United States Government Accountability Office

Report to Congressional Requesters

March 2014

PUERTO RICO

Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources

GAO Highlights

Highlights of GAO-14-31, a report to congressional requesters

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Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources

Why GAO Did This Study

Puerto Rico has access to many federal programs, and is subject to certain federal tax laws; however, for some programs and for some aspects of tax law, Puerto Rico is treated differently than the states. Options for Puerto Rico's political status include statehood.

GAO was asked to review potential fiscal implications for federal programs if Puerto Rico were to become a state. This report examines potential changes to selected federal programs and related spending changes, and changes to selected federal revenue sources that would be expected should Puerto Rico become a state. This report also discusses economic and fiscal factors under statehood that could influence changes in spending and revenues.

To evaluate potential changes to selected federal programs and revenue sources, GAO reviewed federal laws and regulations and interviewed federal and Puerto Rico agency officials. To discuss factors that could influence changes in spending and revenue, GAO reviewed economic data from Puerto Rico's government and interviewed officials from the current and past Puerto Rico government administrations.

What GAO Recommends

GAO is not making recommendations. Federal agency and Puerto Rico government officials reviewed GAO's draft report; their comments were incorporated as appropriate.

To view the Spanish translation of this highlights page, please see GAO-14-301.

View GAO-14-31. For more information, contact Stanley J. Czerwinski at (202) 512-6520 or czerwinskis@gao.gov.

What GAO Found

Of the 29 federal programs GAO reviewed (which accounted for about 86 percent of federal program spending for states or their residents in fiscal year 2010), statehood would likely affect 11 programs. For 3 other programs, while the programs themselves would likely not change under statehood, eligibility determinations for these programs could be affected indirectly by changes that could occur to benefits in other programs. Statehood would not likely affect the 15 remaining programs. See figure below.

Determination of Whether Puerto Rico Statehood Would Affect Selected Federal Programs

Likely to change	• Medicare • Medicaid • Supplemental Nutrition Assistance Program • Supplemental Security Income	• Federal-Aid Highways • Pell Grants • Temporary Assistance for Needy Families	• Title I Grants to Local Educational Agencies • Children's Health Insurance Program • Post-911 GI Bill • Federal Direct Student Loan Program
Eligibility determination may be affected	• Section 8 Housing Assistance Payments Program (Tenant-based)	• Section 8 Housing Assistance Payments Program (Project-based)	• Special Supplemental Nutrition Program for Women, Infants, and Children
Not likely to change	• Social Security – Old Age and Survivor Benefits • Social Security – Disability Insurance • Unemployment Insurance • Veterans Disability Compensation • Deposit Insurance	• National Institutes of Health Extramural Research • Special Education Grants to States • Social Insurance for Railroad Workers • Mutual Mortgage Insurance Program • National School Lunch Program	• Head Start Program • Public Housing Operating Fund • Disaster Relief Public Assistance Grants for Presidentially Declared Disasters • Public Housing Capital Fund • Central Liquidity Facility

Source: GAO analysis of laws and regulations, and discussions with listed program agency officials.

The extent to which federal spending would change for some of the programs affected by Puerto Rico statehood depends on various assumptions: these assumptions include the program eligibility options Puerto Rico might select or the rates at which eligible residents might participate in the programs. For example, for the four largest programs for which federal spending likely would change under statehood—Medicare, Medicaid, the Supplemental Nutrition Assistance Program (SNAP), and Supplemental Security Income (SSI)—GAO used various assumptions to estimate the range of potential effects on federal program spending. The estimated ranges for the four programs, as described below, are based on Puerto Rico being treated the same as the states in either 2010 or 2011, based on the year for which GAO had the most recent data.

Medicare: In fiscal year 2010, actual federal Medicare spending in Puerto Rico was $4.5 billion; if Puerto Rico had been a state in calendar year 2010, estimated federal spending would have ranged from $4.5 billion to $6.0 billion. The Medicare estimates take into account certain changes under the Patient Protection and Affordable Care Act occurring after 2010 that would reduce spending. Also, the Medicare estimates depend on the estimates for Medicaid, as some individuals are eligible for both programs.

Medicaid: In fiscal year 2011, actual federal Medicaid spending in Puerto Rico was $685 million; if Puerto Rico had been a state in calendar year 2011, estimated federal spending would have ranged from $1.1 billion to $2.1 billion. The Medicaid estimates do not take into account the cost of nursing home and home health services in Puerto Rico due to the lack of available cost data, and because Puerto Rico lacks an infrastructure of nursing home facilities, according to Centers for Medicare & Medicaid Services officials. If these services became available, Medicaid spending would likely increase.

SNAP: In fiscal year 2011, actual federal spending for a similar program in Puerto Rico was $1.9 billion; if Puerto Rico had been a state in calendar year 2011, residents would have been eligible for SNAP, and estimated federal spending would have ranged from $1.7 billion to $2.6 billion. One reason why the low end of the estimate range is less than actual spending is because participants' benefits would be reduced because of benefits received from SSI, for which Puerto Rico residents would newly qualify.

SSI: In fiscal year 2011, actual federal spending for a similar program in Puerto Rico was $24 million; if Puerto Rico had been a state in calendar year 2011, residents would have been eligible for SSI, and estimated federal spending would have ranged from $1.5 billion to $1.8 billion.

All the federal revenue sources GAO reviewed—individual and corporate income taxes, employment tax, excise tax, estate and gift taxes, and customs duties—could be affected if Puerto Rico became a state. For example, under statehood, Puerto Rico residents would be subject to federal tax on all their income: currently, they are subject to federal tax only on income from sources outside of Puerto Rico. Also, some sources of income, such as pension income, are taxed differently in Puerto Rico than in the states. As a result, for 2010, Puerto Rico filers' adjusted gross income for federal tax purposes would have been higher than that for Puerto Rico tax purposes. For some revenue sources, the extent to which federal revenue would change depends on various assumptions. For example, for the two largest revenue sources that would be affected substantially by statehood—individual and corporate income taxes—GAO used various assumptions to estimate a range of federal revenue. The estimate ranges, as described below, are based on Puerto Rico being treated the same as the states in either 2009 or 2010, based on the year for which GAO had the most recent data.

Individual income tax: In 2010, Puerto Rico taxpayers reported paying $20 million to the United States, its possessions, or foreign countries. According to officials from Puerto Rico's Department of Internal Revenue, most of these payments would have been to the United States. If Puerto Rico had been a state in 2010, estimated individual income tax revenue from Puerto Rico taxpayers would have ranged from $2.2 billion to $2.3 billion (after accounting for estimated payments in excess of tax liability from refundable tax credits, such as the earned income tax credit).

Corporate income tax: In 2009, U.S. corporations paid about an estimated $4.3 billion in tax on income from their affiliates in Puerto Rico. Most of this amount was from an unusually large amount of dividends repatriated from Puerto Rico (compared to amounts repatriated in earlier years or in 2010). Absent that spike in dividends, the federal taxes these corporations would have paid for 2009 would have been about $1.4 billion. If Puerto Rico had been a state in 2009, estimated corporate income tax revenue from businesses that filed a Puerto Rico tax return for that year (or their parent corporations in the United States) would have ranged from $5.0 to $9.3 billion. The low end of this range assumes that U.S. corporations would have used prior-year losses of affiliated Puerto Rico corporations to offset their federal taxable income to the maximum extent (leaving only smaller or newly generated losses available to offset income in subsequent years), among other assumptions. However, this range does not take into account any behavioral changes of businesses with activities in Puerto Rico. For example, according to tax policy experts at the Department of the Treasury and the Joint Committee on Taxation, changes in federal income tax requirements under statehood would likely motivate some corporations with substantial amounts of income derived from intangible (and therefore mobile) assets to relocate from Puerto Rico to lower tax foreign locations. The extent to which such corporations might relocate from Puerto Rico is unknown. Consequently, GAO produced an alternative set of revenue estimates to account for some businesses with activities in Puerto Rico potentially relocating under statehood: this range was -$0.1 billion to $3.4 billion. The low end of this range is negative because U.S. corporations would have used their Puerto Rico affiliates' prior-year losses to reduce their taxes to such an extent that they would have more than offset the positive tax amounts that other corporations continuing to operate in Puerto Rico under statehood would have paid.

Puerto Rico faces various economic and fiscal challenges that could potentially impact changes in federal spending and revenue under statehood. For example, its economy largely has been in recession since 2006, and its levels of employment and labor force participation are relatively low, compared to those of the states. Persistent deficits have resulted in an increase in Puerto Rico's public debt, which represents a much larger share of personal income than in any state (and in February 2014, Puerto Rico's general obligation bonds were downgraded to speculative—noninvestment—grade by three ratings agencies). Puerto Rico has taken recent steps to improve its fiscal position, such as reducing its government workforce and reforming its largest public employee retirement system. Changes in federal program spending and to federal tax law under statehood could lead to economic and fiscal changes of their own in Puerto Rico. That may have a cascading effect on federal spending and revenue levels. However, the precise nature of such changes is uncertain. Because statehood would cause numerous adjustments important to Puerto Rico's future, it would require careful consideration by Congress and the residents of Puerto Rico. Consequently, statehood's aggregate fiscal impact would be influenced greatly by the terms of admission, strategies to promote economic development, and decisions regarding Puerto Rico's government revenue structure.

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Abbreviations

AABD	Aid to the Aged, Blind, and Disabled
AOTC	American Opportunity Tax Credit
CHIP	Children's Health Insurance Program
CHIPRA	Children's Health Insurance Program Reauthorization Act of 2009
CLF	Central Liquidity Facility
CMS	Centers for Medicare & Medicaid Services
CBO	Congressional Budget Office
CRS	Congressional Research Service
CTC	child tax credit
DSH	Disproportionate Share Hospital
ED	U. S. Department of Education
EITC	earned income tax credit
FHWA	Federal Highway Administration
FMAP	federal medical assistance percentage
FNS	Food and Nutrition Service
FPL	federal poverty level
GDP	gross domestic product
GNP	gross national product
HCERA	Health Care and Education Reconciliation Act of 2010
HPC	Health Policy Center
IPPS	Inpatient Prospective Payment System
IRS	Internal Revenue Service
LEA	local educational agency
MA	Medicare Advantage
MAP-21	Moving Ahead for Progress in the 21st Century Act
MCBS	Medicare Current Beneficiary Survey
MCO	managed care organization
Medicare FFS	Medicare fee-for-service
MSP	Medicare Savings Program
NAP	Nutrition Assistance Program
OMB	Office of Management and Budget
OPPS	Outpatient Prospective Payment System
PPACA	Patient Protection and Affordable Care Act
PRCS	Puerto Rico Community Survey
Recovery Act	American Recovery and Reinvestment Act of 2009
SNAP	Supplemental Nutrition Assistance Program
SNP	Special Needs Plan

SSA	Social Security Administration
SSI	Supplemental Security Income
TANF	Temporary Assistance to Needy Families
TRIM3	Transfer Income Model, version 3
USDA	U. S. Department of Agriculture
VA	Department of Veterans Affairs
WIC	Special Supplemental Nutrition Program for Women, Infants and Children

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March 4, 2014

The Honorable Doc Hastings
Chairman
Committee on Natural Resources
House of Representatives

The Honorable John Fleming
Chairman
Subcommittee on Fisheries, Wildlife, Oceans, and Insular Affairs
Committee on Natural Resources
House of Representatives

In some ways, Puerto Rico—the largest and most populous territory[1] of the United States—has a fiscal relationship with the federal government similar to that with the states.[2] For example, Puerto Rico's residents have access to many federal programs and are subject to certain federal tax laws. However, for some federal programs, Puerto Rico or its residents are subject to different requirements or funding rules than are the states or their residents. Likewise, some federal tax laws apply differently to Puerto Rico residents and corporations than to residents of the states and corporations in the states.

Puerto Rico's political status has been debated for over a century. The policy of the federal executive branch has long been that Puerto Rico's status should be decided by the people of Puerto Rico (although Congress has ultimate authority over the admission of states). To that end, since the 1960s, Puerto Rico has held four plebiscites intended to determine its preferred status relationship with the United States, most

[1]The U.S. Department of the Interior, Office of Insular Affairs, currently defines a territory as an unincorporated insular area: a jurisdiction that is neither a part of one of the several states nor a federal district. The Office of Insular Affairs does not exercise any responsibilities in relation to Puerto Rico.

[2]In this report, the term states refers to the 50 states and the District of Columbia, unless otherwise noted.

recently in 2012.[3] Statehood has been one of the status options included in those plebiscites.[4] If Puerto Rico were to become a state, fiscal relations between it and the federal government would likely change.

You asked us to review the potential fiscal implications for federal programs if Puerto Rico were to become a state. The objectives of this report are to evaluate (1) potential changes to selected federal programs and related changes in federal spending, and (2) potential changes to selected sources of federal revenue, should Puerto Rico become a state. We also describe factors under statehood that could influence changes in federal spending and revenue, such as the effect of statehood on Puerto Rico's economy and public finances.

To evaluate potential changes to selected federal programs under Puerto Rico statehood, we used data from fiscal years 2010 and 2011[5] to identify programs that generally provide funds directly to states and territories, or

[3]A plebiscite is a binding or non-binding referendum on a proposed law, constitutional amendment, or significant public issue. These four plebiscites were non-binding. In addition to the four plebiscites, in 1991, Puerto Rico held a referendum on rights that would have been incorporated into its constitution, including the right to determine its status relationship without being subject to the plenary powers of Congress. The referendum was not approved.

