	33	8.7	60	32.9
Pharmaceutical	13	22.0	791	14.8	1,433	40.4
Other Chemicals	7	23.3	230	8.2	323	123.8
Electrical & Electronic Equip.	35	29.7	1,020	35.8	1,233	102.8
Instruments	14	23.7	127	14.9	208	37.1
Other Manufacturing	17	14.0	80	5.7	82	17.0
TOTAL	101	20.3	2,389	16.5	3,444	49.6

Note: Percentages refer to share of total 936 and foreign owned corporations.

The first order indirect employment effects measure the reduction in employment in companies supplying inputs to relocating corporations. Relocation reduces the demand for the goods and services produced by the supplying corporations. The analysis uses the Input-Output (I-O) Table for the Puerto Rican economy to estimate the effect of relocation on suppliers. Some of the supplier companies are, themselves, 936 companies. To avoid double counting the I-O Table was adjusted to account for the linkages between 936 corporations and the rest of the economy. A detailed description of the methodology is presented in Appendix B.

As described above, the required reduction in after tax rate of return will vary across industries and will be different for new relative to existing investment. Any existing investment would require a higher rate of return differential, certeris paribus, than new investment because firms with existing investment have to receive compensation for the useful life of the assets.

Personal Sector

In the preceding discussion on relocation effects, estimates of job loss were presented. The effect of statehood on the personal sector, however, extends beyond job loss. Under present law, Puerto Rican residents pay no federal income tax on Puerto Rican source income. With the adoption of statehood, Puerto Ricans, like the residents of any other U.S. state with an income tax, would pay both federal and Puerto Rican income taxes. However, individual income tax rates in Puerto Rico are already higher than those of any other state. Puerto Rican personal income tax rates are in fact higher than federal income tax rates.

The adoption of statehood would result in a substantial increase in the combined (Federal and Puerto Rican) effective average and marginal tax rates on Puerto Rican residents. Table I-7 illustrates these rates by income class for Puerto Rican taxpayers before and after statehood. These rates, at 1992 income levels, have been computed using the individual income tax model and data base described earlier in this section. Even with the deductibility of Puerto Rican income taxes when computing federal income taxes, the average tax rate increases from 10.3 percent to 16.1 percent, and the marginal rate increases from 25.8 percent to 40.4 percent. At the lowest income levels, statehood would result in a decrease in tax rates because of the earned income tax credit. For income classes above $5,000 marginal tax rates begin to increase significantly. In fact, once income reaches the $12,500 to $17,000 class, the marginal rate jumps from 12.9 percent to 28.0 percent. For the same class, the average rate increases from 5.4

Table I-6

Estimated Employment and Wage Effects of Relocation Resulting from the Adoption of Statehood under Alternative Rate of Return Thresholds: 1992 Levels

	Employment	Wages (Millions of dollars)
5% Relocation		
Direct Effect	84,500	1,880
Indirect Effect	60,500	700
TOTAL	145,000	2,580
11% Relocation		
Direct Effect	47,000	1,060
Indirect Effect	32,500	375
TOTAL	79,500	1,435

Source: KPMG Peat Marwick

to 6.9 percent, indicating a 28 percent increase in the total tax burden for residents with modest income levels.

The increased tax burden on individuals would certainly affect the economy through the reduction in disposable income of residents and may have some impact on the migration of individuals to the mainland. It is not possible to accurately measure these effects, however, and they are not incorporated into the effect on the Puerto Rico economy.

Financial Sector

Statehood will also have a negative effect on the Puerto Rican financial sector. With the elimination of the tollgate tax[4] imposed by the Puerto Rican government on the repatriation of income and with the phase-out of Section 936 credits, 936 corporations will have no incentive to maintain their financial investments in Puerto Rico. In 1988, 936 deposits in Puerto Rican banks amounted to about $10 billion, or about 40 percent of all bank deposits. The deposits of 936 corporations have contributed to the growth of the financial sector. The financial sector's share of non-manufacturing output increased from 16.6 percent in 1975 to 21.5 percent in 1988. Employment in the sector increased from 17,000 workers in 1975 to 30,000 workers in 1985.[5] If 936 corporations withdraw their deposits from Puerto Rican banks, income and employment in the financial sector would decrease as will the taxes paid by banks to the Puerto Rican Treasury.

As financial investments are withdrawn from Puerto Rican banks, the banking sector will face an $10.1 billion dollar reduction in deposits. This decrease in deposits would reduce income in the sector by $135 million at 1992 levels. The reduction in income would also force banks to reduce services and employment. In addition, the non-relocating 936 corporations would eliminate the positions of the financial officers in charge of investing the income in Puerto Rican banks. The combined reduction in financial sector and 936 finance department employment would be about 2,000 jobs in 1992 with a total reduction in wages of about $60 million.

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[4]U.S. constitutional restrictions preclude continuing the tollgate tax under Statehood.

[5]Financial Sector output is not reported separately. The figures refer to the Financial, Insurance and Real Estate sectors.

TABLE I-7

Combined Federal and Puerto Rican Tax Rate Experienced by Residents Before and After the Adoption of Statehood in 1992

Federal AGI Class	Average Tax Rate		Marginal Tax Rate	
	Before Statehood	After Statehood	Before Statehood	After Statehood
Less than $5,000	0.5	-1.0	0.0	-4.0
5,000 to 8,000	1.4	-0.6	7.0	9.3
8,000 to 12,500	3.3	2.0	10.8	12.8
12,500 to 17,000	5.4	6.9	12.9	28.0
17,000 to 25,000	7.1	11.4	14.2	31.2
25,000 to 35,000	9.3	15.8	20.2	34.3
35,000 to 50,000	12.7	20.6	26.9	39.5
50,000 to 100,000	17.9	27.5	31.9	48.3
More than 100,000	23.1	38.7	30.7	53.4
All Taxpayers	10.3	16.1	25.8	40.4

Note: Under current law, i.e. before the adoption of statehood, Puerto Rican residents generally incur no federal income tax.

The Effect of Statehood on Aggregate Demand in Puerto Rico

The analysis in the earlier parts of this section focuses on the effect of statehood on the after-tax returns to capital and labor in Puerto Rico. Under conservative assumptions, it is clear there would be a significant decline in the Puerto Rican economy from the relocation of 936 companies.

The relocation analysis presents only a partial view of the economic consequences of statehood. From another perspective, there are potential positive effects derived from the massive inflow of Federal funds to Puerto Rican residents. The net effect on aggregate demand, however, includes not only the inflow of federal funds, but also the outflows associated with increased federal taxes and the reduction in wages.

Under statehood, the aggregate demand of Puerto Rican residents would be affected in four ways:

(1) increase in federal government transfers;
(2) reduction in demand resulting from the payment of federal taxes;
(3) reduction in demand resulting from the loss of employment and wages of residents; and
(4) reduction in tax payments to the Puerto Rican government from the relocating non-resident owners or capital.

Federal Entitlement Programs

Under statehood, federal government entitlement programs would increase significantly. In the year 2000, a year which can be considered as a proxy for the long-run effect, federal government payments to Puerto Rico increase by $6.4 billion and $6.1 billion under the 5 percentage point and 11 percentage point relocation scenario, respectively.[6]

Federal tax liability

The imposition of federal taxes would reduce the disposable income of Puerto Rican residents and is therefore a drain on the economy. The total federal taxes paid in the year 2000 would be about $2.2 billion under the 5 percentage point relocation scenario and about $3.7 billion under the 11 percentage point scenario. However, a significant share is paid by 936 companies and foreign owned companies. The payments made by these companies are not appropriately included in this effect since these taxes reduce the

[6]Includes cover over of excise taxes.

income of the owners who are not Puerto Rican residents. The net effect of these federal tax increases, after eliminating the payments made by non-residents is shown in Table I-8. The result would be a reduction of income to Puerto Rico of $1.9 and $2.2 billion in the year 2000 under the 5 and 11 percentage point scenarios, respectively.

Lost wage and salary income from relocation

As 936 and foreign owned firms relocate, there would be an increase in unemployment and a decrease in the demand for local source firm output. This is estimated to cause wage and salary income and local source corporation income to decrease in 2000 by $6.0 billion and $3.4 billion under the 5 percentage point and 11 percentage point scenario, respectively.

Loss in Puerto Rican Tax Revenues From Non-Resident Owners of Capital

Statehood would reduce the tax payments of non-residents in 2000 by $0.8 billion and $0.7 billion under the 5 percentage point and 11 percentage point scenario, respectively. These revenues would have been collected from 936 and foreign-owned companies under the tollgate tax and the local income tax.

Summary

The additional Federal payments under statehood would be offset by the negative effect of Federal tax payments, income loss from relocation, and the loss in Puerto Rican government revenues from relocation. The net effect of statehood would be to decrease aggregate demand in Puerto Rico by $2.3 billion in 2000 under the 5 percentage point scenario, and by $0.2 billion in 2000 under the 11 percentage point scenario. These changes would represent 5.0 and 0.4 percent of GNP, respectively. Puerto Rico's gross national product in the year 2000 is estimated to be approximately $46 billion.[7]

While the net aggregate income flow to the Puerto Rican economy would be small, the gross flows would be significant (the increases in entitlements would represent between 13 and 14 percent of GNP in 2000) and would have major distributional consequences. Under statehood, the Puerto Rican economy would experience a major economic transformation. The economy would lose a significant component of its industrial base because of the relocation of 936 and foreign-owned corporations. Industrial production, capital

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[7]Puerto Rico's gross national product in 1988 was $18.4 billion. Assuming an 8 percent annual growth rate, the GNP in the year 2000 would be about $46 billion.

accumulation, and employment would be replaced by transfers from the Federal government.

Statehood would affect Puerto Rican residents differentially. The most negatively affected by statehood would be the working population, who would either have to pay significantly additional taxes or would lose their jobs because of relocation of corporations outside Puerto Rico. Transfer payments would mitigate the cost of job loss for those who become unemployed, but would not totally compensate for the reduction in wages. The beneficiaries of statehood would be the people outside the labor force and the long-term unemployed. They would receive additional transfers from the Federal Government and would not pay additional taxes (since most earn very little income). As a result of statehood, Puerto Ricans would depend more on government entitlement and less on wages and profits as a source of personal income.

SECTION II

EFFECT OF STATEHOOD ON U.S. GOVERNMENT RECEIPTS AND OUTLAYS

This section presents estimates of the effect of statehood on federal tax revenues and outlays. These estimates are first presented before adjusting for the impact of the increased tax burden under statehood on the level of economic activity, and then presented after accounting for such effects.

This section is divided into five parts. The first three parts deal with the three major sources of revenue -- the corporation income tax, individual income tax, and excise taxes. While the proposed legislation would phase-in the repeal of Section 936 over a five year period, the estimates in these three parts are presented as if fully phased-in. That is, transition rules and the section 936 repeal phase-in period are assumed to have already occurred, with the results presented at 1992 levels of income.

The fourth part discusses the effect of statehood on U.S. outlays. These estimates are presented both with and without including the estimated effect of statehood on the Puerto Rican economy. The final part presents the effect of statehood on revenues and outlays incorporating the full impact of the transition rules contained in the bill, and the change in the level of economic activity. Unlike the single year estimates presented to this point, this forecast extends through the year 2000.

U.S. Corporation Income Tax Revenues

Under S. 712, statehood would result in corporations resident in Puerto Rico becoming subject to U.S. taxation beginning in 1994. As described in Section I of this report, U.S. corporations are generally taxed on their worldwide income. Under current law, however, section 936 corporations are not required to pay corporate income tax to the U.S. Treasury, nor do parent companies generally pay federal income tax on dividends remitted by 936 subsidiaries. This tax exemption results from the availability of a credit equal to the amount of federal income tax a 936 corporation would otherwise have paid. Under S. 712, this credit would be reduced to 80 percent in 1994, 60 percent in 1995, 40 percent in 1996, 20 percent in 1997, and would be eliminated for years after 1997.

Under a transition rule the U.S. Treasury would not retain the increased federal income tax collections in the first two years. Following the adoption of statehood, S. 712 would require that the U.S. Treasury cover-over 1994 and 1995 corporate income tax revenues to the Puerto Rican Treasury. This and other transition rules have not been finalized. For example, the timing and administration of the cover-over has not been determined. Also, it

is unclear whether corporations which presently have not elected to be taxed under Section 936 could elect 936 status during the transition period.[1]

Methodology

The methodology used in determining the federal revenue effect of statehood assumes that the current tax structure in Puerto Rico is not modified, including the retention of the exempt status of 936 and Industrial Incentive Act corporations.

Modeling the revenue effect of statehood on federal receipts, before accounting for statehood's impact on economic activity, includes three basic steps:

(1) model the current rules regarding the U.S. treatment of intangible income;
(2) adjust the model and data base for recent changes in the Puerto Rican tax law; and,
(3) incorporate the differences between U.S. tax law and Puerto Rican tax law.

Each of these steps is described in more detail below.

U.S. tax laws governing the treatment of certain intangible income were changed in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and again in the Tax Reform Act of 1986. Both changes reduced the tax benefits available to 936 corporations by increasing royalty payments to U.S. parents.

Prior to 1982, there were no explicit statutory guidelines on the allocation of income from intangibles (e.g. patents, trademarks, trade names) to possession corporations in Puerto Rico. For example, a U.S. pharmaceutical company could develop a patentable drug in its U.S. laboratories and then transfer the patent to their Puerto Rican subsidiary. The subsidiary would produce the drug and benefit from the tax-exempt nature of the income, while the U.S. parent would claim the deduction for the costs of developing the drug. Both TEFRA and the Tax Reform Act, as described in Section I, provided rules whereby a share of the income from intangibles would be allocated to the U.S. parent.

Because the data base used in this analysis incorporates 1984 tax returns, the full effect of the two acts is not entirely reflected in the taxable income reported by 936 companies. Had the legislation been fully effective in 1984, royalties paid to U.S. affiliates would have been higher, with the income of 936

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[1]Only U.S. corporations are eligible to receive the benefits of Section 936. On January 1, 1992, all Puerto Rican corporations would become U.S. corporations, and thus potentially eligible to claim the benefits of Section 936 during the phase-out period.

corporations correspondingly reduced. This effect has been incorporated by assuming that under the 1986 Act 936 corporations would pay an additional royalty (above that paid in 1984) equal to one-third of their total intangible[2] income. The taxable income of the 936 companies was reduced to reflect this change.

Puerto Rican corporate tax law has also changed since 1984, most significantly with the adoption of the 1987 tax reform program. This legislation contained a number of provisions affecting corporations, including a reduction in tax rates and the implementation of an alternative minimum tax. The 1987 changes were incorporated in the model to allow the development of a current law baseline against which the effect of statehood could be measured. The 1992 level net effect of these changes was not significant for 936 corporations, and resulted in a tax reduction of approximately 2 percent for non-936 corporations.

Estimated Puerto Rican corporate income tax liability in 1992 would be $877 million in the absence of tax reform. Under the Tax Reform Act, tax liability is forecasted to be $863 million, a net decrease of $14 million. Under statehood, the $863 million of corporate tax payments would be allowed as a deduction at the Federal level.[3]

The final step requires the computation of federal tax liability of Puerto Rican companies under statehood. U.S. tax rules differ from Puerto Rican tax law in a number of significant ways, including: (1) marginal tax rates; (2) the federal deductibility of state income taxes; (3) accelerated depreciation; (4) the lack of certain exemptions at the federal level, such as those provided under the Industrial Incentive Acts; (5) the opportunity for 936 corporations to file consolidated returns with U.S. parent corporations under statehood, and; (6) federal rules do not generally require that partnerships be taxed as corporations. Each of these differences is discussed further below.

Puerto Rico allows a $25,000 surtax exemption, but phases out the benefit of the reduced rate on that income by imposing an additional 5 percent tax on income in excess of $500,000, until the benefit is fully recaptured. The United States has reduced rates

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[2]This implicitly assumes that most 936 companies would be under the 50/50 profit split method allowed as a "safe-harbor" under the 1986 Act.

