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TAX POLICY

Analysis of Certain Potential Effects of Extending Federal Income Taxation to Puerto Rico

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The Honorable Don Young
Chairman, Committee on Resources
House of Representatives

The Honorable Elton Gallegly
Chairman, Subcommittee on Native
American and Insular Affairs
Committee on Resources
House of Representatives

In response to your request, this report presents information on some potential consequences of extending the income tax provisions of the federal Internal Revenue Code (IRC) to residents of the Commonwealth of Puerto Rico. Specifically, you asked us for estimates of

(1) the amount of federal income tax that individuals residing in Puerto Rico would pay if they were treated in the same manner as residents of the 50 states, the amount of earned income tax credits (EITC) Puerto Rican residents would receive, the percentage of taxpayers who would have positive federal tax liabilities, and the percentage who would earn EITC;

(2) the extent to which the Government of Puerto Rico would have to reduce its own income tax if it were to keep the amount of combined income tax (both federal and Commonwealth) on individuals the same as it was without the full imposition of the federal tax;

(3) how the amount of income taxes paid by the average taxpayer in Puerto Rico compares with the amount of combined federal, state, and local income taxes paid by residents in the 50 states and the District of Columbia; and

(4) the amount of revenue the U.S. Treasury could obtain by the repeal of the possessions tax credit, which effectively exempts from federal taxation a portion of the income that subsidiaries of U.S. corporations earn in Puerto Rico.

As agreed with your offices, our estimates relating to federal tax liabilities and earned income tax credits are based on the income and demographic characteristics of Puerto Rican taxpayers in 1992, the latest year for which detailed data were available. We did not attempt to adjust these estimates to reflect changes in the Puerto Rican economy, changes in the behavior of individual taxpayers, or different compliance rates that might result from the imposition of federal income taxes. The data that we used in making our estimates also had some limitations that are explained in the scope and methodology section of this letter and in appendix I.

Estimates of the impact of tax policy changes are inherently imprecise. Data limitations and the necessity to make certain behavioral and economic assumptions limits the precision of the estimates. Despite these limitations, we believe our analysis is adequate to provide general information about the magnitude of the potential revenue effect of extending full federal income taxation to the residents of Puerto Rico.

The discussion of the implications of extending federal income taxes to the Commonwealth of Puerto Rico should also be viewed in the context of the broader debate about the status of the Commonwealth under the Constitution. The broader issue of whether the benefits and obligations of statehood or independence should be sought for or granted to Puerto Rico is outside the scope of this analysis. However, any changes to tax policy as it affects Puerto Rico may have an impact on or be affected by this broader debate.

Background

Under the Jones Act, Puerto Rico is part of the United States for purposes of acquiring citizenship of the United States by place of birth. Thus, a person born in Puerto Rico is typically considered a U.S. person for U.S. tax purposes and thus is subject to the U.S. Internal Revenue Code (IRC). However, IRC has different tax rules for residents of Puerto Rico than it does for residents of the United States. Section 933 of IRC provides that income derived from sources within Puerto Rico by an individual who is a resident of Puerto Rico generally will be excluded from gross income and exempt from U.S. taxation, even if such resident is a U.S. citizen. Section 933 does not exempt residents of Puerto Rico from paying federal taxes on U.S. source income and foreign source income. Nor does section 933 affect the federal payroll taxes that residents of Puerto Rico pay. Federal employment taxes for social security, medicare, and unemployment insurance apply to residents of Puerto Rico on the same basis and for the same sources of income that they are applied to all other U.S. residents.

Income Taxes

Puerto Rico has had authority to enact its own income tax system since 1918. The current individual income tax system of Puerto Rico is broadly similar to the U.S. individual income tax system. The Puerto Rican and the

U.S. corporate income tax rules have many similarities and some differences. The structure of Puerto Rico's income tax system is discussed in appendixes II and III.

The current Puerto Rican income tax system is a significant source of revenue for the Puerto Rican government. In fiscal year 1992,[1] individual and corporate income taxes totaled about 40 percent of Puerto Rico's total revenues, with transfers from the federal government accounting for about 30 percent of revenue and other taxes, such as excise taxes, generating about 18 percent. The balance of the Commonwealth's revenues came mainly from nontax sources. For fiscal year 1992, the Puerto Rico Treasury collected about $1.1 billion in individual income taxes and about $1.02 billion in corporate income taxes.[2] About 42 percent of the corporate tax (about $426 million) was paid by U.S. subsidiaries covered by the possessions tax credit.[3] The remaining 58 percent (about $594 million) was paid by corporations not covered by the credit. In addition, about $10 billion of income earned by corporations in Puerto Rico was exempted from the local corporate income tax as a result of Puerto Rico's industrial tax incentive legislation.

Currently IRC has special income tax provisions that extend tax benefits to Puerto Rico that are not available to the states. The United States exempts from income taxation—at the federal, state, and local levels—all bonds issued by the Government of Puerto Rico.[4] Corporations organized in Puerto Rico are generally treated as foreign corporations for U.S. income tax purposes. Like other foreign corporations, they are taxed on their U.S. source income, but their Puerto Rico source income is not subject to U.S. tax. Foreign corporations pay U.S. tax at two rates—a flat 30-percent tax is withheld on certain forms of income not effectively connected with the conduct of a trade or business within the United States, and tax at progressive rates is imposed on income that is effectively connected with a U.S. trade or business. Much interest income is exempt from the withholding tax. Also, IRC's possessions tax credit effectively exempts from federal taxation a portion of the income qualified subsidiaries of U.S.

[1]Puerto Rico's 1992 fiscal year was from July 1991 through June 1992.

[2]These amounts do not include $99 million of tollgate tax (tax paid by corporations on income repatriated from Puerto Rico), $32.1 million of alternative tax withheld on interests and dividends, $62.1 million of income tax withheld from nonresidents, or $1.2 million of tax paid on partnership income.

[3]Section 936 of IRC provides a tax credit to those subsidiaries of U.S. companies with possessions source income. This credit is commonly known as the "possessions tax credit."

[4]48 U.S.C. 745.

corporations (corporations organized in any state of the United States) earn in the possessions. Tax rules related to possessions source income are discussed in more detail in appendix III.

Results in Brief

Our estimates of the potential revenue effect of extending current federal income tax rules to taxpayers in Puerto Rico were derived from our analysis of individual income tax data for tax year 1992 provided by the Government of Puerto Rico. If the characteristics of the Puerto Rican taxpayer population were the same in 1995 as they were in 1992, we estimated that their net aggregate federal tax liability after subtracting EITC would have been about $49 million under U.S. tax rules that had been adopted as of the end of 1995.[5] The aggregate tax liability in the absence of EITC would have been about $623 million, but Puerto Rican taxpayers would have qualified for a total of about $574 million of EITC.

We estimated that about 59 percent of the taxpayers who filed Puerto Rico individual income tax returns in 1992 would have earned some EITC. The average EITC earned by eligible taxpayers would have been about $1,494; the median amount would have been about $1,623. Over half of the taxpayers would have received net transfers from the federal government because their EITC would have been larger than their precredit federal income tax liabilities. We estimated that about 41 percent of the Puerto Rican taxpayers would have had positive federal income tax liabilities including EITC.

Had current federal tax rules been in effect in Puerto Rico at the time, it is probable that some Puerto Rican residents who did not file Puerto Rican tax returns in 1992 would have had an incentive to file federal tax returns because they could have qualified for the refundable EITC. We have no way of knowing with certainty how many of these nonfiler residents would claim EITC. However, we did derive an estimate of the amount of EITC that might have been claimed by residents who were not legally required to file tax returns in 1992. We considered the number of people who had income levels below the income tax threshold and were exempt from withholding as an upper limit on the number of those potential additional filers. If all of

[5]EITC is a refundable tax credit made available to certain low-income workers to offset the impact of Social Security taxes and encourage low-income workers to seek employment rather than welfare. Because there have been significant changes to EITC that do not fully phase in until 1996 and because EITC is an important factor in our results, we used the 1996 rules for the EITC in our analysis.

those residents claimed EITC, we estimated that they would have qualified for about $64 million.[6]

If the additional EITC that could have been claimed by legal nonfiler residents were about $64 million, our estimate of the aggregate amount of EITC that would have been earned would have increased from about $574 million to about $638 million. This additional EITC would be sufficient to eliminate the $49 million of aggregate net federal income tax liability that we estimated would exist for the population that did file. Again, it is important to note that our estimates do not reflect other potential behavioral responses to the availability of the credit or the imposition of the federal income tax.

For tax year 1992, Puerto Rican taxpayers reported about $1.03 billion in individual Puerto Rican income tax. If application of federal income tax resulted in an additional $49 million in tax liability after subtracting EITC as we estimated, and if the Government of Puerto Rico wanted to keep constant the aggregate amount of combined federal and Puerto Rican individual income tax levied on its residents, then it would have had to reduce its own individual income tax revenue by about 5 percent. If, because of additional EITC for residents who did not file returns in 1992, the estimated aggregate federal tax liability were eliminated, then the Government of Puerto Rico would not have had to change its individual income tax revenue to keep the aggregate combined taxes constant. However, even though the aggregate taxes may not have changed significantly, the taxes paid by certain classes of taxpayers could have changed dramatically.

The per-capita amount of Puerto Rico's individual income tax was lower than the state and local income tax in most states and the District of Columbia in 1992. However, the Puerto Rican income tax as a percentage of total personal income was higher than the state and local income tax as a percentage of total personal income of any state and the District of Columbia. Nevertheless, since residents of Puerto Rico paid only about

[6]There were some additional taxpayers in 1992 who had tax withheld but did not file Puerto Rican tax returns. The potential amount of additional EITC these taxpayers could have qualified for would likely have been relatively low because their earned incomes probably were very low.

$4.4 million[7] in federal income tax in 1992 (see discussion of foreign tax credit in app. II), the combined federal and Puerto Rican income tax was lower, in dollars per capita or as a percentage of personal income, than the combined federal, state, and local tax of any state and the District of Columbia. In Puerto Rico, the per-capita combined tax was about $342, and the tax as a percentage of personal income was about 5.3 percent. In Mississippi, which had the lowest combined income tax of any state, the per-capita tax was about $1,147 and the tax as a percentage of personal income was about 8.2 percent. If the federal income tax had been extended fully to Puerto Rico, and the Government of Puerto Rico did not adjust its own tax, we estimated that the per-capita combined individual income tax in Puerto Rico would have increased slightly to about $355—equivalent to about 5.5 percent as a percentage of personal income.

The Joint Committee on Taxation's most recent estimates indicate that the federal tax expenditure for the possessions tax credit would be $3.4 billion in 1996, growing to $4.4 billion by 2000. The U.S. Department of the Treasury's most recent estimates are that the tax expenditure would be $2.8 billion in 1996, growing to $3.4 billion by 2000.[8] Tax expenditure estimates are computed to indicate how much revenue the U.S. Treasury would forgo due to the existence of a tax benefit. The Joint Committee and the Treasury both use a different methodology to estimate tax expenditures than they use to estimate the amounts of revenue that would be saved if specific tax preferences were eliminated. Estimates of revenue savings take into account expected tax avoidance behavior by taxpayers in response to the elimination of preferences; tax expenditure estimates do not reflect these responses.

Given the differences in behavioral assumptions, if either the Joint Committee or the Treasury were to make both a tax expenditure estimate for a tax credit and a revenue gain estimate for the elimination of the credit, using the same set of economic forecasts and the same data, the revenue gain estimate could very well be smaller than the tax expenditure estimate. However, imprecisions in other assumptions, or in the economic

[7]The Government of Puerto Rico does not compile data on the amount of federal income tax paid by individuals residing in Puerto Rico, and although the Internal Revenue Service (IRS) compiles data, the individual income tax is not segregated from other taxes paid by residents of Puerto Rico to the United States. In 1992, individuals claimed a total of $4.4 million in foreign tax credits on their Puerto Rican income tax returns. Officials from the Puerto Rico Treasury told us that a very large percentage of these credits are attributable to income taxes paid to the U.S. federal government. Therefore, for purposes of determining the combined federal and Puerto Rican income tax, we assumed this amount was all for U.S. federal income taxes.

[8]Differences in the estimating methodologies and databases used by each set of estimators account for the differences in the estimates.

forecasts that the Joint Committee or the Treasury uses, could cause both the tax expenditure estimate and the revenue gain estimate to either overstate or understate the true amount of revenue that would flow into the Treasury if the credit were eliminated. The last publicly available revenue savings estimates, made by either the Joint Committee or the Treasury, for the immediate elimination of the possessions tax credit do not reflect the significant limitations that were placed on the credit by the Omnibus Budget Reconciliation Act of 1993.

Estimated Total Federal Tax Would Have Been Substantially Reduced by EITC

As of July 1995, 651,201 individual income tax returns for tax year 1992 had been filed with the Government of Puerto Rico. Some of the individuals filing those returns paid federal income tax because they had income from sources within the United States. However, due to section 933 of IRC, which excludes Puerto Rico source income from federal taxation, the vast majority of Puerto Rican taxpayers were not subject to the federal income tax.

If current federal tax rules were applied to residents of Puerto Rico in the same manner as they are applied to residents of the 50 states, and if the income and demographic characteristics of Puerto Rican taxpayers were the same as they reported on their 1992 tax returns, we estimate that the 651,201 filers would have owed about $623 million in federal income tax before taking EITC into account.[9] The aggregate amount of EITC earned by these taxpayers would have been about $574 million, thus the aggregate net federal tax liability would have been about $49 million (see table 1). We estimate that 384,107 filers, or about 59 percent of the total number, would have earned some EITC. The average amount of EITC earned by the 384,107 filers would have been about $1,494. The median EITC would have been about $1,623 (see table 2).

[9]By "current" federal tax rules, we mean rules adopted as of the end of 1995. For the most part these are the rules that were effective for tax year 1995. The one exception is that we used the rules for the EITC that did not become fully phased in until tax year 1996.

Table 1: Estimated Potential U.S. Tax Liabilities and EITC for Residents of Puerto Rico

Dollars in millions

U.S. adjusted gross income (AGI) classes	Number of Puerto Rican returns	U.S. tax liability before EITC[a]	U.S. EITC	U.S. tax liability after EITC[b]
Less than $0	922	$0	$0	$0
$0 to $2,999	34,906	0	7	–7
$3,000 to $5,999	50,719	0	40	–40
$6,000 to $9,999	133,266	8	200	–192
$10,000 to $14,999	152,916	33	226	–193
$15,000 to $24,999	151,122	118	101	17
$25,000 to $49,999	103,758	261	0	261
$50,000 to $99,999	20,493	128	0	128
$100,000 and over	3,099	75	0	75
Total	**651,201**	**$623**	**$574**	**$49**

[a]U.S. tax liabilities before EITC are reduced by estimated child and dependent care tax credits totaling about $15 million.

[b]Puerto Rican residents and nonresidents claimed as a tax credit on their Puerto Rican tax returns about $4.4 million in U.S. individual taxes in 1992. Estimated U.S. tax liabilities of $49 million under state-like taxation is gross of this amount.

Source: GAO simulation of U.S. tax law applied to 1992 Puerto Rican individual income tax returns.

Table 2: Estimates of Potential Puerto Rican Total, Average, and Median EITCs

Earned income range	Number of credit filers	Percentage of credit returns	Estimate of total credits (in millions)	Average credit	Median credit
Phase-in	59,721	16%	$71	$1,192	$1,026
Maximum	90,759	24	193	2,126	1,920
Phase-out	233,627	61	310	1,326	1,346
Total	**384,107**	**100%**	**$574**	**$1,494**	**$1,623**

Note: Totals may not add because of rounding.

Source: GAO simulation of U.S. tax law applied to 1992 Puerto Rican individual income tax returns.

Our estimates indicate that, before taking the federal child and dependent care tax credit (DCTC) into account, about 41 percent of the 651,201 households that filed Puerto Rican income tax returns in 1992 would have had positive federal income tax liabilities, about 53 percent would have received net transfers from the federal government because their EITC would have more than offset their precredit liabilities, and the remaining 6 percent would have had no federal tax liability. The lack of adequate information on the child and dependent care expenses of Puerto Rican taxpayers made it impossible for us to estimate the amount of DCTC that each taxpayer in our Puerto Rico database would have earned.[10] The nonrefundable DCTC could only have reduced the number of households having positive tax liabilities and increased the numbers with zero liabilities or net transfers. However, it seems unlikely that the DCTC would have caused a large number of taxpayers to shift from one status to another because our estimates indicate that the average credit earned by those claiming the credit would likely be less than $500. Taxpayers would only move from having a positive tax liability to having a zero tax liability, or receiving a net transfer, if they claimed the credit and if their precredit tax liability were less than the amount of credit claimed.[11]

If the federal income tax had been fully extended to residents of Puerto Rico in 1992, it seems likely that additional individuals and married couples who had not filed Puerto Rican tax returns would have filed federal tax returns in order to take advantage of EITC. Individuals with AGIS less than or equal to $3,300 and married couples with AGIS less than or equal to $6,000 were not required to file Commonwealth tax returns in 1992. However, some of these individuals filed in order to claim refunds of taxes that had been withheld on their wages, dividends, or interest. Others did not file, for example, because they were not subject to withholding taxes on their wages or salaries, as is the case for domestic workers and farm laborers, or because the amount withheld was small.

We have no way of knowing with certainty how many of these residents who currently are not required to file would file in order to claim EITC. However, to derive an estimate of what this number might be, we considered the number of people who had income levels below the income tax threshold and also were exempt from withholding as an upper limit of

[10]We did use the experience of U.S. taxpayers as a basis for estimating the aggregate amount of the federal DCTC that Puerto Rican taxpayers might earn (see app. I for details.) This aggregate amount of DCTC is factored into our estimate of the aggregate federal tax liability in table 1. However, we were unable to assign DCTC to specific taxpayers and, consequently, were unable to determine how those credits affected the net federal tax liability of each individual taxpayer.

[11]We estimate that between 30,000 and 40,000 Puerto Rican taxpayers would have qualified for DCTC in 1992—roughly 5 to 6 percent of the taxfiling population. (See app. I for the estimating methodology.) The number who would have moved from a positive tax liability to a zero or negative one simply by the addition of this credit probably would have been small, since the average amount of credit earned by DCTC recipients in the United States in 1992 was about $427.

the number of these potential additional filers.[12] If all of those residents claimed EITC, we estimated that they would have qualified for about $64 million.[13]

If the additional EITC that could have been claimed by nonfiler residents were about $64 million, our estimate of the aggregate amount of EITC that would have been earned would have increased from about $574 million to about $638 million. This additional EITC would be sufficient to eliminate the $49 million of aggregate net federal income tax liability that we estimated would exist for the population that did file.

Our estimates do not reflect other potential behavioral responses to the availability of the credit or the imposition of the federal income tax. For example, we were not able to estimate the number of potential EITC claimants who currently are not filing, even though they are legally obligated to file.

Puerto Rico Would Have Had to Reduce Its Own Tax to Keep the Average Combined Income Tax at Its Current Level

For tax year 1992, Puerto Rican taxpayers reported about $1.03 billion in individual income tax. We estimated that, if current federal tax rules had been fully applied to residents of Puerto Rico and, if there were no behavioral responses to this new taxation, then the aggregate federal income tax liability of Puerto Rican taxpayers in 1992 would have been about $49 million. If the Government of Puerto Rico had wanted to keep the amount of combined federal and commonwealth individual income tax the same as it was without the imposition of full federal income tax, then it would have had to reduce the aggregate liability imposed by its own individual income tax by about 5 percent. If we allowed for the potential expansion of the filing population in response to the availability of EITC (to include residents who had no withholding), then the estimated aggregate federal income tax liability would have been essentially eliminated. In that case, the Government of Puerto Rico would not have to change its own income tax to keep the aggregate combined income tax constant. There are, however, other reasons why the Government of Puerto Rico may have adjusted its own income tax under these circumstances.

[12]There were some additional taxpayers in 1992 who had tax withheld but did not file Puerto Rican tax returns. The potential amount of additional EITC these taxpayers could have qualified for would likely have been relatively low because their earned incomes probably were very low.

[13]According to officials from the Puerto Rican Treasury, the number of domestic workers and farm laborers who were exempt from income tax withholding in Puerto Rico in 1992 was approximately 43,000. We estimated the upper bound for the amount of EITC that these individuals would have earned by assuming that (1) none of the 43,000 workers actually filed a return in 1992; (2) none of these workers were from the same family; (3) all of these workers were qualified for EITC; and (4) they each earned the average EITC which we estimated to be about $1,494.

In comments on a draft of this report, the Secretary of the Treasury of Puerto Rico stated that his government would adjust the island's fiscal system to provide relief to taxpayers who would have positive federal income tax liabilities if the federal income tax were fully extended to residents of Puerto Rico.

Average Combined Individual Income Tax in Puerto Rico Was Low Relative to That in the 50 States

There are several ways to compare individual income tax across jurisdictions. A comparison of per-capita tax shows how much, in dollars, the average resident in each jurisdiction bears. Personal income provides a better indication of a jurisdiction's tax capacity than does population because a person's ability to pay taxes rises as his or her income rises. A comparison of taxes paid as a percentage of total state or commonwealth personal income shows, approximately, the relative extent to which each jurisdiction draws upon its residents' ability to pay. When comparing individual income taxes paid, however, it is important to recognize that some jurisdictions may have relatively low individual income taxes because they rely more heavily on other revenue sources. It is also important to note that comparisons of average taxes paid across jurisdictions do not show the comparative taxes paid by specific classes of taxpayers in each jurisdiction.

In per-capita terms, Puerto Rico's individual income tax is relatively low. In 1992, the per-capita tax burden of Puerto Rico's individual income tax was about $341. The state and local income taxes in 33 states, and the District of Columbia, were higher per capita. Moreover, since residents of Puerto Rico currently pay a relatively small amount of federal income tax, the combined federal and Commonwealth per-capita income taxes in Puerto Rico are lower than those in any of the 50 states and the District of Columbia. If residents of Puerto Rico had been fully subject to the federal income tax in the same manner as residents of the 50 states were, we estimate that the per-capita federal income tax in Puerto Rico would have been about $14 in 1992.[14] In this case, if the Government of Puerto Rico did not adjust its own income tax in response to the imposition of the federal tax, the combined federal and Commonwealth income tax in Puerto Rico would have been about $355 per capita. This amount is about a third of the per-capita combined federal, state, and local income taxes in Mississippi, which has the lowest per-capita income taxes of any state. (See app. IV.)

One reason why Puerto Rico's per-capita income tax is relatively low is that per-capita personal income in Puerto Rico is significantly lower than

[14]This estimate of the per-capita burden is based on the estimated aggregate burden of $49 million.

that in any of the 50 states and the District of Columbia. In 1992, Puerto Rico's per-capita personal income was $6,428, compared to $14,083 in Mississippi, the state with the lowest per-capita personal income.

Puerto Rico's individual income tax collections amounted to 5.3 percent of the Commonwealth's personal income in 1992. This percentage is higher than that of the state and local income tax collections in any of the states and the District of Columbia. New York state, where state and local income taxes amounted to 4.2 percent of state personal income, ranked closest to Puerto Rico. (See app. IV).

One reason why Puerto Rico's income tax as a percentage of personal income is high, relative to those of the 50 states and the District of Columbia, is because Puerto Rico relies more heavily on income taxes as a source of revenue than do most of those other jurisdictions. In 1992, only two states, Maryland and Massachusetts, relied more heavily on their state and local individual income taxes than Puerto Rico did. Puerto Rico's reliance on its corporate income tax was also much higher than that of any state or the District of Columbia. Puerto Rico does not levy a general sales tax and received only 5.8 percent of its general revenues from property taxes. In contrast, in the vast majority of states, general sales taxes and property taxes account for at least 25 percent of general revenues. (See app. IV).

Despite Puerto Rico's heavy reliance on its individual income tax, the combined federal, state, and local individual income taxes, as a percentage of personal income, were significantly lower in Puerto Rico than in any of the states or the District of Columbia because residents of Puerto Rico paid little federal income tax. If residents of Puerto Rico had been fully subject to the federal income tax in 1992, and Puerto Rico did not alter its own income tax, we estimate that the combined income taxes would have amounted to about 5.5 percent of Commonwealth personal income. Combined income taxes in Mississippi amounted to 8.2 percent of state personal income in 1992. In no other state or the District of Columbia did combined income taxes amounted to less than 9 percent of personal income. (See app. IV).

Although the combined average income tax rates paid by residents of Puerto Rico would not have changed substantially, unless the Government of Puerto Rico adjusted its own income tax rate schedule, higher income residents of Puerto Rico would face substantial increases in their combined marginal income tax rates if they were fully subject to the federal income tax. These individuals would face much higher combined marginal income tax rates than similar individuals residing in any of the 50 states or the District of Columbia face. Under Puerto Rico's current income tax law, marginal tax rates can reach as high as 38 percent over certain ranges of income. Rates for single taxpayers and married taxpayers filing joint returns in Puerto Rico reach 31 percent when taxable income is as little as $30,001. Rates for married taxpayers filing separately reach 31 percent when taxable income is as little as $15,001.[15] In contrast, as of 1994, in no state or the District of Columbia did state and local marginal tax rates exceed 12 percent for any taxpayers at any income level. With the full imposition of the federal income tax, some residents of Puerto Rico could face combined marginal income tax rates of over 70 percent, unless the Government of Puerto Rico adjusted its own tax.

Revenue Estimates for the Elimination or Phase-Out of the Possessions Tax Credit

Neither the Joint Committee on Taxation nor the U.S. Department of the Treasury has made public any recent estimates of the amount of revenue that would be saved if the possessions tax credit were eliminated immediately. The last publicly available revenue estimate that the Joint Committee made for an immediate repeal of the possessions tax credit, without any phase out, was in February 1993. At that time, it estimated that the repeal of the credit would increase revenues by $4.1 billion in 1996. That estimate did not reflect the significant limitations that the Omnibus Budget Reconciliation Act (OBRA) of 1993 subsequently placed on the use of the credit. Since the 1993 changes reduced the benefits provided by the credit, the February 1993 estimate was higher than it would have been if the Joint Committee had known about the changes.[16] The U.S. Department of the Treasury also has not publicly released a revenue estimate for the immediate repeal of the credit since the OBRA 1993 changes.

The Seven-Year Balanced Budget Reconciliation Act of 1995 (H.R. 2491) would have repealed the possessions tax credit after December 31, 1995, had it not been vetoed by the President. The act contained a grandfather rule that would have gradually phased out the credit for existing credit claimants over a period of up to 10 years. The Joint Committee on Taxation estimated that this phasing out of the credit would

[15]These current rates became effective for tax years beginning after June 30, 1995. For tax year 1992 the comparable rates would have been 41, 36, and 36 percent. See app. II for further details on the changes made to Puerto Rico's income tax since 1992.

[16]The economic assumptions that the Joint Committee would use when making an estimate now are also likely to be different from the ones used in 1993. We do not know the effect that the change in assumptions would have on the estimate.

save the Treasury $255 million in 1996 and a total of $2.5 billion from 1996 through 2000. This revenue estimate is relevant only to the very specific phase-out rules contained in the act. Other phase-out schemes could have much different revenue consequences.

The Joint Committee on Taxation and the Treasury Department have made "tax expenditure" estimates for the possessions tax credit as recently as September 1995 and March 1996, respectively. The latest Joint Committee estimates indicated that the tax expenditure would be $3.4 billion in 1996, growing to $4.4 billion by 2000. The Treasury Department estimated that the tax expenditure would be $2.8 billion in 1996, rising to $3.4 billion by 2000. The Joint Committee and Treasury both use a different approach for making tax expenditure estimates for specific tax preferences than they use for estimating the revenue gains that would occur if those preferences were eliminated. A revenue gain estimate reflects expected behavioral changes on the part of taxpayers in response to the elimination of a particular preference; a tax expenditure estimate, which represents the amount of tax benefit that taxpayers would receive if the preference were not repealed, does not reflect any behavioral changes.

If a tax credit were eliminated, taxpayers would be likely to seek ways to avoid paying the full amount of tax that the credit had previously offset. For example, if the possessions tax credit were repealed, U.S. corporations might shift some of their investment out of Puerto Rico to operations in foreign countries, where some of the income might not be immediately subject to U.S. taxation. Due to the differences in behavioral assumptions, if either the Joint Committee or Treasury were to make both a tax expenditure estimate for a tax credit and a revenue gain estimate for the elimination of the credit, using the same set of economic forecasts and the same data, the revenue gain estimate could very well be smaller than the tax expenditure estimate. On the other hand, imprecisions in other assumptions and in the economic forecasts that the Joint Committee or Treasury uses could cause both the tax expenditure estimate and the revenue gain estimate to either overstate or understate the true amount of revenue that would flow into the treasury if the credit were eliminated.

Scope and Methodology

To calculate an estimate of the amount of personal income taxes the United States would collect from residents of Puerto Rico and to analyze issues related to EITC, we obtained individual income tax data from the Government of Puerto Rico. The data included selected items from each individual income tax return filed with the Department of the Treasury of

Puerto Rico in 1992, the last year for which detailed information was available.

The data we used were the best available. However, they were taken from an administrative database that had not been cleaned of all errors or inconsistencies. We did our own consistency checks and, with the assistance of the Department of the Treasury of Puerto Rico, corrected the significant errors we detected. Some inconsistencies remain in the data, but we determined that the data is adequate to provide general information about the magnitude of the potential revenue effect of extending full federal income taxation to the residents of Puerto Rico.

We documented the structure of the Puerto Rican individual income tax system and compared it to the U.S. tax system. On the basis of the tax law summary table in appendix II and the data provided by the Commonwealth, we prepared a computer program to estimate the federal income tax that would have been paid if each Puerto Rican 1992 individual filer had filed a U.S. individual tax return according to U.S. tax rules that had been adopted as of December 31, 1995. With one exception, we used U.S. tax rules that were effective for tax year 1995. The one exception was that we used the rules governing EITC that became fully phased in for tax year 1996.

We did not attempt to predict how taxpayers would respond to the new incentives and disincentives they would face under U.S. tax law. Behavioral responses of corporate taxpayers to the elimination of the possessions tax credit would be of particular importance to the aggregate amount of income earned in Puerto Rico. According to officials from the Department of the Treasury of Puerto Rico, corporations covered by the credit directly employed about 109,000 Puerto Rican residents in 1995. As we concluded in our earlier report on the possessions tax credit, reliable estimates of the impact that the elimination of the credit would have on Puerto Rico's economy cannot be made.[17]

A second important limitation of our estimate of federal individual income tax liabilities results from deficiencies of the data available for our estimate. The Puerto Rican tax returns do not contain all of the information that we would need to accurately simulate certain aspects of the federal tax code. For example, under Puerto Rico tax rules, interest from U.S. federal securities is exempt from taxation. No information about

[17]Tax Policy: Puerto Rico and the Section 936 Tax Credit, (GAO/GGD-93-109, June 8, 1993).

this type of interest is reported on the return, and accordingly, we do not have the data to estimate its effect on a possible U.S. tax liability.

To compare the combined income tax burden of the Commonwealth of Puerto Rico to the combined income tax burden of the 50 states and the District of Columbia, we analyzed federal, state, and local individual income taxes in per-capita terms and as a percentage of personal income using published data from the Advisory Commission on Intergovernmental Relations (ACIR), the Commonwealth of Puerto Rico, and IRS statistics of income. Further details on our methodology are contained in appendix I.

As agreed with your staff, we did not produce our own estimate of the amount of revenue the U.S. Treasury could obtain by eliminating the possessions tax credit. We have simply presented the Joint Committee on Taxation's and the U.S. Treasury's estimates of the tax expenditure for the credit.

The Puerto Rico Treasury was unable to provide us with detailed data relating to corporations operating in Puerto Rico that are not covered by the possessions tax credit. There are differences between Puerto Rico's corporate income tax and the federal corporate income tax. In the absence of detailed data relating to the incomes and deductions reported by corporations not covered by the possessions tax credit, we cannot say whether federal income taxation of these corporations would have yielded significantly more or significantly less revenue than the approximately $594 million of income tax actually collected from these corporations by Puerto Rico in 1992. Marginal tax rates for corporations are generally higher in Puerto Rico than in the United States, but Puerto Rico provides significant tax exemptions for income earned from certain designated activities. Appendix III provides a description of the principal differences in the treatment of corporate and partnership income under the Puerto Rican and federal tax codes.

We did our work in Washington, D.C., between August 1995 and June 1996 in accordance with generally accepted government auditing standards.

Agency Comments

We requested comments on a draft of this report from the Secretary of the Treasury of the Commonwealth of Puerto Rico, from officials of the U.S. Treasury, and from the Internal Revenue Service. We discussed the draft on June 7, 1996, with responsible officials from the Office of the Assistant Secretary of the Treasury for Tax Policy. We discussed the draft on

June 11, 1996, with the Secretary of the Treasury of Puerto Rico and members of his staff. The Secretary also provided us with written comments, the full text of which, excluding an attachment of technical comments, is presented in appendix V. IRS' Office of the Associate Chief Counsel provided us with written comments relating to our descriptions of sections of IRC. Most of the comments that the various officials made brought to our attention corrected and updated information. There were also suggestions that parts of our presentation needed to be clarified. We considered their comments and modified the report where appropriate.

The U.S. and Puerto Rican officials made several comments that merit special attention. First, officials from both the U.S. and Puerto Rican Departments of the Treasury pointed out that we did not address the distributional effects that a full imposition of the federal income tax would have in Puerto Rico. An official from the U.S. Treasury noted that the combined marginal income tax rates of higher income individuals in Puerto Rico would be significantly higher than the combined marginal rates on similar individuals in any of the 50 states or the District of Columbia. He suggested that the Government of Puerto Rico would be compelled to modify its own tax system to avoid these extremely high rates. The Secretary of the Treasury of Puerto Rico noted that his government would have to make significant adjustments to the island's fiscal system to provide relief for those who would have positive federal income tax liabilities. IRS' Associate Chief Counsel noted that U.S. persons who currently pay Puerto Rican income tax as well as federal income tax, such as U.S. military personnel stationed on the island, can claim a foreign tax credit against their federal income tax liability. If the Puerto Rican income tax were to be treated as a state income tax, these individuals would only be allowed to claim a deduction for that tax, not a credit. As a result, their U.S. income tax liabilities could increase significantly if Puerto Rico did not adjust its income tax.

We agree that the full imposition of the federal income tax could have significant impacts on specific groups of taxpayers in Puerto Rico, even though the impact on aggregate federal revenue might be negligible. However, the data and our estimating methodology did not support a detailed distributional analysis. We did not mention possible policy responses by the Government of Puerto Rico because that was beyond the scope of this study. In the section of our report that compares the combined individual income taxes in Puerto Rico with those in the 50 states and the District of Columbia, we have added a comparison of the marginal tax rates for Puerto Rico's income tax with the marginal income tax rates for other U.S. jurisdictions. The top marginal income tax rate in Puerto Rico is significantly higher than the rates in the other jurisdictions.

Officials from both the U.S. and Puerto Rican Treasuries were concerned about our discussion of local corporations operating in Puerto Rico that are not covered by the possessions tax credit. The officials felt that we improperly implied that the amount of income tax revenue that the Government of Puerto Rico currently collects from these corporations indicates roughly the amount of revenue that the federal government might collect if the corporations were subject to the full federal income tax. We tried to make clear in our draft that there are differences between Puerto Rico's corporate income tax and the federal corporate income tax and that potential federal revenues could be greater or less than the amount that the Government of Puerto Rico currently collects. In response to the comments, we moved some of the discussion of differences between the two corporate income taxes forward from an appendix to the body of the letter.

Finally, the Secretary of the Treasury of Puerto Rico noted that our report does not address all of the consequences that are likely to follow from a major change in the fiscal relations between Puerto Rico and the federal government. He said that, in particular, we do not address potential changes in federal transfers to Puerto Rico. We agree that there are important considerations relating to potential changes in fiscal relations that are beyond the scope of this report.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this report. At that time, we will send copies of this report to the Ranking Minority Members of the House Committee on Resources, and the Subcommittee on Native Americans and Insular Affairs, and to other appropriate congressional committees. We will also send copies to the Commissioner of the IRS, Secretary of the Treasury, representatives of the government of Puerto Rico, and other interested parties. Copies will also be made available to others upon request.

This work was performed under the direction of James Wozny, Assistant Director, Tax Policy and Administration Issues. Major contributors to this report are listed in appendix VI. If you have any questions please contact me on (202) 512-9044.

Natwar M. Gandhi
Associate Director, Tax Policy
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Abbreviations

ACIR	Advisory Commission on Intergovernmental Relations
AGI	Adjusted Gross Income
AMT	Alternative Minimum Tax
DCTC	Child and Dependent Care Tax Credit
EITC	Earned Income Tax Credit
IRA	Individual Retirement Account
IRC	Internal Revenue Code
IRS	Internal Revenue Service
OBRA	Omnibus Budget Reconciliation Act
SEP	Simplified Employee Pension
SOI	Statistics of Income

Objectives, Scope, and Methodology

The Chairman, House Committee on Resources, and the Chairman, House Subcommittee on Native American and Insular Affairs, Committee on Resources, requested that we provide certain data regarding the potential effects of extending federal income taxation to Puerto Rico. Specifically, they asked that we provide estimates of

(1) the amount of federal income tax that individuals residing in Puerto Rico would pay if they were treated in the same manner as residents of the 50 states, the amount of earned income tax credits (EITC) Puerto Rican residents would receive, the percentage of taxpayers who would have positive federal tax liabilities, and the percentage who would earn EITC;

(2) the extent to which the Government of Puerto Rico would have to reduce its own income tax if it were to keep the amount of combined income tax (both federal and Commonwealth) on individuals the same as it was without the full imposition of the federal tax;

(3) how the amount of income taxes paid by the average taxpayer in Puerto Rico compares with the amount of combined federal, state, and local income taxes paid by residents in the 50 states and the District of Columbia; and

(4) the amount of revenue the U.S. Treasury could obtain by the repeal of the possessions tax credit, which effectively exempts from federal taxation a portion of the income that subsidiaries of U.S. corporations earn in Puerto Rico.

To calculate the amount of personal income taxes the United States would collect from residents of Puerto Rico and analyze issues related to EITC, we obtained individual income tax data from the Government of Puerto Rico. These data included selected items from each individual income tax return filed with the Department of the Treasury of Puerto Rico in 1992, the last year for which detailed information was available.

The data we used were the best available. However, they were taken from an administrative database that had not been cleaned of all errors or inconsistencies. We did our own consistency checks and, with the assistance of the Department of the Treasury of Puerto Rico, corrected the significant errors we detected. Some inconsistencies remain in the data, but we determined that the data is adequate to provide general information about the magnitude of the potential revenue effect of extending full federal income taxation to the residents of Puerto Rico.

To estimate the total U.S. federal income tax related to extending the federal income tax to Puerto Rico, we documented the elements that made up Puerto Rico's taxable income, deductions, exemptions, and credits and compared them to the U.S. federal income tax. To aid that process, we have prepared a summary table tracing each line item from the U.S. 1040 return and schedule of itemized deductions to a comparable item in the 1992 Puerto Rican individual income tax return. On the basis of the tax law summary table in appendix II and the data provided by the Commonwealth, we prepared a computer program to estimate the federal income tax that would have been paid if (1) each Puerto Rican 1992 individual filer had filed a U.S. individual tax return according to U.S. tax rules that had been adopted as of the end of 1995 and (2) his or her filing behavior had not changed as a result of the imposition of U.S. income taxes. U.S. tax law was used to determine U.S. tax treatment of Puerto Rican tax return income, exemption, and deduction items.[1] We assumed that the taxpayers took advantage of any U.S. credits or deductions that were not available under Puerto Rico law, if we had sufficient data to presume their eligibility for those credits and deductions.

The estimate of U.S. federal tax liabilities that we produced in this manner differs in several important ways from an estimate of the amount of revenue that the United States would actually receive if the federal income tax were actually imposed on Puerto Rico residents for tax year 1995. We have not attempted to estimate how the extension of individual and corporate income taxes or any federal aid programs would affect the pretax incomes of Puerto Rican taxpayers.

Another important limitation of our estimate results from deficiencies of the data available for our estimate. The Puerto Rican tax returns do not contain all of the information that we would need to accurately simulate certain aspects of the federal tax code. For example, under Puerto Rico's tax rules, interest from federal securities is exempt from taxation. Also, for example, unemployment compensation is not included in Puerto Rico's definition of gross income, whereas it is in U.S. tax law. Information about this interest and unemployment compensation is not reported on the return, and accordingly, we did not have the data to estimate its effect on a possible U.S. tax liability. The analysis in appendix II describes the extent

[1]We followed U.S. tax laws that were in place as of October 1, 1995. All relevant dollar amounts that are included in the U.S. tax code, such as the amounts for exemptions, standard deductions, and boundaries for tax rate brackets, were deflated into 1992 dollar equivalents. Also, prospective changes in the calculation of the earned income tax credit scheduled to be in place in tax year 1996 were incorporated in the simulation exercise.

to which we could or could not estimate amounts for each line item on the federal tax return from data on Puerto Rican returns.

Finally, a study of compliance with Puerto Rico's income tax prepared for the Puerto Rico Treasury revealed that noncompliance with Puerto Rico income tax laws is significantly more extensive than noncompliance with federal income tax laws. This study indicated that the total income gap (the amount of adjusted gross income (AGI) that went unreported) in 1991 for Puerto Rico was about $3.71 billion, or 26 percent of total income, while for the United States the income gap was about $447.1 billion, or 12 percent. Our estimates reflect the compliance behavior of Puerto Rican taxpayers in 1992. They do not take into account any change in compliance rates in Puerto Rico that have occurred since 1992 or that might occur if full federal income taxation were imposed. Since the completion of that study, the Department of the Treasury of Puerto Rico has implemented new compliance initiatives that, according to Puerto Rico Treasury officials, have increased the number of individual income tax returns filed from 651,201 in 1992 to 720,000 in 1994 and increased their collections of all taxes by about $430 million in fiscal years 1994 and 1995.

EITC Estimate

EITC is a major feature of the U.S. income tax system that would significantly affect estimates of federal tax revenues obtained from Puerto Rico if the federal income tax were extended to Puerto Rico. EITC is a refundable credit that is awarded to tax filers who meet certain earned income requirements and have qualified children residing in their households. A smaller credit is awarded tax filers who have earned incomes but no qualifying children—the so-called "childless" credit. Qualification requirements for the credit are discussed in table II.2. Because the credit is targeted to tax filers with relatively low earned incomes, a tax filing population with a high proportion of low-income earners, such as Puerto Rico's, would be entitled to a substantial amount of EITC in the aggregate.

Our EITC simulation methodology relied on available information contained in Puerto Rican tax returns for 1992 to estimate proxies for earned income, unearned income, AGI, and qualifying children, as defined under federal tax law. We restated all dollar values, such as income thresholds and maximum credits, contained in the EITC computation rules as 1992 dollars. We then applied the restated rules to the estimated proxies in order to compute an EITC for each Puerto Rican taxfiler in 1992 that met the necessary conditions.

A limitation of the simulation described above, apart from the necessity to approximate the value of certain tax elements, is the risk of significantly undercounting the potential EITC-qualified population of tax filers. The 1992 Puerto Rican tax filing population may omit potential filers either because their incomes fell below the filing threshold for the Puerto Rico income tax or because they evaded their filing obligations in 1992.[2] Because the number of these potential filers may be substantial at the lower earned income levels, and thus cause our simulated estimate of EITC to be understated, we examined Census data in an attempt to estimate the number of nonfilers that would file if EITC were available.

The decennial 1990 Census of Puerto Rico contains information on the incomes and family composition of households during the sample period 1989. From the family relationships contained on the Census file we constructed a data file of simulated tax filers, e.g., single, head-of-household, and married joint returns. Information about the age and incomes of nonfiling family members was used to estimate the number of EITC-qualified children. Income elements, although not complete for computing taxable incomes, seemed reasonably adequate for estimating approximations of AGI and earned income.

From the simulated tax filing data set, we estimated the number of potential filers who would qualify for EITC by AGI classes. These counts of potential filers were compared to the count of simulated EITC filers obtained from the 1992 Puerto Rican tax return file. As expected, the number of potential filers in the Census data set in low-AGI groups, roughly those AGIs below tax filing thresholds, exceeded the number from the tax file data set. Many of the simulated filers from the Census data set, in these income groups, could be agricultural workers or domestic service workers who are exempt from tax withholding and thus need not file tax returns. However, in the higher AGI classes, the number of simulated EITC tax filers from the Census data set was lower than the number of simulated EITC filers from the 1992 tax return data set. This result is not plausible because the number of potential EITC recipients in the full Puerto Rican population

[2]In Puerto Rico, the requirements for filing a return for tax year 1992 were $3,300 in gross income for single persons or married individuals not living together, and $6,000 in gross income for married persons living together. Individuals below these tax thresholds may have filed, however, to claim refunds of taxes withheld by employers. Some taxpayers may not have filed for a refund if the amounts withheld were small.

cannot be lower than the number of potential recipients in the tax filing population.

We have more confidence in our simulations based on the tax return data than those based on the Census data. The translation of Puerto Rican filing units into federal filing units is relatively straightforward from the tax data, although there is considerable uncertainty as to how households in the Census database should be translated into filing units. In addition, income amounts reported on the Census survey may differ from the amounts that the same individuals would report for tax purposes. For these reasons we concluded that we could not use the Census data to estimate the total number of nonfilers who might claim EITC if it became available to them.[3] However, as explained in the letter, we did make an upper-bound estimate for the amount of EITC that might be claimed by taxpayers who had legitimate reasons for not filing tax returns in 1992.

Potential noncompliance with the EITC provisions and behavioral responses to the availability of the credit could result in a larger aggregate amount of EITC being earned than we have estimated. A previous GAO report and studies by IRS have raised concerns regarding the vulnerability of EITC to noncompliance including fraud.[4] Also, the introduction of the earned income credit could induce some welfare recipients to forego welfare and obtain employment in order to claim the tax credit. We did not adjust our estimate for these factors because there was insufficient information available to quantify their effect on EITC.

Child and Dependent Care Tax Credit Estimate

Differences between U.S. and Puerto Rican tax rules relating to child and dependent care expenses made it impossible for us to estimate the amount of federal child and dependent care tax credit (DCTC) that each taxpayer in our Puerto Rico database would earn. The federal credit, which is nonrefundable, is equal to a percentage of the expenses that a taxpayer pays for child or dependent care in order to be able to obtain gainful

[3]We examined the possibility that the difference in the years between the two data sets—the Census data were based on information in 1989, whereas the tax return data set were for the year 1992—might have caused the inconsistency in counts between AGI groups. We obtained from the Treasury Department of Puerto Rico a table of tax filers by AGI groups for the same year as the Census data—1989. In order to estimate the number of EITC filers in each AGI group in 1989, we used our 1992 data to compute the proportions of all tax filers that qualified for the EITC by AGI class and then applied these proportions to the 1989 tax filer counts for the respective AGI groups. A comparison of the count of Census simulated EITC tax filers to the imputed EITC tax return simulated filers again led to a statistical inconsistency across AGI groups.

[4]Tax Administration: Earned Income Credit—Data on Noncompliance and Illegal Alien Recipients, (GAO/GGD-95-27, Oct. 25, 1994).

employment. The maximum credit for taxpayers with AGIs of $10,000 or less is $1,440 for two or more dependents, and $720 for one dependent. The maximum credit for taxpayers with AGIs over $28,000 is $960 for two or more dependents, and $480 for one dependent. Puerto Rico allows an itemized deduction for child-care expenses but not for expenses to care for other dependents. The maximum deduction is $800 for two or more children, and $400 for one child. A large majority of Puerto Rican taxpayers do not itemize, so we were unable to determine whether they had any expenses for child care.

In the absence of complete information on the child and dependent care expenses of Puerto Rican taxpayers, we had to rely upon the experience of U.S. taxpayers as a basis for estimating the aggregate amount of federal DCTC that Puerto Rican taxpayers might claim. Using a sample of individual tax returns compiled by IRS for tax year 1991, the latest data available, we classified U.S. returns by nine AGI categories and by the number of children claimed as qualifying for the DCTC. We classified Puerto Rican returns according to estimated U.S. AGI and the number of children claimed as dependents. We computed an average credit amount per U.S. return for each class of return. We assumed that the average credit per Puerto Rican return in a given class would be the same as the average credit for the comparable class of U.S. returns[5] Thus, we multiplied the number of Puerto Rican returns in each class by the appropriate U.S. average credit to obtain the amount of credit earned by each class of Puerto Rican returns. We obtained our overall estimate of about $15 million by summing the estimates for the individual classes.

We were unable to allocate the aggregate amount of DCTC across individual taxpayers. Consequently, we do not know precisely how many taxpayers might have had their federal tax liabilities completely offset by this credit. For this reason, we could not estimate precisely the number of Puerto Rican taxpayers who would have had positive federal tax liabilities.

Combined Individual Income Taxes

Determining the magnitude of the income tax reductions the Government of Puerto Rico would have to make in order to maintain the same level of combined income tax paid by individuals resident in Puerto Rico if they were subject to the federal income tax was a two-step process. First, we

[5]Dependent-care expenses are likely to be lower in Puerto Rico than in the rest of the United States because labor costs are significantly lower in Puerto Rico than in the United States. However, the amount of expenses that qualify for the credit is capped at $2,400 per dependent and at $4,800 in total. These caps should reduce differences between the average amounts of credit that would be claimed in Puerto Rico, by income group, and the average amounts claimed in the rest of the United States.

determined the total amount of 1992 Puerto Rican tax from the income tax return data provided by the Commonwealth. Then, we compared this amount to the total estimated potential U.S. tax liability as calculated in the first objective.

To compare the combined federal and Puerto Rican income tax to the combined federal, state, and local income tax of the 50 states and the District of Columbia, we analyzed federal, state, and local individual income taxes in per-capita terms and as a percentage of personal income. In addition, to understand the results of our analysis of Puerto Rico's income tax, we analyzed the general revenue sources of Puerto Rico and the states. We used published data from the Advisory Commission on Intergovernmental Relations (ACIR), IRS' Statistics of Income Bulletin, and Puerto Rico's Informe Económico al Gobernador, an annual report to the Governor on the economy of the Commonwealth.[6] Generally, ACIR based its calculations on state and local general revenue data collected by the Bureau of the Census.[7] We followed the Census Bureau's Classification Manual definitions of government and finance data.

[6]ACIR was created by Congress to monitor the operation of the American federal system and to recommend improvements.

[7]General revenue, as defined by the Census, includes all revenue except that classified as liquor store, utility, or insurance trust revenue. For purposes of this analysis, the general revenue data we included for the government of Puerto Rico excludes its public corporations.

Comparison of U.S. and Puerto Rico Individual Income Tax Rules

The following tables summarize our comparison of United States and Puerto Rican individual income tax rules relevant to our simulation for each item on the U.S. individual income tax return. These tables provide comments on issues related to the conversion of the Puerto Rican income tax return items to the U.S. individual income tax return items. Our conversion is based on 1992 Puerto Rican income tax rules because that was the latest year for which return information necessary for our simulation was available on computer tape. Since 1992, the Puerto Rican tax system has been changed. In October 1994, Puerto Rico enacted tax reform legislation that according to the government of Puerto Rico, was intended to achieve several objectives. These objectives include (1) establishing a more equitable tax structure, (2) encouraging equal and consistent application of tax laws, and (3) simplifying the tax structure. Generally, the 1994 tax reform lowered individual tax rates and corporate tax rates. Effective for tax years commencing after June 30, 1995, the act lowered all statutory individual income tax rates and increased the level of taxable income subject to the maximum tax rate, from $30,000 to $50,000 for married filing jointly. Tax rates were lowered from 1 to 7 percentage points, depending on the tax bracket and filing status of the taxpayer. We noted some of the significant provisions of the Puerto Rico Tax Reform Act of 1994 in table II.1.

Table II.1: Conversion of Puerto Rican 1992 Individual Income Tax Return Items to U.S. 1995 Individual Income Tax Return Items

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Filing status	U.S. reporting: The United States has four filing statuses: single, married filing jointly or surviving spouse, married filing separately, and head-of-household. Puerto Rico reporting: Puerto Rico has five filing statuses: married and living with spouse, head-of-household, married not living with spouse, single, and married filing separately. Conversion to the U.S. return: The United States does not have a married not living with spouse status. For the married not living with spouse status, taxpayers would have to file as married filing jointly or married filing separately status. For the married not living with spouse status, we classified returns filed under this status as head-of-household filing status if the Puerto Rican return reports a dependent child, since that status has more favorable tax rates. If the return did not report a dependent child, then the return was classified as single.

(continued)

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Exemptions	U.S. reporting: The United States allows a deduction amount based on the number of exemptions claimed. Exemptions can be claimed for the taxpayer, the spouse, and the dependents. Puerto Rico reporting: Puerto Rico allows a deduction amount based on the number of personal exemptions and dependents claimed. However, Puerto Rico allows only one personal exemption for married taxpayers and does not allow a head-of-household taxpayer an exemption for the dependent that qualifies him or her as head-of-household. Conversion to the U.S. return: The number of exemptions was included in the U.S. return as reported on the Puerto Rican return except that married filing jointly taxpayers were considered two exemptions instead of one, and head-of-household taxpayers had an additional dependent added.
Wages, salaries, and tips	U.S. reporting: This includes all compensation for personal services as an employee unless specifically excluded. Puerto Rico reporting: Incudes all amounts paid to employees that constitute compensation. Conversion to the U.S. return: Wages, salaries, and tips on the Puerto Rican return were used as reported.
Taxable interest and tax-exempt interest	U.S. reporting: All interest is taxable, except for interest on certain state and local bonds and certain other exceptions. Puerto Rico reporting: Income from federal, state, and local government bonds is exempt in Puerto Rico and is not reported. Also the first $2,000 of interest income from Puerto Rican banking institutions is exempt. However, the exempt amount is reported on the income tax return, but it is excluded from gross income. Conversion to the U.S. return: Only those interest earnings reported on the Puerto Rican income tax return were included in our simulation. Interest earnings included the exempt amount for interest in Puerto Rican banking institutions but not interest from federal, state, and local government bonds because it was not reported on the Puerto Rican return.
Dividend income	The amount of dividend income was included in the U.S. return as reported on the Puerto Rican return.
Taxable refunds, credits or other offsets	U.S. reporting: This item is an accounting entry in the federal income tax return used only by taxpayers who, during the tax year, received a refund, credit, or offset of state or local income taxes that they paid and deducted in any prior year. Puerto Rico reporting: There is no equivalent line item on the Puerto Rican tax return. Conversion to the U.S. return: This entry was not necessary for our simulation because no prior year deductions would have been made.
Alimony received	The amount for alimony received was included in the U.S. return as reported on the Puerto Rican return.

(continued)

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Business income or loss	U.S. reporting: Sole proprietor income after related expenses is included on the U.S. individual income tax return with certain limits. However, U.S. passive losses generally can only be deducted against passive income. Related expenses include those that are ordinary and necessary such as depreciation. The U.S. tax rules allow straight line and some accelerated depreciation. The United States also allows an immediate write-off of business assets up to $17,500. This amount is reduced if the total cost of the property placed in service during the year exceeds $200,000. Puerto Rico reporting: Sole proprietor income after related expenses is also included on the Puerto Rican return. Puerto Rico also limits the extent to which business losses can offset salary income. Deductions rules, like depreciation, may differ. For example, in 1992, Puerto Rico allowed certain taxpayers to use “flexible depreciation.” This depreciation method allows a depreciation deduction up to the full cost of the asset in the year it is first used. However, the deduction was not to exceed the net benefit of the business or commercial activity in which the property was used. This flexible depreciation method was repealed in the Tax Reform Act of 1994 for assets acquired after June 30, 1995. Conversion to the U.S. return: The amount reported on the Puerto Rican return was used as reported.
Capital gain or loss	U.S. reporting: Net capital gains are fully included in income with an alternative 28-percent tax rate for long-term gains net of long- and short-term losses. Capital losses are deductible to the extent of capital gains; up to a $3,000 loss is allowed against other income. Capital losses can be carried forward and deducted in succeeding years. Long-term capital gain or loss means gain or loss from the sale or exchange of a capital asset held for more than 1 year. Puerto Rico reporting: Gains are fully taxable; capital losses are limited to capital gains plus net income or $1,000, whichever is lower, with the excess losses carried forward for 5 years. Also, there is an alternative tax on net long-term capital gains, which is either the regular tax or a “special 20-percent tax on capital gains,” whichever is more advantageous to the taxpayer. Long-term capital gain or loss means gain or loss from the sale or exchange of a capital asset held for more than 6 months. Puerto Rico also has sale or exchange of principal residence rules that are somewhat similar to those of the United States. In general, if the Puerto Rican taxpayer buys another residence within 1 year before or 1 year after the sale of the old residence (18 months after sale is allowed if a new residence is constructed), the gain is not recognized to the extent the selling price does not exceed the cost of the new residence. A one-time exclusion of $50,000 is provided for taxpayers 60 years old or older at the time of the sale, if the taxpayer lived in the old residence for at least 3 years of the last 5 years prior to the sale. Conversion to the U.S. return: The amount of capital gains and losses was included in the U.S. return as reported on the Puerto Rican return.

(continued)

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Other gains or losses	U.S. reporting: This line item is used for gains and losses reported on U.S. Form 4797. Generally, this form is used to report sales or exchanges and involuntary conversions from other than casualty or theft of property used in a trade or business; disposition of noncapital assets other than inventory or property held primarily for sale to customers; and recapture of IRC section 179 expense deductions for partners and S-corporation shareholders. Business real estate and any depreciable property is excluded from the definition of capital asset. However, if the business property qualifies as IRC section 1231 property, capital gain treatment may apply. Under IRC section 1231, if there is a net gain during the tax year from (1) sales of property used in a trade or business, (2) involuntary conversion of property used in a trade or business, or (3) sales of capital assets held for more than one year, the gain is treated as a long-term capital gain. A net loss is treated as an ordinary loss. Puerto Rico reporting: Net gains on the involuntary conversion, or on the sale or disposition of property used in a trade or business, held for more than 6 months, are treated as "long-term capital gain." This long-term capital gain is reported together with other long-term capital gains and is taxed as explained in the capital gains section. Except for (1) the holding period of 6 months; (2) the inclusion of involuntary conversion from casualty or theft; and (3) the replacement period of 1 year for involuntary conversions, Puerto Rico's capital gains treatment of the property described in this paragraph is consistent with the U.S. tax treatment. Net gains or net losses on the involuntary conversion or on the sale or disposition of property used in a trade or business, held for less than 6 months, are not considered capital gains or losses. These gains or losses are reported as "ordinary income or loss." Conversion to the U.S. return: Other gains and losses were included in the U.S. return as reported on the Puerto Rican return.
Individual Retirement Account (IRA) distributions	U.S. reporting: IRA distributions are taxed as ordinary income in the year received. Distributions are fully taxable unless nondeductible contributions have been made. In the United States, a penalty applies if the taxpayer is not 59 1/2 years or older. Puerto Rico reporting: Similar rules apply; nondeductible contributions are not permitted. In Puerto Rico, the penalty applies if the taxpayer is not 60 years or older, with certain exceptions. Puerto Rico has a penalty provision that is similar to that of the United States for early withdrawals. Conversion to the U.S. return: This line item was used as reported on the Puerto Rican return.

(continued)

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Pensions and annuities	U.S. reporting: The United States taxes each annuity payment as if composed pro rata of taxable income and recovery of cost, projected over the life expectancy of the annuitant. An alternative method is provided for qualified plans; under this method, the total number of payments is determined based on the annuitant's age at the starting date. Puerto Rico reporting: In the case of government pensions, Puerto Rico excludes either \$5,000 or \$8,000 based on age. If the taxpayer paid part or the total cost of the pension, he/she can recover that amount tax free. The excess of the amount received over 3 percent of the aggregate premiums paid is excluded from income until the amount excluded equals the aggregate premiums paid for the annuity. Taxpayers with government pensions are not required to submit Schedule H (Income from Annuities or Pensions) if their pension or annuity income is less than the exclusion amount. Since 1992, the \$5,000 or \$8,000 exclusion has been applied to both government and private sector pensions. Conversion to the U.S. return: This line item was included in the U.S. return as reported on the Puerto Rican return, although the cost recovery rules are different in the United States, and government pensions in the United States are taxed on the same basis as are all other pensions.
Rents, royalties, partnerships, estates, and trusts	U.S. reporting: The United States has complex passive loss rules, limiting the use of losses from passive activities to shelter income from other types of activities. Although a passive activity is defined as one involving the conduct of a trade or business in which the taxpayer does not materially participate, the passive loss rules treat rental activities as passive. Puerto Rico reporting: Passive activity losses may not be used to offset income from another activity. Also, excess losses may be carried forward indefinitely to offset any future income from the same activity. Partnerships that derive at least 70 percent of their gross income from Puerto Rican sources, and at least 70 percent of such income is produced in a specific enterprise, can elect to be treated as special partnerships. However, distributed losses from Special Partnerships can offset up to 50 percent of net income from any source. Puerto Rico's regular partnerships are treated like corporations in the United States. Special partnerships and corporations of individuals (similar to S corporations) are treated like United States partnerships (pass-through entities). Conversion to the U.S. return: These income items were included in the U.S. return as reported on the Puerto Rican return.
Farm income	U.S. reporting: Farm income is reported and taxed in the same way as income from any other business. However, there are inventory and expense deduction rules that recognize the unique issues related to operating a farm. For example, there are special rules for the involuntary conversion of livestock or crop disaster payments. Puerto Rico reporting: Ninety percent of net farm income is exempted from reporting. Puerto Rico also includes some income and expense recognition rules that are specific to farmers. Conversion to the U.S. return: Farm income was included as reported on the Puerto Rican return with the 90-percent exclusion added back to income.

(continued)

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Unemployment compensation	U.S. reporting: Unemployment compensation is included in gross income. Puerto Rico reporting: Unemployment compensation is not included in gross income and, therefore, not reported on the income tax return. According to data provided by the Department of the Treasury of Puerto Rico, unemployment compensation totaled $336.5 million in 1994. Conversion to the U.S. return: We were not able to simulate this income item because we did not know how the total unemployment compensation was distributed among Puerto Rican taxpayers.
Social Security benefits	U.S. reporting: A portion of a taxpayer's Social Security benefits may be taxable. Puerto Rico reporting: Social Security payments are not included as income and, therefore, not reported on the income tax return. Conversion to the U.S. return: We were not able to simulate this income item.
IRA deductions	U.S. reporting: A deduction of up to $2,000 per taxpayer is allowed for IRA contributions for employees who cannot participate in certain employer-sponsored pension plans. Taxpayers who are participants in employer-sponsored plans can deduct a limited amount of IRA contributions, depending on their income. Total contributions of up to $2,250 can be made per taxpayer each year to the taxpayer's IRA and a spousal IRA. Puerto Rico reporting: A $2,000 deduction per taxpayer is allowed, or $4,000 for married taxpayers. Limitations apply when the individual participates in cash or deferred accounts. In 1994, the IRA deduction was increased to $2,500 per taxpayer or $5,000 for married taxpayers. Conversion to the U.S. return: The IRA deduction amount was included in the U.S. return as reported on the Puerto Rican return.
Moving expenses	U.S. reporting: Certain moving expenses are deductible as an adjustment to gross income if the move is related to starting work in a new location. Puerto Rico reporting: Moving expenses are deductible as ordinary and necessary expenses within certain limitations. Conversion to the U.S. return: Because moving expenses are reported with other ordinary and necessary expenses, they were included in our simulation of miscellaneous deductions.