[4]Ballot wording or options in past plebiscites have varied, but have included options—in addition to statehood—such as various forms of the status quo, including commonwealth; independence; and free association. For an overview of the various definitions and debates surrounding Puerto Rico's status, see Congressional Research Service, *Puerto Rico's Political Status and the 2012 Plebiscite: Background and Key Questions* (Washington, D.C.: June 25, 2013).

[5]We used data from 2010 because they were the most recent available when we began our work. Once data from 2011 became available, we assessed whether our program selection would have differed had we used data from that year. Since we found few differences, we did not change our original program selection. The five largest federal programs that would change under statehood based on outlay data for 2010 were also the five largest that would change based on 2011 data.

residents and institutions in the states and territories.[6] Among those programs, we identified those that had total federal net outlays of at least $5 billion and/or programs for which federal spending in Puerto Rico differed by at least $100 million from spending in a set of comparable states. Based on these criteria, we selected 29 programs to review, which accounted for about 86 percent of spending in fiscal year 2010 on programs that generally provide funds directly to states and territories, or residents and institutions in the states and territories.

For each selected program, we reviewed relevant laws and regulations and interviewed federal (and in some cases Puerto Rico) agency officials to determine if and how spending would change under Puerto Rico statehood. For some programs, current law applies certain limitations or exceptions to Puerto Rico by name. For other programs, the governing statutes refer to the 50 states or the 50 states and the District of Columbia. For these programs, we assumed that if Puerto Rico became a state, it would be treated the same as any existing state, either because Congress would amend the statutory limitations and exceptions or because they would otherwise not apply.[7]

To evaluate potential changes in federal spending that could result from potential changes to federal programs, we developed estimates of federal spending under statehood for some programs. The programs for which we developed estimates accounted for about 94 percent of fiscal year 2010 spending on programs that would likely change under statehood. For these programs, we developed a range of estimated spending for a single year in the past, as if Puerto Rico had been treated like the other

[6]Based on this criterion, we excluded certain types of federal spending from our review. Specifically, we excluded spending on the military; international aid and affairs; interest on the national debt; and administrative, operational, procurement, or capital acquisition expenses at federal agencies, including federal employee salaries and retirement compensation. One aspect of military spending—the Department of Defense's TRICARE Prime program—would be likely to change under statehood. A 2011 Department of Defense Report to Congress found that extending TRICARE into Puerto Rico and the other territories would result in a net spending increase of $29.7 million. See Department of Defense, *Report to Congress on Feasibility of TRICARE Prime in Certain Commonwealths and Territories of the United States* (Washington, D.C.: May 2011).

[7]Whether or not Congress would have the power to treat Puerto Rico—as a state—differently from any other state for the purposes of any particular federal program was beyond the scope of our work.

states in that year.[8] The year of the estimate ranges vary by program, based on the data available when we began our work. The estimates are based on various assumptions—such as the program eligibility options Puerto Rico might select or the rates at which eligible residents might participate in the programs—which are described in detail for each program in appendix II.

To evaluate potential changes to selected federal revenue sources under Puerto Rico statehood, we reviewed federal laws and regulations related to the main sources of federal revenue in fiscal year 2012—individual income tax (which accounted for 46.2 percent of federal revenue in fiscal year 2012), employment tax (34.5 percent), corporate income tax (9.9 percent), excise tax (3.2 percent), customs duties (1.2 percent), and estate and gift taxes (0.6 percent).[9] We also used tax return data from Puerto Rico's Department of Internal Revenue and data from the Internal Revenue Service to estimate potential changes in revenue for some federal revenue sources.

To identify factors under statehood that could influence changes in federal spending and revenue, we reviewed economic data from Puerto Rico's government. We also reviewed reports on Puerto Rico's economy, such as those from the Federal Reserve Bank of New York and the Congressional Budget Office. We also interviewed officials from the current and past Puerto Rico government administrations and Puerto Rico business associations representing large economic sectors in Puerto Rico to obtain their views on the potential impacts of statehood on Puerto Rico's economy and public finances.

We took various steps to assess the reliability of the data we used to select programs to evaluate and to estimate changes in spending and revenue. For example, we reviewed available documentation, examined

[8]For some programs, we contracted with the Urban Institute to conduct portions of the work using simulation models. The Urban Institute's analyses required our input on assumptions and about the rules governing federal programs. Therefore, the information presented in this report is attributable only to GAO.

[9]Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal year 2014*, (Washington, D.C.: Apr. 10, 2013). We did not evaluate potential changes to miscellaneous receipts—which accounted for 4.4 percent of total receipts in fiscal year 2012. About 77 percent of miscellaneous receipts in fiscal year 2012 derived from earnings deposited by the Federal Reserve. Other types of miscellaneous receipts included fines, penalties, and forfeitures.

the data for questionable or inconsistent values, and interviewed federal and Puerto Rico agency officials, as appropriate, to understand the data that we used. We also assessed the reliability of the Urban Institute's modeling procedures by reviewing documentation on the models and input data sources, discussing the program rules and underlying assumptions used in the models with staff from the Urban Institute who were responsible for the work provided under our contract, and reviewing the Urban Institute's internal quality control procedures. We determined that the data used in the report, as well as the Urban Institute's modeling procedures were sufficiently reliable for the purposes of this report.

The estimates involve various sources of uncertainty. Some estimates of federal spending are based, in part, on sample survey data, which required us to take sampling error into account. Unless otherwise indicated, the margin of error for estimates using sampling survey data is plus or minus 7 percent, or less, of the estimates themselves.[10] There are other sources of uncertainty that are not readily quantifiable. These include the assumptions we used to develop the estimates, such as those for which program eligibility rules Puerto Rico would adopt and the rates at which eligible Puerto Rico residents would participate in the programs. To some extent, the various scenarios for estimated spending and revenue that we include capture the extent to which these assumptions would impact spending and revenue. In other instances, there may be sources of uncertainty and dynamic changes under statehood that we could not incorporate into our modeling. These could include further changes in eligibility rules once additional program funding becomes available, the reaction of program beneficiaries to changes in the programs, or changes in economic activity (and resulting revenue). For additional details on our scope and methodology, see appendix I.

We conducted this performance audit from June 2012 to March 2014 in accordance with generally accepted government auditing standards.

[10]Sample survey data are obtained by following a probability procedure based on the selection of random samples. Each sample is only one of a large number of samples that might have been selected. Since each sample could have provided different estimates, sampling error measures the level of confidence in the precision of a particular sample's results, which we express as a margin of error at the 95-percent confidence interval. Unless otherwise indicated, all estimates included in this report that used sample survey data, plus-or-minus 7 percent, or less, of the estimates themselves would contain the actual value for the populations we analyzed for 95 percent of the samples that could have been selected.

Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Puerto Rico's Political Status

Puerto Rico, with about 3.6 million residents, is the largest U.S. territory. As a territory, Puerto Rico is subject to congressional authority, although Congress has granted Puerto Rico authority over matters of internal governance.[11]

Puerto Rico has held 4 plebiscites intended to determine its preferred status relationship with the United States. The most recent plebiscite, held in November 2012, asked voters in Puerto Rico two questions: (1) whether Puerto Rico should continue its present form of territorial status, and (2) regardless of how voters answered the first question, which non-territorial status option is preferred—statehood, independence, or a sovereign free associated state.[12] For the first question, about 54 percent

[11] 48 U.S.C. §§ 731b–731e. Under federal statute, Puerto Rico voters elect a Resident Commissioner to represent Puerto Rico in Washington. 48 U.S.C. § 891. The Resident Commissioner serves four-year terms. Under the rules established by the House of Representatives, the Resident Commissioner functions like a member of the House in certain respects: he or she may vote and otherwise act similarly to members in legislative committee, and may participate in debate and make most motions in the House. However, the Resident Commissioner does not enjoy all the same parliamentary rights as Members of the House. For example, the Resident Commissioner may not vote in the House. Likewise, a rules change adopted in the 112th Congress (2011-2012) eliminated the ability of the Delegates and Resident Commissioner to vote in, or preside over, the Committee of the Whole.

[12] According to the Congressional Research Service (CRS), the plebiscite ballot instructions suggest that a sovereign free associated state would entail independence with ongoing, negotiated ties with the United States. The term sovereign free associated state resembles language used to describe freely associated states with which the United States has a relationship, such as the Republic of the Marshall Islands, the Federated States of Micronesia, and the Republic of Palau. See CRS, *Puerto Rico's Political Status and the 2012 Plebiscite: Background and Key Questions*, (Washington, D.C.: June 25, 2013).

of voters indicated that Puerto Rico should not continue its present form of territorial status. For the second question, about 61 percent of voters who chose a non-territorial status option chose statehood.[13]

The Consolidated Appropriations Act, 2014 includes $2.5 million in funding for objective, nonpartisan voter education about, and a plebiscite on, options that would resolve Puerto Rico's future political status.[14] The funds are to be provided to the State Elections Commission of Puerto Rico.

Federal Payments to and Revenue from Puerto Rico

Congress generally determines whether Puerto Rico is eligible for federal programs on a case-by-case basis, and defines any different treatment in law. For example, federal programs in Puerto Rico may be subject to certain funding or eligibility restrictions. For some programs, current law applies certain limitations or exceptions to Puerto Rico by name. For other programs, the governing statutes refer to the 50 states or the 50 states and the District of Columbia.

Where differences are not mandated by law, federal agencies generally treat Puerto Rico the same as the states.[15] Yet, characteristics of federal programs in Puerto Rico may differ from the states for other reasons. For example, a study by the U.S. President's Task Force on Puerto Rico's Status found that governments and organizations in Puerto Rico were not applying for and seeking all available federal funds. It also found that a significant amount of funds available in Puerto Rico are not spent in a timely manner.[16] Furthermore, Puerto Rico residents generally are

[13]According to Puerto Rico's State Election Commission, 1,878,969 voters participated in the plebiscite. For the first question, 67,267 ballots were left blank. For the second question, 498,604 ballots were left blank.

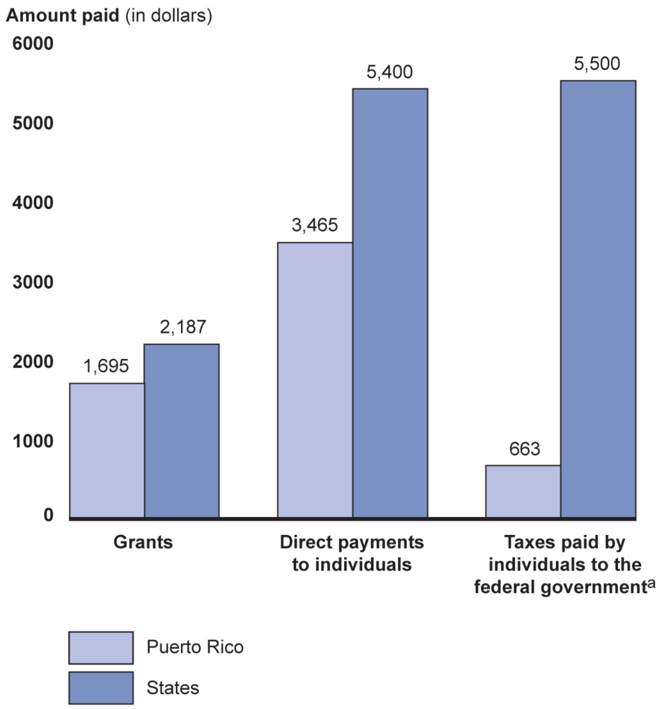
[14]Pub. L. No. 113-76, 128 Stat. 5, 61 (2014).

[15]A Presidential Memorandum to the Heads of Executive Departments and Agencies, dated November 30, 1992, directs all Federal departments, agencies and officials, to the extent consistent with the Constitution and the laws of the United States, to treat Puerto Rico administratively as if it were a state, except insofar as doing so with respect to an existing federal program or activity would increase or decrease federal receipts or expenditures, or would seriously disrupt the operation of such program or activity. 57 Fed. Reg. 57,093.

[16]U.S. President's Task Force on Puerto Rico's Status, *Report by the President's Task Force on Puerto Rico's Status* (Washington, D.C.: March 2011).

exempt from federal taxes on income from Puerto Rico sources.[17] These differences contribute to Puerto Rico and its residents receiving fewer federal payments, and paying less in federal tax, than residents of the states on a per capita basis, as shown in figure 1.

Figure 1: Comparison of Per-capita Federal Grants, Payments, and Taxes in Puerto Rico and the States, 2010



Source: GAO analysis of Census Bureau and Internal Revenue Service data.

[a]Taxes paid include individual income tax, employment tax, estate and trust income tax, and estate and gift taxes, net of refunds and including interest.

Puerto Rico's Economy

Historically, trends in Puerto Rico's economy have tended to follow those in the rest of United States. However, Puerto Rico's latest economic downturn has been longer and more extreme than the mainland U.S. downturn. Specifically, the U.S. economy entered into a recession in December 2007, which ended in June 2009, according to the Business

[17]26 U.S.C. § 933.

