

**An Analysis of the Fiscal Relationship between the
United States Federal Government and Puerto Rico**

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I. Purpose and Principal Findings

A. General Findings

Puerto Rico, while part of the United States, is not subject to the same federal taxes as the 50 States and the District of Columbia, and does not receive federal programs on the same basis. This unique and largely misunderstood fiscal relationship is subject to the control of Congress, which periodically exercises its power through changes to benefit levels or tax credits. Puerto Rican residents and corporations currently do not pay federal income tax on earnings in Puerto Rico, even though Congress has the authority to extend full federal taxes. For many low-income U.S. citizens in Puerto Rico, exemption from federal income taxes actually means exclusion from benefits like the earned income tax credit. Unlike the States, Puerto Rico does not contribute most federal excise taxes or customs duties to the U.S. Treasury. Most federal programs in Puerto Rico, however, are funded on the same basis as in the fifty States, with the exception of several key health and income support programs.

B. Purpose and Context

Purpose. Tiger Woods recently sailed into the San Juan harbor without radioing ahead, breaking with national security regulations in place after 9/11. The captain had not been aware that US regulations applied to Puerto Rico. American misunderstanding extends beyond boating rules to all aspects of Puerto Rico's unique relationship with the United States, not least to the strange fiscal relationship that has developed over the past one hundred years. This report endeavors to provide a rough quantitative basis for understanding this relationship. While some commentators have questioned whether Puerto Rico should still be treated as a foreign entity under the U.S. tax code,¹ the usefulness of this unique status for Puerto Rico and the rest of the US is beyond the purview of this report.

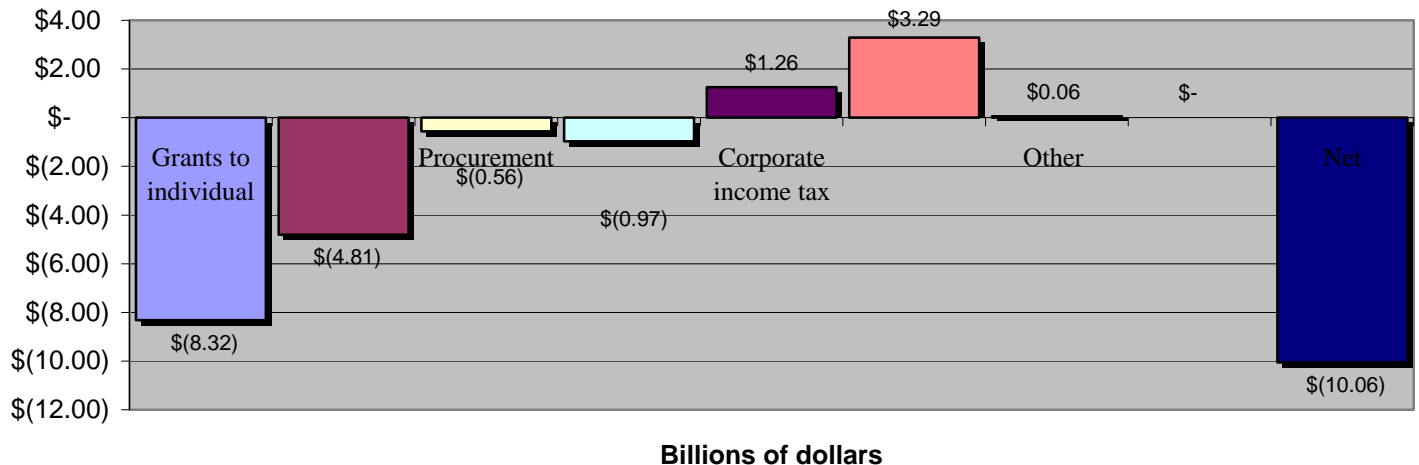
Context. Ignorance and confusion prevail over Puerto Rico's status as both part of the United States and "foreign" under the Internal Revenue Code. Misinformed decisions harmful both to the U.S. Treasury and Puerto Rico are possible. For example, legislation was recently proposed to provide U.S. corporations with a one-year window to repatriate profits at a reduced 5.25% rate from their controlled foreign corporations outside the U.S. Intended to increase investment and employment, these proposals could have the opposite effect in Puerto Rico, which is considered outside the U.S. and "foreign" under the Code. To help inform future decisions, this report attempts to create a brief guide for policy-makers on the current fiscal relationship between the U.S. federal government and Puerto Rico.

¹ See, for example, Hunter (2004).

C. Flow of Federal Funds Review

	2000	2001	2002	2003
Federal spending in Puerto Rico				
Individuals	\$6.567	\$7.532	\$7.921	\$8.324
Grants	\$4.323	\$4.389	\$4.828	\$4.808
Procurement	\$0.419	\$0.477	\$0.365	\$0.561
Wages and salaries	\$0.819	\$0.866	\$0.930	\$0.968
Total	\$12.128	\$13.263	\$14.044	\$14.661
Federal tax collections from Puerto Rico				
Corporate income tax	\$1.604	\$1.380	\$1.327	\$1.256
Individual income and Social Security contributions	\$3.031	\$3.253	\$3.183	\$3.285
Unemployment insurance	\$0.041	0.041	\$0.039	\$0.039
Estate and gift tax	\$0.009	0.007	\$0.005	\$0.022
Excise taxes collected by IRS	\$0.0003	0.002	\$0.0003	\$0.00002
Total	\$4.686	\$4.683	\$4.554	\$4.604
Net flow to / from Puerto Rico	\$7.442	\$8.580	\$9.490	\$10.057
PR Economic Activity Credit and Controlled Foreign Corporation Cost ²				\$1.2
				\$1.7

Flow of Federal Funds to and from Puerto Rico, 2003



² An estimated range of the revenue cost to U.S. Treasury of both existing tax credits and controlled foreign corporation treatment of U.S. corporations in Puerto Rico.

D. Specific Findings

Quantitative

1. **Federal spending in Puerto Rico totaled \$14.66 billion in 2003.** Federal spending amounts to about 31% of the island's gross product, about double the share in the rest of the U.S. Most spending, \$8.3 billion, takes the form of direct federal transfers to individuals. An additional \$4.8 billion in direct grants was provided to the Puerto Rican central and municipal governments. These transfers contributed about a fifth of the consolidated budget of the Puerto Rican government. The federal government also spent \$968 million on its personnel and \$561 million in procuring goods and services in Puerto Rico.
2. **Federal tax collections in Puerto Rico amounted to \$4.604 billion in 2003.** Total receipts had increased about 1% from 2002, but had declined from \$4.661 billion in 2000. Payroll taxes for Social Security and Medicare comprise almost three-quarters of federal tax collections in Puerto Rico, or \$3.285 billion.
3. **Expected federal revenues from repealing Section 936 have been undermined by the shift to controlled foreign corporations (CFC's) by U.S. corporations in Puerto Rico.** Initial projections in 1996 estimated that the phase-out would increase federal revenues by \$500 million from 2000 to 2003. Actual revenues from U.S. corporations in Puerto Rico dropped by \$350 million during the same period (more than offsetting an increase of \$250 million in payroll taxes from workers and their employers).
4. **Puerto Rico gets \$10.1 billion more in federal spending than it bears in federal taxes, up 33% since 2000.** While federal spending increased by \$2.5 billion, tax collections actually dropped by \$82 million. That is a more favorable balance of payments (federal spending received compared with federal taxes paid) per capita than all but three states.
5. **Puerto Rico receives approximately \$8.3 billion in "unearned" federal benefits and tax credits.** Federal grants to Puerto Rico (not payments to individuals "earned" through payment into the Social Security, Medicare and federal retirement systems) totaled \$4.8 billion in 2003. Tax credits for U.S. corporations operating in Puerto Rico amount to \$1.8 billion. Residual tax credits and treating US corporations operating in Puerto Rico as foreign corporations (legally able to defer and reduce their federal tax liability) costs the federal government between \$1.2 and \$1.7 billion.
6. **Per capita, Puerto Rico receives less federal spending than any state.** At \$3,780, overall federal spending is about half of the U.S. average, \$6,910. Federal spending on wages and salaries is \$250 per resident, almost a third of US levels. At \$145 per person, federal procurement spending is the least funded category of federal spending in Puerto Rico (about seven times less than in the U.S. as a whole). Grants per capita are comparable with the U.S. average.

Qualitative

7. **Residents of Puerto Rico do not pay the federal income tax.** Residents of Puerto Rico do contribute payroll taxes like Social Security, Medicare, and Unemployment Insurance. Exemption from federal income taxes actually excludes a majority of working Puerto Rico families from receiving payments under the earned income tax credit and the child tax credit, which help offset payroll taxes paid by working families in the rest of the U.S.
8. **Corporations are also exempt from paying federal income tax.** Corporations organized in Puerto Rico do not pay federal income tax on any income earned in the Commonwealth. Most U.S. corporations operating in Puerto Rico continue to receive significant benefits under the Puerto Rico economic activity credit, which effectively exempts them from paying tax on income earned on the island. As the credit is being phased out,³ most U.S. corporations have taken advantage of Puerto Rico's "foreign" tax status to reduce and defer payment of federal income taxes, employing Section 956 of the Internal Revenue code to organize as Controlled Foreign Corporations (CFCs).
9. **Puerto Rico does not equally contribute federal excise taxes and customs duties to the U.S. Treasury.** Puerto Rico is currently exempt from most federal excise taxes. Taxes are collected on some Puerto Rico-produced goods shipped to the U.S., though in those cases revenues are rebated to the Puerto Rico Treasury. U.S. customs duties collected in Puerto Rico are also returned, or "covered over" to Puerto Rico;⁴ no state receives customs duties. Under equal tax treatment, these annual rebates totaling \$336.8 million would cease and all federal excise taxes would be applied to Puerto Rico.
10. **U.S. citizens in Puerto Rico benefit from most federal programs on the same basis as their mainland counterparts.** Social Security, Medicare, Pell grants, and other major federal programs treat Puerto Rican recipients the same as other U.S. citizens. Several programs are funded differently, however, particularly Supplemental Security Income (SSI), Food Stamps, and Medicaid.
11. **After decades of funding Puerto Rico differently, the U.S. Congress provides key federal education funds to Puerto Rico on an equivalent basis to the 50 States and the District of Columbia.** The 2001 No Child Left Behind Act equalized the financing of Title I, the largest federal grant program, targeted to supporting schools serving low-income students. Federal grant funding for education in Puerto Rico in 2003 totaled almost \$713 million, up over \$160 million or 29% since 2001.