(continued)

U.S. individual income tax item	Issues/comments on conversion to U.S. return
One-half self- employment tax	U.S. reporting: One half of self-employment tax is deductible as an adjustment to income. Dividends typically are not included as earnings for self-employment income. However, a taxpayer's distributed share of ordinary income from a trade or business carried on by a partnership is included in self-employment income. Puerto Rico reporting: Residents of Puerto Rico are subject to federal self-employment tax under IRC section 1402(b). Self-employed residents of Puerto Rico are to file a U.S. Internal Revenue Form 1040PR to compute self-employment tax. This return follows the same employment tax rules applicable to residents of the United States. Conversion to the U.S. return: The tax was computed by multiplying the self-employment tax rate (15.3 percent) times the amount of self-employment income. The Puerto Rican individual income tax return includes corporation dividends and distributions from regular partnerships on the same line of the return. Accordingly, we could not determine the regular partnership distribution amount that would be included as U.S. self-employment income. So that we would not overstate self-employed income and the related tax, we excluded any items from the Puerto Rican return that would not be entirely included as U.S. self-employment income.
Self-employed health insurance deduction	U.S. reporting: Up to 30 percent of health insurance premiums for self-employed persons are deductible as an adjustment to gross income. Puerto Rico reporting: There is no similar provision in the Puerto Rican return. Health insurance premiums for self-employed persons are deductible as an itemized deduction. Conversion to the U.S. return: Self-employed health insurance deduction was not simulated because self-employed insurance premiums and other business adjustments are offset against self-employment income in the Puerto Rican return, and our Puerto Rican individual income tax data file showed only the net self-employment income amount.
Keogh retirement or Simplified Employee Pension (SEP) plans deduction	U.S. reporting: Keogh retirement or SEP payments are deductible as an adjustment to gross income. Puerto Rico reporting: Keogh retirement or SEP payments are deductible as an adjustment to self-employment income. Conversion to the U.S. return: A Keogh retirement or SEP deduction was not simulated because Keogh retirement or SEP payments and other business adjustments are offset against self-employment income in the Puerto Rican return, and our Puerto Rican individual income tax data file showed only the net self-employment income amount.
Penalty on early withdrawal of savings	U.S. reporting: Penalties paid on early withdrawal of savings are deductible. Puerto Rico reporting: There is no similar line item in the Puerto Rican tax return. Conversion to the U.S. return: We were not able to simulate this income adjustment.
Alimony paid	U.S. reporting: Alimony paid is deductible as an adjustment to income. Puerto Rico reporting: Alimony paid is deductible as an adjustment to income. Conversion to the U.S. return: Alimony paid was included in the U.S. return as reported on the Puerto Rican tax return.

(continued)

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Medical and dental expenses	U.S. reporting: Unreimbursed medical and dental expenses are deductible as itemized deductions to the extent they exceed 7.5 percent of AGI. Puerto Rico reporting: Under Puerto Rico's rules, generally, the same kind of medical and dental expenses, except drug expenses, are deductible, but only 50 percent of total medical expenses paid are deductible in the year paid and to the extent they exceed 3 percent of AGI. Conversion to the U.S. return: The gross medical and dental expense amount and any orthopedic equipment expenses (see miscellaneous deductions) were included in the U.S. return as reported on the Puerto Rican tax return and adjusted for U.S. income limitation rules.
Taxes	U.S. reporting: Under U.S. tax rules, certain state, local, and foreign government taxes—such as real property and income taxes—are deductible as an itemized deduction. Personal property taxes are deductible only if paid or accrued to state or local governments. Puerto Rico reporting: Puerto Rico allows as an itemized deduction property taxes paid on the taxpayer's principal residence. Puerto Rico has no personal property or local individual income taxes (below the Commonwealth level). Conversion to the U.S. return: We used the amount of property taxes as reported on the Puerto Rican tax return. No amount was simulated for personal property or local income taxes because they do not exist. We used the actual Puerto Rican tax liability after credits except for the foreign tax credit, which is largely a credit for U.S. income taxes (see foreign tax credit).
Interest	U.S. reporting: The U.S. itemized deduction includes home mortgage interest and points, home equity loans, and refinanced mortgages for a qualified residence. The deduction is limited to principal amounts of $1 million for mortgages and $100,000 for home equity loans. These limits apply to mortgage or home equity loans taken out after October 1987. Additional limits apply if the mortgage exceeds the fair market value of the residence. Puerto Rico reporting: The Puerto Rican deduction includes many of the U.S. provisions, except that there are no limitation amounts and no deduction is allowed if the mortgage exceeds the fair market value of the residence at the time the debt was incurred. Conversion to the U.S. return: The Puerto Rican tax return item was used. The Puerto Rican deduction could be limited under U.S. rules. However, we did not know whether the principal amount exceeded the U.S. limits because that information is not reported on the Puerto Rican income tax return.

(continued)

U.S. individual income tax item	Issues/comments on conversion to U.S. return
Gifts to charity	U.S. reporting: U.S. tax rules generally allow as an itemized deduction total contributions to governmental entities, charitable organizations, cemetery companies, war veterans groups, and certain domestic fraternal societies, which are usually limited to 50 percent of AGI. Certain contributions are also limited to 30 percent or 20 percent of AGI, depending on the type of contribution. A carryover is allowed for any excess up to 5 years. Puerto Rico reporting: The Puerto Rican allowable deduction is the total amount of contributions in excess of 3 percent of AGI. The actual deduction taken must not exceed 15 percent of AGI, except an additional deduction of up to 15 percent of AGI is allowed for contributions to accredited university-level educational institutions established in Puerto Rico. Under certain circumstances an unlimited deduction for charitable contributions is allowed. After 1994, a carryover for excess charitable contributions up to 5 years was allowed. Conversion to the U.S. return: The Puerto Rican tax return line item was used. However, because of the differences stated above, the U.S. deduction may be understated.
Casualty and theft losses	U.S. reporting: U.S. rules allow an itemized deduction for theft, vandalism, fire, storm, or similar causes; car, boat, and other accidents; and money lost due to insolvency or bankruptcy of financial institutions. Each separate casualty or theft loss must be $100 or more. Only losses that total more than 10 percent of AGI are deductible. Puerto Rico reporting: Puerto Rico limits losses of personal property to $5,000 for the year in which the loss was incurred. The carryover of excess losses is allowed for 2 years. Puerto Rico has no limit for casualty loss on a principal residence. Conversion to the U.S. return: The amount reported on the Puerto Rican return was included in the U.S. return as reported, but the U.S. limits were applied.
Miscellaneous deductions	U.S. reporting: The United States allows itemized deductions for unreimbursed employee expenses such as job travel, union dues, and job education. Other expenses are also deductible such as for investing, preparing tax returns, and renting a safe deposit box. Only amounts in excess of 2 percent of AGI are deductible. All itemized deductions are reduced by 3 percent of the amount that AGI exceeds a threshold amount. Puerto Rico reporting: Puerto Rican job expenses are deductible from AGI as “ordinary and necessary expenses” instead of as an itemized deduction. Taxpayers can deduct ordinary and necessary expenses whether or not they itemize. Generally, the expenses deductible are the same as in the United States. The amount deductible is limited to $1,500, or 3 percent of gross income from salaries, whichever is less. In 1994, the deduction of meals and entertainment expenses was reduced from 80 percent to 50 percent of the amount incurred. Conversion to the U.S. return: The amount reported on the Puerto Rican return was included in the U.S. return as a miscellaneous deduction but limited by the U.S. rules. In 1992, the rules on the deduction of meals and entertainment expenses were more restrictive in the United States.

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U.S. individual income tax item	Issues/comments on conversion to U.S. return
Other miscellaneous deductions	U.S. reporting: Several expenses are deductible as miscellaneous itemized deductions. However, they are not subject to the 2-percent limit. Examples of deductible items include the following: Amortizable premium on taxable bonds: Bond premiums are deductible for a bond purchased before October 23, 1986. Gambling losses to the extent of gambling winnings: The taxpayer cannot offset the losses against the winnings. He/she must report the full amount of the winnings and claim the losses as an itemized deduction. Impairment-related work expense of persons with disabilities: These are allowable business expenses incurred for the taxpayer to be able to work. Puerto Rico reporting: Bond premium amortization is allowed as an offset against interest income, and the net amount is reported as miscellaneous income; however, no deduction is allowed for interest-exempt bonds. Gambling losses are deducted from gambling winnings, and net gambling winnings are reported as miscellaneous income. Net gambling losses are not deductible. An itemized deduction is allowed for “orthopedic equipment expenses for the handicapped.” However, this deduction does not have to be directly related to the employment of the taxpayer. Conversion to the U.S. return: Since bond premium amortization is offset against interest income and gambling losses are offset against gambling winnings, we were not able to simulate a miscellaneous deduction for these items. Also, we were not able to simulate a miscellaneous deduction for orthopedic equipment expenses because under Puerto Rico’s tax law the orthopedic equipment expense deduction is not required to be work related to be deductible. However, orthopedic equipment expenses were included as medical and dental expenses (see medical and dental expenses).

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U.S. individual income tax item	Issues/comments on conversion to U.S. return
Child and dependent care tax credit (DCTC)	U.S. reporting: Under U.S. tax rules, the DCTC allows a portion of the child and dependent care expenses for the taxpayer to obtain gainful employment, as a nonrefundable tax credit. A child must be under the age of 13 to qualify. The credit is computed on the basis of maximum allowable related expenses of $2,400 for one child, or $4,800 for two or more children. Then, depending on the AGI of the taxpayer, a credit is computed on a sliding scale from 20 percent to 30 percent of the allowable expenses. Puerto Rico reporting: Puerto Rico allows a child-care, but not dependent-care, itemized deduction of $400 for one child and $800 for two children. The expenses must be for work or a profitable activity. The child must not be over 14 years of age to qualify. The Puerto Rican return lists the expenses, but up to the limitation amount. Conversion to the U.S. return: Because Puerto Rican taxpayers that do not itemize cannot claim the child-care deduction and because the expense limits are low in comparison to the United States, simulating the credit on the basis of the information reported on the Puerto Rican return would significantly understate the potential use of the credit. Because the DCTC could be an important feature of the federal income tax system extended to Puerto Rico, we imputed the potential value of the credit on the basis of available 1991 IRS Statistics of Income data (SOI). From the SOI data, we identified the dollar value of the credit claimed by all taxpayers categorized by the number of dependent children reported and by AGI class. We then calculated the average credit claimed for each number of dependents in each AGI class. This average credit was given to each Puerto Rican taxpayer with the same number of dependents in the same AGI group.
Credit for the elderly	U.S. reporting: U.S. rules allow the credit for taxpayers who are 65 or older or who have a permanent and total disability. The amount of the credit depends on the taxpayer's filing status, age, and level of pension, disability, or annuity income. Puerto Rico reporting: There is no similar credit in Puerto Rico. Conversion to the U.S. return: We were not able to calculate the credit because the necessary data were not available.
EITC	U.S. reporting: See table II.2. Puerto Rico reporting: Puerto Rico does not have a similar credit. Conversion to the U.S. return: EITC was computed using information reported on the Puerto Rican tax return.

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U.S. individual income tax item	Issues/comments on conversion to U.S. return
Foreign tax credit	U.S. reporting: The United States allows a credit or a deduction for any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States. Puerto Rico reporting: Puerto Rico allows a credit for the amount of income, war profits, and excess profits taxes imposed by the United States, possessions of the United States, and foreign countries. Conversion to the U.S. return: Officials from the Department of the Treasury of Puerto Rico told us that almost all of the foreign tax credits claimed by Puerto Rican residents (about $4.4 million) on Puerto Rican individual income tax returns was from income taxes paid to the United States. (Puerto Rican residents with income from sources outside Puerto Rico are subject to federal income taxes.) Because these amounts would be the equivalent of federal tax paid, they would not be deductible on a federal income tax return.
Miscellaneous credits	U.S. reporting: The United States has several targeted credits such as the general business credit, jobs credit, alcohol fuels credit, etc. Puerto Rico reporting: Data were not available from the Puerto Rican return to calculate any of these credits. Conversion to the U.S. return: These credits were not included in our simulation.
Alternative minimum tax (AMT)	U.S. reporting: AMT was developed to ensure that high-income taxpayers who make extensive use of certain tax deductions and exemptions pay a minimum amount of tax. AMT is computed by adding back certain tax preference items, such as certain itemized deductions, investment interest, depletion, and certain tax-exempt interest to taxable income. Certain tax preference items may have to be recomputed under special AMT rules before they are added back. After deducting an exemption amount, a tentative AMT amount is computed by multiplying the remaining income by either a 26-percent or 28-percent tax rate. The difference between the tentative AMT and the regular tax is the amount of AMT actually owed. The tentative AMT is then added to the regular income tax if it is greater than the regular tax. Puerto Rico reporting: Puerto Rico has an alternate basic tax that will be assessed if it is greater than the regular tax. The tax is computed by subtracting ordinary and necessary expenses and capital gains from AGI. Then an additional tax of 10 percent to 20 percent is calculated on alternative AGIs of over $75,000. The regular tax or the alternate basic tax is paid, whichever is larger. Conversion to the U.S. return: Since computing the U.S. AMT requires the application of complex rules for several income and deduction items, it requires a substantial amount of data to be accurately applied. Some of the data needed to apply these rules is not available on the Puerto Rican return, such as certain types of tax-exempt interest income. Accordingly, the AMT tax was not computed for our simulation.

Source: GAO analysis of U.S. and Puerto Rican income tax laws.

EITC Rules

EITC is a refundable tax credit available to low-income working taxpayers. The credit was established in 1975 to achieve two long-term objectives:

(1) to offset the impact of Social Security taxes on low-income workers with families and (2) to encourage low-income individuals with families to seek employment rather than welfare.

EITC amounts generally are determined according to the amount of the taxpayers' earned income and whether they have qualifying children who meet certain age, relationship, and residency tests, which are described in table II.2. The credit gradually phases in, plateaus at a maximum amount, and then phases out until it reaches zero. If the taxpayers' earned income or AGI exceeds the maximum qualifying income level, they are not eligible for the credit. When the taxpayers' AGI falls in the credit's phase-out range, they receive the lesser amount resulting from using either their earned income or AGI in calculating the credit.

When changes made in the 1993 Omnibus Budget Reconciliation Act are fully in effect in tax year 1996, taxpayers with two children and whose earned income ranges from $1 to $8,890 are to receive $0.40 for each dollar earned. Taxpayers with two children and whose incomes range from $8,890 to $11,610 are to receive the maximum credit amount of $3,556. The credit will gradually phase out, declining at a rate of about $0.21 for each additional dollar of income, for taxpayers with two children and incomes ranging from $11,610 to $28,495. Taxpayers with one qualifying child or no children receive EITC at a lower rate, with different plateau amounts and phase-out rates.

Beginning in 1996, taxpayers will be disqualified for EITC if their unearned income exceeds $2,350. Unearned income is defined as the combined amount of taxable and tax-exempt interest income, dividends, and the net income from rents and royalties not received from a trade or business.

The following table summarizes the principal EITC qualification rules and details the extent to which the Puerto Rican tax return provides data for determining eligibility for the credit.

Table II.2: Analysis of the Principal EITC Requirements for Tax Year 1996

EITC requirements	Issues/comments on conversion to U.S. return
Eligible individuals	
(1) Must have a qualifying child; must have had earned income; must not be a qualifying child of another person; if married persons, must file jointly or qualify for head-of-household status; or	See qualifying child definition below.
(2) Must have been a resident of the United States for more than one- half of the tax year; must have had earned income; must not be a dependent of another person; must not be a qualifying child of another person; if married persons, must file jointly or qualify for head-of-household status; must be at least 25 but not 65 years of age at the close of the tax year; and	Puerto Rico reporting: The Puerto Rican tax return reports residency in Puerto Rico at the end of the tax year, not residency for more than one-half of the tax year. Though age information is reported on the Puerto Rican return, this information was not made available for our simulation. The return does not ask whether the taxpayer is taken as a dependent on another taxpayer's return. EITC estimate: We assumed that the taxpayer had been a resident for more than one-half of the tax year, was not taken as a dependent on another taxpayer's return, and met the age requirements.
(3) Must not have disqualified income of more than $2,350. Disqualified income includes interest, dividends, and net income from rents and royalties not received from a trade or business.	Puerto Rico reporting: Specific income items can be identified on the Puerto Rican tax return. However, the Puerto Rican return includes royalties as part of miscellaneous income. EITC estimate: Since royalties and net rental income derived from nonbusiness or trade activity can not be specifically identified, they were not included in our simulation of the U.S. tax return.
Qualifying child	
(1) Relationship test: must be son, daughter, adopted child, or descendant of the son, daughter, or adopted child; stepson or stepdaughter; or foster child. Married child is not eligible unless he or she is a dependent.	Puerto Rico reporting: The Puerto Rican return identifies some relationships between the taxpayer and a dependent. The identified relationships include child, parent, in-laws, and "closely related." However, the return does not identify the specific relationships needed to comply with the EITC requirements. Qualifying child definition: We only included as qualifying children those dependents identified on the Puerto Rican return as "children." We were unable to include other eligible dependents in our simulation, such as "stepson or stepdaughter," because they are identified on the Puerto Rican return as "closely related," which includes other ineligible dependents.
(2) Age Test: must be under age 19, a full-time student under age 24, or permanently and totally disabled.	Puerto Rico reporting: Age and dependent status information is on the Puerto Rican tax return. Disabled persons also qualify as dependents. Qualifying child definition: Dependents listed on the Puerto Rican return as a nonuniversity student or university student and who met the age and relationship tests were counted as qualifying children. In the special case of head-of-household filers, when one dependent is selected as qualifying the filer for head-of-household status and included in a special dependent section, we assumed this dependent to have met the qualifying child requirements (age and relationship).

(continued)

EITC requirements	Issues/comments on conversion to U.S. return
(3) Residence test: child's principal place of residence is with the taxpayer in the United States for more than one-half year (the entire year, in the case of an eligible foster child). There are special rules for members of the U.S. armed services.	Puerto Rico reporting: Under Puerto Rican tax rules, a child's residence does not have to be with the taxpayer to qualify as a dependent. Also, the Puerto Rican return requests information on residency in Puerto Rico at the end of the tax year. It does not request information about whether more than one-half of the year was spent in the United States or Puerto Rico. Qualifying child definition: We assumed that the child had been a resident for more than one-half of the tax year.
Earned income	
Includes wages, salaries, tips and self-employment income, and certain nontaxable earned income items such as voluntary salary deferrals.	Puerto Rico reporting: Many earned income items can be identified on the Puerto Rican tax returns, including wages, salaries, tips, and self-employment income. These self-employment income items may vary from those which would have been reported on U.S. returns because of differences in tax accounting rules, such as those related to depreciation of assets. Earned income definition: We used data elements for wage, salaries, and tips as shown on the Puerto Rican return. Items included in our approximation to U.S. self-employment income were (1) profits or losses from special partnerships, (2) profits or losses from commissions, (3) profits or losses from agriculture, (4) profits or losses from professions, and (5) profits or losses from rental businesses.

Source: GAO analysis of EITC's principal tax requirements.

Comparison of U.S. and Puerto Rico's Taxation of Corporate and Partnership Income

Corporate Taxation

Puerto Rican tax rules for corporations have many similarities to and some differences from U.S. tax rules. Both the United States and Puerto Rico require corporations to report their worldwide income. Also, both Puerto Rico and the United States allow the deduction of "ordinary and necessary" business expenses and have similar rules on accounting for inventories and cost of goods sold. Prior to June 30, 1995, Puerto Rico allowed, under certain circumstances, businesses to expense up to 100 percent of the basis of business assets in the year of acquisition and thereafter. This provision was repealed in Puerto Rico's Tax Reform Act of 1994 for assets acquired after June 30, 1995.

Puerto Rico has generally higher marginal corporate tax rates than does the United States. In 1995, corporate taxes in the United States started at 15 percent for incomes of up to $50,000, with a maximum corporate tax rate of 35 percent.[1] In 1992, Puerto Rico's regular corporation tax rate started at 22 percent. Also, a sliding scale surtax was added to the regular tax, starting at a marginal rate of 6 percent for incomes up to $75,000 with an allowance of a special credit. The maximum surtax marginal rate was 20 percent for incomes over $275,000. Puerto Rico also has an alternative corporate capital gains tax rate of 25 percent and an alternative dividend rate of 20 percent. The Puerto Rico Tax Reform Act of 1994 lowered the regular corporate tax rate to 20 percent, the maximum surtax rate to 19 percent, and the alternative dividend rate to 10 percent.

Both the United States and Puerto Rico offer corporations special tax incentives to meet a variety of economic goals. In the United States these incentives can be either additional deductions from income or tax credits. Some examples of these incentives include accelerated depreciation of buildings, credits for low-income housing, expensing of research and experimentation expenditures, or the possessions tax credit.

Puerto Rico's tax code also includes various deductions and tax credits as incentives. However, since 1947, Puerto Rico has offered a tax incentive program to encourage the establishment and growth of manufacturing and certain other businesses. Most recently, the Puerto Rico Industrial Incentive Act of 1987 provided several tax reductions to industrial units that, for example, manufacture products that had not previously been made in Puerto Rico, produce products designated for export, develop specific types of real estate, or produce energy from recycling or renewable sources. In general, these businesses are exempted from

[1]A corporation with taxable income in excess of $100,000 is required to increase its tax liability by the lesser of 5 percent of the excess or $11,750. A corporation with taxable income in excess of $15 million must increase its tax liability by the lesser of 3 percent of the excess or $100,000.

taxation on 90 percent of the net income derived from these sources; and the same percentage for eligible interest and dividends; currency exchange; and patents, royalties, and other rights. The act also includes a package of municipal, personal property, and real property tax reductions.

The rate reductions are not permanent. The duration of the rate reductions depends on the location of the exempt business and varies from 10 to 25 years. However, the exempted businesses are allowed the option of selecting the specific years they will be exempt from taxation under the Industrial Development Act.

According to statistics provided by the Commonwealth, in 1993, 1,111 corporations were qualified under the Industrial Tax Exemption laws, with about $10.7 billion of exempted income.

Possessions Tax Credit

One U.S. tax policy significantly affecting Puerto Rico is the possessions tax credit defined in section 936 of the federal Internal Revenue Code (IRC). Under this section of the IRC, a portion of income derived from operations of qualified subsidiaries of U.S. corporations in U.S. possessions is effectively exempted from U.S. income tax.

Firms are qualified for the credit if, over the 3-year period preceding the close of a taxable year, 80 percent or more of their income was derived from sources within a possession, and 75 percent or more of their income was derived from the active conduct of a trade or business within a possession.

The 1993 Budget Reconciliation Act limited the possessions tax credit.[2] For tax years beginning after 1993, taxpayers are to calculate the credit as under prior law, but the credit would be capped under one of two alternative options selected by the taxpayer:

- The "percentage limitation" option provides for a decreasing credit equal to a decreasing percentage of the amount computed under prior law. The percentages are set by law at 60 percent for 1994, 55 percent for 1995, 50 percent for 1996, and 45 percent for 1997. The percentage will be 40 percent for 1998 and thereafter.
- The "economic activity limitation" option provides a cap on the credit equal to the sum of three factors:

[2] Omnibus Budget Reconciliation Act of 1993, Pub.L. No. 103-66, S13227, 107 Stat. 312, 489 (1993).

- The first factor is 60 percent of the firm's wages plus allocable employee fringe benefits paid in the possession, with wages limited for each employee to 85 percent of the maximum wage base under the old age survivor and disability insurance portion of Social Security.
- The second factor is a specific percentage of the firm's depreciation deductions for qualified tangible property for each taxable year. The type of property defines the applicable percentage, with factors ranging from 15 percent for property with a relatively short recovery period to 65 percent for assets with a long recovery period.
- The third factor, which applies only to firms that do not use the 50-percent profit-split method of income allocation[3] is a portion of the income taxes paid to the possession government. Included taxes, however, cannot exceed a 9-percent effective tax rate.

Partnership Taxation

U.S. and Puerto Rico's tax laws for partnerships have several significant differences. With a few exceptions, U.S. partnerships are not taxable entities. Distributions of partnership profits are included on the partner's individual income tax return and are taxed at personal income tax rates.

In contrast, Puerto Rico taxes regular partnerships on their net income at corporate tax rates and also requires partners to include distributed partnership profits as taxable income on their individual income tax returns.

"Special partnerships" in Puerto Rico are not taxed at the entity level. Instead, as is the case with U.S. partnerships, partners include on their individual income tax returns their distributable shares of partnership net income. To qualify as a special partnership, 70 percent of the partnership's gross income must come from Puerto Rican sources. Further, not less than 70 percent of such income must be generated from one of several activities including construction, land development, or manufacturing when it generates substantial employment.

[3]This method generally permits allocation to the possession corporation of 50 percent of the affiliated group of U.S. corporations' combined taxable income derived from sales of products that are manufactured in a possession.

Combined Individual Income Taxes: Puerto Rico, the 50 States, and the District of Columbia

The following tables compare the actual federal, state, local, and combined individual income taxes of the 50 states, the District of Columbia, and Puerto Rico. The income tax is measured in per-capita terms (table IV.1) and as percentage of total personal income (table IV.2.) In addition, table IV.3 shows the distribution of general revenue sources for Puerto Rico, the 50 States, and the District of Columbia.

Table IV.1: Actual Federal, State, and Local Individual Income Tax Per Capita, 1992

Puerto Rico/ fifty states/D.C.	Federal income tax	State and local income tax	Combined federal, state, and local income tax
Puerto Rico	**$1**	**$341**	**$342**
Mississippi	979	168	1,147
Louisiana	1,315	203	1,518
West Virginia	1,203	339	1,542
New Mexico	1,264	281	1,545
South Dakota	1,546	N.T.	1,546
Arkansas	1,213	355	1,568
North Dakota	1,480	189	1,669
Tennessee	1,669	19	1,688
South Carolina	1,311	392	1,703
Alabama	1,391	312	1,703
Oklahoma	1,363	380	1,743
Montana	1,368	391	1,759
Texas	1,781	N.T.	1,781
Utah	1,354	431	1,785
Arizona	1,532	324	1,856
Wyoming	1,880	N.T.	1,880
Kentucky	1,358	547	1,905
Maine	1,446	479	1,925
Idaho	1,430	502	1,932
Florida	1,997	N.T.	1,997
Nebraska	1,639	408	2,047
Iowa	1,569	505	2,074
North Carolina	1,558	524	2,082
Missouri	1,692	397	2,089
Vermont	1,623	475	2,098
Kansas	1,778	332	2,110
Georgia	1,680	455	2,135
Indiana	1,735	451	2,186

(continued)

Puerto Rico/ fifty states/D.C.	Federal income tax	State and local income tax	Combined federal, state, and local income tax
Michigan	1,856	385	2,241
New Hampshire	2,235	31	2,266
Washington	2,287	N.T.	2,287
Rhode Island	1,846	478	2,324
Ohio	1,753	581	2,334
Wisconsin	1,798	629	2,427
Oregon	1,688	747	2,435
Pennsylvania	1,909	545	2,454
California	1,957	551	2,508
Alaska	2,534	N.T.	2,534
Nevada	2,536	N.T.	2,536
Colorado	2,083	465	2,548
Virginia	2,039	519	2,558
Illinois	2,256	395	2,651
Minnesota	2,019	671	2,690
Delaware	2,129	759	2,888
Hawaii	2,111	785	2,896
Maryland	2,276	873	3,149
Massachusetts	2,404	891	3,295
New Jersey	2,816	525	3,341
New York	2,341	1,005	3,346
District of Columbia	2,587	1,073	3,660
Connecticut	3,288	569	3,857

N.T. = No Tax

Note: Puerto Rico's federal income tax per-capita amount is based on the foreign income tax credit (about $4.4 million) claimed on the Puerto Rican tax returns, which is almost all for federal taxes paid to the United States (see app. II, foreign tax credit). However, if residents of Puerto Rico had been subject to the federal income tax in the same manner as residents of the states were, we estimate that the federal individual income tax per-capita in Puerto Rico would have been about $14 in 1992, and the combined federal and Puerto Rican individual income tax per-capita would have been about $355 in 1992.

Sources: Significant Features to Fiscal Federalism, Vol. 2, Advisory Commission on Intergovernmental Relations, 1994; Statistics of Income Bulletin, IRS, Spring 1994; Informe Económico al Gobernador, Puerto Rico Planning Board, 1994; and GAO computations using Puerto Rico's taxpayer data provided by the Department of the Treasury of Puerto Rico.

Table IV.2: Actual Federal, State, and Local Individual Income Tax as a Percentage of Personal Income, 1992

Puerto Rico/ fifty states/D.C.	Federal income tax	State and local income tax	Combined federal, state, and local income tax
Puerto Rico	**0.0%**	**5.3%**	**5.3%**
Mississippi	7.0	1.2	8.2
South Dakota	9.0	N.T.	9.0
Tennessee	9.4	0.1	9.5
Louisiana	8.3	1.3	9.6
Texas	9.7	N.T.	9.7
North Dakota	8.7	1.1	9.8
West Virginia	7.7	2.2	9.9
New Mexico	8.2	1.8	10.0
Arkansas	7.8	2.3	10.1
Wyoming	10.1	N.T.	10.1
Florida	10.1	N.T.	10.1
New Hampshire	10.2	0.1	10.3
Alabama	8.4	1.9	10.3
South Carolina	8.1	2.4	10.5
Maine	8.0	2.6	10.6
Oklahoma	8.3	2.3	10.6
Arizona	8.8	1.9	10.7
Washington	10.7	N.T.	10.7
Nebraska	8.6	2.1	10.7
Montana	8.4	2.4	10.8
Kansas	9.2	1.7	10.9
Missouri	8.9	2.1	11.0
Vermont	8.6	2.5	11.1
Iowa	8.6	2.8	11.4
Michigan	9.5	2.0	11.5
Alaska	11.5	N.T.	11.5
Utah	8.7	2.8	11.5
Rhode Island	9.1	2.4	11.5
Kentucky	8.2	3.3	11.5
Georgia	9.1	2.5	11.6
Idaho	8.6	3.0	11.6
North Carolina	8.7	2.9	11.6
California	9.2	2.6	11.8
Nevada	11.7	N.T.	11.7

(continued)

Puerto Rico/ fifty states/D.C.	Federal income tax	State and local income tax	Combined federal, state, and local income tax
Pennsylvania	9.2	2.6	11.8
Indiana	9.4	2.5	11.9
Illinois	10.4	1.8	12.2
Virginia	9.8	2.5	12.3
Ohio	9.2	3.1	12.3
Colorado	10.1	2.3	12.4
Wisconsin	9.4	3.3	12.7
New Jersey	10.8	2.0	12.8
Hawaii	9.5	3.5	13.0
District of Columbia	9.3	3.8	13.1
Oregon	9.1	4.0	13.1
Minnesota	9.8	3.3	13.1
Maryland	9.8	3.8	13.6
New York	9.7	4.2	13.9
Massachusetts	10.2	3.8	14.0
Delaware	10.3	3.7	14.0
Connecticut	12.1	2.1	14.2

N.T. = No Tax

Note: Puerto Rico's federal income tax as a percentage of personal income is based on the foreign income tax credit (about $4.4 million) claimed on the Puerto Rican tax returns, which is almost all for federal taxes paid to the United States (see app. II, foreign tax credit). However, if residents of Puerto Rico had been subject to the federal income tax in the same manner as residents of the states were, we estimate that the federal individual income tax as a percentage of personal income in Puerto Rico would have been about 0.2 percent in 1992, and the combined federal and Puerto Rican individual income tax as a percentage of personal income would have been about 5.5 percent in 1992.

Sources: Significant Features to Fiscal Federalism, Vol. 2, Advisory Commission on Intergovernmental Relations, 1994; Statistics of Income Bulletin, IRS, Spring 1994; Informe Económico al Gobernador, Puerto Rico Planning Board, 1994; and GAO computations using Puerto Rico's taxpayer data provided by the Department of the Treasury of Puerto Rico.

Table IV.3: Puerto Rico, State, and District of Columbia General Revenue Sources, Percentage Distribution, Fiscal Year 1992

Puerto Rico/ fifty states/D.C.	Transfer from federal government	Individual income	Corporation income
Alabama	22.8%	10.1%	1.3%
Alaska	12.6	N.T.	3.0
Arizona	16.8	9.7	1.6
Arkansas	25.0	12.3	1.8
California	18.9	13.3	3.5
Colorado	16.3	12.6	1.0
Connecticut	16.4	12.4	3.9
Delaware	14.5	17.4	4.3
District of Columbia	37.7	13.3	1.9
Florida	13.8	N.T.	1.5
Georgia	19.0	13.8	1.7
Hawaii	16.6	16.0	1.2
Idaho	19.4	15.6	2.0
Illinois	16.5	11.2	2.4
Indiana	18.0	13.8	2.1
Iowa	17.1	14.0	1.9
Kansas	16.7	9.8	2.3
Kentucky	22.8	16.8	2.2
Louisiana	25.8	5.6	1.5
Maine	21.3	12.6	1.5
Maryland	16.3	23.4	1.2
Massachusetts	18.9	20.8	2.9
Michigan	17.8	10.1	4.8
Minnesota	15.9	15.3	2.2
Mississippi	28.2	5.7	1.9
Missouri	20.7	13.3	1.5
Montana	25.1	10.4	1.9
Nebraska	17.1	11.3	1.8
Nevada	15.1	N.T.	N.T.
New Hampshire	19.6	0.9	2.4
New Jersey	14.8	11.3	2.3
New Mexico	20.6	7.4	1.3
New York	18.6	17.6	4.3
North Carolina	19.0	16.5	3.0
North Dakota	24.6	4.9	1.6

Revenues from own sources					
Taxes					
Property	General sales	Other	Total taxes	Nontax revenues	Total revenues from own sources
5.6%	14.0 %	15.3 %	46.3 %	30.9 %	77.2 %
9.4	1.1	20.1	33.6	53.8	87.4
20.1	19.8	9.1	60.4	22.8	83.2
9.1	17.8	11.7	52.7	22.3	75.0
16.1	14.6	8.7	56.3	24.7	81.1
18.3	14.6	8.4	55.0	28.7	83.7
26.1	13.9	10.4	66.7	16.8	83.6
7.6	N.T.	24.4	53.6	31.9	85.5
19.2	9.4	7.3	51.1	11.2	62.3
21.6	18.5	14.7	56.4	29.8	86.2
16.4	15.9	7.6	55.3	25.8	81.0
9.8	22.8	10.0	59.9	23.6	83.4
13.9	12.8	11.0	55.2	25.3	80.6
24.2	13.4	11.5	62.7	20.8	83.5
17.4	15.1	6.4	54.8	27.1	82.0
19.7	10.4	10.2	56.1	26.8	82.9
21.6	13.9	10.6	58.2	25.1	83.3
9.1	11.2	14.6	53.9	23.3	77.2
7.6	17.5	13.2	45.4	28.8	74.2
21.7	12.2	8.7	56.7	22.0	78.7
17.5	8.6	11.8	62.5	21.2	83.7
20.5	7.7	7.7	59.6	21.5	81.1
25.0	10.2	7.0	57.1	25.1	82.2
17.7	11.3	10.1	56.5	27.5	84.1
12.1	15.3	9.8	44.7	27.1	71.8
13.5	16.9	10.8	56.0	23.3	79.3
18.9	N.T.	16.1	47.3	27.6	74.9
20.2	13.3	9.4	55.9	27.0	82.9
13.8	19.0	24.5	57.2	27.7	84.9
37.5	N.T.	17.7	58.4	22.0	80.4
27.2	11.1	10.9	62.8	22.4	85.2
5.7	19.8	12.8	47.0	32.4	79.4
20.7	10.7	8.7	62.0	19.4	81.4
11.8	13.7	12.2	57.3	23.7	81.0
13.8	11.1	14.2	45.6	29.7	75.4

(continued)

Puerto Rico/ fifty states/D.C.	Transfer from federal government	Individual income	Corporation income
Ohio	19.0	17.2	1.7
Oklahoma	19.1	12.3	1.5
Oregon	20.1	18.5	1.3
Pennsylvania	19.3	14.3	3.6
Puerto Rico	**29..3**	**19.3**	**18.0**
Rhode Island	25.4	12.0	1.2
South Carolina	22.2	12.4	1.2
South Dakota	26.1	N.T.	1.5
Tennessee	24.3	0.6	1.9
Texas	16.5	N.T.	N.T.
Utah	20.0	13.1	1.3
Vermont	22.1	11.6	1.3
Virginia	13.9	15.6	1.3
Washington	16.5	N.T.	N.T.
West Virginia	25.9	10.3	3.1
Wisconsin	16.8	16.4	2.3
Wyoming	26.7	N.T.	N.T.

Revenues from own sources					
Taxes					
Property	General sales	Other	Total taxes	Nontax revenues	Total revenues from own sources
16.8	11.7	9.8	57.2	23.8	81.0
7.9	15.8	15.4	52.9	28.0	80.9
21.4	N.T.	10.7	51.9	28.0	79.9
16.0	9.9	13.7	57.6	23.2	80.7
5.8	**N.T.**	**18.0**	**61.2**	**9.5**	**70.7**
23.7	9.8	9.7	56.3	18.3	74.6
14.3	12.9	9.3	50.1	27.7	77.8
18.9	16.5	11.4	48.2	25.7	73.9
11.5	21.8	12.9	48.7	27.0	75.7
22.8	18.5	16.6	57.9	25.6	83.5
14.0	16.4	6.9	51.8	28.3	80.0
23.2	6.7	12.7	55.5	22.4	77.9
19.5	9.7	13.5	59.7	26.4	86.1
17.3	28.5	13.3	59.1	24.4	83.5
8.9	13.4	14.8	50.5	23.6	74.1
21.5	11.6	9.0	60.7	22.5	83.2
18.2	9.3	15.4	42.9	30.4	73.3

N.T. = No Tax

Note: Totals may not add due to rounding.

Sources: Significant Features to Fiscal Federalism, Vol. 2, Advisory Commission on Intergovernmental Relations, 1994; and Informe Económico al Gobernador, Puerto Rico Planning Board, 1994.

Comments From the Secretary of the Treasury of Puerto Rico

TREASURY · GOVERNMENT OF PUERTO RICO

SECRETARY OF THE TREASURY

MANUEL DIAZ SALDAÑA

June 11, 1996

Ms. Lynda D. Willis
Director
Tax Policy and Administration Issues
U.S. General Accounting Office
Washington, D.C.

Dear Ms. Willis:

Thank you kindly for sending us the draft of your report **Analysis of Certain Potential Effects of Extending Federal Income Taxation to Puerto Rico**, for review and comments. We took great care at the Treasury Department in reading the document, and would like to share with you some general observations. More technical comments are included in a brief attachment to this letter.

The request you received referred to the tax effect of treating individuals residing in Puerto Rico as residents of the 50 states for purposes of federal income taxation. Your report addresses that issue. In our opinion, however, useful information about the total consequences of extending federal taxation to Puerto Rico is not elicited from the questions addressed to you. Said information would have been obtained by studying the consequences of integrating Puerto Rico into the federal fiscal system. To address the entire issue, it would have been necessary to consider the whole expected tax and transfer effects in such scenario on the U.S. and Puerto Rico public finances and economy.

It is difficult indeed to make compatible data reported in different tax bases for federal individual income tax liability estimates. We reviewed the methodology used to convert the data provided to the federal individual income tax base and to estimate the aggregate tax effect of extending federal individual income taxation to Puerto Rico. As you stated in the report, the estimates should be regarded as approximations.

One conclusion in your report is that the aggregate tax liability effect of adding the federal individual income tax system to the local, is practically nil. That conclusion did not consider

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Ms. Lynda D. Willis
June 11, 1996
Page 2

the distributional effects of the additional tax burden. These effects should be carefully evaluated and weighted whenever a major change in a tax system is considered or simulated. From the data in your report it is evident that, if distributional effects are taken into account, then (1) the Puerto Rican working poor would be better off, and (2) the fiscal system would have to undergo more profound transformations than a 5 percent reduction in tax collections. Obviously, in Puerto Rico we will not consider earned income tax credits refunds, as taxable income, and we will provide a relief to the remaining taxpayers in order to avoid any increase in their current tax liability. To implement such local tax reliefs would require adjustments in our fiscal system. As you know, in 1994 we were able to put into effect a tax reform, granting $400 million in tax reliefs while taking other public measures that resulted in increasing government revenues significantly.

Finally, the draft report comment regarding the amounts that local corporations may pay if federal income taxation is charged to them, does not appear to be pertinent to the inquiry, since those corporations are neither individuals nor corporations subject to Section 936 of the Internal Revenue Code. The assumption that their federal tax liability is going to be equal to their local one is not justified.

We trust you will find our comments useful. Please feel free to contact us for any further assistance.

Cordially yours,

Manuel Díaz Saldaña

TREASURY · GOVERNMENT OF PUERTO RICO
SECRETARY OF THE TREASURY

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Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate

May 2006

PUERTO RICO

Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit

On June 14, 2006, the PDF file was revised to show on page 65, third paragraph: $4.2 million rather than $3,755 for pharmaceuticals CFCs incorporated outside of Puerto Rico, $1.6 million rather than $1,465 for pharmaceuticals CFCs incorporated in Puerto Rico, and $0.9 million rather than $801 for possessions corporations in the pharmaceutical industry.

G A O

Accountability * Integrity * Reliability

GAO-06-541

May 2006

PUERTO RICO

Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit

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Highlights

Highlights of GAO-06-541, a report to Committee on Finance, U.S. Senate

Why GAO Did This Study

The federal possessions tax credit, which was designed to encourage U.S. corporate investment in Puerto Rico and other insular areas, expires this year.

Proponents of continued federal economic assistance to Puerto Rico have presented a variety of proposals for congressional consideration.

In response to a request from the U.S. Senate Committee on Finance, this study compares trends in Puerto Rico's principal economic indicators with those for the United States; reports on changes in the activities and tax status of the corporations that have claimed the possessions tax credit; explains how fiscal relations between the federal government and Puerto Rico differs from the federal government's relations with the states and other insular areas; and compares the taxes paid to all levels of government by residents of Puerto Rico, the states, and other insular areas.

GAO used the latest data available from multiple federal and Puerto Rican government agencies. Data limitations are noted where relevant. Key findings are based on multiple measures from different sources. GAO is not making any recommendations in this report.

In comments on this report the Governor of Puerto Rico said the report will be useful for evaluating policy options.

www.gao.gov/cgi-bin/getrpt?GAO-06-541.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-9110 or whitej@gao.gov.

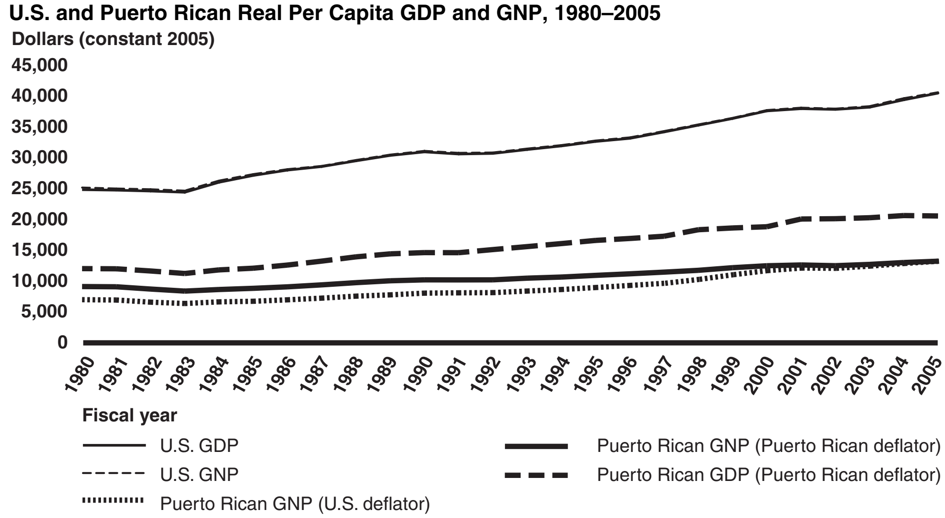
What GAO Found

Puerto Rico's per capita gross domestic product (GDP, a broad measure of income earned within the Commonwealth) in 2005 was a little over half of that for the United States (see figure below). Puerto Rico's per capita gross national product (GNP, which covers income earned only by residents of the Commonwealth) was even lower relative to the United States. Concerns about Puerto Rico's official price indexes make it difficult to say whether the per capita GNP of Puerto Rican residents has grown more rapidly than that of U.S. residents; however, the absolute gap between the two has increased.

U.S. corporations claiming the possessions tax credit dominated Puerto Rico's manufacturing sector into the late 1990s. After the tax credit was repealed in 1996 beginning a 10-year phaseout period, the activity of these corporations decreased significantly. Between 1997 and 2002 (the latest data available) valued added in these corporations decreased by about two-thirds. A variety of data indicates that much of this decline was offset by growth in other corporations, so that some measures of aggregate activity remained close to their 1997 levels. For example, value added in manufacturing remained fairly constant between 1997 and 2002. Most of the offsetting growth was in the pharmaceutical industry.

Residents of Puerto Rico pay considerably less total tax per capita than U.S. residents. However, because of lower incomes they pay about the same percentage of their personal income in taxes. The composition of taxes differed between Puerto Rico and the states with federal taxes being a larger share of the total in the states. This difference reflects the facts that (1) residents of Puerto Rico generally do not pay federal income tax on income they earn in the Commonwealth and (2) the Commonwealth government has a wider range of responsibilities than do U.S. state and local governments.

U.S. and Puerto Rican Real Per Capita GDP and GNP, 1980–2005



Source: GAO analysis of U.S. Bureau of Economic Analysis and Puerto Rican Planning Board data.

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Abbreviations

AABD	Aid to the Aged, Blind, or Disabled
BEA	Bureau of Economic Analysis
BLS	Bureau of Labor Statistics
CACFP	Child and Adult Care Food Program
CCDF	Child Care and Development Fund
CDBG	HUD's Community Development Block Grant Program
CDC	Centers for Disease Control and Prevention
Census	U.S. Census Bureau
CFCs	controlled foreign corporations
CMS	Centers for Medicare & Medicaid Services
CNMI	Commonwealth of the Northern Mariana Islands
CPI	consumer price index
CPL	Commonwealth poverty level
CPS	Current Population Survey
EIN	employer identification number
EPSDT	early and periodic screening, diagnostic, and treatment
ETI	extraterritorial income
FHA	Federal Housing Administration
FICA	Federal Insurance Contributions Act
FPL	federal poverty level
GDP	gross domestic product
GNP	gross national product
HHS	Department of Health and Human Services
HRSA	Health Resources and Services Administration
HUD	Department of Housing and Urban Development
IDEA	Individuals with Disabilities Education Act
IEP	individualized education programs
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LLC	limited liability company

NAP	IRS's National Accounts Profile
NAP	Nutrition Assistance Program (the Puerto Rican food stamp program)
NIH	National Institutes of Health
NOFA	Notices of Funding Availability
NSLP	National School Lunch Program
OCFI	Office of the Commissioner of Financial Institutions
PHA	public housing authorities
PPS	prospective payment system
PRIDCO	Puerto Rico Industrial Development Company
PRPHA	Puerto Rico Public Housing Administration
PRWORA	Personal Responsibility and Work Opportunity Reconciliation Act of 1996
QPSII	qualified possession source investment income
SAMHSA	Substance Abuse and Mental Health Services Administration
SCHIP	State Children's Health Insurance Program
SOI	IRS's Statistics of Income unit
SSI	Supplemental Security Income
TANF	Temporary Assistance for Needy Families
USDA	United States Department of Agriculture
WIC	Special Supplemental Nutrition Program for Women, Infants, and Children

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Washington, D.C. 20548

May 19, 2006

The Honorable Charles E. Grassley
Chairman
The Honorable Max Baucus
Ranking Minority Member
Committee on Finance
United States Senate

In response to your request, this report provides information on the Puerto Rican economy, including corporate activity, during the phaseout of the possessions tax credit, as well as descriptions of the application of federal tax law and federal social policy programs in Puerto Rico.

As we agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days from the date of this letter. We will then send copies to the Governor's office in Puerto Rico, Resident Commissioner Fortuno, and other interested parties. We will also make copies available to others who request them. This report will also be available at no charge on the GAO Web site at http://www.gao.gov. If you or your staffs have any questions on this report, please call me on (202) 512-9110. Key contributors are listed in appendix X.

James R. White

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Director, Tax Issues
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Executive Summary

Purpose

For the past 30 years, the U.S. Tax Code has provided a possessions tax credit specifically designed to encourage U.S. corporations to invest in Puerto Rico and the other U.S. insular areas and create jobs.[1] The credit had the effect of reducing federal taxes on income earned by qualifying U.S. corporations. Congress repealed the credit in 1996, but allowed existing credit claimants to continue use of the credit during a 10-year phaseout period ending in 2006.[2]

As the expiration date of the credit approached, Congress naturally became interested in reviewing the effects of the phaseout, particularly on the Puerto Rican economy, where over 98 percent of the credit has been claimed. At the same time, proponents of continued economic assistance to Puerto Rico have offered up a variety of proposals, including tax incentives to both businesses and low income workers, for congressional consideration. Congress could better assess the merits of the various proposals if it had more complete information relating to the current treatment that Puerto Rico receives under both federal tax policies and federal social programs, and information relating to the taxes paid by residents of Puerto Rico, relative to those paid by residents of the states and the other U.S. insular areas.[3]

To help inform itself and other members of Congress as they decide on future policy toward Puerto Rico, the Senate Committee on Finance asked GAO to

1. explain how the U.S. federal tax treatment of individuals and businesses in Puerto Rico and of the insular government differs relative to the treatment of governments, businesses, and individuals in the states and the other U.S. insular areas;

[1]In this report, GAO refers to the three major U.S. territories, the U.S. Virgin Islands, American Samoa, and Guam, and the two Commonwealths, the Commonwealth of Puerto Rico and the Commonwealth of the Northern Mariana Islands (CNMI), as "the insular areas."

[2]The Small Business Job Protection Act of 1996, Pub. L. No. 104-188 (1996), repealed the credit fully for tax years beginning after December 31, 2005, following a 10-year phaseout period.

[3]In this report, GAO refers to the 50 states and the District of Columbia as "the states."

2. compare trends in Puerto Rico's principal economic indicators since the early 1980s with similar indicators at the national level for the United States and describe what is known about capital flows between Puerto Rico and the United States and between Puerto Rico and foreign countries;

3. report on changes in the activities and tax status of the corporations that have claimed the possessions tax credit since 1993;

4. provide information on the distribution of private-sector economic activity in Puerto Rico by type of business entity;

5. describe the total amount of tax paid by individuals and businesses in the states and the U.S. insular areas and show percentage breakdowns by type of tax; and

6. describe how the principal U.S. federal social programs apply to Puerto Rican residents relative to residents of the states and the other U.S. insular areas.

This report does not contain any recommendations. Members of the Senate Committee on Finance have asked the Joint Committee on Taxation to prepare a companion report evaluating legislative options concerning Puerto Rico.

Background

This report focuses on the Commonwealth of Puerto Rico, the largest insular area associated with the United States, and compares Puerto Rico to the states and the other insular areas—Guam, the U.S. Virgin Islands, the Commonwealth of the Northern Mariana Islands (CNMI), and American Samoa. Although fiscally autonomous, Puerto Rico is similar to the states in many aspects. For example, matters of currency, interstate commerce, and defense are all within the jurisdiction of the U.S. federal government.

Puerto Rico is thought to have one of the most dynamic economies in the Caribbean region, an economy in which manufacturing, driven by the pharmaceutical industry, has surpassed agriculture as the primary sector in terms of domestic income. Over 40 percent of Puerto Rico's domestic income since the mid-1980s has been derived from manufacturing. Pharmaceuticals accounted for about 40 percent of total value added in manufacturing in 1987; that share rose to over 70 percent by 2002.

The Tax Reform Act of 1976[4] established the possessions tax credit under Section 936 of the Internal Revenue Code (IRC), with the stated goal of assisting the insular areas in "obtaining employment-producing investment by U.S. corporations."[5] Prior to 1994, the tax credit was equal to the full amount of the corporation's U.S. income tax liability on income from an insular area. The amount of possession tax credit claimed by corporations operating in Puerto Rico peaked at about $5.8 billion in 1993.[6] A series of limits were placed on the credit beginning with 1994 tax years, which significantly reduced the generosity of the credit throughout the period leading up to the credit's final expiration for tax years beginning after December 31, 2005.[7]

Numerous measures of business activity and broader economic activity exist. Some broad measures that are commonly recognized as key indicators of aggregate economic activity and were included in our past review of Puerto Rico's economy are[8]

[4]Pub. L. No. 94-455 (1976).

[5]The Internal Revenue Code (IRC) has included each of the insular areas in its definition of U.S. "possessions" for the purposes of the tax credits governed by Sections 936 and 30A of the IRC. Following the IRC and Internal Revenue Service (IRS) forms and publications, GAO uses the terms "possessions corporations" and "possessions income" to refer to corporations and income covered by these credits. GAO also uses the term "possessions tax credit" as shorthand to cover both the Puerto Rico and possessions tax credit and the Puerto Rico economic activity credit, which were claimed by possessions corporations operating in Puerto Rico during different periods covered by this report.

[6]All dollar figures in the trend analyses from chs. 3 and 4 of this report are adjusted for inflation to reflect the value of a dollar as of 2005. The data that we report from the U.S. Census Bureau (Census) and other sources for 2002 in chs. 5 and 6 were left in 2002 dollars to make it easier for readers to use our results in conjunction with Census's publications.

[7]The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993), limited the credit for tax years beginning after December 31, 1993. Those corporations whose tax years begin before January 1 may still claim the credit during the 2006 calendar year. For example, a corporation whose latest tax year began December 1, 2005 may claim the credit on income earned through November 30, 2006.

[8]GAO, *Tax Policy: Puerto Rican Economic Trends*, GAO/GGD-97-101 (Washington, D.C.: May 14, 1997).

- employment;
- investment, which is spending devoted to projects producing goods that are not intended for immediate consumption;[9]
- gross domestic product (GDP), which is a comprehensive measure of income earned by both residents and nonresidents within a country's (or, in the case of Puerto Rico, a Commonwealth's) borders;[10] and
- gross national product (GNP), which is the total income earned by residents of a country or other entity.

Measures that focus more specifically on business activity or value are

- value added, which essentially is the difference between the value of the goods and services produced by a firm and the firm's payments for materials, supplies, energy, and contract work, and which is considered to be the best measure of the relative economic importance of manufacturing across industries and geographic areas;
- gross profits, which, in the case of manufacturing firms, is roughly equivalent to value added and which is available from tax returns (whereas value added is not);
- total income, which is the sum of gross profits plus various types of investment income, such as interest, dividends, rents, and royalties;
- net income, which is total income less all expenses; and
- total assets, which is the sum of the value of a business's physical assets (plant, machinery, land, inventories), financial assets (cash, accounts receivable, investments), intangible assets (patents and other intellectual property), and other assets.

To qualify for the possessions tax credit, a corporation has to be organized in the United States; derive 80 percent or more of its gross income from

[9]Capital expenditures (i.e., spending on buildings and equipment) is a significant component of investment.

[10]GDP can also be measured as the total value of goods and services produced within a country's borders.

U.S. possessions; derive 75 percent or more of its gross income from the active conduct of a trade or business in the possessions; and file a form with the IRS electing to be treated as a possessions corporation. As a result of these requirements, possessions corporations usually are established as subsidiaries of a U.S. corporate parent, making the possessions corporation a member of a corporate group. In addition, one option under the credit allowed the U.S. corporate parent and the possessions corporation to apply a 50/50 split of their combined taxable income from the sale of products to third parties. Although a substantial portion of this income can be attributed to manufacturing intangible assets developed and owned by the U.S. corporate parent, there is no requirement that the allocation of income from such manufacturing intangible assets reflect where costs were actually generated, or where value was actually added to the products. Consequently, corporate groups that produced pharmaceuticals, or other products whose final values are largely based on the value of intellectual property, were given flexibility under the law to shift net income to the possessions corporation operating in Puerto Rico or another insular area.

In addition to possessions corporations, U.S. corporate groups often owned other types of businesses that operate in Puerto Rico. These affiliated businesses could include

- corporations incorporated within the United States but operating in Puerto Rico;
- U.S. controlled foreign corporations (CFC), which are incorporated in Puerto Rico or elsewhere outside of the United States, but which are majority-owned (by vote or value) by one or more U.S. shareholders, each of whom owns at least 10 percent of the CFC's voting stock; or
- a "pass-though entity," such as a partnership, a subchapter-S corporation, or a limited liability company (LLC), which generally does not pay federal income tax at the entity level, but whose income passes through, and is taxed in the hands of its partners or shareholders.

Scope and Methodology

Federal Tax Treatment

To determine the U.S. federal tax treatment of individuals and businesses in Puerto Rico, relative to the states and the other insular areas, we examined the IRC, Department of the Treasury regulations, relevant Treasury rulings and notices, and legislation.

Economic Indicators and Capital Flows

To compare trends in principal economic indicators for the United States and Puerto Rico, we obtained data from both U.S. and Puerto Rican sources. The trends we present are commonly used measures of overall economic activity and important components of economic activity, such as saving, investment, labor force participation and unemployment. The data shown are largely drawn from the National Income and Product Account series produced annually by economic statistics agencies in the United States and Puerto Rico. Most of the data we used for the U.S. economic series are produced by the Bureau of Economic Analysis and the Bureau of Labor Statistics. Most of the annual data we used for Puerto Rico economic trends are produced by the Planning Board of Puerto Rico. We also used data from the Economic Census of Puerto Rico and the Economic Census of the United States, produced by the U.S. Census Bureau (Census).

In some instances, the methodologies used by the Planning Board to produce certain data series are outdated relative to the methodologies now used by the United States. In these cases, we reviewed literature concerning the limitations of various series and interviewed Puerto Rican officials about the methods they use to collect and develop their data. These limitations are noted in the report. Wherever possible, we used alternative assumptions and data sources to determine if any conclusions drawn from the data are sensitive to the particular data series used.

To provide information on what is known regarding the flow of capital into and out of Puerto Rico, we interviewed Puerto Rican government officials and private sector experts to help us to ascertain what data were available. We determined that the available data would not allow us to present a comprehensive picture of the trends in capital flows. We can, however, report on changes between 1995 and 2004 in the amount of funds that nonresidents hold in the Puerto Rican banking system and the amount of funds that the banking system invests within and outside of the Commonwealth. In order to identify where the assets held in the Puerto Rican banking system are invested and where the owners of the banks' liabilities reside, we analyzed institution-specific data that the Office of the Commissioner of Financial Institutions (OCFI) collects for oversight purposes. We also use data provided by Puerto Rico's Government Development Bank to show trends in Puerto Rican government borrowing in the U.S. and local capital markets.

Changes in Possessions Corporation Activity

In order to examine changes in the activities of possessions corporations operating in Puerto Rico since the early 1990s, we constructed several databases from an assortment of tax return data we obtained from IRS and Puerto Rico's Department of Treasury. Our principal source of data was IRS's Statistics of Income unit (SOI), which compiles comprehensive data on possessions corporations every other year. We obtained the complete set of these biennial databases from 1993 through 2003 and used information from SOI to identify those possessions corporations that operated in Puerto Rico. We combined these separate databases into a single one that covered 656 possessions corporations that operated in at least 1 year between 1993 and 2003 to report on changes over time in the aggregate income, tax credit and total assets of this population of corporations and to show how these particular variables were distributed across different industries. We also used data from the past four Economic Censuses of Puerto Rico (1987, 1992, 1997, and 2002) compiled by Census to show how the importance of possessions corporations in Puerto Rico's manufacturing sector has changed over time.

For the second stage of our analysis, we focused on a subpopulation of the largest groups of affiliated possessions corporations operating in Puerto Rico. For each of these groups we compiled data on other affiliated corporations (i.e., those sharing the same ultimate parent corporations) that also operated in Puerto Rico, but were not possessions corporations. The objective of this analysis was to assess the extent to which the large corporate groups that accounted for most of the activity of possessions corporations remained active in Puerto Rico, even as the operations of their possessions corporations were being phased out. We started by identifying the 77 largest groups of possessions corporations that accounted for over 90 percent of the tax credit and income earned and over 90 percent of the assets owned by possessions corporations between 1993 and 2003. We then used the database in which IRS maintained the records of all CFCs, as well as a database that the Puerto Rican Department of

Treasury had recently transcribed from all Puerto Rican tax returns for tax years 1998 through 2001 filed by all corporations or partnerships that received tax incentives from the Government of Puerto Rico. We linked CFCs and other types of companies from these two databases to our 77 large corporate groups by using identification numbers and names. We determined that the quality of the data was sufficient for the purposes of our report when viewed with the cautions we raise at various points in the text.

Distribution of Business Activity

In order to show how economic activity in Puerto Rico is distributed across different forms of businesses, we negotiated a special arrangement with IRS and Census that enabled us to disaggregate the data from Census's recently completed 2002 Economic Census of Puerto Rico by categories of business entities that are more specifically relevant to tax policymakers than the categories Census uses for its own publications. The data that we used to determine the tax filing status and place of incorporation for the employers in the Census database came from the IRS and Puerto Rico databases described above, plus a couple of additional sources. Another important source of data was IRS's National Accounts Profile (NAP) database, which contains selected information for all individuals and businesses that have federal tax filing requirements.

Fiscal Comparison

To compare the overall taxes paid by individuals and businesses in Puerto Rico with the taxes paid by individuals and businesses in the states and in the other insular areas, we obtained and analyzed detailed data on state and local government revenues from the U.S. Census of Governments, data on Commonwealth government revenue from the Puerto Rican Department of Treasury, data on municipal tax revenue in Puerto Rico from Oficina del Comisionado de Asuntos Municipales, Centro de Estadisticas Municipales, and revenue data for the other insular areas reported in their 2002 Single Audit reports. We also obtained data on federal taxes collected in Puerto Rico and the states from IRS's 2002 Data Book.[11] We compared taxes paid on a per capita basis and as a percent of personal income. We make our comparison for year 2002 because that is the year of the most recent Census of Governments. We also compare federal expenditures for the

[11] We did not include the federal corporate tax in our comparison because the location where that tax is collected is may not be closely related to where the burden of the tax falls.

states, Puerto Rico and the insular areas using data we obtained from the Consolidated Federal Funds Report for Fiscal Year 2002 and the Federal Aid to States for Fiscal Year 2002.

Federal Social Programs

Interviews with federal agencies and prior GAO work provided the basis for our description of the application of the principal U.S. federal social programs to Puerto Rico residents, relative to the states, and the other insular areas. To select the social programs included in this report we consulted with GAO experts in the areas of health care policy; education, workforce, and income security policy; and financial markets and community investment policy. With the help of these experts, we arrived at a list of the principal federal social programs, which we then pared down, based on program availability in Puerto Rico and expenditure level in Puerto Rico. We relied on prior GAO work and interviews with federal agency officials to determine how each program is applied in Puerto Rico, relative to the other areas. We used program-level data, supplied by federal agencies, to report program expenditures for fiscal year 2002. We selected fiscal year 2002 because in chapter 6 of this report, we provide a more complete analysis of the revenue and expenditures of Puerto Rico, the states, and the other insular areas using the year of the most recent Census of Governments, 2002.

Results in Brief

Individuals who are residents of Puerto Rico or the other U.S. insular areas pay no federal income tax on income from sources within the insular area; however, their wages are subject to Social Security and Medicare taxes. Wages paid to residents of Puerto Rico and the U.S. Virgin Islands also are subject to federal unemployment tax. Corporations organized in Puerto Rico, like those organized in the other U.S. insular areas, are generally treated as foreign corporations for U.S. tax purposes and do not pay federal tax on their income earned in Puerto Rico, but are generally subject to federal tax on any income earned in the United States. Corporations organized in the United States are subject to federal tax on their worldwide income, including that earned in Puerto Rico. U.S. corporations that qualified for the possessions tax credit could reduce the federal tax on their income from Puerto Rico by using the credit.

The economic well-being of Puerto Rican residents, measured in terms of either per capita or median income, remains well below that of residents of the states. Puerto Rico's per capita GNP of about $14,000 in 2005 was significantly below the $41,000 figure for the United States. The latest available data show that in 1999, Puerto Rico's median household income of $14,412 also was well below the U.S. median value of $41,994. The relative progress that the Puerto Rican economy has made since 1980 is difficult to measure with precision for a number of reasons, including the fact that the income U.S. corporations have reported earning in the Commonwealth may overstate their actual activity there. The low rate of labor participation is a crucial issue in Puerto Rico's economic performance, and the rate of investment appears insufficient to significantly reduce the disparity between mainland and Puerto Rican incomes.

