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PUERTO RICO: Background Information on Applicable Federal Legislation, Its Governmental Structure, and Its Finances

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Committee on Finance
United States Senate

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to provide background information for the Committee as it begins its deliberations on the future political status of the Commonwealth of Puerto Rico.

As you begin your work on S.712, understanding the existing relationships between the federal government and Puerto Rico regarding taxes, income security and health care programs, and how the government of Puerto Rico differs from that of the 50 states will provide an important context.

BACKGROUND

Puerto Rico was ceded to the United States by Spain in 1898 and administered as a territory until 1952, when the island became a commonwealth of the United States with its own constitution. The island has about 3.3 million residents, which makes it larger than 26 of the 50 states. Under the provisions of S.712, the people of Puerto Rico will have an opportunity to decide their future political relationship with the United States in 1991. This bill authorizes a referendum and defines three status options: commonwealth, statehood, and independence.

Unlike the cases of the 37 states admitted to the Union since 1791, this bill's approach to deciding political status is based on transition provisions that would automatically implement the status option that receives a majority of votes cast in the referendum. As a result, the specific provisions contained in this bill are very important. They result in costs and benefits that could accrue to both the federal government and the people of Puerto Rico under each of the status options.

I would like to begin my presentation with an overview of the significance of federal spending, federal tax policies, and other related influences on Puerto Rico's economy today.

THE FEDERAL FISCAL INFLUENCE IN PUERTO RICO

Federal spending comprises about 30 percent of Puerto Rico's gross product. In the 50 states, the average is about 22 percent. Puerto Rico's gross product was about $18 billion in 1988. Federal spending on the island that fiscal year, for all purposes, was about $6.2 billion. About 38 percent of this--about $2.4 billion--was in grants to the commonwealth or its local governments. This includes welfare assistance, education, highway aid, and customs duties shared with the island. Another 47 percent was for direct payments to individuals, including those for retirement, disability, and veterans' benefits. Most of the remaining 15 percent was for federal procurement, such as military purchases, and wages of federal employees on the island, such as postal workers.

In addition to federal spending, certain tax benefits accrue to both individuals and corporations. Islanders and U.S. corporations doing business in Puerto Rico are, for the most part, exempt from federal taxes. In a 1987 report, we estimated that, in 1983, the federal treasury would have received an estimated $2.4 billion if federal tax laws were extended to Puerto Rico.[1] About 88 percent of this would have resulted from taxing corporations, and the remainder from taxing individuals.

Finally, the federal government provided $703 million to Puerto Rico in direct loans, loan guarantees, and insurance in fiscal year 1988. For example, the federal government guaranteed $50 million in student loans, $454 million in mortgage insurance, and $9 million in VA home loans.

Given this context, I would now like to discuss several significant federal programs and laws under which Puerto Rico is currently treated differently than are the 50 states.

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[1] Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam, and American Samoa (GAO/HRD-87-60, Sept. 15, 1987).

CURRENT TREATMENT OF PUERTO RICO IN SELECTED FEDERAL LAWS AND PROGRAMS

Generally, Puerto Rico is treated as a state under most federal laws and programs. The major exceptions are in the tax laws, income support programs, and health care programs. Most of these are under this committee's jurisdiction.

Tax Laws

Puerto Rico is not subject to federal individual or corporate income tax laws. Since 1919, Puerto Rico has adopted its own tax law. In this respect, it is similar to a foreign country. Two provisions in federal tax law are designed to encourage industry and improve the Puerto Rican economy. The first is the possessions tax credit, also known as Section 936 of the Internal Revenue Code. The second, Section 7652(a) of the code, governs taxes on shipments to the mainland U.S.

Section 936. The possessions tax credit is designed to encourage U.S. businesses to invest in Puerto Rico and U.S. possessions. It has the effect of exempting the income U.S. firms earn from business operations and certain financial investments in Puerto Rico from federal corporate income taxes. According to the Department of the Treasury, in 1983 (which is the most current published data available), 625 corporations in Puerto Rico received benefits equaling $1.6 billion. These companies employed about 89,000 employees. The estimated tax benefit per employee averaged $18,523, or 125 percent of the average compensation per employee. Forty-six percent of the benefits went to pharmaceutical companies, which accounted for about 15 percent of the total employment.