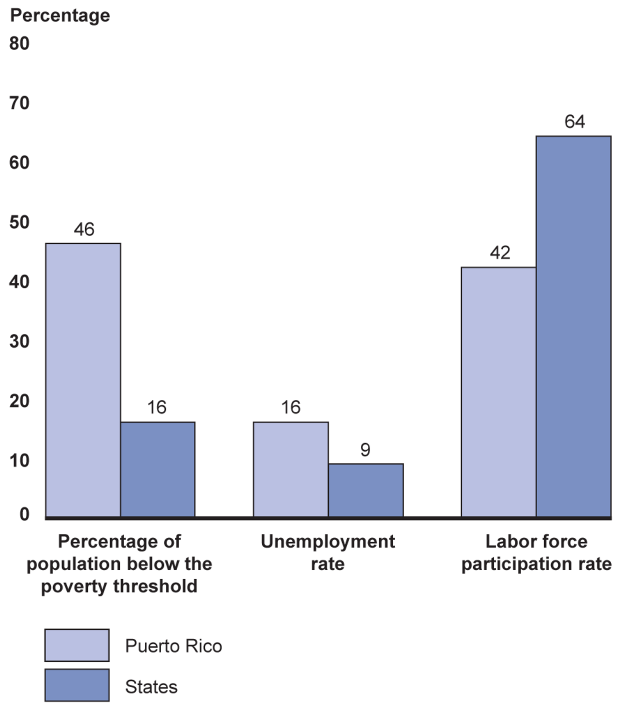
Cycle Dating Committee of the National Bureau of Economic Research. In contrast, Puerto Rico's recession began in the fourth quarter of 2006, and the economy contracted every fiscal year from 2007 to 2011. After growth of 0.1 percent in fiscal year 2012, the economy is projected to have contracted in fiscal year 2013 by 0.4 percent, according to the Government Development Bank for Puerto Rico.[18]

Likewise, income levels and employment in Puerto Rico have been lower than in the states. For example, in 2011 Puerto Rico had 1) a greater percentage of its population with income below the federal poverty threshold,[19] 2) higher unemployment, and 3) lower labor force participation—the proportion of the civilian noninstitutional population older than 15 that is employed—as shown in figure 2.

[18]Government Development Bank for Puerto Rico, *Commonwealth of Puerto Rico, Financial Information and Operating Data Report* (Puerto Rico: Oct. 18, 2013).

[19]In 2011, 45.6 percent of Puerto Rico's population was below the federal poverty threshold, compared to 22.6 percent in Mississippi, the state with the largest percentage of its population below the poverty threshold. The U.S. Census Bureau's poverty threshold for a 2-parent family of 4 for 2011 was $22,811. The Census Bureau poverty thresholds are a measurement of poverty used for statistical purposes. Later in our report, we use the term federal poverty level to refer to the federal poverty guidelines issued each year by the Department of Health and Human Services that are used for administrative purposes, such as determining financial eligibility for certain federal programs.

Figure 2: Percentages of the Population with Income below the Federal Poverty Threshold and Unemployment and Labor Force Participation Rates in Puerto Rico and the States, 2011



Source: GAO analysis of Census Bureau and Department of Labor data.

In 2011, the percentage of the population living below the federal poverty threshold was greater in Puerto Rico than in any state. More broadly, household income in Puerto Rico in 2011 was lower than that in the states—median household income was $18,660, compared to median household income of $50,502 in the states, and was lower than that in any state.[20] Likewise, for 2011, Puerto Rico had a higher unemployment rate and lower labor force participation rate than any single state.[21]

[20]Mississippi's median household income of $36,919 was the lowest of the states in 2011.

[21]In 2011, Puerto Rico's unemployment and labor force participation rates were 16.0 percent and 42.1 percent, respectively. The highest unemployment rate in the states was 13.2 percent (Nevada), and the lowest labor force participation rate was 54.1 percent (West Virginia).

Another salient feature of Puerto Rico's economy is that a substantial share of production is carried out by U.S. multinational corporations, in part because of federal corporate income tax benefits that have been available to firms that located in Puerto Rico. Prior to 1994, certain U.S. corporations could claim the possessions tax credit. In general, the credit equaled the full amount of federal tax liability related to an eligible corporation's income from its operations in a possession—including Puerto Rico—effectively making such income tax-free.[22] In 1993, caps were placed on the amounts of possessions credits that corporations could earn. In 1996, the credit was repealed, although corporations that were existing credit claimants were eligible to claim credits through 2005.[23]

Following the termination of the possessions tax credit, many U.S. corporations operating in Puerto Rico chose to reorganize by establishing Puerto Rico subsidiaries. Under U.S. tax law, Puerto Rico corporations are considered foreign corporations, which generally are not required to pay federal income taxes. U.S. parent corporations with foreign subsidiaries can defer tax on foreign income—including income earned in Puerto Rico—until they repatriate it to the United States, unless anti-deferral rules apply. Depending on their ownership, these Puerto Rico subsidiaries may be considered controlled foreign corporations (CFCs)

[22]The Tax Reform Act of 1976 established the possessions tax credit under section 936 of the Internal Revenue Code with the purpose of assisting U.S. possessions in obtaining employment-producing investments by U.S. corporations. The credit effectively exempted two kinds of income from U.S. taxation: 1) 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 2) certain income earned from financial investments in U.S. possessions or certain foreign countries, if they were generated from an active business in a possession, and were reinvested in the same possession.

[23]The possessions tax credit was criticized on the grounds that the associated revenue cost was high compared to the employment it generated, and because a large share of the benefits of the credit was not reaped by Puerto Rico residents. 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. Pub. L. No. 103-66, § 13227, 107 Stat. 312, 489–494. The Small Business Job Protection Act of 1996 repealed the possessions tax credit for taxable years beginning after 1995. Pub. L. No. 104-188, § 1601, 110 Stat. 1755, 1827–1833.

under U.S. tax law, in which case deferral by the U.S. parent would not be available on certain types of income.[24]

That a large share of production in Puerto Rico is carried out by multinational corporations is evident in the data on Puerto Rico's economic activity. For example, in 2010, Puerto Rico's nominal gross domestic product (GDP)—which measures the income earned by both residents and nonresidents within a country—was roughly $95 billion. Nominal gross national product (GNP)—which measures just the income earned by residents of a country—was roughly $65 billion. The relative gap between GDP and GNP in Puerto Rico is higher than the gaps in similarly sized economies with a high presence of foreign multinational corporations, such as those of Ireland, Panama, and Singapore.[25]

Puerto Rico's Fiscal Position

Recently, Puerto Rico's government has faced various fiscal challenges, including an imbalance between its general fund revenues and expenditures. In fiscal year 2009, Puerto Rico's fiscal deficit reached a high of $2.9 billion—based on $7.8 billion in revenues and $10.7 billion of expenditures.[26] Persistent deficits have resulted in an increase in Puerto Rico's public debt, which represents a much larger share of personal income than in any of the states. In February 2014, Puerto Rico's general obligation bonds were downgraded to speculative—noninvestment—grade by three ratings agencies.

Recently, Puerto Rico has taken steps to improve its fiscal position.

- Beginning in 2007, Puerto Rico began to reduce the size of its government workforce. For example, between 2007 and 2009, government employment declined almost 10 percent. However, as of July 2012, government employment still accounted for a larger share of overall employment in Puerto Rico when compared to the states

[24]CFCs are entities incorporated outside of the United States that are majority-owned (by vote or value) by one or more U.S. shareholder; to meet the definition of a U.S. shareholder, a shareholder must own at least 10 percent of the CFC's voting stock.

[25]Federal Reserve Bank of New York, *Report on the Competitiveness of Puerto Rico's Economy* (New York, NY: June 29, 2012).

[26]The total deficit in fiscal year 2009 equates to a per capita deficit of $731, based on Census Bureau population estimates for July 2009.

(although, government employment as a share of the population older than 15 in Puerto Rico was similar to that in the states).[27]

- In 2009, a fiscal stabilization plan was put into effect that reduced government spending and increased tax revenues.
- In April 2013, Puerto Rico enacted comprehensive reform of its largest public employee retirement system, which is funded primarily with budget appropriations from the government's general fund. The reform was intended to address the retirement system's deteriorating solvency.[28]

Through measures like these, Puerto Rico has reduced its annual deficits. However, the fiscal year 2013 deficit was approximately $1.3 billion, based on projected expenditures of approximately $10 billion. As the Government Development Bank for Puerto Rico notes in its Financial Information and Operating Data Report from October 2013, Puerto Rico's ability to continue to reduce its deficit will depend in part on its ability to continue increasing revenues and reducing expenditures, which in turn depends on a number of factors, including improvements in economic conditions.

[27]Government employment represented 27.3 percent of total nonfarm employment in Puerto Rico in July 2012, compared to 16.5 percent in the states, according to Bureau of Labor Statistics estimates. Government employment as a share of the population over the age of 15 was 8.7 percent in Puerto Rico and 8.9 percent in the states, respectively, based on Census Bureau population estimates for July 2012. Government employment includes employment at the federal, state, and local government levels.

[28]According to the Government Development Bank for Puerto Rico, absent reform, the retirement system's assets would have been depleted by fiscal year 2019, and the government and other employers would have been required to provide funds to make up for subsequent cash funding shortfalls. With the reform, it is projected that the retirement system's gross assets will no longer be depleted. See, Government Development Bank for Puerto Rico, *Commonwealth of Puerto Rico, Financial Information and Operating Data Report* (Puerto Rico: Oct. 18, 2013).

Potential Changes to Selected Federal Programs under Puerto Rico Statehood

Of the 29 selected federal programs we reviewed, statehood would likely affect 11 programs. For 3 other programs, while the programs themselves would likely not change under statehood, eligibility determinations for these programs could be affected indirectly by changes that could occur to benefits in other programs. Statehood would not likely affect the 15 remaining programs. Ultimately, changes to programs under statehood would depend on decisions by Congress and, to some extent, on decisions by federal agencies. For example, Congress could enact legislation that creates or maintains certain exceptions for Puerto Rico. Figure 3 shows whether and how statehood would potentially affect the programs we reviewed. Additional details on programs that statehood would likely affect appear in appendix II.

Figure 3: Potential Changes under Puerto Rico Statehood to Selected[a] Federal Programs, in Descending Order by Total Amount Obligated by the Federal Government in Fiscal Year 2010

Program, total federal obligation (fiscal year 2010)[b]	Program objectives	Puerto Rico's current program treatment, legal citation	Potential changes under Puerto Rico statehood
1. Social Security-Old Age and Survivor's Benefits $581.5 billion	Partially replaces lost earnings due to retirement or worker's death.	Puerto Rico residents pay Social Security taxes and can receive full benefits if qualified. 42 U.S.C. § 410(h)	None.[c]
2. Medicare $524.3 billion	Provides hospital insurance, medical insurance protection for covered services, and prescription drug plans to individuals age 65 and older, the disabled, and individuals with end-stage renal disease. Hospital and medical insurance benefits can be obtained through the original Medicare fee-for-service (Medicare FFS) program or private plan alternatives, called Medicare Advantage (MA). Prescription drug benefits are obtained from private plans, including through MA.	Medicare FFS: Puerto Rico hospitals are reimbursed using different rates than in the states, reflecting different hospital utilization patterns; residents have a different medical insurance enrollment process than in the states. MA: payments to MA plans generally exceed Medicare FFS spending by a greater percentage in Puerto Rico than in the states. Prescription drugs: a subsidy for certain low-income beneficiaries is not available. 42 U.S.C. §§ 1395w-114(a)(3)(F), 1395ww (d)(9), 1396d(p)(4)(A), 1396u-5(e); 42 C.F.R. § 407.17(a)(1)	Medicare FFS: Puerto Rico hospitals would likely receive larger payments per hospital stay; residents' medical insurance enrollment process generally would be the same as in the states. MA: regardless of whether Puerto Rico becomes a state, plans will receive lower payments because of provisions in the Patient Protection and Affordable Care Act. Prescription drugs: the subsidy for qualified low-income beneficiaries would be available.
3. Medicaid $242.3 billion	Provides states with financial assistance for health care coverage to certain categories of low-income individuals.	Puerto Rico's federal funding is capped and its federal matching rate is limited. Eligibility is determined using a local poverty level rather than federal poverty guidelines. Puerto Rico is not eligible for certain program components, such as Disproportionate Share Hospital (DSH) payments. 42 U.S.C. §§ 1308(f), (g), 1396d(b), 1396r-4(f)(9); 78 Fed. Reg. 5182 (Jan. 24, 2013)	Federal funding would not be subject to a cap, and would be based on a higher matching rate. Puerto Rico would be required to extend eligibility to additional low-income individuals. It potentially would qualify for DSH payments.

Sources: Office of Management and Budget, Appendix, Budget of the United States Government, Fiscal Year 2012 (Washington, D.C.: Feb. 14, 2011); discussions with agency officials; and GAO analysis.