Possessions corporations have played an important role in the Puerto Rican economy, particularly in the manufacturing sector, where they accounted for well over half of valued added throughout the 1990s. Most of the possessions tax credit and income earned by possessions corporations in Puerto Rico has been earned by corporations in the pharmaceutical industry. Once the possessions tax credit was repealed, many of the large corporate groups that owned possessions corporations in Puerto Rico began to shift their operations to other types of business entities, such as CFCs and LLCs. According to various measures, the decline in activity of possessions corporations in the chemical industry, which is dominated by pharmaceuticals, has been largely offset by the increased activity of other members of the same corporate groups (i.e., who have the same parent companies) as the possessions corporations. For example, valued added, employment, and capital expenditures in the chemical industry all increased between 1997 and 2002—a period during which the activity of possessions corporations decreased significantly. Declines in the remainder of Puerto Rico's manufacturing sector have not been similarly offset.

U.S.-owned or incorporated businesses accounted for at least 71 percent of value added and at least 54 percent of employment in Puerto Rico's manufacturing sector in 2002. CFCs produced most of this value added but possessions corporations still accounted for most of the employment by U.S. firms. The CFCs are particularly important in the pharmaceutical industry and much less so in other manufacturing industries. U.S.-owned or incorporated businesses appear to account for less than 25 percent of employment in Puerto Rico's wholesale and retail trade sectors, where local corporations are the most important employers. Similarly, U.S.-owned corporations are not the majority employers in any of the large Puerto Rican service industries for which data are available.

Residents of Puerto Rico pay considerably less total tax per capita than do U.S. residents, but they pay about the same percentage of their personal income in taxes. The average burden of federal taxes (excluding the corporate income tax) in Puerto Rico was considerably lower than that in the states, but the difference was made up by the fact that Commonwealth and local taxes in Puerto Rico were higher than the average state and local taxes. Federal grants and payments to the Puerto Rican government in 2002 were about the same as those to all state and local governments in the states on a per capita basis; however, direct federal payments to individuals in Puerto Rico were well below the per capita amounts paid to residents in the states. Similarly, per capita federal payments for salaries and wages and for procurement were significantly lower in Puerto Rico than in the states.

Like the states, Puerto Rico and the other insular areas receive federal funds for a variety of social programs, which provide assistance to the elderly and low-income families and individuals. The social programs that we examined in the insular areas targeted similar populations and delivered similar services to those in the states—although sometimes the program had different rules and funding than in the states.

Principal Findings

U.S. Federal Tax Treatment of Puerto Rico and Other Insular Areas Differs by Area and Type of Tax

Individuals who are residents of Puerto Rico or the other U.S. insular areas pay no federal income tax on income from sources within the insular area. The federal tax treatment of U.S.-source income earned by these individuals varies by insular area. Federal Insurance Contributions Act (FICA) taxes are imposed on wages paid to residents of all of the U.S. insular areas, but the unemployment insurance tax applies only to wages paid to residents of Puerto Rico and the U.S. Virgin Islands.

Corporations created or organized in the United States or under the laws of the United States or of a state are taxed by the federal government on their worldwide income, including that earned in Puerto Rico and the other insular areas. U.S. corporations may be able, however, to reduce their U.S. tax liability on their foreign source income by way of a credit against their U.S. tax for foreign income taxes paid. Additionally, while income from a foreign business operation that is not organized as a separate legal entity is taxed currently, income from the active conduct of business operations set up by U.S. shareholders as separate corporations organized under the laws of a foreign country generally is not taxed to the U.S. shareholders until it is repatriated as dividends. Although, if the income from the foreign corporation is connected to business that the foreign corporation has in the U.S., the income is taxed currently to the foreign corporation.

Corporations organized in Puerto Rico, like those organized in the other insular areas, are generally treated for U.S. tax purposes as if they were organized under the laws of a foreign country. Until this year, a possessions tax credit enabled corporations organized in the United States that met certain conditions to reduce the federal tax payable on income earned in and repatriated from Puerto Rico and other insular areas. The credit had been designed to encourage U.S.-based corporations to invest in these areas.

Federal customs duties apply to foreign goods imported into Puerto Rico, and federal excise taxes apply to selected goods manufactured in Puerto Rico and exported to the United States, but the revenues from these taxes and duties are given to the Puerto Rican Treasury.

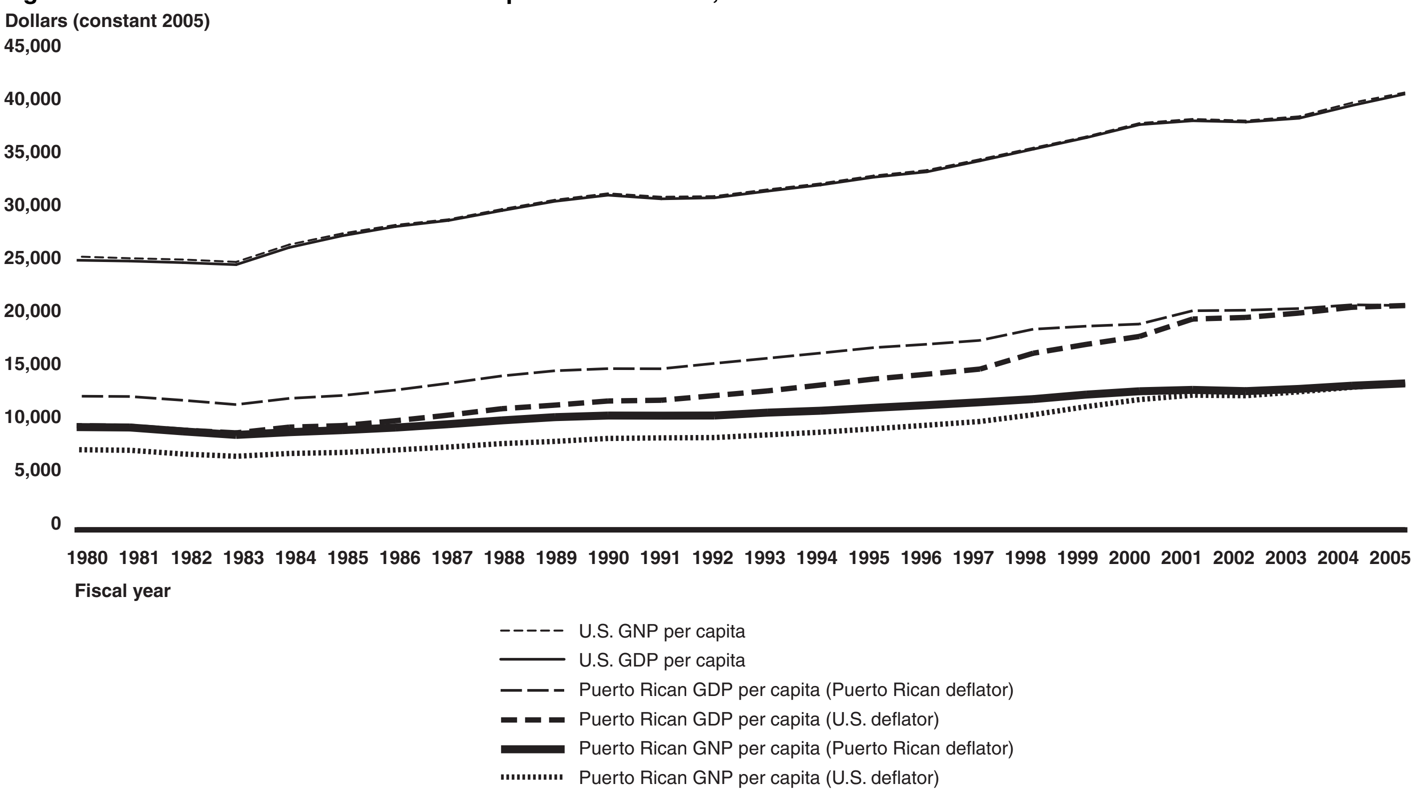
Measuring Economic Progress in Puerto Rico Is Challenging, but the Income of Commonwealth Residents Remains Well Below That of U.S. Residents

As shown in figure 1, Puerto Rico's per capita GDP of about $21,000 in 2005 remained well below U.S. per capita GDP of about $41,000. According to the Puerto Rican and U.S. national income and product accounts, this measure has grown more rapidly in Puerto Rico than in the United States since 1980, when viewed on a per capita basis after adjustments for inflation. However, for a number of reasons, the growth rate of real (meaning inflation-adjusted) GDP likely does not represent a very accurate measure of changes in the economic well-being of Puerto Rican residents. One important reason is that a significant amount of the investment income included in GDP is paid out to U.S. and foreign investors. Per capita GNP and median household income are better measures of the income earned by residents. Puerto Rico's per capita GNP of about $14,000 in 2005 was significantly below the $41,000 figure for the United States. The latest available data show that in 1999, Puerto Rico's median household income of $14,412 also was well below the U.S. median value of $41,994. Puerto Rican government officials acknowledged significant concerns regarding the accuracy of their official implicit price deflator (a measure of price changes), due to the age of the underlying methodology.[12] (There are plans

[12]In the report all references to the Puerto Rican deflator refer to the Puerto Rican implicit gross product deflator.

to overhaul this methodology with the assistance of the U.S. Bureau of Economic Analysis.) The likelihood of inaccuracy in the existing deflator makes it difficult to say precisely how fast Puerto Rican incomes have grown in real (inflation-adjusted) terms. The U.S. price deflator is an alternative for converting the Puerto Rican data into real terms; however, since that deflator is designed to measure price changes in the U.S. economy, it is not clear how well it reflects changes in Puerto Rican prices. Using the amounts shown in figure 1, inflation-adjusted per capita GNP increased at an average annual rate of 1.9 percent in the United States, while it rose at 1.5 percent in Puerto Rico if the Puerto Rican deflator is used. However, if the U.S. deflator is applied to Puerto Rican GNP, annual real per capita GNP rose by 2.5 percent annually, faster than the growth in the United States.

Figure 1: U.S. and Puerto Rican Real Per Capita GDP and GNP, 1980–2005



Source: GAO analysis of U.S. Bureau of Economic Analysis and Puerto Rican Planning Board data.

Note: Figures were adjusted for inflation using U.S. and Puerto Rican gross product deflators.

The other problems with using the trend in per capita GDP as a measure of Puerto Rico's economic progress are that (1) federal tax rules have given U.S.-owned corporations an incentive to overstate the amount of income they earn in Puerto Rico and those rules changed during the 1990s in a way that may have affected the extent of the overstatement, and (2) the scale of the informal, or underground, economy in Puerto Rico relative to the informal economy in the United States is unknown. The first of these problems results in an overstatement of Puerto Rico's GDP, but not its GNP. If the size and growth in the informal economy in Puerto Rico is large relative to the size and growth of informal economy in the United States, comparisons between levels and growth in both per capita GDP and GNP in the two jurisdictions could be affected.

Overall, employment in Puerto Rico has grown over the past two decades, despite a decline in manufacturing jobs. The gap in the rate of unemployment between Puerto Rico and the United States has narrowed in recent years, but Puerto Rico's rate of 10.6 percent in 2005 was still notably higher than the rate in the United States, which was below 6 percent. Puerto Rico's labor participation has been under 50 percent throughout the past two decades, well below the U.S. rate, which has generally been above 65 percent. This low labor participation rate in Puerto Rico, along with a relatively low rate of investment there, despite considerable investment from nonresidents, are two key issues that affect Puerto Rico's economic performance.

Some Measures of Aggregate Manufacturing Activity Have Remained Constant Despite a Decline in Possessions Corporation Activity

U.S. corporations claiming a possessions tax credit played a dominant role in Puerto Rico's manufacturing sector into the late 1990s. According to the economic censuses of the Puerto Rican manufacturing sector that Census compiles every five years, possessions corporations accounted for 38.2 percent of employment and 61.6 percent of output in the manufacturing sector in 1987. These shares rose to 40.8 percent and 72.0 percent in 1997, before falling to 31.8 percent and 26.7 percent by 2002. Tax data show that the amount of possessions tax credit that these corporations claimed peaked at $5.8 billion in 1993, the last year before the generosity of the credit was significantly curtailed, and that the gross profits of these corporations earned in Puerto Rico peaked at $28.8 billion in 1997, the year after the possessions tax credit was repealed (starting a 10-year phaseout period).

From 1993 to 2003, the number of corporations claiming the credit for operations in Puerto Rico fell from 378 to 124, and the amount of credit claimed declined from $5.8 billion to $1.1 billion. The gross profits that these corporations earned in Puerto Rico dropped from $24.8 billion to $12.1 billion, and their total assets declined from $59.5 billion to $41.1 billion.

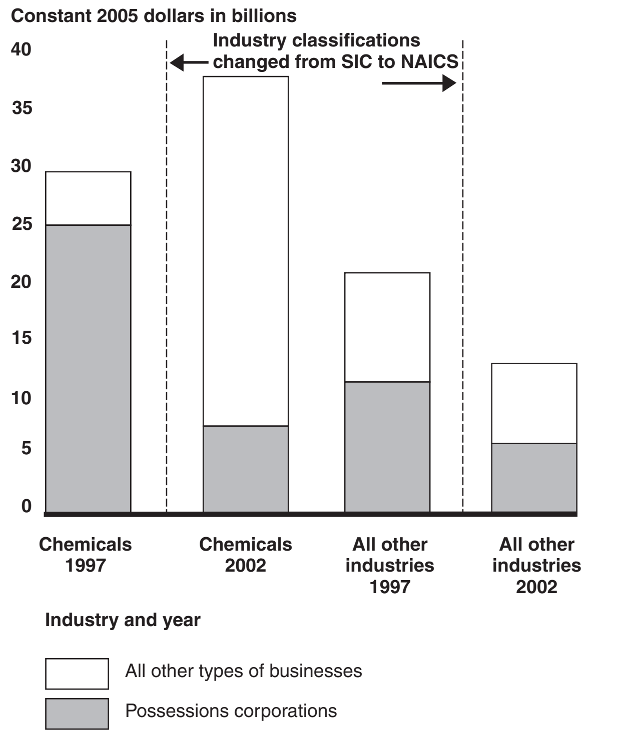
A combination of tax return and Economic Census data indicate that the decline in income and value added of possessions corporations has been largely offset by an increase in the income and value added of affiliated corporations that left aggregate income and value added roughly the same. GAO tracked the best available data on the affiliated corporate groups that have claimed almost all of the possessions tax credit since 1993 and found that the decline in the reported gross profits, total income, and total assets of possessions corporations within those groups was largely offset by increases in the reported gross profits and assets of affiliated corporations operating in Puerto Rico between 1997 and 2001, particularly those incorporated outside of the United States. Data from recent Economic Censuses of Puerto Rico, presented in figure 2, show that the decline in value added by possessions corporations in the chemical industry (which is dominated by pharmaceuticals) between 1997 and 2002 was more than offset by increases in the value added of other types of businesses. In contrast, value added for both possessions corporations and all other types of businesses declined in the remainder of the manufacturing sector over that period. A change in Census's industrial classification system between 1997 and 2002 means that the scope of the industries being compared for those two years in the following figures may not be exactly the same.[13] However, the basic point of each of these figures is not invalidated by this factor.

Although some evidence of a possible change in income-shifting behavior by U.S.-owned businesses makes it difficult to say how accurately trends in reported income and value-added data represent trends in actual economic activity in Puerto Rico, data on capital expenditures (fig. 3), employment (fig. 4), and total assets (none of which should be distorted by income shifting) support the conclusion that a substantial amount of possessions corporation activity has been continued by other types of businesses. However, most of this continued activity is concentrated in the pharmaceutical industry and the decline in possessions corporation

[13]Census used the Standard Industrial Classification (SIC) up until the 1997 Census and used the North American Industrial Classification System (NAICS) for the 2002 Census. This change should not affect the basic message of any of the figures in this report.

activity in the remainder of Puerto Rico's manufacturing sector has not been offset. None of the data GAO presents addresses the question of what corporate activity would have taken place during this period if the possessions tax credit had not been repealed.

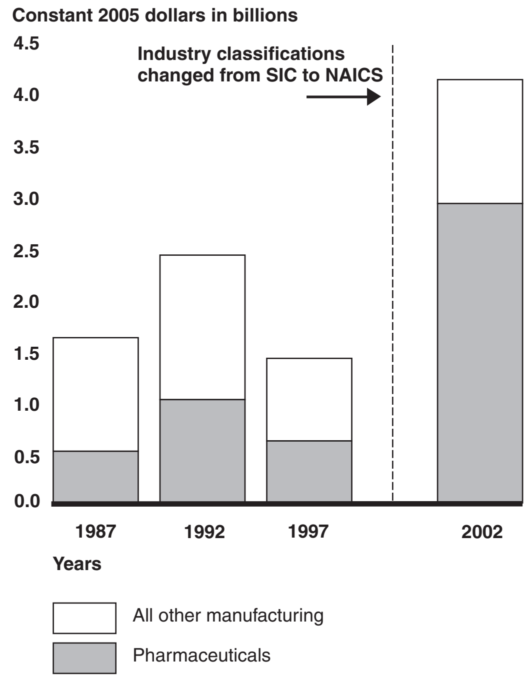
Figure 2: Value Added for Possessions Corporations and Other Types of Employers in the Chemical Industry and All Other Manufacturing Industries, 1997–2002



Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

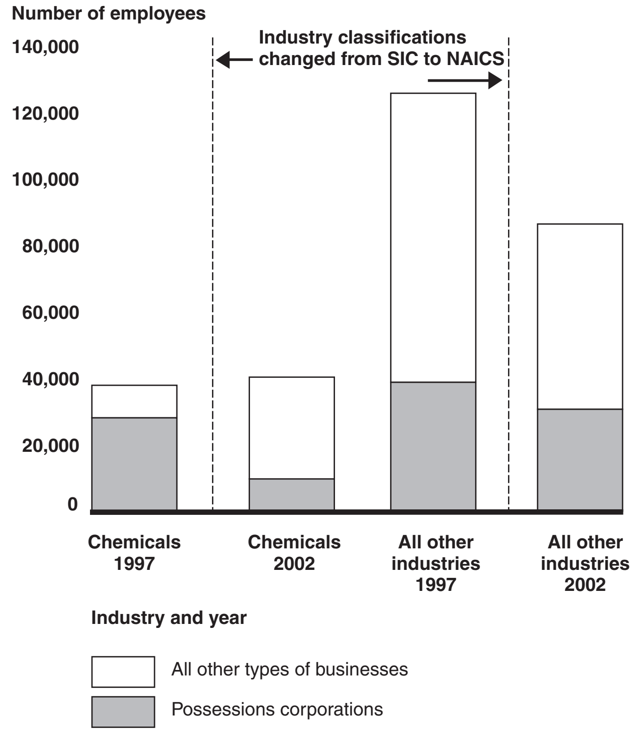
Figure 3: Capital Expenditures in Puerto Rico's Manufacturing Sector, by Industry, 1987–2002



Source: GAO analysis of published data from the 2002 Economic Census of Island Areas and the Economic Census of Outlying Areas for 1987,1992, and 1997.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

Figure 4: Employment in Possessions Corporations and Other Types of Employers in the Chemical Industry and All Other Manufacturing Industries, 1997–2002



Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

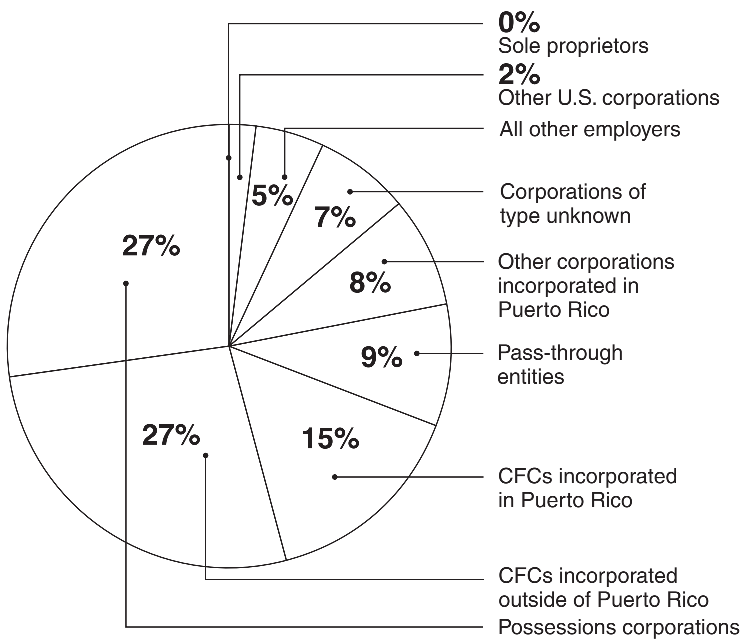
Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

U.S.-owned or U.S.-incorporated Businesses Dominated Puerto Rican Manufacturing in 2002 but Played Much Smaller Roles in Other Sectors of the Economy

U.S.-owned businesses accounted for at least 71 percent of value added and at least 54 percent of employment in Puerto Rico's manufacturing sector in 2002. CFCs produced most of this value added but possessions corporations still accounted for most of the employment by U.S. firms. The CFCs are particularly important in the pharmaceutical industry and much less so in other manufacturing industries. U.S. corporations appear to account for less than 25 percent of employment in Puerto Rico's wholesale and retail trade sectors, where local corporations are the most important employers. Similarly, U.S.-owned corporations are not the majority employers in any of the large Puerto Rican service industries for which data are available.

As of 2002, U.S. CFCs accounted for 42 percent of value added in Puerto Rico's manufacturing sector—a larger share than that of any other type of business entity (see fig. 5). They were able to produce this value added with a relatively small share—14 percent—of the sector's total employment (see fig. 6). Possessions corporations, which had the next largest share of value added, with 27 percent, remained the largest single type of employer, with 31 percent of the sector's employment.

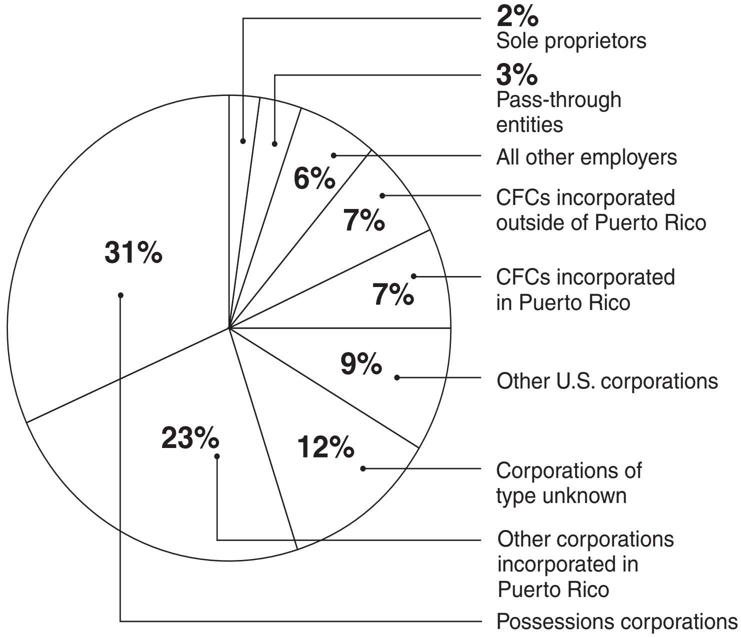
Figure 5: Distribution of Value Added for All Puerto Rican Manufacturing by Type of Business Entity, 2002



Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: Value-added figures for sole proprietors round to 0 percent.

Figure 6: Distribution of Employment for All Puerto Rican Manufacturing by Type of Business Entity, 2002



Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

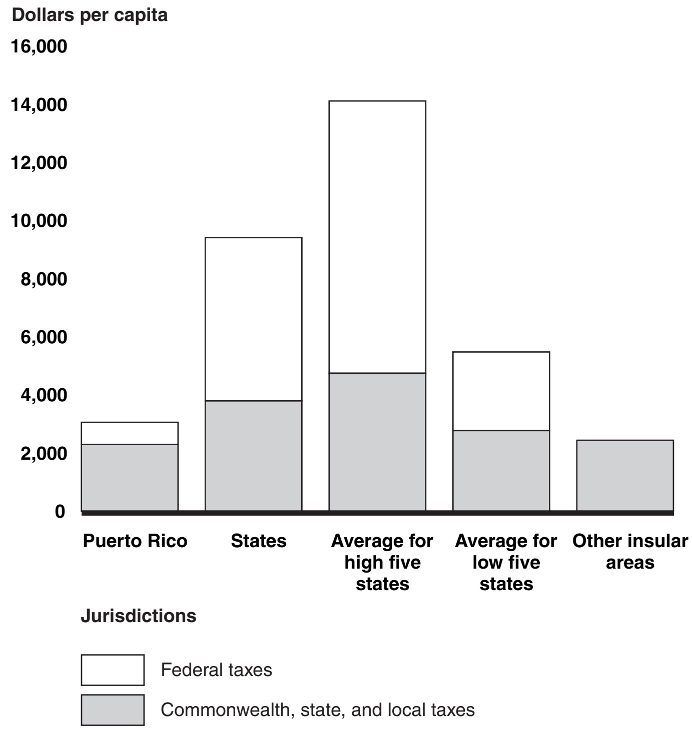
Taxes Paid Per Capita in Puerto Rico Are Considerably Lower Than Those in the States but the Taxes are About the Same Share of Personal Income in Both Places

The per capita tax burden imposed by all levels of government (federal, Commonwealth, and local) in Puerto Rico in 2002 was $3,071, considerably less than the per capita burden of $9,426 in the states (see fig. 7). However, the combined tax burden in Puerto Rico amounted to 28 percent of personal income, which was close to the 30 percent burden in the states (see fig. 8).[14] The rate for the five states with the highest combined tax burden was 39 percent, while that for the five states with the lowest burden

[14]Data on personal income and on federal taxes paid in the other insular areas are not available. Taxes paid by residents of the other insular areas to their own governments in 2002 amounted to $2,451 per capita—slightly higher than the $2,310 per capita that residents of Puerto Rico paid to the Commonwealth and municipal governments.

was 23 percent.[15] The average burden of federal taxes (excluding the corporate income tax, which is difficult to allocate by location) in Puerto Rico was considerably lower than in the states, but this difference was made up by the fact that Commonwealth and local taxes in Puerto Rico were higher than the average state and local taxes. Commonwealth income and sales taxes were higher as a percent of personal income than those of state and local governments, but property taxes in the Commonwealth were lower.

Figure 7: Per Capita Taxes Paid in the United States and Insular Areas, Fiscal Year 2002

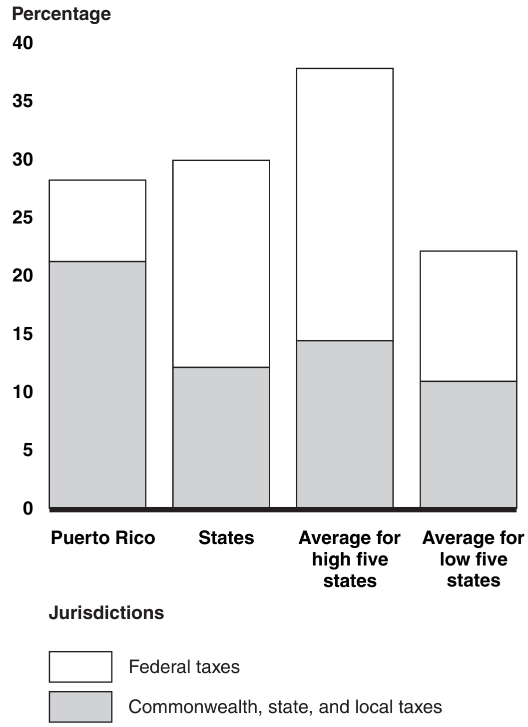


Source: GAO analysis of IRS, Census, and Insular Area Treasury Department data.

[15]The five states with the highest combined tax burden were the District of Columbia, Minnesota, Delaware, Connecticut, and New Jersey. Those with the lowest were Montana, South Carolina, Alabama, West Virginia, and Mississippi.

Federal grants and payments to the Puerto Rican government in 2002 amounted to $1,242 per capita, about the same as the $1,264 per capita paid to all state and local governments in the states, but less than the $1,703 per capita paid to the other insular area governments. The $2,057 per capita of direct federal payments to individuals in Puerto Rico was well below the $3,648 per capita paid to state residents, but higher than the $1,418 per capita paid to residents of the other insular areas. The per capita federal payments of $336 for salaries, wages, and procurement in Puerto Rico were about 20 percent of payments for those purposes in the states and the other insular areas.

Figure 8: Taxes Paid as a Share of Personal Income in the United States and Insular Areas, Fiscal Year 2002



Source: GAO analysis of IRS, Census, and Insular Area Treasury Department data.

The Extent to Which Federal Social Programs in Puerto Rico Mirror Those in the States and U.S. Insular Areas Varies

The social programs that we examined in the insular areas generally targeted similar populations and delivered similar services to those in the states—although sometimes the program had different rules and funding than in the states. For example, in lieu of the Food Stamp Program available in the states, which is an entitlement program based on the number of participants, Puerto Rico receives a capped block grant that has similar eligibility requirements. The major difference between some of the social programs GAO examined in the states versus those in Puerto Rico and the other insular areas is how they are funded. For example, under HOME Investment Partnerships eligibility rules are the same in Puerto Rico and the states; however, unlike for the states, the amount of HOME funding is subject to a cap. To cite another example, where federal Medicaid spending is an open-ended entitlement to the states, it is subject to a statutory cap and a limited matching rate in Puerto Rico and the other insular areas. Some of the social programs that GAO examined are available in the states, but not in some of the insular areas. Table 1 summarizes how selected social programs compare between Puerto Rico and the states.

Table 1: Summary of Selected Social Programs in Puerto Rico Compared to Those in the States

Same in Puerto Rico and the states	Operates the same in Puerto Rico, or comparable programs operate, but financing differs	Some components have financing differences and some do not
Individuals with Disabilities Education Act (IDEA) Part B	Food Stamp or Nutrition Programs	Health Grants
Title I of the Elementary and Secondary Education Act, reauthorized by the No Child Left Behind Act of 2001	Medicare	
Child and Adult Care Food Program	Medicaid	
National School Lunch Program	State Children's Health Insurance Program (SCHIP)	
Special Supplemental Nutrition Program for Women, Infants, and Children (WIC)	Aid to the Aged, Blind, or Disabled (AABD)	
HOPE VI	Temporary Assistance for Needy Families (TANF)	

(Continued From Previous Page)

Same in Puerto Rico and the states	Operates the same in Puerto Rico, or comparable programs operate, but financing differs	Some components have financing differences and some do not
Housing Choice Vouchers	Child Care and Development Fund (CCDF)	
Community Development Block Grants	Foster Care and Adoption Assistance	
Project-based Section 8	HOME Investment Partnerships	
Public Housing		
Section 203 (b) Single Family Mortgage Insurance Program		

Source: GAO analysis of U.S. federal social programs.

Agency Comments

GAO shared a draft of this report with representatives of the Governor of Puerto Rico. In written comments the Governor said that he is confident the report will be useful to Congress for evaluating options for promoting jobs and investment in Puerto Rico. The Governor highlights the disproportionate job loss in Puerto Rican manufacturing over the last 10 years and notes, as the report states, that the report does not attempt to project what the current level of manufacturing employment and value added would have been had the credit not been repealed. The Governor's letter is reprinted in appendix IX.

Introduction

The federal and Commonwealth governments have had a long-term interest in policies to stimulate economic growth in Puerto Rico. Historically, the centerpiece of these policies has been the combination of the possessions tax credit in the U.S. Internal Revenue Code (IRC) and extensive tax incentives in the Puerto Rican tax code for U.S. and foreign businesses. In the early 1990s Congress became dissatisfied with the effectiveness of the credit and introduced restrictions to better target employment-generating activities. Then in 1996 Congress repealed the credit but allowed existing possessions corporations to earn either the possessions credit or a replacement credit during a 10-year phaseout period ending in 2006. Various proposals have been placed before Congress for some form of replacement assistance to the Puerto Rican economy. Congress could better assess the merits of the various proposals if it had more complete information relating to the recent performance of the Puerto Rican economy, the current treatment that Commonwealth residents receive under both federal tax policies and federal social programs, and information relating to the burden of taxes that residents of Puerto Rico pay, relative to those paid by residents of the states and the other U.S. insular areas.

To provide a basis for future decisions regarding legislation on Puerto Rican economic issues, this report

- explains how the U.S. federal tax treatment of individuals and businesses in Puerto Rico and of the insular government differs relative to the treatment of governments, businesses, and individuals in the states and the other U.S. insular areas;
- compares trends in Puerto Rico's principal economic indicators since the early 1980s with similar indicators at the national level for the United States and provides what is known about capital flows between Puerto Rico and the United States and between Puerto Rico and foreign countries;
- reports on changes in the activities and tax status of the corporations that have claimed the possessions tax credit since 1993;
- provides information on the distribution of private-sector economic activity in Puerto Rico by type of business entity;

- describes the total amount of tax paid by individuals and businesses in the states and the U.S. insular areas and shows percentage breakdowns by type of tax; and
- describes how the principal U.S. federal social programs apply to Puerto Rican residents, relative to residents of the states and the other U.S. insular areas.

Background

Puerto Rico is one of the two nonstate Commonwealths associated with the United States. The other is the Commonwealth of the Northern Mariana Islands (CNMI). The United States also has three major territories under the jurisdiction of the U.S. Department of Interior. The major territories are Guam, the U.S. Virgin Islands, and American Samoa. The three major territories plus the two nonstate Commonwealths are referred to in this report as "the insular areas."[1] These areas are often grouped together in this manner for the purpose of federal legislation. For this reason, and when necessary for the purpose of comparison to Puerto Rico, this report provides a limited discussion on the other insular areas.

With the exception of American Samoa, those born in the insular areas are U.S. citizens; however, insular area residents are not afforded all of the rights of citizens residing in the states.[2] More than four million U.S. citizens and nationals live in the insular areas. These areas vary in terms of how they came under the sovereignty of the United States and also in terms of their demographics, such as median age and education levels. Each of the insular areas has its own government and maintains a unique diplomatic relationship with the United States. General federal administrative responsibility for all insular areas but Puerto Rico is vested in the Department of the Interior. All departments, agencies, and officials of the executive branch treat Puerto Rico administratively "as if it were a state";

[1]These five insular areas are the subject of this report. The nine smaller U.S. territories that are not included in our report's definition of insular areas, because they are not included in the scope of this report, are Navassa Island in the Caribbean Sea, and Baker Island, Howland Island, Kingman Reef, Jarvis Island, Johnston Atoll, Midway Atoll, Palmyra Atoll, and Wake Island in the Pacific Ocean.

[2]A person born in American Samoa is considered to be a national of the United States who although not a citizen owes permanent allegiance to the United States. 8 U.S.C. § 1101(a)(21), (22) (2000). While U.S. nationals are not entitled to all the benefits for which only citizens qualify they are not aliens and therefore cannot be expelled or deported.

any matters concerning the fundamentals of the U.S.-Puerto Rican relationship are referred to the Office of the President.[3]

Residents of all the insular areas enjoy many of the rights enjoyed by U.S. citizens in the states. But some rights that, under the Constitution, are reserved for citizens residing in the states have not been extended to residents of the insular areas. For example, residents of the insular areas cannot vote in national elections, nor do their representatives have full voting rights in Congress. Residents of all of the insular areas receive federally funded aid for a variety of social programs. Although residents of an insular area do not pay federal income taxes on income earned in that insular area, federal tax policy does play an important role in the economies of the insular areas.[4] Historically, the federal government has used tax policy as a tool to encourage investment and increase employment in the insular areas.

Puerto Rico's Relationship with the United States

Puerto Rico's Constitution of 1952 defines Puerto Rico as a self-governing Commonwealth of the United States.[5] Although fiscally autonomous, Puerto Rico is similar to the states in many aspects. For example, matters of currency, interstate commerce, and defense are all within the jurisdiction of the U.S. federal government. Puerto Rican residents are required to pay local income taxes on income earned from Puerto Rican sources, but not federal income taxes. Puerto Rican residents, however, do contribute to the U.S. national Medicare and Social Security systems. Generally, federal labor, safety, minimum wage laws and standards also apply in Puerto Rican to the same extent they apply to the states. The federal government plays a pervasive role in Puerto Rico that stems not only from the applicability of the United States Constitution, laws and regulations, but from the transfer to the island of more than $13 billion in federal funds every year to fund social programs to aid Puerto Rican residents, including earned benefits such as Social Security and unemployment benefits.

[3]Memorandum of the President, 57 Fed. Reg. 57, 093 (Nov. 30, 1992).

[4]Residents pay local income taxes while contributing to the U.S. national Medicare and Social Security systems.

[5]L.P.R.A. Const. Art. I § 1 (2004).

Chapters 2 and 7 of this report discuss in detail the how the U.S. federal tax code applies to residents of Puerto Rico and how the principal U.S. federal social programs are applied in Puerto Rico, respectively.

Characteristics of Puerto Rico

Puerto Rico occupies a central position in the West Indies. It comprises six main islands with a land area of 3,421 square miles and a population of almost four million people. Puerto Rico is thought to have one of the most dynamic economies in the Caribbean region, an economy in which manufacturing, driven by the pharmaceutical industry, has surpassed agriculture as the primary sector in terms of domestic income. Over 40 percent of Puerto Rico's domestic income since the mid-1980s has been derived from manufacturing. Pharmaceuticals accounted for almost 40 percent of total value added in manufacturing in 1987; that share rose to over 70 percent by 2002. Table 2 describes some of the demographic characteristics of Puerto Rico and compares them to national averages in 2000.

Table 2: Demographic Characteristics of Puerto Rico Compared to the United States

Characteristics	Puerto Rico	The 50 states
Population	3,808,610	281,421,906
Median age	32.1	35.3
Percent under 19 years of age	32.0	27.1
Percent over 65 years of age	11.2	12.4
Infant mortality per 1,000 live births	9.4	6.9
Percent high school graduate or more (over age 25)	60.0	80.4
Percent bachelor's degree or more (over age 25)	18.3	24.4
Estimated median household income	$14,412	$41,994
Percentage of individuals below poverty level	48.2	12.4

Source: 2000 Census of the United States.

Possessions Tax Credit

Historically, income derived from operations of U.S. corporations in U.S. possessions has been subject to special tax provisions. The Tax Reform Act of 1976 modified the form of the preferential tax treatment by establishing the possessions tax credit under Section 936 of the Internal Revenue Code. The stated purpose of this tax credit was to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations." Prior to 1994, the possessions tax credit was equal to the full amount of the U.S. income tax liability on income from a possession. The credit effectively exempted two kinds of income from U.S. taxation:

- income from the active conduct of a trade or business in a possession, or from the sale or exchange of substantially all of the assets used by the corporation in the active conduct of such trade or business and

- certain income earned from financial investments in U.S. possessions or certain foreign countries, generally referred to as qualified possession source investment income (QPSII).

In order for the income from an investment to qualify as QPSII, the funds for the investment must have been generated from an active business in a possession, and they must be reinvested in the same possession. Dividends repatriated from a U.S. subsidiary to a mainland parent have qualified for a dividend-received deduction since 1976, thus allowing tax-free repatriation of possession income.

The possessions tax credit was criticized on the grounds that the associated revenue cost was high compared to the employment it generated, that a large share of the benefits of the credit were not reaped by Puerto Rican residents and that it distorted debate over Puerto Rico's political status. The Omnibus Budget Reconciliation Act of 1993 placed caps on the amounts of possessions credits that corporations could earn for tax years beginning in 1994 or later.[6] The Small Business Job Protection Act of 1996 repealed the possessions tax credit for taxable years beginning after 1995.[7] However, the act provided transition rules under which a corporation that was an existing credit claimant was eligible to claim credits with respect to possessions business income for a period lasting through taxable years beginning before 2006. Additional background on Section 936 of the U.S. Tax Code and the possessions credit is provided in chapters 2 and 4.

[6]Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993).

[7]Small Business Job Protection Act of 1996, Pub. L. No. 104-188 (1996).

Additional Studies Relating to the Economy of Puerto Rico

Several of our previous studies, as well as work done by the Internal Revenue Service (IRS) and the U.S. Census Bureau (Census), address aspects of the Puerto Rican economy discussed in this report, including the business activity of possessions corporations and employment, payroll, value added, and capital expenditures by economic sector. Our previous work also addresses broader trends in the Puerto Rican economy, as does work underway by the Brookings Institution. A related study is also expected shortly by the Joint Committee on Taxation. Its work will evaluate legislative options concerning Puerto Rico. Table 3 highlights the scope of several recent reports on Puerto Rico, as well as the two studies that are in progress.

Table 3: Recent and Forthcoming Reports on Puerto Rico

Report	Scope
GAO, *Puerto Rico and the Section 936 Tax Credit*, GAO/GGD-93-109 (Washington, D.C.: June 8, 1993)	This report presented information relevant to Congress's consideration of proposals to revise Section 936 of the IRC.
GAO, *Tax Policy: Puerto Rican Economic Trends*, GAO/GGD-97-101 (Washington, D.C.: May 14, 1997)	This report provided information on economic activity in Puerto Rico, before and after the changes in U.S. tax benefits, under Section 936 of the IRC.
GAO, *U.S. Insular Areas: Multiple Factors Affect Federal Health Care Funding*, GAO-06-75 (Washington, D.C.: Oct. 14, 2005)	This report identified the key sources of federal health care funding in the insular areas, the differences between insular areas and the states in the methods used to allocate these funds, and the differences in spending levels per individual between the insular areas and the states.
IRS research on possessions corporations, published by Statistics of Income, in odd years[a]	In odd years, from 1993 to 2001, IRS's Statistics of Income division studied corporations claiming the possessions tax credit in Puerto Rico.
Census's 1992, 1997, and 2002 Economic Census of Island Areas	The censuses include information on employment, payroll, value added, and capital expenditures by economic sector.
Brookings Institution's report on restoring growth in Puerto Rico[b]	Economists from the United States and Puerto Rico address a range of major policy issues affecting the island's economic development and propose a strategy for jumpstarting Puerto Rican economic growth. The book includes Puerto Rico's past experience with growth policies, and an analysis of several reforms and new initiatives in labor, education, entrepreneurship, fiscal policy, migration, trade, and financing development.
Forthcoming study by the Joint Committee on Taxation	This study will analyze the tax and economic policy implications of legislative options concerning Puerto Rico. In particular it will examine the revenue costs of these options and compare the options to current laws relative to the states and the other U.S. insular areas.

Source: GAO.

[a]Randy Miller, "U.S. Possessions Corporations, 1995," *SOI Bulletin*, IRS; Sarah Nutter, "U.S. Possessions Corporations Returns, 1997 and 1999," *SOI Bulletin*, IRS; Daniel Holik, "U.S. Possessions Corporations Returns, 2001," *SOI Bulletin*, IRS.

[b]Susan M. Collins, Barry P. Bosworth, and Miguel Soto-Class, eds., *The Economy of Puerto Rico: Restoring Growth*, (Washington, D.C.: The Brookings Institution, 2006).

Scope and Methodology

The Chairman and Ranking Minority Member of the U.S. Senate Committee on Finance asked us to study fiscal relations between the federal government and Puerto Rico and trends in the Commonwealth's economy with a particular focus on the activities of possessions corporations operating there.

Federal Tax Treatment

To determine the U.S. federal tax treatment of individuals and businesses in Puerto Rico, relative to the states and the other insular areas, we examined the IRC, Department of the Treasury regulations, relevant Treasury rulings and notices, and legislation.

Economic Indicators and Capital Flows

To compare trends in principal economic indicators for the United States and Puerto Rico, we obtained data from both U.S. and Puerto Rican sources. The trends we present are commonly used measures of overall economic activity and important components of economic activity, such as saving, investment, labor force participation, and unemployment. We reported on many of these indicators in our previous report on economic trends in Puerto Rico.[8] The data shown are largely drawn from the National Income and Product Account series produced annually by economic statistics agencies in the United States and Puerto Rico. Most of the data we used for the U.S. economic series are produced by the Bureau of Economic Analysis and the Bureau of Labor Statistics and are publicly available from the Internet. When we compared U.S. data to Puerto Rican data that are based on the Puerto Rican July 1–June 30 fiscal year, we computed annual U.S. figures using monthly or quarterly data to match the Puerto Rican fiscal year.

Most of the annual data we used for Puerto Rican economic trends are produced by the Planning Board of Puerto Rico and are also publicly available. In some instances, the methodologies used by the Planning Board to produce certain data series are outdated relative to the methodologies now used by the United States. For example, the methodology used in calculating certain price indices in Puerto Rico is outdated and the methods used to obtain unemployment data have been somewhat less rigorous than in the United States. In these cases, we reviewed literature concerning the limitations of various series and interviewed Puerto Rican officials about the methods they use to collect and develop their data. These limitations are noted in the report. Wherever possible, we used alternative assumptions and data sources to determine if any conclusions drawn from the data are sensitive to the particular data series used. For example, we applied both U.S. and Puerto Rican price indices to Puerto Rican gross domestic product (GDP) data to see if

[8]GAO, *Tax Policy: Puerto Rican Economic Trends*, GAO/GGD-97-101 (Washington, D.C.: May 14, 1997).

applying different measures of price changes would lead to different conclusions about whether the Puerto Rican economy has been growing faster or slower than the U.S. economy. Puerto Rico's Planning Board has recently contracted with several consultants for a review of their entire set of methodologies for preparing the Commonwealth's income and product accounts, including the deflators. The Board has also been negotiating a memorandum of agreement with the U.S. Bureau of Economic Analysis for the latter to provide advice on this effort.

For some indicators of interest, annual data are not available for Puerto Rico. In some of these cases, we used decennial census data. The decennial census covers both the United States and Puerto Rico and produces comparable statistics on educational attainment and poverty levels. We also used data from the Economic Census of Puerto Rico and the Economic Census of the United States, also produced by Census. These data included detailed information on employment, investment, and value added broken down by sector of the economy. These data, produced by Census every 5th year, are of particular relevance to the possible effects of phaseout of the possessions tax credit.

To provide information on what is known regarding the flow of capital into and out of Puerto Rico, we interviewed Puerto Rican government officials and private sector experts to help us to ascertain what data were available. We determined that the available data would not allow us to present a comprehensive picture of the trends in capital flows. The most significant gap in that picture is data relating to direct investment by corporations incorporated outside of Puerto Rico, which is financed from within their own affiliated groups, rather than through financial institutions.[9] We can, however, report on changes over the years between 1995 and 2004 in the amount of funds that nonresidents hold in the Puerto Rican banking system and the amount of funds that the banking system invests within and outside of the Commonwealth. In order to identify where the assets held in the Puerto Rican banking system are invested and where the owners of the banks' liabilities reside, we analyzed institution-specific data that the Office of the Commissioner of Financial Institutions (OCFI) collects for oversight purposes. Banks and certain other financial institutions in Puerto Rico are

[9]Foreign direct investment is the investment of foreign assets directly into domestic structures, equipment, and organizations. It does not include foreign investment into stock markets. For Puerto Rico, foreign assets are United States assets as well as assets from foreign countries. In Puerto Rico, for the purpose of calculating foreign direct investment, a domestic company is a company incorporated in Puerto Rico.

required to report detailed information regarding their assets, liabilities, and capital to the OCFI through a computerized "CALL report" data system. Appendix I describes our analysis of the financial data.

We also used data provided by Puerto Rico's Government Development Bank to show trends in Puerto Rican government borrowing in the U.S. and local capital markets. The consensus of the government and private sector financial experts whom we interviewed was that all Puerto Rican government bonds that qualify for tax exemption under Section 103 of the IRC, such as bonds that are issued for the purpose of capital improvement projects, are sold in the U.S. market. All other Puerto Rican government bonds that are taxable in the United States but tax exempt in Puerto Rico are sold in the local market. The Government Development Bank was able to provide us with a complete and detailed accounting of each of their debt issues and to identify which ones did or did not qualify for the U.S. tax exemption.

Changes in Possessions Corporation Activity

In order to examine changes in the activities of possessions corporations operating in Puerto Rico since the early 1990s, we constructed several databases from an assortment of tax return data we obtained from IRS and Puerto Rico's Department of Treasury. Our principal source of data was IRS's Statistics of Income unit (SOI), which compiles comprehensive data on possessions corporations every other year. We obtained the complete set of these biennial databases from 1993 through 2003 and used information from SOI to identify those possessions corporations that operated in Puerto Rico. For the first stage of our analysis, we linked the biennial records for each individual corporation by its employer identification number (EIN) so that we could identify any data gaps for specific corporations in particular years and so we could complete a second, more complicated data analysis (described below). We filled in missing data for individual corporations to the extent possible from other IRS files and through imputations based on surrounding-year data. The extent of the imputations were minimal relative to the population totals we report. We used the final database on 656 possessions corporations that operated in at least 1 year between 1993 and 2003 to report on changes over time in the aggregate income, tax credit, and total assets of this population of corporations and to show how these particular variables were distributed across different industries. We also used data from the past four Economic Censuses of Puerto Rico (1987, 1992, 1997, and 2002) compiled by Census to show how the importance of possessions corporations in Puerto Rico's manufacturing sector has changed over time.

For the second stage of our analysis, we focused on a subpopulation of the largest groups of affiliated possessions corporations operating in Puerto Rico. For each of these groups we compiled data on other affiliated corporations (i.e., those sharing the same ultimate parent corporations) that also operated in Puerto Rico, but were not possessions corporations. The objective of this analysis was to assess the extent to which the large corporate groups that accounted for most of the activity of possessions corporations remained active in Puerto Rico, even as the operations of their possessions corporations were being phased out. We started by identifying the 77 largest groups of possessions corporations in terms of the amount of credit they earned, their total income, and their total assets. These large groups gave us a subpopulation that accounted for over 90 percent of the tax credit and income earned and over 90 percent of the assets owned by possessions corporations between 1993 and 2003, and at the same time reduced the number of corporations we had to work with from 656 to 172. This reduction in the number of corporations we had to work with was important because data limitations caused some of the steps in our database development to be very labor intensive.

We used two key data sources to identify and obtain data for the members of the large groups that operated in Puerto Rico but which were not possessions corporations. The first source was the database in which IRS maintained the records of all forms 5471 that had been filed between 1996 and 2002. (The owners of controlled foreign corporations [CFC] must file a separate form 5471 every year for each CFC that they own.) The second source was a database that the Puerto Rican Department of Treasury (with the assistance of the Government Development Bank) had recently transcribed from all Puerto Rican tax returns for tax years 1998 through 2001 filed by all corporations or partnerships that received tax incentives from the Government of Puerto Rico. Officials from the Department of Treasury and from the Puerto Rico Industrial Development Company (PRIDCO) told us that almost all U.S.- or foreign-owned manufacturing corporations operating in Puerto Rico receive tax incentives, as do corporations in designated service industries that export products or services from Puerto Rico. A total of 1,758 different taxpayers appeared in the database for at least 1 of the tax years. We used a series of both automated and manual search and matching approaches to link the CFCs and other types of companies from these two databases to our 77 large corporate groups. We also used information from both databases to determine which of the CFCs had operations in Puerto Rico and, in the case of CFCs with operations in multiple countries, to make a range of estimates for the amount of income they earned in Puerto Rico. The data on income, assets, taxes paid, and place of incorporation that we extracted from the two databases for these linked corporations allow us to provide a more complete picture of the trends in activities of the corporate groups that have taken advantage of the possessions tax credit over the years.

Through interviews with officials from the agencies providing the data and our own computer checks for internal consistency in the data, we determined that the quality of the data was sufficient for the purposes of our report when viewed with the cautions we raise at various points in the text. One problem that afflicted all of the databases to some degree was missing values arising from the fact that IRS and the Puerto Rican Department of Treasury could not always obtain every tax return that should have been in their databases in a particular year and the fact that taxpayers did not always accurately fill in every line of the return that they should have. Our access to multiple databases that overlapped to some extent enabled us to address this problem by filling in gaps with data from an alternative file, making reasonable imputations, or at a minimum assessing whether missing values would have made a significant difference to our results.

Distribution of Business Activity

In order to show how economic activity in Puerto Rico is distributed across different forms of businesses, we negotiated a special arrangement with IRS and Census that enabled us to disaggregate the data from Census's recently completed 2002 Economic Census of Puerto Rico by categories of business entities that are more specifically relevant to tax policymakers than the categories Census uses for its own publications. The 2002 Economic Census collected data on employment, payroll, and other economic measures from all nonfarm, private sector employers in Puerto Rico, making it a comprehensive enumeration of Puerto Rican businesses. We used taxpayer data from IRS and Puerto Rico to determine, in as many cases as possible, the type of federal or Puerto Rican income tax return each of these employers filed and, in the case of corporations, where they were incorporated. We then used this information to place each employer into a business entity group, such as possessions corporation, CFC incorporated in Puerto Rico, CFC incorporated elsewhere, sole proprietor, and so forth. Census then provided us with tabulations of their data for each of these groups, disaggregated by industry to the extent that their disclosure rules would permit. We developed a coding system and a data-exchange procedure that enabled us to link tax and Census data for specific employers in such a way that Census did not have to view restricted IRS data and we did not have to view confidential Census data for specific survey respondents. (See app. III for details.)

The data that we used to determine the tax filing status and place of incorporation for the employers in the Census database came from the IRS and Puerto Rico databases described above, plus a couple of additional sources. Another important new source of data was IRS's National Accounts Profile (NAP) database, which contains selected information for all individuals and businesses that have an EIN. Each employer in Puerto Rico has a federal EIN because it must collect Federal Insurance Contributions Act (FICA) taxes on behalf of its employees. Consequently, we were able to access NAP data for a very high percentage of the employers included in the Census. For those employers we were able to determine what, if any, federal income tax form they were required to file, whether they were included in their parent corporation's consolidated return, and whether or not IRS had identified them as being sole proprietors.

The other data sources that we used for this particular analysis included sets of income tax returns for some of the businesses operating in Puerto Rico that IRS had provided to Census, and a list of CFCs operating in Puerto Rico that PRIDCO had compiled. None of the non-Census data sources that we used was comprehensive and some of the sources more closely met our needs than others. Appendix III describes how we used these data to place each employer into a business entity group. For those cases where we could not reliably place an employer into a group based on tax data or data from PRIDCO we asked Census to place them into certain groups based on their survey responses.

Fiscal Comparison

To compare the overall tax burden borne by individuals and businesses in Puerto Rico with the burden borne by individuals and businesses in the states and in the other insular areas, we obtained and analyzed detailed data on state and local government revenues from the U.S. Census of Governments, data on Commonwealth government revenue from the Puerto Rican Department of Treasury, data on municipal tax revenue in Puerto Rico from Oficina del Comisionado de Asuntos Municipales, Centro de Estadisticas Municipales,[10] and revenue data for the other insular areas

[10] *Ingresos Por Concepto de Patentes Municipales, Ano Fiscal 2001–2002* (Puerto Rico: 2002).

reported in their 2002 Single Audit reports. We also obtained data on federal taxes collected in Puerto Rico and the states from IRS's 2002 Data book.[11] (No such data were available for the insular areas.) We compared taxes paid on a per capita basis and as a percent of personal income. We make our comparison for year 2002 because that is the year of the most recent Census of Governments.

We also compared federal expenditures for the states, Puerto Rico, and the insular areas using data we obtained from the Consolidated Federal Funds Report for Fiscal Year 2002 and the Federal Aid to States for Fiscal Year 2002. In addition, we report specifically on transfers of excise tax and customs duty revenues that the federal government makes to Puerto Rico using data obtained from U.S. Customs and the Alcohol and Tobacco Tax and Trade Bureau.

To assess the reliability of the data, for the Census and Puerto Rican Treasury data we interviewed knowledgeable officials and reviewed supporting documentation to understand the internal procedures in place to ensure data quality. For the insular areas we compared data reported in the Single Audit reports to other published data. We determined that the data we obtained from the Puerto Rican Department of Treasury is consistent with what was reported in the Commonwealth's Comprehensive Annual Financial Report. Although we found the data reliable for the purpose of our engagement, we note certain limitations in the data. In particular, all the state and local data compiled by Census are as-reported by cognizant government officials responsible for financial matters in each of the political entities and may not have been subjected to any internal or external accuracy checks. Checks performed by Census on its data are for completeness and consistency with internal and external sources. The independent auditor's statement in the Single Audit reports for the insular areas indicated that the auditors generally could not verify the accuracy of reported information. In addition, federal, state, and insular area fiscal years differ, so the data do not cover exactly the same period of time.

Federal Social Programs

Interviews with federal agencies and prior GAO work provided the basis for our description of the application of the principal U.S. federal social programs to Puerto Rico residents, relative to the states, and the other

[11] We did not include the federal corporate tax in our comparison because the location where that tax is collected may not be closely related to where the burden of the tax falls.

insular areas. To select the social programs included in this report we consulted with GAO experts in the areas of health care policy; education, workforce, and income security policy; and financial markets and community investment policy. With the help of these experts, we arrived at a list of the principal federal social programs, which we then pared down, based on program availability in Puerto Rico and expenditure level in Puerto Rico. We relied on prior GAO work and interviews with federal agency officials to determine how each program is applied in Puerto Rico, relative to the other areas. We used program-level data, supplied by federal agencies, to report program expenditures for fiscal year 2002. We selected fiscal year 2002 because in chapter 6 of this report, we provide a more complete analysis of the revenue and expenditures of Puerto Rico, the states, and the other insular areas using the year of the most recent Census of Governments, 2002.

Our methodologies for each objective were discussed with experts including those from the Office of the Comptroller General of Puerto Rico, Puerto Rico's Government Development Bank, Puerto Rico's Planning Board, Puerto Rico's Office of the Commissioner of Insurance Institutions and Puerto Rico's Office of the Commissioner of Financial Institutions. Federal-level experts include those from Census and IRS. Our work was performed from February 2004 to April 2006 in accordance with generally accepted government accounting standards.

U.S. Federal Tax Treatment of Puerto Rico and Other Insular Areas Varies by Area and Type of Tax

Individuals who are residents of Puerto Rico or other U.S. insular areas and who earn income only from sources outside of the states generally pay no federal income tax; however, their wages are all subject to Social Security and Medicare taxes, and wages paid to residents of Puerto Rico and the U.S. Virgin Islands also are subject to federal unemployment tax. Corporations organized in Puerto Rico, like those organized in the other U.S. insular areas, are generally treated for U.S. tax purposes as if they were organized under the laws of a foreign country. Until this year, special rules enabled corporations organized in the United States that met certain conditions to reduce the federal tax payable on income earned in and repatriated from Puerto Rico and other insular areas.

U.S. Tax Treatment of Insular Area Residents with U.S.-source Income and U.S. Residents with Insular Area-source Income Varies by Area

Individuals residing in an insular area and who earn income only from sources there file one income tax return there and are required to pay income tax only to that area. The U.S. income tax treatment of U.S.-source income of residents of an insular area (which does not include income earned in the insular areas, other than that earned by U.S. government employees) depends on the area:

- Residents of American Samoa and Puerto Rico must pay U.S. income tax on all their income from sources outside American Samoa or Puerto Rico, respectively, if such income exceeds the federal filing threshold.[1] The U.S. government retains the tax collected from residents of Puerto Rico, but is required to transfer the tax collected from residents of American Samoa to its government.

- Residents of Guam and CNMI owe income tax to the territory and Commonwealth, respectively, on their U.S.-source income; the governments of these Commonwealths and territories are required to transfer a portion of this tax revenue to the U.S. government if the resident's income exceeds certain income thresholds.

- Generally, the U.S. government does not tax, or receive any tax revenue from U.S. Virgin Island residents who have U.S.-source income so long as such residents report all of their income, identify the source of their income, and pay their income taxes to the U.S. Virgin Islands.

[1]Generally, residents of an insular area cannot claim the earned income tax credit or the child tax credit. An exception is that bona fide residents of Puerto Rico with three or more children who pay social security taxes may be eligible for the child tax credit.

The U.S. income tax treatment of U.S. residents with Commonwealth- or insular area–source income also depends on the insular area:

- U.S. residents with income from Puerto Rico or American Samoa are subject to U.S. federal tax on that income. They also pay tax on that income to Puerto Rico or American Samoa, respectively, and receive a foreign tax credit against their U.S. tax liability for this amount.
- U.S. residents with income from Guam or CNMI owe U.S. income tax on that income; the federal government is required to transfer a portion of the tax revenue received from Guam and CNMI residents back to the respective territory and Commonwealth.
- U.S. residents who earn income in the U.S. Virgin Islands must file identical tax returns with both the government there and the U.S. government; each government's share of the revenues is based on where the income was earned.

While FICA Taxes Are Imposed on Wages Paid to Employees in All Insular Areas, Unemployment Insurance Tax Applies Only to Wages Paid in Puerto Rico and U.S. Virgin Islands

The Federal Insurance Contributions Act[2] imposes wage-based taxes on employers and employees in the United States and the Commonwealths and territories to support Social Security and Medicare. The employment upon which taxes are collected includes services performed in the United States and the insular areas. Taxes collected under the act are not transferred to the treasuries of the insular areas.

The Federal Unemployment Tax Act imposes[3] a tax on wages paid to employees, based on wages paid. Puerto Rico and the U.S. Virgin Islands are the only insular areas covered by the Act. The proceeds of the tax are used to support the federal-state unemployment compensation program and are not transferred to the treasuries of either area.

[2] 26 U.S.C. § 3101 et seq. (2004).

[3] 26 U.S.C. § 3301 et seq. (2004).

Taxation of Corporations Incorporated in the United States

The federal government taxes a U.S. corporation on its worldwide income (reduced by any applicable foreign income tax credit), regardless of where the income is earned. When the tax is due depends on several factors, including whether the income is U.S.- or foreign-source and, if it is foreign income, on the structure of the corporation's business operations.

However, since 1976, and through taxable years beginning prior to December 31, 2006, U.S. corporations with a domestic subsidiary conducting a trade or business in insular areas could qualify to receive significant tax benefits through the possessions tax credit.[4] Prior to taxable years beginning in 1994, the credit effectively exempted from U.S. taxation all possession-source income of a qualified possessions corporation. Dividends repatriated from a wholly-owned possessions corporation to the mainland parent qualified for a 100 percent deduction, thus allowing tax-free repatriation of possession income. The credit also exempted qualified possession-source investment income (QPSII), which is certain income the possessions corporation earned from financial investments in U.S. possessions or certain foreign countries. The credit for qualified research expense was also allowed for such research conducted by a possessions corporation.

Starting in taxable years beginning in 1994, the amounts of possessions tax credits that a possessions corporation could claim were capped. Under the cap, a possessions corporation had to choose between two alternatives—a "percentage limitation" option or an "economic activity limitation" option. In 1996, the possessions tax credit was fully repealed for taxable years beginning after 2005. Existing possessions corporations could continue to claim the possessions tax credit for tax years beginning prior to 2006. These existing credit claimants, however, were subject to an income cap[5] based on the average business income that the corporation earned in a possession during a specified "base period." A possessions corporation electing the percentage limitation was subject to the income cap beginning in 1998 and a possessions corporation electing the economic limitation was

[4]Section 936 is the section of the Internal Revenue Code that describes the credit. Because Section 936 refers to the Commonwealths and territories as "possessions," we refer to them in this manner in this section of the report. Under Section 936, it was possible for a domestic corporation owned by individuals to qualify for the credit.

[5]A possessions corporation that is an existing credit claimant for Guam, American Samoa, or CNMI is not subject to the income cap.

subject to the income cap beginning in 2002. Only QPSII earned before July 1, 1996, qualified for the credit for tax years beginning after December 31, 1995.

Taxation of Corporations Incorporated outside the United States

Corporations organized outside the United States, including corporations organized in Puerto Rico and the other insular areas,[6] are generally treated as foreign corporations for U.S. tax purposes. These corporations are taxed on their U.S. source earnings—the tax paid generally depends on whether the income is "effectively connected" with the conduct of a trade or business within the United States, but income from insular areas is not subject to U.S. tax.

Foreign corporations pay U.S. tax at two rates—a flat 30 percent rate is withheld on certain forms of nonbusiness gross income from U.S. sources, and a tax is imposed at progressive rates on net income from a U.S. trade or business.[7] Corporations in Puerto Rico must pay the 30 percent withholding tax; corporations in the other insular areas do not pay the withholding tax if they meet certain tests that establish close connections with the insular area in which the corporation was created. U.S.-source dividends paid to corporations organized in Puerto Rico are subject to a 10 percent withholding tax provided that the same tests mentioned above are satisfied and the withholding tax on dividends paid to the U.S. corporations is not greater than 10 percent.