[3]If Puerto Rico were to become a state, it would need to adopt some form of corporate income apportionment similar to the three factor formula apportionment rules now in effect in most states. This analysis implicitly assumes that the income levels in the model are equal to those that would result from state apportionment.

on the first $75,000 of taxable income and recaptures that benefit at a 5 percent rate on incomes in excess of $100,000. The top marginal tax rate is higher in Puerto Rico than in the United States, but the top U.S. rate is effective at a lower income level.

A full deduction for state taxes is allowed to U.S. corporations. Therefore, Puerto Rican corporate income taxes would be deductible at the federal level under statehood. Depreciation rates and schedules differ between the United States and Puerto Rico. Puerto Rican corporations are allowed to claim current and flexible depreciation, while the U.S. rules are based upon the modified accelerated cost recovery system.

The Industrial Incentive Acts of Puerto Rico grant exemptions to certain Puerto Rican corporations which produce a specific product, or in a certain region. This exemption reduces taxable income by a certain percentage for a specified length of time. The United States has no such exemption system at the federal level.

Section 936 corporations are often subsidiaries of U.S. parents that, under present law, may not be included in the parent's consolidated income tax returns filed in the United States. Following repeal of Section 936, these corporations may be included within the consolidated group. Estimating the effect of this additional taxable income on federal receipts first requires the computation of the amount of additional taxable income to be reported. For this purpose it has been assumed that the taxable income of all Section 936 corporations is included in the U.S. taxable income of consolidated groups. Second, it requires the use of an appropriate federal marginal income tax rate. The tax rate to be used for this purpose is not easily computed because the data necessary for a direct linkage with tax returns of U.S. parents of Section 936 corporations are not available. While it would be simple to assume that all the 936 corporation taxable income would be included in the returns of U.S. parents at the top statutory rate of 34 percent, such an assumption is likely to overstate actual tax liability. Some parents are likely to be in either a current year loss position, or possibly to have tax credits available to shelter some or all of the additional taxable income in a given year.

The Policy Economics Group U.S. Corporate Income Tax Model, which is conceptually similar to the model used with the Puerto Rican corporation income tax returns, was used to develop marginal tax rates for Section 936 corporations. The methodology underlying this computation is described in Appendix C. An effective federal corporate marginal income tax rate of 29 percent was developed for use in determining the revenue effect of imposing U.S. tax rules on Section 936 corporations.

Table II-1 provides the effect of federal law on the tax liability of Puerto Rican corporations at 1992 income levels.

Under statehood it is estimated that 936 corporations would be required to pay $1.7 billion in income taxes to the U.S. Treasury, while non-936 corporations would pay $0.6 billion, for a total increase in federal collections of $2.3 billion. This first set of revenue estimates assumes no change in economic activity as a result of statehood.

In Section I, estimates of the effect of statehood on the Puerto Rican economy were presented. These effects were the result of the relocation of 936 companies and foreign owned companies. Relocation would reduce both corporate profits and wages, and therefore, would affect both corporation and individual income tax revenues. The relocation analysis in Section I assumes that all relocating firms would move to a foreign jurisdiction. It is also possible for firms to relocate to the U.S. Firms may decide to expand existing capacity in the U.S. instead of investing in a foreign country. In this analysis we assume that 10 percent of the relocation in the 11 percent relocation scenario would relocate in the U.S. It is also assumed that 50 percent of the increase in relocation between the 11 percent and the 5 percent relocation scenarios would relocate in the U.S.

Table II-2 shows the effect of statehood on U.S. corporation income tax revenues at 1992 income levels when the full impact on the economy is included. Estimates are shown for each of the two relocation assumptions -- 5 and 11 percentage point reduction in the after-tax rate of return. The static revenue effect is, of course, the same under each of the three relocation assumptions. The effect of reduced economic activity is divided between the direct and indirect effect. The direct effect is the loss from 936 and foreign owned companies. The indirect effect is the reduction in profitability of supplier firms located on the island. Under the three assumptions, revenues to the U.S. Treasury would increase by $1.0 billion and $1.3 billion in 1992, respectively.

U.S. Individual Income Tax Revenues

This part presents estimates of the revenue the United States would derive from imposing the U.S. individual income tax on Puerto Rican residents following the adoption of statehood.

The adoption of statehood would make Puerto Rican residents subject to the U.S. individual income tax beginning January 1, 1994. The tax would be in addition to individual income taxes that Puerto Rico would continue to impose as a state. However, like other state income taxes, the Puerto Rican income tax paid would be allowed as an itemized deduction in computing U.S. taxable income. As a transitional statehood grant, there would be a cover-over under S. 712 that would refund to Puerto Rico the revenues derived from the U.S. individual income tax during 1994 and 1995.

Table II-1

Estimated Revenue Effect of Statehood on 1992 U.S. Corporate Tax Liability (Assuming No Change in Economic Activity)
(Millions of dollars)

Type of Corporation	Tax Liability
936 Corporations	1,734
Other Corporations	577
TOTAL, ALL FIRMS	2,311

rce: KPMG Peat Marwick estimate

TABLE II-2

Revenue Effect of Statehood on U.S. Corporation Income Tax Liability (Including the Effect of Reduced Economic Activity in Puerto Rico): Fully Phased-in at 1992 Levels
(Millions of dollars)

	Relocation Assumption: Reduction In After Tax Rate of Return of:	
	5 Percentage Points	11 Percentage Points
Revenue Effect		
Before Relocation	2,311	2,311
Effect of Relocation		
Direct Effect	-1,230	-923
Indirect Effect	-60	-40
Total	-1,290	-963
NET EFFECT ON REVENUE	1,021	1,348

Source: KPMG Peat Marwick estimate

Before estimating the impact on federal government revenues, a 1992 baseline was developed that fully incorporated the effects of Puerto Rico's 1987 tax reform program. The Puerto Rico Tax Reform Act of 1987 made several changes to the tax law. It expanded the tax base by limiting some adjustments to Adjusted Gross Income, most notably, the deduction for ordinary and necessary business expenses, and it limited the consumer interest deduction. On the other hand, it increased the personal exemption, and introduced a standard deduction. Marginal tax rates were lowered significantly, with the top rate being reduced from 50 percent to 33 percent, and a minimum tax was adopted. The net effect of these changes on Puerto Rican revenues was to decrease estimated 1992 tax liability from approximately $1.6 billion to $1.4 billion.

The computation of U.S. tax liability differs from the computation of Puerto Rican tax liability as a result both of a different definition of taxable income, and because of different marginal tax rates. The general reason for the difference in taxable income is that U.S. law allows fewer and different adjustments to income; however, those adjustments allowed are usually larger. While U.S. deductions for ordinary and necessary business expenses are more restrictive, federal law does allow a full deduction for Puerto Rican income taxes. In addition, U.S. standard deduction and personal exemption amounts are much higher. Finally, while both laws have a maximum tax rate of 33 percent, the top rate becomes effective at a much lower level of taxable income under Puerto Rican law. Table II-3 provides a summary of the major differences between U.S. and Puerto Rican tax laws.

The U.S. tax liability of Puerto Rican taxpayers under statehood is shown on Table II-4. Total Federal tax liability in 1992 for Puerto Rican taxpayers would be $843 million. This estimate does not incorporate any change in the level of economic activity in Puerto Rico.

Effects of Behavior on U.S. Individual Income Tax Revenues

Table II-5 shows the effect of statehood on U.S. individual income tax liability after incorporating the decline in the Puerto Rican economy. Separate estimates are shown in the table reflecting the two relocation assumptions described in Section I. Under the 5 and 11 percentage point relocation assumptions, the net increase in Federal individual income taxes in Puerto Rico would be $685 million and $731 million, respectively. Relocation would reduce federal individual income tax revenues in Puerto Rico by 18.7 percent and 13.3 percent, respectively.

Table II-3

Major Differences between the Puerto Rico and U.S. Individual Income Tax Systems

	Puerto Rico	U.S. Federal
Adjustments to AGI		
Deductibility of expense to earn wages	Allows a deduction of 3 percent of wages, with $1,500 limit.	No deduction for expenses to earn wages
Pension exclusion	Allows exclusion equal to $8,000 for government pensions.	No pension exclusion allowed.
IRAs	Up to $2,000 per taxpayer, without regard to income.	Up to $2,000 per taxpayer, but benefit phased-out based on income.
Personal Exemptions (at estimated 1992 level)		
Single	$1,300	$2,300
Married	$3,000	$4,600
Head of household	$3,000	$2,300
Aged and blind	$1,300	see increased standard deduction
University student	$1,600	not applicable
Other dependents	$1,300	$2,300
Indexation for inflation	not indexed	indexed
Deductions		
Itemized	Similar to U.S., plus 10 percent of rental payments with $500 limit, interest expense on car loans with $1,200 limit. No state income tax deduction, charitable contributions above 3 percent of AGI.	Home mortgage, property tax, state income tax, medical expense above 7.5 percent of AGI, miscellaneous deduction and employee business expenses above 2 percent of AGI, charitable contributions.

Table II-3 (Continued)

Major Differences between the Puerto Rico and U.S. Individual Income Tax Systems

Standard (at estimated 1992 level)				
Single	$2,000		$3,600	
Married	$3,000		$6,050	
Head of household	$2,600		$5,300	
Aged and blind	see exemption		additional $900	
Indexation for inflation	Not indexed		Indexed	
Marginal Rates				
	Bracket	Rate	Bracket	Rate
All taxpayers	$0-2,000	9%		
	2,001-17,000	15%		
	17,001-30,000	25%		
	30,001 or more	33%		
Single			$0-21,600	15%
			21,601 or more with 5% surtax at $52,300.	28%
Married			$0-36,050	15%
			36,051 or more with 5% surtax at $87,150.	28%
Head of household			$0-28,950	15%
			28,951 or more with 5% surtax at $74,750.	28%
Indexed for inflation	Brackets not indexed		Brackets indexed	

TABLE II-4

Federal Tax Liability for Puerto Rican Tax Payers
1992 Levels of Income and Population
By Federal Adjusted Gross Income Class
(Returns in thousands, Dollars in millions)

AGI Class	Number of returns	AGI	Tax[a]
Less than $5,000	49	92	0
5,000 to 8,000	45	305	2
8,000 to 12,500	116	1,235	22
12,500 to 17,000	114	1,702	54
17,000 to 25,000	126	2,633	125
25,000 to 35,000	82	2,465	164
35,000 to 50,000	52	2,153	173
50,000 to 100,000	30	1,986	193
More than 100,000	5	714	112
All Taxpayers	616	13,286	843

Source: KPMG Peat Marwick estimate

[a]The tax liability is reported without regard to the refundable portion of the Earned Income Tax Credit.

TABLE II-5

Revenue Effect of Statehood on U.S. Individual Income Tax Liability (Including the Effect of Reduced Economic Activity in Puerto Rico): Fully Phased-in at 1992 Levels
(Millions of dollars)

	Relocation Assumption: Reduction In After Tax Rate of Return of:	
	5 Percentage Points	11 Percentage Points
Revenue Effect		
Before Relocation	843	843
Effect of Relocation		
Direct Effect	-113	-80
Indirect Effect	-45	-32
Total	-158	-112
NET REVENUE EFFECT	685	731

Source: KPMG Peat Marwick estimate

Excise Taxes

Under current law, federal excise taxes do not apply to Puerto Rico, with one exception. Goods subject to excise tax manufactured in Puerto Rico and shipped for consumption in the United States are taxed as if they had been produced in the United States. Revenue collected from the tax is covered-over to the Puerto Rican Treasury. Under statehood, all federal excise taxes not currently applicable to Puerto Rico will take effect on the date of admission as the 51st state.

As a statehood grant, the bill provides that all revenues attributable to the extension of federal excise taxes to Puerto Rico will be covered-over to the Puerto Rican Treasury. The grant will remain in effect until at least fiscal year 1998, at which time Congress can determine whether to extend it for additional years.

Table II-6 presents federal excise tax collections in Puerto Rico by type of product. The three largest categories are gasoline, cigarettes, and distilled spirits. They account for 66 percent of all excise tax collections.

Estimate of the Effect of Statehood on U.S. Outlays

This part presents estimates of the impact of statehood on U.S. outlays. Separate estimates are shown for food stamps, medicaid, medicine, supplemental security income, AFDC, foster care and the outlay portion of the earned income tax credit.

Food Stamps. The U.S. Department of Agriculture's (USDA) estimate of Food Stamp participation under statehood is consistent with the Congressional Budget Office (CBO) estimate; however, the benefits are considerably lower. The USDA estimate assumes the new food stamp program would resemble the pre-block grant program, but Puerto Rico's Food Stamp benefits in 1982 were capped. Because Food Stamp benefits would no longer be capped under statehood, future benefits would be higher than those available in 1982. The CBO estimate is therefore used in this analysis.

The CBO estimate is adjusted in this analysis in two ways. First, as explained below, it is assumed in this analysis that the Puerto Rican Government would increase AFDC benefits. Cash benefits are included as income in the Food Stamp benefit calculation, so the increase in AFDC payments would reduce Food Stamp benefits. Since the CBO estimate assumes no change in AFDC payments, their Food Stamp estimates were adjusted to account for the increased AFDC payments. Second, the estimate incorporates an

Table II-6

The Effect of Statehood on U.S. Excise Tax Revenues: 1992 Levels
(Millions of dollars)

Tax Category	Amount
Distilled Spirits	36
Wines	1
Beer	5
Alcohol Occupational Taxes	7
Cigarettes	61
Tobacco Occupational Tax	*
Gasoline Tax	75
Diesel Tax	15
Trucks	5
Trailers	7
Air Passenger Ticket Tax	22
International Departure Tax	3
Crude Oil Tax	3
LUST Tax	2
Telephone Excise Tax	16
Harbor Maintenance Tax	*
Firearms Occupational Tax	*
Vaccine Injury Compensation Tax	2
Wagering Excise Tax	*
TOTAL	259

Source: Puerto Rico Treasury Department

* Less than $500,000

allowance for the cost of food equal to the allowance currently given to the U.S. Virgin Islands.[d]

Medicaid. Both CBO and the U.S. Department of Health and Human Services (HHS) use a similar methodology in their estimates of Medicaid benefits. Both assume the Puerto Rican government would not increase Aid for Families with Dependent Children payments, thus eligible participants would fall from the current level of 1.65 million persons.

This analysis assumes the Puerto Rican government would increase the maximum AFDC benefits (for a family of three) from the current $90 a month to $180 a month. Eligible Medicaid participants would decrease to about 1.5 million persons in 1992. An alternative methodology would assume the Government of Puerto Rico would maintain the pre-statehood level of Medicaid eligibility. In order to maintain eligibility constant, Puerto Rico would be required to increase the maximum AFDC payment (for a family of three) to $360 a month. Such fourfold increase would raise total monthly transfer payments for the average family above the Federal minimum wage. If the minimum wage represents the opportunity wage for the average unemployed worker in Puerto Rico, such a high level of transfer payments would provide a major disincentive to work. A household would receive more income from Food Stamps and AFDC than from a full-time job.

Nevertheless, it is very conceivable that the Puerto Rican government could increase the maximum AFDC benefits to $360 a month. Since the Federal government provides 83% of the AFDC funding, the Puerto Rican government may decide to increase benefits to maximize Federal outlays. Furthermore, it may be politically difficult to reduce Medicaid eligibility by 150,000 persons (if AFDC benefits are not increased to $360 a month). If benefits are increased fourfold, Federal Medicaid outlays under Statehood would increase by $2,737 million in 2000, an increase of $165 million over the estimate in Table III-9.

Program costs per participant would increase under statehood because services would be extended and participants would be able to use the more expensive private health care facilities. Under the current system, Medicaid participants may only receive services in public facilities. It is assumed the cost per participant would increase to the level of the lowest cost state; however, an

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[d]Jurisdictions outside the continental U.S. (Alaska, Hawaii, and the U.S. Virgin Islands) receive cost-of-food allowances in their Thrifty Food Plans. The Virgin Islands (a jurisdiction similar to Puerto Rico) receives a 28.3 percent cost-of-food increment in benefits. Since under statehood Puerto Rico is likely to receive a similar adjustment, the CBO estimates were increased by 28.3 percent.

adjustment of 25 percent has been made to account for lower health care costs in Puerto Rico. Federal government payments to the 1.5 million Medicaid participants in 1992 would increase by $1,375 million.