Section 7652(a). Another important provision of the tax code allows taxes collected under the internal revenue laws on items produced in Puerto Rico and sold in the states (or consumed on the island) to be deposited in the Treasury of Puerto Rico. Puerto Rico received $227 million under this provision in 1987.

Income Support Programs

Of the six largest income support programs, three are applied in the same way as they are in the 50 states, and three are applied differently to Puerto Rico. The three that are applied the same are social security, unemployment insurance, and child nutrition. Those that differ are Adult Assistance (the predecessor program to Supplemental Security Income, or SSI), Nutrition Assistance (which is similar to Food Stamps), and Aid to Families With Dependent Children (AFDC). For these programs, federal funding is capped and benefits are lower than they are in the 50 states.

Adult Assistance. Among states, assistance to the needy, aged, blind, and disabled individuals is provided through the SSI program. This program is completely federally funded and administered. Puerto Rico is excluded from participating in this program. Instead, its assistance to these individuals continues through SSI's predecessor adult assistance programs, which are jointly funded by the federal and Puerto Rican governments, and administered by Puerto Rico. In fiscal year 1989, the federal share of Puerto Rico's adult assistance programs was $11.9 million. The average monthly payment was $32 plus half of actual shelter costs, compared with the U.S. average under SSI of $362 a month.

Aid to Families with Dependent Children. AFDC provides cash payments to needy children and their caretakers through state-operated programs that are jointly funded by the state and federal governments. The federal share is an open-ended match ranging from 50 to 83 percent of total costs, depending on a state's per capita income. However, the federal share for Puerto Rico is fixed at 75 percent and funding is capped. The federal share of Puerto Rico's AFDC payments amounted to about $50 million in fiscal year 1988. Its monthly benefit of $90 for a family of three is $28 lower than the lowest maximum payment in the 50 states.

Nutrition Assistance. Among the states, the Food Stamp program provides federal open-ended funding for a state-administered program of food assistance. Puerto Rico is excluded from participating in this program. In its place, the federal government has created a separate federal Nutrition Assistance program. This grant is not open-ended, like the Food Stamp program; however, as in the states, it is administered by Puerto Rico. A funding ceiling of $937 million was authorized for fiscal year 1990.

Ms. Merck, in her testimony, will discuss the implications of the various political status options for each of these three programs.

Health Care

I would now like to briefly summarize the differences in the two major health care programs, Medicaid and Medicare. In both cases, federal funding is lower in Puerto Rico.

Medicaid. Among the states, Medicaid provides health care through state-operated programs that are jointly funded by the state and federal governments. However in Puerto Rico there is a funding cap, much like in the three income security programs just discussed. A funding ceiling of $79 million is authorized for fiscal year 1990.

Medicare. In the case of Medicare, federal cost reimbursements are open-ended, as they are in the 50 states, but the cost reimbursement rate is lower because it is based on the average Puerto Rican hospitalization costs, not the U.S. average, as they are for the 50 states.

Again, Ms. Merck will discuss these in more detail.

GOVERNMENTAL STRUCTURE AND FINANCES

I would now like to turn to several characteristics of Puerto Rico's governmental structures that differ from those of the states and that could be affected by a change in political status. I will then discuss briefly Puerto Rico's financial structure.

First, I would like to note that government (federal, commonwealth, and local) is the largest employer on the island, employing about 201,000 people, or about 23 percent of the total number employed on the island. This is greater than the 7 percent for the United States as a whole. In addition, the Commonwealth operates 52 public corporations.

Governmental Structure

While similar to the states' governmental structure in most respects, Puerto Rico's system of government has two unique characteristics. First, the central government directly provides a number of services that, in the 50 states, local governments provide. And second, the central government owns or controls a number of public corporations. It is not clear how a status change might affect either characteristic.

Role of Local Governments. Municipalities are the only political subdivisions in Puerto Rico, and they have limited service delivery responsibilities. The great majority of governmental functions are financed and administered by the central government and its public corporations. For example, municipalities share a limited responsibility for education and health, providing services such as school bus and ambulance personnel. Localities raise few of their own resources and depend heavily on Commonwealth and federal grants for their operating revenues. The Commonwealth provides public education, public health, police, fire, and utility services. Some municipalities augment the Commonwealth police with their own local police forces, and two provide their own electric power because they are too remote from the facilities of the Electric Power Authority.