Corporations organized under the laws of an insular area may be treated as a controlled foreign corporation (CFC) for U.S. income tax purposes. To qualify as a CFC, the corporation must be more than 50 percent U.S.-owned, taking into account only U.S. shareholders that meet a 10 percent stock ownership test. Gross income from the active conduct of business in Puerto Rico or elsewhere outside of the United States is not taxed until it is repatriated to the U.S. shareholders in the form of dividends. Subject to certain limitations, these shareholders are entitled to a credit for any foreign income taxes paid by the CFC with respect to the earnings distributed.

[6]A possessions corporation that is an existing credit claimant for Guam, American Samoa, or CNMI is not subject to the income cap.

[7]Most interest income is exempt from the withholding tax.

Certain types of passive income, such as dividends and interest, earned by CFCs are currently includable in the income of the U.S. shareholders, under subpart F of the U.S. Tax Code, even though those amounts are not actually distributed to them.[8] These shareholders are, subject to certain limitations, also entitled to a credit for foreign income taxes paid with respect to the amounts includible in income under subpart F.

Certain kinds of income received by a CFC organized under the laws of an insular area are not considered subpart F income:

- income received from the sale in the insular area of personal property manufactured by the CFC in that area,
- dividend or interest income received from a related corporation[9] also organized under the laws of that insular area, and
- rents or royalties from a related corporation received by a CFC organized under the laws of an insular area for the use of property in the insular area where the CFC is organized.

The allocation of gross income, deductions, and credits between related taxpayers, such as intercompany sales from a CFC to a U.S. domestic parent, is subject to transfer pricing rules that are designed to prevent manipulation of the overall tax liability.

Deduction for Income from Domestic Production Activities

In 2004, in response to a long-running dispute with the European Union, Congress repealed the extraterritorial income (ETI) exclusion and enacted a deduction relating to income attributable to domestic production

[8]The subpart F rules generally "attempt to prevent" (or negate the tax advantage from) deflection of certain types of moveable income, either from the United States or from a high-tax foreign country, into another jurisdiction that is a tax haven or that has a preferential tax regime for certain types of income. In this report we refer to the passive income earned by CFCs, subject to these rules, as "subpart F income." If the CFC's subpart F income, which may include dividends, interest, royalties, rents, and annuities, does not exceed the lesser of 5 percent of gross income or $1 million, this income currently income by the U.S. shareholder.

[9]Generally, a related corporation is any corporation which controls, or is controlled by, the CFC, or the corporation and the CFC are controlled by the same person, through ownership of more than 50 percent of the stock.

activities.[10] For purposes of the ETI exclusion, the United States included Puerto Rico. Puerto Rico is not included, however, in the definition of U.S. for purposes of the deduction for domestic production.

Goods Imported to Insular Areas Are Generally Exempt from U.S. Excise Taxes, but a Special Tax Is Imposed on Goods Made in Puerto Rico and U.S. Virgin Islands

Merchandise imported into an insular area from the United States is exempt from U.S. excise taxes. The only U.S. excise taxes that apply to products imported into any of the insular areas from another country are those where specific language extends the tax beyond the "United States," which is generally defined, for tax purposes, as only the states. This language exists for a tax on petroleum (an environmental tax), a tax on certain vaccines, a tax on certain chemicals, and a tax on certain imported substances.

If any revenue from these excise taxes is collected in American Samoa, Puerto Rico, or the U.S. Virgin Islands, the U.S. government retains the revenue. The governments of Guam or CNMI receive any revenue from these taxes collected in their respective territory and Commonwealth.

There is a special "equalization" U.S. excise tax on articles manufactured in Puerto Rico or the U.S. Virgin Islands and exported to the United States equal to the tax that would have been imposed had the articles been manufactured in the United States. Subject to the limitations described below for distilled spirits, the U.S. Treasury returns all the revenue from the tax on articles manufactured in Puerto Rico to the Treasury there except the amounts needed to pay refunds and drawbacks[11] to manufacturers and the amount needed to cover its enforcement expenses. The return to the U.S. Virgin Islands also excludes amounts needed to pay refunds and drawbacks, plus one percent of the total tax collected. All U.S. excise taxes collected on articles manufactured from Guam and CNMI and exported to the United States must be transferred to their respective territory and Commonwealth governments.

A special limitation applies for the U.S. excise tax on distilled spirits manufactured in Puerto Rico and the U.S. Virgin Islands and exported to

[10]Pub. L. No. 108-357 (2004).

[11]A drawback is the refund of all or part of customs duties, or domestic tax paid on imported merchandise that was subsequently either exported or manufactured into a different article and then reexported.

the United States. The tax rate ordinarily applied to rum is $13.50 per proof gallon exported, of which $10.50 per proof gallon is returned to the appropriate insular area. Puerto Rico and the U.S. Virgin Islands also share revenue from the U.S. excise tax collected on all rum imported into the United States from a foreign country. Their respective shares are proportionate to the relative sizes of their rum exports to the United States during the prior fiscal year. Puerto Rico's share, however, cannot exceed 87.626889 percent or be less than 51 percent while the U.S. Virgin Islands' share cannot exceed 49 percent nor drop below 12.373111 percent.

U.S. Government Is Responsible for Collecting Customs Duties in Puerto Rico and Helps Collect Duties in U.S. Virgin Islands

The U.S. government collects duties on goods imported into "U.S. customs territory," which encompasses the states and Puerto Rico, unless they are exempt. U.S. customs duties collected in Puerto Rico are deposited in a special U.S. Treasury account. After deductions for refunds and the expenses of administering customs activities in Puerto Rico, the remaining amounts are transferred to the treasury there.

Although the U.S. Virgin Islands are not in "U.S. customs territory," the U.S. government helps collect local duties there. These collections are transferred to the government of the U.S. Virgin Islands after items such as operational expenses are deducted. The U.S. government has authority to administer and enforce collection of custom duties in American Samoa, upon request of the Governor. Guam and CNMI administer and enforce their own customs policies and procedures. Items imported into "U.S. customs territory" from American Samoa, Guam, CNMI, and the U.S. Virgin Islands are subject to U.S. customs duties unless the items are exempt.

Trends in Production, Income, and Other Economic Indicators for Puerto Rico

The economic well-being of Puerto Rican residents, measured in terms of either per capita or median income, remains well below that of residents of the states. The relative progress that the Puerto Rican economy has made since 1980 is difficult to measure with precision for a number of reasons, including tax-induced distortions in how U.S. corporations have reported income earned in the Commonwealth. The low rate of labor participation is a crucial issue in Puerto Rico's economic performance, and the rate of investment appears insufficient to significantly reduce the disparity between mainland and Puerto Rican incomes.

Measuring Economic Progress in Puerto Rico Is Challenging but the Income of Commonwealth Residents Remains Well Below That of U.S. Residents

As shown in figure 9, Puerto Rico's per capita GDP of about $21,000 in 2005 remained well below U.S. per capita GDP of about $41,000. GDP is a broad measure of overall income or economic activity occurring within a nation's borders in a given year. According to the Puerto Rican and U.S. national income and product accounts, this measure has grown more rapidly in Puerto Rico than in the United States since 1980, when viewed on a per capita basis after adjustments for inflation. However, for a number of reasons, the growth rate of real (meaning inflation-adjusted) GDP likely does not represent a very accurate measure of changes in the economic well-being of Puerto Rican residents.

First, as a result of U.S. tax provisions and a development strategy pursued by successive Puerto Rican governments to use local tax incentives to attract investment by U.S. and foreign firms, a significant amount of the investment income included in GDP is paid out to U.S. and foreign investors. In figure 9, the income earned by nonresidents is approximately represented by the gap between Puerto Rican GDP and Puerto Rican GNP. GNP is a measure of the total amount of income earned by residents in a given year from sources within and from outside of the country. In contrast to Puerto Rico, GDP has been consistently about the same as GNP in the United States, which indicates that the amount of income earned abroad by U.S. residents is close to the amount of income earned by foreign owners of assets located in the United States. As of 2005, Puerto Rico's per capita GNP of about $14,000 remained well below the U.S. level of about $41,000.

Second, using the possessions tax credit, U.S.-based groups of affiliated corporations (i.e., those owned by a common U.S. parent corporation) with certain types of operations in Puerto Rico have had incentives to attribute as much net income to those operations as is legally permissible, rather than to related operations in the United States.[1] Moreover, the nature of these incentives has changed during the period covered by our review. Consequently, the income reported by these corporations to have been earned in Puerto Rico in a given year may overstate the actual economic importance of their Puerto Rican production, and changes in income over the years may reflect not only changes in the economic activity of these corporations, but also changes in how corporations have computed their Puerto Rican source income. Some of the data reported later in this chapter suggest that this so-called "income shifting" has taken place. This particular issue affects data on GDP and income and possibly value added for corporations owned by U.S. parent corporations; it should not affect GNP or income and value added for Puerto Rican-owned corporations.

Third, as is the case for any country, the scale of the informal, or underground, economy in Puerto Rico is difficult to measure. If the informal economy in Puerto Rico is large relative to the informal economy in the United States, as some analysts believe, a relatively large amount of economic activity in Puerto Rico may not be reflected in national income and labor market statistics. As discussed below, the presence of a large informal economy may be one explanation of low reported labor force participation rates in Puerto Rico. Analysts who have recently looked at this issue disagree on the size of the informal economy and on whether it has been growing as a share of the total economy. The size and any growth in the informal economy in Puerto Rico, relative to that in the United States, would affect comparisons between levels and growth in per capita income earned in the two jurisdictions.

Lastly, as acknowledged by the Puerto Rico Planning Board, there are problems with some Puerto Rican price indices, which cause an unknown degree of inaccuracy in the inflation adjustments to the long-term trend data on the Puerto Rican economy and, therefore, some imprecision in the real growth rates of key economic indicators that are stated in terms of dollar values. Most concerns center on the Puerto Rican consumer price index (CPI, a measure of prices on consumer goods) and the fact that the market basket of goods used to compute the index has not been updated since the 1970s. This means that the index will tend to overstate price changes. In the analysis in this chapter, we have used the Puerto Rican gross product deflator—a broad measure of how prices have changed on

[1] These incentives and the flexibility that corporate groups have had in identifying the geographic sources of their income are discussed in more detail in ch. 4.

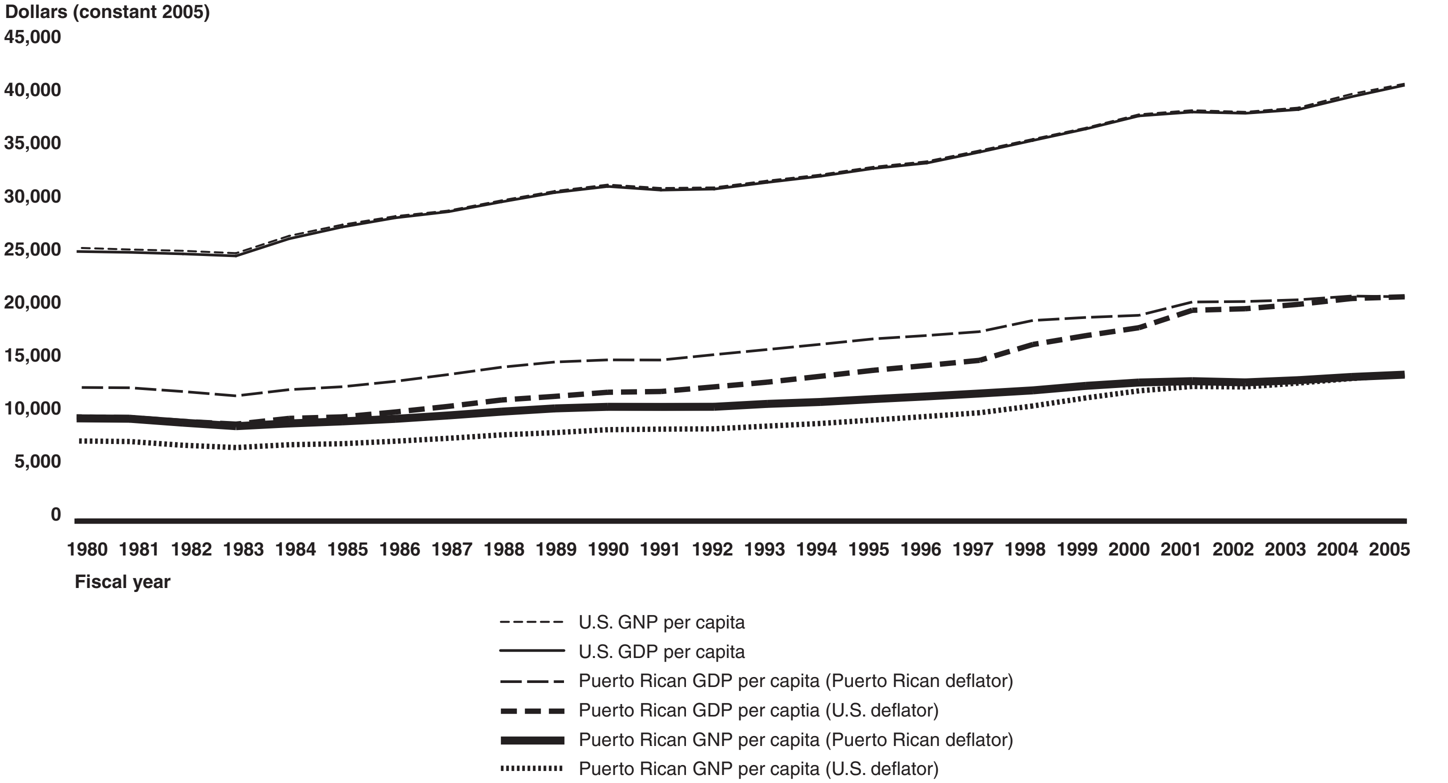
average for goods and services in the economy—for our inflation adjustments. Although analysts within and outside of Puerto Rico's Planning Board, which produces the deflator, consider it to be less problematic than the CPI, they still have concerns relating to fact that the CPI is one of the components used in estimating the deflator and the fact that methodologies for other components are also outdated.[2]

Given the concerns with the Puerto Rican deflator, there is a question as to whether that measure or the U.S. gross product deflator more accurately accounts for the changes in prices in Puerto Rico. The U.S. deflator shows slower price increases over this period than does the Puerto Rican deflator. For this reason, we also report some results based on the use of the U.S. deflator in cases where they differ notably from those based on the Puerto Rican deflator.

When comparing the trends in real per capita GNP in Puerto Rico and the United States from 1980 to 2005, the choice of deflators does make a difference. Over that period, inflation-adjusted per capita income increased at an average annual rate of 1.9 percent in the United States, while it rose at 1.5 percent in Puerto Rico if the Puerto Rican deflator is used. However, if the U.S. deflator is applied to Puerto Rican GNP, annual real per capita GNP rose by 2.5 percent annually, faster than the growth in the United States. Real per capita GDP rose more rapidly in Puerto Rico than in the United States, regardless of which deflators are used. U.S. GDP rose at an annual average rate of 1.9 percent from 1980 to 2005, while the average annual growth rate for Puerto Rico was 2.1 percent using the Puerto Rican deflator and 3.2 percent using the U.S. deflator.

[2]The Planning Board has contracted with several consultants to complete a diagnostic analysis of all of their national income and product account methodologies, including those for the deflator. The Board is also negotiating a memorandum of agreement with the U.S. Bureau of Economic Analysis (BEA) for the latter's assistance in this effort.

Figure 9: U.S. and Puerto Rican Per Capita GDP and GNP, 1980–2005



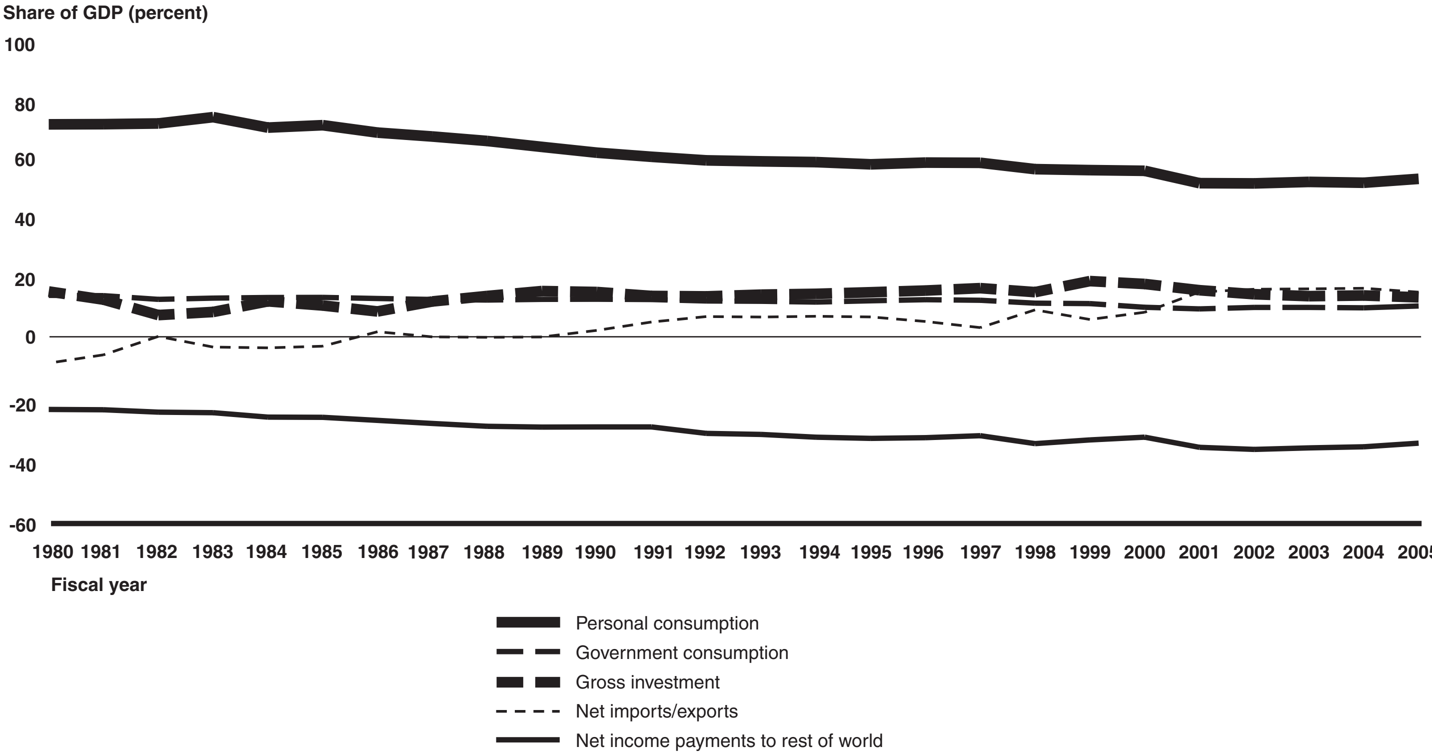
Source: GAO analysis of U.S. Bureau of Economic Analysis and Puerto Rican Planning Board data.

Note: Figures were adjusted for inflation using U.S. and Puerto Rican gross product deflators.

Figure 10 shows the composition of Puerto Rican GDP over time and the trend in net income payments abroad. GDP consists of expenditures on personal consumption, investment, government consumption of goods and services, and net exports (the value of exports minus the value of imports). The figure shows that net exports have risen substantially from 1980 to 2005 as a share of GDP, and consumption, which is largely determined by Puerto Rican income, has fallen as a share of GDP.

Figure 10 also shows net income payments abroad, expressed as a share of GDP. This series represents the amount of income paid to foreign owners of capital located in Puerto Rico, minus income earned by Puerto Ricans from investments outside of Puerto Rico. GNP differs from GDP by this amount. For Puerto Rico, the net outflow of income has increased as a share of GDP over the period, increasing the gap between GDP and GNP.

Figure 10: Composition of Puerto Rican GDP and Net Income Payments Abroad, 1980–2005



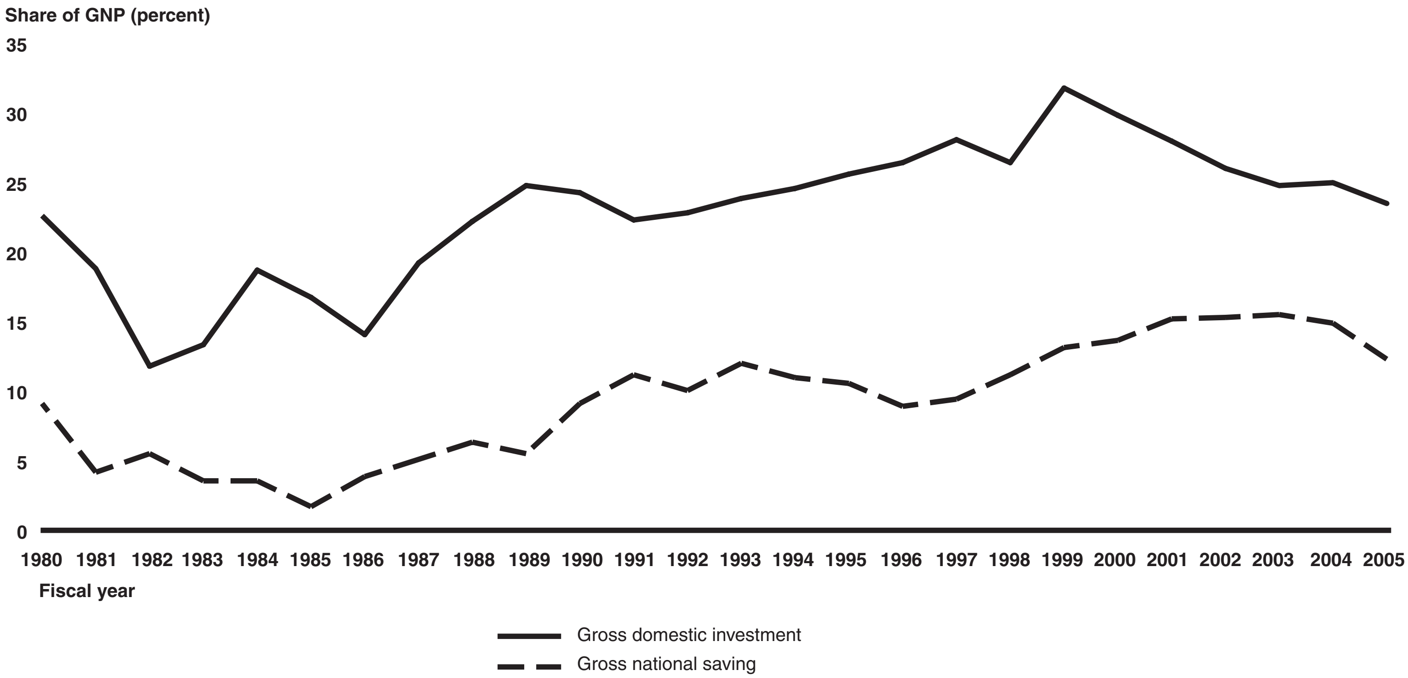
Source: GAO analysis of Puerto Rico Planning Board data.

Note: Consumption, investment, government, and net export expenditures constitute GDP.

Puerto Rico Relies Heavily on Nonresidents to Finance Local Investment

Figure 11 shows the relationship between savings and investment in Puerto Rico. The components of total national saving in Puerto Rico are personal saving, government saving, business saving through retained earnings, and depreciation. The figure shows that investment in Puerto Rico has been greater than national saving, highlighting again that investment in Puerto Rico has been significantly financed by foreign sources. Since 2001, government saving has fallen and undistributed corporate profits have risen significantly. The personal saving rate as measured in the Puerto Rican national accounts has been negative since 1980. If transfers from foreigners to residents of Puerto Rico are underreported, however, the official data for income and saving would also be understated.[3]

Figure 11: Puerto Rico's Gross Domestic Investment and National Saving, 1980–2005



Source: GAO analysis of Puerto Rico Planning Board data.

Note: Data for 2005 are preliminary.

We cannot provide a comprehensive picture of the trends in various components of U.S. and foreign investment in Puerto Rico because data are not available for one of the most important components—direct foreign investment, for which corporations obtain financing from within their own

[3]Bosworth and Collins, "Economic Growth in Puerto Rico."

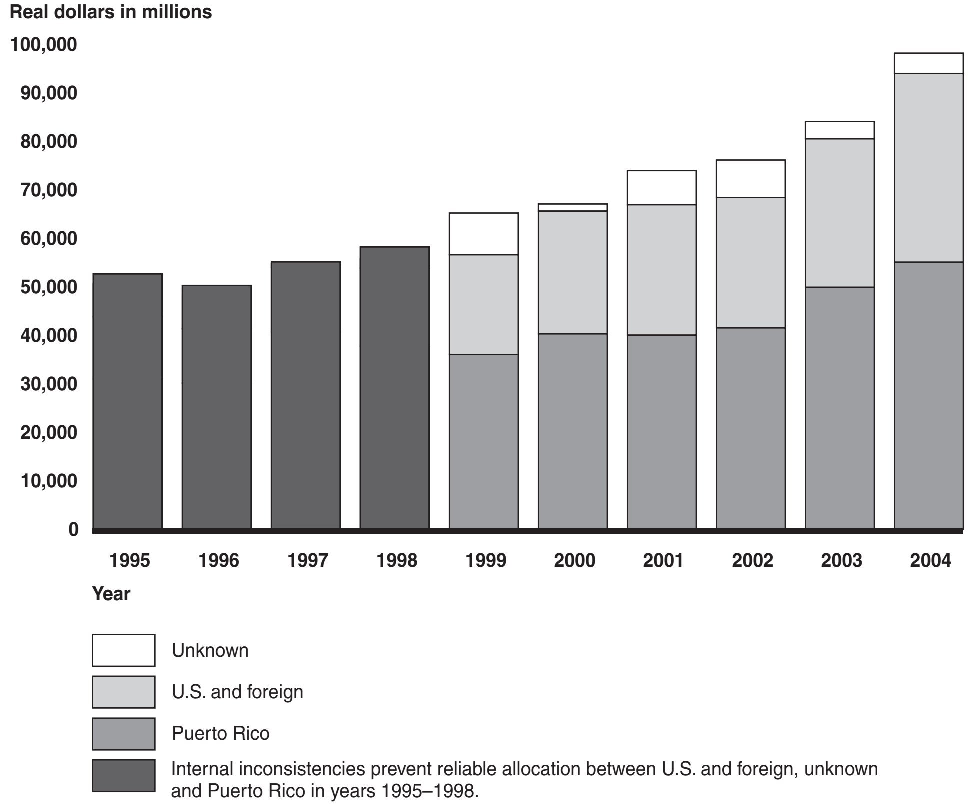
affiliated groups, rather than through financial institutions.[4] We can, however, report trends for foreign funds flowing through key types of financial institutions and the Puerto Rican government. In the next two chapters, we will also provide some information on investments by important subpopulations of corporations.

Over the past decade, the amount of nonresident funds flowing into depository institutions in Puerto Rico has increased steadily. Figure 12 shows Puerto Rico's depository institutions' liabilities between 1995 and 2004, and figures 52 and 53 in appendix II show the shift in deposits and debt, respectively. The composition of deposits has changed significantly with "exempt investments" by possessions corporations (which in the past had been encouraged by a special component of the possessions tax credit) being replaced by deposits obtained through brokers that sell certificates of deposits for the banks in the U.S. capital market. (Fig. 54 in app. II shows those offsetting trends.)

Figure 13 below shows that the share of assets held by depository institutions in the United States and foreign countries has also increased over the past decade. A large part of this growth can be attributed to the increase in U.S. and foreign securities investments. Loans made by Puerto Rico's depository institutions, which we assume to be primarily local, have also increased steadily. Figures 55 and 56 in appendix II show these two trends.

[4]Puerto Rico's Planning Board stopped compiling data on U.S. and foreign direct investment in the Commonwealth in the early 1990s after the Commonwealth government devolved the property tax to the municipalities. Changes in the location and storage technology for property tax records that accompanied this change in responsibility for the tax made it difficult for the Board to continue its investment estimation, which relied heavily on these property tax records.

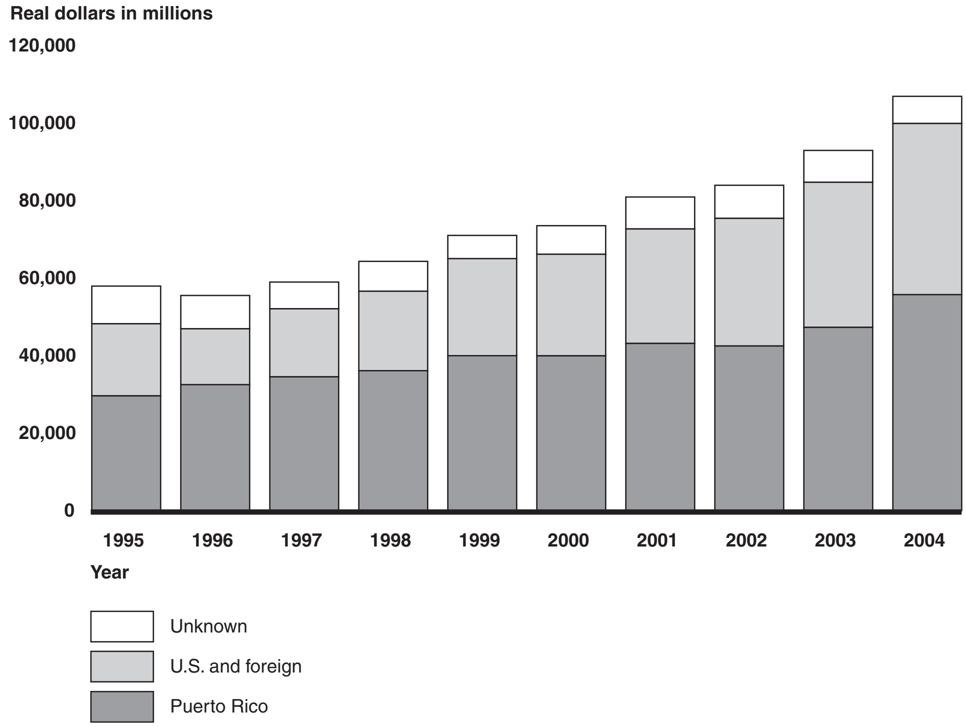
Figure 12: Puerto Rico's Depository Institutions' Liabilities, 1995–2004



Source: GAO analysis of Puerto Rico's Office of the Commissioner of Financial Institutions (OCFI) data.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

Figure 13: Puerto Rico's Depository Institutions' Assets, 1995–2004



Source: GAO analysis of Puerto Rico's Office of the Commissioner of Financial Institutions (OCFI) data.

Notes: The allocation of total assets includes the assumption that 95 percent of depository institution loans are made locally in Puerto Rico and 5 percent in the United States or foreign countries.

Figures were adjusted for inflation using Puerto Rico's gross product deflator.

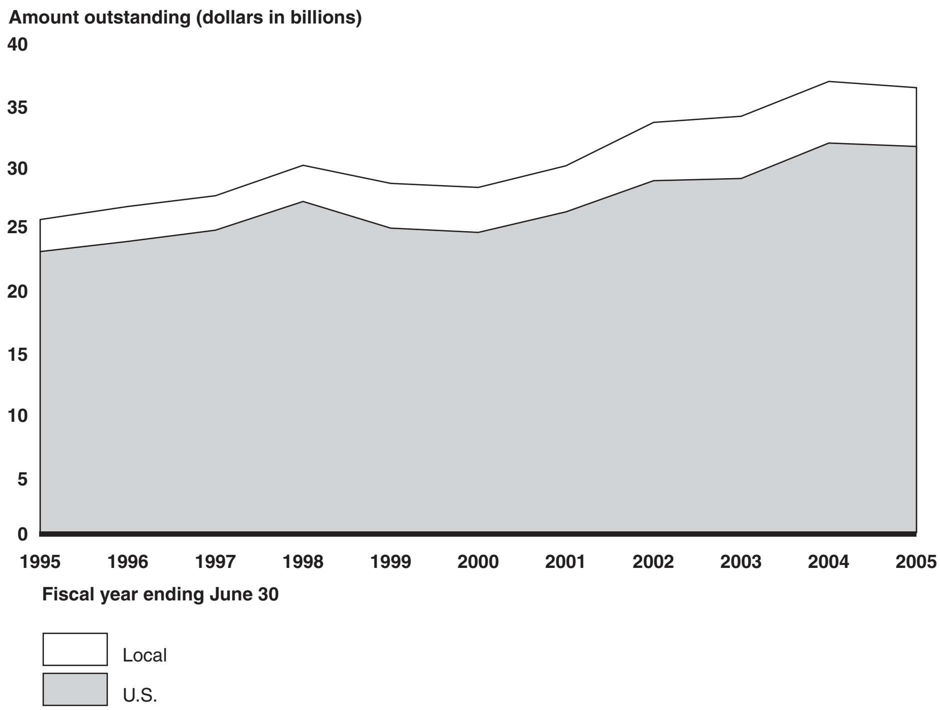
Puerto Rican government debt has increased steadily over the past decade. Between 1995 and 2005, Puerto Rico's real total public debt outstanding increased from $25.6 billion to $36.4 billion (see fig. 14 below).[5] Most of Puerto Rican public debt is sold in the U.S. market, but the amount sold within Puerto Rico has increased steadily since 1999. In 2005 an estimated $31.6 billion was sold in the United States, and $4.8 billion was sold locally in Puerto Rico.

In appendix II we include both the breakdown of debt payable by the government and debt issued by the government but repaid by others (such

[5]For the purpose of this section, real numbers were calculated using the Puerto Rican GNP deflator.

as the federal government or the private sector) because there are differences of opinion about what should be termed “government debt” (see figs. 58 and 59). An example of this type of debt is the series of bond issues linked to The Children’s Trust Fund between 2001 and 2005, all of which are backed by assets from the United States Attorney General’s 1999 Master Tobacco Settlement Agreement. Between 1995 and 2005, total debt issued by the Puerto Rican government, but payable by others, increased from an estimated \$6.6 billion to an estimated \$7.1 billion in 2005.

Figure 14: Puerto Rico’s Total Real Government-issued Debt, by Market of Purchaser, 1995–2005



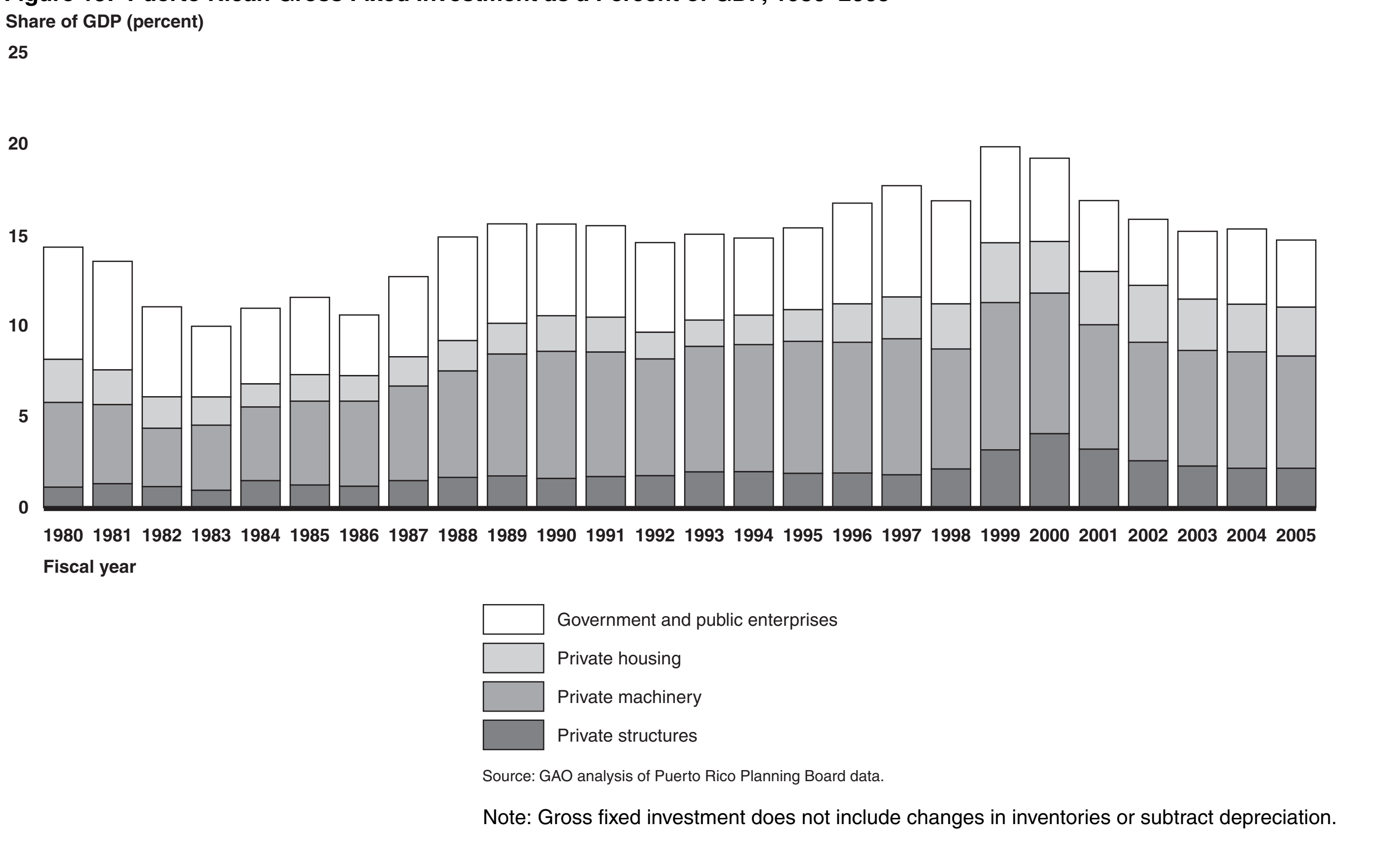
Source: GAO analysis of Government Development Bank of Puerto Rico data.

Note: Figures were adjusted for inflation using Puerto Rico’s gross product deflator.

Investment Appears Insufficient to Reduce the U.S.-Puerto Rican Income Gap

Figure 15 shows the level and composition of gross investment spending in Puerto Rico from 1980 to 2005. During the recession of the early 1980s, investment fell below 10 percent of GDP by 1983. Thereafter, investment recovered and remained around 15 percent of GDP for a number of years until a period of rapid growth in largely private-sector investment in the late 1990s pushed the share close to 20 percent of GDP by 2000. Investment rates have fallen back to about 15 percent of GDP most recently.

Figure 15: Puerto Rican Gross Fixed Investment as a Percent of GDP, 1980–2005



Source: GAO analysis of Puerto Rico Planning Board data.

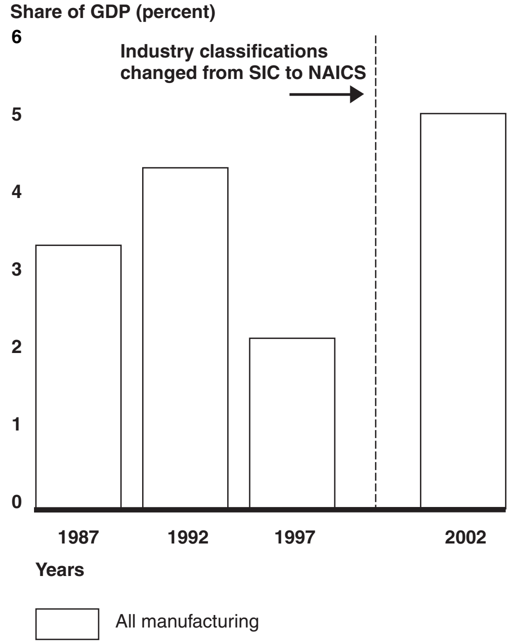
Note: Gross fixed investment does not include changes in inventories or subtract depreciation.

If Puerto Rico's investment rate remains at recent levels, the gap between U.S. and Puerto Rican per capita incomes is unlikely to diminish. The U.S. investment rate, including both private investment and a measure of government investment, has been about 19 percent of GDP in recent years. Continuation of these relative investment rates implies that the per capita income gap is unlikely to narrow significantly, unless capital formation is augmented by increases in employment, education, training, or other types of productivity improvements.

Figure 16 shows a breakdown of Census data on capital spending in the manufacturing sector for 1987, 1992, 1997, and 2002.[6] The data show that investment in manufacturing dipped significantly between 1992 and 1997, before rebounding by 2002. This slump in investment does not appear in the Planning Board investment data for private sector investment shown in figure 15. The Planning Board data cover more sectors than do the Census data; however, investment in manufacturing should represent a substantial portion of the investment in private structures and machinery.

[6]Census does not report capital spending for other sectors. Between the 1997 and 2002 reports, Census switched from using the Standard Industrial Classification (SIC) system to the North American Industrial Classification System (NAICS) in order to place businesses into particular industrial categories. As a result, the scope of the industries covered in the 2002 census is not strictly comparable to the scopes for the earlier reports. However, those technical changes should not be a significant factor in the changes in investment depicted in fig. 16.

Figure 16: Puerto Rico's Capital Expenditures as a Percentage of Gross Domestic Product, 1987–2002



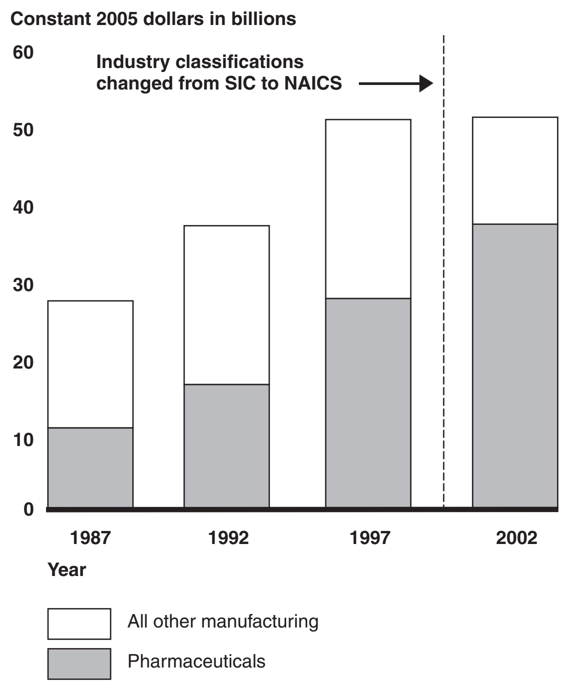
Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1987, 1992, and 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Data on Value Added and Income Show That the Pharmaceuticals Industry Has Significantly Increased Its Dominance of Puerto Rican Manufacturing but Evidence Suggests That These Measures May Be Overstated

Although both Census data on value added and Puerto Rican government data on domestic income show that the pharmaceutical industry has significantly increased its already dominant position in the manufacturing sector since the early 1990s, evidence suggests that income shifting within U.S.-owned corporate groups likely has resulted in overstatements of the importance of the manufacturing sector, as a whole, and the pharmaceutical industry, in particular, when measured in terms of value added or income. Unfortunately, it is difficult to know the extent of any overstatement in these economic variables. Evidence is mixed as to whether the extent of the overstatement increased as the pharmaceutical operations of possessions corporations were shifted over to other types of businesses. Other measures of economic activity, such as employment and capital spending, should not be affected by income shifting and, therefore, can be used to either support or challenge conclusions based on measures of value added and income.

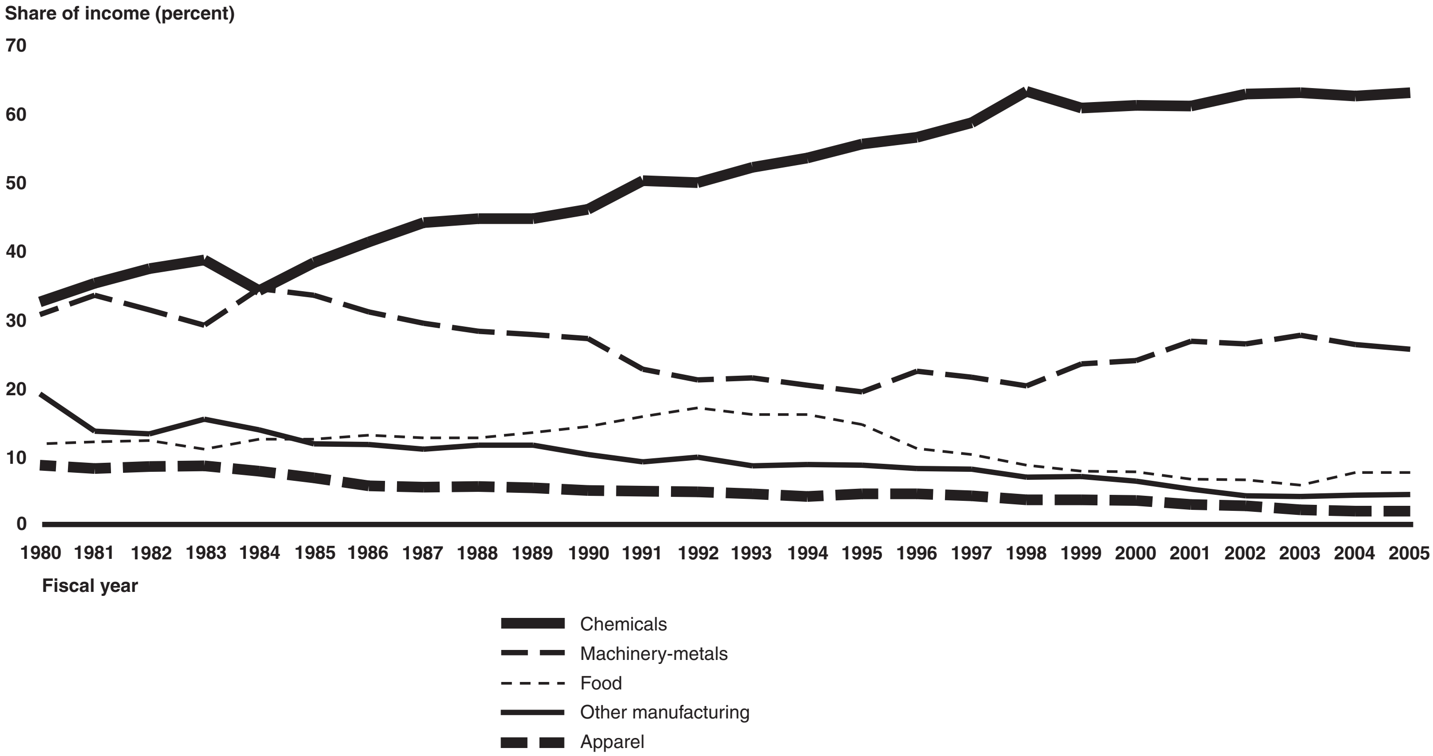
Census data on value added and Puerto Rican Planning Board data on domestic income both show steady and significant growth in the pharmaceutical industry. Figure 17 shows that value added in the pharmaceutical industry more than doubled in real terms from 1992 to 2002, while value added in all other manufacturing industries, as a whole, declined. Figure 18 shows that the chemical industry, which consists mainly of pharmaceuticals, saw its share of net manufacturing domestic income increase from around 50 percent in 1992 to over 60 percent in 2005.

Figure 17: Value Added for Puerto Rican Manufacturing Industries, 1987–2002



Source: GAO analysis of published data from the 2002 Economic Census of Island Areas and the Economic Census of Outlying Areas for 1987,1992, and 1997.

Figure 18: Share of Net Manufacturing Domestic Income in Puerto Rico, 1980–2005



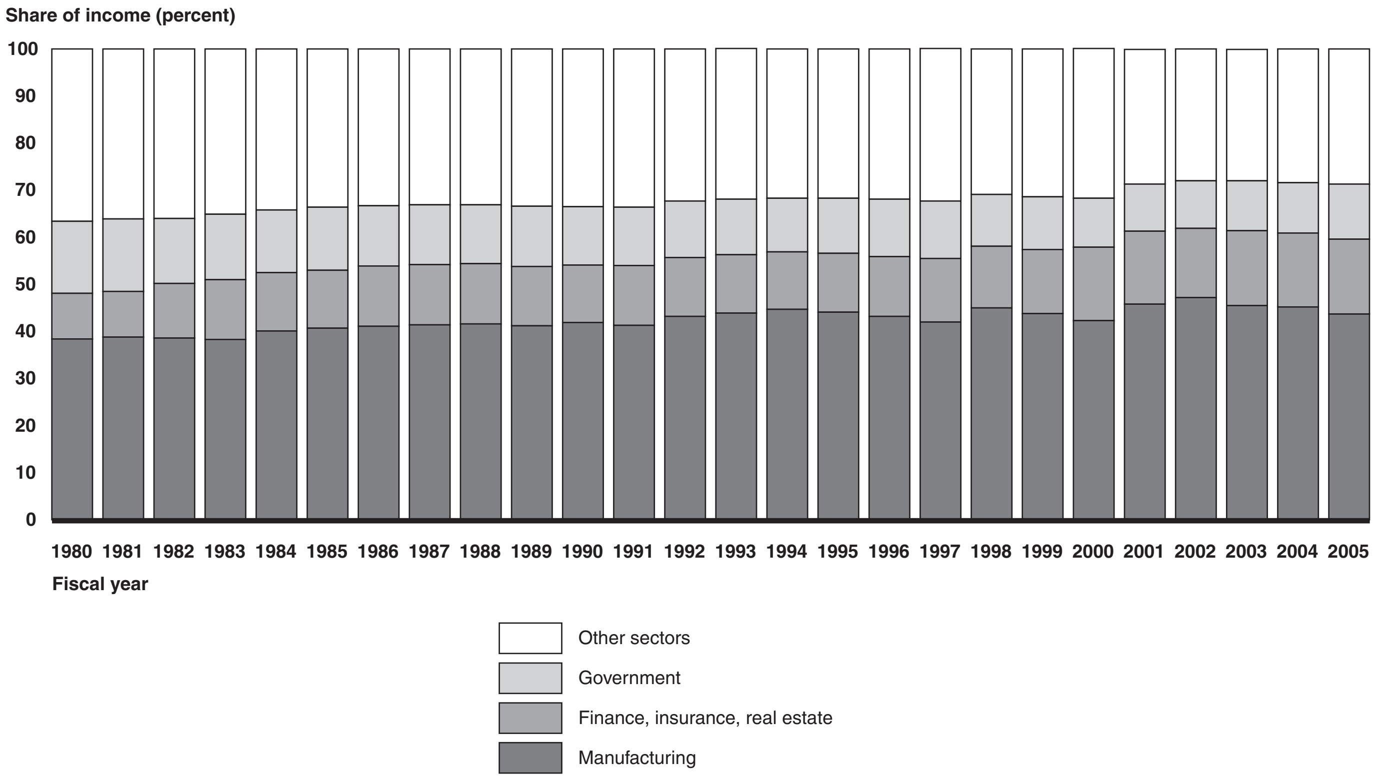
Source: GAO analysis of Puerto Rico Planning Board data.

Note: 2005 figures are preliminary.

The strong reported performance of the pharmaceutical sector is the reason that the manufacturing sector has been able to slightly increase its share of domestic income, while the share of income of most other manufacturing industries has declined. Manufacturing's share of income, shown in figure 19, greatly exceeds its share of employment, as shown in figures 23 and 24. Some of the difference may be attributable to a higher level of labor productivity in manufacturing than in other sectors. Recent research suggests, however, that reported levels of value added in Puerto Rican manufacturing are implausible. For example, the official data imply that labor's share of value added in manufacturing fell from an average of

50 percent from 1950 to 1970 to only 14 percent in 2004. Similar declines are not evident in data for other sectors or in U.S. manufacturing statistics.[7]

Figure 19: Shares of Puerto Rico's Domestic Income by Sector, 1980–2005



Source: GAO analysis of Puerto Rico Planning Board data.

Note: 2005 figures are preliminary.

Over the years, several analysts have concluded that the incentives provided by the possessions tax credit have led U.S. corporate groups to

[7]Bosworth and Collins, *The Economy of Puerto Rico: Restoring Growth.*

shift income to Puerto Rican affiliates.[8] Until the mid-1990s, the credit essentially allowed profits earned from qualified Puerto Rican operations to be returned to the mainland free of federal tax (even when largely exempted from Puerto Rican income taxes). In addition, one option under the credit allowed the U.S. corporate parent to apply a 50-50 split of their combined taxable income from the sale of products to third parties if the products were derived from an intangible asset, such as a patent, invention, formula, or trademark. Although a substantial portion of this income can be attributed to manufacturing intangibles developed and owned by the U.S. corporate parent, there is no requirement that the allocation of income from such manufacturing intangible assets reflect where costs were actually generated, or where value was actually added to the products. Consequently, corporate groups that produced pharmaceuticals, or other products whose final values are largely based on the value of intellectual property, were given flexibility under the law to shift net income to the possession corporations operating in Puerto Rico or another insular area. This shifting of income and value added to the Puerto Rican operations of possessions corporations ultimately gets reflected in economic data compiled by the Puerto Rican government, which is based heavily on data pulled from samples of corporate tax returns, and possibly in data that Census collects in its surveys of employers for the economic censuses, if the economic data the employers provide are based on their tax accounts.

The nature of income shifting changed significantly after 1995, when the phaseout of the possessions tax credit began. Some of the corporate groups that owned possessions corporations in Puerto Rico began to close or reduce operations in those corporations and shift production to CFCs located on the island. Corporate groups still have some incentives to retain operations in Puerto Rico rather than shift that production to the United States. First, Puerto Rico responded to the phaseout of the credit by increasing the generosity of its own tax incentives. Second, manufacturing income earned from an active trade or business by the CFCs is not subject to federal tax unless it is repatriated to the United States. A change in

[8]Grubert and Slemrod developed a theoretical model and then tested it empirically using corporate tax data for 1987. They concluded that "a large fraction of U.S. investment in Puerto Rico is due to the income shifting opportunities." Harry Grubert and Joel Slemrod, "The Effect of Taxes on Investment and Income Shifting to Puerto Rico," *The Review of Economics and Statistics*, vol. 80, no. 3 (August 1998), pp. 365–373. More recently, Bosworth and Collins also conclude that income shifting has been significant. Bosworth and Collins, "Economic Growth in Puerto Rico" in *The Economy of Puerto Rico: Restoring Growth*, ed. Susan M. Collins, Barry P. Bosworth, and Miguel Soto-Class (Washington, D.C.: The Brookings Institution, 2006).

income shifting has also occurred because the rule for arbitrarily splitting net income 50-50 between Puerto Rican and U.S. operations does not apply to CFCs. Nevertheless, corporate groups may be able to shift income to Puerto Rico through the manner in which they set prices on goods and services transferred among affiliated corporations.

Data from the last four economic censuses of manufacturing in Puerto Rico, presented in figure 20, show that valued added per employee in the pharmaceutical industry was already at least twice as high as the ratio for all other industries in 1987 and 1992. The difference between the pharmaceutical industry and the other industries grew larger in 1997 and then broadened dramatically by 2002. The 2002 figure of $1.5 million for value added per employee in Puerto Rican pharmaceutical manufacturing was three times as high as the ratio for the U.S. pharmaceutical industry for the same year. Moreover, while the U.S. ratio grew only 8 percent in real terms between 1997 and 2002, the Puerto Rican ratio grew by 65 percent over that same period.[9]

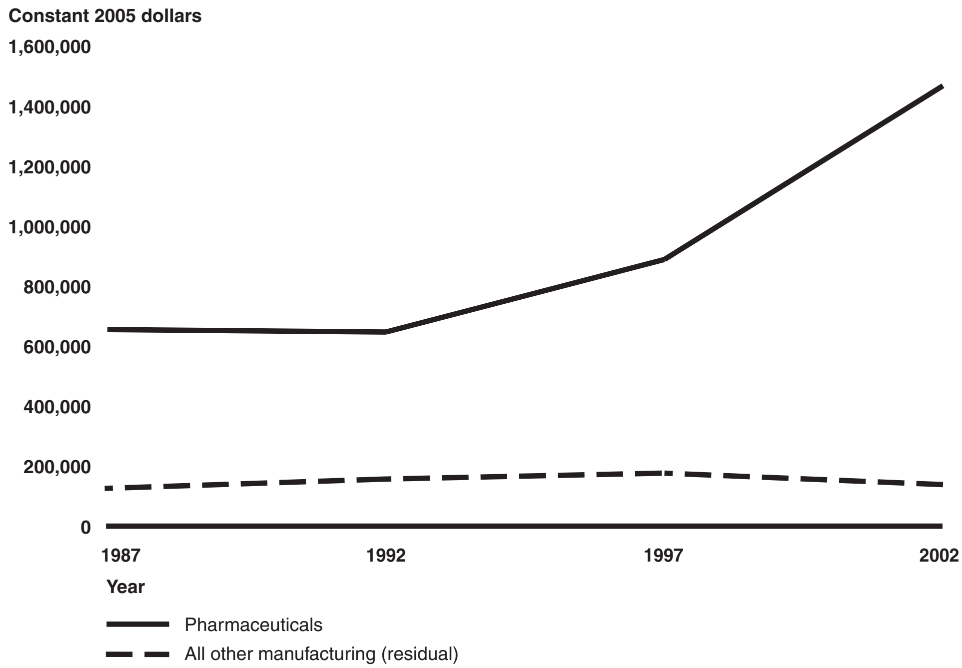
The data on value added per employee by type of business in figure 21 suggest that the sharp increase in that measure between 1997 and 2002 may have been a direct result of the shift in pharmaceutical operations from possessions corporations to CFCs. (These data are derived from a special research effort in which we obtained assistance from Census and IRS to aggregate data from the 2002 Economic Census of Puerto Rico by particular types of business entities, including possessions corporations and CFCs.)[10] The value added per employee of $4.2 million for pharmaceuticals CFCs incorporated outside of Puerto Rico was dramatically higher than for any other type of business in Puerto Rico. The next highest ratio was $1.6 million for pharmaceuticals CFCs incorporated in Puerto Rico, which was still considerably higher than the ratio of $0.9 million for possessions corporations in the pharmaceutical industry. That data, combined with the data in figure 20, suggest a significant change in transfer pricing by large pharmaceuticals groups, which makes it difficult to say how much of the strong reported growth in output and income in the Puerto Rican pharmaceutical industry, and in the

[9]If the U.S. gross product deflator is used instead of the Puerto Rican one to adjust the value-added figures, the Puerto Rican ratio would be about three times as high as the U.S. ratio, but it would have grown by 89 percent between 1997 and 2002.

[10]Most of the results of that research effort are reported in ch. 5. App. III provides a description of the methodology for that analysis.

manufacturing sector as a whole, represents an increase in actual economic activity.

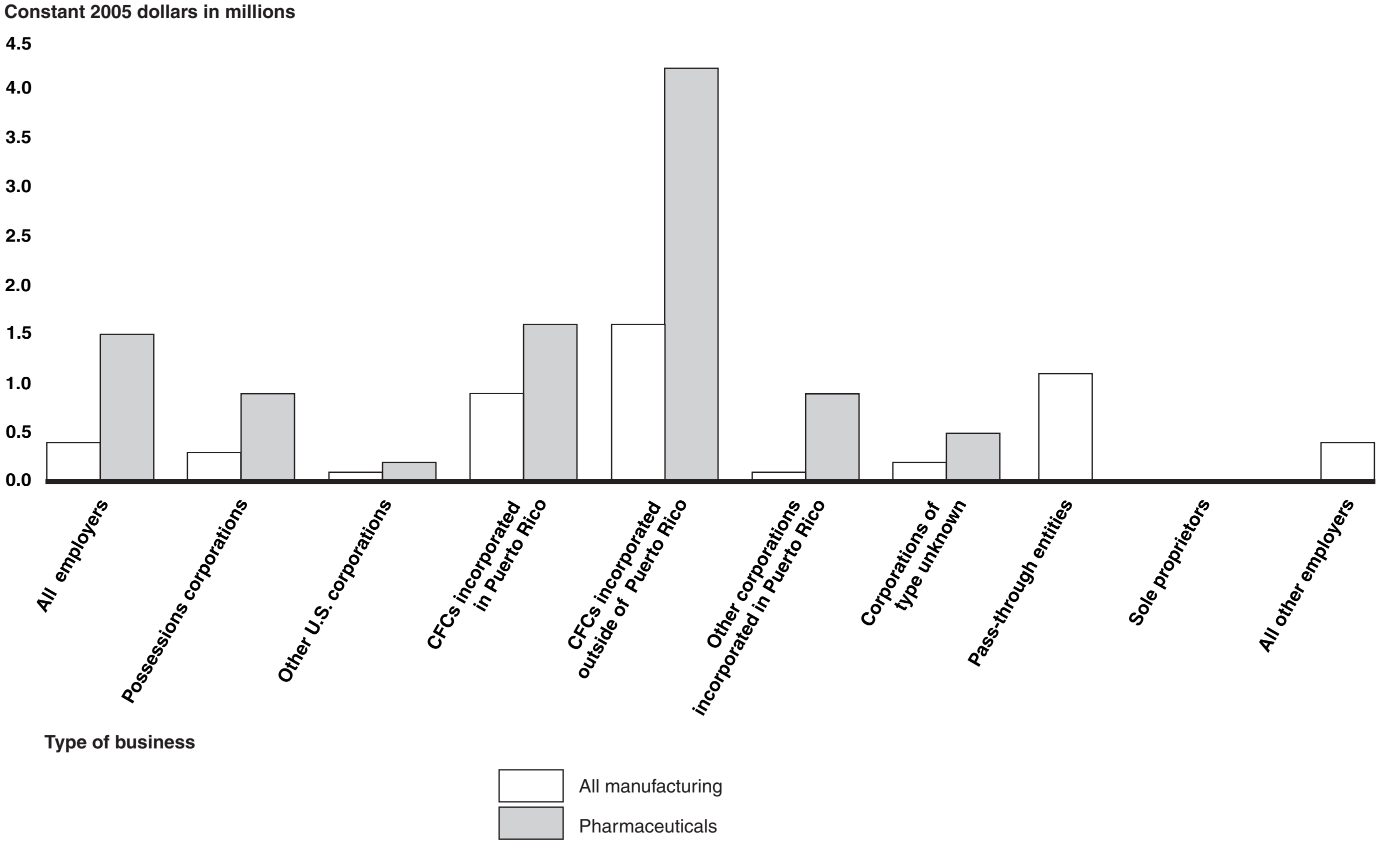
Figure 20: Value Added per Employee for Key Puerto Rican Manufacturing Industries, 1987–2002



Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

Figure 21: Value Added per Employee in Puerto Rico by Type of Business, 2002



Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

Data on rates of return on assets for possessions corporations and CFCs in the chemical industry do not confirm the conclusion that a dramatic change in income-shifting practices occurred as CFCs replaced possessions corporations in the industry. We used data from federal tax returns to compare various rates of return for CFCs and possessions corporations in the Puerto Rican chemical industry. The comparisons we were able to make for 1997 through 2001 did not show a consistent difference between the two types of corporations. The ratios of gross profits (the closest tax-data equivalent to value added) to total assets for CFCs were significantly higher than those for possessions corporations in both 1997 and 1999, but the ratios were very close together in 2001. We also compared the gross and net operating rates of return of the two types of corporations and found that neither type dominated the other one consistently across the years. The results of our analysis are presented in appendix IV.

International Trade Plays a Large Role in Puerto Rico's Economy

International trade plays a much larger role in the Puerto Rican economy than it does in the U.S. economy. While the output of an economy (GDP) depends on the difference between exports and imports (net exports), the size of exports and imports relative to GDP are indicators of the importance of trade to the economy. For the United States, exports of goods and services averaged about 10 percent of GDP between 1980 and 2005. Imports increased from about 10 percent of GDP in the early 1980s to about 16 percent of GDP in 2005. While potential distortions in trade data should be kept in mind, the share of exports and imports has been substantially greater in Puerto Rico. For Puerto Rico, the value of exported goods and services as a percentage of GDP grew from about 70 percent of GDP in the 1980s to about 80 percent in 2005. Imports fell as a share of GDP from about 70 percent to about 63 percent in recent years.