AFDC. Both the CBO and HHS estimates assume benefits would remain constant under statehood, increasing federal outlays in fiscal year 1995 by only $6 million. As explained above, it was assumed the Puerto Rican government would double AFDC payments. If the maximum AFDC benefit is doubled, total AFDC payments in Puerto Rico would be $162 million in 1992. The Federal share would be $134 million, an increase of $73 million.[8]

Medicare. CBO and HHS Medicare estimates are very similar because they were calculated using the same methodology. The CBO estimate of $80 million for fiscal year 1995 has been adopted in this report.

Supplemental Security Income. The SSI estimates from both sources are also very similar. CBO's estimate of $600 million for fiscal year 1994 and $900 million for 1995 was also accepted as reasonable.

Earned Income Tax Credit (EITC). The EITC was estimated by modeling the effect of the U.S. individual income tax system on Puerto Rican taxpayers. According to the model, there would be 137,500 families claiming $79 million in EITC refunds in 1992. This estimate only reflects the refunds to individuals filing Puerto Rico tax returns. There are many low income families with no Puerto Rico tax liability that are not required to file a tax return. Some of these non-filers would be able to claim the U.S. earned income credit under U.S. tax law should they have dependent children and some earned income. Therefore, the value of the model simulation was adjusted upwards to 344,000 families claiming $220 million in EITC refunds. The adjustment was based on the Congressional Budget Office estimate of EITC recipients and assumes the nonfiling recipients would receive the average EITC for Puerto Rico filers.

Transitional Grants. The transitional grants proposed by S. 712 would represent increases in U.S. Treasury outlays to Puerto Rico. The transitional grants are the cover over of excise taxes from 1992 until at least 1998 and the cover over of income taxes in 1994 and 1995. Estimates of the excise tax cover-over are

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[8]If AFDC benefits are increased fourfold as explain in the previous footnote, the increase in Federal AFDC payments in 2000 would be $650 million, or $370 million more than the estimate in Table III-9.

presented in Table II-8.[a] The cover over of income taxes would amount to $1,009 million in 1994, $1,552 million in 1995, and $533 million in 1996. The income tax cover-over extends to the 1996 fiscal year because the fiscal year begins on October 1, 1995, during tax year 1995.

Outlay Estimates

Table II-7 presents a summary of the effect of statehood on federal outlays in fiscal year 1995. The 1992 outlay estimates were projected to 1995 at 5 percent per year, except for Medicaid and Medicare outlays which were increased by 8 percent per year. Total outlays for 1995, including the cover over of tax revenues, would be $5,703 million.

Estimate of the Effect of Statehood on U.S. Treasury Outlays, Including Impact to the Economic Activity in Puerto Rico

The reduction in economic activity analyzed in the previous sections would not only affect Puerto Rican and U.S. Treasury revenues, but it would also affect U.S. Treasury outlays to Puerto Rico. Many of the outlay programs discussed in Sections I and III are means-tested programs. A reduction in individual incomes as a result of relocation would increase eligibility and benefits in these programs.

Food Stamps. The reduction in direct and indirect employment caused by relocation of 936 corporations would increase participation in the food stamp program by 261,000 persons under the 5 percentage point relocation scenario and 148,500 persons under the 11 percentage point scenario. The estimate is derived by assuming that 50 percent of the unemployed would participate in the program and each unemployed represents one household. There are 3.6 persons per food stamp household so after adjusting for increased AFDC payments, food stamp outlays would increase by in 2000 by $396 million and $274 million for the 5 percentage point and 11 percentage point relocation scenarios, respectively.

While program participation in Puerto Rico is higher than 50 percent, not all the recently unemployed workers would be eligible for food stamps. They may be ineligible because of high non-labor income or because total household income does not fall below the eligibility threshold. The latter case is more likely in two-wage earning households where only one worker becomes unemployed.

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[a]The cover-over of excise taxes is assumed to continue after 1998 since, as provided in S.712, the cover-over can only be changed by an act of Congress.

Table II-7

Estimated Federal Outlays in Fiscal Year 1995 Under Statehood Excluding the Effect on the Puerto Rican Economy
(Millions of dollars)

Item	Amount
Food Stamps	706
Medicaid	1,703
Medicare	82
SSI	900
AFDC	219
Foster Care	3
Cover Over of Tax Revenues	1,847
EITC	243
TOTAL SPENDING	5,703

Source: KPMG Peat Marwick estimate

AFDC. The increase in unemployment would increase AFDC eligibility. CBO estimates that a one percentage point increase in the U.S. unemployment rate increases AFDC payments in the U.S. by 2.5 percent after one year and by 3 percent thereafter. While this relationship may not be the same in Puerto Rico, (because of cultural differences and higher structural unemployment), it provides an indication of the possible effects on U.S. outlays due to changes in the economic activity in Puerto Rico.[a] U.S. AFDC outlays in Puerto Rico would increase by 35.0 percent under the 5 percentage point scenario and by 21.9 percent under the 11 percentage point scenario. The increase would amount to $104 million and $72 million, respectively, in 2000.

Medicaid. Increased unemployment would also affect Medicaid payments. A one percentage point increase is the U.S. unemployment is estimated by CBO to increase Medicaid outlays in the U.S., with a one year lag, by 1.6 percent. Using this relationship as an indication of the possible effect on Puerto Rico, Medicaid payments would increase by $404 million and $279 million in 2000 for the 5 percentage point and 11 percentage point scenarios, respectively.

Supplemental Security Income. Supplemental Security Income benefits in the United States are not very sensitive to changes in economic activity. SSI recipients (the aged and the disabled) are generally not in the labor force so they are not directly affected by unemployment. They may be indirectly affected if their household income falls as a result of the unemployment of another member. While outlays to Puerto Rico may increase because of the lower standard of living, no change in outlays was assumed.

Revenue and Outlay Effect through 2000

The revenue and outlay estimates presented in the first three parts of this section reflect the fiscal effect of statehood at 1992 levels as if all programs were fully phased-in. In this part, estimates of the actual effect on revenues and outlays are forecast through the year 2000.

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[a]The U.S. estimates are likely to underestimate the effect of changes in unemployment and entitlement outlays in Puerto Rico. Because of lower earnings in Puerto Rico, the average Puerto Rican worker is closer to qualifying for program benefits than the average worker in the U.S. Therefore, it would take a lower reduction in employment for the average Puerto Rican worker to qualify for benefits than it would the average U.S. worker. In other words, a given reduction in unemployment would cause a larger proportion of Puerto Ricans to be eligible for benefits. Unfortunately, the data necessary to estimate the relationship between unemployment and program outlays in Puerto Rico is not available.

Forecasting the fiscal impact of statehood requires a number of adjustments to the fully phased-in estimates. First, the bill provides for a transition period. The imposition of the U.S. tax and outlay structure is not even started until 1994 and the tax structure is not fully effective until 1998. Under the transition rules, Section 936 benefits are phased-out rateably at 20 percent per year starting in 1994. In addition, certain tax revenues are covered-over (i.e. paid back to Puerto Rico) in the first few years. All individual and corporation income tax liability (excluding 936 companies) for 1994 and 1995 is covered over to Puerto Rico. New excise taxes are covered over through 1998. These transition rules affect both the static revenue effect as well as the timing of the impact on the Puerto Rican economy.

Second, the estimates should reflect the growth in the economy through the forecast period. Consistent with the economic forecast supplied by the Puerto Rico Planning Board, it is assumed that without statehood, the economy would grow at about 8 percent per year. It was assumed 936 corporations would grow at 10 percent per year, one half of one percent higher growth than the Planning Board's forecast for the manufacturing sector to be consistent with the U.S. Treasury who assumes a 10 percent growth rate for 936 corporations in its forecast. However, actual growth in 1989 was only 5 percent and the Planning Board is currently revising downward its economic forecasts.

The forecast of revenues and outlays under the 5 percentage point scenario for the period 1992 to 2000 is shown on Table II-8 and Table II-9, respectively. Table II-10 summarizes the net effect of statehood on the U.S. Treasury. While net federal outlays decrease substantially as the cover-over of taxes expires, the net cost of statehood to the Federal Government is significant. Total net outlays between 1992 and 1996 would be $14.0 billion. By 2000, statehood would cost the Federal Government in excess of $3.0 billion a year. Tables II-11, II-12, and Table II-13 present similar forecasts under the 11 percentage point scenario. Total net outlays between 1992 and 1996 would be $13.5 billion and, by 2000, statehood would represent an increase in net outlays in excess of $2.0 billion a year.

Over the full forecast period 1992-2000, the net cumulative cost to the U.S. Government would be between $22.3 billion and $25.9 billion depending on the assumed relocation threshold.

Table II-8

The Effect of Statehood on U.S. Government Revenues:
5 Percentage Point Relocation Scenario
(Millions of dollars)

Source	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Corporation Income Tax									
Excluding Economic Effects	-	-	634	1377	1971	2672	3495	4053	4418
Economic Effects	-	-	-187	-536	-951	-1445	-2026	-2410	-2649
Net	-	-	447	841	1020	1227	1469	1643	1769
Individual Income Tax									
Excluding Economic Effects	-	-	651	962	1010	1061	1114	1169	1228
Economic Effects	-	-	-24	-62	-102	-147	-197	-219	-231
Net	-	-	627	900	908	914	917	950	997
Excise Taxes									
Excluding Economic Effects	174	268	281	295	310	325	342	359	377
Economic Effects	-	-	-	-	-	-	-	-	-
Net	174	268	281	295	310	325	342	359	377
Grand Total									
Excluding Economic Effects	174	268	1566	2634	3291	4058	4951	5581	6023
Economic Effects	-	-	-211	-598	-1053	-1592	-2223	-2629	-2880
Net	174	268	1355	2036	2238	2466	2728	2952	3143

Table II-9

The Effect of Statehood on U.S. Government Outlays
5 Percentage Point Relocation Scenario
(Millions of dollars)

Item	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Extension of Outlay Programs to Puerto Rico Residents:									
Food Stamps	615	858	729	706	741	779	817	858	901
Medicaid	946	1460	1577	1703	1839	1987	2145	2317	2502
Medicare	46	70	76	82	88	96	103	111	120
Supplemental Security Income (SSI)	0	0	600	900	944	992	1041	1093	1148
Aid to Families with Dependent Children (AFDC)	51	141	208	219	230	241	253	266	279
Foster Care	2	3	3	3	4	4	4	4	4
Earned Income Credit	0	0	12	243	255	268	281	295	310
Total, Excluding Economic Effects	1660	2532	3205	3856	4101	4367	4644	4944	5264
Economic Effects:									
Food Stamps	0	0	0	45	113	181	267	355	396
Medicaid	0	0	0	37	98	171	252	347	402
AFDC	0	0	0	10	28	46	68	91	104
Net	1660	2532	3205	3948	4340	4765	5231	5737	6166
Cover-Over of Tax Revenues in Transition Years	174	268	1268	1794	823	325	342	359	377
Total Outlays	1834	2800	4473	5742	5163	5090	5573	6096	6543

Table II-10
Summary of the Effect of Statehood on U.S. Tax Revenues and Outlays:
5 Percentage Point Relocation Scenario
(Millions of dollars)

	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	TOTAL
Revenues	174	268	1355	2036	2238	2466	2728	2952	3143	17360
Outlays	1834	2800	4473	5742	5163	5090	5573	6096	6543	43314
Increase in Surplus (+) or Deficit (-)	-1660	-2532	-3118	-3706	-2925	-2624	-2845	-3144	-3400	-25954

Table II-11

The Effect of Statehood on U.S. Government Revenues:
11 Percentage Point Relocation Scenario
(Millions of dollars)

Source	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Corporation Income Tax									
Excluding Economic Effects	-	-	634	1377	1971	2672	3495	4053	4418
Economic Effects	-	-	-140	-400	-711	-1080	-1515	-1801	-1981
Net	-	-	494	977	1260	1592	1980	2252	2437
Individual Income Tax									
Excluding Economic Effects	-	-	651	962	1010	1061	1114	1169	1228
Economic Effects	-	-	-17	-43	-73	-105	-140	-155	-164
Net	-	-	634	919	937	956	974	1014	1064
Excise Taxes									
Excluding Economic Effects	174	268	281	295	310	325	342	359	377
Economic Effects	-	-	-	-	-	-	-	-	-
Net	174	268	281	295	310	325	342	359	377
Grand Total									
Excluding Economic Effects	174	268	1566	2634	3291	4058	4951	5581	6023
Economic Effects	-	-	-157	-443	-784	-1185	-1655	-1956	-2145
Net	174	268	1409	2191	2507	2873	3296	3625	3878

Table II-12

The Effect of Statehood on U.S. Government Outlays
11 Percentage Point Relocation Scenario
(Millions of dollars)

Item	Fiscal Year 1992	1993	1994	1995	1996	1997	1998	1999	2000
Extension of Outlay Programs to Puerto Rico Residents:									
Food Stamps	615	858	729	706	741	779	817	858	901
Medicaid	946	1460	1577	1703	1839	1987	2145	2317	2502
Medicare	46	70	76	82	88	96	103	111	120
Supplemental Security Income (SSI)	0	0	600	900	944	992	1041	1093	1148
Aid to Families with Dependent Children (AFDC)	51	141	208	219	230	241	253	266	279
Foster Care	2	3	3	3	4	4	4	4	4
Earned Income Credit	0	0	12	243	255	268	281	295	310
Total, Excluding Economic Effects	1660	2532	3205	3856	4101	4367	4644	4944	5264
Economic Effects:									
Food Stamps	0	0	0	31	78	128	185	246	274
Medicaid	0	0	0	25	68	118	175	241	279
AFDC	0	0	0	7	19	32	47	63	72
Net	1660	2532	3205	3919	4266	4645	5051	5494	5889
Cover-Over of Tax Revenues in Transition Years	174	268	1290	1847	843	325	342	359	377
Total Outlays	1834	2800	4495	5766	5109	4970	5393	5853	6266

Table II-13
Summary of the Effect of Statehood on U.S. Tax Revenues and Outlays
11 Percentage Point Relocation Scenario
(Millions of dollars)

	Fiscal Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	TOTAL
Revenues	174	268	1409	2191	2507	2873	3296	3625	3878	20221
Outlays	1834	2800	4495	5766	5109	4970	5393	5853	6266	42486
Increase in Surplus (+) or Deficit (-)	-1660	-2532	-3086	-3575	-2602	-2097	-2097	-2228	-2388	-22265

SECTION III

THE EFFECT OF STATEHOOD ON THE PUERTO RICAN BUDGET

There is little doubt the Puerto Rican budget would be very different under statehood than under its current commonwealth status with the U.S. The budget would be significantly affected by changes in the economy - the loss in economic activity from the relocation of 936 companies and the redistribution of income resulting from Puerto Rico residents being subject to U.S. taxes and being eligible for U.S. entitlement programs. In addition, the current Puerto Rican tax structure and expenditure policies reflect the opportunities and constraints imposed under commonwealth status - most of which change under statehood.

The first part of this section describes the effect of statehood on Puerto Rico tax revenues. The most significant effect is from the relocation of 936 companies. As shown in Section I, the relocation of these corporation would result in a decline in profits and employment that in turn reduces tax revenues.

The second part discusses the potential for reductions in Puerto Rican expenditure programs as residents become eligible for Federal government programs. The third section discusses the budget implications of Puerto Rico changing its tax structure to better align itself with the other states. Without the 936 tax incentive, alternative policies must be designed to allow Puerto Rico to successfully compete against the states and Caribbean nations for economic activity.

Puerto Rican Tax Revenues

Statehood would affect tax revenues in Puerto Rico in four ways. First, the tollgate tax that currently applies to repatriations to the U.S. from 936 companies would be repealed. Second, as corporations relocate, the income and therefore tax revenue paid under the current Puerto Rican income tax would be reduced. Third, as corporations relocate and unemployment increases and wages and personal income decline, Puerto Rico would experience a reduction in tax revenues from the individual income tax. Finally, financial institutions which currently enjoy the benefits from 936 funds that are not repatriated to the United States would necessarily be forced to downsize, further increasing unemployment and lowering tax revenues from both the individual and corporation income tax.