³ The credit has cost the U.S. Treasury over \$88 billion in 1997 dollars since 1976, and an estimated total of \$1.8 billion in 2003, according to the Joint Committee on Taxation.

⁴ Both customs duty and excise tax collections by the federal government are rebated to Puerto Rico after deducting for administrative costs and refunds.

12. **Federal funds finance highway projects in Puerto Rico, although the federal gasoline tax does not apply on the island.** The federal Highway Trust Fund finances highway construction and maintenance in Puerto Rico and the fifty States through revenues from the federal gasoline tax, which is not paid by motorists in Puerto Rico.

II. Introduction

The principal findings of this report in *Chapter I* are based on a detailed review of Puerto Rico's current treatment under federal tax law and federal spending programs. Estimates are based on fiscal year 2003, or the most recent year with available Puerto Rican and federal data. This introduction, *Chapter II*, provides an overview of the report.

Chapter III reviews Puerto Rico's current tax treatment under federal law. Corporations and residents do not pay all federal taxes on the same basis as in the fifty States. *Chapter III* examines which federal taxes apply to Puerto Rico, and reviews how. It further reviews how much revenue is currently collected from individuals and corporations by type of tax and in total. For context, tax collections in Puerto Rico are compared with the 50 States and the District of Columbia in overall and per capita terms.

Chapter IV analyzes current federal spending in Puerto Rico and examines the current significance of federal transfers to the Puerto Rican government in general, and by budget categories. The differences and similarities between the funding of federal social programs in Puerto Rico and the fifty States are identified. An outline is provided in *Appendix I*. The level of federal spending in Puerto Rico is compared with the 50 States and the District of Columbia, in overall and per capita terms.

Chapter V compares the "net" of federal taxation and spending in Puerto Rico, or the balance of payments Puerto Rico receives from and sends to the federal government each year.

The conclusion, *Chapter VI*, reviews the principal findings of this report and suggests further areas for study. *Appendix I* compares how major federal social programs are funded in Puerto Rico with how they are funded in the rest of the US, drawing on a publication from the House of Representatives Ways and Means Committee.

III. Current Federal Tax Rules and Collections

As a Commonwealth, Puerto Rico is currently treated differently than the fifty States under federal tax laws. Corporations organized in Puerto Rico are treated as foreign corporations under the Internal Revenue Code, and pay no federal income tax. Many U.S. corporations still earn tax free income under the Puerto Rico Economic Activity Credit scheduled to phase out by 2006.⁵ As the credit phases out, many U.S. corporations have restructured as Puerto Rico controlled foreign corporations (CFC's) in order to defer and reduce their federal income tax liability. In effect, Puerto Rico's current foreign status under the Internal Revenue Code prevents the U.S. Treasury from collecting full income taxes on U.S. corporations operating in Puerto Rico and creates an incentive for U.S. firms to move operations outside the "domestic" U.S. (the 50 States and the District of Columbia).

Residents of Puerto Rico are exempt from paying federal income tax on their earnings. They do, however, contribute payroll taxes like Social Security on the same basis as residents of the fifty States. For many U.S. citizens in Puerto Rico, exemption from federal tax also means exclusion from tax-based incentives to encourage work and support families, like the earned income tax credit and child tax credit.

Puerto Rico is also exempt from most federal excise taxes, including the federal gasoline tax which finances highway projects in Puerto Rico and the fifty States. Unlike in any state, customs duties collected in Puerto Rico are refunded, or "covered over" to the Puerto Rican Treasury.

Federal tax collections in Puerto Rico totaled \$4.6 billion in 2003. Most federal collections, \$3.3 billion, came in the form of payroll taxes for Social Security and Medicare paid by Puerto Rico residents and their employers. The remainder of collections is derived mostly from corporations. The amount collected from those corporations would have constituted a fraction of their full Internal Revenue Service tax liability under the domestic Internal Revenue Code. In fact, U.S. corporations have reduced their tax liability in Puerto Rico by almost a quarter, from \$1.60 billion in 2000 to \$1.23 billion in 2003.

It should be recognized that the tax treatment of the residents and corporations of Puerto Rico (including excise, estate and gift taxes) is subject to the control of Congress, and can be changed as deemed appropriate by Congress.⁶

⁵ The Puerto Rican economic activity credit has replaced the possessions tax credit that was repealed by the Small Business Job Protection Act of 1996. The new credit will be phased out by 2006.

⁶ Congress has authority to alter Puerto Rico's tax status unilaterally, to change the tax treatment of Puerto Rico and to extend federal taxes not currently applicable. Federal case law indicates that Congress retains authority over Puerto Rico, under the territorial clause of the Constitution. See *Harris v. Rosario*, 446 U.S. 651 (1980); *United States v. Sanchez*, 992 F.2d 1143 (11th Cir. 1993); U.S. Department of Justice Memorandum dated July 28, 1994, cited in H.R. Rep. 104-713, Pt. 1, p. 21-22. Congress has already applied federal tax laws to Puerto Rico without its consent on several occasions. For example, Congress changed the Section 936 tax credit on numerous occasions since 1982 and extended federal estate and gift taxes to certain resident Puerto Ricans in 1958.

A. Payroll Taxes

Social Security/Medicare. Puerto Rican taxpayers pay Social Security (OASDI) and Medicare (HI) taxes on the same basis as taxpayers in the fifty states and the District of Columbia. In 2001, Puerto Ricans paid \$2.98 billion in Social Security and Medicare taxes (\$2.374 billion in Social Security and \$606 million in Medicare). According to Social Security Administration estimates, 1.194 million Puerto Rican workers contributed to Social Security and 1.26 million contributed to Medicare (Social Security Administration, 2004). Since 1997, U.S. citizens in Puerto Rico have contributed an estimated \$16.76 billion (see Table 2 below).

Table 1: Social Security and Medicare Payments from Puerto Rico, 1997-2003
(millions of dollars)

Year ¹	Total	Wages and Salaries	Self-Employment
1997	\$2,407	\$2,253	\$154
1998	\$2,478	\$2,322	\$156
1999	\$2,669	\$2,503	\$165
2000	\$2,855	\$2,676	\$179
2001	\$2,980	\$2,803	\$177
2002	\$3,144	\$2,957	\$187
2003	\$3,317	\$3,120	\$197

Notes: ¹ Expressed in calendar (not fiscal) years. ² 2002 and 2003 figures are estimated based on historical growth rates.

Source: Social Security Administration, Office of Research, Evaluation, and Statistics. (2004) *Annual Statistical Supplement to the Social Security Bulletin*. Washington, D.C.: U.S. Government Printing Office.

Unemployment insurance payments. Puerto Ricans also pay taxes for unemployment insurance on the same basis as workers in fifty States under the Federal Unemployment Tax Act.⁷ In 2003, Puerto Rican workers paid \$39.1 million in unemployment insurance taxes, a little less than the average of \$39.9 million they have paid since 1998. See Table 2 below.

Table 2: Unemployment Insurance Contributions by Puerto Ricans, 1998 – 2003
(millions of dollars)

<u>Year</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
Contribution	\$39.1	\$39.2	\$41.4	\$40.9	\$39.5	\$39.1

Source: *IRS Data Book*, Table 6.

B. Federal income tax

1. Individuals

Residents of Puerto Rico are exempt from paying federal income tax on income derived within Puerto Rico, under section 933 of the Internal Revenue Code. Exemption from federal income taxes also excludes many U.S. citizens in Puerto Rico from receiving direct benefits delivered through the Code. Income earned outside Puerto Rico by U.S. persons is

⁷ Guam, American Samoa, and the Northern Marianas are not subject to unemployment insurance payments.

generally subject to U.S. taxation. Individuals are, however, subject to the local Puerto Rican income tax.

Other U.S. territories, such as the Virgin Islands, Guam and the Northern Marianas, are required to use the federal income tax system as their own. This so-called “mirror” tax system then reflects any ongoing changes in the U.S. Code. Puerto Rico does not apply the U.S. Code, but utilizes its own income tax rates and regulations.

Federal tax credits for individuals. Because they are exempt from federal income taxation, individuals in Puerto Rico are not eligible for most federal tax credits or incentives. Most credits are not refundable, meaning that they do not result in a payment to the taxpayer beyond federal taxes already paid. For example, the dependent care tax credit (DCTC) provides a credit against federal tax liability for some costs of providing for dependents, but it does not create a refund beyond federal tax paid. Therefore, in respect to most federal tax credits, residents of Puerto Rico are not adversely affected by their exemption from paying individual federal taxes.

However, Puerto Ricans are not fully eligible for two refundable tax credits for individual filers that serve as major social welfare programs in the fifty States: the earned income tax credit (EITC) and the child tax credit (CTC). Inclusion within the U.S. Code would provide significant benefits for many residents of Puerto Rico, who now pay U.S. payroll taxes for Social Security and Medicare.

Earned income tax credit. A refundable tax credit available to low-income working taxpayers, the EITC has become one of the nation’s largest social welfare programs, reducing the tax receipts from low-income Americans and directing funds to working families in the amount of over \$34 billion in 2004 (Joint Committee on Taxation, 2003). The EITC was designed to reduce the tax burden, reward work, and reduce poverty among working families. It is estimated that 3.7 million Americans were lifted out of poverty by the EITC in 1995 (Schotz, 1997). Unlike other credits, the EITC is refundable, meaning that any excess of the credit over tax liability results in a payment to the taxpayer. The refund was intended to offset the payroll taxes paid by low-income workers and their employers for Social Security and Medicare. Because residents of Puerto Rico are exempt from paying federal individual income tax, they are not eligible to receive payments through the EITC.

Because of low incomes, a majority of Puerto Rican workers and families would benefit from the extension of the federal tax Code to Puerto Rico. These low-income workers contribute over \$3 billion annually in Social Security and Medicare payroll taxes, which would have been partly offset by EITC payments had they lived in the 50 States or the District of Columbia. In fact, about 58% of married couples with children would receive some benefits under the EITC were the Code to apply in Puerto Rico. 69% of single working mothers would also receive some support under the EITC.