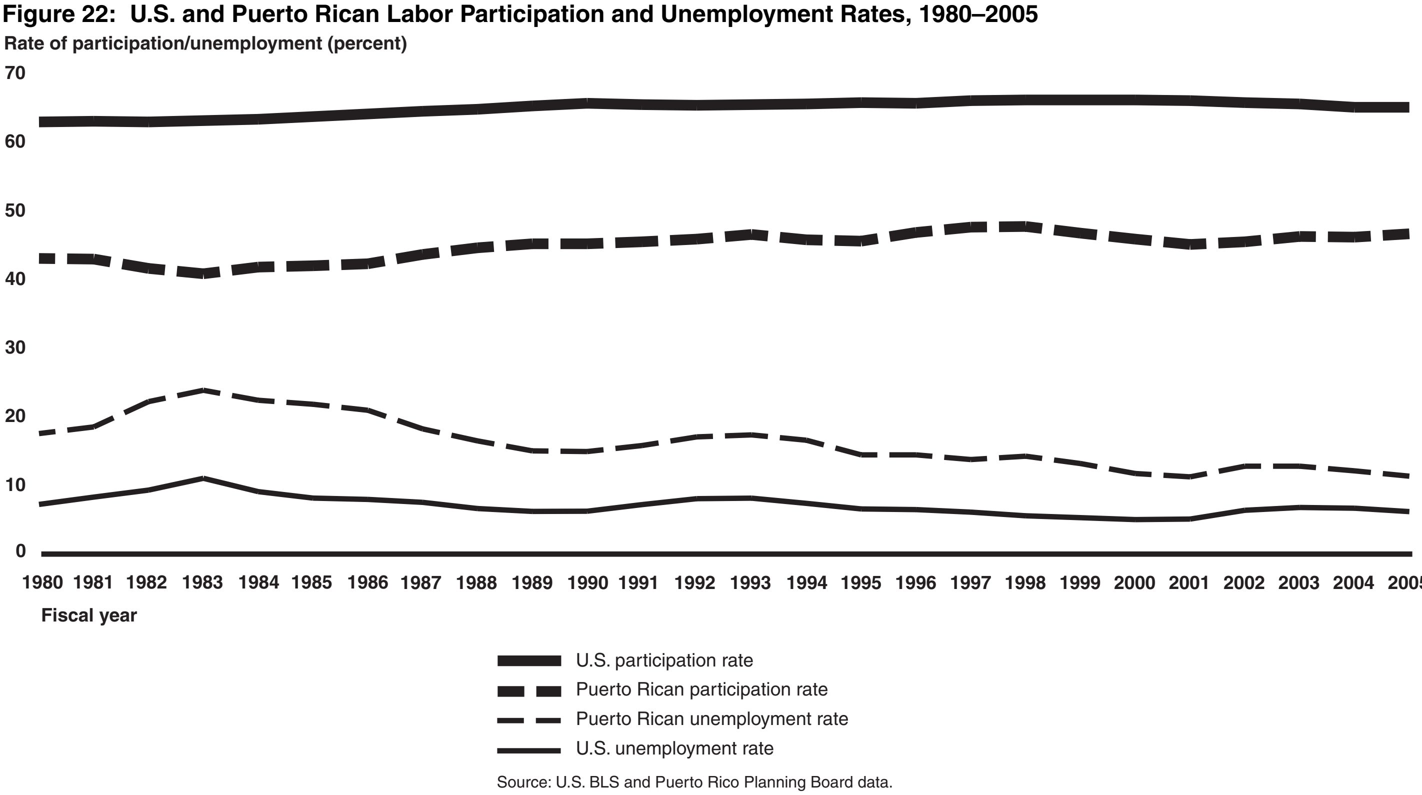
As reported in the Puerto Rican national accounts, the value of pharmaceutical imports and exports increased substantially from 1996 to 2005. The value of imported pharmaceuticals increased from about 9 percent of all merchandise imports to about 33 percent during that period. As a share of GDP, the value of imported pharmaceuticals increased from about 4 percent to about 15 percent. The value of pharmaceutical exports rose rapidly as a share of merchandise exports—from about 27 percent to about 61 percent. As a percentage of GDP, the value of pharmaceutical exports rose from about 14 percent to about 42 percent. However, as noted above, a significant portion of the recorded increase in Puerto Rico's trade surplus may reflect changes in transfer pricing, with artificially low values for Puerto Rico's imports and high values for Puerto Rico's exports, rather than increased activity.

While the United States is the largest trading partner for Puerto Rico for exports and is a large source of Puerto Rican imports, the foreign country share of imports to Puerto Rico has been growing since 1995. In 2005, slightly less than half of the value of imports to Puerto Rico came from foreign countries. About 80 percent of Puerto Rico's exports go to the United States. Puerto Rico's overall trade surplus reflects a trade surplus with the United States as Puerto Rico exports more to the United States than it imports from the United States, and a smaller trade deficit with the foreign countries.

Official Statistics Indicate That Unemployment Has Been Much Higher in Puerto Rico Than in the United States and Labor Force Participation Has Been Lower

Figure 22 shows the unemployment rates and labor force participation rates for the United States and Puerto Rico from 1980 to 2005. The unemployment rate has been significantly higher in Puerto Rico than in the United States, and the labor force participation rate has been much lower.

Figure 22: U.S. and Puerto Rican Labor Participation and Unemployment Rates, 1980–2005



Source: U.S. BLS and Puerto Rico Planning Board data.

Academics and economists from research institutions have offered several possible explanations for the relatively low labor force participation rate in

Puerto Rico and attempted to determine which of these factors might be important. While the low labor force participation rate is seen as a crucial issue for the economic performance of Puerto Rico, there is no consensus on its cause.[11]

Possible explanations for the low labor force participation rate include

- the migration of Puerto Rican citizens with the most interest in participating in the labor force to seek higher wage employment in the United States, leaving residents that have relatively less attachment to the labor force;[12]
- the fact that government programs that are in place, such as the Nutrition Assistance Program (NAP, the Puerto Rican food stamp program) and disability insurance, can discourage work, while the U.S. program that encourages labor force participation—the Earned Income Tax Credit—is not a part of the tax system in Puerto Rico;
- the fact that the U.S. minimum wage applies in Puerto Rico may discourage business demand for lower-skilled workers, who are likely to make up a larger share of the potential work force in Puerto Rico than in the United States; and
- that a relatively large share of Puerto Ricans work in the informal economy and that this work is not reflected in economic statistics.

Regarding this last issue, analysts have raised issues with the quality of the Puerto Rican labor force survey, which is the data source for the unemployment rate and the labor force participation rate. The survey is designed to be similar to the U.S. Current Population Survey (CPS), from which the U.S. data are derived, but the questions regarding labor market

[11]An analysis of Census data indicates that employment rates have been lower in Puerto Rico than in the United States across gender and education level. Steven J. Davis and Luis Rivera-Batiz, "The Climate for Business Development and Employment Growth in Puerto Rico," in Collins, Bosworth, and Soto-Class, *The Economy of Puerto Rico: Restoring Growth.* Several other chapters in the book also consider the labor force participation issue.

[12]During the 1980s and 1990s the number of men migrating to the United States is estimated to be slightly larger than the number of women. Most migrants to the United States were estimated to be in their twenties. For age groups older than 45, Census estimated that more individuals migrated to Puerto Rico from the mainland than migrated from the island to the United States.

activity in the surveys differed and the question asked by the Puerto Rico household survey may not have captured work activity in the informal sector of the economy as well as the question asked in the CPS.[13] On the other hand, labor force participation as measured in the decennial census—which uses the same question as the CPS—has also been low and the estimate for 2000 was lower than the household survey estimate for that year.[14] The Bureau of Labor Statistics (BLS) has been working with the Puerto Rican government to improve the household survey in several areas. In addition, labor force data for 2005 are scheduled to be reported for Puerto Rico as a part of the Census Bureau's American Community Survey effort.

Educational attainment can play an important role in developing labor market skills. Data on educational attainment in Puerto Rico is collected in the decennial census and can be compared to data for the United States. These data show that the gap in educational attainment between Puerto Rico and the United States narrowed significantly during the 1990s. Nonetheless, in 2000, 40 percent of the population over 25 in Puerto Rico had not finished high school, which is nearly the double the U.S. share. At the same time, about 38 percent of adults reported having at least some college education (see table 4).

[13]Maria Enchautegui and Richard B. Freeman, "Why Don't More Puerto Rican Men Work? The Rich Uncle (Sam) Hypothesis," in Collins, Bosworth, and Soto-Class, *The Economy of Puerto Rico: Restoring Growth.*

[14]The 47.3 percent labor force participation rate reported in the Census for 1990 in Puerto Rico was close to the 45.5 percent reported by the Puerto Rico Planning Board for fiscal year 1990. Census found a 40.7 percent participation rate in 2000, while the Planning Board reported a 46.2 rate for fiscal year 2000. Census has reported much higher unemployment rates in 1990 and 2000 (20.4 and 19.2 percent) than have been reported by the Planning Board for those years.

Table 4: Educational Attainment in the U.S. and Puerto Rico, 1990 and 2000

Educational attainment (percent of population 25 years old and over)	1990		2000	
	United States	Puerto Rico	United States	Puerto Rico
High school or more	75.2	49.7	80.4	60.0
Some college or more	45.2	28.7	51.8	37.7
Bachelor's degree or more	20.3	14.3	24.4	18.3
Advanced degree	7.2	3.6	8.9	4.7

Source: Census.

Recent research concluded that there is a substantial mismatch between Puerto Rico's industry structure and the educational achievement of its population.[15] While the mean years of schooling among Puerto Rican adults was substantially below that of any state in the last three censuses, the average years of schooling of people typically employed by the industries operating in Puerto Rico exceeds that of at least two-thirds of the states. The researchers suggest that the Puerto Rican economy has failed to generate jobs that fit the educational qualifications of the Commonwealth's population. In some sense, therefore, Puerto Rico's "missing jobs" can be found in labor intensive industries heavily reliant on less-educated workers. The authors conclude that the Possessions Tax Credit and other federal tax incentives contributed to an industry structure that is poorly aligned with the sort of job opportunities needed by Puerto Rico's population.

Annual data on employment in Puerto Rico come from two sources: the Puerto Rico household survey, and the BLS establishment survey. The Puerto Rico household survey has consistent sector definitions across time and includes the self-employed. The establishment survey data are limited to employees and reflect the new North American Industry Classification System industry definitions. In the figures that follow, we aggregated some of the industry categories and show the distribution of employment by sector. Both surveys show employment in Puerto Rico generally increasing since 1991 and show manufacturing employment declining since 1995. As shown in figure 25, data from the Census of Manufacturing for Puerto Rico for 1997 and 2002 also indicate a decline in manufacturing employment. Manufacturing employment fell by about 27 percent from 1995 to 2005,

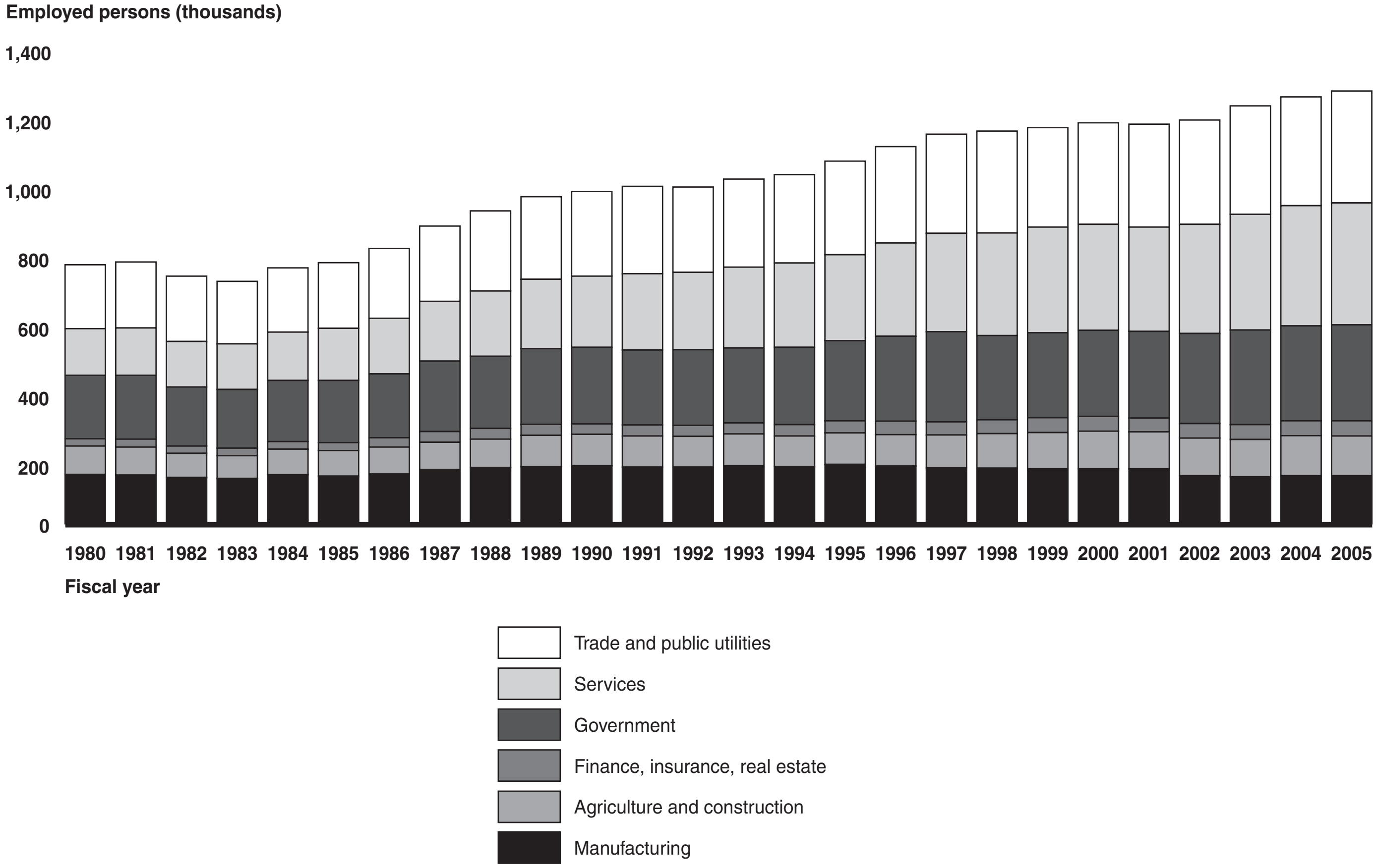
[15]Davis and Rivera-Batiz, "The Climate for Business Development and Growth in Puerto Rico."

according to establishment survey data.[16] Both the household and establishment data sources show that the government sector employs a large percentage of workers—about 23 percent in the household survey and about 30 percent in the establishment survey.

For the United States, manufacturing employment has been falling, both in absolute numbers of employees and as a percentage of all employees. Between 1980 and 2005, manufacturing employment fell by about 4.5 million employees (about 24 percent). From 1995 to 2005, manufacturing employment fell by about 3 million employees (about 17 percent). As of 2005, manufacturing employees represented about 10.7 percent of all employees. Government employees constituted about 16 percent of total employees in the United States, down from about 18 percent in 1980.

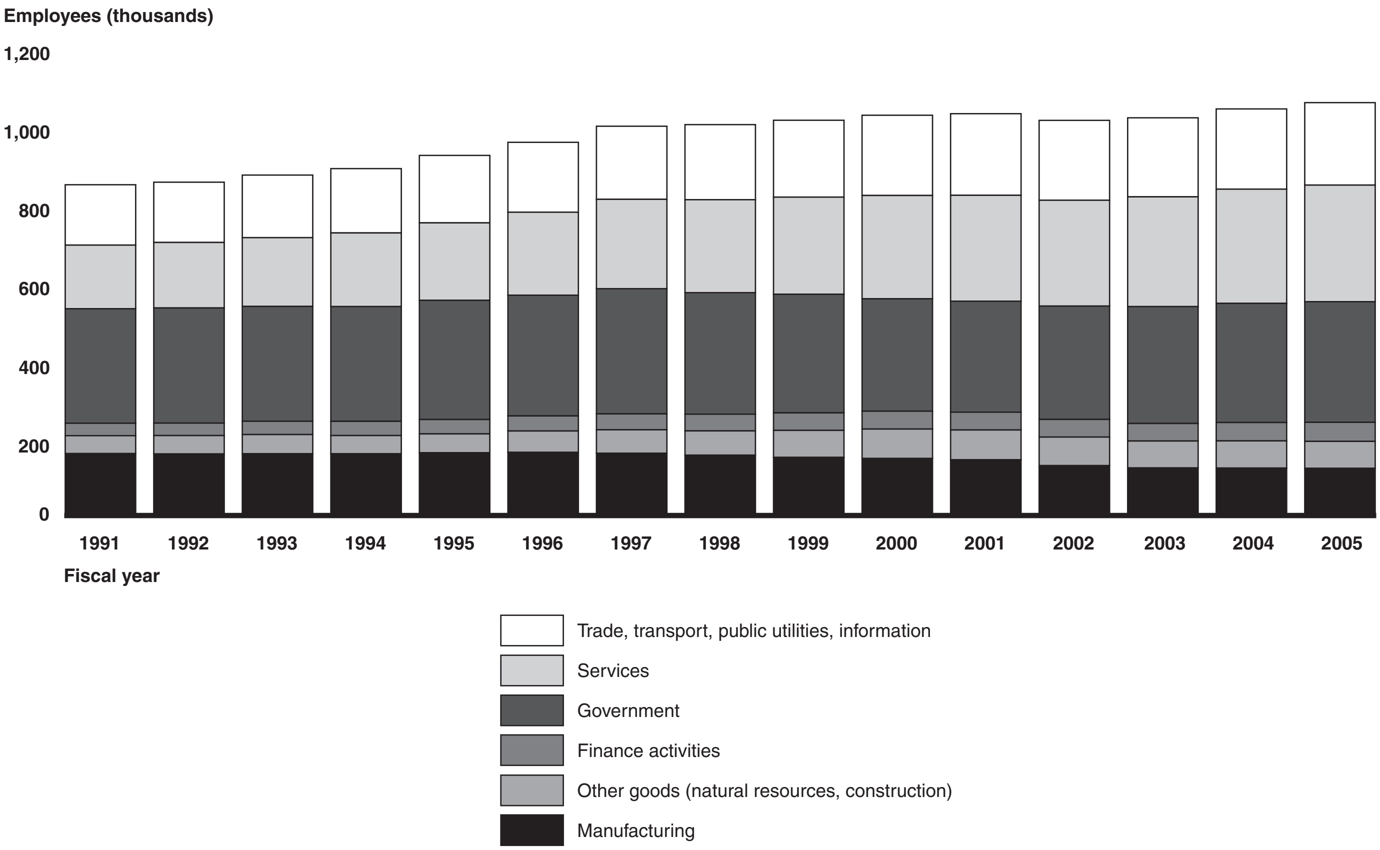
[16]BLS data for the first two months of 2006 indicate a further drop in manufacturing employment. However, these data are not seasonally adjusted.

Figure 23: Puerto Rican Employment by Sector—Household Survey, 1980–2005



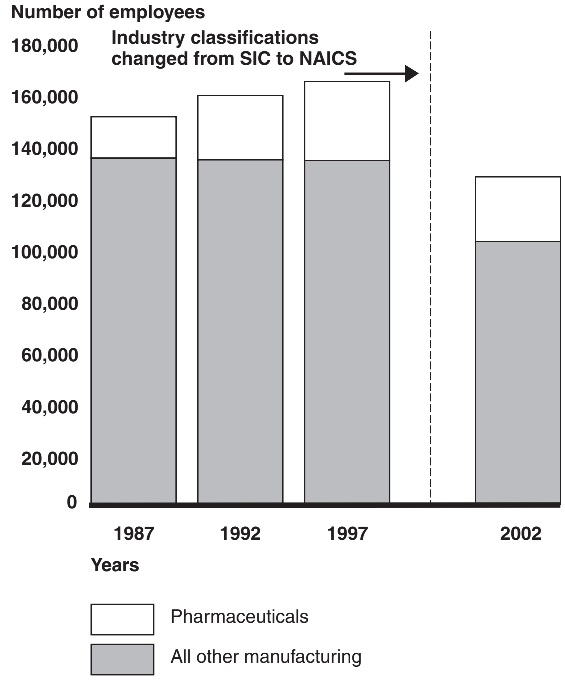
Source: GAO analysis of Puerto Rico Planning Board data.

Figure 24: Puerto Rican Employment by Sector—Establishment Survey, 1991–2005



Source: GAO analysis of U.S. BLS data.

Figure 25: Employment in Puerto Rican Manufacturing Industries, 1987–2002

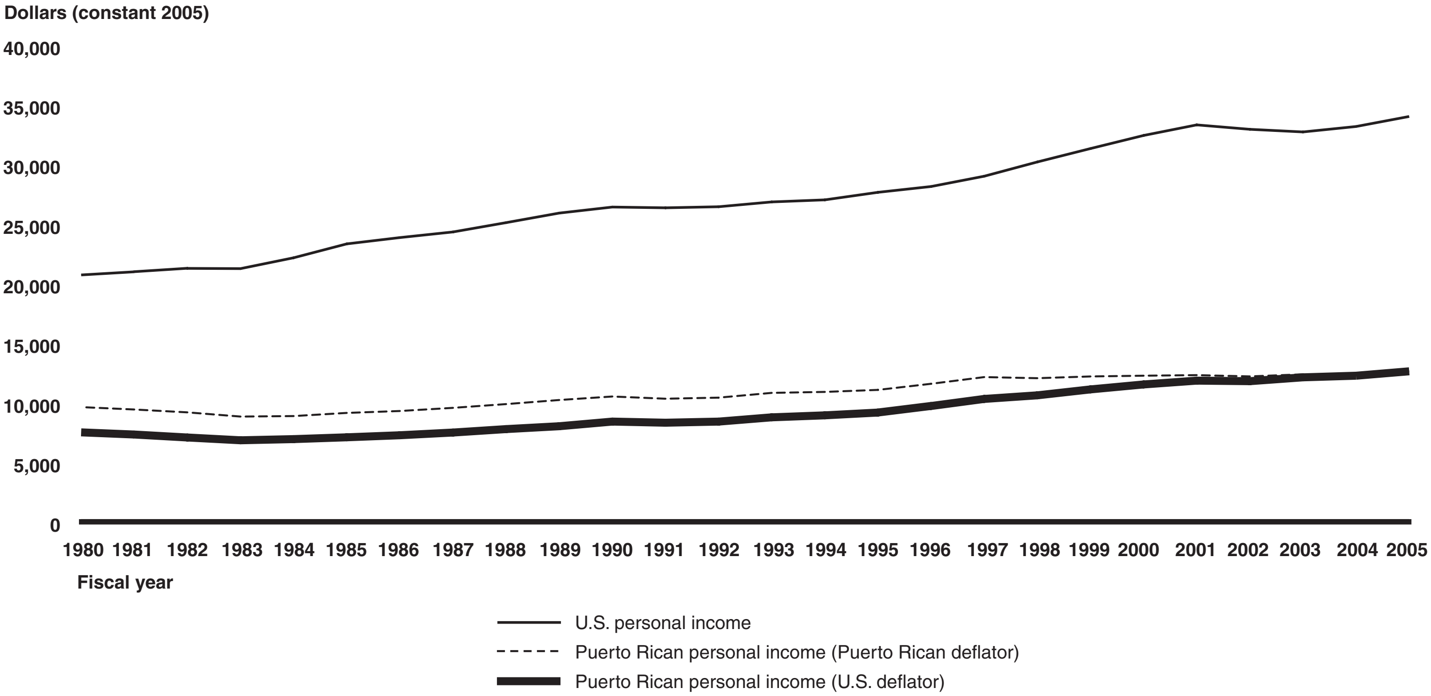


Source: GAO analysis of published data from the 2002 Economic Census of Island Areas and the Economic Census of Outlying Areas for 1987,1992, and 1997.

Since 1980, Real Per Capita Personal Income in Puerto Rico Has Not Grown Enough to Substantially Reduce the Gap between U.S. and Puerto Rican Living Standards

Although the likely imprecision of price deflators for Puerto Rico leaves the exact growth rate of real per capita personal income there difficult to determine, the rate has not been sufficient to substantially reduce the gap between U.S. and Puerto Rican living standards. Puerto Rican per capita personal income is well below that in the United States (see fig. 26).

Figure 26: U.S. and Puerto Rican Real Per Capita Personal Income, 1980–2005



Source: GAO analysis of U.S. BEA and Puerto Rico Planning Board data.

Note: Figures were adjusted for inflation using U.S. and Puerto Rican gross product deflators.

As we did in comparing U.S. and Puerto Rican GDP and GNP, we adjusted aggregate per capita personal income data using both U.S. and Puerto Rican price deflators. The growth rate in per capita personal income is somewhat higher in Puerto Rico than in the United States when the U.S. deflator is used to adjust Puerto Rican per capita personal income for inflation. In this case, the average annual percentage increase in Puerto Rican per capita personal income was 2.1 percent while U.S. per capita personal income rose by 2.0 percent on average per year. When the Puerto Rican deflator is used to make adjustments for inflation, Puerto Rican per capita personal income grew at a slower rate (1.1 percent) than in the United States (2.0 percent). The difference arises because the U.S. price deflator increased less than the Puerto Rico price deflator. Using both price indices serves to illustrate the sensitivity of the calculation to the index used.

In addition, private income transfers from Puerto Rico emigrants now living in the United States made to Puerto Rican residents may be understated, which would lead to an understatement of Puerto Rican personal income. As U.S. citizens, Puerto Ricans are free to migrate to the mainland United States and return as they wish. According to Census estimates, net migration from Puerto Rico to the United States in the 1980s totaled about 126,000.[17] During the 1990s, net migration was estimated to be about 111,000.

Census data show the distribution of income in Puerto Rico and the United States and the percentages of individuals and families with incomes below official poverty lines.[18] The median household income in 1999 was $41,994 in the United States and $14,412 in Puerto Rico. In 1999, 48.2 percent of households in Puerto Rico had incomes below the poverty level, which was nearly four times the U.S. share, as shown in table 5.

Table 5: Poverty Status in the United States and Puerto Rico, Percentage below Poverty Levels, 1999

Percent

	United States	Puerto Rico
All ages	12.4	48.2
Related children under 18	16.1	58.3
5–17 years	15.4	58.5
Population 65 and over	9.9	44.0
All families	9.2	44.6
Families with female head and at least one child	34.3	70.8

Source: Census.

As the disparity between average incomes in the United States and Puerto Rico suggests, a much higher percentage of Puerto Rican households is in the lower income categories. In 1999, only about 10 percent of U.S.

[17]Matthew Christenson, "Evaluating Components of International Migration: Migration Between Puerto Rico and the United States," Population Division Working Paper no. 64 (Washington, D.C.: U.S. Census Bureau, January 2002), www.census.gov/population/www/techpap.html.

[18]The Census income data do not include the value of in-kind government transfer payments.

households had annual incomes below $10,000, compared to 37 percent of Puerto Rican households (see table 6).

Table 6: Income Distribution of Households in the United States and Puerto Rico, 1999

Household income	United States	Puerto Rico
Less than $10,000	9.5	37.1
10,000–24,999	19.2	32.9
25,000–49,999	29.4	19.9
50,000–74,999	19.4	5.7
75,000–99,999	10.2	2.0
100,000–149,999	7.7	1.4
150,000–199,999	2.2	0.4
200,000 or more	2.4	0.6

Source: Census.

Note: Income data do not include capital gains and the value of in-kind government benefits and employer contributions.

The distribution of income is more unequal in Puerto Rico than in the United States. Economies in general have a small share of households receiving a disproportionately large share of income. As a result, the ratio of mean to median household income exceeds 1.0. As an indication of the greater degree of income inequality in Puerto Rico, the ratio of mean to median household income in 1999 was 1.69 in Puerto Rico[19] compared to 1.35 in the United States.

[19]U.S. Census Bureau, "QT-P32. Income Distribution in 1999 of Households and Families: 2000" (United States and Puerto Rico), http://factfinder.census.gov.

Much Possessions Corporation Activity Has Shifted to Affiliated Corporations

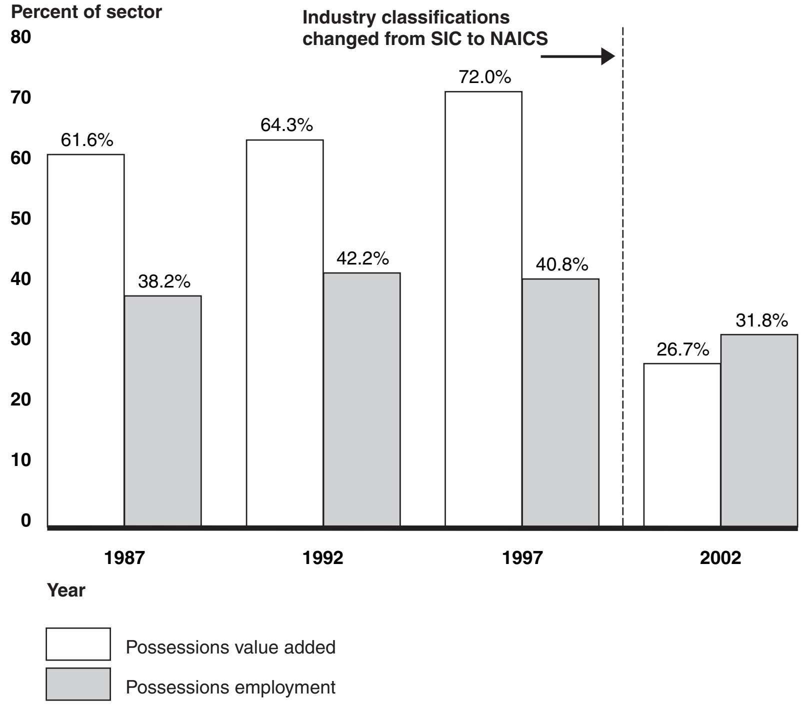
Possessions corporations have played an important role in the Puerto Rican economy, particularly in the manufacturing sector, where they accounted for well over half of valued added throughout the 1990s. Most of the possessions tax credit and income earned by possessions corporations in Puerto Rico has been earned by corporations in the pharmaceutical industry. Once the possessions tax credit was repealed, many of the large corporate groups that owned possessions corporations in Puerto Rico began to shift their operations to other types of business entities. Although the various tax and economic census data that we present in this chapter have significant limitations, we believe that, together, they form the basis for a reasonably accurate picture of the broad changes that have occurred in Puerto Rico's manufacturing sector over the past two decades. Those data indicate that much of the decline in activity of possessions corporations in the manufacturing sector was offset by the growth in other corporations, so that some measures of aggregate activity remained close to their 1997 levels. For example, value added in manufacturing remained fairly constant between 1997 and 2002. Most of the offsetting growth was concentrated in the chemical industry, which is dominated by pharmaceuticals.

Possessions Corporations Dominated Puerto Rico's Manufacturing Sector up until the Late 1990s

Possessions corporations continued to dominate Puerto Rican manufacturing through the mid-1990s, despite the legislative changes that made the possessions tax credit significantly less generous after 1993. According to the *1992 Economic Census of Puerto Rico Manufacturing*, these corporations accounted for 42.2 percent of employment and 64.3 percent of valued added in the manufacturing sector (as seen in fig. 27). By the next economic census in 1997, possessions corporations' share of value added had increased to 72 percent, while their share of employment remained little changed at 40.8 percent.[1] This pattern of growth up to 1997 is also apparent in the data from the federal tax returns of possessions corporations shown in figure 28. The aggregate total income, gross profits, and net income of possessions corporations operating in Puerto Rico all increased slightly between 1993 and 1997 (after adjusting for inflation), although there was a small decline in the corporations' total assets.

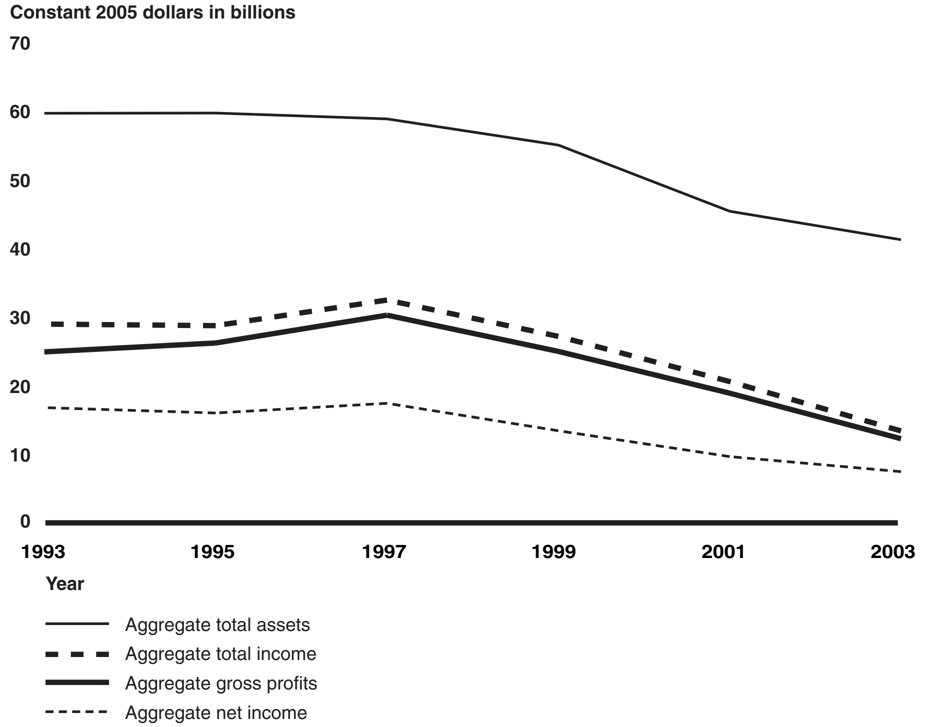
[1]This growth in value added and stability in employment was true in absolute terms, as well as in terms of the percentage shares shown in fig. 27.

Figure 27: Share of Possessions Corporations in Value Added and Employment in Puerto Rican Manufacturing, 1987–2002



Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1987, 1992, and 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Figure 28: Income and Assets from the Tax Returns of Possessions Corporations Operating in Puerto Rico, 1993–2003



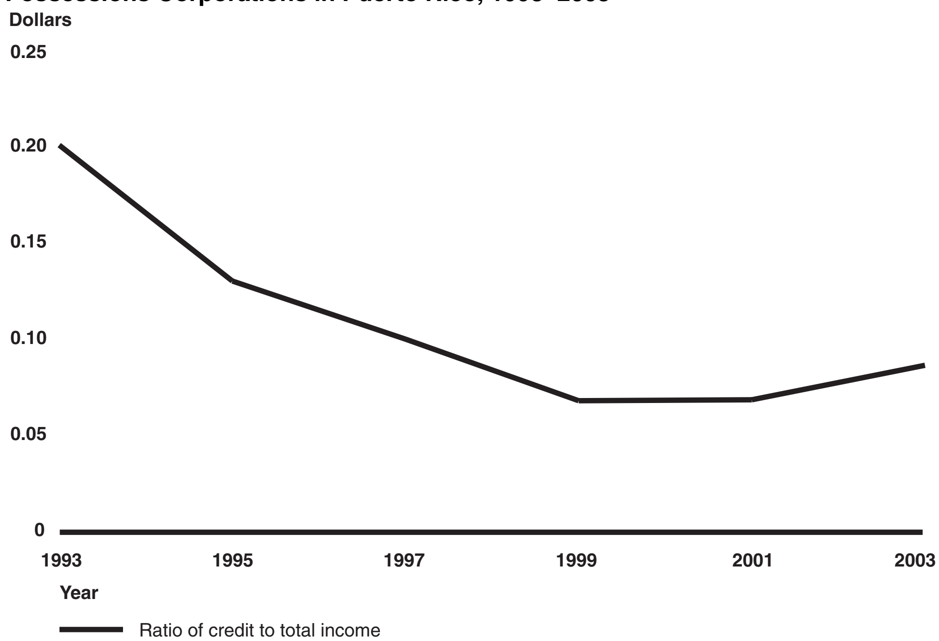
Source: GAO analysis of data from IRS.

The growth in possessions corporation activity occurred despite the limitations that Congress placed on the possessions tax credit after 1993 and a decline in the number of corporations claiming the credit. Figure 29 shows that those limitations significantly reduced the generosity of the credit. Possessions corporations earned about 20 cents of credit for each dollar of income they earned in 1993, but only half that amount by 1997. Over that period, the number of corporations claiming the credit for operations in Puerto Rico fell from 378 to 291 and the amount of credit claimed declined from $5.8 billion to $3.2 billion.

The decline in possessions corporation income, value added, and employment began after the Small Business Job Protection Act of 1996, which placed additional limits on the amount of credit that corporations could earn and, more importantly, repealed the credit completely for tax years beginning after 1995, subject to a 10-year phaseout. The generosity of the credit reached a low of less than 7 cents per dollar of income by 1999.

The number of corporations claiming the credit fell to 124 by 2003 and the amount of credit they claimed that year fell to $1.1 billion. Moreover, in contrast to the period leading up to 1997, the aggregate total income, gross profits, and net income earned by possessions corporations all declined by more than 50 percent between 1997 and 2003, while their total assets declined by almost 30 percent. The significantly decreased importance of possessions corporations is also apparent in the most recent economic census data (fig. 27), showing that these corporations accounted for only 26.7 percent of manufacturing value added and only 31.8 percent of manufacturing employment in 2002.

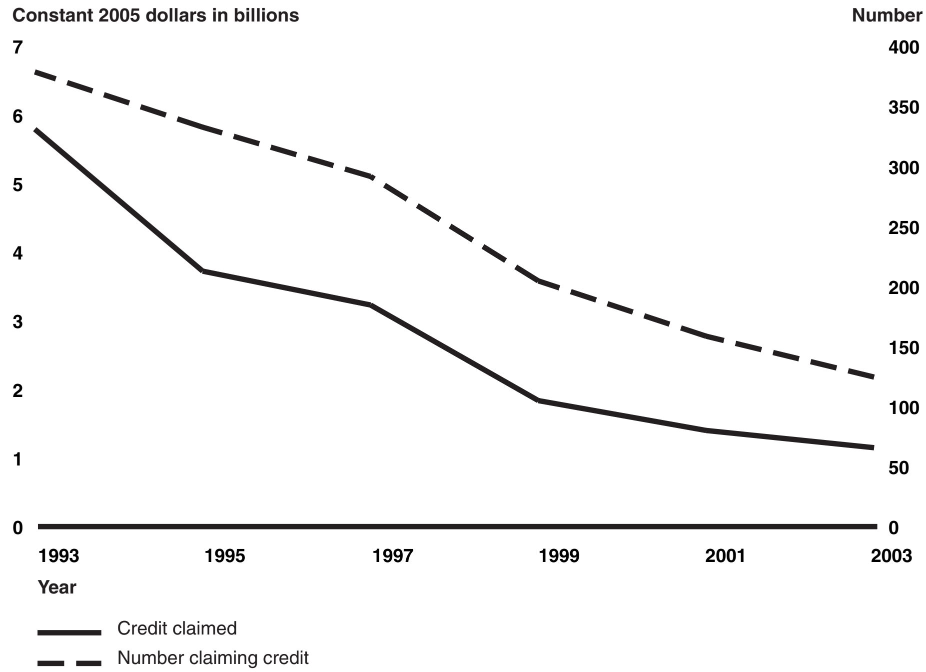
Figure 29: The Ratio of Possessions Tax Credit to Total Income Earned by Possessions Corporations in Puerto Rico, 1993–2003



Source: GAO analysis of data from IRS.

Note: The rate of credit per dollar of income increased slightly between 1999 and 2003, as corporations with relatively low rates of credit were more likely to stop operating as possessions corporations (and, therefore, drop out of the population represented in fig. 29) than those with higher rates.

Figure 30: The Number of Corporations in Puerto Rico Claiming the Possessions Tax Credit and the Amount Claimed, 1993–2003

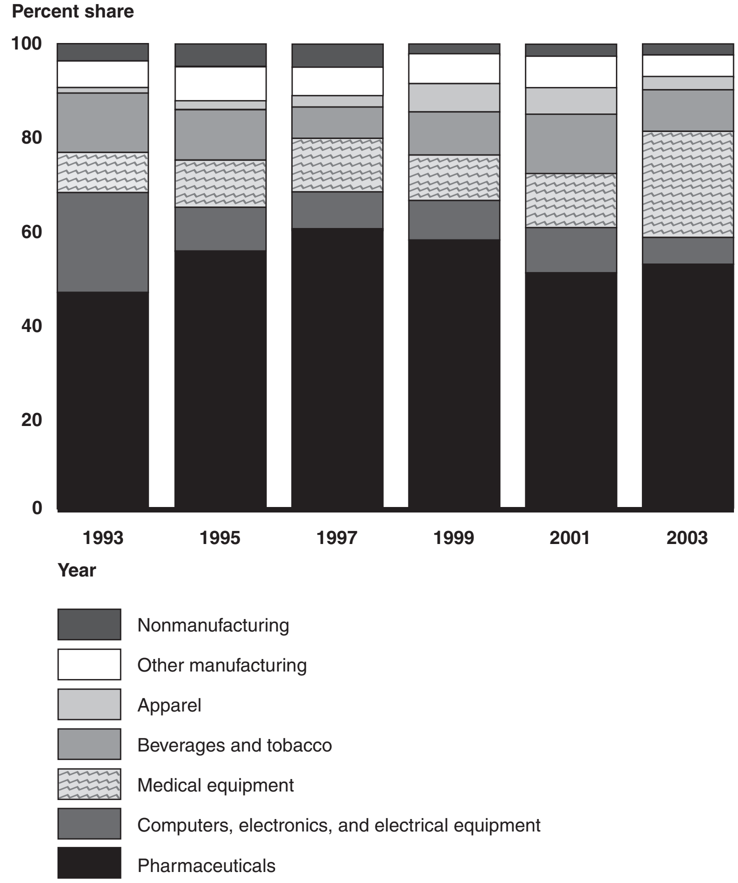


Source: GAO analysis of data from IRS.

The Pharmaceutical Industry Has Dominated the Use of the Possessions Tax Credit in Puerto Rico

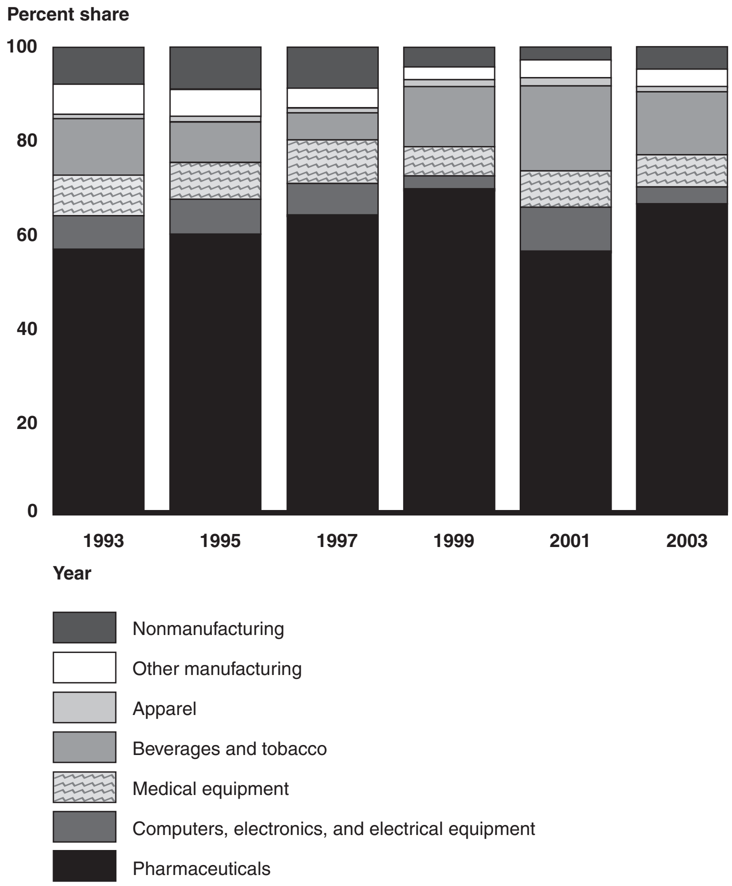
Most of the possessions tax credit and income earned by possessions corporations in Puerto Rico has been earned by corporations in the pharmaceutical industry. Figure 31 shows that pharmaceuticals corporations earned over half of all the credit earned each year from 1995 through 2003. Figure 32 shows that these corporations earned an even larger share of the aggregate gross profit earned by possessions corporations in each of those years. Manufacturers of beverages and tobacco products, medical equipment, and computers, electronics, and electrical equipment were also heavy users of the credit during this period, though not nearly to the same extent as pharmaceuticals manufacturers. Both of these figures are based on data for possessions corporations in the 77 largest corporate groups operating in Puerto Rico. (See the following section.)

Figure 31: Industry Shares of the Possessions Tax Credit in Puerto Rico, 1993–2003



Source: GAO analysis of data from IRS.

Figure 32: Industry Shares of Gross Profits Earned by Possessions Corporations in Puerto Rico, 1993–2003



Source: GAO analysis of data from IRS.

Businesses Have a Variety of Options for Continuing Operations in Puerto Rico after They Cease Operating as Possessions Corporations

Parent corporations have a number of options for conducting business in Puerto Rico if they wish to do so after termination of the possessions tax credit. Large corporate groups are believed to have used at least four different approaches to rearranging their overall corporate structure (including the possessions corporation and their Puerto Rican operations) in anticipation of termination of the possessions tax credit. The U.S. federal tax consequences of these approaches vary as follows:

- *The possessions corporation loses its 936 status but remains a subsidiary incorporated in the United States and is consolidated into* *its parent's federal tax return.* The parent corporation includes the relevant income and expenses of the subsidiary when computing its own federal taxes. Tax attributes, such as carryovers of certain accumulated losses, of the former possessions corporation would be governed by applicable IRS regulations and guidance.

- *The possessions corporation liquidates into its parent (i.e., it no longer remains a separate corporate entity).* Generally, if the parent satisfies certain ownership requirements, no gain or loss would be recognized to either the parent or the subsidiary for U.S. federal income tax purposes. The domestic parent would inherit and take into account certain items of the former possessions corporation, such as earnings and profits, net operating and capital loss carryovers, and methods of accounting. No foreign tax credit is allowed for any foreign taxes paid in connection with the liquidation, and the deduction of certain losses and other tax attributes may be limited.

- *The possessions corporation is converted into or replaced by a CFC.* This change can occur if the possessions corporation reincorporates and conducts business as a CFC; if it sells or contributes most of its assets to a CFC; or if it winds down its operations as its parent corporation starts up a new CFC to operate in Puerto Rico. Any income that the replacement CFC earns from the active conduct of business in Puerto Rico or elsewhere outside of the United States generally is not taxed until it is repatriated to the U.S. shareholders in the form of dividends. A number of tax consequences arise in cases where the possessions corporation actually reincorporates as a CFC.[2] There are also significant tax issues (discussed further below) relating to the transfer of assets (through either a contribution or a sale) from possessions corporations to CFCs.

- *The possessions corporation is converted into or replaced by a limited liability corporation (LLC) or partnership.* An LLC can elect to be treated as a corporation, as a partnership, or as a "disregarded entity." If the LLC elects to be treated as a corporation, its net earnings would be included either individually or, if required to file a consolidated return,

[2]These consequences include the loss of any foreign tax credit or deduction with respect to any possessions tax credit or other foreign tax imposed on accumulated earnings of the corporation. Reincorporation also causes adjustments to the alternative minimum tax and could cause the recapture of certain losses.

on its parent's return. If it chose partnership treatment, the LLC itself would generally not be subject to federal income tax but its income, deductions, gains, and losses would be distributed to its members, who would include such amounts in calculating their federal income tax. If the LLC is treated as a disregarded entity, its income, deductions, gains, and losses are included on the member's federal tax return.

Parent corporations could substantially change the manner in which income from their Puerto Rican business operations were treated for federal tax purposes even without making a formal change in the legal status of their possessions corporations. The parents could simply reduce production by their possessions corporations and start up or expand production in other forms of businesses operating in Puerto Rico. We used tax return data from both IRS and the Treasury of Puerto Rico to track changes in the activity of possessions corporations, as well as to assess the extent to which declines in that activity have been offset by increases in the activity of affiliated businesses operating in Puerto Rico. In order to make this assessment for a particular group of affiliated corporations, we needed to examine data for each member of the group that had operations in Puerto Rico.[3] Given that considerable effort was required to identify the group members that operated in Puerto Rico, we limited our review to the largest 77 groups, which included at least one possessions corporation between 1993 and 2001. These 77 large groups accounted for over 92 percent of the credit and income earned by possessions corporations in every year from 1993 through 2001 and for over 91 percent of the assets owned by such corporations in each of those years.

The large groups included a total of 172 possessions corporations that we tracked between 1993 and 2003.[4] The number of possessions corporations that these 77 large groups owned and operated in Puerto Rico declined from a high of 146 in 1995 to 58 by 2003. As of 2001, these groups also conducted operations in Puerto Rico through 49 CFCs and at least 28 other businesses. Fourteen of the groups operated both possessions

[3]By "affiliated corporate group," we mean a parent corporation and all of its subsidiary corporations.

[4]The full population of possessions corporations that operated in Puerto Rico in at least one of those years was 656. Table 14 in app. IV shows the attributes of the full population of possessions corporations, while table 15 shows those of the subset that we examined in detail.

corporations and CFCs in Puerto Rico in 2001. In the following section we report on trends in the income and assets of these large corporate groups.

The popular choice of replacing the operations of possessions corporations with CFCs offers long-term tax benefits but could entail high initial tax costs for some corporations. Many corporate groups have chosen to operate in Puerto Rico through CFCs, possibly to take advantage of the federal tax deferral on income earned there. Some may have rejected this choice because their possessions subsidiaries owned valuable intangible assets, such as drug patents or food recipes, and the transfer of these assets to a non-U.S. entity, such as a CFC, could have been treated as a taxable exchange, possibly resulting in a substantial, one-time tax liability.[5] Affiliated groups can avoid this tax if they keep the intangible assets in their U.S. firms, rather than transferring them to their new CFCs. However, in order for those CFCs to use those intangibles in their production processes, they must pay royalties to the U.S. owners and those royalties would be subject to federal income tax.

IRS officials have expressed concern that the repeal of section 936 has not had its intended effect. Congress repealed section 936 because it was viewed as providing an overly generous tax benefit to taxpayers with operations in Puerto Rico. However, IRS officials believe that despite the repeal of section 936, many taxpayers with operations in Puerto Rico could be incurring approximately the same or even lower tax liabilities than they did under section 936 by restructuring their activities through CFCs. Taxpayers who converted into CFCs may have avoided the tax consequences typically associated with such a conversion, namely, tax liabilities arising from the transfer of intangibles from possessions corporations to CFCs or a significant increase in royalty payments from Puerto Rico. One private sector tax expert familiar with the practices of U.S. businesses operating in Puerto Rico could not recall any case in which a taxpayer reported a transfer of intangibles of any significant value from a possessions corporation to a CFC. The expert also told us that the reason

[5] If the possessions subsidiary reincorporates as a foreign corporation, it is treated as having sold any marketing or manufacturing intangibles in exchange for payments contingent upon productivity, use, or disposition of such property. These payments would be treated as ordinary income. If the subsidiary transfers the property while it is still a possessions corporation, the payments are included as U.S.-source ordinary income. If the possessions election has terminated, the payments would be considered foreign-source ordinary income. Source rules are important for domestic corporations to determine whether a foreign tax credit is available to offset U.S. income taxes and for a foreign corporation to determine whether the income is subject to U.S. income taxation.

why the IRS has not seen a notable increase in royalty payments from CFCs to U.S. firms holding intangibles is that, well before the expiration of the possessions tax credit, corporate groups had their existing or newly formed CFCs enter into research cost-sharing arrangements with their possessions corporations so that they would be codevelopers of new intangibles and, thereby, would have certain ownership rights to use the technology without paying royalties. The groups also tried to involve their CFCs as much as possible in the development of new products through other arrangements, such as research partnerships with unrelated technology-developing firms.

Some Measures of Aggregate Manufacturing Activity Have Remained Constant Despite a Decline in Possessions Corporation Activity

A combination of tax return and economic census data indicate that the decline in income and value added of possessions corporations between 1997 and 2002 has been largely offset by an increase in the income and value added of affiliated corporations that left aggregate income and value added roughly constant. Although some evidence of a change in income-shifting behavior by these corporate groups makes it difficult to say how accurately trends in reported income and value-added data represent trends in actual economic activity in Puerto Rico, data on employment, capital expenditures, and total assets (which should not be distorted by income shifting) support the conclusion that a substantial amount of possessions corporation activity has been continued by other types of businesses. However, most of this continued activity is concentrated in the pharmaceutical industry and the decline in possessions corporation activity in other industries has not been offset. None of the data we present address the question of what corporate activity would have taken place during this period if the possessions tax credit had not been repealed.

Tax Return and Economic Census Data Indicate That Much of the Income and Value Added of Possessions Corporations Declined While That of Affiliated Businesses Increased

Tax return data on the affiliated corporate groups that have claimed almost all of the possessions tax credit indicate that between 1997 and 2001 at least a large portion (and possibly all) of the decline in reported incomes of possessions corporations operating in Puerto Rico was offset by increases in the reported incomes and total assets of affiliated corporations operating in Puerto Rico, particularly that of CFCs. The offset left the income that these groups earned in Puerto Rico roughly the same in 2001 as in 1997. This finding is consistent with data on value added in manufacturing from recent economic censuses of Puerto Rico.

Gross profit, which equals income from sales minus the cost of goods sold, is the income measure from tax returns that is closest in definition to the value-added measure from census data that we presented earlier.[6] Both of these measures may be distorted by income shifting, as we explain in the next section; however, value added is considered to be the best measure of the economic importance of manufacturing activity. We examined data for both of these measures, as well as other measures not distorted by income shifting, to assess the extent to which possessions corporation activity has been replaced by the activity of other types of businesses.

Figure 33 shows that the aggregate gross profit of the possessions corporations in our 77 large groups peaked at $28.8 billion in 1997 and then fell to $11.4 billion by 2003. The figure also presents our "lower-bound" estimates for the amount of gross profits from Puerto Rico that CFCs reported. These estimates include only the profits of those CFCs for which we had Puerto Rican tax returns or that appeared to have operations only in Puerto Rico because those are the cases where we can be the most confident that our figures represent profits attributable only to Puerto Rican operations. The gross profits of those CFCs grew from $2.4 billion to $7.1 billion between 1997 and 2001.[7] These estimates are likely to represent a lower bound for the amount of CFC profits in Puerto Rico because they do not include any of the profits for CFCs whose income was difficult to allocate between Puerto Rico and other locations. We present alternative estimates, labeled "CFC total if allocated by tax ratio," of the gross profits from Puerto Rico of all of the CFCs in our large groups.[8] These more comprehensive estimates are not likely to be very precise, but they are

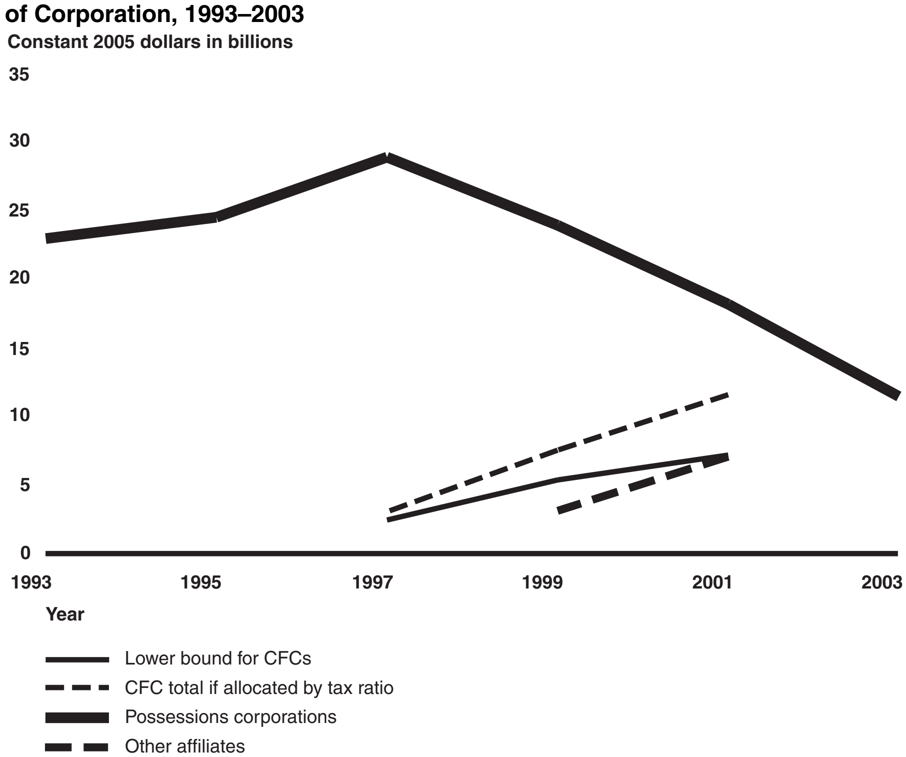
[6]No other expenses, such as employee compensation, interest, taxes, or depreciation, are deducted to arrive at gross profits. Although the following discussion relates to the gross profits of the various types of businesses, the trends are very similar for the total incomes and net incomes of these businesses. Data on the latter two measures of income are presented in table 15 in app. IV. The data in figure 33 and in tables 15 through 18, all of which contain U.S. tax data, are inflation-adjusted with the U.S. GDP deflator.

[7]There were only three years (1997, 1999, and 2001) for which we had federal tax returns for both possessions corporations and CFCs. There were only two years (1999 and 2001) for which we had both federal and Puerto Rican returns for possessions corporations, CFCs, and other types of corporations.

[8]These estimates cover all of the CFCs included in our lower bound estimates and then add in estimated amounts for the multinational CFCs. The latter estimates are made by multiplying the amount of tax paid to Puerto Rico by each CFC (which is reported on their federal tax return) by the average ratio of Puerto Rico gross profits over taxes paid to Puerto Rico by CFCs for which we did have Puerto Rican tax returns.

consistent with some of the census data that we present on CFCs in chapter 5. The estimates show CFC gross profits growing from $3.0 billion to $11.5 billion between 1997 and 2001. Finally, figure 33 also shows the gross profits reported on Puerto Rican tax returns by members of the 77 large groups, other than possessions corporations and CFCs. The gross profits of these businesses increased from $3.0 billion to $7.0 billion between 1999 and 2001.

Figure 33: Gross Profits Earned by Large Corporate Groups in Puerto Rico, by Type of Corporation, 1993–2003



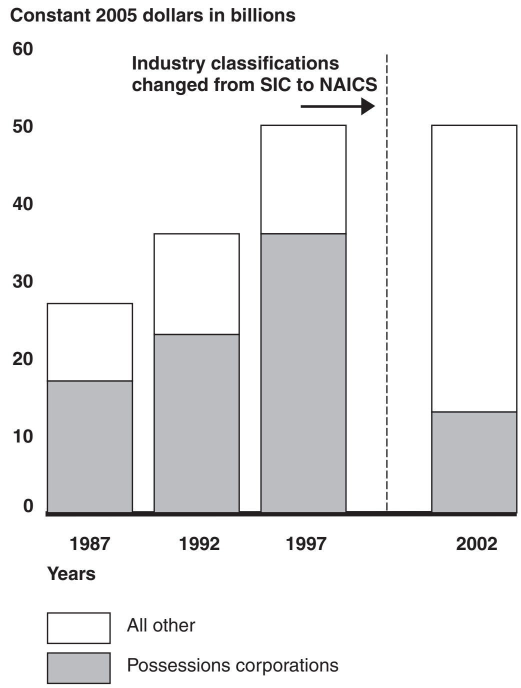
Source: GAO analysis of data from IRS and the Puerto Rican Department of Treasury.

The data in figure 33 indicate that much of the $10.7 billion decline in the gross profits of possessions corporations between 1997 and 2001 was offset by increases in the profits of affiliated corporations. The lower-bound estimates for CFCs grew by $4.7 billion over that period, while the profits of the other affiliates, including LLCs, grew by $3.9 billion between 1999 and 2001.[9] The combined profits of these two sets of businesses, therefore, grew by about $8.7 billion. If we use the "tax ratio" estimate for all CFCs, the combined growth in profits grew by about $12.5 billion. The gross profit of the "other affiliated" businesses is likely to be understated relative to those of the possessions corporations because of differences in the income definitions used for federal and Puerto Rican tax purposes. For those possessions corporations for which we had both federal and Puerto Rican returns, the gross profit from the Puerto Rican return averaged about 70 percent of the gross profit on the federal return. For this reason figure 33 may understate the extent to which the decline in possessions corporations' Puerto Rican operations has been offset by these other affiliates.

Data from recent economic censuses on value added in Puerto Rican manufacturing lend additional support to the conclusion that we draw from figure 33—that much, if not all, of the decline in income of possessions corporations in Puerto Rico between 1997 and 2001 was largely offset by increases in the incomes of other types of businesses. Figure 34 shows that valued added by possessions corporations in Puerto Rican manufacturing followed roughly the same pattern as the gross profits data presented in figure 33; it also shows that other types of businesses made up for approximately all of the possessions corporations' decline between 1997 and 2002.

[9] Tax experts, including those in IRS, suggested that one potential explanation for this use of LLCs is that the "special allocation rules" under partnership tax law allow corporate groups more flexibility in allocating income and expenses within a group. At least one case was identified where manufacturing operations in Puerto Rico were held in a partnership owned by two partners—one was a possessions corporation, the other was a CFC. This partnership allocated the profits from old product lines that qualified for the possessions tax credit to the possessions corporation; it passed profits from new product lines that did not qualify for the credit to the CFC.

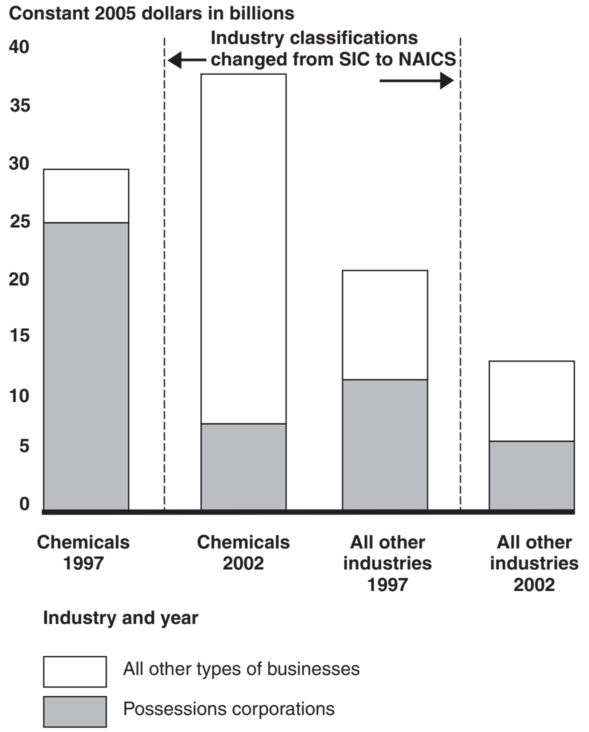
Figure 34: Value Added for Possessions Corporations and Other Types of Employers in Manufacturing in Puerto Rico, 1987–2002



Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1987, 1992, and 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

The extent to which the decline in income and value added of possessions corporations was offset by the growth of their affiliates varied significantly by industry. Figure 35 decomposes the last two columns of figure 34 into the chemical industry (which includes pharmaceuticals) and all other manufacturing industries. It shows that a significant drop in the value added of possessions corporations in the chemical industry was more than offset by the substantial growth in value added by other types of businesses. In contrast, the value added of both possessions corporations and all other types of businesses declined between 1997 and 2002 in the remainder of the manufacturing sector, outside of chemicals.

Figure 35: Value Added for Possessions Corporations and Other Types of Employers in the Chemical Industry and All Other Manufacturing Industries in Puerto Rico, 1997–2002



Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

Our tax data for large corporate groups showed similar variation across industries. The corporate groups in the chemicals and medical equipment industry group offset a larger proportion of the decline in the income of their possessions corporations between 1997 and 2002 with income from other types of affiliates operating in Puerto Rico than was the case for large corporate groups as a whole.[10] Trends in the income of possessions corporations in the other two industrial groupings that we are able to present with our tax data—computer, electronics, and electrical equipment; and food and kindred products—were somewhat erratic between 1993 and 2001 before declining by 2003. There was negligible to no growth in the incomes of CFCs and other types of businesses in these two industrial groupings during the period we could observe between 1997 and 2002. (See tables 17 and 18 in app. IV.)