Tollgate Tax

Under current law, Puerto Rico imposes a tax on repatriations of income of 936 companies. The tax rate varies significantly from

company to company, but generally varies between 4 and 10 percent. In addition the tax is, to a certain extent, a voluntary tax. That is, companies only pay the tax when income is repatriated to the parent company in the United States. Taxpayers, therefore, can defer or accelerate repatriation to manage the amount of tax liability due under the tollgate tax. This fact makes it extremely difficult to forecast revenues from the tollgate tax. Under statehood, the tollgate tax would necessarily be repealed. States are not allowed to impose taxes on interstate commerce.

Corporation Income Tax

Table III-1 shows the loss of income and tax revenue from the firms relocating outside of Puerto Rico for the two relocation scenarios. There are two interesting points shown in the table. First, while the number of firms relocating is the same as that shown in Section I, the loss in income resulting from relocation is somewhat higher. The reason for this is that the loss of income shown in Section I incorporates an offset for the additional super royalty paid to the Unites States. Puerto Rico, however, would experience the full loss in income without any offset from the super royalty. The second fact is that the reduction in tax revenues is very small relative to the loss in income. Relocating firms generally enjoy tax exemptions in Puerto Rico under current law. While the top statutory tax rate in Puerto Rico is 38 percent, the average tax paid by 936 companies is only about 4 percent of income.

The second part of the table shows the impact on Puerto Rican revenues of the loss of income of firms that previously supplied the relocating firms. The supplier companies' change in tax revenue is a much higher percent of the change in income. This is because supplier firms are not generally given tax exemption in Puerto Rico. The average tax rate of these companies is about 18 percent. The final two columns of the table show the total change in income and total change in tax revenues.

Individual Income Tax

The relocation of 936 companies induces a reduction in employment, and therefore wages, in the Puerto Rican economy. Tables III-2 and III-3 show the fully phased-in estimates (in 1992 levels) of the reduction in income and tax revenues by income class for the two relocation scenarios. In total, the income reported on Puerto Rican individual income tax returns would decline by $1,723 million or about 14 percent in the 5 percentage point relocation scenario and by $952 million or about 8 percent in the 11 percentage point relocation scenario. This reduction in income would lower tax revenues by $350 million (about 26 percent of total individual income tax revenues) and $199 million (15 percent) for the 5 and 11 percentage point scenarios, respectively.

Table III-1

The Effect of Statehood on Puerto Rican Tax Revenues from the Corporation Income Tax (Excluding Financial Institutions)
(Millions of dollars)

Industry	Relocation of Section 936 and Foreign-Owned Companies			Supplier Companies		Total	
	Firms	Income	Revenues	Income	Revenues	Income	Revenues
5 Percentage Point Scenario							
Manufacturing	333	-7,997	-296	-134	-21	-8,131	-317
Non-Manufacturing	19	-31	- 3	-360	-65	-391	-68
Total	352	-8,028	-299	-494	-86	-8,522	-385
11 Percentage Point Scenario							
Manufacturing	153	-5,355	-228	-72	-12	-5,427	-240
Non-Manufacturing	4	-12	- 2	-194	-35	-206	-37
Total	157	-5,367	-230	-266	-47	-5,633	-277

Table III-2

The Effect of Statehood on Puerto Rican Tax Revenues From the Individual Income Tax Under the 5 Percentage Point Relocation Scenario
(Millions of dollars)

Income Class	Change in Income		Change in Tax Revenues	
	Amount	Percent	Amount	Percent
Less than 5,000	-14	-9	-0	-44
5,000 to 8,000	-72	-12	-6	-42
8,000 to 12,500	-263	-13	-35	-38
12,500 to 17,000	-276	-15	-41	-31
17,000 to 25,000	-367	-15	-62	-28
25,000 to 35,000	-309	-15	-73	-30
35,000 to 50,000	-205	-13	-62	-26
50,000 to 100,000	-162	-11	-53	-19
100,000 and over	-56	-9	-19	-13
TOTAL	-1,723	-14	-350	-26

Source: KPMG Peat Marwick estimate

Table III-3

The Effect of Statehood on Puerto Rican Tax Revenues From the Individual Income Tax Under the 11 Percentage Point Relocation Scenario
(Millions of dollars)

Income Class	Change in Income		Change in Tax Revenues	
	Amount	Percent	Amount	Percent
Less than 5,000	-6	-4	-0	-17
5,000 to 8,000	-26	-6	-2	-23
8,000 to 12,500	-119	-8	-15	-22
12,500 to 17,000	-153	-8	-23	-18
17,000 to 25,000	-197	-8	-32	-16
25,000 to 35,000	-179	-8	-41	-17
35,000 to 50,000	-130	-8	-39	-15
50,000 to 100,000	-107	-7	-35	-11
100,000 and over	-34	-5	-12	-7
TOTAL	-952	-8	-199	-15

Source: KPMG Peat Marwick estimate

Financial Institutions

As a direct result of the tollgate tax, 936 companies have historically maintained a high level of financial assets in Puerto Rico. The result is that Puerto Rico has a very large well established financial institution sector to administer 936 funds. Following the repeal of the tollgate tax, these funds would leave Puerto Rico and return to the mainland. The shifting of funds from Puerto Rico institutions to U.S. institutions would not have an impact on the revenues of the Treasury Department since the Treasury Department would tax the income on these funds whether located in Puerto Rico or on the mainland. However, Puerto Rican tax revenues would be significantly impacted. While Puerto Rico does not currently tax the income from these funds, there are two ways that Puerto Rican revenues are affected by the loss of the funds. The first is that profits of financial institutions are reduced. This has a direct impact on corporate tax revenues from financial institutions. The second is that financial institutions losing these funds would be forced to downsize, and therefore reduce employment.

As employment is reduced, individual income tax revenues of Puerto Rico would be reduced. This impact is identical to the indirect effect on the individual income tax of the relocation of 936 companies. Table III-3 shows the revenue impact of these effects on financial institutions. As shown in the table, the revenue loss from the reduced profitability of financial institutions is $45 million in fiscal year 2000.

Summary of the Impact on Puerto Rican Revenues

Tables III-4 and III-5 present a summary of the revenue impact of statehood on Puerto Rican tax revenues for each of the two relocation scenarios. These estimates are divided into each of the four categories discussed above in this section. Estimates are presented for each year from 1992 through 2000. These revenue effects are adjusted for assumptions concerning the phase-in of the repeal of 936, and therefore assumptions considering the timing of relocation.

While the reduction in corporate and income tax revenues would take effect over five years as corporations relocate, the repeal of the tollgate tax and the impact on financial institutions would take immediate effect on the adoption of statehood in 1992. As explained above, the repeal of the tollgate tax would be commensurate with statehood. Because the tollgate tax would be repealed immediately in 1992 it is assumed that 936 funds would be repatriated in 1992. Thus, for these two sources of effect on Puerto Rican tax revenues we have assumed a full effect beginning in 1992.

Table III-4

Summary of the Impact of Statehood on Puerto Rican Tax Revenues: 5 Percentage Point Relocation
(Million of dollars)

	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Corporation Income Tax (Excluding Financial Institutions	-	-	-42	-142	-216	-402	-567	-695	-762
Individual Income Tax	-	-	-39	-120	-209	-306	-413	-481	-505
Tollgate Tax	-81	-164	-167	-174	-174	-177	-181	-184	-188
Financial Institutions	-13	-26	-29	-31	-33	-36	-39	-41	-45
TOTAL (excluding cover-over of taxes)	-94	-190	-277	-467	-632	-921	-1200	-1401	-1500
Cover-over of Federal Tax Revenues	117	265	996	1791	1089	322	338	355	373
Total (including cover-over of taxes)	23	75	719	1324	457	-599	-862	-1046	-1127

Table III-5

Summary of the Impact of Statehood on Puerto Rican Tax Revenues: 11 Percentage Point Relocation
(Million of dollars)

	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Corporation Income Tax (Excluding Financial Institutions)	-	-	-30	-103	-188	-290	-410	-503	-551
Individual Income Tax	-	-	-22	-68	-119	-174	-235	-273	-287
Tollgate Tax	-81	-164	-167	-174	-174	-177	-181	-184	-188
Financial Institutions	-13	-26	-29	-31	-33	-36	-39	-41	-45
TOTAL (excluding cover-over of taxes)	-94	-190	-248	-376	-514	-677	-865	-1001	-1071
Cover-over of Federal Tax Revenues	117	265	1011	1836	1117	322	338	355	373
Total (including cover-over of taxes)	23	75	763	1460	603	-355	-527	-646	-694

The combined effect of these four impacts on Puerto Rican revenues would be a decline in revenues, under both scenarios, of $94 million in 1992 which is about 2 percent of Puerto Rican revenues. The reduction would increase to $1,500 million (about 18 percent of Puerto Rican revenues) and $1,071 (about 13 percent) by the year 2000 for the 5 percentage point and 11 percentage point scenario, respectively. However, the cover over of federal income and excise taxes partially compensates the Puerto Rico Treasury for these reductions in revenues.[1] The net effect after accounting for the federal cover-over would be an increase in revenues of $23 million in 1992, under both scenarios, increasing to $1,460 million and $1,324 million in 1995 under the 5 and 11 percentage point scenario, respectively. The net effect would be negative after 1997.

Puerto Rico Outlays

The extension of all entitlement programs to Puerto Rico would have two main effects on Puerto Rico government outlays. To the extent the increases in Federal outlays overlap with the current Puerto Rico programs, it would be possible for the Puerto Rican Government to reduce its own expenditures while still maintaining (or even increasing) services. On the other hand, increases in federal outlays in matching rate programs (such as AFDC) entail increases in Puerto Rican outlays for the programs. The net effect of Federal outlays on Puerto Rican outlays is presented in Tables III-6 and III-7 for the two relocation scenarios.[2]

The most significant overlap of federal outlays would be in the area of Medicaid. Because of the current low spending cap, Puerto Rico has had to provide most of the health care services to the Medicaid population. Under statehood, federal Medicaid payments would substitute for most of the services currently provided by the Puerto Rican government. The full elimination of

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[1] The cover-over of taxes in Table III-3 differs from the cover-over in Table II-9 because of differences in the fiscal years between the U.S. and Puerto Rico. The Federal government follows a october-september fiscal year while Puerto Rico follows a july-june fiscal year.

[2] The increase in entitlement benefits under statehood would also provide an incentive for Puerto Ricans residing in the U.S. (and participating in these programs) to return to Puerto Rico. Return migration would cause an increase in Puerto Rican government outlays. Federal outlays would not be significantly affected since it would just be a transfer between states. The estimates of the effects of return migration are not included in this report.

health services to the medicaid population would reduce Puerto Rican expenditures by $296 million in fiscal year 2000.

The replacement of the Aid to the Aged, Blind and Disabled Program (AABD) with SSI would also lower Puerto Rico outlays, albeit by a very small amount. Since SSI is fully funded by the Federal Government, Puerto Rico would save its share of the AABD program matching rate. Puerto Rico AABD outlays for 1995 would amount to only $7 million.

Food stamps outlays are also fully funded by the federal government, except for administrative costs which are shared equally with the Puerto Rican Government. With the return to the Food Stamp program, Puerto Rico would be subject to additional federal rules which would increase administrative cost. Puerto Rico outlays for Food Stamp administration could increase by $1 million in 1992.

The effects of Medicare outlays are more difficult to estimate. The Puerto Rico Government receives Medicare payments through its public hospitals. While the Medicare reimbursement rate would increase under statehood, the government provision of health care services is likely to decrease substantially because of the changes in the Medicaid program. The net effect depends on how much health care services is provided by the government after statehood.

Finally, the increase in AFDC benefits by the Puerto Rican Government would increase Puerto Rico AFDC outlays significantly. In 1992, AFDC outlays would increase by $4 million. Outlays would increase even further in 1993 and 1994 with the implementation of the AFDC-Unemployed Parent program. Total AFDC outlays for the Puerto Rican government would increase by $28 million in 1994.

Possible Changes in the Puerto Rico Tax Structure

Under statehood, Puerto Rico would have the highest tax rates of any state of the Union. Table IV-8 shows the combined effective average and marginal individual income tax rates for Puerto Rico residents under different U.S. state income tax laws. For example, taxpayers with adjusted gross income between $17,000 and $25,000 would face an average tax rate of 11.4 percent under Puerto Rico law, but only 6.1 percent under New York law. The average tax rate for all taxpayers under Puerto Rico law would be 16.1 percent, almost 7 percentage points higher than the highest state.

Table III-6

The Effect of Statehood on Puerto Rico Government Outlays:
5 Percentage Point Relocation Scenario
(Millions of dollars)

Item	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Extension of Outlay Programs to Puerto Rico Residents:									
Food Stamps	1	2	2	2	2	3	3	3	3
Medicaid	-83	-173	-186	-201	-217	-235	-254	-274	-296
Medicare	-4	-5	-6	-6	-7	-7	-8	-8	-9
Supplemental Security Income (SSI)	0	0	-5	-7	-7	-8	-8	-8	-9
Aid to Families with Dependent Children (AFDC)	4	15	28	36	38	40	42	44	46
Foster Care	1	1	1	1	1	1	1	1	1
Total, Excluding Economic Effects	-81	-160	-166	-175	-190	-206	-224	-242	-264
Economic Effects:									
Food Stamps	0	0	0	0	0	0	0	0	0
Medicaid	0	0	0	7	24	44	67	93	112
AFDC	0	0	0	2	6	12	18	24	28
Change in Outlays	-81	-160	-166	-166	-160	-150	-139	-125	-124

Table III-7

The Effect of Statehood on Puerto Rico Government Outlays:
11 Percentage Point Relocation Scenario
(Millions of dollars)

Item	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Extension of Outlay Programs to Puerto Rico Residents:									
Food Stamps	1	2	2	2	2	3	3	3	3
Medicaid	-83	-173	-186	-201	-217	-235	-254	-274	-296
Medicare	-4	-5	-6	-6	-7	-7	-8	-8	-9
Supplemental Security Income (SSI)	0	0	-5	-7	-7	-8	-8	-8	-9
Aid to Families with Dependent Children (AFDC)	4	15	28	36	38	40	42	44	46
Foster Care	1	1	1	1	1	1	1	1	1
Total, Excluding Economic Effects	-81	-160	-166	-175	-190	-206	-224	-242	-264
Economic Effects:									
Food Stamps	0	0	0	0	0	0	0	0	0
Medicaid	0	0	0	4	13	24	37	52	62
AFDC	0	0	0	1	4	7	10	14	16
Change in Outlays	-81	-160	-166	-170	-173	-175	-177	-176	-186

TABLE III-8

Combined Federal and Puerto Rican Tax Rate Experienced by Puerto Rican Residents if Tax Systems Used in Selected Other States were to be Substituted for the Current Puerto Rican System in 1992

Marginal Tax Rate

Federal AGI Class	California	New York	Virginia	Rhode Island	Puerto Rico
Less than $5,000	-4.0	-4.0	-4.0	-4.0	-4.0
5,000 to 8,000	2.3	2.3	3.5	2.3	9.3
8,000 to 12,500	9.8	10.4	11.6	10.4	12.8
12,500 to 17,000	17.0	19.4	19.3	18.6	28.0
17,000 to 25,000	20.1	22.6	22.0	21.0	31.2
25,000 to 35,000	19.5	20.9	20.8	19.1	34.3
35,000 to 50,000	22.3	22.4	22.1	21.6	39.5
50,000 to 100,000	33.2	31.7	30.6	33.9	48.3
More than 100,000	37.2	35.6	34.9	38.3	53.4
All Taxpayers	21.4	22.2	22.0	21.8	40.4

Average Tax Rate

Federal AGI Class	California	New York	Virginia	Rhode Island	Puerto Rico
Less than $5,000	-1.5	-1.5	-1.4	-1.9	-1.0
5,000 to 8,000	-2.0	-2.0	-1.6	-2.4	-0.6
8,000 to 12,500	-1.0	-1.0	-0.4	-1.6	2.0
12,500 to 17,000	2.0	2.4	3.1	1.9	6.9
17,000 to 25,000	5.3	6.1	6.5	5.4	11.4
25,000 to 35,000	8.4	9.4	9.5	8.3	15.8
35,000 to 50,000	11.2	12.1	12.1	11.0	20.6
50,000 to 100,000	16.5	17.0	16.6	16.5	27.5
More than 100,000	26.0	25.5	24.8	26.4	38.7
All Taxpayers	8.6	9.2	9.3	8.5	16.1

Source: KPMG Peat Marwick estimate

The relatively higher average tax rates that individuals would pay in Puerto Rico would likely influence migration patterns between Puerto Rico and the Mainland. Further, the high marginal tax rates would hinder work incentives and distort the allocation of resources to the detriment of the overall economic activity in Puerto Rico. High tax rates would also erode Puerto Rico's tax base by providing incentives for under-reporting of income and tax evasion.