Child tax credit. In the 50 States and the District of Columbia, low-income workers are eligible to receive a refundable tax credit of as much as \$1,000 per child. The refund was partly designed to offset payroll taxes paid by the worker and operates only to the extent that it exceeds payments already made to the worker through the EITC. In the 50 States, the

EITC payroll tax refunds are enough to offset tax liability for the first two children in the family. In Puerto Rico, only residents that file a U.S. income tax return and who have three or more children can currently claim the child tax credit. In effect, because the EITC does not apply in Puerto Rico, low-income families with one and two children do not receive tax relief to counter their payroll taxes. However, because middle-income families in Puerto Rico do not have federal tax liability, they are eligible for refunds (where they would not be in the rest of the U.S. had they been subject to federal income tax).

An unreleased report from the Internal Revenue Service notes that 152,000 Puerto Rican families were eligible to receive refunds through the existing child tax credit (limited to families with three or more children). Last year, only a fraction of eligible families, 35,000, filed to receive about \$50 million in benefits. The Joint Committee on Taxation estimates that removing the child tax credit in Puerto Rico would cut payments to families by \$859 million over five years, and \$2.122 billion over 10 years.

2. Corporations

Puerto Rico corporations. Corporations organized under the laws of Puerto Rico do not pay federal income tax on any income derived in Puerto Rico, or so-called Puerto Rican “source income.” Corporations chartered in the territories are considered “foreign” corporations under the U.S. Internal Revenue Code, and are treated the same as corporations in Ireland, Mexico, or any other foreign country. Corporations organized in Puerto Rico are liable for paying local Puerto Rican income taxes.

U.S. corporations. U.S. corporations with subsidiaries or branches operating in Puerto Rico still receive significant tax breaks through the Puerto Rico economic activity credit. Now being phased out to end by 2006, the credit effectively provides many U.S. corporations with an exemption from federal taxation on income from operations and investments in Puerto Rico. As the credit phases out, U.S. corporations have taken advantage of Puerto Rico’s tax status to defer and reduce their federal tax liability by restructuring as controlled foreign corporations (CFC’s). Legislation previously under consideration in Congress (H.R. 2550 and S. 1475) proposed that US CFC’s operating in Puerto Rico be provided with an almost total (90%) credit against their profits generated in Puerto Rico, effectively imposing a similar cost to the U.S. taxpayer as Section 936 did in the past, in addition to subjecting the U.S. taxpayer and U.S. government to World Trade Organization (WTO) legal action.

Federal income tax collections from U.S. corporations operating in Puerto Rico have declined by about \$400 million, or almost a quarter, since 2000 (declining from \$1.60 billion in 2000 to \$1.26 billion in 2003). In fact, despite the phase-out of Section 936, tax collections from U.S. corporations operating in Puerto Rico have not markedly changed since 1996, when collections totaled \$1.23 billion.

The change in the Joint Committee on Taxation’s projected value of the Puerto Rico Economic Activity Credit reflect the successful avoidance of federal tax liability by U.S. corporations operating in Puerto Rico.

The Puerto Rico Economic Activity Credit. Under this tax credit, U.S. corporations operating in Puerto Rico are still exempt from paying federal income tax on some earnings in Puerto Rico. Established in 1976, the credit (originally known as “Section 936” for its location in the Internal Revenue Code) was intended to help bring U.S. investment and economic development to Puerto Rico and the other U.S. possessions. The credit effectively allowed U.S. corporations to earn income from operations and investments in Puerto Rico free from federal income tax. The credit was substantially reduced in 1993, and in 1996 Congress repealed the tax credit for new corporations and phased out the credit for existing claimants, ending all benefits by 2006.⁸

Profits repatriated to mainland corporations from their Section 936 Puerto Rican operations increased rapidly in the 1980’s and 1990’s, and the value of the credit peaked at \$4.6 billion in 1993 (Nutter, 2003). The total value of the credit claimed by U.S. corporations has declined each successive year. The most recent audit from 1999 corporate tax returns estimates the annual value at \$1.6 billion (Nutter, 2003).

Table 5: US Possessions Corporations and Credit Value, 1983-1999
(billions of dollars)

	Number of corporations	Value of credit
1983	553	\$ 2.00
1986	510	\$ 2.40
1987	452	\$ 2.80
1989	434	\$ 2.80
1991	402	\$ 3.50
1993	395	\$ 4.60
1995	353	\$ 3.10
1997	310	\$ 2.80
1999	206	\$ 1.60

Source: Nutter, Sarah. (2003). US Possessions Corporations 1997 and 1999. *Statistics of Income Bulletin*, Summer 2003.

The credit has totaled more than \$90 billion in 1997 dollars since its inception in 1976. Despite the phase-out, the credit will cost the Treasury an estimated \$1.4 billion in 2004. See Table 6 below.

⁸ New rules for existing claimants are provided in section 30A of the Internal Revenue Code.

Table 6: Estimated Tax Expenditures for Federal Tax Credits to Corporations Operating in Puerto Rico, FY 2004 – 2008 (billions of dollars)

	2004	2005	2006	Total
Tax credit	\$1.4	\$1.2	\$0.3	\$2.9

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2006*, Table 1, p. 29.

The estimated annual cost of the Puerto Rico Economic Activity Credit has declined in large part because the alternative for U.S. corporations, becoming controlled foreign corporations, has become more costly to the U.S. Treasury. Table 7 below lists the annual estimates from the Joint Committee on Taxation (Estimates of Federal Tax Expenditures) on the cost of the credit over the subsequent five years, starting in 1996.

For example, the Joint Committee on Taxation in 1999 through 2001 estimated the cost of the credit at about \$3.2 billion for fiscal year 2003. However, over the following two years, the estimated cost of the credit dropped almost in half, to \$1.8 billion. U.S. corporations were shifting their operations to controlled foreign corporations. Joint Tax reduced the “cost” of the credit down to reflect that U.S. corporations now organized as CFC’s were not paying federal tax as had been initially expected. The expected “cost” of the credit dropped the most for 2005, the last full year of the phase-out, from the \$2.8 billion estimated in 2002 to the most recent \$1.2 billion prediction. In fact, estimated revenue costs of the credit have dropped by a non-trivial \$5.8 billion over the five-year 2002-2006 period.

Table 7. Estimates of the Tax Costs of the Puerto Rico Economic Activity Credit, 1999 – 2004, in billions

1999	2000	2001	2002	2003	2004	2005	2006
\$3.6	\$3.8	\$4.0	\$3.6	\$3.2			
	\$3.8	\$4.0	\$3.6	\$3.2	\$3.0		
		\$4.0	\$3.6	\$3.2	\$3.0	\$2.8	
			\$2.6	\$2.2	\$2.0	\$1.8	\$0.5
				\$1.8	\$1.6	\$1.4	\$0.4
					\$1.4	\$1.2	\$0.3

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2006*, Table 1.

Revenues expected from the repeal and phase-out of section 936 simply did not materialize. The Joint Committee on Taxation had estimated that repealing and phasing out Section 936 would create over \$600 million in additional corporate income tax revenue from 2000 to 2003.⁹ In fact, corporate income taxes collected from U.S. corporations in Puerto Rico fell by over \$348 million during this period.¹⁰

Controlled foreign corporations. Most U.S. corporations operating in Puerto Rico have restructured operations left uncovered by the phasing out of the PR Economic Activity

⁹ A marginal increase from \$498 million in additional revenue from 2000 to \$1.116 billion in 2003. (Joint Committee on Taxation, 1996).

¹⁰ Corporate income taxes collected in Puerto Rico dropped from \$1.604 billion in 2000 to \$1.256 billion in 2003.

Credit as controlled foreign corporations (CFC's), since Puerto Rico is considered "foreign" under the U.S. tax Code. CFC's enjoy significant tax benefits over U.S. corporations. Profits earned in Puerto Rico are not immediately subject to federal corporate taxation, but can be kept outside the United States. Taxes need not be paid until the profits are repatriated to the U.S. parent company. Deferring tax liability from Puerto Rico operations effectively enables U.S. corporations to reduce their federal tax liability. The Joint Committee on Taxation estimates that the total cost of allowing the deferral of taxation by all U.S. controlled foreign corporations will be \$4.6 billion in 2004, and \$4.8 billion in 2005 (Joint Committee on Taxation, 2003).

Little information is available on the changing corporate structure of U.S. corporations in Puerto Rico. However, the purported savings from the phase-out of Section 936 have not materialized. Current income tax collections from U.S. corporations in Puerto Rico total \$1.26 billion, only \$30 million more than was collected in 1996, the year Congress voted to phase out the credit.

U.S. source income. Both residents and corporations in Puerto Rico are liable for taxes on income earned in the U.S. (U.S. "source income"). Table 8 below indicates that Puerto Rico-based corporations and individuals residing in Puerto Rico pay income tax on limited earnings in the U.S., totaling \$380 million in 2000, accountable almost entirely from U.S. corporations and their interest and dividends from U.S. financial holdings.

Table 8: U.S. Source Income and Taxes Withheld in Puerto Rico, 2000
(thousands of dollars)

	Number of returns	US tax withheld	US Source Income	Interest	Dividends	Rents	Social Security	Personal services income
Total	14,777	\$2,407	\$380,193	\$375,956	\$3,737	\$49	\$3	\$5
Individuals	10,349	\$182	\$1,106	\$260	\$500	\$44	\$3	\$5
Corporations	905	\$390	\$174,181	\$172,523	\$1,510	\$5--	--	--

Source IRS, *Data Book – 2003*, Table 6. It is unclear why the individual and corporate figures do not add up.

Enterprise Zone / Enterprise Community. The enterprise zone / enterprise community (EZ/EC) program is designed to promote broad economic development and self-sufficiency in low-income communities by employing a range of federal assistance programs. Assistance includes Social Service Block Grants through the Department of Health and Human Services, tax breaks, grants, and financing benefits.¹¹ Designation as an EZ or EC is based on a variety of criteria, including degree of need and the quality of the strategic plan submitted by the community. Communities in Puerto Rico are not currently eligible to apply for either designation, but could be eligible for these incentives if tax and spending parity was introduced.