Program, total federal obligation (fiscal year 2010)[b]	Program objectives	Puerto Rico's current program treatment, legal citation	Potential changes under Puerto Rico statehood
4. Social Security-Disability Insurance $125.4 billion	Partially replaces earnings lost due to a physical or mental impairment (or a combination of impairments) that has lasted 12 months or is expected to result in death and which prevents substantial gainful work activity. An individual may also be entitled to benefits due to blindness.	Puerto Rico residents pay Social Security taxes and can receive full benefits if qualified. 42 U.S.C. § 410(h)	None.[c]
5. Unemployment Insurance $124.5 billion[d]	Provides administration of unemployment insurance program for eligible workers through federal and state cooperation; provides administration of assistance payments for trade adjustments, disaster unemployment, and federal/ex-military unemployment compensation.	Puerto Rico employers pay unemployment insurance payroll taxes, and employees can receive full benefits if qualified. 26 U.S.C. § 3306(j)(1)	None.
6. Supplemental Nutrition Assistance Program (SNAP) $57.8 billion	Seeks to improve nutrition levels of low-income households by ensuring access to nutritious, healthful diets through monthly nutrition assistance (food purchase) benefits.	Although Puerto Rico previously received nutrition assistance through the Food Stamp Program (the precursor to SNAP), in 1982 Congress replaced the program in Puerto Rico with a block grant, which Puerto Rico uses to fund the Nutrition Assistance Program (NAP). 7 U.S.C. §§ 2012(s), 2028	Benefits would be available to eligible Puerto Rico residents; funding for NAP would cease. Cash benefits from SSI and TANF may reduce SNAP benefits for eligible participants.
7. Supplemental Security Income (SSI) $54.5 billion	Assures a minimum level of income for people who are age 65 or over, or who are blind or disabled and who do not have sufficient income and resources to maintain a standard of living at the established federal minimum income level.	The program does not extend to Puerto Rico. Instead, the Aid to the Aged, Blind, and Disabled Program (AABD) provides funding to eligible Puerto Rico residents for a similar program. 42 U.S.C. §§ 301 to 306, 1301(a)(1), 1382c(e)	Benefits would be available to eligible Puerto Rico residents; funding for AABD would cease.

Sources: Office of Management and Budget, Appendix, Budget of the United States Government, Fiscal Year 2012 (Washington, D.C.: Feb. 14, 2011); discussions with agency officials; and GAO analysis.

Program, total federal obligation (fiscal year 2010)[b]	Program objectives	Puerto Rico's current program treatment, legal citation	Potential changes under Puerto Rico statehood
8. Veterans Disability Compensation $43.5 billion	Provides compensation to veterans with disabilities resulting from disease or injury incurred (or aggravated) during active military service. Survivors of servicepersons or veterans whose death occurred while on active duty (or as a result of service-connected disabilities) may also receive compensation.	Puerto Rico is considered to be a state for the purposes of this program. 38 U.S.C. § 101(20)	None.
9. Federal-Aid Highways $42.3 billion	Assists state transportation agencies in planning and developing an integrated, interconnected transportation system by providing funds for constructing and rehabilitating the National Highway System, including Interstates; provides funds for other purposes.	Puerto Rico highway users do not contribute to the Highway Trust Fund, which finances federal highway programs. Puerto Rico receives funding in a different manner than the states. 23 U.S.C. § 165; 48 U.S.C. § 738	Puerto Rico highway users would be required to contribute to the Highway Trust Fund; Puerto Rico would receive funding in the same manner as the states.
10. Deposit Insurance[e] $39.5 billion	Helps maintain stability and public confidence in the U.S. financial system and insures deposits and protects depositors of insured banks and savings associations. Backed by the full faith and credit of the United States government; covers all deposit accounts, including checking, savings, and money market accounts, and certificates of deposit.	Puerto Rico is considered to be a state for purposes of this program. 12 U.S.C. § 1813(a)(3)	None.
11. National Institutes of Health Extramural Research $25.3 billion	Advances biomedical research and health by funding innovative scientific research and research training that seeks fundamental knowledge about the nature and behavior of living systems and the application of that knowledge to enhance health, lengthen life, and reduce illness and disability.	Researchers in Puerto Rico are eligible to apply for and receive funding. U.S. Dept. of Health and Human Services, National Institutes of Health (NIH), NIH Grants Policy Statement, (Bethesda, MD, October 1, 2012).	None.

Sources: Office of Management and Budget, Appendix, Budget of the United States Government, Fiscal Year 2012 (Washington, D.C.: Feb. 14, 2011); discussions with agency officials; and GAO analysis.

Program, total federal obligation (fiscal year 2010)[b]	Program objectives	Puerto Rico's current program treatment, legal citation	Potential changes under Puerto Rico statehood
12. Pell Grants $25.1 billion	Provides grant assistance to help meet educational expenses for eligible undergraduate postsecondary students who have demonstrated financial need.	In general, Puerto Rico residents are eligible for the grants. However, the formula component used to determine an applicant's grant amount is based on taxable income in his or her state of residence. Puerto Rico is not subject to the analysis used to determine grant-related state tax allowances. Rather, a nominal amount is included in the formula for Puerto Rico residents. 20 U.S.C. § 1003(21)	Puerto Rico would be included in the analysis to determine state tax allowances, which could affect eligibility for grants.
13. Section 8 Housing Assistance Payments Program (Tenant-based) $18.1 billion	Provides rental assistance to very low-income individuals and families to enable them to live in affordable, decent, safe, and sanitary housing.	Puerto Rico residents are eligible to participate under the same rules as state residents. Cash assistance payments from other federal programs, such as SSI and TANF, count as income in determining eligibility for this program. 42 U.S.C. § 1437a(b)(6), (7)	Although the program treats Puerto Rico residents in the same manner as those in the states, changes to SSI and TANF under statehood could affect eligibility determinations.
14.Temporary Assistance for Needy Families (TANF) $17 billion	To provide grants to states, territories, the District of Columbia, and federally-recognized Indian tribes to assist needy families with children so that children can be cared for in their own homes; to reduce dependency by promoting job preparation, work, and marriage; to reduce and prevent out-of-wedlock pregnancies; and to encourage the formation and maintenance of two-parent families.	Puerto Rico's funding is set in statute. In addition, total funding for a group of programs that includes TANF is statutorily capped. Puerto Rico is not eligible for the TANF Contingency Fund, which provides states meeting certain criteria additional TANF funds. 42 U.S.C. §§ 619(5), 1308	Puerto Rico's funding would continue to be set in statute. Funding for the group of programs that includes TANF would not be capped. Puerto Rico would be eligible to receive assistance from the TANF Contingency Fund. Total funds available to states would be unlikely to increase, according to officials from the Administration for Children and Families.
15. Title I Grants to Local Educational Agencies $14.5 billion	Provides instruction and instructional support to assist disadvantaged children (pre-kindergarten through grade 12) in mastering curricula and meeting state academic achievement standards.	The formulas for some types of grants contain exceptions and limits for Puerto Rico. 20 U.S.C. §§ 6332(e), 6335(c)(1)(D), 6337 (b)(2)(B)	The formula exceptions and limits for some types of grants would not apply or would change.

Sources: Office of Management and Budget, Appendix, Budget of the United States Government, Fiscal Year 2012 (Washington, D.C.: Feb. 14, 2011); discussions with agency officials; and GAO analysis.

Program, total federal obligation (fiscal year 2010)[b]	Program objectives	Puerto Rico's current program treatment, legal citation	Potential changes under Puerto Rico statehood
16. Special Education Grants to States $11.5 billion	Provides grants to states to assist them in providing special education and related services to all children with disabilities.	Puerto Rico is considered to be a state for purposes of this program. 20 U.S.C. § 1411(g)(2)	None.
17. Social Insurance for Railroad Workers $11.2 billion	Pays social security-level railroad benefits, based on rail service alone, vested dual benefits, supplemental annuities, annuities based on total (or occupational) disability, and sickness/unemployment benefits to railroad workers and (in some cases) their families, to assist with expenses of daily living.	Puerto Rico residents can receive full benefits if qualified. 45 U.S.C. § 231a(d)(4); 42 U.S.C. §§ 416(h), 410(h)	None.
18. Children's Health Insurance Program (CHIP) $10.7 billion	Provides funds to states for maintenance and expansion of child health assistance to uninsured, low-income children.	Provides states with financial assistance for health care coverage to individuals (primarily children) in families whose household income exceeds Medicaid eligibility requirements and who generally do not have health insurance, subject to certain exceptions. 42 U.S.C. §§ 1396d(b), 1397ee	Puerto Rico would qualify for funding at a higher federal matching rate. Eligibility rules would be affected by changes in eligibility for Medicaid.
19. Mutual Mortgage Insurance Program[f] $10.0 billion	Provides lenders with protection against losses that result from homeowners defaulting on their mortgage loans.	Puerto Rico is considered to be a state for purposes of this program. 12 U.S.C. § 1707(d)	None.
20. National School Lunch Program $9.9 billion	Provides cash grants and food donations to assist states in making the school lunch program available to school children; seeks to encourage domestic consumption of nutritious agricultural commodities.	Puerto Rico is considered to be a state for purposes of this program. Regulations allow Puerto Rico to conduct surveys to determine the number of eligible children for funding purposes; states must report the number of eligible children who received funded lunches. 42 U.S.C. § 1760(d)(8)); 7 C.F.R. § 245.4	None. *(The exception allowing Puerto Rico to conduct the surveys would likely remain under statehood, according to officials at the U.S. Department of Agriculture.)*

Sources: Office of Management and Budget, Appendix, Budget of the United States Government, Fiscal Year 2012 (Washington, D.C.: Feb. 14, 2011); discussions with agency officials; and GAO analysis.

Program, total federal obligation (fiscal year 2010)[b]	Program objectives	Puerto Rico's current program treatment, legal citation	Potential changes under Puerto Rico statehood
21. Section 8 Housing Assistance Payments Program (Project-based) $8.8 billion	Provides rental assistance to very low-income individuals and families to enable them to live in affordable, decent, safe, and sanitary housing.	Puerto Rico residents are eligible to participate in the program under the same rules as state residents. Cash assistance payments made to individuals from other federal programs, such as SSI and TANF, count as income in determining eligibility for this program. 42 U.S.C. § 1437a(b)(6), (7)	Although the program treats Puerto Rico residents in the same manner as those in the states, changes to SSI and TANF under statehood could affect eligibility determinations.
22. Special Supplemental Nutrition Program for Women, Infants, and Children (WIC) $7.2 billion	Provides supplemental nutritious foods, nutrition education, and referrals to health and social services at no cost to low-income pregnant, breastfeeding, and postpartum women; infants; and children to age five determined to be at nutritional risk.	Puerto Rico residents are eligible to participate in the program under the same rules as state residents. Participation in SNAP, TANF, or Medicaid affects eligibility. In 2010, about 2 percent of WIC participants were eligible solely because of participation in one of these programs, as they had incomes over the federal WIC income limit. 7 C.F.R. § 246.2	Although the program treats Puerto Rico residents in the same manner as those in the states, changes to SNAP, TANF, and Medicaid under statehood could affect eligibility determinations. It is uncertain whether Puerto Rico would set income eligibility requirements for these programs at a level that would substantially increase WIC participation.
23. Head Start Program $7.2 billion	Promotes school readiness through the provision of health, educational, nutritional, social, and other services, including some for parents.	Puerto Rico is considered to be a state for purposes of this program. 42 U.S.C. § 9832(25)	None.
24. Post-9/11 GI Bill $5.3 billion	Seeks to help military servicepersons adjust to civilian life after separation, assists in recruitment and retention of highly qualified personnel in active and reserve components by providing education benefits, and provides educational opportunities to dependents of certain service members and veterans.	Veterans attending education programs in Puerto Rico receive a monthly housing allowance based on the Overseas Housing Allowance. Veterans attending programs in the states receive the Basic Allowance for Housing based on the zip code of the program they attend. The Department of Defense sets both allowance rates. 37 U.S.C. § 403(c); 38 U.S.C. § 3313(c)(1)(B)	The Basic Allowance for Housing would apply. Whether or not program participants attending Puerto Rico schools receive more under the Overseas Housing Allowance rate than they would under the Basic Allowance for Housing could vary, depending on how the Department of Defense sets rates each year.

Sources: Office of Management and Budget, Appendix, Budget of the United States Government, Fiscal Year 2012 (Washington, D.C.: Feb. 14, 2011); discussions with agency officials; and GAO analysis.

Program, total federal obligation (fiscal year 2010)[b]	Program objectives	Puerto Rico's current program treatment, legal citation	Potential changes under Puerto Rico statehood
25. Public Housing Operating Fund $4.8 billion[g]	Seeks to provide and operate cost-effective, decent, safe, and affordable dwellings for lower-income families through an authorized local Public Housing Agency.	Puerto Rico is considered to be a state for purposes of this program. 42 U.S.C. § 1437a(b)(6), (7)	None.
26. Disaster Relief Public Assistance Grants for Presidentially Declared Disasters $4.3 billion[h]	Provides assistance to state and local governments responding to and recovering from presidentially-declared disasters.	Puerto Rico is considered to be a state for purposes of this program. 42 U.S.C. §§ 5122(3), (4), 5195a(a), 5197d, 5204	None.
27. Federal Direct Student Loan Program $3.5 billion[i]	Provides loan capital directly from the federal government (rather than through private lenders) to vocational, undergraduate, and graduate post-secondary school students and their parents.	In general, Puerto Rico residents are eligible for the loans. However, the formula component used to determine an applicant's loan eligibility is based on taxable income in his or her state of residence. Puerto Rico is not subject to the analysis done to determine state tax allowances. Rather, a nominal amount is included in the formula, which likely decreases loan eligibility for Puerto Rico residents. 20 U.S.C. §§ 1003(21)	Puerto Rico would be included in the analysis to determine state tax allowances, which could affect eligibility for loans.
28. Public Housing Capital Fund $2.5 billion[g]	Provides funds to public housing agencies for capital and management activities, including modernization and development of public housing.	Puerto Rico is considered to be a state for purposes of this program. 42 U.S.C. § 1437a(b)(6), (7)	None.
29. Central Liquidity Facility[j] $85 million[k]	Seeks to improve the general financial stability of credit unions by serving as a liquidity lender to credit unions experiencing unusual or unexpected liquidity shortfalls. Membership is voluntary and requires that a member purchase stock in the fund.	The provisions governing this program apply to Puerto Rico. Credit unions organized and operated under Puerto Rico law are treated the same as those organized and operated under state law. 12 U.S.C. §§ 1752(6), 1772	None.