Corporations operating in Puerto Rico would also face tax rates higher than in any state. The current top rate in Puerto Rico is 36 percent. With the federal rate of 34 percent, even after allowing for the deduction of Puerto Rican taxes, the combined rate would be nearly 58 percent. By comparison, the combined rate in the highest taxed state is only 42 percent.

The Puerto Rican government could choose among several tax policy options. Their decision would most certainly depend on the local political, social and economic conditions. It nevertheless seems likely they would have to reduce, on net, tax revenues. Puerto Rican tax revenues are out of line compared to the other states. As a share of GDP, Puerto Rican tax revenues in 1987 were 15 percent, 4 percentage points higher than the state average and slightly higher than the highest state (New York). One strategy would be to reduce the tax revenue share to the average level of the states. Under this scenario, the reduction of 4 percentage points in the share of total tax revenues to GDP would represent a net reduction in tax revenues in 1992 of about $1.0 billion.

Again, the government could achieve the revenue reduction in several ways. The government could, for example, reduce the individual income tax to avoid the negative effects of high marginal rates. The reduction of individual income tax rates to rates similar to other states would have a significant effect on revenue collections. Table III-9 shows, for the two relocation scenarios, fully phased-in 1992 Puerto Rico individual income tax liability for Puerto Rico residents (net of the individual income tax reductions due to relocation of 936 companies) under its own current law and four other states' laws. The second column of each table shows revenue collections if Puerto Rico adopted the tax laws of that state and the third column shows the difference between collections under Puerto Rican tax laws and the laws of each state. In every case the reduction in revenues would be greater than $750 million dollars.

Tables III-10 and III-11 present the net effect of statehood on the Puerto Rican budget for the two relocation scenarios. The net effect of statehood on the Puerto Rican budget after accounting

Table III-9

Estimated Puerto Rican Individual Income Tax Collections if Tax Systems Used in Selected Other States were to be Substituted for the Current Puerto Rican System in 1992
5 Percentage Point Scenario
(Millions of dollars)

State Tax Law Adopted	Individual Collections	Change in Revenue from Current Law	Top Marginal Tax Rate
California	190	-830	9.00
New York	255	-765	7.00
Rhode Island	171	-849	7.60
Virginia	269	-751	5.75
Puerto Rico	1,020	-	33.00

11 Percentage Point Scenario
(Millions of dollars)

State Tax Law Adopted	Individual Collections	Change in Revenue from Current Law	Top Marginal Tax Rate
California	218	-945	9.00
New York	291	-872	7.00
Rhode Island	202	-961	7.60
Virginia	305	-858	5.75
Puerto Rico	1,163	-	33.00

Source: KPMG Peat Marwick estimate

for the cover-over of Federal taxes is positive until 1996 and negative thereafter. The tables also incorporate the effect on the Puerto Rican budget of reducing individual income taxes to the rates of New York state (shown in Table III-9).

These results should be considered only as an illustration of one of the many policies the government could adopt to reduce the high tax burden imposed on its residents by the combination of Federal and current local income taxes. The reduction in individual income taxes would eliminate the negative effects of high marginal rate, but it would also create a serious budgetary deficit of about $2 billion in 2000.

A second approach would be to reduce corporate income tax to a level similar to other states. In so doing, the government would repeal (or let expire) the special tax exemptions allowed to 936 companies. It should be noted that any increase in the tax rate of these companies would induce further relocation and is probably not a prudent action. The combined reduction of the corporate income tax to a flat rate of 8 percent and repeal of tax incentives would decrease corporate income tax revenues between $230 million and $300 million in 1992. These calculations are also made assuming relocation due to statehood has already occurred.

Faced with large reductions in revenues, the government would have to increase taxes or decrease spending. Both alternatives would have negative effects on the economic activity of the new state. Additional tax increases would have the same negative effects the government set out to correct by lowering tax rates. Higher corporate taxes would reduce corporate investment in Puerto Rico, while higher personal taxes would cause increased tax evasion and migration of professionals to lower tax states.

On the expenditure side, the government would have to analyze all expenditure categories and decide which transfers and/or services to reduce. Any expenditure reduction would most likely include a reduction in the public payroll. Since government wages are very close to the Federal minimum wage, the Puerto Rican government would not be able to lower wages significantly. It could only reduce its payroll by reducing employment. The government's share of total employment is much higher than any state. In 1988, public employment accounted for 23 percent of total employment while state and local employment in the U.S. represented only 13 percent of total employment. Reducing employment to the U.S. average would mean laying-off about 90,000 workers. This cut-back would reduce government expenditures by about $1.0 billion in 1992.

Table III-10
Summary of the Effect of Statehood on Puerto Rico Tax Revenues and Outlays:
5 Percentage Point Relocation Scenario
(Millions of dollars)

	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Revenues (Excluding cover-over of taxes)	-94	-190	-277	-467	-632	-921	-1200	-1401	-1500
Outlays	-81	-160	-166	-166	-160	-150	-139	-125	-124
Increase in Surplus (+) or Deficit (-) (Excluding cover-over of taxes)	-13	-30	-111	-301	-472	-771	-1061	-1276	-1376
Cover-over of Taxes	117	265	996	1791	1089	322	338	355	373
Increase in Surplus (+) of Deficit (-) (Including cover-over of taxes)	104	235	885	1490	617	-449	-723	-921	-1003
Reduction in Individual Income Taxes	-344	-782	-821	-862	-906	-951	-998	-1048	-1101
Net Effect	-240	-547	64	628	-289	-1400	-1721	-1969	-2104

Table III-11
Summary of the Effect of Statehood on Puerto Rico Tax Revenues and Outlays:
11 Percentage Point Relocation Scenario
(Millions of dollars)

	Fiscal Year								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Revenue (Excluding cover-over of taxes)	-94	-190	-248	-376	-514	-677	-865	-1001	-1071
Outlays	-81	-160	-166	-170	-173	-175	-177	-176	-186
Increase in Surplus (+) or Deficit (-) (Excluding cover-over of taxes)	-13	-30	-82	-206	-341	-502	-688	-825	-885
Cover-over of Taxes	117	265	1011	1836	1117	322	338	355	373
Increase in Surplus (+) of Deficit (-) (Including cover-over of taxes)	104	235	929	1630	776	-180	-350	-470	-512
Reduction in Individual Income Taxes	-392	-892	-936	-983	-1032	-1084	-1138	-1195	-1255
Net Effect	-288	-657	-7	647	-256	-1264	-1488	-1665	-1767

Summary

Statehood would have two main fiscal effects on the Puerto Rican economy. First of all, tax revenues would decrease because of the reduction in economic activity and second, the government would face pressure to reduce tax rates in line with other states. While the proposed statehood grants would reduce the fiscal deficits, they would not cover the total negative impact of both effects. The Puerto Rican government would therefore have to adopt their own measures to reduce budget deficits by increasing revenues or reducing expenditures. In either case, the policies would have an additional negative effect on economic activity.

Appendix A

Data Bases and Computer Models Used in the Analysis

The structure of the data files and the information collected is similar to that used by the U.S. Treasury Department and the Joint Committee on Taxation to analyze the revenue and economic impacts of the federal tax legislation. Specific tax models for simulating the individual and corporate income tax systems of both the United States and Puerto Rico employ the same conceptual approach used by these U.S. Government organizations for tax policy analysis.

Data Bases

Returns Included in Data Bases

Tax policy analysis is frequently based upon a carefully selected sample of tax returns designed to statistically represent the entire population of tax return filers. As described below, the Puerto Rican procedures produce data bases that substantially exceed coverage of those employed by the U.S. Government.

Corporation and Partnership Income Tax Returns. In 1984, approximately 11,500 corporation and partnership[1] returns were filed in Puerto Rico. In contrast, approximately 3.2 million corporation tax returns, plus another 1.6 million partnership returns, were filed with the Internal Revenue Service in 1984. Tax policy analysis using these data in the U.S. Government is performed with a sample of returns, which in 1984 was comprised of about 94,000 corporation returns and 30,000 partnership returns, or about 2.6 percent of the filing population. Because of the relatively small number of corporation and partnership returns filed in Puerto Rico, the data base used in this study includes all returns.

Individual Income Tax Returns. Approximately 490,000 individual income tax returns were filed in 1984. By comparison, individual income tax returns filed with the U.S. Government during 1984 totaled 99.4 million. As with the corporation and partnership files, the Internal Revenue Service prepares a sample of individual tax returns to be used in tax policy analysis. In 1984, this sample included 94,000 returns, or slightly less than one percent of the returns filed. The U.S. Treasury Department further reduces

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[1]In contrast to the method under which partnership income is taxed to the ultimate owner in the United States, Puerto Rico imposes an entity-level tax on partnerships. For this reason, corporations and partnerships are treated identically in this analysis.

this sample to approximately 75,000 returns for most tax policy analysis and revenue estimating work. The Puerto Rico tax policy file includes 105,000 returns, or about 21 percent of the return-filing population.

Item Content

Table A-1 and Table A-2 list the information available for each taxpayer on the file. Table A-1 shows the information for corporations and Table A-2 shows the information for individuals and partnerships. Each item used for modeling purpose was carefully checked for internal consistency with the other information edited from the return, with errors resolved either through manual verification or through a computerized procedure designed to ensure the integrity and consistency of the information used.

Corporate Income Tax Return Data Base. The corporate data items edited from tax returns fall into four general categories:

- Descriptive information, such as the industry type, the month in which the fiscal year ended, and the type of corporation (Sec. 936 corporation, Industrial Incentive Act corporations, etc.).

- Income statement information necessary to calculate taxable income, including specific sources of income and expense. Certain other data was collected from Annex G providing information on exempt income.

- Balance sheet information, including detailed categories of assets, liabilities, and shareholder equity.

- Special items used in calculating tax liability, such as net operating loss carryovers, foreign and investment tax credits.

In addition to the corporate income tax return data, supplementary franchise tax return data was collected for large banks.

Individual Income Tax Return Data Base. The individual income tax file is similar in structure to the corporate file, with the extensive detail necessary to allow an accurate calculation of tax liability. The item content of the file, as indicated in Table A-2, provides the specialized detail necessary for computing taxable income and tax liability, both under the

TABLE A-1

Select Data Items on the Puerto Rico Corporation Income Tax Return Data Base

Descriptive data

Industry Code
936 Option Question
Type of Corporation
Exempt by Law Code
Accounting Method
Month Ending of Fiscal Year

Income Statement

Total Gross Income
Net Operating Income
Dividends & Profits
Materials Beginning of Year
Finished goods
Purchases
Total Cost
Goods in progress End of Year
Cost of Sales or Product
Short Term Gain
Long Term Gain
Rents
Dividends Received
Royalties and Annuities
Salaries, Bonuses, Commissions
Social Security Taxes
Unemployment Taxes
Medical & Hospital Insurance
Interest Expense
Property Taxes
Vehicle Expenses
Professional Fees
Pension Profit Sharing
Flexible Depreciation
Contributions
Windmills/Solar Energy
Total Deductions
Net Operating Loss
Net Sales
Goods in Progress Beginning of Year
Direct Wages
Materials End of Year
Finished Goods End of Year
Ending Inventory
Gross Profit on Sales or Product
Net Gain
Commissions
Freight and Passenger Fare
Miscellaneous Income
Commissions to Other Business
State Insurance Fund Taxes
Insurance Expense
Rent Paid
Casualty or Theft Losses
Travel & Entertainment Expenses
Current Depreciation
Bad Debts
Repairs
Other Deductions

Balance Sheet

Cash on Hand
Bad Debt Reserves
Notes Receivable
Investments
Depreciation Reserve
Land
Total Assets
Notes Payable
Other Liabilities
Preferred Stocks
Accounts Receivable
Total Accounts Receivable
Inventories
Depreciable Assets
Total Depreciation Assets
Other Assets
Accounts Payable
Accrued Expenses
Total Liability
Common Stocks

Capital Surplus
Reserve Surplus
Undistributed Profit
Total Capital Liability

Earned Surplus
Total Capital

Special Tax Items

Net Operating Loss Carryover
Foreign Tax Credit
Tax Liability After Credits

Tax Before Credits
Investment Tax Credit
Net Income Per Books

law as it existed in 1984, and under the new provisions adopted in 1987. In addition, the file includes extensive demographic information to allow a comprehensive assessment of the distributional effects both of current law and of any proposed alternatives.

To further enhance the functionality of the model, the tax return information was statistically merged with Current Population Survey information collected by the Bureau of the Census. These data provide more extensive information on occupation, hours worked, family size, ages of family members, and non-taxed sources of income.

The data collected can be classified into the following general categories:

- Taxpayer classification characteristics necessary for the determination of which rate to use and the number of personal exemptions.
- Sources of income, including the composition of income from unincorporated businesses.
- Sources of exemptions and deductions, again including information of the composition of the various business deductions allowed to proprietorships.
- Information on withholding, estimated payments, and final payments of tax liability.
- Tax computation items, including tax before credits, foreign tax credits used, and tax after credits.
- Demographic information to facilitate an analysis of distributional effects of tax policy options.

Extrapolation Procedure

The analytical tables presented in this report are at 1992 income levels. As the economy grows, there will be a larger population and more employment causing the number of returns filed to increase. In addition, both the income and deductions on each return filed will increase. The methodology used to adjust the 1984 returns is designed to make the files look just like the Puerto Rico administrative returns processing files will look in 1992.

An income forecast for the economy is required to allow the 1992 data bases to be created. The major components of the

TABLE A-2

Selected Data Items on the Puerto Rico Income Tax Return Data Base

Taxpayer Type and Personal Exemption Codes

- Taxpayer Type Code
- Type of Return (Single, Married, Head of Household)
- Other Dependents (Blind or Disabled)
- Other Dependent University Students
- Other Dependents not University Students
- Resident/Citizen Code
- Blind or Disabled Dependent Children
- Dependent Children who are University Students
- Dependent Children not University Students
- Old Age Flag
- Number of Children

Sources of Income

- Wages and Salaries Subject to Withholding
- Total Wages
- Partnership Profits
- Annuities/Pension Income After Exemptions
- Profit/Loss From Industry/ Commerce
- Profit/Loss From Professions
- Profit/Loss From Rental Business
- Profit/Loss Sale of Non-Capital Assets
- Net Operating Loss Previous Year
- Adjustments for Expenses Incurred (W&S)
- Income from Dividends
- Interest Income After Exemptions
- Wage Income not Subject to Withholding
- Farming Profit/Loss After Special Deduction
- Profit/Loss From Commissions
- Profit/Loss From Sale of Capital Assets
- Miscellaneous Income (After Expenses)
- Total Adjusted Gross Income

Deductions

- Standard Deduction
- Government Pension/Retire Payment Deduction
- Child Care Expense
- Property Tax Deduction
- Net Medical Expenses Deduction
- Net Charity Contributions
- Casualty Loss Deduction Personal Property
- Personal Exemption Amount
- Total Deductions and Credits
- Interest Paid Deduction
- Personal Use Auto License Deduction
- Rent Paid Deduction
- Casualty Loss Deduction on Residence
- Veteran's Deduction
- Other Deductions (Two Earner, IRA, etc.)
- Total Credits

Withholding Information

- Tax Withheld from Salaries
- Estimated Tax Payments
- Tax Withheld to Nonresidents
- Tax Withheld from Annuities or Pensions

Tax Liability Computation Items

Net Taxable Income
Foreign Tax Credit
Tax Before Credits
Tax After Credits

Demographic Characteristics

Marital Status
Age of Children
Age Head & Spouse
Hours Worked Head & Spouse
Sources of Income Head & Spouse
Household Income
SMSA Place of Residence
Number of Children
Occupation Head & Spouse
Industry Code Head & Spouse
Public Assistance Income
Family Income
SMSA Place of Work

income forecast used for this purpose were provided by the Puerto Rico Planning Board. Additional information was derived from the IAU-Wharton model of the Puerto Rico economy. Table A-3 provides the specific forecast used in the models. In addition to these aggregate macroeconomic forecasts, other information was provided by the Puerto Rican government relating to the anticipated growth rates of various other sources of income and expense.