Other credits. Corporations operating in the U.S. are eligible for two tax credits designed to encourage the hiring of welfare recipients: the work opportunity tax credit (WOTC) and the welfare-to-work tax credit. U.S.-chartered corporations operating in Puerto Rico are eligible

¹¹ Block grants were set at \$40 million for each rural Empowerment Zone; \$100 million for each urban Empowerment Zone; and \$2,947,368 for each Enterprise Community.

for these tax credits because federal tax is levied on the total international income. Corporations based in Puerto Rico, however, are not subject to the federal corporate income tax system and are not, therefore, qualified to receive federal tax credits.

C. Estate and gift taxes

Federal estate and gift taxes do not apply to residents of Puerto Rico on the same basis as in the fifty States. Federal tax law exempts life-long residents of Puerto Rico but applies tax on the estate and gifts of U.S. citizens born in the U.S. who have moved to Puerto Rico. Residents of Puerto Rico do pay estate and gift taxes on property owned in the fifty States. These revenues represent only a small fraction of total federal revenues from Puerto Rico, amounting to only \$22.3 million in 2004 (IRS, 2003).

D. Excise taxes and customs duties

Excise taxes. Most federal excise taxes do not apply to goods consumed in Puerto Rico, even if they are not imported from the U.S.¹² A special excise tax is levied on goods produced in Puerto Rico and shipped to the U.S., and set at the same level as the federal excise tax for articles manufactured in the U.S.¹³ A majority of these revenues come from taxes on rum.¹⁴ After administrative costs and refunds are deducted, revenues collected are transferred, or “covered over” to the Puerto Rico Treasury. Excise taxes can be fully applied under Commonwealth status; statehood would require their application.

The federal gasoline tax, for example, now 18.4 cents per gallon in the U.S., does not apply in Puerto Rico. Instead, the Puerto Rican government imposes its own 16 cents per gallon tax (comparable to the U.S. average of about 19 cents per gallon) (Federal Highway Administration, 2002) and spends the revenues on transportation projects. Proceeds from the federal gas tax in the fifty States flow to the federal Highway Trust Fund, from which funds are allocated to the States for transportation projects on the basis of prior funding, miles of highway, and other criteria. Although its residents do not contribute to the federal Highway Trust Fund, Puerto Rico does receive funding through the Fund for highway projects.

Puerto Rico received \$38 million from the federal Highway Trust Fund in 2002, and \$125 million from the Federal Transit Administration in 2003 (Federal Transit Authority, 2003). From 1956 through 2002, Puerto Rico received \$1.873 billion in funding through the Highway Trust Fund (not adjusting for inflation) (Federal Highway Administration, 2004).

Customs duties. The federal government collects tariffs on goods imported into Puerto Rico, which is part of the U.S. “customs territory.”¹⁵ However, no taxes are collected on

¹² Some products imported from outside the U.S. are subject to taxation in Puerto Rico, including petroleum and some chemicals.

¹³ Under Section 7652 of the Internal Revenue Code.

¹⁴ An excise tax of \$13.50 per proof gallon is levied, of which \$11.30 is transferred to Puerto Rico. A similar arrangement is in place with the Virgin Islands. Both territories also share the revenues on excise taxes imposed on rum imported from foreign countries into the U.S.

¹⁵ The four other territories are outside the U.S. customs area, although the U.S. Customs Service helps the Virgin Islands to collect its local customs duties.

goods imported into Puerto Rico from the fifty States.¹⁶ Trade between Puerto Rico and the fifty States is not subject to tariffs or any of the restrictions or requirements applicable to trade with foreign countries. Puerto Rico now receives the customs duties (net of refunds and expenses) collected in its territory. No U.S. State has a similar arrangement. See Table 9 below for customs duty and excise tax revenues rebated to the Puerto Rico Treasury by the federal government since 1999.

Table 9: Customs Duty and Excise Tax Collections Rebated to Puerto Rico, 1999 – 2002 (millions of dollars)

	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
Customs duties	61.4	50.2	43.1	30.6
Excise duties	217.3	245.7	286.9	214.2
Total	278.7	295.9	330.0	344.8

Source: Commonwealth of Puerto Rico, Office of the Governor, Planning Board: *Economic Report to the Governor 2002*, Table 28.

These excise and customs rebates to Puerto Rico together totaled \$351 million for the federal 2002 fiscal year.¹⁷ See Chapter IV on current federal transfers to Puerto Rico.

E. Other tax provisions

Interest from bonds issued by the Puerto Rican government is exempt from U.S. income tax,¹⁸ like the interest from bonds issued by any State. Interest is also exempt from state and local taxation, providing Puerto Rico with the only “triple-exempt” bonds (exempt from federal, state, and local tax) in the U.S.

F. Total federal revenues

Internal Revenue Service collections in Puerto Rico, including payroll withholding taxes, federal withholding on U.S. source income, gift and estate taxes, and some excise tax revenues totaled \$4.604 billion in fiscal year 2003.

Table 10: Federal Internal Revenue Collections in Puerto Rico, FY 2000-2003. (billions of dollars)

	2000	2001	2002	2003
Corporate income tax	\$1.604	\$1.380	\$1.327	\$1.256
Individual income and Social Security contributions	\$3.031	\$3.253	\$3.183	\$3.285
Unemployment insurance	\$0.041	0.041	\$0.039	\$0.039
Estate and gift tax	\$0.009	0.007	\$0.005	\$0.022
Excise taxes collected by IRS	\$0.0003	0.002	\$0.0003	\$0.00002
Total	\$4.686	\$4.683	\$4.554	\$4.604

Source: IRS, *IRS Data Book*, Table 6, various years.

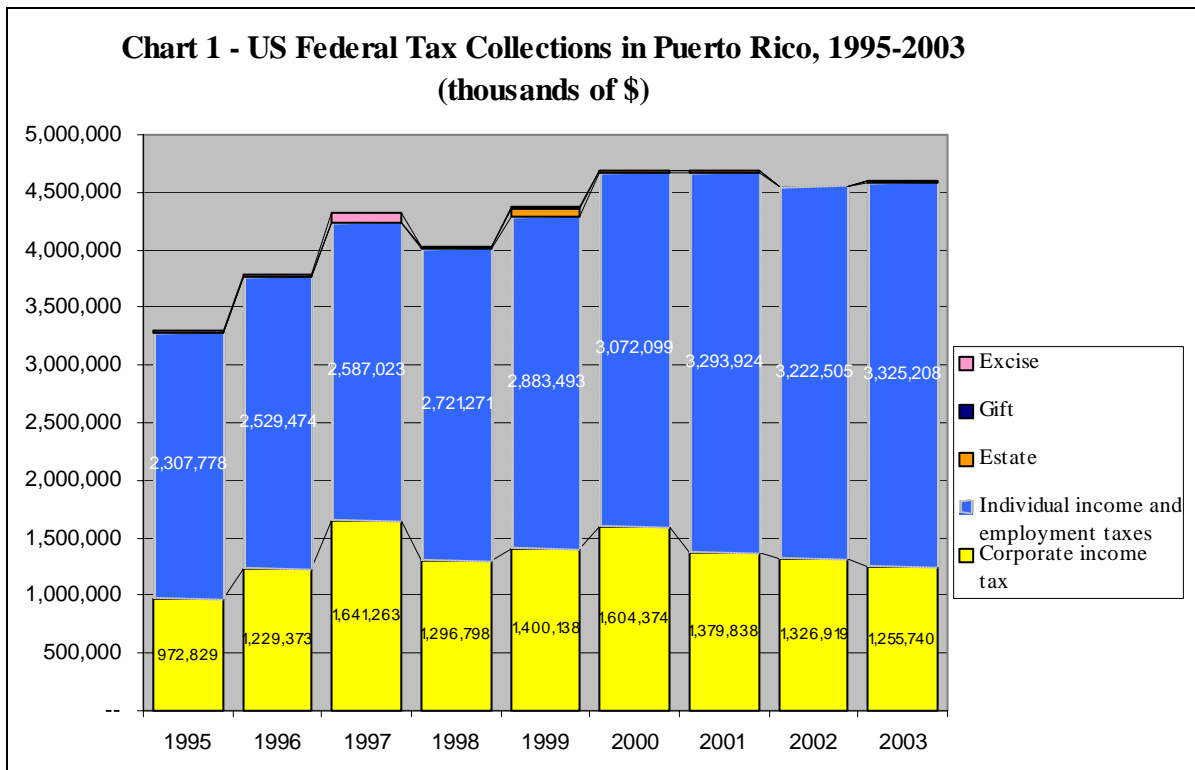
¹⁶ Under Section 7653 of the Internal Revenue Code.

¹⁷ Rebates were \$345 million for the Puerto Rican fiscal year. The Puerto Rican fiscal year ends on June 30, the federal fiscal year on September 30.

¹⁸ Under Section 103(a) of the Internal Revenue Code.

IRS collections in Puerto Rico from 2000 to 2003 are listed in the table above. These figures represent collections, not the geographic *incidence* of taxation. The actual incidence of taxation in Puerto Rico may be different than the collection figures. For example, corporate taxes are listed as being paid from Puerto Rico, although the final incidence of the taxes may have fallen on stockholders, employees and consumers who lived outside Puerto Rico.

Chart 1 below illustrates that between 1995 and 2000 tax collections increased by over 40%, from \$3.3 billion to \$4.7 billion. Overall collections have since stagnated, declining by about 2% since 2000.



Source. IRS, *IRS Data Book*, Table 6, various years.

IV. Current Federal Spending

Federal spending in Puerto Rico totaled \$14.66 billion in 2003, up 4.3% from 2002. Per capita, Puerto Rico received less federal spending than any state. With Puerto Rico's income per capita at a third of US levels, federal spending contributed a higher share of the local economy than in any state. Almost two-thirds of federal spending in Puerto Rico is taken up by "earned" payments to individuals, such as Social Security, Medicare, and veterans benefits. However, unearned payments to individuals, government grants and federal wages and salaries total over \$6 billion annually, not including the continuing cost of tax credits for U.S. corporations. Since 1952, Puerto Rico has cost the U.S. Treasury an estimated \$200 billion in 1997 dollars.