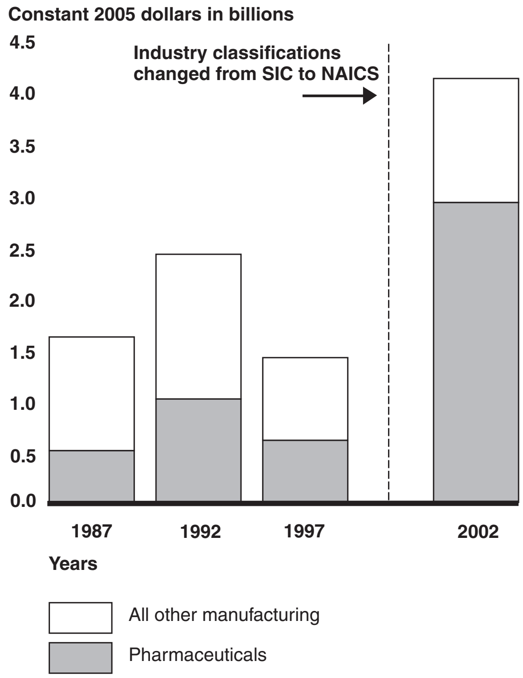
Data on Capital Expenditures, Total Assets, and Employment Also Indicate That a Substantial Amount of Possessions Corporation Activity Has Been Continued by Other Types of Businesses in Certain Industries

As we explained in chapter 3, the data on income and value added for members of large corporate groups operating in Puerto Rico may be distorted by changes in the income reporting practices of these groups during the late 1990s. For this reason it is difficult to know how accurately trends in reported income and value added represent trends in actual economic activity in Puerto Rico. Nevertheless, data on capital expenditures, total assets, and employment (which should not be distorted by income shifting) support the conclusion that a substantial amount of possessions corporation activity has been continued by other types of businesses. Much of this continued activity is concentrated in the chemical industry, which is dominated by pharmaceutical producers.

The economic census data on capital expenditures on manufacturing plant and equipment in figure 36 show that this investment increased dramatically between 1997 and 2002 after having dropped from 1992 to 1997. We cannot divide this time series of capital spending data between possessions corporations and other forms of business; however, figure 36 shows that most of the spending increase was in the pharmaceutical industry, which was the source of about two-thirds of total possessions corporations profits in 1997. Consequently, it appears that any overall decline in possessions corporations' capital spending that may have occurred since 1997 must have been more than offset by the investment of other businesses.

[10] These differences can be seen by comparing the data in tables 15 and 16 in app. IV.

Figure 36: Capital Expenditures in Puerto Rico's Manufacturing Sector, by Industry, 1987–2002



Source: GAO analysis of published data from the 2002 Economic Census of Island Areas and the Economic Census of Outlying Areas for 1987,1992, and 1997.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

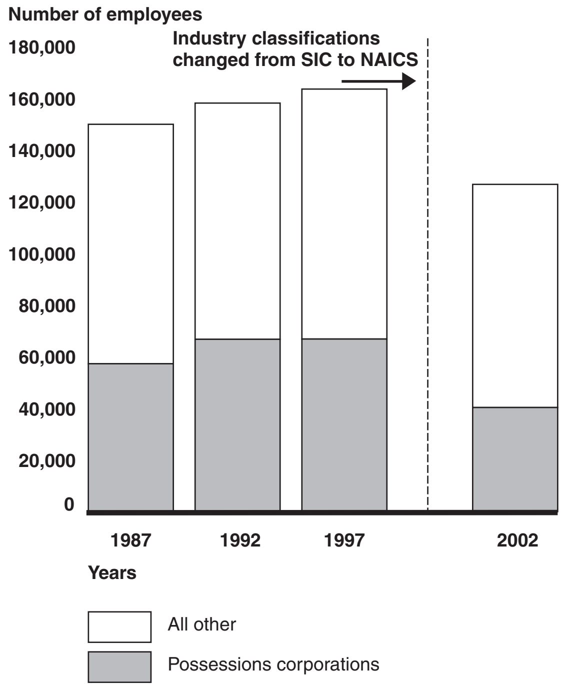
The tax data for our 77 large corporate groups show that the $12.1 billion decline in the total assets of the possessions corporations in these groups between 1997 and 2001 was largely offset by an increase of at least $9.4 billion in the total assets of affiliated corporations operating in Puerto Rico (see table 15 in app. IV). The decline in assets may have been more than fully offset, depending on the growth in the Puerto Rican assets of the CFCs that we were not able to include in our estimates.[11] However, as was the case with income and value added, there were significant differences across industries behind the trends for the manufacturing sector as a

[11]That increase is based on a lower-bound estimate for CFCs. We did not attempt to estimate the Puerto Rican assets of any multinational CFCs for which we did not have Puerto Rican tax returns because we considered the relationship between assets and taxes paid to be weaker than the relationships between income and taxes paid that we had used to estimate the Puerto Rican income of these CFCs.

whole. The decline in assets of possessions corporations in the chemical and medical equipment industries between 1997 and 2001 was more than offset by the increased assets of their affiliates even if we use just our lower-bound estimates for CFCs. In comparison, a little over half of the decline in possessions corporations' assets in the computer, electronics, and electrical equipment industries between 1997 and 2001 was offset by the growth in affiliated CFCs' assets. (See tables 16 and 17 in app. IV.)

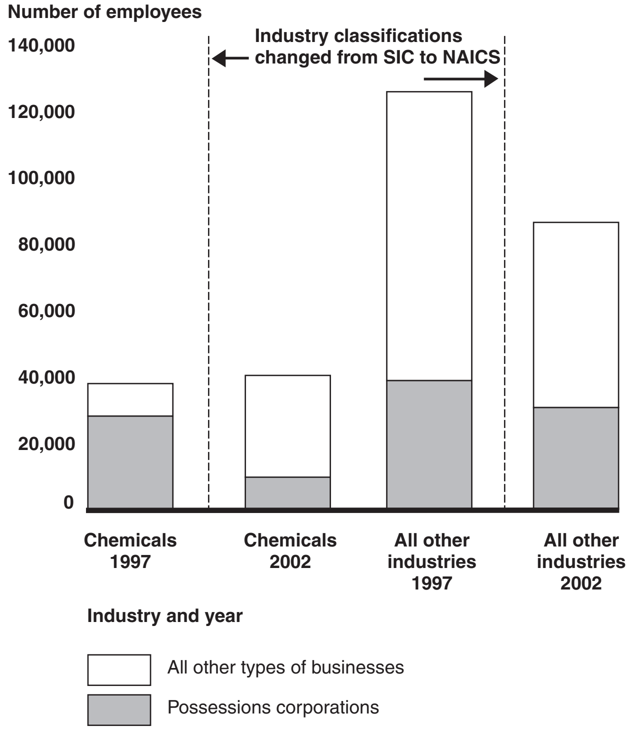
The economic census data on employment in Puerto Rico's manufacturing sector in figure 37 shows that the decline in employment by possessions corporations between 1997 and 2002 was not as drastic as the declines in their profits or value added over that period (shown previously in figs. 33 and 34); however, there was no offsetting increase in overall employment by other types of manufacturing firms. Figure 38, which decomposes the last two columns of figure 37 into the chemical industry and all other industries, shows that employment by possessions corporations in the chemical industry did, in fact, fall sharply between 1997 and 2002, but other types of businesses in the industry more than made up for that decline. In the remaining industries as a whole, there was a smaller percentage decrease in employment by possessions corporations but there was also a decrease, rather than an offsetting increase, in the employment by other types of businesses. The chemical industry is much less important in terms of overall employment in manufacturing than it is in terms of value added. For this reason the continued strength of that industry was not enough to prevent an overall decline in manufacturing employment.

Figure 37: Employment in Possessions Corporations and Other Types of Employers in Manufacturing in Puerto Rico, 1987–2002



Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Figure 38: Employment in Possessions Corporations and Other Types of Employers in the Chemical Industry and All Other Manufacturing Industries in Puerto Rico, 1997–2002



Source: GAO analysis of IRS data, published data from the Economic Census of Outlying Areas for 1997, published data from the 2002 Economic Census of Island Areas, and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

U.S. Businesses Dominated Puerto Rican Manufacturing in 2002 but Played Smaller Roles in Other Sectors

U.S.-owned businesses accounted for at least 71 percent of value added and at least 54 percent of employment in Puerto Rico's manufacturing sector in 2002. CFCs produced most of this value added but possessions corporations still accounted for most of the employment by U.S. firms. The CFCs are particularly important in the pharmaceutical industry and much less so in other manufacturing industries. U.S. corporations appear to account for less than 25 percent of employment in Puerto Rico's wholesale and retail trade sectors, where local corporations are the most important employers. Similarly, U.S.-owned corporations are not the majority employers in any of the large Puerto Rican service industries for which data are available.[1]

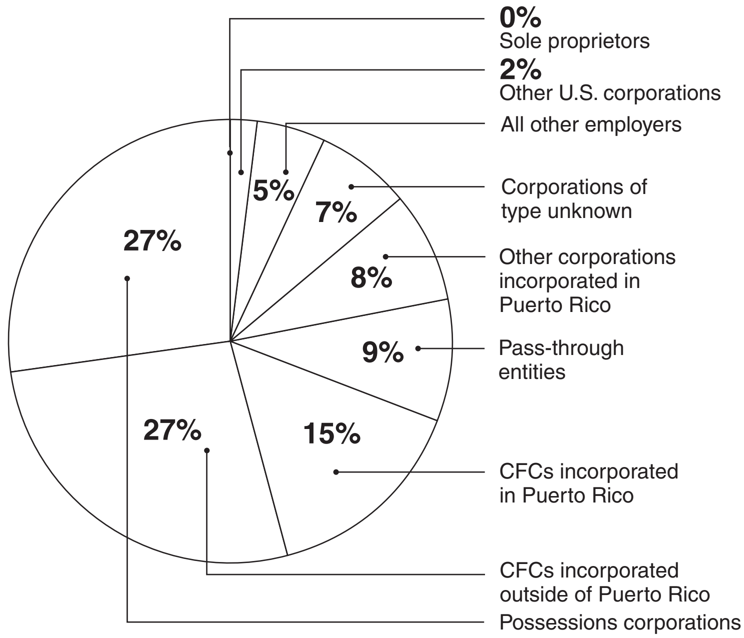
U.S. CFCs Have Become the Most Important Type of Business Entity in Puerto Rico's Manufacturing Sector in Terms of Value Added but Not in Terms of Employment

As of 2002, U.S. CFCs accounted for 42 percent of value added in Puerto Rico's manufacturing sector—a larger share than that of any other type of business entity (see fig. 39). Possessions corporations had the next largest share of value added with 27 percent, and other U.S. corporations accounted for 2 percent of the total. Together, these three types of businesses produced at least 71 percent of total manufacturing value added. A small number of U.S.-owned or U.S.-incorporated businesses may be included in the category "corporations of type unknown," but we believe that most of the data for that category (in all of the figures in this chapter) are attributable to corporations that are not incorporated in the United States and are not CFCs.[2]

[1]These findings are based on a special research project that we completed with the cooperation of Census and IRS. App. III includes a description of our methodology and tables in app. V provide as much detail on the results of this project as Census and IRS disclosure rules permit.

[2]The corporations in that category include only those for which IRS had no record of any requirement for them to file as U.S. corporations. The category also includes a very small number of foreign-owned corporations that we could not report on separately due to Census nondisclosure rules; it may also include a very small number of CFCs for which we could not determine a place of incorporation. See app. III for more detail on our criteria for placing businesses into each of our categories.

Figure 39: Distribution of Value Added for All Puerto Rican Manufacturing by Type of Business Entity, 2002

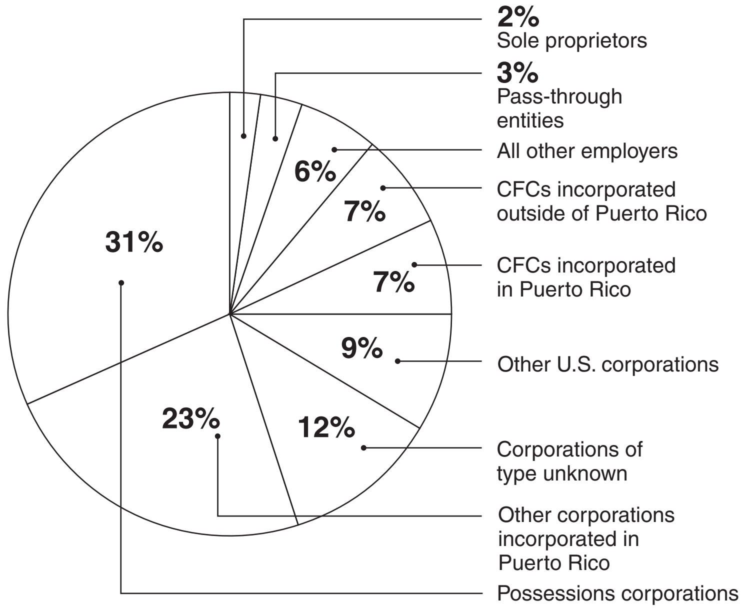


Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: Value-added figures for sole proprietors round to 0 percent.

Possessions corporations remained the largest single type of employer, with 31 percent of the sector's total employment (see fig. 40). Despite their large share of manufacturing value added, CFCs had a relatively small share—14 percent—of the sector's total employment, which resulted in the extraordinarily high ratios of value added per employee that we discussed earlier. In contrast, other U.S. corporations and corporations incorporated in Puerto Rico had significantly larger shares of total employment than they did of value added.

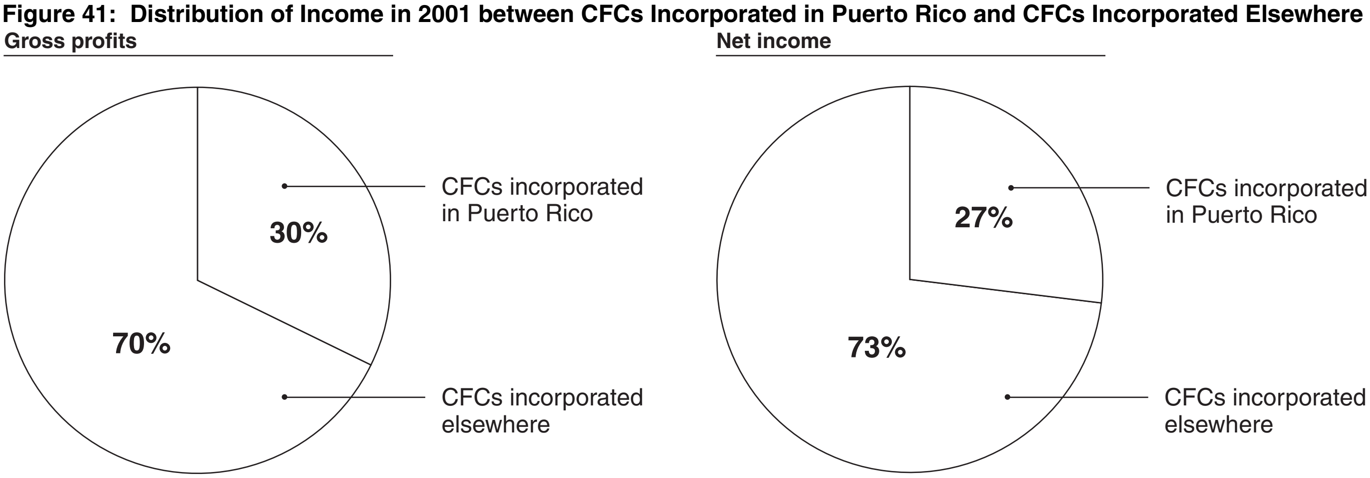
Figure 40: Distribution of Employment for All Puerto Rican Manufacturing by Type of Business Entity, 2002



Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

A little less than two-thirds of the CFCs' value added and half of their employment is attributable to CFCs incorporated outside of Puerto Rico. This distribution of value added is similar to the estimated distribution of gross profit between the two types of CFCs, based on the tax data for our 77 large corporate groups for 2001. The estimates presented in figure 41 are based on our tax ratio approach for attributing portions of the income of multilocation CFCs to Puerto Rico. The estimates indicate that 70 percent of the gross profit and 73 percent of net income that CFCs earned in Puerto Rico in 2001 were earned by CFCs incorporated outside of Puerto Rico. Using the tax data, we estimate that more than three-quarters of the total gross and net income earned by the CFCs incorporated outside of Puerto Rico in 2001 is attributable to CFCs incorporated in the Cayman Islands, Ireland, the Netherlands, and the U.S. Virgin Islands.

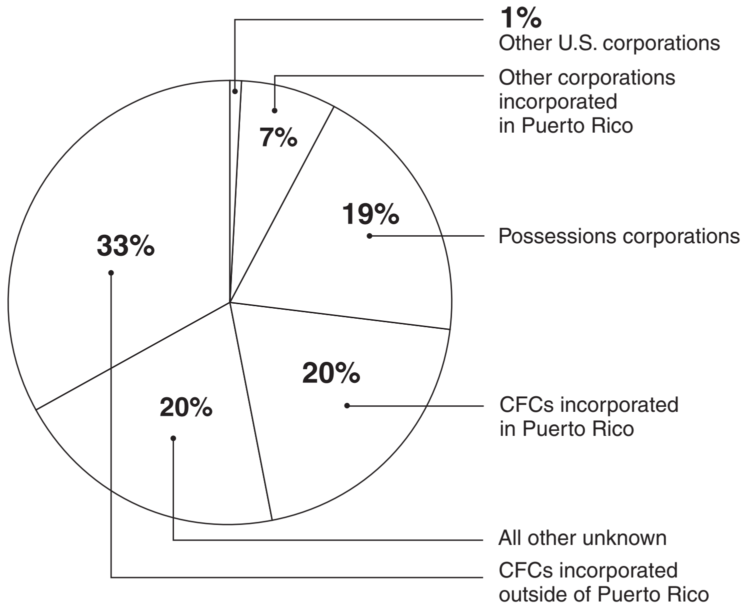
Figure 41: Distribution of Income in 2001 between CFCs Incorporated in Puerto Rico and CFCs Incorporated Elsewhere



Source: GAO analysis of data from IRS and the Puerto Rican Department of Treasury.

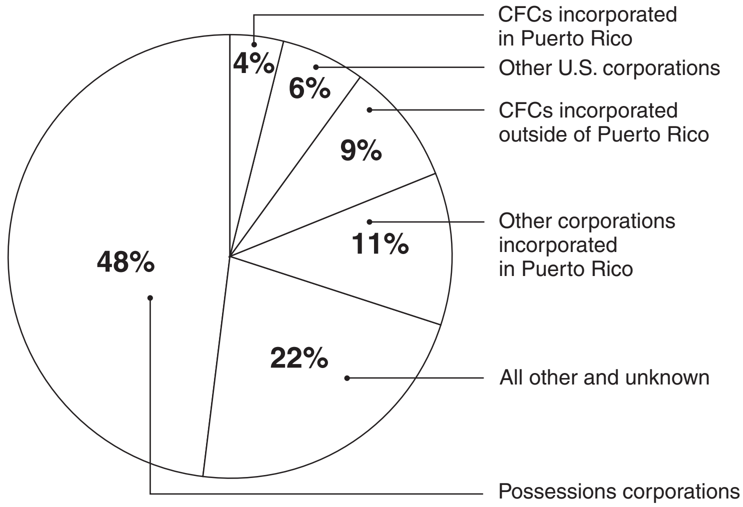
A comparison of figures 42 and 43 shows that the value added of CFCs in 2002 was concentrated in the pharmaceutical industry. These firms accounted for over half of the value added in that industry, or almost three times as much as the value added of possessions corporations. In contrast, CFCs accounted for only 13 percent of the value added in all of the remaining manufacturing sectors, where possessions corporations still dominated with a 48 percent share. At this more specific industry level of data, Census nondisclosure rules prevent us from providing as much detail about other forms of businesses. We needed to add pass-through entities into the "all other and unknown" category. However, from table 20 in appendix V, we do know that between approximately 80 percent and 90 percent of the employees of these entities were concentrated in two industries—pharmaceuticals and medical equipment—and that between 25 percent and 63 percent of these employees were in each of these industries. If the value added of these entities was distributed across industries in approximately the same manner as their employment, then pass-through entities would have accounted for between 3 percent and 7 percent of value added in pharmaceuticals.

Figure 42: Value Added in the Pharmaceutical Industry by Type of Business Entity, 2002



Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Figure 43: Value Added in Manufacturing, Excluding Pharmaceuticals, by Type of Business Entity, 2002



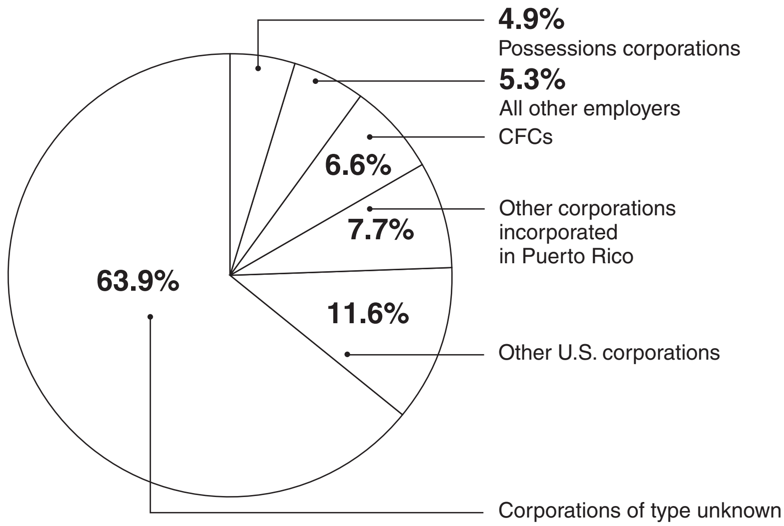
Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Data in table 20 of appendix V show that possessions corporations and CFCs were approximately equal in importance in terms of employment in the pharmaceutical industry in 2002 and, together, they accounted for 61 percent of the industry's employment. The data also show that possessions accounted for a little over a quarter of total employment in all other manufacturing industries, while CFCs accounted for only 9 percent.

The Role of U.S. Corporations Is Much Smaller in Puerto Rico's Wholesale and Retail Trade Than in Manufacturing

Corporations that were U.S. CFCs and businesses incorporated in the United States accounted for less than a quarter of total employment in the Puerto Rican wholesale trade sector and, as figure 44 shows, about half of their employment was in corporations other than CFCs or possessions corporations. Corporations in the unknown category, which we believe to be largely ones that are not incorporated in the United States or owned by U.S. parent corporations were by far the largest employers in the wholesale trade in 2002, as shown in figure 44. Figure 45 indicates that this employment distribution was similar for the retail trade sector. The primary difference between the two sectors is that possessions corporations played no role at all in retail trade and sole proprietors played a more important role in that sector than in wholesale trade. The distributions of payroll across entities in these two sectors largely mirrors the distributions of employment (see table 17 in app. V).

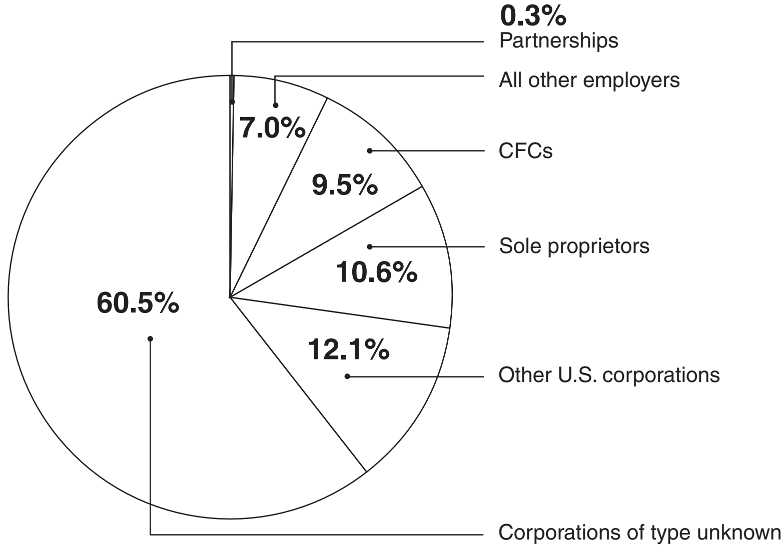
Figure 44: Share of Employment in Wholesale Trade in Puerto Rico by Type of Business Entity, 2002



Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: Sole proprietors and partnerships could not be reported because of disclosure constraints. Therefore, they are captured in the “all other employers” category.

Figure 45: Share of Employment in Retail Trade in Puerto Rico by Type of Business Entity, 2002



Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Neither Possessions Corporations nor CFCs Were Significant Employers in 2002 in Most Puerto Rican Service Industries for Which Data Are Available

In general, possessions corporations and CFCs played minor roles as employers in Puerto Rico's service sector. The 2002 Economic Census of Island Areas compiled data for 11 service industries, as well as the mining, utilities, and transportation and warehousing sectors in Puerto Rico. Table 7 shows the distribution of employment across types of businesses for the six largest services (in terms of employment) covered by the census. Appendix V tables 25–27 show the distribution of employment, sales, and payroll, for all 11 service industries and the three other sectors.

CFCs accounted for 32.7 percent of employment in the information services industry (which includes telecommunications, broadcasting, publishing, motion pictures, and Internet services), but for no more than 5.1 percent in any of the other five large services. Possessions corporations accounted for 10 percent of employment in the accommodations industry but for no more than 2.4 percent in any of the other large services. Other U.S. corporations accounted for between 10 percent and 20 percent of employment in each of the six services. Most of the remaining employment in the large service industry is attributable to local corporations (in the type unknown group) and sole proprietors. The category "all other employers," which includes nonprofit entities, accounts for up to 22 percent of total employment in healthcare services, which is the largest service industry.

Table 7: Distribution of Employment by Business Entity Type for the Six Largest Services Included in the 2002 Economic Census of Puerto Rico

Type of business entity	Healthcare services	Accommodations	Administrative support services	Finance	Professional services	Information
Total employment number						
All employers	68,338	63,810	61,703	36,059	26,197	16,696
Share of employment (percent)						
Possessions corporations	0.4–0.8	10.0	0.2–0.4	0.1–0.3	2.1	2.4
Other U.S. corporations	11.3	17.4	15.4	10.9	20.2	11.0
U.S. CFCs	3.3	0.4–0.8	5.1	5.1	3.4	32.7
Other corporations incorporated in Puerto Rico	0.1	(D)	1.0	3.5.2	3.4	10.9
Corporations of type unknown	(D)	(D)	(D)	(D)	(D)	(D)
Sole proprietors	(D)	(D)	(D)	(D)	(D)	(D)
Partnerships/pass-through entities	1.4–1.8	6.8	1.5–2.4	0.3–1.0	11.2	1.6–1.7
All other employers	33.9–38	0.2–0.3	10.6–11.5	10.6–11.5	4.3–5.6	0.6

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Note: We are unable to report specific figures on “corporations of type unknown” or “sole proprietors” due to disclosure contraints.

Taxes Per Capita in Puerto Rico Are Lower Than in the States but Are about the Same Share of Income

The taxes paid to all levels of government (federal, Commonwealth, and local) in Puerto Rico in 2002 were $3,071 per capita—considerably less than the per capita taxes of $9,426 paid in the states. However, the combined taxes paid by Puerto Rico residents amounted to 28 percent of their personal income, which was close to the 30 percent figure in the states. Puerto Rico's outstanding government debt in 2002 was much higher than that of state and local governments as a share of personal income, partly because the Commonwealth government has a wider range of responsibilities.

Taxes Paid Per Capita in Puerto Rico Are Lower Than Those in the States but the Taxes Are about the Same Share of Personal Income in Both Places

The amount of taxes that Puerto Rico residents paid per capita in fiscal year 2002 ($3,071) was about one-third of the amount paid by residents of the states ($9,426) (see fig. 46).[1] The mix of the taxes was also quite different. While nearly 60 percent ($5,619) of the taxes paid by residents of the states were federal taxes, only about 25 percent ($760) of the total taxes paid by Puerto Rico residents were federal taxes because those residents generally are not subject to federal income tax on the income they earn in Puerto Rico. Data on federal taxes paid in the other insular areas are not available. Taxes paid by residents of the other insular areas to their own governments in 2002 amounted to $2,451 per capita—slightly higher than the $2,310 per capita that residents of Puerto Rico paid to the Commonwealth and municipal governments. The location where a tax is paid is not necessarily the same location as where the economic burden of the tax falls. The data we present in this chapter pertain to the former.[2]

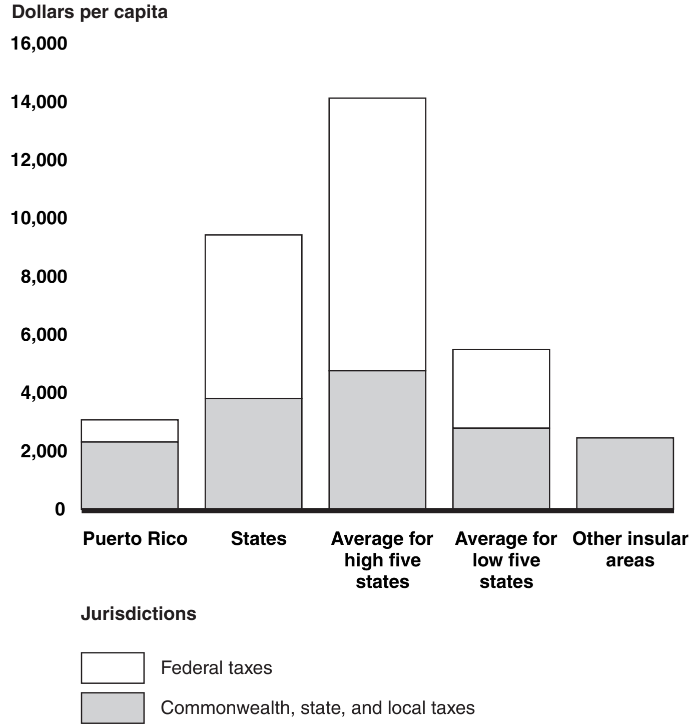
Comparing the taxes Puerto Rico residents paid to the average of the five states whose residents paid the least total taxes, we found that Puerto Rico residents paid about 54 percent of the amount paid by these state residents

[1]We use the term "taxes" as shorthand to cover both taxes and some nontax revenues, such as licenses and lotteries, that are collected by state and local government. These nontax revenues constitute a relatively small share of the total revenues reported in this chapter and they are included, along with other tax revenues, in the "other" category in figs. 48 and 49.

[2]We exclude federal corporate income tax payments from our comparisons because the available data assign all of the tax that a corporation pays to the jurisdiction where it files its federal return. In many cases, much of the income on which a corporation is taxed is earned outside of the jurisdiction from which it files its return.

($5,713).[3] The average percentage of taxes paid in these same five states that were federal taxes was nearly 47 percent ($2,705), still nearly double the percentage for Puerto Rico. The average per capita amount of taxes paid in the five highest tax states was $15,491—five times the per capita tax in Puerto Rico.[4]

Figure 46: Per Capita Taxes Paid in the United States and Insular Areas, Fiscal Year 2002



Source: GAO analysis of IRS, Census, and Insular Area Treasury Department data.

Note: Data on federal taxes paid in the other insular areas are not available.

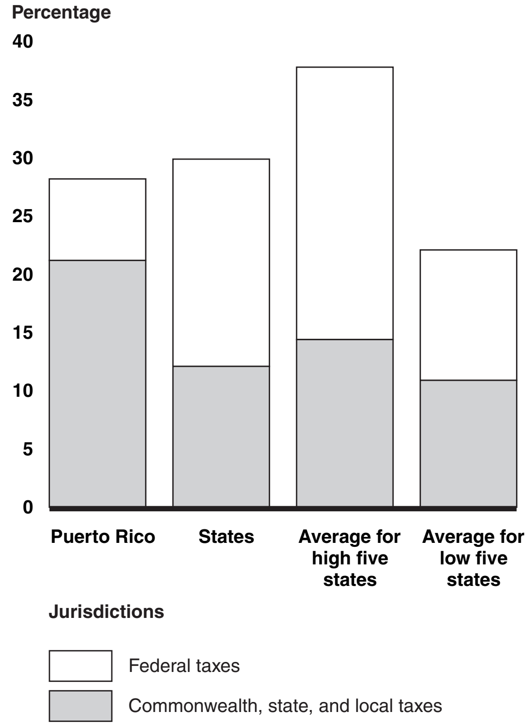
Taxes as a share of personal income are about the same in Puerto Rico and the states, which is not surprising because Puerto Rico's income per capita

[3]The five states whose residents paid the least total taxes were Montana, South Carolina, Alabama, West Virginia, and Mississippi.

[4]The five highest tax states were the District of Columbia, Minnesota, Delaware, Connecticut, and New Jersey.

is so much lower. Taxes paid in Puerto Rico amounted to 28 percent of the Commonwealth's personal income, while those paid in the states amounted to 30 percent of aggregate state personal income. Taxes in the five lowest-tax states were an average of 23 percent of the states' aggregate personal income, while those in the five highest-tax states averaged 39 percent. (See table 28 in app. VI for additional detail.)

Figure 47: Taxes Paid as a Share of Personal Income in the United States and Insular Areas, Fiscal Year 2002



Source: GAO analysis of IRS, Census, and Insular Area Treasury Department data.

Note: Data on personal income in the other insular areas are not available.

Income and Employment Taxes Account for about Two-thirds of the Taxes Paid in Both Puerto Rico and the States, but the Allocation of Those Taxes by Level of Government Differs between the Two Locations

As shown in figure 48, about 75 percent of the taxes paid in Puerto Rico are levied by the Commonwealth and municipal governments.[5] The property tax and gross receipts tax imposed by the municipal government accounted for a little over 17 percent of taxes paid with the remainder going to the Commonwealth government.[6] Commonwealth income taxes accounted for 41 percent of total taxes with slightly more than half of that being paid by resident individuals. Sales and excise taxes represented 23 percent of the total.

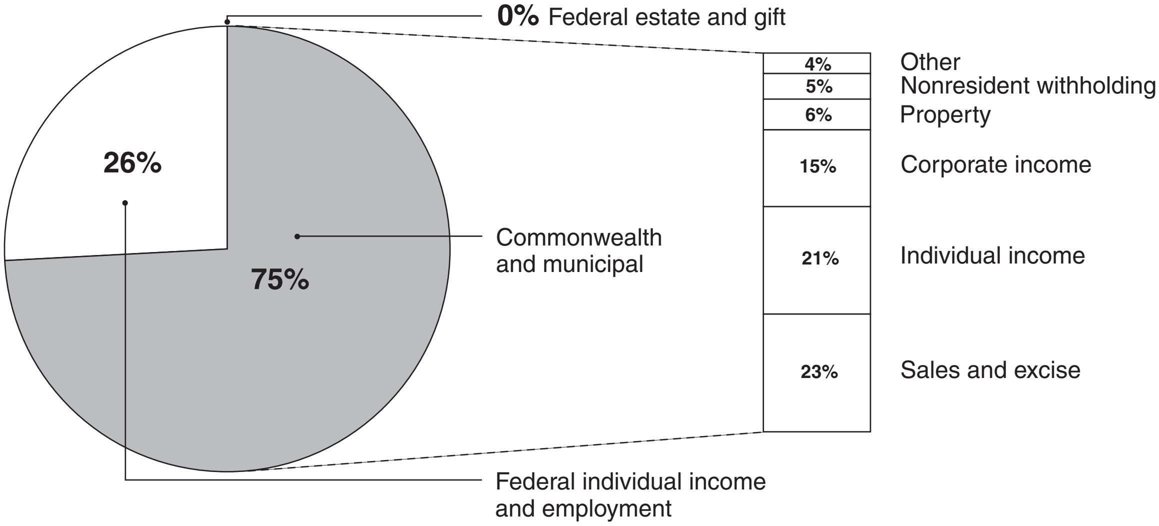
Data available from IRS for Puerto Rico and the states do not separate federal individual income tax payments from payments of federal employment taxes, such as those for Social Security, Medicare, and unemployment compensation; however, most of the tax shown for that combined category in figure 48 should be employment taxes because most residents of Puerto Rico pay little, if any federal income tax. Even less federal estate, gift, or excise tax is paid in Puerto Rico. Federal excise taxes on goods manufactured in Puerto Rico and sold in the states are transferred to the Commonwealth and more than offset any federal excise tax on products consumed there.[7]

[5] The taxes being compared in this section exclude the federal corporate income tax, which is difficult to allocate by location.

[6] The municipal gross receipts tax is included in the "sales and excise" category.

[7] In fig. 48 federal excise taxes are represented as a zero, rather than the net positive amount transferred to the Commonwealth.

Figure 48: The Composition of Taxes Paid in Puerto Rico, Fiscal Year 2002



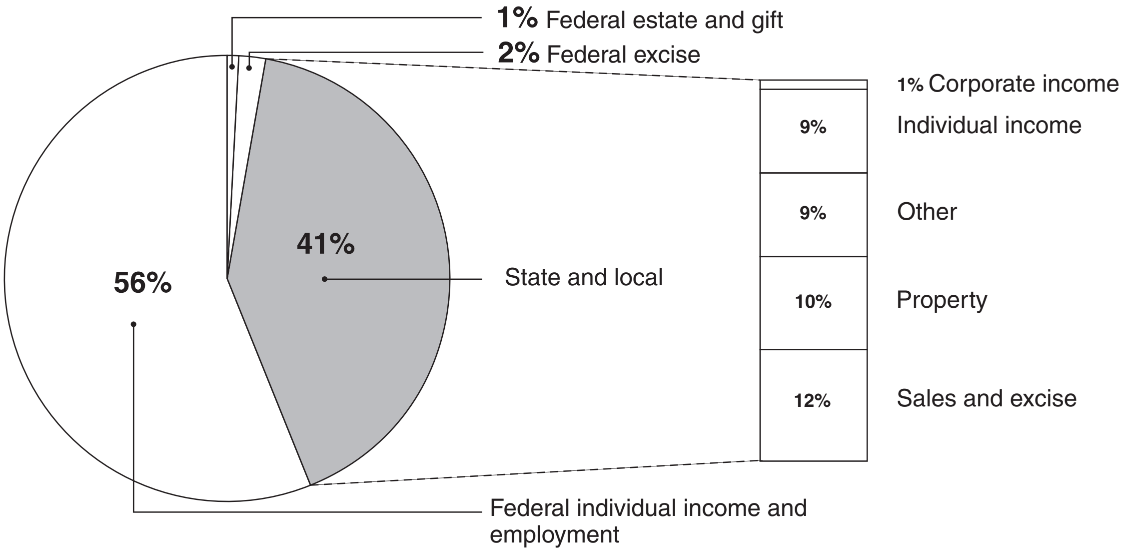
Source: GAO analysis of IRS and Puerto Rico Treasury data.

Notes: Numbers do not sum because of rounding.

The figures for federal estate and gift taxes round to 0 percent.

In contrast to the case of Puerto Rico, more than half of the taxes paid in the states go to the federal government, which provides a larger range of services to the states than it does to the Commonwealth. Federal individual income and employment taxes accounted for 56 percent of the taxes paid, while federal estate, gift, and excise taxes amounted to an additional 3 percent, resulting in a combined federal share of 59 percent (see fig. 49). When the 10 percent of taxes paid in the form of state and local income taxes are added to the 56 percent that go to federal individual income and employment taxes, the resulting 66 percent share is almost equal to the 67 percent share in Puerto Rico for this same group of taxes. Of the remaining total, state and local property taxes and “other” revenues (including lotteries and licenses) account for greater shares of the total taxes paid in the state than they do in Puerto Rico, while sales and excise taxes represent a smaller share.

Figure 49: The Composition of Taxes Paid in the States, Fiscal Year 2002

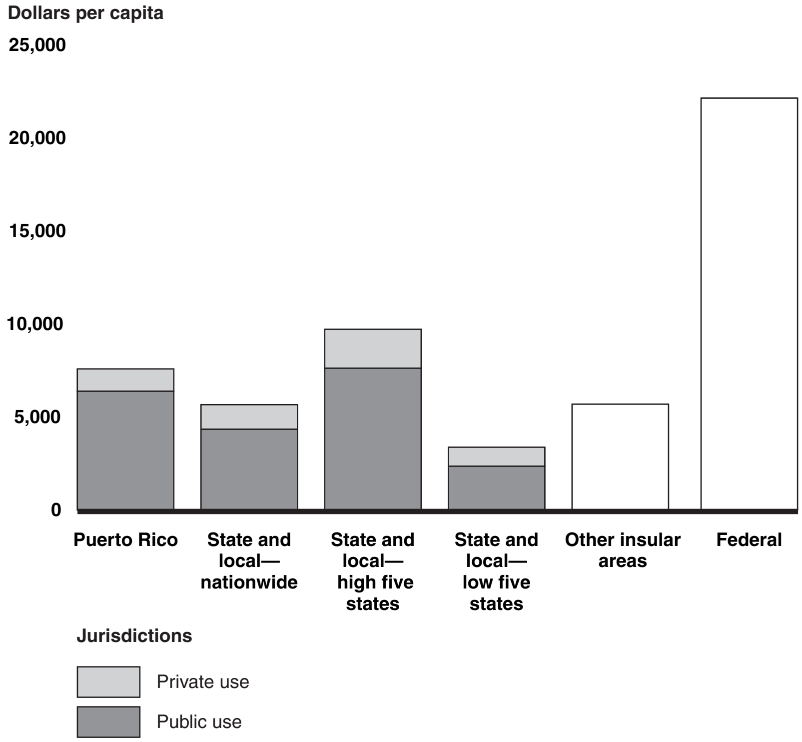


Source: GAO analysis of IRS and Census data.

Puerto Rico's Outstanding Government Debt in 2002 Was Much Higher Than That of State and Local Governments as a Share of Personal Income, Partly Because the Commonwealth Government Has a Wider Range of Responsibilities

The amount of Puerto Rican government-issued debt outstanding as of 2002 was slightly higher in per capita terms, but much higher as a share of personal income, than was state and local government-issued debt. As shown in figure 50, the outstanding amount of Puerto Rican government debt per capita in 2002 was about $7,580, compared to a national average of $5,820 for state and local government-issued debt. The per capita debt of the governments of the other insular areas in 2002 was about $5,690. Although all of this debt was issued by the respective governments, some of it is directed to private use and will be paid back by targeted beneficiaries. About 16 percent of Puerto Rico's government debt fell into this "private use" category, compared to about 23 percent for state and local government debt.[8]

Figure 50: Per Capita Government Debt in the United States and Insular Areas, Fiscal Year 2002

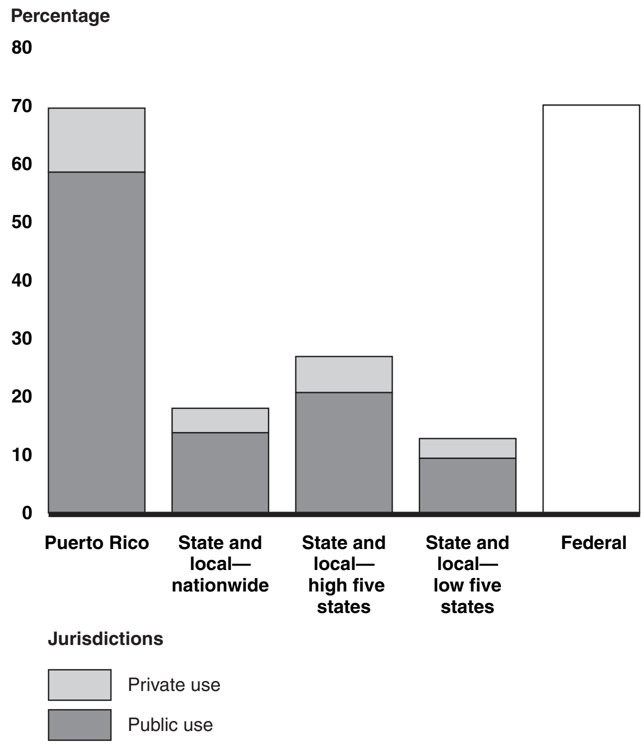


Source: GAO analysis of IRS, Census, Puerto Rico Government Development Bank, and Insular Area Treasury Department data.

Note: We did not categorize federal or other insular areas debt into "public use" or "private use."

[8]Puerto Rico's Government Development Bank provided us detailed information on specific Puerto Rican government debt issues and we assigned those issues to the private or public use categories in a manner that was consistent with how the U.S. Census of Governments categorizes state and local government debt.

Figure 51: Government Debt as a Share of Personal Income in the United States and Insular Areas, Fiscal Year 2002



Source: GAO analysis of IRS, Census, Puerto Rico Government Development Bank, and Insular Area Treasury Department data.

Note: We did not categorize federal debt into "public use" or "private use."

Federal Grants and Payments to Governments Per Capita Are the Same for Puerto Rico and the States but Direct Federal Payments to Individuals Per Capita Are Significantly Lower in Puerto Rico

The states and insular areas receive funds from the federal government in the form of grants, direct aid, loans, and insurance and procurement payments (see table 8). Federal grants and payments to the Puerto Rican government in 2002 amounted to $1,242 per capita, about the same as the $1,264 per capita paid to all state and local governments in the states, but less than the $1,703 per capita paid to the other insular area governments. The $2,057 per capita of direct federal payments to individuals in Puerto Rico was well below the $3,648 per capita paid to state residents, but higher than the $1,418 per capita paid to residents of the other insular areas.[9] The following chapter and appendix VII provide detailed information on the amount of spending for specific federal social programs in Puerto Rico, the states, and other insular areas and describes similarities and differences in the operation of these programs in the various locations. The per capita federal payments of $336 for salaries, wages, and procurement in Puerto Rico were about 20 percent of payments for those purposes in the states and the other insular areas.

[9]These payments do not include outlays made to individuals through refundable credits in the federal tax code, such as the child tax credit and the earned income tax credit. IRS does not report the refundable portion of the child tax credit by state; it does report the refundable portion of the earned income tax credit, but it combines the amounts earned in Puerto Rico and the other insular areas. For tax year 2001, the per capita amount for those areas was $3.1, while the nationwide average amount per capita was $102.8. Generally, residents of an insular area cannot claim the earned income tax credit or the child tax credit.

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Table 8: Federal Expenditures in Fiscal Year 2002

Fiscal activity	Puerto Rico: Dollars (in thousands)	Puerto Rico: Per capita	Puerto Rico: Percent of commonwealth personal income	Nationwide per capita
Federal expenditures				
Grants and payments to governments[a]	$4,793,333	$1242.1	11.4	$1,263.9
Direct payments	7,939,376	2,057.4	18.6	3,648.3
Salaries/wages	930,078	241.0	2.2	692.0
Procurement	364,652	94.5	0.9	903.5
Loans	1,353,279	350.7	3.2	866.0
Insurance	3,171,069	821.7	7.5	2,358.1

Source: GAO analysis of Census data.

[a]Data reported are actual cash outlays. Includes transfers of custom duties and excise tax revenues.

The States					Insular areas
High five per capita	Low five per capita	Nationwide percent of state personal income	High five percent of state personal income	Low five percent of state personal income	Combined per capita
$2,202.1	$927.5	4.0	9.7	2.7	$1,702.8
4,969.2	3,059.8	11.6	19.1	8.9	1,417.6
2,784.4	352.9	2.2	7.9	1.1	838.7
3,723.8	314.5	2.9	10.8	1.1	893.2
2,146.1	477.9	2.7	7.4	1.6	227.9
13,127.7	346.6	7.5	45.1	1.2	779.3

Some federal funds that Puerto Rico received as grants and direct payments were in the form of a rebate on custom duties and a cover over[10] of excise taxes collected on rum. These funding sources are not available to the states or the District of Columbia, or most of the insular areas except for the U.S. Virgin Islands. On a per capita basis the U.S. Virgin Islands received a larger rebate payment than Puerto Rico and a larger cover over payment than Puerto Rico (see table 9).

Table 9: Federal Custom Duties and Excise Taxes Returned to Puerto Rico in Fiscal Year 2002

	Puerto Rico		U.S. Virgin Islands		50 states and the District of Columbia
	Revenues (in thousands)	Per capita	Revenues (in thousands)	Per capita	Revenues (in thousands) (median)
Rebates of customs' duties	$33,635	$8.7	$2,405	$22.1	n.a.
Excise cover over	339,414	87.9	64,936	595.7	n.a.

Source: GAO analysis of Customs and Alcohol and Tobacco Tax and Trade Bureau data.

Note: n.a. means not applicable.

[10] 26 U.S.C. 7652 provides that federal alcohol excise taxes collected on rum produced in Puerto Rico and the U.S. Virgin Islands and imported into the United States, after deducting administrative expenses, are "covered over" or paid into the treasuries of Puerto Rico and the U.S. Virgin Islands.

The Extent That Federal Social Programs in Puerto Rico Mirror Those in the States and Other U.S. Insular Areas Varies

Comparison of Selected Federal Social Programs

Like the states, Puerto Rico and the other U.S. insular areas receive federal funds for a variety of social programs—including federal housing assistance, education, and health care financing programs—which provide assistance to elderly and needy families and individuals. Generally, the social programs we examined in these areas targeted similar populations and delivered similar services—although Puerto Rico and the other insular areas did not always do so through the program as it exists in the states (see table 10). For example, in lieu of the Food Stamp Program available in the states, which is an entitlement[1] program based on the number of participants, Puerto Rico receives a capped block grant that has similar eligibility requirements. The major difference between some of the social programs we examined in the states versus those in Puerto Rico and the other insular areas is how they are funded. For example, where federal Medicaid spending is an open-ended entitlement to the states, it is subject to a statutory cap and a limited matching rate in Puerto Rico and the other insular areas.[2] Some of the social programs and housing programs that we examined are available in the states, but are not available in some of the insular areas.

[1]A government entitlement program provides benefits to all that meet certain eligibility criteria.

[2]For additional information on the health care financing programs in these areas, see GAO, *U.S. Insular Areas: Multiple Factors Affect Federal Health Care Funding*, GAO-06-75 (Washington, D.C.: Oct. 14, 2005).

Table 10: Comparison of Selected Social Programs in the U.S. Insular Areas to Those in the States

Program	Program rules in the U.S. insular areas compared to those in the states
Education programs	
Individuals with Disabilities Education Act (IDEA) Part B	Puerto Rico and the other insular areas receive IDEA funds and must comply with IDEA requirements that apply in the states as a condition of funding.
Title I of the Elementary and Secondary Education Act, reauthorized by the No Child Left Behind Act of 2001	Title I funds are provided to schools in Puerto Rico and in the other insular areas. Schools in these locations are subject to the same requirements as schools in the states.
Food and nutrition programs	
Child and Adult Care Food Program	Same in the states, Puerto Rico, the U.S. Virgin Islands, and Guam; program does not operate in CNMI and American Samoa.
Food Stamp or Nutrition Programs	Same in the states, the U.S. Virgin Islands, and Guam; Puerto Rico, American Samoa, and CNMI provide assistance similar to the Food Stamp Program through a capped block grant; certain eligibility rules for the grant differ.
National School Lunch Program	Same in the states, Puerto Rico, the U.S. Virgin Islands, and Guam; program does not operate in CNMI and American Samoa, but funds under capped block grants for nutrition programs may be used to provide school meals in these insular areas.
Special Supplemental Nutrition Program for Women, Infants, and Children (SS Nutrition for WIC)	Same in the states, Puerto Rico, American Samoa, Guam, and the U.S. Virgin Islands; program does not operate in CNMI.
Health care financing and grant programs	
Medicare	Program eligibility and benefits largely similar between the insular areas and the states; however, differences exist regarding the new Part D outpatient prescription drug benefit.
Medicaid	Federal share of expenditures in the insular areas is limited to a 50 percent matching rate and federal Medicaid spending for the insular areas is subject to statutory caps. In light of federal funding limits, the Centers for Medicare & Medicaid Services (CMS) does not hold Puerto Rico and the other insular areas accountable for covering all the mandatory Medicaid benefits required of the states.
State Children's Health Insurance Program (SCHIP)	Federal allotment to Puerto Rico and the other insular areas is based on statutorily set proportions versus the population of low-income, uninsured children, as is the case in the states. Insular areas receive minimum federal matching contributions that do not apply to the states.
Health grants	Method used to determine funding amounts varies by grant. Certain grants use the same allocation method for the states and the insular areas, while other grants treat some or all of the insular areas differently.
Income assistance programs	
Aid to the Aged, Blind, or Disabled (AABD)	Supplemental Security Income (SSI), which serves a similar population, exists in the states and CNMI, but not in the other insular areas. The other insular areas continue to operate their grant programs that existed before SSI was created, specifically AABD for Puerto Rico.
Temporary Assistance for Needy Families (TANF)	Program provisions generally the same for Puerto Rico, Guam, and the U.S. Virgin Islands, but they cannot receive all funding sources available to the states; American Samoa and CNMI do not participate.
Child care programs	

(Continued From Previous Page)

Program	Program rules in the U.S. insular areas compared to those in the states
Child Care and Development Fund (CCDF)	Program provisions generally the same for the states, Puerto Rico, and the insular areas, but the insular areas cannot receive all funding sources available to the states.
Foster Care and Adoption Assistance Funds	Puerto Rico participates in these programs and receives funds, which are limited by the federal funding cap, set by the 1996 federal welfare law. Other insular areas do not participate in these programs.
Housing programs	
Public Housing	Funding formula the same in the states, Puerto Rico, the U.S. Virgin Islands, and Guam.[a]
HOPE VI	Same in the states and insular areas.
Housing Choice Vouchers	Same in the states and insular areas.
Community Development Block Grant	Same in the states and Puerto Rico; other insular areas receive an amount determined by the U.S. Department of Housing and Urban Development (HUD) based on population and performance in previous years.
HOME Investment Partnerships Program	Puerto Rico subject to a funding cap that does not apply to the other states; the initial HOME allocation amount for each of the insular areas is based on its population and occupied rental units compared to all the insular areas
Project-based Section 8 Program	Same in the states and insular areas.
Section 203 (b) Single Family Mortgage Insurance Program	Same in the contiguous 48 States and Puerto Rico; different mortgage insurance limits for Guam, the U.S. Virgin Islands, Alaska, and Hawaii.[a]

Source: GAO analysis of U.S. federal social programs.

[a]Information was not readily available for CNMI and American Samoa.

More detailed information on how each of the programs is applied in the insular areas and the states can be found in appendix VII.

Methodology for Allocating the Assets and Liabilities of Depository Banks by Geographic Location

In order to identify where the assets held in the Puerto Rican banking system are invested and where the owners of the banks' liabilities reside, we analyzed institution-specific data that the Office of the Commissioner of Financial Institutions (OCFI) collects for oversight purposes. Banks and certain other financial institutions in Puerto Rico are required to report detailed information regarding their assets, liabilities, and capital to OCFI through a computerized "CALL report" data system.[1] In addition to a basic balance sheet, the institutions are required to file various supporting schedules and addenda. In the case of depository banks (Puerto Rican, U.S., and foreign commercial banks, plus Puerto Rican government banks) some of the schedules and addenda ask the institutions to identify the geographic location of assets they own; others ask for the residency of the owners of the banks' liabilities. We obtained a copy of the computer file OCFI has compiled containing all of the detailed CALL report data submitted by each of these institutions for the years 1997 through 2004. The data, in combination with other information, allowed us to allocate substantial portions of the total assets and liabilities of depository banks between Puerto Rico and elsewhere. (There were no reporting requirements that enabled us to allocate the banks' capital by residency of shareholders.) In 2004 the depository banks accounted for about two-thirds of the assets held in financial institutions supervised by OCFI. Given the lack of location-specific data for the other financial institutions, we simply report their total assets to indicate their size in relation to the depository banks.

Table 11 identifies the lines from the various schedules that we used to allocate specific balance sheet items by geographic location. We sent a draft version of this allocation methodology to OFCI for their review and incorporated several corrections that they identified for us. We ultimately allocated each dollar from the balance sheets into one of three categories: U.S. and foreign, Puerto Rican, or unknown. The last category covers all amounts that we could not identify as belonging to either of the first two categories. The CALL report data did not provide a means for allocating most loans and leases. For this line item we assume that 95 percent of loans and leases are made to borrowers in Puerto Rico, based on the fact that several financial experts from Puerto Rico all agreed that at least 95 percent of the loans were made locally, even though some of the larger banks have begun to enter the U.S. market.

[1]The system contains no data for insurance companies, credit unions, mutual funds, or pension funds.

Table 11: Allocation of Balance Sheet Items by Geographic Location

Sheet line item	Sources identified for portions that could be allocated
ASSETS	
Cash	
Non-interest-bearing balances	**U.S. and Foreign combined identified:** Addendum-RC-Balance sheet (CALL report) line 1b. **Puerto Rican identified:** Addendum-RC-Balance sheet (CALL report) line 1a.
Interest-bearing balances	**U.S. and Foreign combined identified:** Addendum-RC-Balance sheet (CALL report) line 2b. **Puerto Rican identified:** Addendum-RC-Balance sheet (CALL report) line 2a.
Securities	**U.S. identified:** Schedule RC-B Securities lines 1, 2a, 2b, 4a(1), 4a(2), 4b(1), and 4b(2). **Foreign identified:** RC-B Securities line 6b. **U.S. and Puerto Rican combined identified**: RC-B Securities lines 3 and 6a.
Federal funds sold and securities purchased	**U.S. and Foreign combined identified:** Addendum-RC-Balance sheet (CALL report) lines 3a and 4a. **Puerto Rican identified:** Addendum-RC-Balance sheet (CALL report) lines 3b and 4b.
Loans and leases	Allocated 95 percent to Puerto Rico and 5 percent to the U.S. and Foreign categories based on the consensus of experts that we interviewed.
Trading assets	No ability to allocate to any source.
Other assets	No ability to allocate to any source.
LIABILITIES	
Deposits	
Private	**Puerto Rican identified:** Addendum-RC-Balance sheet lines 17a, 17b. **U.S. and Foreign identified:** line17d.
936 deposits	**U.S. identified:** Addendum-RC-Balance sheet lines 17c.
States, political divisions	**U.S. identified:** Addendum-RC-Balance sheet (CALL report) lines 18b, 18c, 18d. **Puerto Rican identified:** Addendum-RC-Balance sheet (CALL report) lines 18a.
Commercial banks	**U.S. identified:** Addendum-RC-Balance sheet (CALL report) lines 20b(1) and 20b(2). **Foreign identified:** Addendum-RC-Balance sheet (CALL report) lines 20a(1) and 20a(2).
Foreign/government banks	**U.S. identified:** Schedule RC-E-Deposit liabilities line 2. **Foreign identified:** Schedule RC-E-Deposit liabilities lines 5 and 6.
Total debt	**Puerto Rican identified:** Addendum-RC-Balance sheet (CALL report) lines 6a, 7a, and 8a. **U.S. identified:** Addendum-RC-Balance sheet (CALL report) line 7c. **U.S. and Foreign combined identified:** Addendum-RC-Balance sheet (CALL report) lines 6b, 7b, and 8b.
Trading liabilities	No ability to allocate to any source.
Other liabilities	**U.S. and Foreign identified:** Addendum-RC-Balance sheet (CALL report) line 9b. **Puerto Rican identified:** Addendum-RC-Balance sheet (CALL report) line 9a.

Source: GAO.

OCFI conducts a set of quality reviews on the CALL report data that the financial institutions submit. We undertook our own consistency checks on the data relevant to our allocation analysis. We detected some differences between the total amounts reported on the balance sheet and the summations of amounts listed in the addenda that should have totaled to the balance sheet amounts. Some differences were extremely small, which we attributed to inconsequential reporting errors. However, we identified three types of significant discrepancies. The first type of discrepancy was due to financial institutions reporting a positive amount for a balance sheet item but not providing the geographic detail that should have been reported in an addendum. The second type of discrepancy resulted from financial institutions listing more in the addendum than in the balance sheet for a given line item. In these cases there was always a specific amount that appeared to be either double-counted in the addendum or not reported in the balance sheet amount. The last type of discrepancy comprised cases of financial institutions that reported either too little or too much in the addendum for corresponding balance sheet items but with no obvious pattern or explanation.

We provided experts in OCFI a spreadsheet with the specific cases of discrepancies for each type of discrepancy and each affected balance sheet line item along with a detailed explanation and suggested resolutions where we could offer any. Based on OCFI's responses, we adjusted our unknown group to include discrepancy amounts due to financial institutions reporting zero on the addendum. Officials from the Commissioner's office considered the balance sheet values to be more accurate than the addendum breakouts so in the second and third types of discrepancies we were unable to make any corrections to adjust for these differences. In our consultation with Puerto Rican officials we further determined that in early years the financial institutions were not required to fill out the addendum and that the remaining differences result largely from reporting discrepancies at the institution level.

Table 12 provides a summary of the absolute value of the unexplained discrepancies as a percentage of the balance sheet line item for selected items. For those cases where the unexplained discrepancies exceeded 5 percent of the total value for a line item in a given year we decided that our allocation results were too uncertain to be presented and we simply show the totals for those items in our figures.

Table 12: Percent of Discrepancies by Line Item (percent)

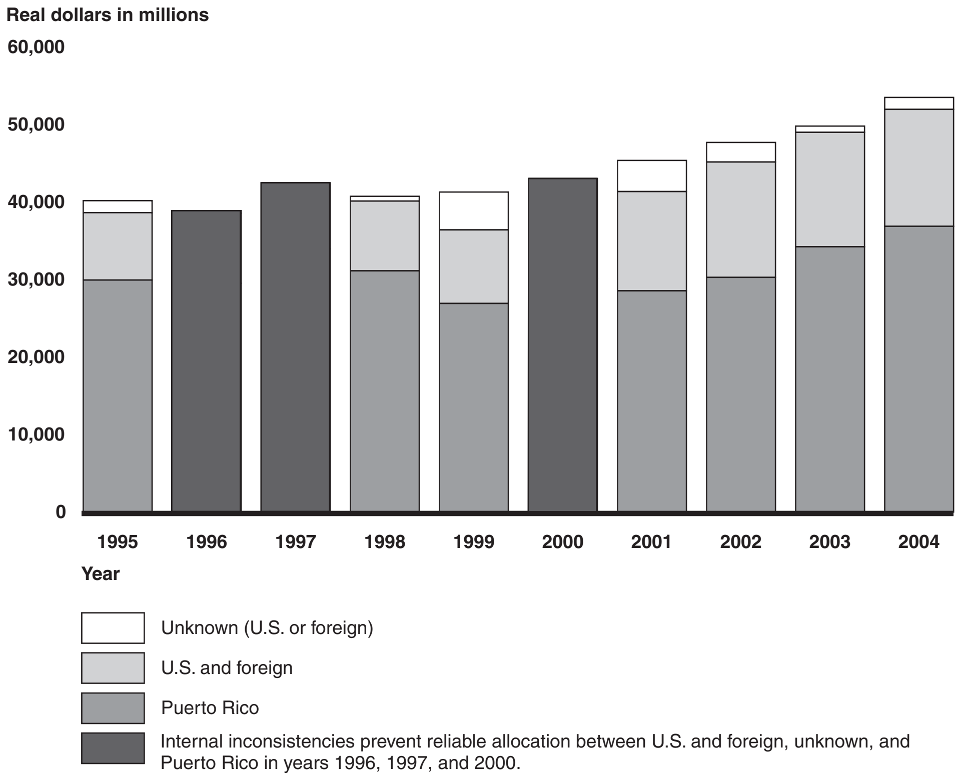
Year	Total assets	Loans and leases	Total liabilities	Deposits	Total debt
2004	0.3	0.5	4.6	0.8	0.3
2003	1.5	2.2	2.0	0.8	1.5
2002	1.0	2.0	4.2	0.2	1.0
2001	2.6	3.5	2.6	2.4	2.6
2000	1.2	0.7	4.2	5.7	1.2
1999	1.8	0.9	3.1	2.5	1.8
1998	0.6	0.5	5.0	2.4	0.6
1997	2.5	1.0	17.7	15.0	2.5
1996	0.4	0.7	16.5	5.5	0.4
1995	0.4	0.7	10.1	1.3	0.4

Source: GAO.

Additional Information on Puerto Rican Economic Trends and Capital Flows

The following series of figures present additional information on the sources and uses of funds for financial institutions operating in Puerto Rico.