Sources: Office of Management and Budget, Appendix, Budget of the United States Government, Fiscal Year 2012 (Washington, D.C.: Feb. 14, 2011); discussions with agency officials; and GAO analysis.

[a]We identified budget accounts with at least $5 billion, and then reviewed the programs within each account to identify those with outlays of at least $5 billion. We defined a program as an organized set of activities with the same objective(s) and funded by the federal government. We focused on programs that are expected to have an ongoing impact on the federal budget, meaning we did not consider temporary funding, such as that provided under the American Recovery and Reinvestment Act of 2009. We also identified programs where spending in Puerto Rico differed by more than $100 million from average spending in 5 comparable states. The table reports federal obligations for each program because net outlays information was not consistently available at the program level.

[b]Obligation amounts do not include funding from the American Reinvestment and Recovery Act of 2009. Pub. L. No. 111-5, 123 Stat.115.

[c]One exception to the Social Security program in Puerto Rico is residents' exclusion from special age-72 benefits, which are paid out of general revenues to uninsured individuals who turned 72 before

1972, and which restricts benefits to residents of the 50 States, the Northern Mariana Islands, and the District of Columbia. As most of these beneficiaries are likely deceased, the exception may no longer have any impact. 42 U.S.C. § 428.

[d]Unemployment Insurance is typically funded with payroll taxes, but recently has been supplemented with general revenues.

[e]The Federal Deposit Insurance Corporation (FDIC) charges premiums to member institutions to ensure adequate fund reserves. Thus, deposit insurance payouts are not typically funded with taxpayer dollars. At the end of September 2010, the fund was $81.2 billion less than the level needed to reach 1.35 of estimated insured deposits. By statute, that target must be reached by September 30, 2020.12 U.S.C. § 1817 note.

[f]Generally, agencies with loan insurance or guarantee programs must produce annual updates of the estimated costs of their programs—referred to as credit subsidy reestimates—on the basis of information about actual performance and estimated changes in future loan performance. In fiscal year 2010, $8.4 billion of the $10 billion in obligations for the Mutual Mortgage Insurance program were for subsidy reestimates.

[g]We included this program in our review because spending in Puerto Rico differed from average spending in five comparable states by at least $100 million.

[h]Although Disaster Relief Public Assistance Grants for Presidentially Declared Disasters obligations were less than $5 billion, total net outlays for the program were $5.2 billion in fiscal year 2010.

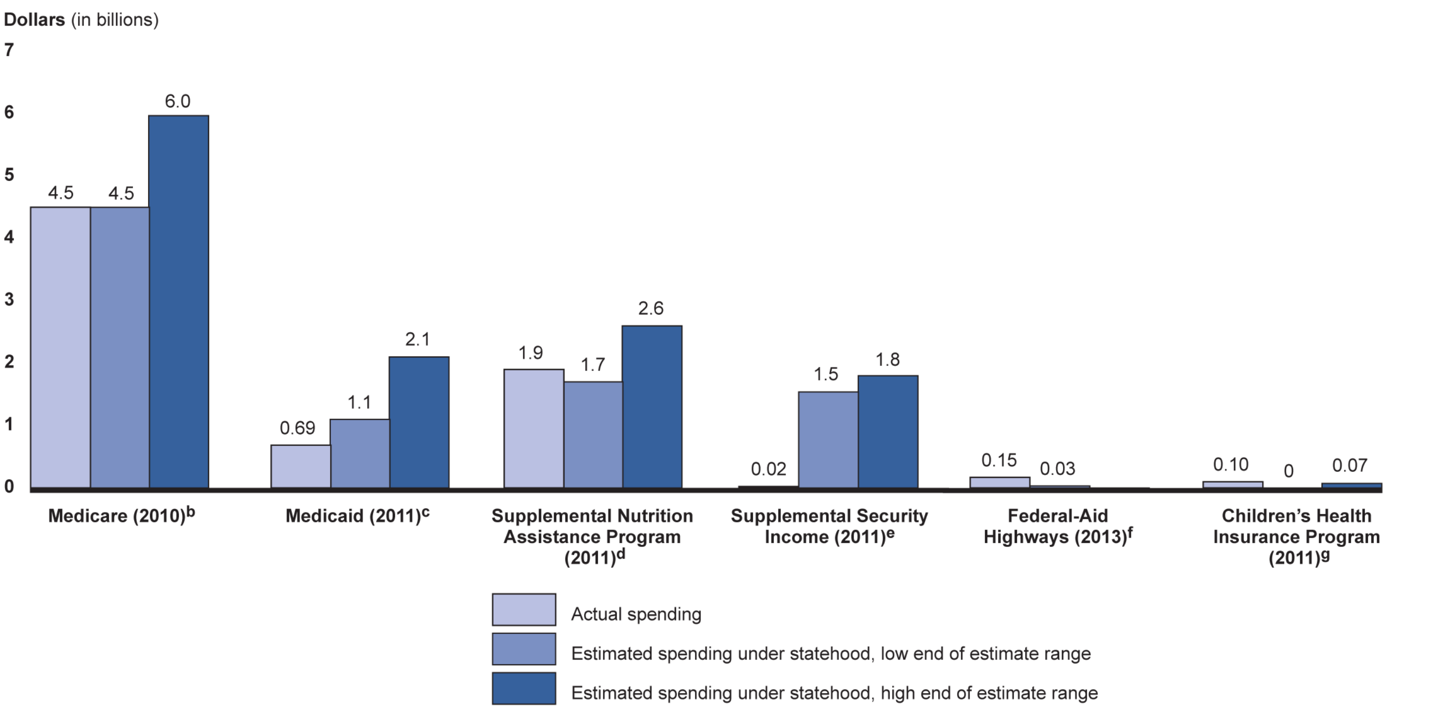
[i]The $3.5 billion in Federal Direct Student Loan Program obligations reflects the costs to the federal government associated with loans obligated for the program, estimated on a present value basis. While fiscal year 2010 obligations did not exceed $5 billion, this program met our selection criteria because net outlays in fiscal year 2010 were -$9.1 billion, due in part to lower borrowing costs paid by the federal government. There were $142.6 billion in fiscal year 2010 obligations reflected in the program's financing account, a non-budgetary account that records all cash flows to and from the federal government.

[j]Member credit unions own the Central Liquidity Facility (CLF), which exists within the National Credit Union Administration. CLF obtains its funding through credit union capital investments and borrowings from the Federal Financing Bank, which provides reduced-cost financing to federal agencies that issue government-backed obligations. At the end of fiscal year 2010, CLF borrowing from the Federal Financing Bank totaled $10.1 billion. Fiscal year 2010 was not a typical year for the CLF, in terms of outlays, because of factors stemming from the 2007 to 2009 financial crisis. In fiscal year 2012, net outlays were $155 million.

[k]Although obligations for the CLF were less than $5 billion, net outlays were -$8.4 billion.

The extent to which federal spending would change for some of the programs that would be affected by Puerto Rico statehood depends on various assumptions, such as which program eligibility options Puerto Rico might select, and the rates at which eligible residents might participate in the programs. For example, for the four largest programs for which federal spending would be likely to change under statehood—Medicare, Medicaid, SNAP, and SSI—and for the ninth largest program for which federal spending would be likely to change—CHIP—GAO used various assumptions to estimate a range of federal spending. Figure 4 below shows the range of estimated federal spending for these programs based on these assumptions, which are described in detail for each program in appendix II. Figure 4 also shows a Federal Highway Administration estimate for federal spending for Federal-Aid Highways, the fifth largest program for which federal spending would be likely to change under statehood. The estimates were developed for a single year in the past, as if Puerto Rico were treated the same as the states in the year specified for each program. For programs other than Federal-Aid Highways, the estimates are in calendar-year terms because the eligibility and other data used to develop the estimates were in calendar-year terms. The estimate for Federal-Aid Highways is in fiscal-year terms. Actual spending in Puerto Rico, to which we compare the estimates, is in fiscal-year terms because the spending data were reported in fiscal-year terms.

Figure 4: Actual Federal Spending in Puerto Rico and Estimated Range of Federal Spending under Puerto Rico Statehood for Selected Programs[a]



Sources: GAO and Federal Highway Administration analysis.

[a]Actual spending is in fiscal-year terms. Estimated spending is in calendar-year terms, except for Federal-Aid Highways, which is in fiscal-year terms. The margins of error for the estimates are plus or minus 7 percent, or less, of the estimates themselves, except for the margin of error for the high end of the CHIP estimate range (which has a margin of error of plus or minus 27 percent of estimate amount).

[b]The Medicare estimates take into account certain changes under the Patient Protection and Affordable Care Act occurring after 2010 that would reduce spending. Also, the Medicare estimates depend on the estimates for Medicaid, as some individuals are eligible for both programs.

[c]The Medicaid estimates do not take into account the cost of nursing home and home health services in Puerto Rico due to the lack of available cost data, and because Puerto Rico lacks an infrastructure of nursing home facilities, according to Centers for Medicare & Medicaid Services officials. If these services became available, Medicaid spending would likely increase.

[d] Actual spending is for Puerto Rico's Nutrition Assistance Program. One reason why the low end of the estimate range is less than actual spending is because participants' benefits would be reduced because of benefits received from SSI, for which Puerto Rico residents would newly qualify.

[e] Actual spending is for Puerto Rico's Aid to the Aged, Blind, and Disabled program.

[f] Actual spending for Federal-Aid Highways is for Puerto Rico's authorization through the Puerto Rico Highway Program. The sole estimate for federal spending on Federal-Aid Highways represents the net deficit of what highway users in Puerto Rico would have contributed to the Highway Trust Fund (about $232 million) minus its estimated apportionment (about $265 million).

[g] The lower estimate assumes Puerto Rico would have discontinued its CHIP program, as individuals enrolled in CHIP instead would have received benefits through Medicaid. The higher estimate assumes Puerto Rico would have extended CHIP coverage to previously unenrolled individuals.

Potential Changes to Selected Federal Revenue Sources under Puerto Rico Statehood

All the federal revenue sources we reviewed could be affected if Puerto Rico became a state. As with our review of programs, we assumed that if Puerto Rico becomes a state, it would be treated as such for purposes of revenue collection. For example, under statehood, Puerto Rico residents would be subject to federal tax on all their income: currently they are subject to federal tax only on income from sources outside of Puerto Rico.[29] However, for two revenue sources through which Puerto Rico receives revenue not provided to other states—excise taxes and customs duties—whether or how statehood would result in changes would depend on decisions by Congress. Figure 5 shows how the revenue sources we reviewed potentially would change under statehood. Additional details on the two largest revenue sources that would be affected substantially by statehood—individual and corporate income taxes—appear after figure 5 and in appendix III.[30]

[29] Puerto Rico residents also are required to file Puerto Rico tax returns if their gross income exceeds the applicable filing thresholds. Some sources of income are taxed differently in Puerto Rico than in the states. For example, Puerto Rico taxpayers can exclude certain amounts of pension income from their taxable income. Because of differences such as this, for 2010, Puerto Rico filers' adjusted gross income for federal tax purposes (about $32.1 billion, based on our estimates) would have been higher than that for Puerto Rico tax purposes (about $28.2 billion, according to Puerto Rico Department of the Treasury data).

[30] Although certain of the various statutory exceptions from the definition of wages for employment taxes do not apply to Puerto Rico, federal employment taxes generally apply to residents of Puerto Rico on the same basis, and for the same sources of income, as to residents of the states. 26 U.S.C. §§ 3121(e), 3306(j).

Figure 5: Potential Changes Under Puerto Rico Statehood to Federal Revenue Sources, in Descending Order by Amount of Federal Receipts in Fiscal Year 2012


Revenue source, total federal receipts (fiscal year 2012)	Related laws applicable to the states	Related laws applicable to Puerto Rico, legal citation	Potential changes under Puerto Rico statehood
Individual income tax $1,132 billion	State residents generally are required to pay tax on all income regardless of where it is earned. Eligible residents can receive refudable tax credit payments in excess of liability.	Puerto Rico residents generally are not required to pay federal income tax on Puerto Rico-source income; income from sources outside of Puerto Rico is taxable. Some tax credits are not available. 26 U.S.C. § 933	Puerto Rico residents' income would be subject to federal income tax regardless of where it was earned. All tax credits would be available to eligible residents.
Employment tax $845 billion	Employers, employees, and self-employed individuals generally must pay Social Security and Medicare taxes (FICA, or SECA for self-employed) on wages. Employers must also pay federal unemployment tax (FUTA) based on their employees' wages. For FICA and FUTA, there are various statutory exceptions from the definition of wages.	Generally, federal employment taxes apply to residents of Puerto Rico on the same basis and for the same sources of income as to residents of the states. However, certain of the statutory exceptions from the definition of wages for FICA and FUTA do not apply to Puerto Rico. 26 U.S.C. §§ 3121(e), 3306(j)	The statutory exceptions from the definition of wages would apply in Puerto Rico in the same manner as in the states.
Corporate income tax $242 billion	U.S. corporations generally are required to pay tax on all income regardless of where it is earned. U.S. parent corporations can defer federal income tax on income earned by Puerto Rico (and other foreign) subsidiaries until it is distributed to the parent, unless anti-deferral rules apply. Corporations can receive tax credits to offset foreign taxes they pay (i.e. foreign tax credits).	Puerto Rico corporations are generally treated as if they were organized under the laws of a foreign country for federal tax purposes. As such, they owe federal corporate income tax only on income they earn from activities effectively connected to a trade or business in the states. In addition, a withholding tax is imposed on certain investment income from sources in the states and not connected to a trade or business. 26 U.S.C. §§ 881, 882, 7701	Corporations organized under Puerto Rico law would be subject to federal income tax on their income regardless of where it was earned. Deferral would not be available to U.S. parent corporations with Puerto Rico subsidiaries.