A. Total federal spending

In fiscal year 2003, the federal government spent \$14.66 billion in Puerto Rico, according to the Census Department (Census Dept., 2003). A majority of federal spending (57%) took the form of direct payments to individuals living in Puerto Rico, including retirement, disability, and veteran's benefits. Grants to the Puerto Rico and municipal governments comprised an additional 33% of spending, which included nutritional assistance, highway aid, medical aid, and customs duties shared with the government. The remaining 10% of spending went to the salaries and wages of federal employees and the procurement needs of federal agencies in Puerto Rico. See Table 11 below.

Table 11: Total Federal Expenditures in Puerto Rico, FY 2003

(millions of dollars)

Direct payments for individuals	\$8,324
Grants to state and local governments and other recipients	\$4,808
Salaries and wages	\$968
Procurement	\$561
Total	\$14,661

Source: Census Department, *Consolidated Federal Funds Report for Fiscal Year 2003*.

Table 1. Federal fiscal year.

Per capita spending. In 2003, the federal government spent \$3,780 per capita in Puerto Rico, about 55% of the per capita spending in the U.S. as a whole (\$6,910). In fact, Puerto Rico received less per capita than any state. In per capita terms, Nevada received the least federal spending of the states, \$4,939, while Alaska received the most, \$11,746. However, because of lower per capita income levels in Puerto Rico, federal spending in Puerto Rico as a percentage of income is significantly higher than in any state.

In 2003, overall federal spending in Puerto Rico grew 4.3%, or by about \$598 million over the previous year, and 30.1% over the past five years (since 1998). Over the past five years,

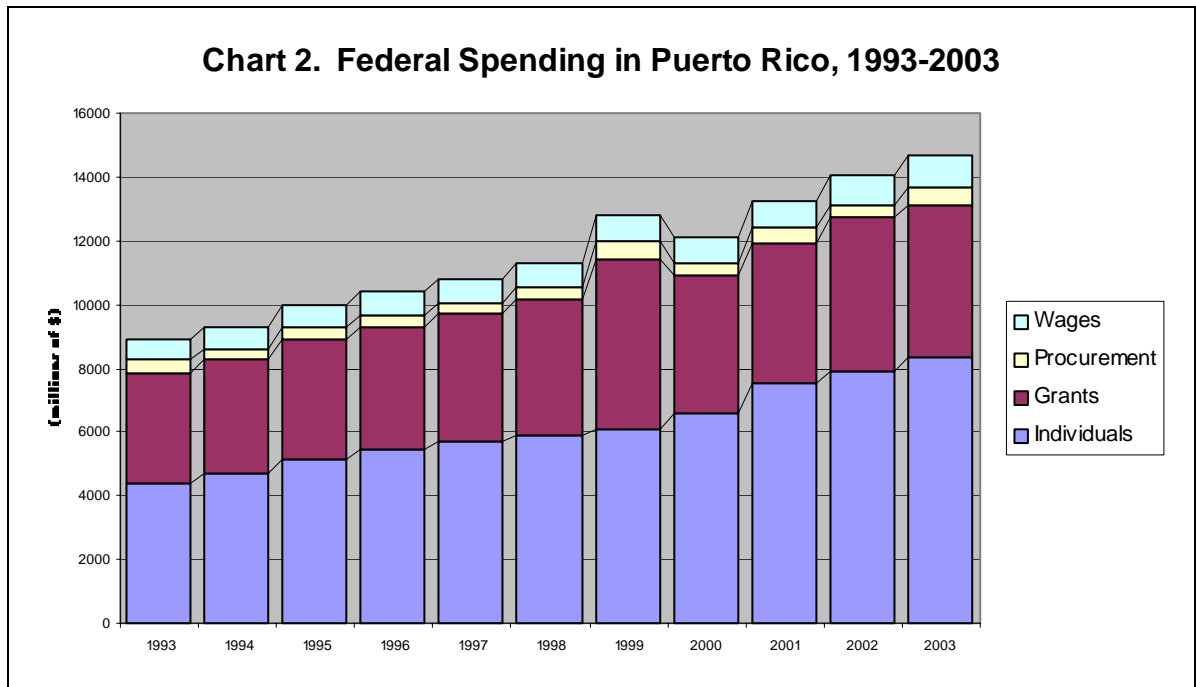
federal spending in Puerto Rico has increased at an average rate of 5.8% annually. As Table 12 illustrates, federal spending decreased in 2000 and recovered lost ground in 2001.

Table 12. Federal Spending in Puerto Rico, 1998 – 2003

	1998	1999	2000	2001	2002	2003
Total spending	\$11,266.59	\$13,257.34	\$12,127.72	\$13,263.90	\$14,062.24	\$14,661.23
Annual change		\$1,990.75	-\$1,129.62	\$1,136.18	\$798.34	\$598.99
% change		17.7%	-8.5%	9.4%	6.0%	4.3%

Source. US Census Bureau, *Consolidated Federal Funds Reports*, various years.

The chart below illustrates the steady growth in federal spending in Puerto Rico over the past 10 years.



Over the past 10 years, total federal spending in Puerto Rico has increased at a comparable rate to that of the United States as a whole. From 1994 to 2003, spending increased in Puerto Rico by 58%, slightly more than the 57.2% growth overall in the U.S. Comparable growth rates have not caught up per capita spending with the rest of the country. Projected future declines in defense spending in Puerto Rico with the closure of the Roosevelt Roads Naval Station will make catching up even more difficult.

Federal spending contributes a relatively large proportion of the Puerto Rican economy in comparison to the rest of the United States. In 2003, federal spending in Puerto Rico as measured by the Census Bureau totaled about 31% of the island's gross product.¹⁹ In

¹⁹ Gross product is a more appropriate measure of the Puerto Rican economy than gross domestic product. About a third of gross domestic product in Puerto Rico flows out of the island in the form of repatriated profits to mainland U.S. corporations.

comparison, federal spending amounted to 19% of gross domestic product in the U.S.,²⁰ about 60% of the Puerto Rican level.

B. Measuring federal spending

The best source of information on federal transfers to the states and territories is an annual publication by the Bureau of the Census, the *Consolidated Federal Funds Report*. The Census Bureau's data does not correspond exactly to figures in the President's budget, because certain areas of the budget, like foreign aid and some military spending, are not included in the Census data. The Census also does not attempt to distribute other general federal spending like deposit insurance, net interest, and undistributed net receipts by geographical region. Nevertheless, the Census publication compiles information on transfers to States and Territories like Puerto Rico for almost all federal programs consistent with standard budget concepts.

C. Federal spending by category

1. Payments to individuals

Most federal funds spent in Puerto Rico are direct federal transfers, or payments to individuals, which totaled \$8.3 billion in FY 2003, and comprised 57% of all federal spending. In terms of size, Social Security is by far the largest federal program in Puerto Rico, funded at \$4.724 billion, followed by Medicare, which is funded at \$1.562 billion. Puerto Rican workers and their employers contribute payroll taxes for these benefits on the same basis as residents of the 50 States and the District of Columbia. Benefits for veterans living in Puerto Rico earned from service in the U.S. military total \$423 million. Table 13 below lists the major direct transfer programs in Puerto Rico in 2003 in order of size. Largely reflecting the lower incomes in Puerto Rico (which partly determine social security benefits), total payments to individuals (both retirement and disability, and other payments) amounted to \$2,146 per capita in FY 2003, about 58% of the U.S. average of \$3,690.

Several differences distinguish the direct transfer programs in Puerto Rico from the fifty States. The Food Stamp Program does not exist as a direct transfer in Puerto Rico, but as the Nutrition Assistance Block Grant to the Puerto Rican government, under which Puerto Rico has greater flexibility in program design than the fifty States. The Supplemental Security Income program does not exist in Puerto Rico either. Instead, the federal government continues to fund its predecessor programs for the needy, aged, blind and disabled, which no longer operate in the fifty States, under the Social Security Act. See Appendix 1 for differences in the funding of social welfare programs in Puerto Rico.

²⁰ Federal spending in the U.S. in FY 2002 totaled \$2.061 trillion, and gross domestic product totaled \$11.004 trillion.

Table 13: Federal Transfers to Individuals in Puerto Rico, FY 2003
(thousands of dollars)

Total	8,324,088
Social security	4,724,459
Medicare	1,561,599
Other	809,966
Veterans benefits	423,246
Federal retirement and disability	292,543
Unemployment	287,006
Housing assistance	115,686
Federal employee life and health	49,815
Agricultural assistance	19,440
Earned income tax credit	3,173

Source: Census Bureau, *Consolidated Federal Funds Report for Fiscal Year 2003, Table 2.*

The large majority of federal transfers to individuals listed in the table above are so-called “earned” benefits, for which payments have already been made under payroll contributions or through services rendered, like military service or federal employment.

2. Grants to the Puerto Rican central and municipal governments

Federal transfers to the Commonwealth and municipal governments of Puerto Rico in FY 2003 totaled \$4.808 billion. Table 14 below lists the distribution of grants by federal agency. By far the largest federally funded program in Puerto Rico is the Nutritional Assistance Program (NAP) block grant, which replaced the Food Stamp Program and constitutes the largest federal means-tested program on the island.²¹ Placed in context, as measured by recurrent funds, federal funds represented about 27% of the Puerto Rico government budget.²² Federal government grants amounted to \$1,239 per capita in Puerto Rico, lower than most States, but comparable to the U.S. average of \$1,496.

Table 14: Federal Grants to Commonwealth and Local Governments
FY 2003 (thousands of dollars)

Total	\$ 4,807,666
Dept of Agriculture	\$ 1,796,308
Dept of Commerce	\$ 11,382
Corp for Natl and Comty Service	\$ 7,345
Corp for Pub Broadcasting	\$ 3,317
Dept of Defense	\$ 19,701
Dept of Education	\$ 712,753
Election Assistance	\$ 3,151

²¹ Food Stamps in the fifty States are considered a payment-to-individuals program, and do not fit in the grants-to-government category.

²² Measured according to the Puerto Rican fiscal year. Federal transfers include customs and excise cover-overs (Puerto Rico Planning Board, 2003).