Figure 52: Puerto Rico's Depository Institutions' Deposits, 1995–2004

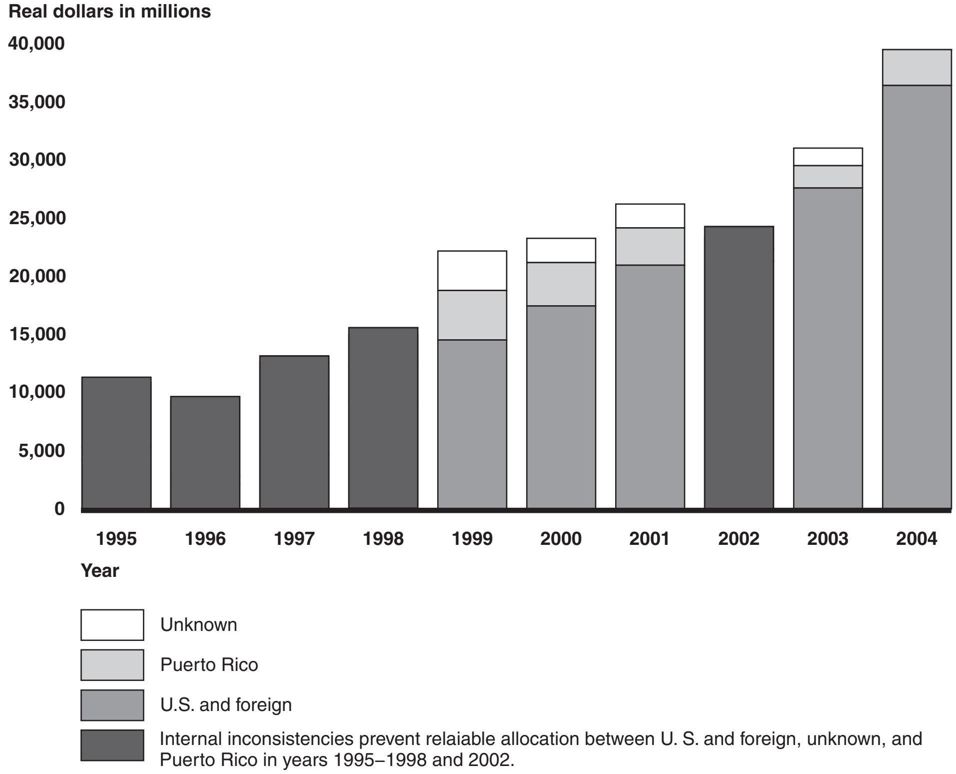


Source: GAO analysis of Puerto Rico's Office of the Commissioner of Financial Institutions data.

Notes: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

In 1997 and 2000, the sum of Puerto Rican, U.S., and foreign deposits from the addenda exceeded the balance sheet totals by $4,811 and $86 million, respectively.

Figure 53: Puerto Rico's Depository Institutions' Debt, 1995–2004

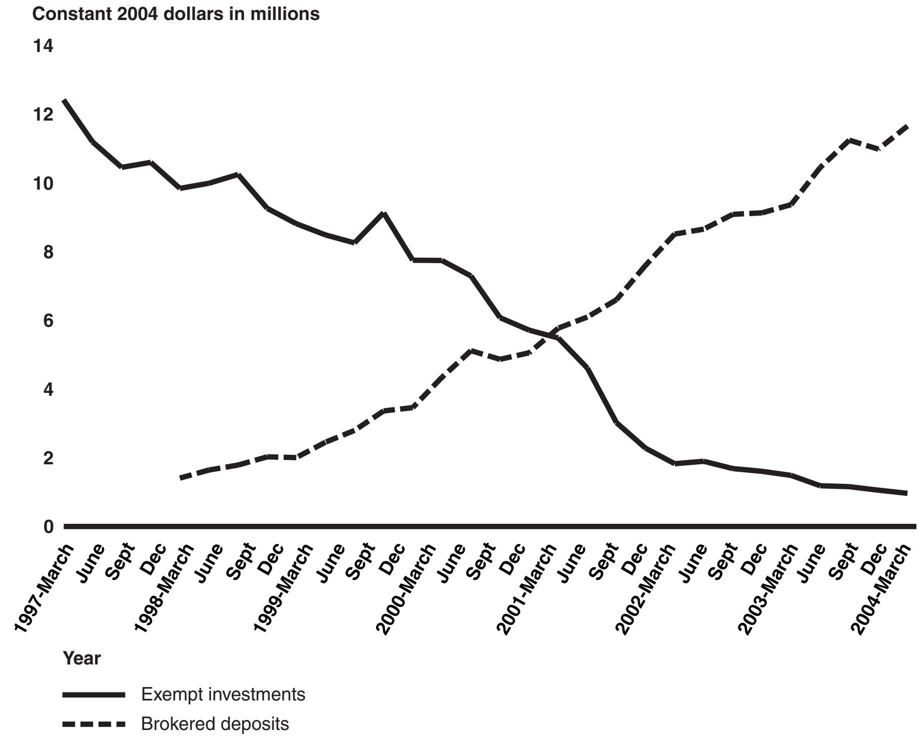


Source: GAO analysis of Puerto Rico's Office of the Commissioner of Financial Institutions data.

Notes: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

In 2004, the sum of Puerto Rican, U.S., and foreign debt from the addenda exceeded the balance sheet totals by $823 million.

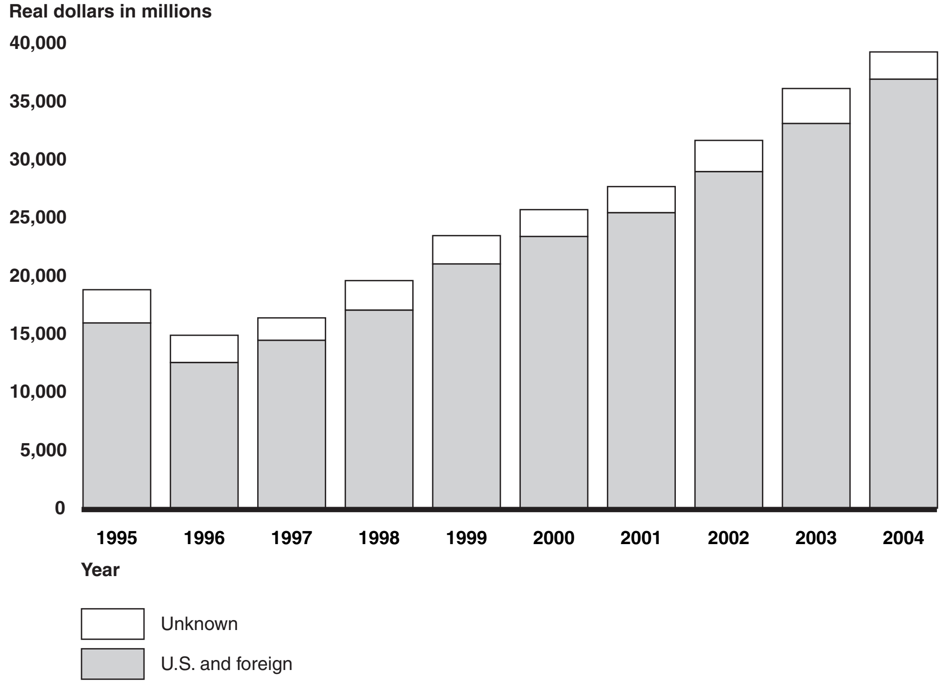
Figure 54: Exempt Deposits of Possessions Corporations and Brokered Deposits in Puerto Rican Banks, 1997–2004



Source: GAO analysis of data provided by the Commissioner of Financial Institutions, Commonwealth of Puerto Rico.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

Figure 55: Puerto Rico's Depository Institutions' Securities Investments, 1995–2004



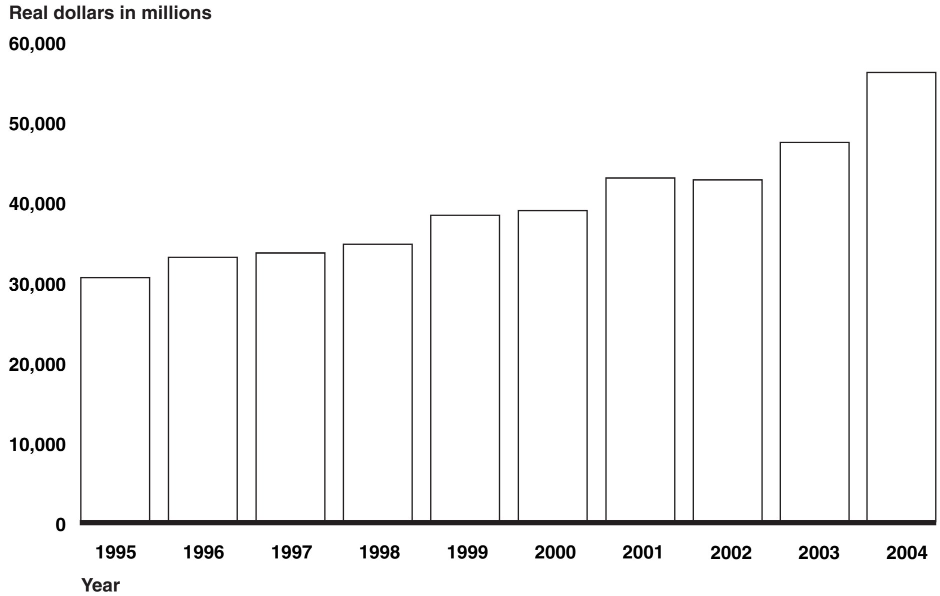
Source: GAO analysis of Puerto Rico's Office of the Commissioner of Financial Institutions data.

Notes: No securities were clearly identified as being located in Puerto Rico.

Known investment in foreign securities make up less than 1 percent of the total for every year between 1995 and 2004.

Figures were adjusted for inflation using Puerto Rico's gross product deflator.

Figure 56: Puerto Rico’s Depository Institutions’ Loans and Leases, 1995–2004

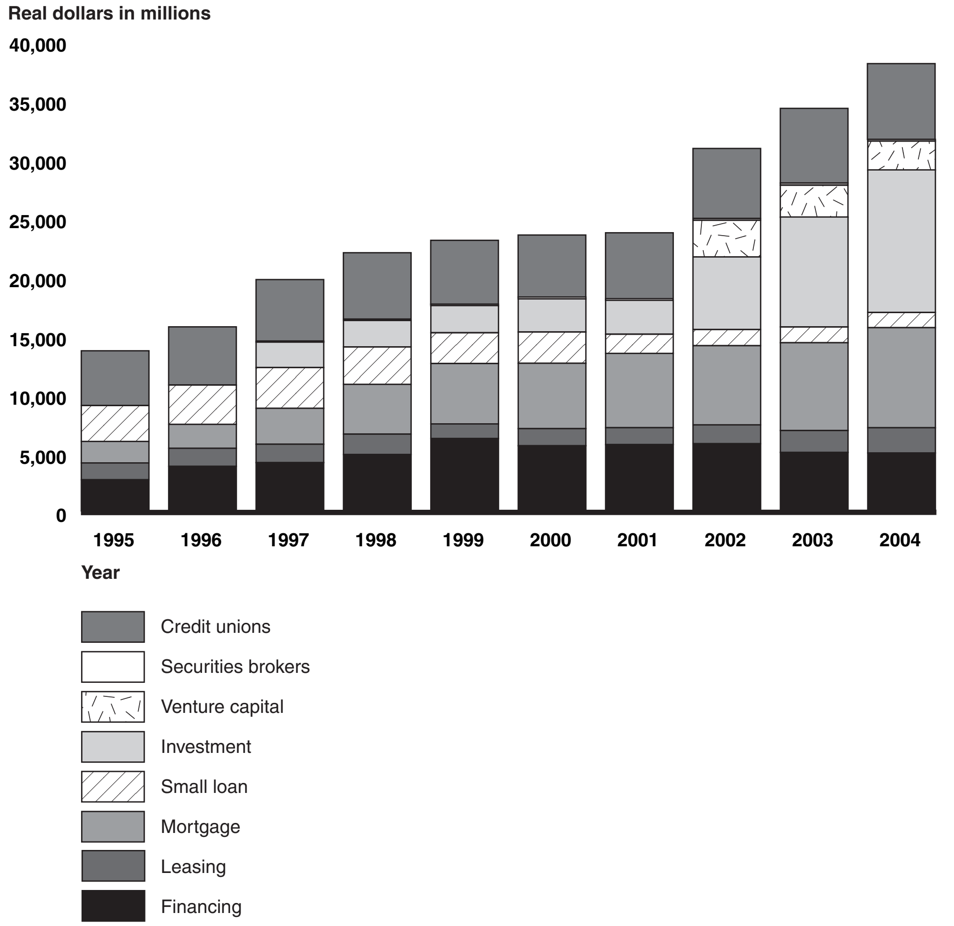


Source: GAO analysis of Puerto Rico's Office of the Commissioner of Financial Institutions data.

Note: Figures were adjusted for inflation using Puerto Rico’s gross product deflator.

In chapter 3 of this report we provided information on the physical location of the assets and liabilities of depository institutions operating in Puerto Rico. Although we are unable to report this kind of detail for the other types of financial institutions in Puerto Rico, in figure 57 we are able to present data from OCIF on selected other types of institutions. Table 14 presents summary descriptions of the sources and uses of funds for these institutions, as explained to us by several private sector financial experts in Puerto Rico and confirmed by OCIF. The figure and table do not include international banking entities, which OCIF also oversees, because those entities do not form part of the local capital market.

Figure 57: Assets of Selected Financial Institutions in Puerto Rico, 1995–2004



Source: GAO analysis of data from Puerto Rico's Office of the Commissioner of Financial Institutions.

Notes: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

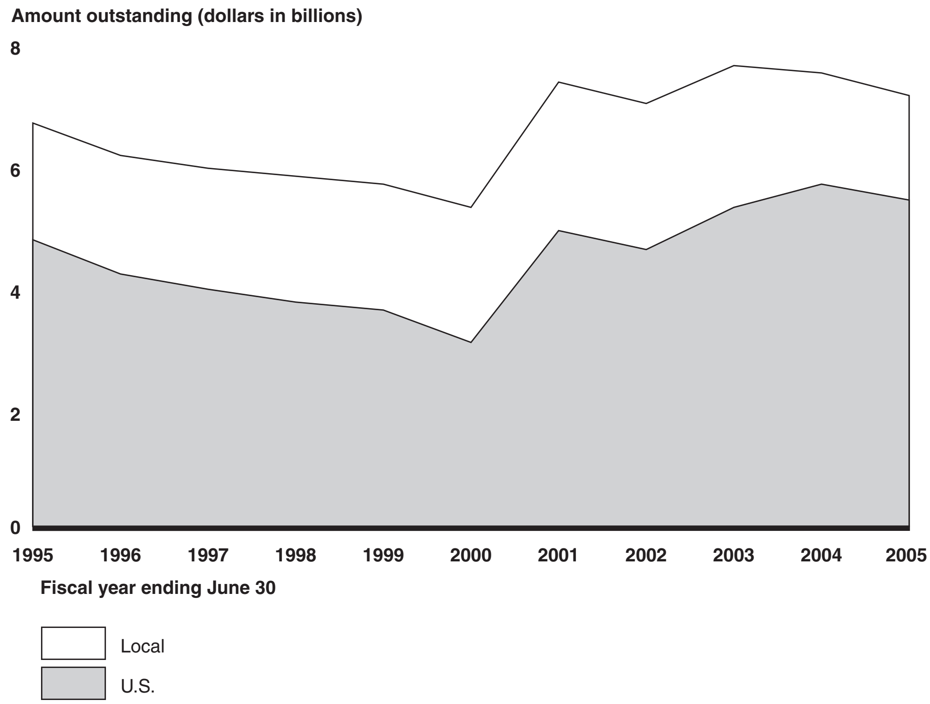
No data were available for investment or venture capital prior to 1997; no data were available for securities brokers prior to 2002.

Table 13: The Source and Use of Funds for Selected Financial Institutions in Puerto Rico

Type of Institution	Description of Source and Use of Funds
Credit unions	They obtain and use their funds in the local (Puerto Rican) market.
Broker/dealers	The broker/dealers represented in fig. 57 obtain all but a small portion of their funds locally and invest most of those funds locally.
Small-loan companies	These companies obtain their funds in the U.S. market and lend to subprime borrowers in Puerto Rico.
Mortgage banks	On the funding side the Puerto Rican mortgage market is indistinguishable from the U.S. market. Most funds are lent locally.
Investment companies	Only Puerto Rican residents can invest in these companies. Most of their funds are invested in Puerto Rico with a minor portion going to the United States.
Leasing companies	These companies are subsidiaries of banks and their funding is the same as for their parent banks.
Financing companies	These companies, which operate in the car loan market, obtain their funds in the United States and lend locally.

Source: GAO.

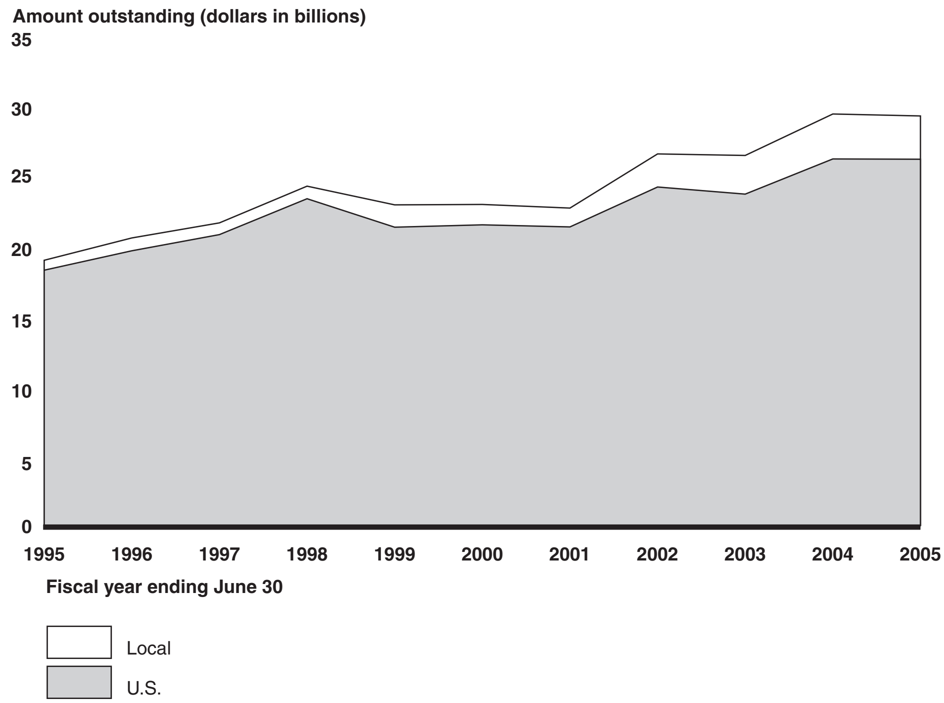
Figure 58: Real Debt Issued by the Government of Puerto Rico, but Payable from Private or Federal Funds, or Asset Sales, by Market of Purchaser, 1995–2005



Source: GAO analysis of Government Development Bank of Puerto Rico data.

Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

Figure 59: Real Debt Issued and Payable by the Government of Puerto Rico, by Market of Purchaser, 1995–2005



Source: GAO analysis of Government Development Bank of Puerto Rico data.

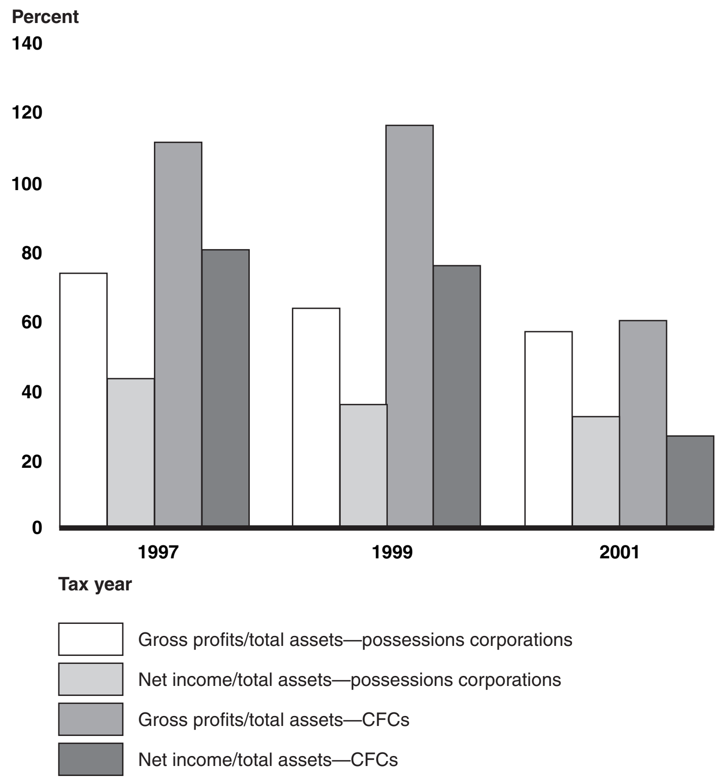
Note: Figures were adjusted for inflation using Puerto Rico's gross product deflator.

A Comparison of Rates of Return for Possessions Corporations and Controlled Foreign Corporations (CFC) in Puerto Rico's Chemical Industry

In contrast to the various U.S. Census Bureau (Census) data we have presented that show a sharp increase in value added per employee as pharmaceuticals production was shifted from possessions corporations to CFCs, the tax data for our large corporate groups do not show a clear trend in the rates of return on assets for these two types of corporations. We could not exactly replicate the comparison we made with the Census data with our tax data because we lacked employment data for our large groups of corporations. Instead, we compared the ratios of gross profit (the closest tax data equivalent of value added) to total assets. The results presented in figure 60 shows that the ratios for CFCs in the chemical industry were significantly higher than those for possessions corporations in the same industry in both 1997 and 1999, but the ratios were very close in

2001.[1] We also compared the ratio of net income over total assets and found a similar pattern, except for the fact that the net return for possessions corporations in 2001 was slightly higher than that for CFCs.

Figure 60: Rates of Return on Total Assets for Possessions Corporations and CFCs in the Chemical Industry, Puerto Rico, 1997, 1999, 2001



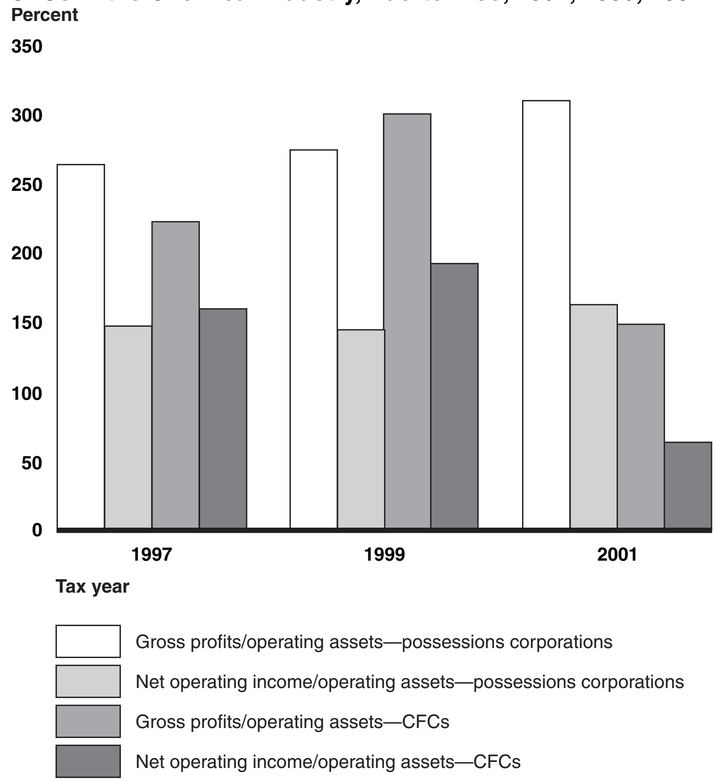
Source: GAO analysis of data from IRS.

In addition, we compared the gross and net operating rates of return of possessions corporations and CFCs in the chemical industry and found that neither type of corporation dominated the other type consistently across the years (see fig. 61). We used the same measure of net operating rate of return that Grubert and Slemrod had computed for possessions

[1]For the CFC side of the comparison we included only those CFCs for which we had Puerto Rican tax returns, or that appeared to have operations only in Puerto Rico.

corporations for 1987.[2] With one exception (for CFCs in 2001), our net return estimates for both types of corporations for 1997, 1999, and 2001 all exceeded 200 percent and were significantly higher than Grubert and Slemrod's estimate of 138.6 percent for possessions corporations in the pharmaceutical industry in 1987.

Figure 61: Rates of Return on Operating Assets for Possessions Corporations and CFCs in the Chemical Industry, Puerto Rico, 1997, 1999, 2001



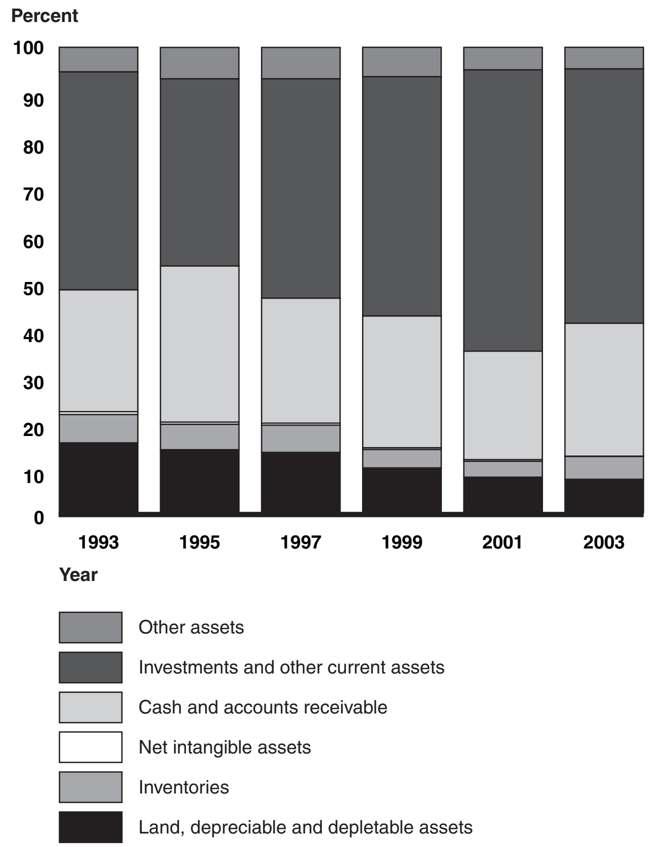
Source: GAO analysis of data from IRS.

Possessions corporations fared better relative to CFCs in terms of their returns on operating assets, rather than total assets, because the operating

[2]Grubert and Slemrod defined net operating rate of return as the ratio of operating income (net income, plus interest paid, and less interest received) over operating assets (inventories, plus gross depreciable and depletable assets, and land). We computed a gross operating rate of return by substituting gross profits for operating income.

assets of possessions corporations represented a significantly lower share of their total assets than was the case for CFCs. Figure 62 shows that as the large corporate groups gradually decreased the size of their possessions corporations' operations in Puerto Rico after 1997, operating assets accounted for a progressively smaller share of total assets until 2003, when an accumulation of inventories stopped the decline. In 2001, operating assets accounted for only 17.7 percent of possessions corporations' total assets in the chemical industry. In contrast, operating assets accounted for 41.9 percent of the total assets of all of the CFCs in the chemical industy for which we had reliable asset information in 2001. Internal Revenue Service (IRS) officials with expertise in possessions corporations issues told us that the large corporate groups would have an incentive to keep as many of the liquid assets of the possessions corporations (everything but land and depreciable and depletable assets) within those entities, even as they transferred the latter's fixed assets to CFCs, because a transfer of those liquid assets to a foreign corporation could be subject to federal income tax.

Figure 62: Composition of Assets of the Possessions Corporations of All Large Groups, Puerto Rico, 1993–2003



Source: GAO analysis of data from IRS.

Methodology for Analyses of Business Activities

Methodology for Determining How Economic Activity in Puerto Rico is Distributed across Types of Business Entities

We used a combination of data provided by Census, IRS, and the Puerto Rican Department of Treasury to determine how economic activity in Puerto Rico is distributed across types of business entities. The multistage procedure we followed in cooperation with Census and IRS was as follows:

1. We obtained a database from IRS that contained the employer identification numbers (EIN) and names for approximately 50,126 employers that either (1) operated in Puerto Rico or (2) were businesses related to those operating in Puerto Rico. The initial population for Census's surveys of employers for the 2002 Economic Census of Puerto Rico was included among these 50,126 employers.

2. We assigned each EIN to one of 11 groups based on IRS or Puerto Rican tax data, using the criteria described below. Ten of the groups represented types of businesses. We assigned each group an identification letter and did not tell Census the types of businesses that they represented. We labeled the 11th group "unknown" and assigned all of the EINs that we could not place into other groups into that one.[1]

3. Census matched the EINs in each group to the EINs of respondents to their surveys. Census then aggregated the economic data, such as value added, number of paid employees, and capital expenditures, for all of the EINs in a given group and industry. Census did the same for the EINs in our "unknown" group, but for that group they also provided a breakdown according to the type of business entity that the respondents reported themselves to be in the Census surveys. Census reviewed these results to ensure compliance with their legal requirement to ensure confidentiality of individual survey respondents; they suppressed the data in any entity-industry grouping that, otherwise, would have disclosed confidential information. In some cases we combined two of our original groups to avoid having data suppressed.

4. Where possible, we added the data from 1 of our 10 entity groups to the data from one or more of the entity categories that Census identified in our unknown group. For example, we added data for partnerships that Census identified to the data for our pass-through entity group.

[1]We followed a similar procedure for an additional set of 84 EINs that were not in Census's original EINs, but that we identified in IRS data as businesses with income earned in Puerto Rico.

The entity groupings that we report in our figures and tables are defined as follows:

Possessions corporations. All EINs associated with corporations that IRS identified as being a possessions corporation in 2002 and which were identified as operating in Puerto Rico.

U.S. CFCs.[2] This category contains all EINs belonging to corporations that (1) were reported on a form 5471 in 2001 or 2002; (2) were identified for us as U.S. CFCs by the Puerto Rico Industrial Development Company (PRIDCO), which gathered information from the Office of Industrial Tax; or (3) were incorporated outside of the United States, had no record of a filing a standard form 1120 (corporate tax return) or 1065 (partnership tax return) with IRS, and had names indicating they were members of one of the 77 large U.S. corporate groups operating in Puerto Rico. We divided this category into two groups, depending on whether a form 5471 or a Puerto Rican tax return identified the corporation as being incorporated in Puerto Rico or elsewhere.

Other U.S. Corporations. This category contains EINs of corporations that were incorporated in the United States, but were not possessions or pass-through (partnership) corporations.

Other corporations incorporated in Puerto Rico. These were corporations for which we found Puerto Rican tax returns that identified the place of incorporation as Puerto Rico, but which did not meet the criteria we used to identify CFCs.

Corporations of type unknown. The overwhelming majority of the EINs that we sent to Census in this group were for employers that we determined to be corporations (because their name did not suggest they were a partnership or LLC, they filed a form 1120-F [tax return of a foreign corporation], or their name indicated that they were corporations) and for which we had no indicator of a place of incorporation. We also included small numbers of three other types of corporations in this category because disclosure constraints prevented us from reporting on them separately. They are (1) CFCs for which we could not determine a place of incorporation, (2) corporations that were incorporated outside of the

[2]For the Census groupings we did not need to establish a connection to Puerto Rico with our tax data because Census established those connections through their surveys.

United States or Puerto Rico but which were not CFCs, and (3) nonprofit corporations that Census identified from our unknown group but whose data they suppressed.[3]

Sole proprietors. This category contains EINs that were associated with sole proprietors in IRS's records or in Census's surveys.

Pass-through entities. This category contains EINs for employers that IRS reported to have filing requirements as partnerships or subchapter S corporations, or that had names on Puerto Rican tax returns indicating that they were partnerships or LLCs.

Other entities. The IRS codes that we used to identify EINs that we put in this category covered government agencies, churches, nonprofits, estates and trusts, political organizations, homeowners organizations, and settlement funds. This does not imply that the Census population of employers included all these type of entities. We also included in this category the data that Census provided to us relating to nonprofit corporations.

[3]Census includes these nonprofits in their "corporations" category. For industries where Census suppressed separate figures for these nonprofits, we could not move them from the corporations category to the "other entities" category.

Additional Data on Possessions Corporations and Their Affiliates

Table 14: Selected Data for the Full Population of Possessions Corporations Operating in Puerto Rico, 1993–2003

Dollars in billions (constant 2005)

	1993	1995	1997	1999	2001	2003
Number of corporations claiming tax credit	378	332	291	204	158	124
Amount of tax credit	$5.8	$3.7	$3.2	$1.8	$1.4	$1.1
Total income	28.8	28.6	32.3	27.0	20.5	13.3
Gross profits	24.8	26.1	30.1	24.8	18.8	12.1
Net income	16.7	15.9	17.3	13.3	9.5	7.3
Total assets	59.5	59.6	58.7	54.9	45.3	41.1

Source: GAO analysis of IRS data.

Table 15: Selected Data for Large Corporate Groups Operating in Puerto Rico, by Type of Entity, 1993–2003

Dollars in billions (constant 2005)

	1993	1995	1997	1999	2001	2003
Number of corporations						
Possessions corporations	136	146	127	105	79	58
CFCs			34	43	49	
Other				25	28	
Possessions tax credit						
Possessions corporations	$5.5	$3.5	$3.0	$1.7	$1.3	$1.1
Total income						
Possessions corporations	26.7	26.8	30.7	25.9	19.8	12.5
Lower bound for CFCs			2.4	5.2	7.4	
CFC total if allocated by tax ratio			3.0	7.2	11.5	
Other affiliates				3.3	7.5	
Gross profit						
Possessions corporations	22.9	24.4	28.8	23.9	18.1	11.4
Lower bound for CFCs			2.4	5.3	7.1	
CFC total if allocated by tax ratio			3.0	7.5	11.5	
Other affiliates				3.0	7.0	
Net income						
Possessions corporations	15.9	15.1	16.6	12.8	9.3	7.1
Lower bound for CFCs			1.6	2.4	3.9	
CFC total if allocated by tax ratio			1.9	3.4	6.0	
Other affiliates				2.1	5.8	
Total assets						
Possessions corporations	54.3	54.4	54.4	50.8	42.3	38.2
Lower bound for CFCs			7.8	14.5	16.7	
Other affiliates				6.7	7.2	

Source: GAO analysis of data from IRS and the Puerto Rican Department of Treasury.

Table 16: Selected Data for Large Corporate Groups Operating in the Chemical and Medical Equipment Industries in Puerto Rico, by Type of Entity, 1993–2003

Dollars in billions (constant 2005)

	1993	1995	1997	1999	2001	2003
Number of corporations						
Possessions corporations	74	74	60	52	38	27
CFCs			15	21	26	
Other				17	18	
Possessions tax credit						
Possessions corporations	$3.1	$2.3	$2.2	$1.2	$0.9	$0.8
Total income						
Possessions corporations	15.9	18.2	22.0	19.4	13.0	9.3
Lower bound for CFCs			1.8	3.7	4.7	
CFC total if allocated by tax ratio			1.8	5.7	8.8	
Other affiliates				2.8	7.3	
Gross profit						
Possessions corporations	15.4	17.0	21.0	18.3	12.0	8.6
Lower bound for CFCs			1.8	4.0	4.8	
CFC total if allocated by tax ratio			1.8	6.1	9.1	
Other affiliates				2.7	6.9	
Net Income						
Possessions corporations	8.9	10.7	12.4	10.2	6.8	5.5
Lower bound for CFCs			1.2	2.3	2.8	
CFC total if allocated by tax ratio			1.2	3.4	4.8	
Other affiliates				2.0	5.8	
Total assets						
Possessions corporations	29.7	32.7	30.1	33.1	25.2	23.3
Lower bound for CFCs			2.3	4.9	7.7	
Other affiliates				5.5	6.0	

Source: GAO analysis of data from IRS and the Puerto Rican Department of Treasury.

Table 17: Selected Data for Large Corporate Groups Operating in the Computer, Electronics, and Electrical Equipment Industries in Puerto Rico, by Type of Entity, 1993–2003

Dollars in billions (constant 2005)

	Large computer/electronics/electrical equipment groups					
	1993	**1995**	**1997**	**1999**	**2001**	**2003**
Number of corporations						
Possessions corporations	15	29	25	16	13	11
CFCs			10	10	12	
Other				6	4	
Possessions tax credit						
Possessions corporations	$1.2	$0.3	$0.2	$0.1	$0.1	$0.1
Total income						
Possessions corporations	3.9	1.9	2.1	0.8	1.8	0.6
CFCs			0.2	0.2	0.3	
Other affiliates				0.5	0.1	
Gross profit						
Possessions corporations	1.6	1.8	2.0	0.7	1.7	0.4
CFCs			0.2	0.2	0.2	
Other affiliates				0.4	0.0	
Net income						
Possessions corporations	3.3	1.1	1.0	0.5	0.5	0.5
CFCs			0.1	0.2	0.2	
Other affiliates				0.1	0.0	
Total assets						
Possessions corporations	3.3	5.0	5.2	2.8	2.1	1.7
CFCs			0.5	0.7	2.3	
Other affiliates				1.2	0.8	

Source: GAO analysis of data from IRS and the Puerto Rican Department of Treasury.

Table 18: Selected Data for Large Corporate Groups Operating in the Food and Kindred Products Industries in Puerto Rico, by Type of Entity, 1993–2003

Dollars in billions (constant 2005)

	Possessions corporations in the large food and kindred products groups					
	1993	1995	1997	1999	2001	2003
Number of corporations	14	17	17	15	11	6
Possessions tax credit	0.7	0.4	0.2	0.2	0.2	0.1
Total income	3.1	3.0	2.3	4.0	3.9	1.6
Gross profit	2.9	2.3	1.8	3.2	3.4	1.6
Net income	2.1	1.8	1.5	1.6	1.5	0.9
Total assets	5.4	6.4	9.2	10.6	11.3	9.8

Source: GAO analysis of data from IRS and the Puerto Rican Department of Treasury.

Note: Other affiliates of possessions corporations had less than $0.1 billion of all of these measures.

Table 19: Distribution of Tax Credits, Income, and Assets of Possessions Corporations Operating in Puerto Rico, by Industry, 1993–2003

Percent

	1993	1995	1997	1999	2001	2003
Possessions tax credit						
Apparel	1.2	1.9	2.4	6.1	5.7	0.8
Beverages and tobacco	12.8	10.8	6.6	9.3	12.7	10.8
Computers, electronics, and electrical equipment	21.5	9.4	8.2	8.5	9.7	13.8
Medical equipment	8.6	10.1	11.3	9.8	11.6	7.8
Nonmanufacturing	3.7	4.8	4.9	2.4	2.7	10.6
Other manufacturing	5.7	7.4	6.0	6.4	6.7	5.8
Pharmaceuticals	46.5	55.7	60.5	57.6	50.9	50.4
Total income						
Apparel	0.8	1.1	1.0	1.4	1.7	1.1
Beverages and tobacco	10.9	10.4	6.9	14.6	19.2	12.5
Computers, electronics, and electrical equipment	14.7	7.3	7.0	3.1	9.0	5.4
Medical equipment	7.9	7.7	9.3	6.3	7.6	7.8
Nonmanufacturing	10.0	9.1	8.9	5.4	4.6	6.1
Other manufacturing	5.8	6.0	4.2	2.8	3.4	3.7
Pharmaceuticals	49.9	58.4	62.7	66.4	54.4	63.5
Gross profits						
Apparel	0.9	1.2	1.0	1.5	1.8	1.2
Beverages and tobacco	12.1	8.7	5.8	12.9	18.2	13.5
Computers, electronics, and electrical equipment	7.2	7.5	7.0	3.2	9.8	3.6
Medical equipment	8.7	7.9	9.3	6.3	7.8	6.9
Nonmanufacturing	7.9	9.0	8.7	4.3	2.9	4.8
Other manufacturing	6.5	5.8	4.2	2.7	3.8	4.0
Pharmaceuticals	56.6	60.0	64.0	69.1	55.8	66.0
Net income						
Apparel	1.2	1.8	1.6	2.5	3.0	1.5
Beverages and tobacco	13.0	11.7	8.5	12.1	16.0	11.6
Computers, electronics, and electrical equipment	21.3	7.7	6.0	3.8	5.9	7.1
Medical equipment	8.8	9.3	10.9	6.2	8.4	8.9
Nonmanufacturing	3.9	3.4	2.8	1.6	1.6	0.8
Other manufacturing	5.7	6.6	4.5	2.0	1.5	2.1
Pharmaceuticals	46.2	59.6	65.7	71.8	63.6	67.9

(Continued From Previous Page)

Percent

	1993	1995	1997	1999	2001	2003
Total assets						
Apparel	0.5	0.5	0.5	0.8	2.5	3.0
Beverages and tobacco	9.5	11.1	16.0	19.4	25.2	25.4
Computers, electronics, and electrical equipment	6.3	8.9	7.9	5.6	4.9	4.4
Medical equipment	10.8	12.9	10.7	5.1	5.4	6.4
Nonmanufacturing	21.1	10.2	12.9	11.7	10.9	11.6
Other manufacturing	9.0	8.1	7.0	5.9	5.5	3.4
Pharmaceuticals	42.8	48.3	45.1	51.5	45.6	45.7

Source: GAO analysis of data from IRS.

Appendix V

Additional Data on the Distribution of Business Activity by Type of Business Entity

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Table 20: Employment in Puerto Rican Manufacturing by Industry and Business Entity Type, 2002

Type of business entity	All manufacturing	Food	Beverages	Apparel
All employers[a]	126,707	14,509	3,859	9,731
Possessions corporations	40,313	3,218	1,991	5,735
Other U.S. corporations	11,006	1,238	250–499	436
CFCs incorporated in Puerto Rico	8,973	20–99	0	100–249
CFCs incorporated outside of Puerto Rico	8,657	0	0	0
Other corporations incorporated in Puerto Rico	28,630	6,155	509	2,751
Corporations of type unknown	14,642	(D)	(D)	(D)
Pass-through entities[b]	3,949	0–19	250–499	20–99
Sole proprietors[c]	2,933	(D)	(D)	(D)
All other employers	7,604	898–996	0–452	0–114

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Notes: We use the symbol (D) in this table to represent data that Census withheld to avoid disclosing information for individual companies.

[a]Census did not disclose specific figures for entities in the “all other employers” group in manufacturing. However, we were able to impute employment figures for this group by calculating the residual of employees not included in any other group.

[b]The data in this line do not include those for five partnerships that we were able to identify, but which we could not add into this line (see app. III for explanation). Data for those five partnerships, which together had between 100 and 249 employees, are included in the “all other employers” line.

[c]The data for sole proprietors are from the published version of the 2002 Economic Census of Island Areas (see app. III for explanation).

Pharmaceuticals	Machinery	Computers and electronics	Medical equipment	All other manufacturing
25,036	1,697	17,989	16,241	37,645
7,772	500–999	6,017	7,246	7,335–7,834
1,744	100-249	1,111	1,191	4,538–4,936
4,443	0	1,000–2,499	540	1,143–2,870
2,961	0	2,500–4,999	2,078	0–1,118
2,712	474	1,752	491	13,786
(D)	(D)	(D)	(D)	(D)
1,000–2,499	0	100–249	1,000–2,499	0–1,579
(D)	(D)	(D)	(D)	(D)
2,517–4,016	0–546	1,164–5,469	0–2,685	

Table 21: Value Added in Puerto Rican Manufacturing by Industry and Business Entity Type, 2002

Dollars in thousands

Type of Business Entity	All Manufacturing	Food	Beverage	Apparel
All employers[a]	45,614,305	3,596,987	783,483	505,836
Possessions corporations	12,183,980	2,997,247	584,187	434,762
Other U.S. corporations	1,016,055	52,471	(D)	14,976
CFCs incorporated in Puerto Rico	7,057,958	(D)	0	(D)
CFCs incorporated outside of Puerto Rico	12,254,469	0	0	0
Other corporations incorporated in Puerto Rico	3,578,053	395,597	59,529	39,358
Corporations of type unknown	3,124,760	(D)	(D)	(D)
Pass-through entities[b]	3,891,900	(D)	(D)	(D)
Sole proprietors[c]	121,954	(D)	(D)	(D)
All other employers	2,385,176	(D)	(D)	(D)

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Notes: We use the symbol (D) in this table to represent data that Census withheld to avoid disclosing information for individual companies.

[a]Census did not disclose specific figures for entities in the “all other employers” group in manufacturing. However, we were able to impute payroll figures for this group by calculating the residual of value added that was not included in any other group.

[b]The data in this line do not include those for five partnerships that we were able to identify, but which we could not add into this line. Data for those five partnerships, which together had between 100 and 249 employees, are included in the “all other employers” line.

[c]The data for sole proprietors are from the published version of the 2002 Economic Census of Island Areas (see app. III for explanation).

Pharmaceuticals	Machinery	Computers and electronics	Medical equipment	All other manufacturing
33,159,557	171,969	1,878,700	1,998,440	3,519,333
6,222,318	(D)	338,847	512,883	(D)
323,294	(D)	98,679	122,964	(D)
6,511,093	0	(D)	117,270	(D)
11,118,836	0	(D)	509,005	(D)
2,236,129	17,169	148,413	15,705	666,153
(D)	(D)	(D)	(D)	(D)
(D)	0	(D)	(D)	(D)
(D)	(D)	(D)	(D)	(D)
(D)	(D)	(D)	(D)	(D)

Table 22: Annual Payroll in Puerto Rican Manufacturing by Industry and Business Entity Type, 2002

Dollars in thousands

Type of business entity	All manufacturing	Food	Beverage	Apparel
All employers[a]	3,130,631	230,955	102,833	161,743
Possessions corporations	1,074,215	80,356	62,082	83,816
Other U.S. corporations	217,620	12,847	(D)	4,897
CFCs incorporated in Puerto Rico	272,198	(D)	0	(D)
CFCs incorporated outside of Puerto Rico	342,960	0	0	0
Other corporations incorporated in Puerto Rico	519,675	97,606	13,329	27,007
Corporations of type unknown	299,001	(D)	(D)	(D)
Pass-through entities[b]	155,755	(D)	(D)	(D)
Sole proprietors[c]	21,910	(D)	(D)	(D)
All other employers	227,297	(D)	(D)	(D)

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Notes: We use the symbol (D) in this table to represent data that Census withheld to avoid disclosing information for individual companies.

[a]Census did not disclose specific figures for entities in the “all other employers” group in manufacturing. However, we were able to impute payroll figures for this group by calculating the residual of payroll that was not included in any other group.

[b]The data in this line do not include those for five partnerships that we were able to identify, but which we could not add into this line. Data for those five partnerships, which together had between 100 and 249 employees, are included in the “all other employers” line.

[c]The data for sole proprietors are from the published version of the 2002 Economic Census of Island Areas (see app. III for explanation).

Pharmaceuticals	Machinery	Computers and electronics	Medical equipment	All other manufacturing
1,109,166	30,918	437,092	343,164	714,760
347,821	(D)	127,202	162,712	(D)
50,689	(D)	28,697	26,029	(D)
185,991	0	(D)	6,677	(D)
159,087	0	(D)	45,162	(D)
117,845	6,297	27,873	3,888	225,830
(D)	(D)	(D)	(D)	(D)
(D)	0	(D)	(D)	(D)
(D)	(D)	(D)	(D)	(D)
(D)	(D)	(D)	(D)	(D)

Table 23: Capital Expenditures in Puerto Rican Manufacturing by Industry and Business Entity Type, 2002

Dollars in thousands

Type of business entity	All manufacturing	Food	Beverage	Apparel
All employers[a]	3,673,690	84,912	57,403	6,249
Possessions corporations	904,214	47,386	12,577	1,280
Other U.S. corporations	246,259	2,127	(D)	182
CFCs incorporated in Puerto Rico	590,686	(D)	0	(D)
CFCs incorporated outside of Puerto Rico	409,731	0	0	0
Other corporations incorporated in Puerto Rico	674,034	24,969	34,322	4,662
Corporations of type unknown	125,890	(D)	(D)	(D)
Pass-through entities[b]	443,727	(D)	(D)	(D)
Sole proprietors[c]	(D)	(D)	(D)	(D)
All other employers	(D)	(D)	(D)	(D)

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Notes: We use the symbol (D) in this table to represent data that Census withheld to avoid disclosing information for individual companies.

[a]Census did not disclose specific figures for entities in the “all other employers” group in manufacturing. However, we were able to impute figures for this group by calculating the residual of capital expenditures that were not included in any other group.

[b]The data in this line do not include those for five partnerships that we were able to identify, but which we could not add into this line. Data for those five partnerships, which together had between 100 and 249 employees, are included in the “all other employers” line.

[c]The data for sole proprietors are from the published version of the 2002 Economic Census of Island Areas (see app. III for explanation).

Pharmaceuticals	Machinery	Computers and electronics	Medical equipment	All other manufacturing
2,614,797	9,355	81,453	184,344	635,177
716,751	(D)	14,469	41,390	(D)
172,013	(D)	5,350	9,143	(D)
565,582	0	(D)	6,187	(D)
386,979	0	(D)	17,228	(D)
231,607	4,243	3,094	2,392	368,745
(D)	(D)	(D)	(D)	(D)
(D)	0	(D)	(D)	(D)
(D)	(D)	(D)	0	(D)
(D)	(D)	(D)	(D)	(D)

Table 24: Value of Shipments in Puerto Rican Manufacturing by Industry and Business Entity Type, 2002

Dollars in thousands

Type of business entity	All manufacturing	Food	Beverage	Apparel
All employers[a]	58,580,060	4,883,924	1,547,995	725,181
Possessions corporations	16,010,390	3,504,753	923,020	559,109
Other U.S. corporations	2,097,568	103,317	(D)	22,800
CFCs incorporated in Puerto Rico	7,675,116	(D)	0	(D)
CFCs incorporated outside of Puerto Rico	13,912,333	0	0	0
Other corporations incorporated in Puerto Rico	5,583,289	911,875	106,780	111,327
Corporations of type unknown	4,718,126	(D)	(D)	(D)
Pass-through entities[b]	5,450,104	(D)	(D)	(D)
Sole proprietors[c]	194,760	(D)	(D)	(D)
All other employers	2,938,374	(D)	(D)	(D)

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Notes: We use the symbol (D) in this table to represent data that Census withheld to avoid disclosing information for individual companies.

[a]Census did not disclose specific figures for entities in the “all other employers” group in manufacturing. However, we were able to impute figures for this group by calculating the residual of value of shipments that were not included in any other group.

[b]The data in this line do not include those for five partnerships that we were able to identify, but which we could not add into this line. Data for those five partnerships, which together had between 100 and 249 employees, are included in the “all other employers” line.

[c]The data for sole proprietors are from the published version of the 2002 Economic Census of Island Areas (see app. III for explanation).

Pharmaceuticals	Machinery	Computers and electronics	Medical equipment	All other manufacturing
38,446,602	284,538	3,388,664	2,982,585	6,320,571
7,623,306	(D)	742,735	728,864	(D)
586,596	(D)	178,841	238,777	(D)
6,881,368	0	(D)	151,256	(D)
11,885,537	0	(D)	681,684	(D)
2,942,219	28,716	205,789	22,734	1,253,849
(D)	(D)	(D)	(D)	(D)
(D)	0	(D)	(D)	(D)
(D)	(D)	(D)	(D)	(D)
(D)	(D)	(D)	(D)	(D)

Table 25: Share of Employment for Puerto Rico's Manufacturing, Wholesale Trade, Retail Trade, and Services Sectors in 2002

Sector or service industry	Employment value	Possessions (percent)	CFCs (percent)	Other U.S. corporations (percent)
Manufacturing	126,707	31.8	13.9	8.7
Wholesale trade	39,316	4.9	6.6	11.6
Retail trade	122,435	2.0–4.0	9.5	12.1
Mining	949	0.0	2.1–10.4	2.1–10.4
Utilities	503	0.0	4.0–19.7	4.0–19.7
Transportation and warehousing	13,137	0.2–0.8	0.8	9.8
Information	16,696	2.4	32.7	11.0
Finance and insurance	36,059	0.1–0.3	5.1	10.9
Real estate and rental and leasing	13,086	0.2–0.8	1.5	14.8
Professional, scientific, and technical services	26,197	2.1	3.4	20.2
Management of companies and enterprises	2,237	0.0	4.5–11.1	3.9
Administrative support and waste management	61,703	0.2–0.4	5.1	15.4
Educational services	4,647	0.0	0.4–2.1	8.7
Health care and social assistance	68,338	0.4–0.8	3.3	11.3
Arts, entertainment, and recreation	3,115	0.0	0.0	15.3
Accommodation and food services	63,810	10.0	0.4–0.8	17.4
Other services (except public administration)	18,417	0.1–0.5	0.1–0.5	9.0

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Notes: We use the symbol (D) in this table to represent data that Census withheld to avoid disclosing information for individual companies.

[a]We included nonprofits in the group labeled "other employers." However, Census included these employers in the group labeled "corporations of type unknown." In order to be consistent with the groups that we created for the manufacturing sector, we removed nonprofits from Census's "corporations of type unknown" and combined them with our "other employers" group, whenever possible.

[b]Census did not disclose specific employment figures for entities in the "other employers" group. However, we were able to impute employment figures for this group by calculating the residual of employees not included in any other group.

Types of business entities				
Corporations of type unknown[a] (percent)	Sole proprietors (percent)	Partnerships (percent)	Other corporations incorporated in Puerto Rico (percent)	Other employers (percent)
11.6	2.3	3.1	22.6	6.0[b]
63.9	2.8–4.1	1.6	7.7	0.9–2.2
60.4	10.6	0.3	2.0–4.1	1.3
(D)	(D)	0.0	43.9	0.0
(D)	(D)	4.0–19.7	0.0	0.0
(D)	(D)	1.2–2.3	13.0	1.5–3.2
(D)	(D)	1.6–1.7	10.9	0.6
36.5	1.4	0.3–1.0	35.2	10.6–11.5
(D)	(D)	11.3	1.2	2.3–4.1
(D)	(D)	11.2	3.4	4.3–5.6
(D)	(D)	0–0.8	22.4–44.7	0–2.5
(D)	(D)	1.5–2.4	1.0	1.0–1.7
(D)	(D)	0–0.4	0–0.4	29.4–35.2
(D)	(D)	1.4–1.8	0.1	33.9–38
(D)	(D)	3.9–11.2	0–0.6	19.9–43.9
(D)	(D)	6.8	2.9	0.2–0.3
(D)	(D)	3.5	0.6	16.4

Table 26: Share of Sales and Value of Shipments for Puerto Rico's Manufacturing, Wholesale Trade, Retail Trade, and Services Sectors in 2002

Sales/value of shipments			
Sector or service industry	Sales value	Possessions (percent)	CFCs (percent)
Manufacturing	58,580,060	27.3	36.9
Wholesale trade	16,172,710	2.6	15.3
Retail trade	20,422,975	(D)	10.6
Mining	107,000	(D)	(D)
Utilities	369,932	(D)	(D)
Transportation and warehousing	2,076,573	(D)	0.8
Information	3,686,792	3.7	41.6
Finance and insurance	10,233,015	(D)	8.4
Real estate and rental and leasing	1,698,631	(D)	3.0
Professional, scientific, and technical services	2,836,774	2.5	4.6
Management of companies and enterprises	511,676	(D)	(D)
Administrative support and waste management	2,336,978	(D)	7.0
Educational services	242,810	(D)	(D)
Health care and social assistance	4,967,317	(D)	3.0
Arts, entertainment, and recreation	278,975	0.0	0.0
Accommodation and food services	3,360,226	10.1	(D)
Other services (except public administration)	1,470,563	(D)	(D)

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Notes: We use the symbol (D) in this table to represent data that Census withheld to avoid disclosing information for individual companies.

[a]We generally included nonprofits in the group labeled "other employers," however, for wholesale trade some nonprofits are included in the group labeled "corporations of type unknown," as a result of the disclosure constraints under which we worked (see app. III for details).

[b]Census did not disclose specific figures for employers in the "other employers" group in manufacturing. However, we were able to impute sales figures for this group by calculating the residual of sales not included in any other group.

Types of business entities					
Other U.S. corporations (percent)	Corporations of type unknown[a] (percent)	Sole proprietors (percent)	Partnerships (percent)	Other corporations incorporated in Puerto Rico (percent)	Other employers (percent)
3.6	8.1	0.3	9.3	9.5	5.0[b]
10.3	60.0	(D)	(D)	8.0	(D)
12.4	61.2	5.1	0.2	(D)	1.1
(D)	(D)	(D)	(D)	50.5	(D)
(D)	(D)	(D)	(D)	(D)	(D)
9.3	(D)	(D)	(D)	3.9	0.4
13.0	(D)	(D)	1.5	9.2	0.2
10.7	(D)	(D)	(D)	22.6	
14.9	(D)	(D)	12.0	1.6	(D)
21.7	(D)	(D)	12.7	2.8	(D)
1.9	(D)	(D)	(D)	(D)	(D)
20.3	(D)	(D)	(D)	2.1	(D)
14.1	(D)	(D)	(D)	(D)	(D)
14.8	(D)	(D)	(D)	0.1	(D)
(D)	(D)	(D)	(D)	(D)	(D)
(D)	(D)	(D)	7.4	3.3	(D)
8.7	(D)	(D)	7.1	1.1	16.5

Table 27: Share of Payroll for Puerto Rico's Manufacturing, Wholesale Trade, Retail Trade, and Services Sectors in 2002

Payroll				
Sector or service industry	Payroll value	Possessions (percent)	CFCs (percent)	Other U.S. corporations (percent)
Manufacturing	3,130,631	34.3	19.6	7.0
Wholesale trade	1,009,360	5.5	10.4	13.3
Retail trade	1,655,584	(D)	11.2	11.8
Mining	18,834	0.0	(D)	(D)
Utilities	21,040	0.0	(D)	(D)
Transportation and warehousing	253,758	(D)	1.0	10.2
Information	633,161	2.9	35.0	9.9
Finance and insurance	1,152,628	(D)	6.5	10.0
Real estate and rental and leasing	231,189	(D)	2.5	16.3
Professional, scientific, and technical services	701,485	2.3	4.1	23.5
Management of companies and enterprises	79,091	0.0	(D)	2.5
Administrative support and waste management	888,063	(D)	7.0	0.0
Educational services	74,829	(D)	(D)	9.8
Health care and social assistance	1,224,260	(D)	3.9	13.1
Arts, entertainment, and recreation	45,393	0.0	0.0	14.9
Accommodation and food services	732,147	10.3	(D)	22.6
Other services (except public administration)	281,805	(D)	(D)	8.9

Source: GAO analysis of IRS data and custom tabulations from the 2002 Economic Census of Island Areas provided by the U.S. Census Bureau.

Notes: We use the symbol (D) in this table to represent data that Census withheld to avoid disclosing information for individual companies.

[a]Census did not disclose specific figures for employers in the "other employers" group in manufacturing. However, we were able to impute payroll figures for this group by calculating the residual of employees not included in any other group.

Types of business entities				
Corporations of type unknown (percent)	Sole proprietors (percent)	Partnerships (percent)	Other corporations incorporated in Puerto Rico (percent)	Other employers
9.6	0.7	5.0	16.6	7.3[a]
59.5	(D)	(D)	7.5	(D)
61.6	7.6	0.3	(D)	1.0
(D)	(D)	0.0	57.3	0.0
(D)	(D)	(D)	(D)	0.0
(D)	(D)	(D)	8.1	(D)
(D)	(D)	(D)	13.7	0.4
(D)	(D)	(D)	34.1	(D)
(D)	(D)	11.8	1.4	(D)
(D)	(D)	14.0	3.0	(D)
(D)	(D)	(D)	(D)	(D)
(D)	(D)	(D)	1.6	(D)
(D)	(D)	(D)	(D)	(D)
(D)	(D)	(D)	0.2	(D)
(D)	(D)	(D)	(D)	(D)
(D)	(D)	9.8	3.7	(D)
(D)	(D)	6.0	1.0	17.2

Additional Comparative Fiscal Data

This appendix provides more detail on how Puerto Rico's fiscal situation compares to the states and the other insular areas.

Table 28: Federal, State, Commonwealth, and Insular Area Revenues Collected in Fiscal Year 2002[a]

	Puerto Rico			
Fiscal activity	**Revenues (in thousands)**	**Per capita**	**Percent of commonwealth personal income**	**Nationwide per capita**
Total revenue	**$11,847,725**	**$3,070.6**	**28.2**	**$9,425.1**
Federal tax[c]				
Total[d]	**2,933,360**	**760.1**	**7.0**	**5,618.8**
Individual and employment tax	2,929,247	759.1	7.0	5,346.1
Estate and gift tax	4,730	1.2	0.0	91.5
Excise tax	-617	-0.2	0.0	181.2
State and entity revenues				
Total	**8,914,365**	**2,310.0**	**21.2**	**3,806.2**
Corporate income tax	1,768,322[g]	458.2	4.2	111.6
Individual income tax[h]	2,526,840	654.8	6.0	863.8
Nonresident withholding	583,256	151.1	1.4	
Property tax	768,065	199.0	1.8	992.1
Sales and excise tax	2,745,974	711.6	6.5	1,151.7
Other taxes and nontax revenues	521,908	135.2	1.2	841.7

Source: GAO analysis of IRS, Customs, and Insular Area Treasury Department data.

[a]Data reflect fiscal year of the jurisdiction. The federal government's fiscal year and those of the other insular areas end September 30, 2002. Puerto Rico's and most states' fiscal years end June 30, 2002.

[b]Excludes states with zero values.

[c]All federal tax figures represent net tax collections.

[d]Does not include the federal corporate income tax.

[e]Not available, IRS does not report data separately for insular areas, other than Puerto Rico.

States					Insular areas
High five per capita	Low five per capita[b]	Nationwide percent of state personal income	High five percent of state personal income	Low five percent of state personal income	Combined per capita
$15,490.5	**$5,712.9**	**29.9**	**41.4**	**23.0**	**$2,450.6**
10,732.7	**2,784.6**	**17.8**	**28.9**	**11.1**	**n.a.[e]**
9,066.1	2,526.1	17.0	22.4	10.1	
164.6	30.2	0.3	0.4	0.1	
643.7	15.4	0.6	2.2	0.1	
5,359.7	**2,682.7**	**12.1**	**15.1**	**10.2**	**2,450.6[f]**
278.7	39.2	0.4	0.8	0.1	
1,444.3	44.9	2.7	4.0	0.3	
1,589.8	394.8	3.1	4.8	1.5	
1,834.2	359.4	3.7	5.9	1.2	
2,183.8	517.8	2.7	7.4	1.8	

[f]A more detailed breakdown is not available.

[g]Includes partnerships and tollgate taxes.

[h]Census data for income tax include dividend and interest income. Puerto Rican Treasury data listed these items separately. For the purpose of comparison we added them together.

Additional Details on the Application of Federal Social Programs

Education Programs

Individuals with Disabilities Education Act Part B

The Individuals with Disabilities Education Act (IDEA) is the primary federal law that addresses the unique needs of children with disabilities, including children with specific learning disabilities, speech and language impairments, mental retardation, and serious emotional disturbance. The law mandates that a free, appropriate public education be made available for all eligible children with disabilities. As such, local education agencies are required to provide accommodations for children as needed, including accommodations for instruction and assessment. IDEA also requires the inclusion of students with disabilities in state- and districtwide assessment programs and the placement of students in the least restrictive environment, to the maximum extent appropriate. Teachers and staff work with parents and special education experts to create individualized education programs (IEP) for students with disabilities. These IEPs outline academic goals, appropriate accommodations, and measurable objectives. IDEA provides grants to states to help them implement the requirements. All 50 states, Puerto Rico, and all insular areas must comply with IDEA requirements as a condition of funding. Part B of IDEA authorizes grants for children age 3 to 21 with disabilities and contains provisions regarding the structure of special education and related services and the procedural safeguards that guarantee the provision of a free and appropriate public education to children with disabilities. Information on the special education students and grants provided under IDEA part B for fiscal year 2002 is summarized in table 29.