Income Tax Models

Overview

The corporate and individual income tax models are essentially straight-forward income tax calculators that include a decision-making capability. They are designed to replicate the procedures used by each taxpayer to fill out a return. Unlike estimating methods that rely on aggregate information, this approach allows the model to choose among allowable alternative methods of reporting income and deductions, such as itemizing or using the standard deduction. It also forces taxes to be calculated according to certain statutory rules, such as those required under the corporate alternative minimum tax, where each taxpayer must pay the greater of regular tax or alternative minimum tax liability.

Each model actually has two tax calculators. This structure allows two different income tax systems to be compared, and is a standard design for tax policy analysis within the U.S. Government. Typically, the first calculator (which is referred to as plan X in the figure below) will include all the characteristics of present law.[2] The second calculator (referred to as plan Y) will, using computer instructions, describe an alternative policy option. A simple example might be to include a higher personal exemption in plan Y. The difference between the two calculations illustrates the effects of the policy change, both in the aggregate and on the population by income class and type of taxpayer.

Model Design

While the individual and corporate models differ significantly in the technical tax calculations, both are conceptually similar. The following figure is a simple visual

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[2]Present law is here assumed to be the law as it exists today. That is, even though the underlying tax return information is for the 1984 tax year, all the present law calculations in the model are based on the 1987 revisions to the Puerto Rico Income Tax Act.

Table A-3

Base Case Forecast of the Puerto Rican Economy Through 1992

Item	Year									
	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
U.S. Real GNP, Bill. 1982 $	3189.7	3405.3	3558.1	3682.3	3763.9	3943.4	4085.7	4177.6	4301.3	4430.3
Percent Change	-0.59	6.76	4.49	3.49	2.22	4.77	3.61	2.25	2.96	3.00
GNP, Mill. $	12932.8	14010.0	14805.4	15829.4	17068.3	18575.9	20036.2	21439.7	23127.3	25192.4
Percent Change	2.43	8.33	5.68	6.92	7.83	8.83	7.86	7.01	7.87	8.93
Real GNP, Mill. 54 $	3894.8	4048.4	4172.8	4281.6	4502.0	4731.2	4924.1	5077.3	5287.1	5521.2
Percent Change	-2.08	3.94	3.07	2.61	5.15	5.09	4.08	3.11	4.13	4.43
Gross Domestic Product, Mill. $	16987.5	18622.0	19683.3	21270.1	23645.4	25902.2	28061.9	30244.1	32836.4	36003.9
Percent Change	3.49	9.62	5.70	8.06	11.17	9.54	8.34	7.78	8.57	9.65
Gross Domestic Product, Mill. 54 $	4626.6	4933.8	5040.4	5391.4	5778.6	6132.5	6399.1	6633.0	6954.3	7322.8
Percent Change	1.68	6.64	2.16	6.96	7.18	6.12	4.35	3.66	4.84	5.30
Personal Income, Mill. $	12694.5	13536.6	14330.2	15126.5	16037.6	17351.0	18694.1	19995.3	21528.3	23372.3
Percent Change	0.06	6.63	5.86	5.56	6.02	8.19	7.74	6.96	7.67	8.57
Personal Income, Mill. 54 $	3827.1	4034.8	4163.3	4338.0	4535.5	4750.1	4921.6	5053.0	5223.4	5425.4
Percent Change	-2.72	5.43	3.18	4.20	4.55	4.73	3.61	2.67	3.37	3.87
Disposable Income, Mill. $	11936.0	12775.4	13501.8	14069.3	14991.4	16264.6	17653.3	18869.8	20299.1	22019.3
Percent Change	-0.28	7.03	5.69	4.20	6.55	8.49	8.54	6.89	7.57	8.47
Disposable Income, Mill. 54 $	3598.4	3807.9	3922.7	4034.8	4239.7	4452.8	4647.7	4768.7	4925.3	5111.4
Percent Change	-3.04	5.82	3.01	2.86	5.08	5.03	4.38	2.60	3.28	3.78
Fixed Invest., Mill. $	1658.7	1975.7	2258.7	2319.9	2879.4	3129.7	3278.5	3336.8	3464.6	3776.2
Percent Change	-7.21	19.11	14.32	2.71	24.12	8.69	4.75	1.78	3.83	8.99
Fixed Invest., Mill. 54 $	407.2	469.2	541.4	562.0	669.7	703.1	712.1	701.2	707.2	741.9
Percent Change	-7.87	15.32	15.29	3.80	19.16	4.99	1.28	-1.52	0.85	4.91

SOURCE: Puerto Rico Planning Board and IAU-Wharton Model

representation of the individual model that illustrates the general design.

The individual income tax model of Puerto Rico begins with the "general parameter environment." This section of the model includes a description of the marginal income tax rates, personal exemption amounts, the standard deduction amount, and a large number of other specific dollar amounts or rates that are part of both the current and the proposed income tax structures. These values remain constant as each tax return is processed by the model.

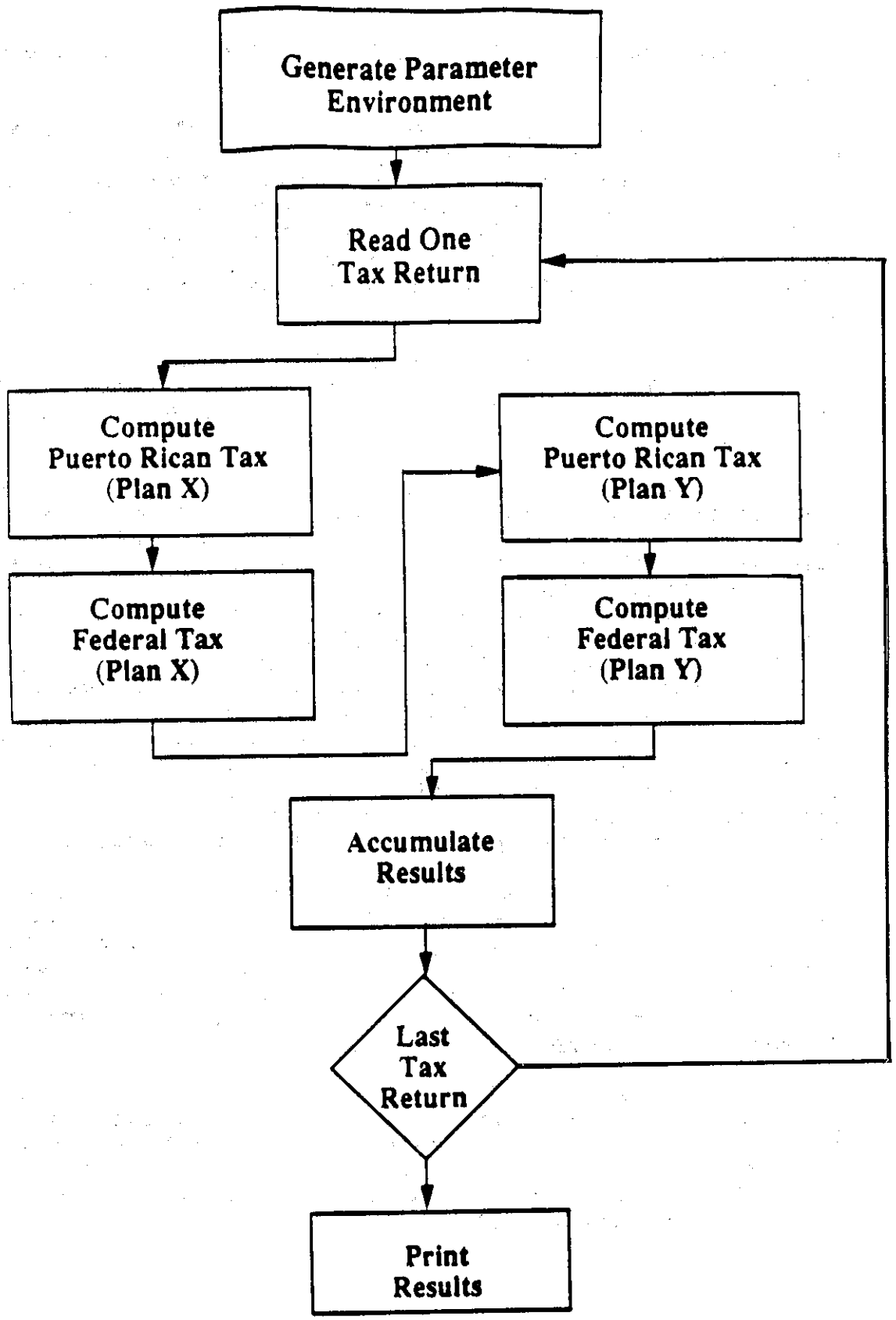
The next step is to go to the data base to "read one tax return." This is simply making the data from one tax return available to the calculator to allow income tax liability to be computed.

Once the data for one return is available, the model goes to the "compute Puerto Rican tax (plan X)" section. Here the model uses the data on the return, and the rates and other parameters read in the first section, to calculate the taxes due to Puerto Rico in 1992. Again, this is simply repeating the process a taxpayer would follow when preparing a tax return when adding up the sources of income, the personal exemption amounts, and available deductions. The standard deduction is compared to total itemized deductions, and the model chooses the method that provides the larger amount. Taxable income is calculated, and income tax rates are used to determine tax liability before credits. Allowable credits are determined, subject to statutory limitations on their use. Finally, the model calculates the individual's alternative basic tax where applicable, compares it to the regular tax, and requires the payment of the greater amount.

While Puerto Ricans are not generally required to file U.S. income tax returns under present law, they would be required to do so under statehood. Both plan X and plan Y allow federal income taxes to be calculated. This calculation is similar to the calculation described above for the Puerto Rican tax law, but with U.S. tax law parameters and specifications used wherever there are differences between the two systems.

Once these calculations are completed for plan X, the procedure is repeated for plan Y. The parameters describing plan Y Puerto Rican tax law are assumed to be identical to those used in plan X. That is, for the purposes of this report, it has been assumed that the Puerto Rican government will not change the tax rules between now and 1992.

Figure A-1
Model Overview



Under federal tax plan Y, as used in this report when replicating the effects of adopting statehood, the model will, subject to certain filing requirements, complete a U.S. federal income tax return for all Puerto Ricans. When such a return is filed, a deduction will be taken on the U.S. return for Puerto Rican income taxes paid. This deduction will reduce U.S. income tax liability otherwise due.

Following the completion of the plan X and plan Y tax calculations, the model will accumulate results for that tax return in a table for subsequent printing. The model will then check to determine whether all the returns in the data base have been processed. If not, the model goes back to the data base to get the next tax return.

Several tables are printed by the model when the processing of all returns has been completed. These results are classified in a number of ways to allow both the aggregate and distributional effects of policy changes to available for analysis.

Appendix B

Input-Output Estimate of the Indirect Effects of Relocation

The relocation of 936 corporations will reduce the demand of local corporations which supply inputs to the 936 firms. To estimate the effects of relocation on these local source firms, we use the Input-Output tables of the Puerto Rican economy. The I-O tables measure the linkages between the different industries in the economy. For each of the 93 industries identified in the tables, the coefficients from the I-O table of direct requirements show the proportion of intermediate inputs, labor, and capital used in the production of goods and services in each industry. The coefficients measure how much (in dollars) of the output of industry i is used as an input in a dollar's worth of output of industry j. For example, the table reflects how much paper product output is needed for each dollar of output in the pharmaceutical industry.

The effect of relocation on the source corporations is estimated by reducing the output in each industry by the level of intermediate inputs used by the relocating corporations. If, for example, the apparel industry demands $0.01 of paper products for each dollar of intermediate inputs and the reduction in output in the apparel industry causes its intermediate inputs to decrease by $10 million, local paper products output would then decrease by $100,000. Paper products output is affected because it is used as an input in the production of apparel goods, and the output in the apparel industry decreased because of relocation.

To estimate the reduction in wages paid by source corporations, the reduction in source industry output is multiplied by the share of wages in the value of output. If the share of labor in the output of a dollar of paper products is $0.20, the $100,000 reduction in output will decrease wages by $20,000. The relocation of $10 million in intermediate inputs to the apparel industry therefore reduces the demand for labor in the paper products sector by $20,000. The reduction in source industry profits is calculated in a similar manner.

As explained in the Treasury Department's Sixth Possessions Corporations Report, the above methodology will overestimate the indirect effects of 936 relocation if there are 936 corporations providing inputs to other 936 corporations. These 936 source corporations would be included both in the direct relocation loss and in the indirect effect. To eliminate double-counting, we adjust the I-O coefficients to take into account the share of 936 output in each industry. We reduce the demand of source industry output by the ratio of 936 sales to total sales in each source industry. In our previous example, if 936 corporations account for 50 percent of all paper product sales in Puerto Rico, we adjust the

purchase of paper products by 936 corporations by 50 percent. The apparel industry would therefore only purchase $0.005 of paper products for each dollar of intermediate inputs. The adjustment of the I-O table would be unnecessary if we could identify the share of 936 output sold to other 936 corporations in Puerto Rico. Unfortunately, it is not possible to identify the destination of 936 output with the available data.

The adjustment assumes the share of 936 suppliers to a given industry is equal to the share of 936 sales in the supplying industries. While this adjustment reduces significantly the indirect effects of 936 corporations in the Puerto Rican economy, it might still provide an overestimate of the 936 effect on source industries. If 936 corporations have a policy of only purchasing inputs from 936 corporations (because they may produce better quality goods), there would be no indirect effect on non-936 source corporations. While there are no data available to identify this behavior, it is unlikely to have a significant effect on our estimate of the indirect effects since our adjustment is already near 100 percent for the three industries with most 936 investment (pharmaceutical, machinery, electrical and electronic, and instruments). On the other hand, if the majority of 936 corporations in a given industry produce for export, and not for the local market, our adjustment would underestimate the indirect effects on local source corporations because there would be few 936 source corporations.

Furthermore, our estimate of the indirect effect only measures the effect on the source industry. It does not incorporate the full linkage (multiplier) effect on the economy. The total indirect revenue effects are likely to be higher than our estimate. A decrease in the output of source industries will in turn induce a reduction in the output of their source industries, who have source industries of their own. The relocation of 936 corporation, therefore, will affect the whole economy. While the first effect on source industries is the largest, the sum of the secondary effects (measured by a multiplier) can be sizable. We did not attempt to estimate a 936-adjusted multiplier for each sector because any discrepancy in our adjustment for 936 source industries would be compounded in a multiplier calculation.

Finally, it is argued that even if the Input-Output table accurately reflects the effect on locally-owned source industries, our methodology ovestates the effect of relocation because the resources of the sources industries would not remain idle. They would be used by the same industries or other industries, only they would be receiving a lower return (lower wages and lower profits).

While it is correct to assume the return to labor and capital would tend to decrease in a normal economy, the Puerto Rican case

is different for two reasons. First, Puerto Rican wages would not adjust significantly because they can not fall below the federal minimum wage. Second, the Puerto Rican economy has historically adjusted very slowly to changes in economic conditions. The resources affected by relocation would be eventually used productively but it would probably take longer than the period analyzed in this report. It is also unclear what type of additional investment Puerto Rico would be able to attract. If the economy could not reach full employment of resources while enjoying a very attractive tax incentive, it would most likely experience less resource utilization without the incentive.