Public Corporations. Puerto Rico has 52 public corporations. Puerto Rico relies on public corporations to deliver more kinds of services than are currently provided by similar state authorities, boards, and other quasi-independent state agencies. While some, such as the University of Puerto Rico and the Electric Power Authority, have counterparts in the states, others do not. For example, Puerto Rico's Telephone Authority and Communications Authority operate the island's telephone system. The Electric Power and the Aqueduct and Sewer Authorities provide public utilities. The Sugar Corporation grows sugar cane, buys it from private firms, processes it, and markets it. The Maritime Shipping Authority operates three shipping lines. And the Government Development Bank is the financial advisor and fiscal agent for the Commonwealth government, and makes loans to the public corporations as well as to private enterprises.

In 1987, 11 of the largest of these corporations had net assets of about $5 billion and revenues of about $2.7 billion. While most of these corporations obtained their revenues from charges for services or products, a number of the corporations, such as the Sugar Corporation and the Maritime Shipping Authority, operated with a net loss and were subsidized by the central government.

Under any of the status options, there are no obvious reasons why the current governmental use of public corporations would necessarily change.

Government Finances

The aggregate short-term financial condition of the Commonwealth's central government, its public corporations, and its municipalities shows a surplus. The Commonwealth's 1990 budget projects revenues of about $10.5 billion for 1989 (for the central government, its public corporations, and the municipalities) and expenditures of about $9.8 billion. About 36 percent of these revenues are from the sales of goods and services from the public corporations.

Puerto Rico, however, has a relatively high public debt that was exceeded by only 6 of the 50 states, although much of it is attributable to Puerto Rico's public corporations. In 1987, the public debt was $10.1 billion, of which public corporations comprised about 71 percent. Even excluding Puerto Rico's debt attributable to public corporations, however, the percent of the Commonwealth's and municipalities' debt in relation to the island's gross product is about one-third higher than the average for the 50 states and their localities.

Revenues. Total revenues for Puerto Rico's central and municipal governments, excluding the public corporations, will be about $4.8 billion in 1989. This is about 26 percent of the island's gross product. For the 50 states, the average is about 18 percent.

The largest share of total revenues--24 percent--will be from federal aid. This is nearly twice the average for the 50 states. The other three major components, almost equally divided, are sales, and individual and corporate income taxes. Puerto Rico relies more heavily on individual and corporate income taxes than the states--41 percent of total revenues, as compared to 14 percent for the states and their localities. For example, corporate income taxes account for 22 percent of Puerto Rico's revenues--significantly higher than the 3 percent U.S. average. Conversely, property taxes account for about 6 percent of Puerto Rico's revenues--less than half that of the states and their localities.

The implications of the status option for independence on revenues are not clear. Even though nearly a quarter of the government's revenues are derived from federal assistance, it is unclear whether it would necessarily lose this support under the independence option. For example, treaties similar to those in the Phillipines on base use payments could supplement an independent Puerto Rico's budget. In addition, the current market for the government's and the public corporations' tax-exempt issues could be affected. This could have potentially adverse ramifications on its debt structure, depending on how the banking community perceives the transition from a U.S. commonwealth to an independent nation.

Under the statehood option, the heavy reliance on income taxes, especially corporate income taxes, would probably change because of the imposition of federal income taxes. This could place pressures for increasing other tax sources. The option of continued commonwealth would probably have very little effect on revenues.

Expenditures. Excluding the public corporations, the Commonwealth spends about 29 percent less per capita than state and local governments. It tends to spend less on education than the states. Education comprises 23 percent of total spending in Puerto Rico compared with 33 percent for the states. Puerto Rico also spends less on welfare (6 percent vs. 11 percent). But it spends more on housing and community development (8 percent vs. 2 percent), and more on health care and hospitals (11 percent vs. 8 percent).

The independence status option would create new demands for expenditures, potentially in defense, postal, and other services currently provided by the federal government. Under the statehood option, uncapping federal benefit programs and imposing federal standards could result in pressure for the Commonwealth to increase its expenditures in the areas of income security and health care as federal matching programs drive greater expenditures. Under the commonwealth status option, the potential for change is unclear.

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Mr. Chairman, this concludes my presentation. I would be happy to answer any questions you may have. Thank you.