Sources: Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2014 (Washington, D.C.: Apr.10, 2013), and GAO analysis.

Revenue source, total federal receipts (fiscal year 2012)	Related laws applicable to the states	Related laws applicable to Puerto Rico, legal citation	Potential changes under Puerto Rico statehood
Excise tax $79 billion	Excise taxes are levied on purchases of specific goods, such as gasoline, or on activities, such as wagering.	Federal excise taxes generally do not apply within Puerto Rico, but equivalent taxes generally are imposed on Puerto Rican products coming into the United States and withdrawn for consumption or sale. For some products, collected tax generally is returned, or covered over, to Puerto Rico. Excise tax on rum imported to the United States from any country is covered over to Puerto Rico and the U.S. Virgin Islands.[a] 26 U.S.C. §§ 5314, 7652; 48 U.S.C. § 734	Federal excise taxes would likely apply. It would be incumbent on Congress to determine if excise tax on rum would continue to be covered over to Puerto Rico.
Customs duties $30 billion	Tariffs are imposed on certain goods imported into the United States.	Tariffs on imports are applied in the same manner as in the states. Collected duties, minus the cost of collection by Customs and Border Protection, are covered over to Puerto Rico.[b] 48 U.S.C. §§ 739, 740	It would be incumbent on Congress to determine if customs duties would continue to be covered over to Puerto Rico.
Estate and gift taxes $14 billion	Certain transfers of property at death or through a gift are subject to tax.	Puerto Rico residents are generally treated as nonresident aliens for estate and gift tax purposes. As such, property located in Puerto Rico generally is tax exempt. 26 U.S.C. § 2209	Estate and gift taxes for Puerto Rico residents would apply in the same manner as for residents of the states.

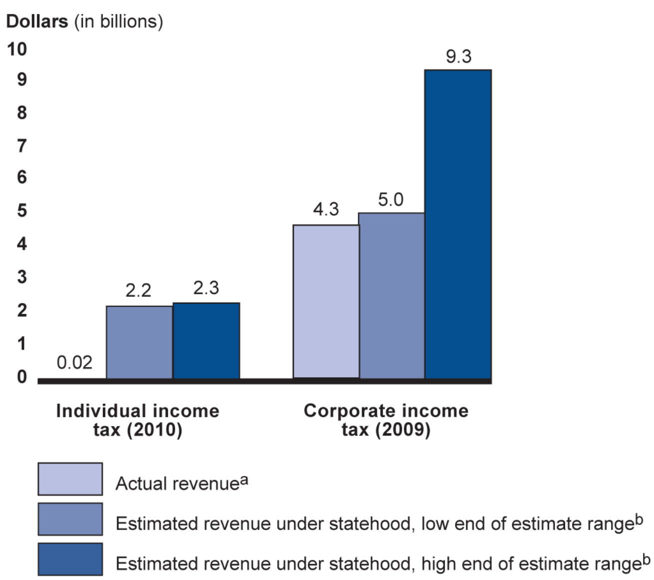
Sources: Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2014 (Washington, D.C.: Apr.10, 2013), and GAO analysis.

[a]The amount of tax covered over to Puerto Rico and the U.S. Virgin Islands is limited to $10.50 per proof gallon. Between June 30, 1999, and January 1, 2014, the limit on the amount of this tax covered over to Puerto Rico and the U.S. Virgin Islands was $13.25 per proof gallon of imported rum. 26 U.S.C. § 7652(f). The formula for dividing the cover over of excise tax on rum imported from other countries is based roughly on the relative market share of rum that Puerto Rico and the U.S. Virgin Islands produce. According to the Government Development Bank for Puerto Rico, Puerto Rico received about $401 million in covered-over excise tax on rum in fiscal year 2012. See, Government Development Bank for Puerto Rico, Commonwealth of Puerto Rico: Financial Information and Operating Data Report, May 17, 2013.)

[b]In fiscal year 2012, U.S. Customs and Border Protection covered over $4.8 million to Puerto Rico. See, Department of Homeland Security, U.S. Customs and Border Protection Puerto Rico Trust Fund, Fiscal Year 2014 Congressional Justification.

The extent to which statehood would affect federal revenue depends on various assumptions. For example, for the two largest revenue sources that would be affected substantially by statehood—individual and corporate income taxes—we used various assumptions to estimate a range of federal revenue. The estimate ranges are based on Puerto Rico being treated the same as the states in either 2009 or 2010, based on the year for which the most recent data were available. An example of how assumptions affect the estimates is illustrated by the estimate range for corporate income tax. That estimate is influenced by assumptions on applicable tax rates for business with activities in Puerto Rico, the extent of ownership of Puerto Rico businesses by U.S. corporations, and the extent to which U.S. corporations use prior-year losses from their affiliated Puerto Rico businesses to offset their federal taxable income. For example, the low end of the estimate range shown in figure 6 below is based on lower-bound assumptions for applicable corporate income tax rates, upper-bound assumptions for the extent of U.S. ownership of Puerto Rico businesses, and the assumption that U.S. corporations would have used prior-year losses of affiliated Puerto Rico corporations to offset their federal taxable income to the maximum extent. The high end of the estimate range shown in figure 6 is based on the upper-bound assumptions for applicable tax rates, lower-bound assumptions for the extent of U.S. ownership of Puerto Rico businesses, and the assumption that U.S. corporations would not have used any prior-year losses of affiliated Puerto Rico corporations to offset their federal taxable income.

Figure 6: Actual Federal Income Tax Revenue from Puerto Rico and Estimated Range of Federal Income Tax Revenue under Puerto Rico Statehood



Sources: GAO analysis of Puerto Rico tax return and IRS data.

[a]Actual individual income tax revenue represents the amount Puerto Rico taxpayers reported paying to the United States, its possessions, or foreign countries. According to officials from Puerto Rico's Department of Internal Revenue, most of these payments would have been to the United States. Actual corporate income tax revenue is our estimate—based on Internal Revenue Service (IRS) data—of taxes paid by U.S. corporations on income from branches or subsidiaries in Puerto Rico.

Most of the estimated $4.3 billion in tax U.S. corporations paid is attributable to an unusually large amount of dividends that were repatriated from Puerto Rico in 2009 (compared to amounts repatriated in earlier years or in 2010). In the absence of that spike in dividends, the federal taxes these corporations would have paid for 2009 would have been about $1.4 billion. For various reasons, we could not determine the precise amount of corporate income tax paid directly by businesses in Puerto Rico in addition to the $4.3 billion (although based on IRS data, the amount would have been no more than about $145 million).

[b]Individual income tax estimates are net of estimated payments for refundable tax credits, such as the earned income tax credit.

The estimates for corporate income tax in figure 6 do not take into account any changes in behavior of businesses with activities in Puerto Rico. For example, according to tax policy experts at the Department of the Treasury and the Joint Committee on Taxation, changes in federal income tax requirements under Puerto Rico statehood are likely to motivate some corporations with substantial amounts of income derived from intangible (and therefore mobile) assets to relocate from Puerto Rico to a lower tax foreign location. The extent to which such corporations might relocate from Puerto Rico is unknown. Consequently, we produced an alternative set of corporate income tax revenue estimates to account for some businesses with activities in Puerto Rico potentially relocating under statehood.[31] Accounting for this assumption, in conjunction with the other assumptions described previously, resulted in an estimated range of corporate income tax revenue of -$0.1 billion to $3.4 billion.[32]

[31]We assumed that all filing businesses in the pharmaceuticals and the medical equipment and supplies industries—which derive much of their income from mobile assets—would have relocated from Puerto Rico. Taxes are only one of various factors corporations generally take into account when determining where to locate their operations.

[32]For the low end of the estimate range for this set of scenarios, the accumulated losses from the Puerto Rico affiliates included in the consolidated federal corporate income tax return of U.S. corporations reduced taxes paid by the consolidated groups to such an extent that those reductions more than offset the positive amounts of taxes paid by other corporations operating in Puerto Rico, and resulted in a net revenue effect that was slightly less than zero.

Factors under Statehood that Could Influence Changes in Federal Spending and Revenue

Statehood could result in dynamic economic and fiscal changes for Puerto Rico, changes that could ultimately impact the level of federal spending in Puerto Rico, and the revenue collected from residents of, and corporations in, Puerto Rico. However, the precise nature of how such changes would affect federal spending and revenue is uncertain. Because statehood would cause numerous adjustments important to Puerto Rico's future, it would require careful consideration by Congress and the residents of Puerto Rico. Consequently, statehood's aggregate fiscal impact would be influenced greatly by the terms of admission, strategies to promote economic development, and decisions regarding Puerto Rico's revenue structure. As we have reported in the past, the history of statehood admissions is one of both tradition and flexibility. While Congress has emphasized the traditional principles of democracy, economic capability, and the desire for statehood among the electorate, it has also considered potential states' unique characteristics, including population size and composition, geographic location, economic development, and historical circumstances when making these decisions. Any decision to transition Puerto Rico to statehood in the future will also involve assessing a complex array of similar factors, in addition to economic and fiscal ones. Some factors that could influence changes in federal spending and in revenue for specific programs or types of tax are discussed in appendix II and appendix III of this report. In this section, we discuss general factors that could influence how Puerto Rico statehood could affect future federal spending and revenue.

Effect of Statehood on Puerto Rico's Economy and Employment

As previously discussed, Puerto Rico's economy has largely been in recession since 2006. Likewise, Puerto Rico's unemployment rate has been relatively high, and its labor force participation rate has been relatively low, compared to those of the states. Statehood—and the resultant changes to spending programs in Puerto Rico, and in tax requirements for Puerto Rico residents and corporations—could have wide-reaching effects on Puerto Rico's economy and employment.

Under statehood, Puerto Rico residents would be eligible for the federal earned income tax credit (EITC)—including refundable payments—which is designed to encourage work.[33] Also, in the short-term, increased federal transfers—such as through SSI benefits, which Puerto Rico residents would become eligible for under statehood—could stimulate Puerto Rico's economy. However, some Puerto Rico industry group representatives we interviewed worried that the relatively high rate of government transfer payments in Puerto Rico could discourage work. According to the Federal Reserve Bank of New York, such transfer payments equate to roughly 40 percent of personal income, more than double the share in the states.[34]

Likewise, the effect of statehood on Puerto Rico migration—and the corresponding effect of that migration on Puerto Rico's economy and employment—is uncertain. From 2002 to 2012, Puerto Rico's population decreased by about 5 percent based on U.S. Census Bureau estimates.[35] Migration has been cited as a possible explanation for Puerto Rico's relatively low labor force participation rate, particularly if those Puerto Rico residents most interested in participating in the labor force are migrating to the states in search of higher wage employment, leaving behind residents that have relatively less attachment to the labor force.[36]

In terms of business activity, one possibility is that statehood could raise Puerto Rico's visibility as a place for U.S. producers to locate. Likewise, statehood could eliminate any risk associated with Puerto Rico's uncertain political status and any related deterrent to business investment. However, the extension of federal corporate income taxes could result in U.S. or foreign corporations that currently operate in Puerto Rico relocating to lower-tax locations (although taxes are only one of

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[33]Although Puerto Rico has a similar tax credit for Puerto Rico income taxes (the employment credit), its maximum credit amount is relatively small compared to the maximum federal EITC amount. For example, the maximum federal credit for tax year 2012 was $5,891 (for taxpayers with 3 or more qualifying children), compared to a maximum Puerto Rico employment credit of $400.

[34]Federal Reserve Bank of New York, *Report on the Competitiveness of Puerto Rico's Economy* (New York, NY: June 29, 2012).

[35]From 2002 to 2012, population in the states increased by 9.1 percent, and decreased in only 2 states—Rhode Island and Michigan (by 1.5 percent in both states)—based on U.S. Census Bureau estimates.

[36]GAO, *Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit*, GAO-06-541 (Washington, D.C.: May 19, 2006). Individuals born in Puerto Rico are U.S. citizens with unrestricted access to the states.

various factors corporations generally take into account when determining where to locate their operations). Also, local businesses could incur higher costs because of additional tax liabilities.

Effect of Statehood on Puerto Rico's Public Finances

As previously discussed, Puerto Rico has run persistent fiscal deficits in recent years, which has increased Puerto Rico's public debt. As a result, Puerto Rico government-issued debt represents a much larger share of personal income than in any of the states. Recently, Puerto Rico has taken steps to improve its fiscal position, including reducing the size of its government workforce and reforming its primary public employee retirement system. However, in February 2014, Puerto Rico's general obligation bonds were downgraded to speculative—noninvestment—grade by three ratings agencies, in part because of concerns about Puerto Rico's fiscal position.