Table 29: Special Education Grant Allocation to, and Number of Students Covered by IDEA Part B in, the States and Puerto Rico Authorized by IDEA Part B, Fiscal Year 2002

	Total for the states, Puerto Rico, and the other insular areas	Puerto Rico	Puerto Rico as percent of total
Special education allocation	$7,528,533,000	$67,879,755	0.9
Number of students	48,995,357	596,502	1.2
Number of students with individualized education programs	6,531,405	69,327	1.1

Source: U.S. Department of Education.

Title I of the Elementary and Secondary Education Act

Title I of the Elementary and Secondary Education Act, reauthorized by the No Child Left Behind Act of 2001,[1] is the largest federal program supporting elementary and secondary education; with annual expenditures of more than $10.3 billion, the Act accounts for about 3 percent of total education expenditures nationally. Title I is an important source of funding for many high-poverty school districts and individual schools as funds are directed toward states and school districts with greater numbers and percentages of poor children. Title I offers grants designed to help local education agencies and schools improve the teaching and learning of children failing, or most at risk of failing, to meet state academic standards. The program aims to ensure that all children have a fair, equal, and significant opportunity to obtain a high-quality education and reach or exceed proficiency on state academic achievement standards and assessments. Program goals can be accomplished by efforts including

1. ensuring that high-quality academic assessments, accountability systems, teacher preparation and training, curriculum, and instructional materials are aligned with challenging state academic standards;

2. meeting the educational needs of low-achieving children in the nation's highest-poverty schools, limited-English-proficient children, migratory

[1]Pub. L. No. 107-110.

children, children with disabilities, Indian children, neglected or delinquent children, and young children in need of reading assistance;

3. closing the achievement gap between high- and low-performing children;

4. holding schools, local educational agencies, and states accountable for improving the academic achievement of all students and identifying and improving low-performing schools, while providing alternatives to students in such schools to enable them to receive a high-quality education; and

5. distributing and targeting resources sufficiently to make a difference to local educational agencies and schools where needs are greatest.

Title I funds are provided to the states, Puerto Rico, and the other insular areas, and all must comply with the same requirements of the law as a condition of funding. Each location has established its own specific performance goals and program accountability system (e.g., academic assessments, graduation rates, teacher qualifications), consistent with federal regulations. Table 30 shows Title I grant data for Puerto Rico relative to national data for fiscal year 2002.

Table 30: Title I Grant Allocation and Number of Covered Students, Fiscal Year 2002

	Total for the states, Puerto Rico, and the other insular areas	Puerto Rico	Puerto Rico as percent of total
Title I grant allocation	$10.35 billion	$333,295,520	3.3
Number of students	48,995,357	596,502	1.2

Source: U.S. Department of Education.

Food and Nutrition Programs

The Child and Adult Care Food Program

The Child and Adult Care Food Program (CACFP) serves nutritious meals and snacks to eligible children and adults who are enrolled for care at participating child-care centers, day-care homes, and adult day-care centers. CACFP also provides meals to children residing in homeless shelters and snacks to youths participating in after-school care programs. Meal providers in licensed care facilities or institutions receive reimbursement per meals served; meals must meet nutrition guidelines. Reimbursement rates are adjusted for changes in the consumer price index (CPI)[2] for food-away-from-home. This program was started in 1975 as the Child Care Food Program. In 1989, the name of the program was changed to Child and Adult Care Food Program.[3]

CACFP operates in the same way in the states, the U.S. Virgin Islands, Puerto Rico, and Guam, and has the following characteristics:

- The target population includes children, chronically impaired adults, and adults 60 or older who eat meals in group settings, such as centers, homes, and shelters. Teenagers in after-school programs in low-income areas can also participate.
- Public or private not-for-profit and for-profit centers may participate. For-profit centers must have at least 25 percent low-income participants; there is no similar requirement for not-for-profit centers.
- In centers, participants from households with income at or below 130 percent of the federal poverty level (FPL) can receive free meals, and those with income between 130 and 185 percent can receive reduced-price meals. Low-income day-care providers or day-care homes in low-income areas can receive reimbursement at higher rates than those for other homes.

CACFP does not operate in CNMI and American Samoa; however, the Nutrition Assistance Program block grant can be used to provide such meals and snacks in American Samoa.

Food Stamp and Nutrition Assistance Programs

Created in 1964, the Food Stamp Program is intended to help low-income individuals and families obtain a more nutritious diet by supplementing

[2]The consumer price index is a measure of the average change in prices over time in a given market basket of goods.

[3]Pub. L. No. 101-147.

their income with benefits to purchase food.[4] The structure of the Food Stamp Program is the same in the states, the U.S. Virgin Islands, and Guam. Puerto Rico, CNMI, and American Samoa do not operate the Food Stamp Program; instead, they receive block grants from the federal government, which are referred to as Nutrition Assistance Programs, whose design and eligibility rules differ from those of the Food Stamp Program. Table 31 summarizes the key features of these programs.

Table 31: Comparison of the Food Stamp and Nutrition Assistance Programs

	Food Stamp Program	Nutrition Assistance Programs		
	The states, the U.S. Virgin Islands, Guam	Puerto Rico	CNMI	American Samoa
Funding basis	Entitlement based on number of participants; benefits adjusted annually to reflect changes in the thrifty food plan.[a]	Capped block grant adjusted to reflect the percent change in the indexed level of the thrifty food plan.	Capped block grant, the amount of which is agreed to annually in a memorandum of understanding.	Capped block grant adjusted to reflect the percent change in the indexed level of the thrifty food plan.
Eligibility rules	Complex formula based on household size, income, assets, and other factors. Generally, household net income cannot exceed 100 percent of the federal poverty level. Hawaii, Alaska, the U.S. Virgin Islands, and Guam have slightly different eligibility criteria.	Formula similar to Food Stamp Program.	Has its own rules, some of which differ from those in the Food Stamp Program, to stay within the capped block grant.	Has its own rules, some of which differ from the Food Stamp Program, to stay within the capped block grant. Serves only low-income elderly, blind, and disabled individuals.
Average monthly benefit amount per person (fiscal year 2003)	$84 for the 50 states, $92 for the District of Columbia, $119 for the U.S. Virgin Islands, and $186 for Guam.	$103	$79	$103
Administrative costs	States and insular areas each fund about half.	Block grant and Puerto Rico each fund about half.	Block grant funds all.	Block grant funds all.

Source: GAO analysis of U.S. Department of Agriculture (USDA) Food and Nutrition Service documents and interviews with program staff.

[a]The thrifty food plan is a market basket of foods for a nutritious, low-cost diet for a four-person reference family.

[4]Pub. L. No. 88-525.

National School Lunch Program

The National School Lunch Program (NSLP) was created in 1946 to provide nutritionally balanced, low-cost or free lunches to children in public and not-for-profit private schools and residential child-care institutions. The program was expanded in 1998 to include snacks served in after-school and enrichment programs.[5]

The NSLP operates in the same way in the states, the U.S. Virgin Islands, Puerto Rico, and Guam. The program provides free meals to children from families with incomes at or below 130 percent of the FPL.[6] Children from families with incomes between 130 and 185 percent of the FPL can receive reduced-price meals for which no more than 40 cents may be charged. Children from families with incomes above 185 percent of the FPL pay full price. Local officials who administer the program decide what fees to charge for full-price meals and determine participants' eligibility. NSLP does not operate in CNMI or American Samoa, but funds provided under the Nutrition Assistance Program block grant support lunches and snacks for school age children in these insular areas.

NSLP is an entitlement program. School districts and independent schools that take part in the lunch program are reimbursed for each meal served and get donated commodities from the U.S. Department of Agriculture (USDA). In return, they must serve lunches that meet federal nutrition requirements and offer free or reduced-price lunches to eligible children. Reimbursement rates are adjusted with changes in the CPI for food-away-from-home.[7] The reimbursements rates for the 2003–2004 school year are summarized in table 32.

[5]There is also a school breakfast program, which is not included in this description.

[6]For 2005, the FPL in the 48 contiguous states and the District of Columbia was $19,350 for a family of four.

[7]The consumer price index is a measure of the average change in prices over time in a given market basket of goods.

Table 32: National School Lunch Program Reimbursement Rates, School Year 2003–2004

Reimbursement category	48 contiguous states	Alaska	Hawaii	Puerto Rico	Guam	The U.S. Virgin Islands
Free	$2.19	$3.55	$2.55	$2.19	$2.21	$2.36
Reduced	1.79	3.15	2.15	1.79	1.81	1.96
Full	0.21	0.34	0.24	0.21	0.23	0.29

Source: USDA Food and Nutrition Service documents.

Special Supplemental Nutrition Program for Women, Infants, and Children

The Special Supplemental Nutrition Program for Women, Infants, and Children (WIC) was created in 1972.[8] WIC is designed to safeguard the health of low-income women who are pregnant, postpartum, or breastfeeding; infants; and children up to age 5 who are at nutritional risk. Participants receive supplemental nutritious foods, nutrition education and counseling, and screening and referrals to other health, welfare, and social services. WIC is a federal grant program for which Congress authorizes a specific amount each year. Participants' income must not exceed 185 percent of the FPL. They must also meet state residency requirements and be determined by a health professional to be at nutritional risk. WIC operates the same in the states, American Samoa, Guam, Puerto Rico, and the Virgin Islands. There is no WIC program in CNMI. Table 33 below provides estimated food and nutrition program federal expenditures for the states, Puerto Rico, and the other U.S. insular areas for fiscal year 2003.

[8] Pub. L. No. 92-433.

Table 33: Estimated Food and Nutrition Program Federal Expenditures for the States, Puerto Rico, and the Other U.S. Insular Areas, Fiscal Year 2003

Program	50 States	The District of Columbia	Puerto Rico	The U.S. Virgin Islands	Guam	CNMI	American Samoa
Food Stamp Program/Nutrition Assistance Program	$21.3 billion	$90.1 million	$1.4 billion	$18.5 million	$53.4 million	$7.1 million	$5.6 million
National School Lunch Program	7.0 billion	16.5 million	123 million	4.6 million	3.8 million	5.0 million	11.2 million
WIC	4.1 billion	11.0 million	169 million	5.3 million	5.3 million	n.a.	5.9 million
Child and Adult Care Food Program	1.9 billion	3.1 million	20.0 million	597,000	54,000	n.a.	n.a.

Source: GAO analysis of USDA Food and Nutrition Service documents and interviews with program staff.

Note: n.a. = Estimates not available.

Health Care Financing and Grants Programs

Medicare

Created in 1965 as Title XVIII of the Social Security Act, Medicare provides health insurance coverage for the elderly and disabled, as well as for individuals with end-stage renal disease. The Medicare program covers beneficiaries in the states and American Samoa, CNMI, Guam, Puerto Rico, and the U.S. Virgin Islands. In fiscal year 2003, over 41 million beneficiaries had Medicare coverage, including nearly 600,000 in the U.S. insular areas, and Medicare spending represented the largest single source of federal health care spending nationwide.

Medicare includes separate components, or “parts,” that cover different types of services. Individuals eligible for Medicare automatically receive Hospital Insurance, known as Part A, which helps pay for inpatient hospital care, skilled nursing facility services following a hospital stay, certain home health services, and hospice care. U.S. residents aged 65 or over are automatically entitled to Medicare Part A if they or their spouses are eligible for Social Security payments.[9] Medicare-eligible individuals may elect to purchase Part B Supplemental Medical Insurance, which helps pay for certain physician, outpatient hospital care, laboratory, and other services. Part C encompasses private health plans that provide Medicare covered benefits to enrollees. Part D is the outpatient prescription drug benefit that was authorized in 2003 and was implemented in January 2006. In fiscal year 2003, federal Medicare expenditures totaled over $274 billion. In that year, total Medicare enrollment in Puerto Rico was over 574,000 and total expenditures were nearly $1.6 billion.

Table 34: Estimated Medicare Enrollment and Expenditures as of July 2003, Fiscal Year 2003

	Total for the states, Puerto Rico, and the other insular areas	Puerto Rico	Puerto Rico as percent of total
Enrollment[a]	40.2 million	575,000	1.4
Federal expenditures[b]	$274.3 billion	$1.6 billion	0.6

Source: GAO analysis of data from the Centers for Medicare and Medicaid Services (CMS).

[a]Enrollment includes individuals enrolled in Part A or Parts A and B of the program.

[b]Expenditures include benefit payments and exclude program administration.

Medicare beneficiaries in Puerto Rico and the other insular areas have been treated the same as those in the states in terms of eligibility and entitlement to benefits; however, certain structural differences, such as the methods used to calculate Medicare payments to hospitals, exist. For example, Medicare reimburses hospitals in Puerto Rico under a prospective payment system (PPS) distinct from the PPS used for hospitals in the states.[10] Each

[9]Social Security benefits are paid to workers who meet requirements for age and for the time they have worked in “covered employment,” that is, jobs through which they have paid Social Security taxes. Typically, workers must contribute for a total of 40 quarters (or 10 years in total) to qualify, though the requirements are different if they become disabled or die. Benefits are also paid to qualified spouses and certain divorced spouses of workers who have met the covered employment requirement or who are disabled. Social Security covers about 96 percent of all U.S. workers; the vast majority of the rest are state, local, and federal government employees.

[10]Puerto Rico is the only insular area for which hospitals are paid using a PPS. The other insular area hospitals are paid based on their costs.

of Puerto Rico's PPS rates is a "blended rate," comprising 75 percent of the national rate used for hospitals in the states and 25 percent of a local rate, which is lower than the national rate. The rates are further adjusted for each hospital using cost factors. These adjustments account for the lower costs of providing hospital services in Puerto Rico compared to the states and for differing costs among hospitals across Puerto Rico.

The Medicare Part D prescription drug program marks the first time that Medicare beneficiaries in the insular areas are treated differently with regard to available benefits. In 2004 and 2005, Medicare beneficiaries in the states who enrolled paid a fee to receive a discount drug card, with an expected discount of 10 to 15 percent on covered drugs, and certain low-income beneficiaries who participated were entitled to assistance to subsidize drug costs, in an amount generally $600 per year. In contrast, beneficiaries in Puerto Rico and the other insular areas did not receive these direct benefits. Instead, each insular area was given a lump sum, which most, including Puerto Rico, used to subsidize Medicaid prescription drug coverage to certain low-income Medicare beneficiaries. The permanent Part D program, which went into effect in January of 2006, allows for similar coverage to most beneficiaries in the insular areas and states. However, as in the interim program, certain low-income beneficiaries in the insular areas will not directly receive funds to subsidize their prescription drug expenses. Instead, the insular areas' governments will receive a lump-sum payment and administer benefits to certain low-income beneficiaries based on a locally developed plan.

Medicaid

Created in 1965 as Title XIX of the Social Security Act, Medicaid is a federal-state health care financing program that covers medical and health-related services to certain categories of the country's low-income population, primarily children and individuals who are aged, blind, or disabled. Medicaid programs operate in each state, the District of Columbia, Puerto Rico, and the other insular areas.

Table 35: Estimated Medicaid Enrollment and Federal Expenditures, Fiscal Year 2004

	Total for the states, Puerto Rico, and the other insular areas	Puerto Rico	Puerto Rico as percent of total
Enrollment[a]	42.9 million	938,000	2.2
Federal expenditures	$173.7 billion[b]	$219.4 million	0.1

Source: GAO analysis of CMS and Puerto Rico data.

[a]The figure represents the number of enrollees in terms of person years. The total number of individuals served by Medicaid in 2004 was nearly 55 million, some of whom were enrolled in the program for less than the full year. A similar number for total individuals served by Medicaid in Puerto Rico was not available.

[b]The figure includes expenditures for medical services and administration.

The Medicaid programs in Puerto Rico and the other insular areas has financing, eligibility, service, and administrative requirements that differ from Medicaid requirements and operations in the states.

Financing

In the states, there are no limits on federal payments for Medicaid as long as the state contributes its share of program expenditures for services provided under a federally approved plan. A statutory formula is used to calculate the portion of each state's Medicaid expenditures for medical assistance that the federal government will pay, referred to as the federal matching percentage. The matching percentage varies by state, depending in part on the state's per capita income in relation to the national average, and ranges from 50 to no more than 83 percent of Medicaid expenditures.[11] For fiscal year 2005, the highest federal matching percentage was 77.

The federal share of expenditures in the insular areas is limited to a 50 percent matching rate, and in contrast to the states, federal Medicaid spending for the insular areas is subject to statutory caps.[12] For fiscal year 1999 and beyond, the spending caps are increased annually by the

[11]The District of Columbia has a higher matching percentage than what would be calculated under the statutory formula. This higher matching rate, which is currently 70 percent, was authorized by the Balanced Budget Act of 1997, Pub. L. No. 105-33 § 4725(b)(1), 111 Stat. 251, codified at 42 U.S.C. § 1396d(b)(3).

[12]Puerto Rico was originally included in the legislation that created Medicaid and was granted a 55 percent federal matching rate. Effective in 1967, its federal matching rate was lowered to 50 percent.

percentage increase in the medical-care component of the CPI for all urban consumers.

Eligibility

In the states, Medicaid requires coverage of certain categories of low-income individuals, including children, pregnant women, and aged and disabled individuals. For example, federal law requires coverage of pregnant women and children up to age 6 in families with incomes up to 133 percent of the FPL, and children age 6 through age 18 in families with incomes up to 100 percent of the FPL. However, insular areas are not required to meet all Medicaid eligibility requirements, and in light of the statutory limits on federal funding, CMS does not hold these areas accountable for covering all Medicaid benefit requirements. For example, Puerto Rico and the U.S. Virgin Islands have implemented eligibility criteria that are more restrictive than federal standards. They determine Medicaid eligibility based on locally established poverty levels, which, at less than the federal poverty level, are more restrictive in terms of enrollment. According to officials in these areas, restricting eligibility allows them to target Medicaid services to fewer, albeit needier, individuals. Puerto Rico's locally established poverty level, called the Commonwealth poverty level (CPL) is currently $8,220 per year for a family of four and has not changed since 1998. In contrast, American Samoa, whose median household income is less than half that of the United States, neither uses specific categories to determine eligibility nor links eligibility to income levels that reflect local conditions. Instead, it considers every resident with an income at or below the federal poverty level—the majority of the population—as eligible for Medicaid.

Services and Administration

Medicaid also requires states to cover certain services in their Medicaid programs.[13] Mandatory services include inpatient and outpatient hospital care; physician services; nursing home care; lab and x-ray services; immunizations and other early and periodic screening, diagnostic, and treatment (EPSDT) services for children under age 21; family planning services; health center and rural health-clinic services; and nurse midwife and nurse-practitioner services. Services that are optional include outpatient prescription drugs, institutional care for persons with mental retardation, personal care, and dental and vision care for adults. With

[13]The Deficit Reduction Act of 2005 allows states to establish "benchmark benefit packages" for certain eligible populations that would not include all of the services previously classified as mandatory. See Pub. L. No. 109-171 § 6044; 120 Stat. 4, 88-92. This section of the law will take effect on March 31, 2006.

certain exceptions, states' Medicaid programs must allow recipients freedom of choice among health-care providers participating in Medicaid. Also, overall administrative expenditures for states are not limited, and states receive a 50 percent federal match for most types of administrative expenditures.[14]

Despite federal requirements for mandatory coverage of certain services, the Medicaid programs in the insular areas do not cover all mandatory services. For example, while Puerto Rico has skilled nursing facilities and home health services, its Medicaid program does not include them in its benefit package. Similarly, other mandatory Medicaid services, such as nurse midwife services, are also not covered by Puerto Rico's Medicaid program.[15] However, Puerto Rico and the other insular areas have all chosen to add optional benefits under the statute, such as outpatient prescription drug coverage. In addition, as is the case with all the insular areas, Puerto Rico is exempt from freedom of choice requirements that apply to states' Medicaid programs. Also, federal spending for administrative expenditures in Puerto Rico and the other insular areas are subject to their respective Medicaid caps.

State Children's Health Insurance Program

The State Children's Health Insurance Program (SCHIP) was enacted in 1997 as Title XXI of the Social Security Act to provide health care coverage to low-income, uninsured children living in families whose incomes exceed the states' eligibility limits for Medicaid.[16] In general, states and insular areas may design their SCHIP programs in one of three ways—by expanding their Medicaid programs, developing separate child health programs that function independently of Medicaid, or combining these two approaches. As of April 2005, 17 states and insular areas opted to expand their Medicaid programs, 18 states opted to develop separate programs, and 21 states had combination programs. An SCHIP Medicaid expansion must follow Medicaid rules, including enrollment structure and benefits. A state that chooses a separate program has greater flexibility in designing its

[14]Certain administrative expenditures are eligible for higher federal matching rates. For example, there is a 75 percent federal match for quality review of hospital services and the operation of Medicaid management information systems.

[15]According to Puerto Rico government officials, some EPSDT services for children are effectively limited by the federal spending cap.

[16]Pub. L. No. 105-33 § 4901, 111 Stat. 251, 552-570.

SCHIP program and may introduce limited cost-sharing or offer different benefit packages. While Puerto Rico expanded its Medicaid program to cover additional children, none of the other insular areas has developed a unique SCHIP program to extend health insurance coverage to additional children as is done in the states.[17] Instead, the insular areas, besides Puerto Rico, primarily use SCHIP funds to pay for services provided to Medicaid-eligible children once the Medicaid cap has been reached.

Table 36: Estimated SCHIP Enrollment and Federal Allotments, Fiscal Year 2004

	Total for the states, Puerto Rico, and the other insular areas	Puerto Rico	Puerto Rico as percent of total
Enrollment[a]	4.1 million	78,785	1.9
Federal allotments	$3.175 billion	$30.3 million	1.0

Source: GAO analysis of CMS and Puerto Rico data.

[a]The SCHIP enrollment figure represents the number of enrollees in terms of person years. The total number of individuals served by SCHIP in 2004 was 6.1 million, some of whom were enrolled in the program for less than the full year. A similar number for total individuals served by the SCHIP program in Puerto Rico was not available.

In contrast to Medicaid, where federal funding to states is open-ended, the SCHIP statute provides for an annual allotment for each state, Puerto Rico, and the other insular areas for fiscal years 1998 through 2007. The insular areas, including Puerto Rico, receive a total of 0.25 percent of the annual nationwide SCHIP appropriation,[18] which is allotted among them based on set percentages.[19] The SCHIP statute also provides for an enhanced federal

[17]Guam also used SCHIP funds to pay for coverage to children whose coverage was previously paid for by the local government. Although none of the insular areas besides Puerto Rico have not expanded coverage to include additional children, CMS considers insular area SCHIP programs Medicaid expansions.

[18]In addition to the 0.25 percent allotment, each of the insular areas receives supplemental SCHIP payments through fiscal year 2007. For fiscal years 1998 to 2002, the insular areas and Puerto Rico also received redistribution funds, which are SCHIP funds not spent by states within the prior 3-year period. The insular areas are eligible for 1.05 percent of the total available redistribution funds, which are allocated among them according to the percentages each receives of the initial annual allotment. The amounts listed in table 20 include these supplemental funds.

[19]SCHIP funds are allotted in the following proportions: Puerto Rico—91.6 percent; Guam—3.5 percent; the U.S. Virgin Islands—2.6 percent; American Samoa—1.2 percent; and CNMI—1.1 percent.

matching rate that exceeds the rates established by Medicaid. The SCHIP enhanced match is equal to each state's and insular area's Medicaid matching rate plus 30 percent of the difference between the Medicaid match and 100 percent, not to exceed a federal share of 85 percent. Thus, states that receive the minimum 50 percent Medicaid match, receive a 65 percent match under SCHIP. Similarly, because the Medicaid match rate for all insular areas is set at 50 percent, they also receive a 65 percent match rate under SCHIP.

As with the Medicaid program, eligibility for SCHIP in Puerto Rico is tied to its CPL. In 1998, Puerto Rico implemented its SCHIP program for children under age 19 with family incomes between 100 and 200 percent of the CPL. As a Medicaid expansion, Puerto Rico's SCHIP program covers the same benefits and services as provided under its Medicaid program, which are similar, but not the same, as those provided in the states. For states and insular areas, SCHIP administrative expenses are limited to 10 percent of available expenditures.

Health Grants

The states and insular areas also receive health-related grants from a number of agencies within the Department of Health and Human Services (HHS), including the Centers for Disease Control and Prevention (CDC), the Health Resources and Services Administration (HRSA), the National Institutes of Health (NIH), and the Substance Abuse and Mental Health Services Administration (SAMHSA). These four agencies represent the largest sources of health-related HHS grant funds apart from Medicare, Medicaid, and SCHIP.[20] Grants from these agencies may be used to fund a variety of services and activities, including immunization programs, bioterrorism preparedness programs, community health centers, programs for individuals with HIV or AIDS, maternal and child health grants, scientific medical research, and substance abuse prevention and treatment. Grants from CDC, HRSA, and SAMHSA tend to fund direct health service programs and are often awarded to public health agencies, while NIH grants fund scientific medical research and are generally awarded to universities.

[20]Other HHS agencies provide smaller awards that were not considered in this analysis.

Table 37: Population and Estimated Grant Awards from Four Health and Human Service Agencies, Fiscal Year 2004

Dollars in millions

	Total for the states, Puerto Rico, and the other insular areas	Puerto Rico	Puerto Rico as percent of total
Population[a]	285.6	3.8	1.3
Total awards from four HHS agencies	**$33,550.4**	**$272.5**	**0.8**
Center for Disease Control and Prevention (CDC)	4,480.5	47.5	1.1
Health Resources and Services Administration (HRSA)	5,857.6	131.8	2.2
National Institutes of Health (NIH)	20,336.1	59.7	0.3
Substance Abuse and Mental Health Services Administration (SAMHSA)	2,876.2	33.5	1.2

Source: GAO analysis of HHS Tracking Accountability in Government Grants System data.

[a]Population figures are based on the 2000 census and include the states and insular areas.

In general, the process Puerto Rico and the other insular areas must follow to apply for federal grants are the same as in the states. However, differences exist in how some grant awards are calculated. For example, Puerto Rico and the other insular areas are treated differently from the states for two of SAMHSA's grants: The Community Mental Health Block Grant and the substance abuse prevention and treatment block grant. These grants are allocated among the states based on a set formula with a minimum amount for each state. In contrast, Puerto Rico and the other insular areas receive 1.5 percent of the total appropriation in block grant funds. The funds are divided among each insular area according to its share of the total insular area population.[21] However, Puerto Rico is treated as a state for certain other grants, such as the bioterrorism grants from HRSA and CDC.

[21]For both of these block grants, each insular area will receive a minimum amount of $50,000, even if its share of the 1.5% would be less than $50,000.

Income Assistance Programs

Aid to the Aged, Blind, or Disabled

The Social Security Amendments of 1972[22] created Supplemental Security Income (SSI), a cash payment entitlement program that replaced grant programs providing economic assistance to low-income adults who are aged, blind, or disabled in the states. Eligibility for SSI was extended to CNMI, effective 1978. The SSI program does not include Puerto Rico, American Samoa, Guam, or the U.S. Virgin Islands.

Instead, for adults in these groups, these insular areas have continued to operate their grant programs that existed before SSI was created. Puerto Rico, for example, operates an adult assistance program—Aid to the Aged, Blind, or Disabled (AABD). The federal government provides a grant in the form of a 75 percent match of state funds for payments for AABD recipients—subject to a cap on Puerto Rico's combined payments for Temporary Assistance for Needy Families (TANF—see below), AABD, and foster care and related payments—and a 50 percent match for administrative expenses. In contrast to SSI, which has federally determined cash benefits, Puerto Rico determines its own benefit amounts for AABD. In fiscal year 2003, the federal government provided $21 million in benefits to 41,567 AABD recipients. Puerto Rico provided a monthly benefit of $64 for one person. In contrast, the monthly SSI benefit rate for one person not living independently was $368 in January 2003.

Temporary Assistance for Needy Families

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) repealed the Aid to Families with Dependent Children, Job Opportunities and Basic Skills Training, and Emergency Assistance programs and created TANF.[23] The purposes of TANF are to increase state flexibility in operating a program to (1) help needy families care for children at home; (2) end dependence of needy parents upon government benefits by promoting job preparation, work, and marriage; (3) reduce out-of-wedlock pregnancies; and (4) encourage formation and maintenance of

[22] Pub. L. No. 92-603.

[23] Pub. L. No. 104-193.

two-parent families. TANF has a 5-year time limit on federal cash assistance for most families and requires states to impose federally established work and other program requirements on most adults receiving aid. Otherwise, states and insular areas have broad flexibility to design their own eligibility rules and the types of services provided.

The insular areas participating in TANF are subject to the same requirements as the states, although these insular areas are not eligible to receive all of the five TANF grants. The states and Puerto Rico, Guam, and the U.S. Virgin Islands operate TANF programs.[24] American Samoa does not participate in TANF, and CNMI is not eligible because it was not included in PRWORA. Federal funding for Puerto Rico, Guam, the U.S. Virgin Islands, and American Samoa is capped for TANF, AABD, foster care and adoption assistance, and independent living programs. The federal government provides a basic TANF block grant to cover benefits, administrative expenses, and services targeted to needy families in the states and insular areas. The amount of the grant reflects expenditures in pre-TANF programs. To receive this grant, states and insular areas must provide at least 75 percent of the amount of state funds they spent on programs replaced by TANF in fiscal year 1994. Like the states, Puerto Rico, Guam, and the U.S. Virgin Islands can receive additional TANF bonuses for high performance and a reduction in out-of-wedlock births. Furthermore, a special provision allows the insular areas to receive funding above their federal TANF grant if certain conditions are met. Puerto Rico did not qualify to receive such funding in fiscal year 2003.[25] The insular areas are not eligible to receive contingency funds or supplemental grants for population increases that states may qualify to receive. Table 38 compares selected TANF program data on Puerto Rico to national data for fiscal year 2003.

[24]Puerto Rico implemented its TANF program on July 1, 1997.

[25]Under section 1108(b) of the Social Security Act, additional federal matching grant funds (up to the capped amount) are available to an insular area if its expenditures exceed the capped amount of its TANF block grant and its required state expenditure. The total expenditure requirement is $99.7 million.

Table 38: Comparison of Selected Data on TANF Program in Puerto Rico to TANF Program in the States, Fiscal Year 2003

	The states, Puerto Rico, and the other insular areas	Puerto Rico
Total federal expenditure	$16.25 billion[a]	$38.38 million
State expenditures at 75 percent rate	$10.35 billion[a]	$21.19 million
Total number of recipients (as of March 2003)	4.96 million[b]	54,544
Monthly TANF benefits for a family of three	Ranges from $170 to $923, depending on state	$160

Sources: U.S. Department of Health & Human Services, Congressional Research Service: *TANF Cash Benefits As of January 1, 2004,* Puerto Rico fiscal year 2003 State Plan.

[a]Includes only the states, not Puerto Rico or the other insular areas.

[b]Includes the states, Guam, the U.S. Virgin Islands, and Puerto Rico.

Programs for the Care of Children

Child Care and Development Fund

PRWORA increased the amount of federal funding for child-care subsidies for low-income families, with the expectation that the newly implemented work requirements for welfare recipients—many of whom are single mothers—would create a greater demand for child-care services as recipients went to work or participated in training or education. Funding is provided through two funding streams: one discretionary and one mandatory. These two streams constitute the Child Care and Development Fund (CCDF).

All states and all insular areas are eligible to receive CCDF funds. All states and insular areas can receive funds under the discretionary portion of CCDF, but only the states can receive funds under the mandatory portion of the grant. Funding amounts for the discretionary portion of CCDF are determined in the annual appropriations process, while funding amounts for the mandatory portion are directly appropriated by the welfare reform law. CCDF gives states and insular areas greater flexibility to design their child-care policies than previous federal child-care policy.

Table 39: Child Care and Development Fund Expenditures and Children Served, Fiscal Year 2003

	States, Puerto Rico, and the other insular areas	Puerto Rico
Expenditures	$7.25 billion[a]	$57.15 million[b]
Number of children served	1.75 million[c]	25,917[d]

Source: U.S. Department of Health & Human Services.

[a]Includes mandatory, matching, and discretionary CCDF funds for the states, Puerto Rico, and the other insular areas.

[b]Includes only discretionary funds.

[c]Average number of children served per month for the states, American Samoa, and Guam.

[d]Total number of children served for entire year.

Foster Care and Adoption Assistance Funds

Title IV-E of the Social Security Act authorizes the foster care and adoption assistance programs.[26] These programs provide federal funds to help offset child welfare costs related to providing (1) safe, appropriate substitute care for children who need temporary placement outside their homes because of abuse and neglect, and (2) subsidies to families or individuals adopting children who meet certain eligibility requirements. The states and Puerto Rico participate in these programs and receive federal funds for their administration. Table 40 shows the total child welfare population and data for Puerto Rico for fiscal year 2001.

[26]Pub. L. No. 96-272.

Table 40: Estimated Child Welfare Population, Fiscal Year 2001

	Total for the states and Puerto Rico	Puerto Rico	Puerto Rico as percent of total
Children in foster care	542,000	8,476	1.6
Children waiting to be adopted[a]	126,000	418	0.3
Children adopted	50,000	257	0.5

Source: Adoption and Foster Care Analysis and Reporting System, preliminary estimates for fiscal year 2001 (as of March 2003), as reported in U.S. Department of Health and Human Services, Administration for Children and Families, Administration on Children, Youth, and Families, Children's Bureau, *Child Welfare Outcomes 2001: Annual Report to Congress.*

[a]Waiting children are children who have a goal of adoption or whose parents' parental rights have been terminated.

For Puerto Rico, foster care and adoption assistance are two of several public assistance programs that are subject to a federal funding cap, under the 1996 federal welfare law that created the TANF block grant.[27] The total payment to Puerto Rico for all of these programs—adult assistance, TANF, foster care, adoption assistance, and independent living—cannot exceed $107,255,000.

Federal funds are set at the applicable Medicaid matching rate. In fiscal year 2003, the matching rate, which ranged from 50 to 83 percent nationwide, was 50 percent for Puerto Rico. States and insular areas may also claim funds at a rate of 50 percent for administrative costs and at a rate of 75 percent for training costs. In 2003, Puerto Rico did not claim either.

[27]Pub. L. No. 104-193.

Table 41: Estimated Federal Foster Care and Adoption Assistance Funding, Fiscal Year 2003

	Federal share for the states and Puerto Rico	Federal share for Puerto Rico	Puerto Rico as percent of total
Adoption Assistance Payments	$1.17 billion	$373,000	3.2
Foster Care Payments	$1.69 billion	$14 million	0.008

Source: Title IV-E State Claims for Expenditures for fiscal year 2003 (as of May 2004) for Adoption and Foster Care. U.S. Department of Health and Human Services, Administration for Children and Families, Administration on Children, Youth, and Families, Children's Bureau.

Note: According to HHS, for both foster care and adoption, Puerto Rico's claims for the 4th quarter of fiscal year 2003 were estimated using the average of the previous three quarters.

Housing Programs

Public Housing Program

The public housing program was authorized by the United States Housing Act of 1937 to provide decent, safe, and affordable housing for low-income families through public housing authorities (PHA).[28] Through this program, eligible families are able to rent units in single-family or multifamily public housing properties, such as high-rise apartments. Families are generally required to pay 30 percent of their monthly adjusted household income in rent.

Administration and Funding

Public housing is owned and operated by approximately 3,200 PHAs nationwide. Each PHA is responsible for operating and maintaining its public housing inventory and managing the selection of residents.

Public housing can be developed through the construction of units on a site owned by a PHA, development of units on a developer-owned site that is sold to the PHA after completion, or through units that the PHA purchases. The Department of Housing and Urban Development (HUD) has not provided new funding for public housing development since fiscal year 1994. However, PHAs can use capital and HOPE VI funding (see below) for development.

[28]Pub. L. No. 75-412.

HUD provides annual formula-based subsides to PHAs to operate and maintain public housing. These subsidies, which consist of operating and capital (formerly modernization) funds, supplement rent paid by tenants.

Public Housing in Puerto Rico and Other Insular Areas

Operating subsidies for PHAs in the states, Puerto Rico, the U.S. Virgin Islands, and Guam are generally calculated by subtracting estimated rental income from the allowable utility and nonutility expense levels.[29] However, these expenses for Puerto Rico, the U.S. Virgin Islands, Guam, and Alaska were initially determined using a slightly different methodology than that used in most of the states. A HUD public housing fund regulation changed the way operating subsidies are calculated for Puerto Rico, the U.S. Virgin Islands, Guam, and Alaska—these PHAs will no longer receive funding for operating costs outside of the general operating fund formula.

The capital fund grant formula is generally applied in the same way to PHAs in the states, Puerto Rico, and the other insular areas. Regulations governing the administration of public housing also apply to PHAs in the states, Puerto Rico, and the other insular areas. Eligibility rules are the same for all residents, regardless of where they live.

The Puerto Rico Public Housing Administration (PRPHA) administered all 56,524 units of public housing in Puerto Rico in fiscal year 2005. PRPHA ranked third among all PHAs in the amount of annual operating fund subsidy received in fiscal year 2002 (see table 42), and second in the number of public housing units (see table 43). HUD's Caribbean field office is responsible for overseeing PRPHA's administration of these units.

[29]No information was available on public housing in CNMI and American Samoa.

Table 42: Estimated Amount and Percent of Total Operating Subsidy Received by the Five Largest Public Housing Authorities, Fiscal Year 2002

Public housing authority	Operating subsidy (millions)	Percent of total operating subsidy
New York City Housing Authority	$752	22
Chicago Housing Authority	182	5
Philadelphia Housing Authority	102	3
Puerto Rico Public Housing Administration	96	3
Housing Authority of Baltimore City	61	2
National	$3,495	100

Source: HUD.

Table 43: Total Number and Percent of Public Housing Units for the Five Largest Public Housing Authorities, Fiscal Year 2005

Public housing authority	Number of public housing units	Percent of total units
New York City Housing Authority	161,389	13
Puerto Rico Public Housing Administration	56,524	5
Chicago Housing Authority	28,925	2
Philadelphia Housing Authority	16,027	1
Housing Authority of Baltimore City	14,554	1
National	1,200,000	100

Source: HUD.

In fiscal year 2004, PRPHA received approximately $148 million in capital fund grants (approximately 6 percent of that year's appropriation for the capital fund).

Housing Choice Voucher Program

The Housing Choice Voucher Program is HUD's largest housing assistance program. Authorized by the Housing and Community Development Act of 1974 as the Rental Certificate Program, it assists extremely low- to low-income families in obtaining decent, safe, and sanitary rental housing.[30]

Through this program, eligible families rent privately owned units that they would otherwise not be able to afford. Families pay a portion of the rent (generally 30 percent of their monthly income, less deductions), and the local PHA pays the remainder directly to the property owners.

Program Administration and Funding

Expiring increments of Section 8 housing voucher assistance are automatically renewed by HUD. Other vouchers are available either on an as-needed, noncompetitive basis or through competitive Notices of Funding Availability (NOFA).

HUD is responsible for developing policies, regulations, and guidance for the program, allocating funds, providing technical assistance, and monitoring PHAs' compliance with program requirements. PHAs are responsible for determining eligibility, maintaining waiting lists, selecting families for admission, inspecting program units for compliance with housing quality standards, and making housing assistance payments to property owners. Property owners must be willing to participate in the program and are responsible for screening and selecting tenants, collecting tenants' share of the rent, and maintaining the property in compliance with the program's housing quality standards. Families with vouchers are responsible for choosing the house or apartment that they want to rent.

Housing Choice Vouchers in Puerto Rico and the Other Insular Areas

Like Puerto Rico, Guam, CNMI, and the U.S. Virgin Islands are eligible for Housing Choice Vouchers. HUD's Caribbean field office is responsible for overseeing PHAs' administration of Housing Choice Vouchers in Puerto Rico. The formula that HUD uses to determine the number of vouchers in a given area does not make any exceptions for Puerto Rico or the eligible insular areas. The regulations governing the administration of the voucher program apply to PHAs in the states, Puerto Rico, and the eligible insular areas. Eligibility rules are the same for all residents, regardless of where they live.

[30]Pub. L. No. 93-383.

In fiscal year 2003, PHAs in Puerto Rico received approximately $139 million in funding from HUD to administer the voucher program, which was approximately 1.1 percent of total budget outlays for the voucher program for the fiscal year. Seventy-seven PHAs administered approximately 29,000 vouchers in Puerto Rico, or 1.4 percent of total available vouchers. California and New York have the largest number of vouchers, CNMI and the U.S. Virgin Islands have the smallest number of vouchers, and Puerto Rico ranks 33rd among all the states and insular areas that have vouchers (see table 44).

Table 44: Number of Housing Choice Vouchers and Estimated Budget Authority in Puerto Rico and Selected States and Insular Areas, Fiscal Year 2003

State	Number of housing choice vouchers	Estimated budget authority
California	294,701	$2.4 billion
New York	201,558	$1.3 billion
Puerto Rico	28,654	$139 million
U.S. Virgin Islands	1,029	$7 million
CNMI	215	$1.8 million
National	2,054,905	$12,827,326,159

Source: HUD.

Community Development Block Grant Program

HUD's Community Development Block Grant Program (CDBG) is the largest source of federal assistance for state and local governments' community development and neighborhood revitalization activities. These programs include "entitlement grants"—which award grants to qualified units of general local government to provide decent housing and a sustainable living environment and to expand economic opportunities for low- and moderate-income individuals—and state-administered CDBG, which awards grants to states which in turn make grants to nonentitlement units of general local government to carry out similar developmental activities.

Program Administration and Funding

Under the entitlement communities program, HUD determines the amount of each grant by a statutory formula that uses several objective measures of community needs, including the extent of poverty, population, housing overcrowding, age of housing, and population growth lag relative to other metropolitan areas. To receive its annual grant, a grantee must develop and submit to HUD a consolidated plan, certifications, and application for funding. The development goals outlined in the plan serve as the criteria against which HUD will evaluate a jurisdiction's performance and future eligibility for funding.

The state-administered CDBG program is designed to provide funding to nonentitlement areas, which do not receive CDBG funding as part of the entitlement grant program. HUD distributes funds to each state based on a statutory formula that takes into account population, poverty, incidence of overcrowded housing, and age of housing. Participating states award grants to eligible localities to carry out community development activities. Each state annually develops funding priorities and criteria for selecting projects. HUD ensures participating states' compliance with federal laws, regulations, and policies.

CDBG in Puerto Rico and the Other Insular Areas

For purposes of determining CDBG grants, Puerto Rico is considered a state. Thus, the laws and regulations governing the application for, and distribution and use of, CDBG funds apply to Puerto Rico and the states. HUD's Caribbean field office is responsible for overseeing the use of CDBG funds in Puerto Rico.

Each fiscal year, the insular areas may apply for $7 million of CDBG funding. Grant amounts are based on population.

Table 45 provides information on the total CDBG funding for fiscal years 2001 through 2004, and the percentage of those funds that were used by eligible cities and states to fund housing initiatives.

Table 45: Estimated Disbursement of CDBG Funds for Housing, Fiscal Years 2001–2004

Dollars in billions

	Entitlement program	Nonentitlement/state-administered program	Total disbursements (both programs)
Total CDBG funding, fiscal year 2001	$3.5	$1.2	**$4.7**
Percent of total funding used for housing initiatives, fiscal year 2001	29.4	15.1	
Total CDBG funding, fiscal year 2002	$3.8	$1.3	**$5.1**
Percent of total funding used for housing initiatives, fiscal year 2002	27.1	15.1	
Total CDBG funding, fiscal year 2003	$3.4	$1.3	**$4.7**
Percent of total funding used for housing initiatives, fiscal year 2003	27.5	14.9	
Total CDBG funding, fiscal year 2004	$3.5	$1.4	**$4.9**
Percent of total funding used for housing initiatives, fiscal year 2004	27.0	16.4	

Source: HUD.

In fiscal year 2004, Puerto Rico received approximately $130 million in total CDBG funding—3 percent of total funding for the year. Collectively, Guam, the U.S. Virgin Islands, American Samoa, and CNMI received about $6.96 million in fiscal year 2004. Table 45 provides information on how areas in Puerto Rico receiving CDBG funds in fiscal year 2004 used some of their CDBG funds for housing-related initiatives.

HOPE VI Program

Originally known as the Urban Revitalization Demonstration, the HOPE VI Program was developed as a result of recommendations by the National Commission on Severely Distressed Public Housing. In its August 10, 1992, report to Congress, the commission recommended revitalization in three general areas: physical improvements, management improvements, and social and community services to address resident needs.

On the basis of this recommendation, in October 1992, Congress appropriated $300 million for the Urban Revitalization Demonstration, also known as HOPE VI, as part of the Independent Agencies Appropriations Act of 1993.[31] The program is designed to replace severely distressed public housing with mixed-income housing and to provide housing vouchers to enable some of the original public housing residents to rent apartments in the private market. The program was authorized through annual appropriations until fiscal year 1999 when it was separately authorized as part of the Quality Housing and Work Responsibility Act of 1998.[32] In fiscal years 2004, 2005, and 2006 Congress appropriated $150 million, $144 million, and $100 million, respectively, for the HOPE VI program.

Program Administration and Funding

Any PHA that has severely distressed public housing units is eligible to apply for a HOPE VI revitalization or demolition grant. HOPE VI revitalization grants fund capital costs of major rehabilitation, new construction, and other physical improvements; demolition of severely distressed public housing; acquisition of sites for off-site construction; and community and supportive service programs for residents, including those relocated as a result of revitalization efforts. HOPE VI demolition grants fund the demolition of severely distressed public housing and relocation of residents as a result of the demolition.

HUD's requirements for HOPE VI grants are laid out in each fiscal year's grant agreement and NOFA, which announces the availability of funds and contains application requirements, threshold requirements, rating factors,[33] and information on the application selection process. HUD has used the

[31]Pub. L. No. 102-389.

[32]Pub. L. No. 105-276.

[33]A threshold requirement is a requirement that an applicant must meet to be eligible for a HOPE VI revitalization grant. Threshold requirements may include the following: (1) the PHA must have met all performance requirements under any of its existing HOPE VI grants to apply for additional grants, (2) the PHA must submit certification by an engineer or architect that the project is severely distressed, and (3) the PHA must verify compliance with applicable fair housing civil rights laws. A rating factor is a category used to evaluate specific aspects of the application, such as funding need. For each factor, HUD can award points, which are used to evaluate PHAs' applications for revitalization grants.

same procedure each year to screen, review, and rank grant applications: when grant applications are received, they are screened to determine whether they meet the eligibility and threshold requirements in the NOFA. Next, reviewers rate applications on the basis of the rating factors described in the NOFA and rank them. Generally, a group of applications representing twice the amount of funds available is sent to a final review panel. The final review panel assigns a final score and recommends for selection the highest rated applications, subject to the amount of available funding.

HOPE VI in Puerto Rico and the Other Insular Areas

HUD NOFA requirements and guidelines are generally applied to the PHAs in the states, Puerto Rico, and the other insular areas in the same way. HUD's Office of Public Housing Investments at HUD headquarters is responsible for monitoring the implementation of HOPE VI grants and revitalization plans.

HOPE VI Grants

Between fiscal years 1993 and 2003, PRPHA received one HOPE VI revitalization grant, of $50 million. In that same decade, HUD made a total of 217 revitalization grants worth approximately $5.5 billion to 118 PHAs in 34 states, the District of Columbia, and Puerto Rico.[34]

Between fiscal years 1996 and 2003, Puerto Rico did not receive a HOPE VI demolition grant. During the same period, the U.S. Virgin Islands received four such grants, totaling approximately $5 million. In that same period, HUD made 287 demolition grants worth $395 million to 125 PHAs in 34 states, the District of Columbia, and the U.S. Virgin Islands.

HOME Investment Partnerships Program

The HOME Investment Partnerships Program is a federal formula block grant to state and local governments designed to create affordable housing for low-income households. The program provides funds to states and localities to build, buy, and rehabilitate affordable housing for rent or homeownership. Also, funds can be given to low-income people to help pay their rent. At least 90 percent of HOME funds used for rental housing and rental assistance must be used for families whose income is below 60 percent of the median income in their area; in rental projects with five or more assisted units, at least 20 percent of the units must be occupied by families with incomes that do not exceed 50 percent of the median income.

[34]No information was available on HOPE VI funding in American Samoa, Guam, and CNMI.

Homeownership assistance must benefit families below 80 percent of the median income in their area.

Program Administration and Funding

Program funds are allocated to state and local governments based on a formula that considers the relative inadequacy of each jurisdiction's housing supply, incidence of poverty, fiscal distress, and other factors. Shortly after HOME funds become available each year, HUD informs eligible jurisdictions of the amounts allocated for them. HUD establishes trust funds for each grantee, providing a line of credit that the jurisdiction may draw upon as needed.

The participating jurisdiction is responsible for managing the day-to-day operations of its HOME program, ensuring that funds are used according to program requirements and written agreements and taking appropriate actions when performance problems arise.

HOME in Puerto Rico and the Other Insular Areas

For purposes of determining grants under the program, Puerto Rico is considered a state.[35] Thus, the laws and regulations governing the application for, and distribution and use of, HOME funds apply to Puerto Rico as they do to the states. HUD's Caribbean field office is responsible for overseeing the use of HOME funds in Puerto Rico. HUD regulations cap the amount of funding Puerto Rico and its localities can receive under HOME.

The initial HOME allocation amount for each of the insular areas is based on its population and occupied rental units compared to all the insular areas. HUD may reduce an insular area's allocation based on its performance in using HOME funds. The Honolulu field office is responsible for overseeing the use of HOME funds in Guam, American Samoa, and CNMI. HUD's Caribbean office is responsible of overseeing the use of HOME funds in the U.S. Virgin Islands.

For fiscal year 2005, Puerto Rico and the other insular areas received HOME grants totaling $37,349,848, approximately 2 percent of total HOME funding for the year (see table 46).

[35]For purposes of the American Dream Downpayment Initiative—a subprogram under HOME that provides downpayment and closing cost assistance to low-income families.

Table 46: Estimated Amount of HOME Grants for Puerto Rico and the Other Insular Areas, Fiscal Year 2005

	Total grant amount
Puerto Rico: state	$17.8 million
Puerto Rico: local (27 localities)	15.9 million
Total for Puerto Rico	**$33.7 million**
Guam	1.4 million
U.S. Virgin Islands	1.2 million
CNMI	642,000
American Samoa	338,000
Total for Insular Areas	**$37.3 million**

Source: HUD.

Project-based Section 8 Program

The Housing and Community Development Act of 1974[36] amended the U.S. Housing Act of 1937 to create project-based Section 8, under which a variety of programs provide rental housing assistance payments to private landlords on behalf of eligible families.[37] The objective of the program is to provide decent, safe, and sanitary housing to families that have extremely low-to low-incomes.

Project-based Section 8 subsidies are linked to specific multifamily properties, wherein all the units may be subsidized by the program. The subsidy can be used in properties with subsidized mortgages or mortgage insurance under various multifamily housing programs or in properties that have been privately financed.[38]

Through rent subsidies, payments to private landlords cover the difference between what the family is required to pay (generally 30 percent of adjusted income) and the actual rent for the property. Because the subsidy is linked to the unit, tenants lose the subsidy if they move.

[36]Pub. L. No. 93-383.

[37]Project-based Section 8 refers to the following programs: New Construction/Substantial Rehabilitation, Loan Management Set-Aside, Property Disposition, Moderate Rehabilitation, and Preservation.

[38]Examples include programs under HUD's sections 221(d)(3) or 221(d)(4), Section 202, and Section 236 programs, and the Department of Agriculture's Section 515 program.

Program Administration and Funding

HUD has primary responsibility for contract administration but has assigned portions of these responsibilities to project-based contract administrators, generally state housing finance agencies or PHAs. Private owners enter into individual housing assistance payment contracts for each of their properties receiving assistance.

Congress appropriates the amount of project-based Section 8 funding available to HUD each fiscal year. Funding for project-based Section 8 is currently available only as contract renewals for properties with existing contracts. While no new funding is available, families that are not receiving assistance may apply for subsidies on properties with existing project-based rental assistance contracts.

Project-based Section 8 in Puerto Rico

In 2000, HUD began transferring the administration of eligible project-based Section 8 contracts in Puerto Rico from HUD field offices to the Puerto Rico Housing Finance Corporation, a contract administrator. HUD's Atlanta field office is responsible for overseeing the corporation's oversight of project-based Section 8 contracts in Puerto Rico.

Regulations governing the administration of the program apply to property owners and contract administrators in the particular state or insular area (the Guam administrator also oversees CNMI). Eligibility rules are the same for residents in all areas. As of 2004, Puerto Rico, Guam, and the U.S. Virgin Islands all had project-based Section 8 properties.

In fiscal year 2005, the Puerto Rico Housing Finance Cooperation administered about 180 project-based Section 8 contracts covering more than 19,000 units.

Section 203(b) Single Family Mortgage Insurance Program

The Federal Housing Administration (FHA) Section 203(b) mortgage insurance program promotes homeownership for families with low to moderate incomes by providing mortgage insurance for the purchase or refinancing of a principal residence. The program provides mortgage insurance to protect lenders, such as mortgage companies, banks, and savings and loan associations, against the risk of default on loans to qualified buyers. The insurance allows homebuyers to finance approximately 97 percent of the home's cost through their mortgage.[39]

The Section 203(b) Single-Family Mortgage Insurance Program in Puerto Rico and the Other Insular Areas

Individuals in the states, Puerto Rico, Guam, and the U.S. Virgin Islands are eligible for the program. HUD insures 203(b) mortgages and oversees the selling of homes where families with Section 203(b) insurance cannot meet their payments.[40]

Section 214 of the National Housing Act[41] provides that Section 203(b) mortgage limits for Alaska, Guam, Hawaii, and the U.S. Virgin Islands may be adjusted up to 150 percent of the mortgage ceilings set for those areas. This provision, however, does not apply to Puerto Rico or the other insular areas.

For fiscal year 2006, HUD commitments to guarantee single-family loans cannot exceed a loan principal of $185 billion for the Section 203(b) program. In fiscal year 2004, 8,269 residents of Puerto Rico received a Section 203(b) loan. As of April 2005, halfway through fiscal year 2005, 4,162 residents had received such a loan.

[39]Another HUD program, the Section 203(k) program, enables homebuyers and homeowners to finance the purchase (or refinancing) and rehabilitation of a house that is at least a year old through a single mortgage.

[40]When this occurs, the lender forecloses on the home: HUD pays the lender what is owed, takes ownership of the home, and attempts to sell the home at its market value.

[41]12 U.S.C. 1715d.

U.S. Gross Domestic Product Deflator and Puerto Rican Gross Product Deflator, 1980–2005

	U.S. GDP Deflator	Puerto Rico Gross Product Deflator
	(2005=100)	(2005=100)
1980	46.788	36.358
1981	51.306	39.729
1982	55.262	42.402
1983	57.990	44.746
1984	60.138	46.853
1985	62.234	48.117
1986	63.762	49.631
1987	65.322	51.001
1988	67.264	52.805
1989	69.863	54.648
1990	72.405	57.743
1991	75.228	60.403
1992	77.357	62.260
1993	79.083	63.919
1994	80.811	66.078
1995	82.560	68.225
1996	84.175	70.490
1997	85.680	72.623
1998	86.824	76.363
1999	87.915	80.011
2000	89.492	84.080
2001	91.562	88.083
2002	93.534	90.440
2003	95.248	93.284
2004	97.393	96.326
2005	100	100

Source: Bureau of Economic Analysis and the Puerto Rico Planning Board.

Note: The U.S. series has been adjusted to reflect the Puerto Rican fiscal year.

Agency Comments

COMMONWEALTH OF PUERTO RICO

ANÍBAL ACEVEDO VILÁ
GOVERNOR

May 15, 2006

Mr. James R. White
Director, Tax Issues
Government Accountability Office
441 G Street, N.W.,
Washington, D.C. 20548

Dear Mr. White:

We appreciate the opportunity that the Government Accountability Office (GAO) has given to the Government of the Commonwealth of Puerto Rico to review and comment on its report to the Senate Finance Committee on Puerto Rico's economy and the impact of U.S. federal tax policy. The leadership of the Senate Finance Committee requested this report to determine the need for new incentives to generate private investment in Puerto Rico. Its conclusions demonstrate the critical role that sound federal tax incentives can have on job creation in Puerto Rico.

It is important to highlight the disproportionate manufacturing job loss in Puerto Rico over the last 10 years. Congress in 1996 departed from long-established Federal tax policy and phased out the possessions tax credit for U.S. investment in Puerto Rico. In the ten years following enactment of legislation phasing out the possessions tax credit, Puerto Rico has lost over 48,000 manufacturing jobs or 30.2 percent of its manufacturing workforce -- far greater than the 18.2 percent decline in manufacturing employment in the rest of the United States.

The GAO report confirms this dramatic job loss in Puerto Rico and shows that manufacturing value added has stagnated since 1997 following enactment of legislation repealing the possessions tax credit in October 1996. However, the report does not attempt to project what the current level of manufacturing employment and value added in Puerto Rico would have been had the credit not been repealed, nor does it attempt to quantify the impact of the repeal of the possession tax credit on the Puerto Rico economy or take account of the economic linkages that exist between the manufacturing sector and other sectors of the Puerto Rican economy. As the report shows, manufacturing value

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May 15, 2006
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added in Puerto Rico had been growing at a robust rate prior to the repeal of the credit — a very different picture from the stagnation in high paying manufacturing jobs that has followed since 1996.

From the adoption of "Operation Bootstrap" in 1948 until the early 1970s, Puerto Rico's GNP per capita was converging with that of the rest of the United States; however, per capita income remains at one-third of the U.S. level, and the lack of growth in manufacturing since 1997 has been a major obstacle to further convergence.

Through aggressive efforts to attract new companies in cutting edge industries such as bioengineering, the Commonwealth government has been able to mitigate job losses. The pharmaceutical and bio industries have grown in Puerto Rico since 1997, but this has not been sufficient to allow the overall manufacturing sector to grow. As the report makes clear, if Puerto Rico is to narrow the gap in per capita income with the rest of the United States, it needs to encourage additional investment.

Since the beginning of its association with the United States in 1898, Puerto Rico has been granted taxing jurisdiction, or fiscal autonomy, with respect to Puerto Rican residents and corporations. Beginning with the Revenue Act of 1921, federal tax policy has mitigated U.S. taxation of income earned in Puerto Rico (and certain other U.S. possessions) by U.S. corporate investors. The purpose of the possessions tax credit, which expired for tax years beginning after 2005, was to promote employment-creating investment in Puerto Rico and the possessions. The credit served to offset U.S. imposed regulatory costs on companies doing business in Puerto Rico and encouraged the creation of high-wage local employment opportunities comparable to those on the mainland.

This successful policy, though modified in its particulars from time to time, has produced great results. Since the establishment of "Operation Bootstrap" in 1948, Puerto Rico has developed from one of the poorest islands in the Caribbean -- comparable at that time to Haiti -- into a modern industrial society with the highest standard of living in all of Latin America. As part of this transformation, Puerto Rico has become the 12th largest merchandise export market for the United States, generating and supporting over 280,000 jobs on the U.S. mainland.

With the repeal of the possessions credit, future job growth in Puerto Rico largely will depend on investments made through foreign subsidiaries of U.S. companies, so-called controlled foreign corporations ("CFCs"). Puerto Rico must compete for U.S. investment with many low tax jurisdictions such as Mexico, Malaysia, Ireland, and Singapore. U.S. companies investing in these countries are not subject to U.S. minimum wage, environmental, health and safety, shipping, and other federal regulatory requirements that

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typically are more rigorous than those imposed by competitor countries. With the repeal of the possessions credit, Puerto Rico must compete with foreign countries for U.S. investment without any U.S. tax advantage. Worse, the United States imposes higher taxes on income from manufacturing in Puerto Rico than in the 50 states, because the manufacturing deduction (Code section 199) does not apply to possessions manufacturing. In summary, without a Federal tax policy that recognizes these realities, Puerto Rico's economic development will face difficult challenges in the years to come.

On behalf of the Commonwealth Government I would like to express my appreciation for the hard work that you and your staff have put into this report. I am confident that it will be useful to the Congress in evaluating options for promoting investment and jobs in Puerto Rico.

Sincerely,

Aníbal Avecedó Vila

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Highlights

Highlights of GAO-06-541, a report to Committee on Finance, U.S. Senate

Why GAO Did This Study

The federal possessions tax credit, which was designed to encourage U.S. corporate investment in Puerto Rico and other insular areas, expires this year.

Proponents of continued federal economic assistance to Puerto Rico have presented a variety of proposals for congressional consideration.

In response to a request from the U.S. Senate Committee on Finance, this study compares trends in Puerto Rico's principal economic indicators with those for the United States; reports on changes in the activities and tax status of the corporations that have claimed the possessions tax credit; explains how fiscal relations between the federal government and Puerto Rico differs from the federal government's relations with the states and other insular areas; and compares the taxes paid to all levels of government by residents of Puerto Rico, the states, and other insular areas.

GAO used the latest data available from multiple federal and Puerto Rican government agencies. Data limitations are noted where relevant. Key findings are based on multiple measures from different sources. GAO is not making any recommendations in this report.

In comments on this report the Governor of Puerto Rico said the report will be useful for evaluating policy options.

www.gao.gov/cgi-bin/getrpt?GAO-06-541.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-9110 or whitej@gao.gov.

May 2006

PUERTO RICO

Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit

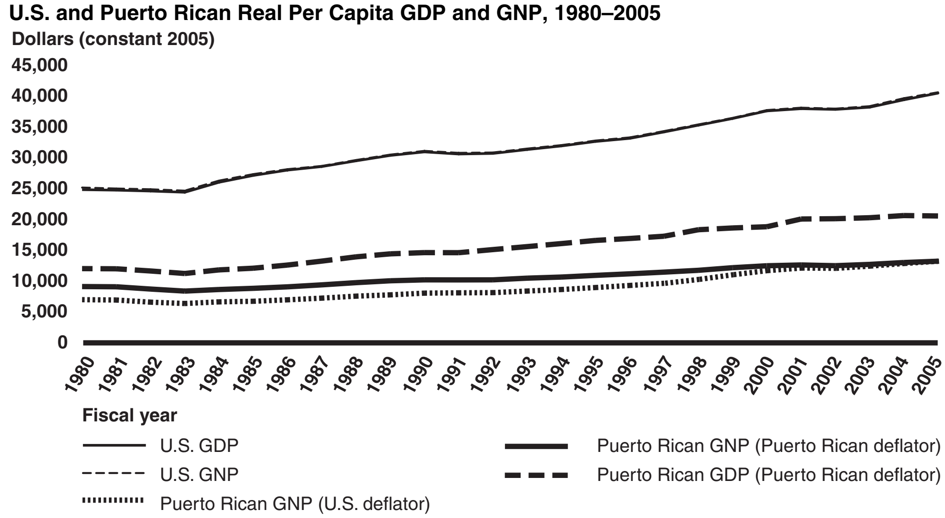
What GAO Found

Puerto Rico's per capita gross domestic product (GDP, a broad measure of income earned within the Commonwealth) in 2005 was a little over half of that for the United States (see figure below). Puerto Rico's per capita gross national product (GNP, which covers income earned only by residents of the Commonwealth) was even lower relative to the United States. Concerns about Puerto Rico's official price indexes make it difficult to say whether the per capita GNP of Puerto Rican residents has grown more rapidly than that of U.S. residents; however, the absolute gap between the two has increased.

U.S. corporations claiming the possessions tax credit dominated Puerto Rico's manufacturing sector into the late 1990s. After the tax credit was repealed in 1996 beginning a 10-year phaseout period, the activity of these corporations decreased significantly. Between 1997 and 2002 (the latest data available) valued added in these corporations decreased by about two-thirds. A variety of data indicates that much of this decline was offset by growth in other corporations, so that some measures of aggregate activity remained close to their 1997 levels. For example, value added in manufacturing remained fairly constant between 1997 and 2002. Most of the offsetting growth was in the pharmaceutical industry.

Residents of Puerto Rico pay considerably less total tax per capita than U.S. residents. However, because of lower incomes they pay about the same percentage of their personal income in taxes. The composition of taxes differed between Puerto Rico and the states with federal taxes being a larger share of the total in the states. This difference reflects the facts that (1) residents of Puerto Rico generally do not pay federal income tax on income they earn in the Commonwealth and (2) the Commonwealth government has a wider range of responsibilities than do U.S. state and local governments.

U.S. and Puerto Rican Real Per Capita GDP and GNP, 1980–2005



Source: GAO analysis of U.S. Bureau of Economic Analysis and Puerto Rican Planning Board data.