APPENDIX C

ESTIMATES OF EFFECTIVE U.S. CORPORATION MARGINAL INCOME TAX RATE OF U.S. AFFILIATES OF 936 CORPORATIONS

The Policy Economics Group U.S. Corporate Income Tax Model currently uses 1985 tax return data for U.S. companies, and is programmed to calculate U.S. tax liability under the operation of current law. Specifically, the model will calculate taxes using methods that reflect the Tax Reform Act of 1986, as well as other more recent changes. This model is similar to the tax model of Puerto Rican corporations described in Appendix A.

Estimates of applicable marginal income tax rates were prepared for the five largest industries for which Section 936 credits were claimed in 1985. These industries, as shown in table C-1, accounted for 79 percent of all Section 936 credits claimed.

The effective marginal income tax rate was estimated by increasing the taxable income of firms in each of these industries to determine the effect of that increase on final U.S. income tax liability. The change in liability, divided by the change in taxable income, is the effective marginal income tax rate.

Once a rate was determined for each industry, an adjustment was required to reflect the relative importance of that industry to total Section 936 income. The marginal tax rate is used to compute additional U.S. tax collections resulting from an increase in taxable income of the parents of 936 companies and of the foreign owned companies in Puerto Rico. In order to compute an overall marginal rate, it is necessary to weight the tax rate computed for each industry by the increase in taxable income at 1992 income levels. Table C-2 provides the estimated change in taxable income in each of these industries. Table C-3 provides the average marginal tax rate computed for each industry, and the overall average marginal rate once it has been weighted by the increase in taxable income. The resulting average marginal income tax rate of 29 percent was used in determining the federal revenue effect of imposing U.S. tax rules on Section 936 corporations.

Table C-1

Industries Claiming Section 936 Credits in 1985
(Millions of dollars)

	Credit Claimed	Percent of Total
Food and kindred products	225	9.1
Apparel	62	2.6
Pharmaceutical	903	36.8
Electronics	532	21.7
Instruments	206	8.4
Subtotal	1,928	78.7
All other industries	523	21.3
TOTAL	2,451	100.0

1985 Corporation Statistics of Income, IRS

Table C-2

1992 Estimated Taxable Income of Selected Industries Claiming Section 936 Credits in 1985
(Millions of dollars)

	Taxable Income	Percent of Total
Food and kindred products	1,021	11.0
Apparel	333	3.6
Pharmaceutical	4,016	43.3
Electronics	1,447	15.6
Instruments	634	6.8
Subtotal	7,450	80.4
All other industries	1,817	19.6
TOTAL	9,267	100.0

Source: KPMG Peat Marwick estimate

Table C-3

1992 Estimated Marginal Tax Rates of Selected Industries Claiming Section 936 Credits in 1985

	Marginal Rate
Food and kindred products	29.8
Apparel	22.8
Pharmaceutical	31.2
Electronics	25.0
Instruments	28.2
AVERAGE	29.2

Source: KPMG Peat Marwick estimate

APPENDIX D

PRELIMINARY ESTIMATES OF THE FISCAL IMPACT OF STATEHOOD AS PREPARED BY VARIOUS GOVERNMENT AGENCIES

This section presents current estimates of the impact of statehood on U.S. revenues and outlays as prepared by various government agencies. Understandably, as issues evolve and more analysis is conducted, government estimates of the impact may change. The estimates presented in this appendix are the most recent publicly released estimates; however, the final government estimates may ultimately differ from those presented in this report. These estimates were prepared following the Senate Energy Committee vote to report S.712.

The appendix is divided into two parts. The first part presents the U.S. Treasury Department's current estimates of the impact of statehood on U.S. tax revenues. The second part presents the current government estimates of the effect on U.S. outlays. These outlay estimates were prepared by the Congressional Budget Office (CBO) and certain federal agencies.

Tax Revenues

U.S. Treasury Department estimates of the effect of statehood on U.S. Government tax collections are presented in Table D-1. As seen in the table, Treasury estimates that statehood would result in increased federal tax collections of $258 million in fiscal year 1992, and by fiscal year 1998 receipts would be increased by almost $5 billion.

Except for phase-out and timing effects, the Treasury estimates are based on an assumed annual growth rate of 10 percent for 936 revenues and 5 percent for the other revenue sources. The scheduled phase-out of the Section 936 credit results in a rapid increase in federal collections as the benefits are reduced. Following 1998, with the completion of the phase-out, the Section 936 revenues would increase by 10 percent per year.

Corporate income tax revenues are split between Section 936 corporations and non-Section 936 corporations. Treasury Department estimates assume that corporations responsible for 35 percent of the Section 936-source income would relocate outside the U.S., resulting in a lower net increase in receipts than

Table D-1

U.S. Treasury Estimates of the Effect of Statehood on U.S. Treasury Revenues
(Millions of dollars)

	1992	1993	1994	1995	1996	1997	1998
Corporate Tax							
Sec. 936 phase-out	45	128	538	1,204	1,889	2,610	3,325
Non-sec. 936	-	-	249	427	448	471	495
Individual Tax	-	-	645	676	707	739	773
Excise Taxes	213	295	309	325	341	358	376
Total	258	423	1,741	2,632	3,385	4,178	4,969

Source: U.S. Treasury Department testimony before the Senate Finance Committee, November 15, 1989.

would otherwise occur.[1] The increased collections in 1992 and 1993 presumably result both from corporate relocations in anticipation of the effective date, and from a reduction in new incorporations. Non-Section 936 corporations would be fully subject to U.S. income tax law as of January 1, 1994; that is, unlike the Section 936 companies, there is no phase-in of the increased tax burden.

The estimated increase in individual income tax receipts is net of the earned income tax credit. As will be discussed in Section II, the earned income tax credit represents a significant offset to individual income tax collections.

Unlike income taxes, federal excise taxes would apply to Puerto Rico on January 1, 1992. The increase in federal excise taxes was calculated by applying excise tax rates under present law to the forecasted level of consumption of taxed commodities in Puerto Rico. The amounts exclude the excise taxes on rum and all customs duties since their taxes are already imposed under current law.

Outlays

Estimates of the increase in federal outlays resulting from the extension of all federal entitlement programs to Puerto Rico were prepared by both the Congressional Budget Office and by the Departments responsible for administering each program. These estimates are provided in Tables D-2 and D-3, below.

Congressional Budget Office Outlay Estimates

The CBO estimates in Table D-2 show that statehood would cause an increase in federal outlays to Puerto Rico of $1,669 million in 1992, increasing to $3,253 million in 1995. The two main outlay components in 1992 are Food Stamps ($700 million) and Medicaid ($900 million). These increases result from the elimination of current spending caps on each program.

Total estimated federal outlays increase by 36 percent in fiscal year 1994 resulting from the commencement of SSI payments. An additional increase in outlays in 1995 results from the extension of the U.S. individual income tax system to Puerto Rico in 1994, with Puerto Rico taxpayers becoming eligible for the Earned Income Tax Credit. These rebates increase outlays by $300

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[1]While 35 percent of the income would relocate, Treasury assumes that some of this income would still be subject to U.S. tax under the super royalty rules leaving a net relocation of 25 percent.

million in fiscal year 1995, raising the effect of statehood on outlays to $3,153 million.

Administration Estimates

The administration outlay estimates were presented by the Departments of Agriculture and of Health and Human Services (HHS) in testimony before the Senate Committee on Agriculture, Nutrition and Forestry and the Senate Finance Committee, respectively. Table D-3 presents estimates for fiscal year 1995. Since the Department's estimates for each program were not presented for the same fiscal years, the estimates were adjusted (as indicated in the table) to correspond to fiscal year 1995.

Food Stamps

In 1982 Puerto Rico converted from the Food Stamp program to a block grant program with a specific cap on expenditures. Under this program, eligibility requirements were tightened, with a resulting decrease in participation. While under S. 712 the state of Puerto Rico could elect to continue receiving a block grant, the amount of the grant would increase and would enable the government to relax eligibility requirements and increase benefits.

CBO's estimated increase of $700 million in Food Stamp benefits in 1992 is calculated by subtracting the cost of the existing Nutritional Assistance Program ($1.0 billion) from the estimated total cost of the Food Stamp program ($1.7 billion). There are two key assumptions in the cost estimate: (1) average participation rate; and, (2) average monthly benefits.

The estimate assumes a level of participation of 1.75 million persons per month. This estimate takes Puerto Rico's participation in 1982 (the last year the island participated in the Food Stamp program) and adjusts it to account for the recent national decline in Food Stamp participation. It was assumed that the decline in participation in Puerto Rico during this period was half that of the United States.

Average monthly benefits in 1992 were estimated to be $77 per person. It was assumed that average benefits in Puerto Rico would be 17 percent higher than in the rest of the United States. Total benefits decrease in 1994 because some households beginning to receive cash benefits under the Supplemental Security Income program would no longer be eligible for Foods Stamp benefits (or would be eligible for lower benefits).

The Department of Agriculture's estimate assumes that participation would increase from the current level under the block grant program to the 1982 level of 1.8 million participants, i.e. the last year when Puerto Rico participated in the national Food

Table D-2

Congressional Budget Office Estimated Federal Outlays under Statehood
Fiscal years
(Millions of dollars)

	1992	1993	1994	1995
Food Stamps	700	700	600	600
Medicaid	900	1,000	1,100	1,200
Medicare	60	70	80	80
SSI	-	-	600	900
AFDC	6	40	70	70
Foster Care	3	3	3	3
Earned Income Tax Credit	-	-	10	300
Total Outlays	1,669	1,813	2,563	3,253

SOURCE: Congressional Budget Office, 11/2/89

Table D-3

Administration Estimates of Increased Outlays Under Statehood: Fiscal Year 1995
(Million of dollars)

	FY 1995
Food Stamps[a]	620
Supplemental Security Income	800
AFDC[b]	75
Medicaid[c]	1,020
Medicare[d]	60
Foster Care	0
Total Outlays	2,570

SOURCE: U.S. Department of Agriculture (11/9/89) and Department of Health and Human Services (11/15/89)

[a]The Department's 1992 estimate of $535 million was increased to 1995 at 5 percent per year.

[b]HHS FY 1994 estimate of $70 million increased by 5 percent.

[c]HHS FY 1996 estimate of $1,100 million decreased by 8 percent.

[d]HHS FY 1992 estimate increased to 1995 at 8 percent per year.

Stamp program. The estimate assumes maximum benefits in 1992 would resemble those of the pre-Nutritional Assistance Program.[2] As noted in Table D-6, the Department estimates an increase of $535 million for 1992. Our projected increase to 1995 assumes a growth in Food Stamps outlays of 5 percent per year. The Department estimate is not adjusted for the effect of SSI payments on Food Stamp benefits.

Medicaid

Under statehood, the federal matching rate for Medicaid outlays would increase from 50 percent to the 83 percent rate applicable to a state with Puerto Rico's income level. Furthermore, the ceiling on Medicaid spending ($79 million in 1990) would be eliminated. The CBO estimate incorporates these changes and assumes that the program would annually serve 1.35 million of the 3.35 million residents of the island. It also assumes that the cost per participant would increase as benefits are extended.

The Department of Health and Human Services' estimate assumes benefits would increase because of the expansion of services and more accurate reporting by the Puerto Rican authorities. As noted above, the Department's testimony reported an estimate of $1,100 million for 1996. This estimate was discounted by an assumed 8 percent annual growth rate.

Medicare

Under statehood, Medicare benefits would increase by a factor equal to the cost differential between hospital care rates currently paid in Puerto Rico and in the United States. CBO's outlay estimates for 1992 to 1995 were calculated by inflating the 1989 cost differential by the CBO Hospital Insurance program growth rates for years 1990 to 1995.

The estimate by HHS adjusts current reimbursement costs by the difference between the national reimbursement rate and the current rate for Puerto Rico.

Supplemental Security Income (SSI)

Aged and disabled Puerto Ricans would be eligible for SSI on January 1, 1994. CBO's estimated increase in outlays for this program has three components: (1) number of eligible participants; (2) participation rate; and, (3) monthly benefits per participant.

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[2]In the testimony, the Department of Agriculture acknowledges that Food Stamp benefits under statehood could be higher than the pre-block grant benefits.

CBO calculated the number of eligible participants over 65 years of age from the 1980 Census for Puerto Rico. Eligible disabled participants were calculated by applying to the aged participants the 1979 U.S. ratio of disabled participants to estimated aged SSI recipients. The resulting estimates assumed a participation rate of 43 percent, which is the same participation rate as for all U.S. aged recipients. The 1980 Census was also used to estimate average monthly benefits. The estimate of $260 a month for aged recipients is 20 percent higher than the average benefit for U.S. recipients. Finally, the total outlays for 1994 are considerably lower than the 1995 outlays because the program benefits would not begin until the fourth month of the 1994 fiscal year.

The Department of Health and Human Services derived their outlay estimate by applying the average national monthly benefit to the estimated 185,000 participants in 1992.

Aid to Families with Dependent Children (AFDC)

Federal AFDC outlays under statehood would increase because the federal matching rate would increase from 75 percent to 83 percent, and because the current spending cap would be eliminated. Outlays increase after 1992 because of the implementation of the AFDC-Unemployed Parent program. The outlay estimates depend on the level of Puerto Rico payment standards. If, for example, the Puerto Rican Government decides to use the savings due to the higher federal matching rate to increase payments to AFDC participants, federal outlays would increase accordingly. Both CBO and HHS assume no change in program benefits.

Foster Care

The CBO estimate assumes the foster care program would be extended to Puerto Rico, with 60 percent of children in foster care in Puerto Rico qualifying for federal reimbursements.

Earned Income Tax Credit (EITC)

As a result of the extension of U.S. tax laws, on January 1, 1994 some Puerto Ricans would become eligible for Earned Income Tax Credits. CBO used the 1980 Census of Population to estimate the number of families eligible for the credit. After adjusting for population and income for growth between 1979 and 1989, CBO estimates there would be 337,000 eligible families. The average credit per taxpayer was assumed by CBO to equal the U.S. average credit.

The Administration did not separately identify its estimates of the EITC, but rather included the EITC offset in its estimates of increased individual income tax collections.

Summary of the Effect of Puerto Rico Statehood on the U.S. Budget

Table D-4 shows the effect of statehood on U.S. revenues and expenditures. The estimates prepared by CBO and the U.S. Treasury Department show a net cost to the U.S. Government over the first five years after statehood, but a net gain in the last two years of the forecast period.

The main reason for the high losses in the early years is that federal excise taxes and income taxes are covered-over (paid back to Puerto Rico) in these years and Section 936 credits are not fully repealed. As the cover-over ends and 936 is fully repealed, tax revenues exceed outlays producing the net gain to the U.S. Government. Nevertheless, even under the combined Treasury and CBO estimates, statehood would result in a net cumulative budget deficit of $6.6 billion from 1992 to 1998.

Table D-4

Summary of the Effect of Puerto Rico Statehood on U.S. Tax Revenues and Expenditures as Estimated by CBO and the U.S. Treasury Department Fiscal Years (Millions of dollars)

	Fiscal Year							
	1992	1993	1994	1995	1996	1997	1998	TOTAL
Tax Revenues	258	423	1,741	2,632	3,385	4,178	4,969	17,586
Expenditures								
Entitlement[a] Programs	1,669	1,813	2,463	3,153	3,355	3,560	3,780	19,793
Cover-over of Taxes	213	295	1,040	1,418	683	358	376	4,383
Total Expenditures	1,882	2,108	2,853	3,881	4,038	3,918	4,156	22,836
Net Budget Effect	-1,624	-1,685	-1,762	-1,939	-653	260	813	-6,590

[a]Amount for 1996 through 1998 were computed by increasing the CBO estimates for 1995 by 5 percent except for Medicaid and Medicare which was increased by 8 percent per year.

Puerto Rican Statehood:
A Precondition to Sound Economic Growth

A memorandum prepared for submission to
the Senate Finance Committee during hearings on S.712
May 17, 1990

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[1] This memorandum provides the essence of a report under preparation by Hex, Inc. of Cambridge, Massachusetts. J. Tomas Hexner is the Chairman of Hex, Inc. Glenn Jenkins is the Director of the International Tax Program at Harvard Law School and Fellow, Harvard Institute for International Development. Helen F. Ladd is Professor of Public Policy Studies at Duke University and Senior Fellow, Lincoln Institute of Land Policy. K. Russell LaMotte is a research assistant at the Lincoln Institute and will attend Harvard Law School this fall.