Dept of Energy	\$	1,215
Environmental Protection Agency	\$	14,894
Equal Employment Opportunity Commission	\$	383
Dept of Health and Human Services	\$	865,042
Homeland Security	\$	79,267
Housing and Urban Development	\$	532,959
Museum and Library Services	\$	2,107
Dept of Interior	\$	4,944
Dept of Justice	\$	64,131
Dept of Labor	\$	219,585
NASA	\$	4,477
National Endowment for the Arts	\$	629
National Endowment for the Humanities	\$	832
National Science Foundation	\$	27,346
Social Security Administration		-
Dept of State	\$	242
State Justice Institute		-
Dept of Transportation	\$	75,555
Dept of Treasury	\$	358,705
Dept of Veterans Affairs	\$	966
Other	\$	429

Source: Census Bureau, *Consolidated Federal Funds Report, FY 2003, Table 4.*

Transfers included Treasury Department rebates of excise taxes and custom duties collected in Puerto Rico that totaled \$337 million in FY 2003.

3. Salaries and wages

The federal government spent \$968 million on the wages and salaries of its personnel in Puerto Rico in FY 2003. Table 15 below provides more detailed information on the federal government's spending on wages and salaries by federal department in Puerto Rico. As the table indicates, the biggest spender on personnel was the Defense Department at \$267 million, followed by the Post Office, the Veteran's Administration, and the Justice Department. Spending on salaries and wages in Puerto Rico is \$250 per capita, lower than in any state, and 35% of the U.S. average (\$713).

Table 15: Federal Spending on Wages and Salaries, FY 2003
(in thousands of dollars)

Total	968,168
-Department of Defense	266,898
-Non-defense agencies	701,282
Agriculture	31,967

Commerce	2,450
Education	403
Energy	-
Environmental Protection Agency	3285
Federal Deposit Insurance Corporation	712
General Services Agency	2,024
Health and Human Services	8,703
Homeland Security	51,275
Housing and Urban Development	6,343
Interior	8,185
Justice	71,225
Labor	2,438
Postal Service	224,346
Small Business Administration	2,439
Social Security Administration	25,603
Transportation	31,660
Treasury	41,765
Veterans Affairs	135,270
Other nondefense	24,020

Source: Census Bureau, *Consolidated Federal Funds Report for Fiscal Year 2003*, Table 6.

4. Procurement

The federal government spent \$561 million purchasing goods and services in Puerto Rico. At \$145 per capita, procurement expenditure in Puerto Rico is a fraction of federal spending in the fifty states, where the spending is \$1,011 per capita. In fact, per capita non-defense procurement in Puerto Rico composes a lower portion of all spending than in the fifty States. In the U.S. as a whole, non-defense spending comprises 40% of the all spending; in Puerto Rico, it only contributes 28%. Much of the existing military procurement has been related to the naval bases in Puerto Rico, particularly at Roosevelt Roads, one of the largest U.S. naval facilities in the world. With the closure of the Roosevelt Roads Naval Station in early 2004, it is likely that federal procurement spending in Puerto Rico will decline significantly in subsequent years. Table 16 below provides background on the procurement spending for all federal agencies in Puerto Rico.

Table 16: Federal Procurement in Puerto Rico, FY 2003
(thousands of dollars)

Total	561,295
<i>-Department of Defense</i>	401,964
<i>-Non-defense Agencies</i>	158,331
Agriculture	4,712
Commerce	267

Education	182
Energy	-
Environmental Protection Agency	-
General Services Administration	22,496
Health and Human Services	3,360
Homeland Security	19,172
Housing and Urban Development	231
Interior	1,317
Justice	1,407
Labor	20,925
National Aeronautics and Space Admin.	198
Postal Service	60,762
Social Security Administration	141
Transportation	1,051
Treasury	19
Veterans	21,693
Other non-defense	447

Source: Census Bureau, Consolidated Federal Funds Report for Fiscal Year 2003, Table 5.

5. Loans and insurance

The federal government also issued \$154 million in direct loans and \$1.259 billion in guaranteed loans in Puerto Rico during FY 2003. These loans are not recorded as federal expenditures, as they do not represent actual spending. Direct loans included \$72 million in U.S.D.A. loans and \$82 million in direct student loans. The largest category of federal guaranteed loans was mortgage insurance for homes at \$780 million.

D. Different funding of selected social, health and education programs

Most federal programs are available on the same basis in Puerto Rico as in the fifty States. However, Puerto Ricans receive funding at lower levels from several health and social welfare programs and are often subject to different eligibility rules. Appendix 1 reviews Puerto Rican eligibility for selected major federal social welfare programs and the different rules for funding currently in place.

1. Payments to individuals

Residents of Puerto Rico are eligible for most federal social welfare programs that provide direct transfers to individuals on the same basis as U.S. citizens in the fifty States, including for Social Security, Medicare, Pell Grants, and other major programs. These programs are entirely funded by the federal government, and impose no fiscal burden on Puerto Rico. Most direct payment programs operate on the same basis as in the U.S., with the primary exception of the Supplemental Security Income (SSI) program, which does not exist in Puerto Rico. The payment rates for medical services under Medicare are generally lower in Puerto Rico than in the States, but rates also differ across the States on the basis of regional health care costs.

SSI. The Supplemental Security Income (SSI) program, which provides cash payments to needy adults who are aged, blind or disabled, does not operate in Puerto Rico. Its predecessor programs, which provided matching grants to State governments, were not replaced by SSI in Puerto Rico and continue today.²³ Under SSI, individuals receive benefits set by the federal government. In the case of the old public assistance programs for adults, the Puerto Rican government has the authority to set benefit levels.

Federal funding for all public assistance programs in Puerto Rico is capped into a block grant each year. The block grant covers the adult public assistance programs; the Temporary Assistance for Needy Families (TANF) program, which replaced the AFDC program; and programs for foster care, adoption assistance and independent living, which fall under title IV-E of the Social Security Act.

Medicare funding. Medicare benefits are received by individuals on the same basis in Puerto Rico as in the fifty States. Hospitals, however, are reimbursed under a separate prospective payment schedule (PPS) that generally results in a lower reimbursement rate. Hospitals in Puerto Rico were previously paid a blended rate of 50% of the full federal rate and 50% of the reduced Puerto Rico payment rate. Under the recent Medicare legislation,²⁴ hospitals in Puerto Rico received a 62.5% federal rate / 37.5% Puerto Rico rate from April 1 to September 30, 2004. Since October 1, 2004, the blend has increased to a 75% Federal and 25% Puerto Rico blended rate. It is estimated that hospitals in Puerto Rico will receive an additional \$400 million over 10 years from these provisions.

2. Federal-Commonwealth programs

Puerto Rico is also eligible for all standard social welfare programs that are jointly administered by the federal and state governments, with the exception of the Food Stamp Program, which is administered as a block grant in Puerto Rico. Funding is determined on a different basis in Puerto Rico for several grant programs, including: Medicaid, the public assistance programs (including TANF), the State Children's Health Insurance Program (SCHIP), Food Stamps,²⁵ and Social Service Block Grants (SSBG's).

Medicaid. Medicaid is a jointly funded, Federal-State health insurance program for certain low-income and needy people. In the fifty States, there is no limit on Federal payments for Medicaid-related expenses. Each year, the federal government reimburses each State for its Medicaid expenditures on the basis of a federal matching rate, based on its per capita income. The federal matching rate, or "FMAP," is set within the range of 50% to 83%. In FY 2005, several states received a 50% match, including high per capita income states like Connecticut, Massachusetts, Maryland, Delaware, Illinois, New Hampshire, and New Jersey. Arkansas and Mississippi received the highest FMAP's, 75% and 77% respectively. While its low per capita income would give Puerto Rico the highest possible FMAP, its FMAP is fixed, along with Guam and the Virgin Islands, at 50%.

²³ Social Security Act Title I, Grants to States for Old-Aged Assistance for the Aged; Title X, Grants to the States for Aid to the Blind; Title XIV, Aid to the Permanently and Totally Disabled; and Title XVI, Grants to the States for the Aid to the Aged, Blind, and Disabled.

²⁴ Medicare Prescription Drug, Improvement, and Modernization Act of 2003.

²⁵ Food Stamps are considered a direct payment to individuals in the rest of the United States.

Medicaid funding for Puerto Rico is capped at \$207 million for FY 2003 and \$219 million for FY 2004.²⁶ Because of the spending cap, Puerto Rico Federal Affairs Administration recently reported that federal funds only covered 19.8% of program expenditures on its Medicaid eligible population, not the 50% established by law. [The percentage covered by federal funds decreases even more when factoring in administrative costs.] In FY 2002, for example, Puerto Rico spent \$973.3 million on Medicaid, of which \$192.9 million was contributed by the federal government to provide medical coverage for 867,000 people.²⁷

Table 17: Federal Funding for Medicaid Expenditures in Puerto Rico, FY 1999-2003

Year	1999	2000	2001	2002	2003
Spending Cap	\$172	\$178	\$184	\$193	\$216

Note: Federal fiscal year. Source: CMS Center for Medicaid and State Operations.

Public Assistance. The welfare system in the United States underwent a radical restructuring with the passage of the Welfare Reform Law of 1996, which created the Temporary Assistance for Needy Families (TANF) Program. TANF has been in effect since July 1, 1997 and replaced what was then known as welfare: Aid to Families with Dependent Children (AFDC) and the Job Opportunities and Basic Skills Training (JOBS) programs. While AFDC provided cash assistance directly to children and families according to need, the TANF program provides States with federal funds and broad flexibility to develop and implement their own welfare programs to assist needy families.

The current welfare legislation provides most of its funding in a block grant based on federal payments to each State from FY 1992 to FY 1995. In Puerto Rico, public assistance programs (AFDC, adult assistance, and title IV-E programs) were already capped into a grant. The welfare bill raised this cap by about 10% for Puerto Rico and other U.S. possessions. In addition, it authorized a new matching grant for the title IV-E programs (foster care, adoption assistance, and independent living) that reimbursed 75% of spending above 1995 levels. In FY 2003, federal funds for TANF in Puerto Rico were capped at \$70 million, and an additional \$35.7 million was made available collectively for adult assistance, child protection and the matching grant for funds spent on title IV-E programs.