One factor that may have facilitated Puerto Rico's ability to issue debt is that the interest on most bonds issued by Puerto Rico's government, its political subdivisions, and its public corporations generally is not subject to income tax at the federal, state, or local levels.[37] Under statehood, if Puerto Rico was treated like the states, its government-issued debt would no longer enjoy this so called triple-exemption, as income accruing to residents of other states would become taxable at the state and/or local levels. The loss of triple-exempt bond status could result in reduced demand for Puerto Rico's debt.

As a result of statehood, changes to Puerto Rico government spending and revenue could ultimately affect the government's efforts to maintain a balanced budget. On the spending side, an increase in federal spending could allow Puerto Rico to reduce its own spending. For example, we estimated that if Puerto Rico had been a state in 2011, increased federal Medicaid spending of about $415 million to about $1.4 billion would have been accompanied by decreased Puerto Rico Medicaid spending of $152 million to $358 million.[38] However, statehood could result in reduced Puerto Rico tax revenue. For example, Puerto Rico's individual and corporate income tax rates are relatively high in comparison to those in the states. If Puerto Rico's government wished to maintain pre-statehood

[37] 48 U.S.C. § 745.

[38] The $152 million estimate is subject to a high level of statistical imprecision, with a margin of error of plus or minus 14.5 percent of the estimate itself.

tax burdens for individuals and corporations, it would need to lower its tax rates, which could reduce tax revenue.

Effect of a Statehood Transition Period

Under statehood, certain federal programs in Puerto Rico could change substantially if Puerto Rico were treated the same as the states. Likewise, Puerto Rico residents and corporations operating in Puerto Rico would become subject to significant changes in their tax requirements under statehood. Prior bills on Puerto Rico's status that Congress has considered have included provisions providing for a transition period or plan.[39] Under one approach, if Puerto Rico were to become a state, federal funding would increase incrementally until parity with other states was reached, and federal income tax requirements would be phased in.[40] If Congress granted statehood to Puerto Rico, it could decide to establish a similar transition period. In turn, the characteristics and length of time of such a transition period could affect federal spending and revenue during—and beyond—that period.

Agency and Puerto Rico Government Officials Comments

We provided draft sections of this report to the relevant federal program agencies, the Department of the Treasury, and IRS. We also shared a draft of the report with officials from the Government of Puerto Rico and the Resident Commissioner from Puerto Rico (Puerto Rico's Congressionally-authorized representative in Washington, D.C.).

In total, we sent draft report sections to 16 federal agencies.[41] Six agencies had no comments on their draft report sections. Ten agencies provided technical comments, which we incorporated as appropriate. We also received technical and written comments from the Governor of Puerto Rico and the Resident Commissioner from Puerto Rico. Technical comments were incorporated as appropriate; the written comments are

[39]For example, from 1989 to 1998, several bills included provisions providing for a transition period or plan: H.R. 3536, 101st Cong. (1989); H.R. 4765, 101st Cong. (1990); S. 712, 101st Cong. (1990); H.R. 3024 104th Cong. (1996); H.R. 856 105th Cong. (1998).

[40]S. 712, 101th Cong. (1990). Additionally, in the current Congress, bills on Puerto Rico's status introduced in the Senate and the House include language for a ballot on statehood that describes a period of transition to statehood, during which equal treatment of Puerto Rico in program and tax laws would be phased in. S. 2020, 113th Cong. (2013) and H.R. 2000, 113th Cong. (2013).

[41]Three agencies—the Centers for Medicare & Medicaid Services, the Administration for Children and Families, and the National Institutes of Health, are part of the Department of Health and Human Services.

reproduced as appendix V (Governor) and appendix VI (Resident Commissioner) to this report.

In his written comments, the Governor of Puerto Rico noted that if we had considered two factors omitted from our estimate of individual income tax revenue under statehood, estimated revenue would have been higher. First, the Governor noted that different federal filing thresholds and tax rates, compared to those for Puerto Rico, would have resulted in more individuals subject to tax and an increased amount of federal taxes paid by individuals. Our individual income tax revenue estimates take these differences into account, as they are based on the federal filing thresholds and federal tax rates. That is to say, we were able to determine which Puerto Rico residents who filed a Puerto Rico tax return for 2010 would have met federal filing thresholds and what tax rates would have applied to their taxable income, if at all. The Governor also noted that Puerto Rico does not tax Social Security benefits, which may be taxable at the federal level. In the individual income tax section of appendix III to this report, we note that because Social Security benefits are not included on Puerto Rico tax returns, our estimates do not take taxable Social Security benefits into account, and as a result our estimates could understate individual income tax revenue.

In response to our estimate for corporate income tax revenue, the Governor noted that to counter the effect of increased taxes on Puerto Rico businesses upon the imposition of federal taxes, our draft report suggested that Puerto Rico would reduce its corporate tax rate to 3.8 percent to be on par with the average corporate tax rate in the states (state taxes are deductable against corporate income for federal tax purposes). He noted that this assumption is unrealistic given Puerto Rico's current level of corporate tax rates and Puerto Rico's current fiscal situation. We based our modeling of corporate income tax revenue under statehood on the assumption that Puerto Rico would lower its corporate tax rates to be more in line with those in the states. However, we used the average effective rate in the states, which is different than a simple marginal rate.[42] Based on this comment, we conducted a sensitivity analysis to determine how our estimates would change if we assumed

[42]The effective tax rate, which shows how much tax a corporation pays as a percentage of its taxable income, incorporates more aspects of the tax code than just the statutory tax rate. It also reflects, among other things, the impacts of tax credits, exemptions, deferrals, and other provisions that can reduce tax liability.

that the effective rate of Puerto Rico's corporate income tax under statehood would have been twice as high as the average effective state rate (an effective rate of 7.6 percent). We found that the estimate ranges would not have changed substantially using this alternative assumption.[43]

Finally, the Governor noted that the characterization in the draft report of the percent of votes received by statehood in the 2012 plebiscite is inaccurate, and that the report should explain further the structure and outcomes of the plebiscite. In response to this comment, we provided additional detail on the number of voters and blank votes for both questions from the plebiscite. Assessing the structure of the plebiscite is outside the scope of this report.

In his written comments, the Resident Commissioner for Puerto Rico summarized the central findings of the draft report. He also pointed out some of the uncertainties and limitations inherent in developing estimates for how federal spending and revenue would change if Puerto Rico became a state, which we recognize in the report.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the heads of the relevant agencies for the programs and revenue sources in this report, Puerto Rico's governor, the Resident Commissioner for Puerto Rico, appropriate congressional committees, and other interested parties. In addition, the report will be available at no charge on the GAO website at http://www.gao.gov.

[43]Using this higher effective rate, we found that the estimate range changed from a range of $5.0 billion to $9.3 billion to a range of $4.6 billion to $9.0 billion. Incorporating the assumption that some corporations would relocate from Puerto Rico under statehood, the estimate range changed from a range of -$0.1 billion to $3.4 billion to a range of -$0.2 billion to $3.2 billion.

If you or your staff members have any questions about this report, please contact me at (202) 512-6520 or at czerwinskis@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix VII.

Stanley J. Czerwinski
Director, Strategic Issues

Appendix I: Objectives, Scope, and Methodology

The objectives of this report are to evaluate (1) potential changes to selected federal programs and related changes in federal spending, and (2) potential changes in selected sources of federal revenue, should Puerto Rico become a state. We also describe factors under statehood that could influence changes in federal spending and revenue.

Potential Changes to Selected Federal Programs and Related Changes in Federal Spending

To evaluate potential changes in selected federal programs under Puerto Rico statehood, we selected programs to review based on three criteria.

- **Programs that generally provide funds directly to states and territories, or residents and institutions in the states and territories.** Based on this criterion, we excluded certain types of federal spending from our review. Specifically, we excluded spending on the military;[1] international aid and affairs; interest on the national debt; and administrative, operational, procurement, or capital acquisition expenses at federal agencies, including federal employee salaries and retirement compensation.

- **Programs with net outlays of at least $5 billion.** We used the Office of Management and Budget (OMB) public budget database from fiscal years 2010 and 2011 to select programs to review.[2] We identified budget accounts with at least $5 billion, and then reviewed the programs within each account to identify those with outlays of at least $5 billion. We defined a program as an organized set of activities with the same objective(s) and funded by the federal government. We focused on programs that are expected to have an ongoing impact on the federal budget, meaning we did not consider temporary funding, such as that provided under the American Recovery and Reinvestment Act of 2009.[3] To further support whether

[1]One aspect of military spending—the Department of Defense's TRICARE Prime program—would likely change under statehood. A 2011 Department of Defense Report to Congress found that extending TRICARE into Puerto Rico and the other territories would result in a net cost increase of $29.7 million. See Department of Defense, *Report to Congress on Feasibility of TRICARE Prime in Certain Commonwealths and Territories of the United States* (Washington, D.C.: May 2011).

[2]We used data from 2010 because they were the most recent available when we began our work. Once data from 2011 became available, we assessed whether our program selection would have differed had we used data from that year. Since we found few differences, we did not change our original program selection. The five largest federal programs that would change under statehood based on outlay data for 2010 were also the five largest that would change based on 2011 data.

[3]Pub. L. No. 111-5, 123 Stat. 115.

the programs met our selection criteria, we compared programs with total federal outlays of at least $5 billion (from the OMB database) to those described in the *Catalog of Federal Domestic Assistance* and the *Appendix to the Budget of the U.S. Government*.[4] Through this process, we identified 27 programs to review.

- **Programs for which federal spending in Puerto Rico differed significantly from spending in a set of comparable states.** To identify programs with less than $5 billion in net outlays that may be subject to relatively large spending changes under statehood—such as those providing little or no funding to Puerto Rico—we reviewed federal program spending by state from the Census Bureau's *Consolidated Federal Funds Report* for fiscal year 2010. We selected five states[5] most similar to Puerto Rico in terms of population and median household income, and identified programs for which the difference in average federal spending between these states and Puerto Rico was at least $100 million.[6] Through this process, we identified two additional programs to review: the Public Housing Operating Fund and the Public Housing Capital Fund.

The 29 programs we selected to review accounted for about 86 percent of spending in fiscal year 2010 on federal programs that generally provide funds directly to states and territories, or to residents and institutions in the states and territories.

We asked the 12 federal agencies that administer the 29 programs we selected to review our selection methodology and confirm that inclusion of each program was appropriate based on our criteria. The agencies provided additional information and documentation, when necessary. In one instance, a selected program comprised a subset of a larger budget account, and the agency overseeing the program was unable to provide a

[4]General Services Administration and Office of Management and Budget, *2011 Catalog of Federal Domestic Assistance* (Washington, D.C.: Nov. 2011) and Office of Management and Budget, *Appendix, Budget of the U.S. Government, Fiscal Year 2012* (Washington, D.C.: Feb. 14, 2011).

[5]The five selected states were Alabama, Arkansas, Kentucky, Mississippi, and Oklahoma.

[6]We did not conduct a comprehensive assessment of the reliability of spending data from this data source. However, we assessed whether the spending amounts by state and program were reasonable based on the overall size of the program.

net outlay figure.[7] To consistently report federal spending across programs, we report obligation amounts for the 29 programs we selected for our review, as obligation amounts were available for all selected programs (see figure 3 earlier in this report).

For each selected program, we reviewed federal laws and regulations to determine whether and how statehood might affect funding or other requirements for Puerto Rico. We based our analyses on the assumption that, if it is granted statehood, eventually Puerto Rico would be treated the same as the states. For some programs, current law applies certain limitations or exceptions to Puerto Rico by name. For other programs, the governing statutes refer to the 50 states or the 50 states and the District of Columbia. For these programs, we assumed that, if Puerto Rico became a state, it would be treated the same as any existing state, either because Congress would amend the statutory limitations and exceptions or they would otherwise not apply. We did not evaluate whether Puerto Rico would be required to be treated the same as the states in the context of any specific program.[8] We confirmed with the relevant agencies whether and how statehood would affect funding or other requirements for Puerto Rico.

To evaluate potential changes in federal spending related to changes to federal programs, we evaluated the five largest programs that would be likely to change under statehood. We developed estimate ranges of the potential changes in federal spending for the four largest programs that would be likely to change under statehood: Medicare, Medicaid, the Supplemental Nutrition Assistance Program (SNAP), and Supplemental Security Income (SSI). The Federal Highway Administration developed an estimate on our behalf of potential changes in federal spending for the fifth largest program that would be likely to change under statehood—Federal-Aid Highways. We also developed an estimate of potential changes in spending for the ninth largest federal program that would be likely to change under statehood—the Children's Health Insurance Program (CHIP)—because Puerto Rico receives federal CHIP funding as part of its Medicaid program. The programs for which we developed estimates accounted for about 94 percent of fiscal year 2010 spending on

[7] In this instance, the agency confirmed that net outlays were greater than $5 billion.

[8] Whether or not Congress would have the power to treat Puerto Rico—as a state—differently from any other state for the purposes of any particular federal program was beyond the scope of our work.

programs that would likely change under statehood. We developed estimate ranges for a single year in the past, as if Puerto Rico had been treated the same as the states in that year. The years of the estimate ranges vary by program and are based on the most recent relevant data when we began our work. For programs other than Federal-Aid Highways, the estimate ranges are in calendar-year terms because the eligibility and other data used to develop the estimates were in calendar-year terms. The estimate for Federal-Aid Highways is in fiscal-year terms. Actual spending in Puerto Rico, to which we compare the estimates, is in fiscal-year terms because the spending data were reported in fiscal-year terms.