936. To the contrary, eliminating 936 will provide the stimulus needed to modernize the island's development strategy.

Recent years have witnessed a dramatic change in the composition of section 936 corporations. As Puerto Rican wages have risen above those in competing Caribbean and Asian countries (while still remaining well below those on the mainland), the share of section 936 activity in labor intensive industries such as textiles has diminished significantly while the share in capital intensive electronics and pharmaceuticals industries has increased commensurately. In 1960, chemicals and machinery made up 22 percent of the net manufacturing income in Puerto Rico; by 1989 that share had increased to over 73 percent.[3] Increasingly a subsidy for capital intensive firms, section 936 represents a perverse economic development tool for the labor surplus economy of Puerto Rico.

As a subsidy to labor, section 936 is grossly inefficient. Section 936 now primarily transfers income to mainland parent corporations and serves as a subsidy to the parent corporations for tax planning rather than as a stimulus for job creation in Puerto Rico. The tax subsidy to wages is astounding. In 1983 (the latest year for which complete data is available[4]), the tax benefits received by 936 corporations averaged 125 percent of employee compensation; for the pharmaceutical industry, tax benefits were 265 percent of employee compensation. The bankruptcy of section 936 as an incentive to hire labor also emerges from outcome data: while manufacturing's share of Puerto Rico's gross domestic product increased from 29 percent to 40 percent between 1975 and 1988, the share of manufacturing income accruing to labor declined precipitously from 48 percent to 27 percent.[5]

Moreover, the 936 incentive will become increasingly ineffective in the future as firms respond to the 1986 reduction in the U.S corporate tax rate, to proposals outlined in the Treasury's White Paper on intercompany pricing[6], and to the uncertainty associated with the inevitable periodic attempts by the U.S. to get rid of this inefficient and costly subsidy.

At a time of severe budget pressure in the U.S., American taxpayers should not be asked to give up large amounts of tax revenues for such an inefficient subsidy. On April 26, 1990 Philip D. Morrison, the International Tax Counsel of the Department of the Treasury testified that the 936 corporations received $2.1 billion in net tax benefits in 1990 and that these benefits are predicted to grow at 10 percent per year. Estimating that 75 to 80 percent could be recovered by the Treasury

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[3] April, 1990 CBO Report, Table 3.

[4] Data on section 936 corporations is from the Department of Treasury, "The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report," March 1989.

[5] Puerto Rico Planning Board, "Economic Report to the Governor 1988," Tables 9 and 11.

[6] Treasury Department, Office of International Tax Counsel, Office of Tax Analysis, A Study of Intercompany Pricing, October 18, 1988.

if 936 were phased out as proposed under the statehood option of S. 712, he predicted that an additional $2.7 to $2.9 billion (in 1990 dollars) would be available to the U.S. Treasury by 1997.

It is time for both Congress and Puerto Ricans to acknowledge the need for change. The U.S. needs cost effective programs and Puerto Rico needs investment in people and facilities that effectively promote private sector development and income for Puerto Ricans. Whether or not statehood is adopted, section 936 should be eliminated. The statehood option is desirable in that it forces an immediate change in the island's development strategy while at the same time providing the preconditions for an alternative economic vision.

A Brief Digression on Federal Grant Programs and Economic Development

Statehood also calls for the extension of full federal entitlement programs to Puerto Rico. How might this extension affect the island's long term economic growth? Critics claim that expanded welfare would cause over-dependence to the detriment of productive work and real economic expansion. Proponents of statehood point to the stimulation of aggregate demand associated with the inflow of federal funds and draw attention to the national trend of combining skill development and training with welfare programs. Neither argument is without merit, but both miss the main point. The real issue is not what increased entitlements will do to stimulate demand or reduce work effort, but rather whether the economy can generate jobs. Without more jobs and sustained economic growth, Puerto Ricans will continue to be poor, to be dependent on federal welfare, and to migrate to the mainland to find work. Solving the job problem calls for a shift to statehood. Statehood both builds the foundation for economic growth and also assures a more adequate safety net of fair social welfare programs.

Pressure to Restructure the Public Sector

A political fact of life: without statehood, the size and efficiency of the Puerto Rican public sector will not change. Casting no aspersions on the multitude of sincere and dedicated government officials, the Puerto Rican public sector, when viewed from a macro perspective, appears beset by problems including a bloated payroll, a centralized bureaucracy, a history of balancing the budget with one-time windfalls and gimmicks, a lack of accountability, and poor planning and insufficient investment in infrastructure and public works.

Between 1975 and 1988 the average annual growth rate of public sector employment was 2.6 percent, substantially higher than the 1.4 percent growth rate of non-government employment.[7] A 1985 prominent citizens' report commissioned (and seemingly ignored) by the current Governor recommended a vast overhaul of the Commonwealth's governmental structure on the grounds that this bureaucratic growth was an ad hoc response to employment crises on the island and did not represent

[7] Treasury Department, "Sixth Report", Table 3.3.

improved service delivery[8]. A more recent May 6, 1990 article in the San Juan Star echoed this diagnosis, attributing the growth to the "Twin traditions of political patronage and government expansion to reduce unemployment." The 1985 report goes on to argue that the expansion of government has harmed Puerto Rico's private sector: "The government has assumed responsibilities and direct operations in the country's economic sector in which private capital enjoys a comparative advantage in providing more efficient service."[9] The reference here is to public sector involvement in traditionally private sector activities such as shipping, commercial banking and other enterprises.

Statehood will force changes in the way the Puerto Rican government operates. On the one hand, additional federal funds for entitlement programs will free up some locally generated funds for other purposes. On the other hand, Puerto Rican taxpayers newly subject to federal taxes will demand lower Puerto Rican income taxes, a more streamlined public sector, and possibly some decentralization of taxes and spending to the municipal level. A combination of privatization of various activities, spending cuts, and alternative revenue sources would provide space for the imposition of the new federal income taxes with no increase in the (already high) tax burdens on Puerto Ricans. An overhaul of the ineffective collections process would (with the assistance of the Internal Revenue Service) also yield substantial revenues: a 1987 report on tax reform in Puerto Rico prepared by Booz, Allen & Hamilton estimated that $1.5 billion in personal income is currently untaxed because of non-filing and under-reporting and that an additional $135 million could be collected by improving the administration, enforcement, and compliance incentives.

No economy seeking investment and reinvestment can afford a bloated and reputedly ineffective and overcentralized public sector. Long run growth is possible only with meaningful and painful public sector cuts to generate some of the funds necessary for refurbishing the infrastructure and for reducing the island's tax burden. Only statehood will force these painful but essential decisions.

The Statehood Provisions of S.712: Needed Adjustments

With minor changes to the current version of S.712, the transition to statehood can be accomplished with minimal disruption and in compliance with the discipline of the Gramm-Rudman-Hollings legislation. Under a slightly modified transition plan, between 1992 and 2000 statehood would generate over $2.5 billion (in net present value) to the U.S. Treasury, which if desired could be considered a source of funds to smooth the transition to statehood.

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[8] See "A Study on the Organization and Function of the Executive Branch of the Puerto Rican Government," prepared by the Committee for the Economic Development of Puerto Rico, 1985.

[9] Committee for the Economic Development of Puerto Rico, p. 32.

The statehood provisions of S.712 stipulate the immediate extension of most U.S. social welfare programs[10], a gradual phase-out of the section 936 tax credit, a delayed imposition of federal income taxes for Puerto Rican citizens and corporations until 1994, and contain certain assumptions about the form and content of a "statehood grant." By extending the entitlement programs immediately while delaying the implementation of taxes, S.712's transition program frontloads the federal costs. This frontloading is undesirable in that it aggravates the U.S. budgetary problems during the initial years of statehood, understandably produces U.S. opposition to statehood, and focuses the statehood debate in Puerto Rico too heavily on the extension of entitlements.

Hence, the transition assumptions of S.712 should be adjusted to treat the expenditure and revenue sides of the transition comparably. According to historical precedent, the Constitution imposes few constraints on the transition package, and grants Congress broad powers to make economic adjustments to minimize disruptions and dislocations associated with the transition to statehood. The flexibility to design an appropriate transition applies both to the tax side and to entitlement programs. From the U.S. perspective, extending full health and social welfare programs to Puerto Ricans before they are required to pay federal taxes seems inappropriate. Delaying the expansion of welfare benefits can also be justified in terms of the adjustments required in Puerto Rico: a delay would provide more time to plan for the expansion of these federal programs and to begin to make the necessary adjustments in locally financed health and welfare programs.

Table 1 reflects our modified transition assumptions. Specifically, the table assumes that Puerto Ricans will not begin to pay federal excise and income taxes until 1994 and, to bring taxes and transfers into line, that none of the health and welfare programs are extended until that same year. S.712's assumption about the phase out of section 936 (a five year period beginning in 1994) is retained to assuage any potential disruptions and to render fair treatment to corporations who made section 936 a significant element of their locational investment decisions. Table 1 does not include a statehood grant because that is a separate issue to be considered in light of these financial flows.

Impact of Statehood on the U.S. Treasury

Table 1 shows that, excluding any special statehood grants, the shift to statehood would have a beneficial effect on the U.S. Treasury over the 1992 to 2000 period, the time period used in the April CBO report. In particular the shift to statehood would reduce the present value of net federal outlays for Puerto Rico over the period by $2.5 billion. Thus, Puerto Rican statehood could reasonably free up federal budgetary resources relative to what would occur under continued Commonwealth status. Even under the assumption of federal budget neutrality, substantial federal

[10] The exception is the Supplemental Security Income program (SSI), the introduction of which would be delayed until 1994 to provide for the required administrative adjustments.

Table 1
Financial Benefits and Costs of Statehood
Relative to Commonwealth, No Statehood Grants
($ Millions)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	Total
From Perspective of U.S. Treasury										
Additional Outlays Entitlements (a)	0	0	2,550	2,950	3,068	3,191	3,318	3,451	3,589	
Additional Revenues 936 Phase Out (b)	45	128	538	1,204	1,889	2,610	3,325	3,491	3,666	
Non-936 Corp. Taxes (c)			249	427	448	471	495	519	545	
Indiv. Income Taxes (d)			645	676	707	739	773	809	846	
New Excise Taxes (e)			309	325	341	358	376	395	414	
Net Outlays	(45)	(128)	809	318	(317)	(987)	(1,651)	(1,763)	(1,882)	
Present Value of Net Outlays (10% discount rate)	(41)	(106)	608	217	(197)	(557)	(847)	(823)	(798)	(2,544)
From Perspective of Puerto Rico (f)										
Net Inflow to Puerto Rico	0	0	1,347	1,522	1,572	1,623	1,674	1,728	1,784	
Present Value of Net Inflow (10% discount rate)	0	0	1,012	1,040	976	916	859	806	757	6,366

All entries represent estimates of the additional costs or revenues associated with statehood compared to Commonwealth status. Additional outlays for entitlements are set equal to zero in 1992 and 1993 based on the authors' proposal that the expansion of entitlements be delayed until 1994. Similarly, excise taxes would not be imposed until 1994. The phase out of section 936 complies with the terms of S.712. The table includes no statehood grant. Specifically, the cover over (transfer to the Puerto Rico Treasury) of federal taxes paid by Puerto Ricans included in S.712 is excluded.

Notes:
(a) Entitlement figures from April CBO Report, Table 7.
(b) 936 phase out figures from November, 1989 Treasury testimony; post-1998 figures are calculated from an arbitrarily assigned 5% growth rate.
(c) Non-936 corporate taxes from November Treasury testimony; post-1996 figures from April CBO, Table 7.
(d) Individual income taxes from November Treasury testimony; post-1996 figures from April CBO, Table 7. They are net of the Earned Income Tax Credit.
(e) New excise taxes from November Treasury testimony; post-1998 figures from April CBO, Table 7. (Customs duties and rum excise taxes are exluded because their treatment would not change under statehood.)
(f) Calculations not shown. The entries can be derived from the top panel by considering federal outlays as inflows and federal revenues (minus 936 revenues) as outlays.

revenue could be available for a special statehood grant to Puerto Rico should Congress deem that desirable.

Before discussing such a grant, the net financial flow from the perspective of Puerto Rico should be noted.

Impact of Statehood on the Net Flow of Funds to Puerto Rico

Not only does Puerto Rican statehood impose no additional costs on the U.S. Treasury, but it also substantially increases the flow of funds to Puerto Rico. The explanation for this apparent paradox is that the additional revenue to the U.S. Treasury generated from the elimination of section 936 will be paid not by Puerto Ricans but rather by the mainland corporate parents of the section 936 corporations.

Under the transition assumptions advocated above -- and without providing for any form of statehood grant -- the net inflow of federal transfers by the year 2000 is estimated to be $1.8 billion dollars and the present value (in 1991) of the total inflow through the year 2000 is $6.4 billion. In terms of net financial flow, statehood is clearly beneficial for Puerto Rico. However, these financial flows should be scrutinized in the context of their economic effects as projected fully and carefully in the April CBO report which predicted a lower growth rate under statehood due to reduced investment caused by the elimination of the section 936 tax provisions. The CBO scenario needs to be addressed and provides a strong argument for designing a statehood grant that could stimulate and partially fuel Puerto Rico's economic growth in the short run to provide breathing room until the full long term positive effects on the economy of the move to statehood as discussed in this memorandum take hold.

Preparing a Statehood Grant

Every state that has entered the Union since 1803 has received some form of statehood grant. Examples of these grants range from natural resource transfers to monetary aids. Historically Congress has recognized the desirability of enacting special assistance measures for new states and has shown remarkable flexibility in tailoring the statehood grants to their particular needs.

S.712 includes a statehood grant in the form of a cover over of federal taxes paid by Puerto Ricans. The federal government would turn over to the Puerto Rican Treasury all the proceeds from the federal tax on individuals and corporations in 1994 and 1995 and all the revenue from the new federal excise taxes at least through 1998.[11] The present value (as of 1991) of this statehood grant

[11] In addition, the United states would continue to rebate to Puerto Rico customs duties and excise taxes on rum. We have not include these rebates as part of the statehood grant because they would be provided under enhanced Commonwealth status as well as under statehood.

is $2.8 billion which is slightly above the $2.5 billion that would be consistent with U.S. budget neutrality over the ten-year period.

This approach to the statehood grant deserves serious rethinking based on two considerations. First, this cover over approach may reduce incentives for the Puerto Rican public sector to adjust to statehood. Second, the statehood grant should be used to offset more directly the economic disruptions that may accompany the elimination of 936 and to help Puerto Rico restructure its economy to move into the 21st century.[12]

Statehood will require significant changes in the operation of the Puerto Rican public sector. Although difficult, the number of public sector employees will have to be reduced and government operations will have to be streamlined and made more efficient. Because the new federal taxes will not be paid until 1994, the transition period itself provides over two years for the Puerto Rican government to prepare for the change. No reason exists to delay the pressure for these changes by providing the Puerto Rican Treasury with a full cover over of the new federal taxes paid by Puerto Ricans. Even if some cover over is deemed desirable to ease the government's adjustment to statehood, it should at most be partial.

Another compelling argument for a creative approach to the statehood grant is the need to help Puerto Rico restructure its economy to provide growth in private, not public, jobs. As we have argued throughout this memorandum, eliminating the 936 tax provisions is in the long run interest of the Puerto Rican economy. Even with the tax provision, unemployment has been high in recent years and will continue to be high in the future, unless new initiatives are undertaken. The elimination of the tax provision simply focuses attention on some basic structural problems in the Puerto Rican economy and the need to develop a new approach to economic development.

Following the lead of mainland states, Puerto Rico should deemphasize tax breaks and other gimmicks in favor of investment in basic infrastructure. Investments in physical infrastructure and in education would do more for the long term economic development of the island than any set of tax breaks. In this light, then, it is hoped that the Finance Committee will consider an alternative statehood grant which would be specifically designed to promote the conditions for strong private sector economic growth in Puerto Rico.

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[12] A third concern has been expressed by the Treasury Department, which has testified that the cover over approach poses significant administrative difficulties.