State Children’s Health Insurance Program. Established in 1997, this program provides matching federal funds for states to insure poor children not eligible for Medicaid benefits. The program, also known as “S-CHIP,” operates in Puerto Rico under the same rules as in the fifty States and the District of Columbia, although it is funded at a lower level. The program matches Commonwealth funds at a 65% rate up to a maximum cap, set to be .229% of total available funding for the program.²⁸ In fiscal year 2003, that cap was set at \$30.3 million for Puerto Rico.

Funding for the States is based on each State’s share of uninsured children at or below 200% of the federal poverty level, adjusted for the local cost of medical care. State allocations for

²⁶ As provided by Tax Relief Reconciliation Act of 2003, Subsection 104(a).

²⁷ According to estimates from the Puerto Rican Federal Affairs Administration.

²⁸ .25% of the total amount is allotted to the territories and commonwealths, with 91.6% of this amount allocated to Puerto Rico. (.25% * 91.6% = .229%).

FY 1998 ranged from a low of \$3.5 million for Vermont, which has 7,000 poor uninsured children, to \$854 million for California, with 1.28 million. The current program provides appropriations for the “S-CHIP” program through FY 2007.

Nutritional Assistance Program. The Food Stamp Program is a joint federal/state program to help low-income families buy food. The program operates as a block grant in Puerto Rico known as the Nutritional Assistance Program, or “NAP.” As noted in the House Ways and Means *Green Book for 1998*, the NAP is different from the Food Stamp Program in five ways:

(1) Funding is limited to an annually indexed amount specified by law; (2) the Food Stamp Act allows the Commonwealth a great deal of flexibility in program design, as opposed to the regular program’s extensive Federal rules (e.g., 75 percent of benefits, paid through electronic benefit transfers, are earmarked for food purchases, the remainder may be claimed as cash, and rules barring certain citizens do not apply); (3) income eligibility limits are about one-third those used in the regular Food Stamp Program; (4) maximum benefit levels are about 40 percent less than in the 48 contiguous States and the District of Columbia; and (5) different rules are used in counting income for eligibility and benefit purposes. (U.S. House, 2004).

In FY 2003, the NAP grant was \$1.395 billion, which was to include a contribution of 50% of the administrative costs of implementing the program and 100% of the benefits themselves (U.S. General Services Agency, 2004). An average of about one million people, or about a quarter of the island’s population, received benefits each month during FY 2002, and monthly benefits per person averaged \$98 (U.S. House, 2004).

Social Services Block Grants. Social services block grants (SSBG’s) are provided to the states to achieve a wide range of poverty alleviation and prevention goals. Overall, Congress appropriated \$1.7 billion for the SSBG’s in 2003. State funding for SSBG’s is based on population. Grants to Puerto Rico and the territories are based on their share of funding in 1981, adjusted to the new overall funding level. In 2003, Puerto Rico received \$8.8 million in SSBG’s.

Education. The No Child Left Behind (NCLB) legislation of 2001 brought an historic growth in federal funding for education, along with a concomitant increase in federal control, for the entire country and also for Puerto Rico. NCLB equalized the formula for determining the level of Title I funding for low-income schools in Puerto Rico for the first time.

Federal grant funding for education in Puerto Rico in 2003 totaled over \$712 million, up over \$160 million, a 29% increase, since 2000. As Table 14 below illustrates, teacher quality, special education and low-income schools under Title I were all targeted for significant additional funding in Puerto Rico.

Table 18. Federal grant funding of education in Puerto Rico, 2000 - 2003

	2000	2001	2002	2003 (e)
Selected grants				
Title I grants to schools	\$262,415,735	\$267,301,458	\$272,694,803	\$283,853,847
Teacher quality	0	0	\$93,047,206	\$97,130,455
Tech literacy	\$13,952,522	\$15,164,217	\$19,835,915	\$22,807,822
21st century learning centers	\$490,172	\$474,354	\$10,100,237	\$18,229,511
Vocational training block grants	\$58,765,998	\$50,751,651	\$65,596,494	\$65,596,494
Vocational rehab grant	\$26,572,630	\$19,089,614	\$20,519,543	\$24,267,000
Special education grants	\$44,390,885	\$56,447,698	\$67,879,755	\$63,323,000
All grants	\$552,690,357	\$619,525,045	\$678,394,147	\$712,752,521

Source: Census Department, *Consolidated Federal Funds Report*, (2000 – 2003).

V. Net flow of federal funds to Puerto Rico

In 2003, the federal government spent \$10.1 billion more in Puerto Rico than it brought in through tax collections. This imbalance has jumped almost 33% since 2000, from \$7.4 billion. If Puerto Rico were included in rankings of the 50 States and the District of Columbia by its balance of federal payments, it would have placed twelfth (and twentieth if balance of payments were calculated per capita). Because its income levels are a third of the U.S. level, the balance of payments relative to the Puerto Rico economy is higher than in any State.²⁹

A. Net flow to Puerto Rico

Each State's annual balance of payments with the federal government is scrutinized to assess the fairness of federal policy and its impact on local economies. It should be emphasized that a variety of federal needs and policies determine the balance of payments. For example, many 'Sunbelt' states attract retirees who pay little in federal income taxes while drawing on accrued Social Security and Medicare benefits. Other states, like Virginia, house defense installations and private contractors that drive heavy federal spending on wages and salaries. Table 18 below illustrates the composition of the current balance of payments between Puerto Rico and the federal government, \$10.057 billion.

Table 18. Net flow of federal funds with Puerto Rico, 2000 – 2003				
	2000	2001	2002	2003
Federal spending in Puerto Rico				
Individuals	\$6.567	\$7.532	\$7.921	\$8.324
Grants	\$4.323	\$4.389	\$4.828	\$4.808
Procurement	\$0.419	\$0.477	\$0.365	\$0.561
Wages and salaries	\$0.819	\$0.866	\$0.930	\$0.968
Total	\$12.128	\$13.263	\$14.044	\$14.661
Federal tax collections from Puerto Rico				
Corporate income tax	\$1.604	\$1.380	\$1.327	\$1.256
Individual income and Social Security contributions	\$3.031	\$3.253	\$3.183	\$3.285
Unemployment insurance	\$0.041	0.041	\$0.039	\$0.039
Estate and gift tax	\$0.009	0.007	\$0.005	\$0.022
Excise taxes collected by IRS	\$0.0003	0.002	\$0.0003	\$0.0002
Total	\$4.686	\$4.683	\$4.554	\$4.604
Net flow to Puerto Rico / from federal government	\$7.442	\$8.580	\$9.490	\$10.057

²⁹ The balance of payments with the federal government relative to the economy is slightly higher in Washington, DC, the home of the federal government.

The balance has become significantly more favorable to Puerto Rico over the past three years, increasing over 30% from \$7.442 billion in 2000. While federal spending increased by \$2.5 billion from 2000 to 2003, federal tax collections actually dropped by \$80 million. An over \$350 million drop in corporate tax revenues was not offset by increasing payroll tax collections made by workers and their employers.

B. Net flow compared with the rest of the United States

Puerto Rico's positive balance of payments of \$10 billion with the federal government would be the 12th highest among the States and the District of Columbia, with a slightly more positive balance than West Virginia (\$9.4 billion). See Appendix 2 for a ranking of federal spending and taxes collected for 2003. The balance of federal payments per capita is closer to that of the average State; Puerto Rico would rank 19th. Chart 3 on the next page illustrates the ranking of the States with Puerto Rico according to their balance in 2003 with the federal government. However, because per capita income levels are about a third of U.S. levels, Puerto Rico's balance of payments represents about 23% of the local economy, higher than in any State, and lower only than in Washington, DC, the site of federal government.

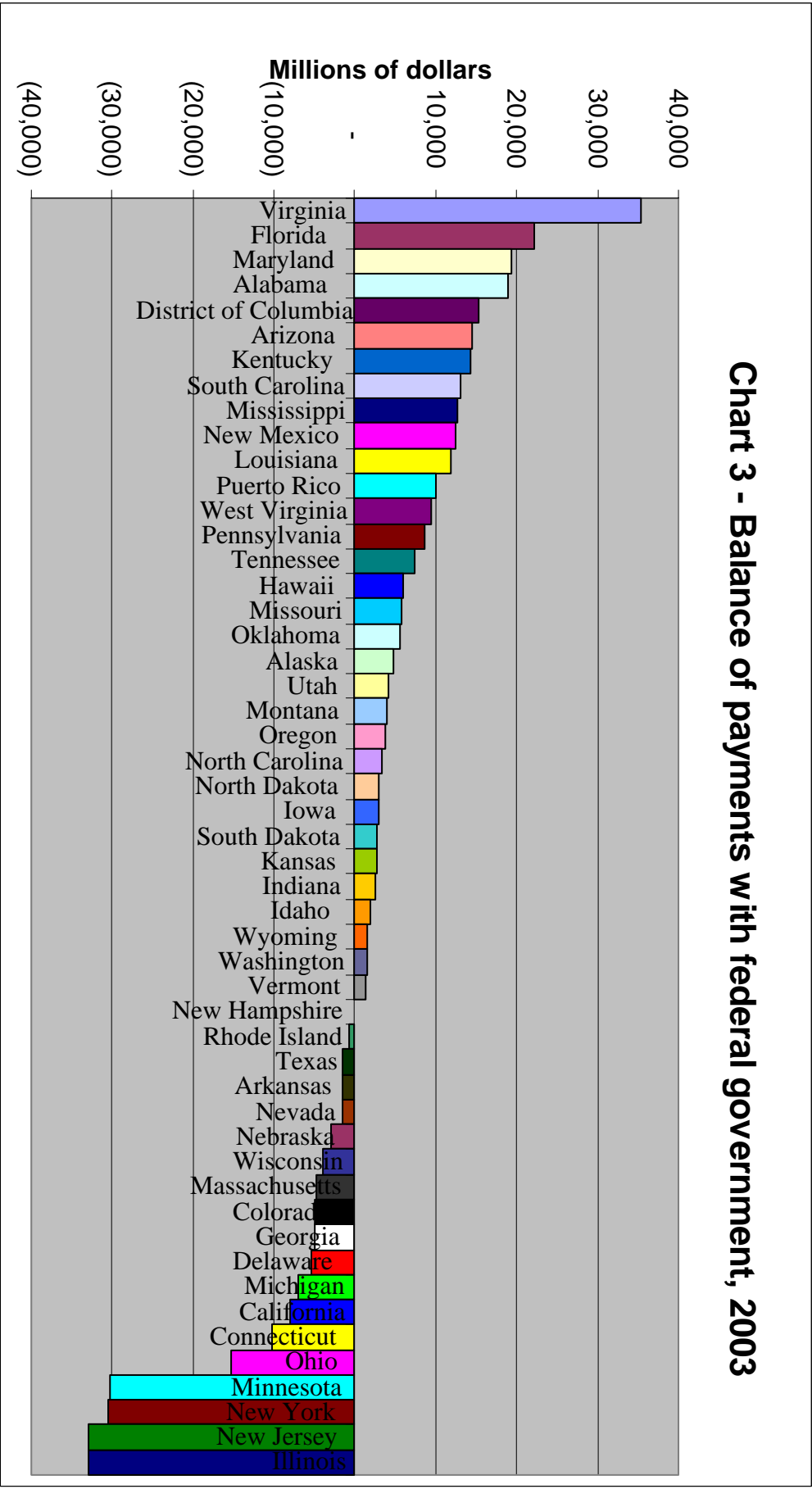


Chart 3 - Balance of payments with federal government, 2003

VI. Conclusions

Neither totally domestic nor fully foreign, Puerto Rico is often misunderstood. Such misunderstanding can sometimes lead to perverse and unintended consequences. This report attempts to create a database for better understanding and quantifying the unique fiscal relationship between the United States and Puerto Rico.

Exemption from federal income taxes excludes many working families in Puerto Rico from receiving tax relief or benefits under the earned income and child tax credits. The more low-income individual taxpayers in Puerto Rico are left out. Changing the child tax credit, for example, inadvertently provided tax relief to mostly low-income Puerto Rican families, but benefited only families with three or more children and failed to target only low-income beneficiaries.

Treating U.S. corporations in Puerto Rico as foreign under the U.S. Code can also lead to unintended consequences. Recent efforts in Congress to stimulate domestic investment and employment through the repatriation of overseas corporate funds could have the opposite effect, draining funds from Puerto Rico.

This overview leaves for future discussion several questions that naturally arise from a review of this unique relationship. In particular:

Is this arrangement the fairest possible for U.S. taxpayers and for U.S. citizens living in Puerto Rico? Each year, much debate in Washington and across the U.S. rages over whether each State gets its “fair share” of federal spending and pays its “fair share” of taxes. Each year, Puerto Rico receives the most net federal spending per capita, and yet no individuals pay federal income tax. Low-income workers in Puerto Rico pay a higher tax burden than they would anywhere else in the United States because they don’t receive the “tax break” provided through the earned income tax credit. Families with three or more children receive a tax break, but without respect to income. Similarly, federal programs like medical insurance for children are not funded on an equal basis in Puerto Rico. The inherent fairness of these arrangements, while beyond the scope of this report, will undoubtedly continue to be revisited.

Is this relationship the most effective for the economic development and sustained growth of Puerto Rico? Puerto Rico has long been integrated into the U.S. tariff, monetary, and judicial systems, but remains outside the U.S. tax code. A level of fiscal independence has been one of the cornerstones of Puerto Rico’s economic development strategy. Proponents have argued that it provides the flexibility to mold fiscal policies that are appropriate to Puerto Rico’s needs and has permitted the island’s rapid economic growth. After decades of stagnant growth and double-digit unemployment, however, faith in this once unquestioned principle has diminished. Some commentators (see, for example, Hunter, 2004) have asked whether Puerto Rico’s foreign status might have outlasted its effectiveness.

What would be the implications of equal fiscal treatment of Puerto Rico under the U.S. Code? This report reviews how individuals and corporations are treated differently and assesses the current payment and receipt of federal funds. It does not, however, address the implications of equal treatment for residents, corporations and the government of Puerto Rico. Nor does this paper evaluate the economic impact of equal fiscal treatment on the Puerto Rico economy.

VII. References

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VIII. Appendices

Appendix 1

Federal Social Welfare Programs in Puerto Rico, FY 2003

<u>Direct payments to individuals</u>	<u>Eligible</u>	<u>Special Rules</u>
Social Security	Yes	No
Medicare	Yes	Yes ^a
Supplemental Security Income	No ^b	NA
Guaranteed Student Loans	Yes	No
Pell grants	Yes	No
<u>Joint Federal – Commonwealth Program</u>	<u>Eligible</u>	<u>Special Rules</u>
Unemployment compensation	Yes	No
Public assistance and social insurance		
TANF (new AFDC)	Yes	Yes ^c
Child Support Enforcement	Yes	No
Foster Care and Adoption Assistance	Yes	No
Nutrition Programs		
Food Stamps	Yes	Yes ^d
WIC	Yes	Yes
School Lunch/Breakfast	Yes	No
Medical assistance		
Medicaid	Yes	Yes ^e
State Children's Health Insurance Program	Yes	No
Maternal and Child Health Block Grant	Yes	No
Social Services Block Grant (title XX)	Yes	No

Notes

^a Benefits and eligibility are the same as in the fifty States. Hospitals are reimbursed on a different basis in Puerto Rico, using a different base rate on which payments for different medical services are calculated.

^b The SSI program does not operate in Puerto Rico. Instead, its predecessor, the programs for the Aged, Blind, and Disabled under the Social Security Act (Titles I, X, XIV, and XVI) continue to be funded, albeit at lower levels than a comparable SSI program.

^c Welfare reform legislation (Public Law 104-193) in 1996 replaced Aid to Families with Dependent Children (AFDC) with the new Temporary Assistance for Needy Families (TANF) program. The law established a basic capped family assistance grant of \$71.56 million, and additional funds of \$35.69 million available for public assistance and related programs at a 75% reimbursement rate.

^d Puerto Rico receives a special Nutrition Assistance Block Grant under which it has greater flexibility than under the regular Food Stamp Program. The grant is fixed yearly, and was \$1.351 billion in FY 2002.

^e The fifty States are not subject to any limits on Federal payments for Medicaid expenditures. Puerto Rico, like the other territories, is subject to an annual spending cap, set at \$207 for FY 2003 and increased to \$219 million for FY 2004. The Medicaid matching rate, which in the States determines the share of Medicaid expenditures paid by the Federal government, is fixed by law at 50 percent for Puerto Rico and all the territories. In the States federal funding is based on the matching rate, which is based on the State's per capita income.

A Appendix 1 – Federal Social Welfare Programs in Puerto Rico, FY 1999

<u>Joint Federal – Commonwealth Program</u>	<u>Eligible</u>	<u>Special Rules</u>
Education and Training		
Compensatory education for the disadvantaged	Yes	No
Job Training Partnership Act (JTPA)	Yes	No
Child Protection		
Child welfare services (title IV-B Part 1)	Yes	No
Family preservation services (title IV-B Part 2)	Yes	No
Child Abuse Prevention and Treatment Act	Yes	No
Individual Tax Credits^a		
Dependent Care Tax Credit	No	-
Earned Income Tax Credit	No	-
Corporate Tax Credits^b		
Work Opportunity Tax Credit	Yes	No
Welfare to Work Tax Credit	Yes	No

Notes.

^a Because residents of Puerto Rico do not pay federal income taxes, they are not presently eligible for these tax credits.

^b U.S. chartered corporations operating in Puerto Rico and other territories are eligible for both the Work Opportunity Tax Credit and the Welfare to Work Tax Credit, as their Federal tax is levied on worldwide income, although tax liability may already be significantly reduced as a result of the Puerto Rico economic activity tax credit now being phased out. Corporations chartered in Puerto Rico, however, would not be eligible for the credits, as they are considered “foreign corporations” under U.S. tax Code.

Appendix 2. Federal Balance of Payments with the States, FY 2003
(in order of balance)

	Spending	Taxes	Balance
Virginia	82,454	47,095	35,359
Florida	113,341	91,247	22,094
Maryland	57,646	38,251	19,395
Alabama	36,871	17,907	18,964
District of Columbia	34,750	19,413	15,337
Arizona	37,801	23,231	14,570
Kentucky	31,153	16,812	14,341
South Carolina	28,038	14,999	13,039
Mississippi	21,741	9,014	12,727
New Mexico	18,736	6,271	12,465
Louisiana	31,646	19,878	11,768
Puerto Rico	14,661	4,604	10,057
West Virginia	14,226	4,830	9,396
Pennsylvania	90,350	81,812	8,538
Tennessee	42,602	35,251	7,351
Hawaii	11,269	5,262	6,007
Missouri	43,874	38,120	5,754
Oklahoma	25,254	19,635	5,619
Maine	9,966	5,194	4,772
Alaska	7,944	3,249	4,695
Utah	13,500	9,306	4,194
Montana	7,092	3,096	3,996
Oregon	21,253	17,540	3,713
North Carolina	51,766	48,365	3,401
North Dakota	5,726	2,721	3,005
Iowa	17,550	14,559	2,991
South Dakota	6,202	3,375	2,827
Kansas	18,208	15,516	2,692
Indiana	35,525	33,066	2,459
Idaho	8,654	6,757	1,897
Wyoming	4,226	2,712	1,514
Washington	43,368	41,906	1,462
Vermont	4,443	3,035	1,408
New Hampshire	7,349	7,366	(17)
Rhode Island	8,036	8,664	(628)
Texas	140,451	141,935	(1,484)
Arkansas	18,340	19,849	(1,509)
Nevada	11,637	13,170	(1,533)
Nebraska	11,000	13,867	(2,867)
Wisconsin	30,237	34,153	(3,916)

	Spending	Taxes	Balance
Massachusetts	51,265	56,054	(4,789)
Colorado	28,874	33,739	(4,865)
Georgia	51,910	56,847	(4,937)
Delaware	5,061	10,481	(5,420)
Michigan	57,870	64,764	(6,894)
California	219,706	227,611	(7,905)
Connecticut	28,595	38,746	(10,151)
Ohio	69,902	85,242	(15,340)
Minnesota	27,580	57,906	(30,326)
New York	137,898	168,462	(30,564)
New Jersey	53,679	86,514	(32,835)
Illinois	73,020	105,855	(32,835)