To estimate potential changes in federal spending for Medicaid, SNAP, SSI, and CHIP, we contracted with the Urban Institute to conduct portions of the work using two simulation models. We also used aspects of the Urban Institute's simulations in estimating spending for Medicare.

The estimates of potential spending changes involve various sources of uncertainty. Except for Federal-Aid Highways, the estimates are based, in part, on sample survey data, which include sampling error. Sample survey data are obtained by following a probability procedure based on the selection of random samples, and each sample is only one of a large number of samples that might have been selected. Since each sample could have provided different estimates, sampling error measures the level of confidence in the precision of a particular sample's results, which we express as a margin of error at the 95-percent confidence interval. Unless otherwise indicated, the estimates included in this report that used sample survey data—plus or minus 7 percent, or less, of the estimates themselves—would contain the actual value for the populations we analyzed for 95 percent of the samples that could have been selected.

There are other sources of uncertainty that are not readily quantifiable. These include the assumptions we used to develop the estimates, such as those for which program eligibility rules Puerto Rico would adopt, and the rates at which eligible Puerto Rico residents would participate in the programs. To some extent, the various scenarios for estimated spending included in this report capture how these assumptions would impact spending. In other instances, there may be sources of uncertainty and dynamic changes to the programs that we could not incorporate into our modeling. These could include further changes in eligibility rules once additional program funding becomes available, the reaction of program beneficiaries to changes in the programs, or congressional action resulting from statehood.

Medicare Estimate

To estimate potential changes in federal spending for Medicare for 2010, we estimated spending for the two options through which Medicare beneficiaries can obtain insurance coverage for hospital and medical services—Medicare fee-for-service (Medicare FFS) and Medicare Advantage (MA), the private plan alternative to Medicare FFS—as well as the optional prescription drug benefit.

For Medicare FFS, we first calculated average spending for various demographic groups of Medicare beneficiaries in the states, using the Centers for Medicare & Medicaid Services's (CMS) Medicare Current Beneficiary Survey (MCBS) Cost and Use file for 2010, the most recent available at the time we began our work.[9] The file contains demographic information on Medicare beneficiaries, matched to administrative data on actual spending. Using these data, we developed estimates for average Medicare FFS spending by categories of age, gender, disability status, and dual-eligible status—that is, beneficiaries eligible for both Medicare and Medicaid. For some groups of Medicare beneficiaries, the MCBS sample size allowed for finer age and gender group breakdowns; for others, we combined age and gender groups.

To identify corresponding groups of Puerto Rico residents by age and gender, we used data from the Census Bureau's Puerto Rico Community Survey (PRCS) three-year sample for 2009-2011: the years closest to the year of the MCBS data we used.[10] We also used estimates of dual-eligible beneficiaries that the Urban Institute developed.[11] We calculated the number of disabled but non-dual-eligible enrollees by subtracting the number of dual-eligible enrollees and the number of enrollees over age 65 from the total number of enrollees. We multiplied the average Medicare spending amounts from MCBS respondents in the states for

[9]The MCBS is a survey of a nationally representative sample of the Medicare population, including both aged and disabled beneficiaries. The survey data are released annually and the results are contained in two data files, Access to Care and Cost and Use.

[10]The PRCS is part of the Census Bureau's American Community Survey and collects demographic, income, and other data. Using a multiyear estimate increases the statistical reliability and precision of the data for less populated areas or smaller subgroups. We used this larger sample size for Puerto Rico Medicare beneficiaries to increase the reliability of our estimate.

[11]The Urban Institute estimated two scenarios for Medicaid based on two different assumptions for eligibility, as discussed in the Medicaid section below. These two scenarios resulted in two different estimates of dual-eligible beneficiaries, both of which we incorporated into our estimates for Medicare.

each group or category to the corresponding Puerto Rico beneficiary count.

To account for different health care costs in Puerto Rico relative to the states, we adjusted the wage indices used to calculate spending for Medicare FFS Part A and the Geographic Practice Cost Indices used to calculate spending for Medicare FFS Part B. We also made adjustments to account for the lower Medicare FFS Part B take-up rate and lower utilization rates in Puerto Rico relative to the states.

For MA, we used data from the MCBS file to estimate the average cost for Puerto Rico MA enrollees. Because the benchmark underlying payments to MA plans in Puerto Rico is changing (regardless of whether Puerto Rico becomes a state) because of provisions in the Patient Protection and Affordable Care Act (PPACA),[12] we modeled spending based on two benchmark scenarios: (1) the benchmark generally applicable for Puerto Rico for fiscal year 2014 (147.5 percent), and (2) the benchmark that generally will apply in 2017, when PPACA is fully phased-in (115 percent). Given that these changes in benchmarks could result in Puerto Rico MA enrollees switching to Medicare FFS, we developed estimates based on two MA enrollment scenarios: (1) the percentage of Puerto Rico Medicare beneficiaries enrolled in MA in 2010 (about 64 percent), and (2) the highest MA enrollment percentage in the states (about 42 percent). These changes are the only potential impacts of PPACA we incorporated into our estimates for Medicare. For a description of how PPACA could affect Medicare spending in Puerto Rico, see appendix IV.

For the Medicare prescription drug benefit, we estimated the number of enrolled beneficiaries by applying the percentage of Puerto Rico beneficiaries who enroll in a benefit plan (77 percent) to our estimates of Puerto Rico Medicare beneficiaries. Our estimates of Puerto Rico Medicare beneficiaries include the estimates of dual-eligible beneficiaries that the Urban Institute developed. We assumed that there would be different costs per person depending on whether an enrolled beneficiary was a dual-eligible beneficiary, a disabled but non-dual eligible beneficiary, or any other beneficiary (essentially, all other enrolled beneficiaries age 65 or older). Using MCBS data, we estimated average

[12]Pub. L. No. 111-148, 124 Stat. 119 (2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010).

prescription drug benefit costs for each of the three categories of beneficiaries and applied those costs to the number of beneficiaries in each category. We also assumed that the percentage of eligible Puerto Rico Medicare beneficiaries who would have enrolled in the low-income subsidy—which covers all, or a portion of, a beneficiary's prescription drug benefit plan premiums, deductibles, copayments, and other out-of-pocket costs—would have been the same as that for all Medicare beneficiaries (about 77 percent).

We assessed the reliability of the PRCS and MCBS data by performing appropriate electronic data checks, comparing MCBS data to administrative data, and by interviewing CMS officials who were knowledgeable about the data. We found the data were sufficiently reliable for the purposes of this report.

Medicaid, SNAP, SSI, and CHIP Estimates

To estimate potential changes in federal spending for Medicaid, SNAP, SSI, and CHIP, we contracted with the Urban Institute to conduct portions of the work using two simulation models: (1) the Health Policy Center's American Community Survey Medicaid/CHIP Eligibility Simulation Model (HPC Medicaid/CHIP model), and (2) the Transfer Income Model, Version 3 (TRIM3), which simulates major federal tax and transfer programs, including SNAP, SSI, and Temporary Assistance for Needy Families (TANF). For this work, these models used 2011 PRCS data and other data sources to estimate the effect of program eligibility changes on the number of eligible and enrolled individuals for a select program and, in certain instances, they estimate the associated costs. We chose PRCS as a data source because of its large sample size and detailed information on the respondents' demographics and participation in public assistance programs.[13] 2011 was the most recent available year of PRCS data. We assessed the reliability of these data by reviewing available documentation and conducting reliability tests on the data that we used. We determined that the data were sufficiently reliable for the purposes of this report.

[13]The Urban Institute captured sampling errors by using the 80 different sets of replicate weights the Census Bureau provides for households and individuals in the PRCS sample. The Urban Institute treated the program estimates its models produced as if they were numbers tabulated directly from the survey data. The Urban Institute tabulated the various model-created variables 80 times, once with each set of weights, and used the formula that converts that information into a standard error for each estimate. We then used the standard error to calculate the margin of error at the 95 percent confidence interval.

We assessed the reliability of the Urban Institute's modeling procedures by reviewing documentation on TRIM3 and the HPC Medicaid/CHIP model and input data sources, reviewing the Urban Institute's internal quality control procedures, and discussing the program rules and underlying assumptions used in the models with staff from the Urban Institute who were responsible for the work provided under our contract. Further, we evaluated the estimates on the basis of substantive significance (rather than statistical significance) by considering their size and the direction of the effect of changes to the programs under statehood. We determined that none of the modeling assumptions compromised the analysis for this report and that the data were sufficiently reliable for our purposes.

Using the HPC Medicaid/CHIP model and TRIM3 to estimate spending changes for these programs required our input on assumptions, and about the rules governing federal programs. Therefore, the information presented in this report is attributable only to GAO. Specific steps taken to estimate spending for these programs appears below.

Medicaid

To estimate federal Medicaid spending for 2011, the Urban Institute used the HPC Medicaid/CHIP model to estimate (1) the number of individuals who would have been eligible for Medicaid, and (2) the number of eligible individuals who would have enrolled in Medicaid. We then estimated (1) total (federal and Puerto Rico) Medicaid spending, and (2) the federal share of total Medicaid spending. We also estimated the extent to which Puerto Rico's spending on Medicaid would change.

The Urban Institute estimated eligibility based on our input for income eligibility assumptions. To determine the most appropriate income eligibility assumptions, we identified federal Medicaid mandatory categories of individuals for states and Puerto Rico's 2011 Medicaid eligibility standards. We asked Puerto Rico officials for input on what optional Medicaid income eligibility standards might be selected under statehood. They told us that it would be difficult to determine what optional coverage groups would be selected, given the significant economic and budgetary restraints Puerto Rico currently faces, and uncertainty around the cost to Puerto Rico of expanding coverage. Ultimately, we chose to model two eligibility scenarios:

- Assuming Puerto Rico would have covered only mandatory categories of individuals. Under this scenario, Medicaid eligibility would have increased for some categories (such as pregnant women and as well as children). Optional categories (such as childless, non-elderly, non-disabled adults) would no longer be covered. This scenario represents the lower bound of potential federal Medicaid spending under statehood.

- Assuming Puerto Rico would have covered mandatory categories of individuals and expanded coverage levels for the optional categories it actually covered in 2011.[14]

For certain populations, such as pregnant women, infants, and children, Medicaid eligibility is based on a family's income level as a proportion of a defined poverty level. Although Puerto Rico currently uses its own local poverty level (see the section on Medicaid in appendix II), we assumed that as a state, Puerto Rico would be required to adhere to the same federal poverty guidelines as the 48 contiguous states and the District of Columbia.[15] We based this assumption, in part, on our general assumption that Puerto Rico would be treated in the same manner as the states, and on input from officials with the Department of Health and Human Services' Office of the Assistant Secretary for Planning and Evaluation (ASPE). This office updates and publishes the annual federal poverty guidelines.[16] For other populations, eligibility is based on participation in federal programs, such as SSI, for which Puerto Rico residents would become eligible under statehood.

To estimate enrollments, we assumed that all actual Medicaid beneficiaries and individuals estimated to have received SSI and TANF benefits in 2011 would have enrolled.[17] For all other eligible individuals,

[14]For this scenario we assumed that, where permitted by law, Puerto Rico would have adopted optional rules to expand coverage to individuals that were eligible for Puerto Rico's Medicaid or local health insurance program in 2011. We also assumed that if Puerto Rico had been a state at the beginning of 2011, it would have exercised its early expansion option by the beginning of the year to begin covering childless, non-disabled, non-elderly adults with incomes up to the federal poverty level equivalent of 200 percent of the local poverty level—as permitted under PPACA. This population of beneficiaries would otherwise have been covered through Puerto Rico's local health insurance program (although as of July 1, 2011, Puerto Rico began covering the part of this population with incomes at or below 100 percent of the local poverty level through Medicaid).

[15]The federal poverty guidelines differ for Alaska and Hawaii.

[16]ASPE officials told us that their office would not generate separate poverty guidelines for Puerto Rico unless directed by Congress or the Office of Management and Budget.

[17]Estimated Medicaid enrollment of individuals receiving SSI benefits is based on a scenario under which SSI participation is based on national participation rates (see the SSI section of this appendix).

we decided to apply participation rates observed for actual Puerto Rico Medicaid and CHIP enrollees in the top decile of the distribution of income-to-poverty ratio by subgroup (i.e., a matrix of age group, insurance coverage, and disability status), based on the assumption that newly eligible individuals would be more similar to higher-income eligible individuals than to lower-income eligible individuals.[18] The enrollment estimates are by geographic region in Puerto Rico. The Urban Institute also estimated the number of beneficiaries dually eligible for Medicare and Medicaid.

To estimate total (federal and Puerto Rico) Medicaid spending, we applied annualized per member per month rates paid for different categories of enrolled individuals to estimated enrollments. The annualized per member per month rates we used were those paid by Puerto Rico to its managed care organization for Medicaid enrollees between October 2010 and June 2011 for physical and mental health services.[19] These rates generally varied by geographical area and ranged from about $1,180 to $1,852.[20] For dual-eligible beneficiaries enrolled in Puerto Rico's *Platino* program—for whom the majority of health care costs are covered by Medicare—the rate was $120. According to CMS officials, the vast majority of beneficiaries enrolled in the *Platino* program are dual-eligible beneficiaries. Thus, we used the Urban Institute's estimates for dual-eligible beneficiaries as a proxy for the number of *Platino* enrollees when applying per person costs.

To estimate the federal share of total Medicaid spending, we applied a predicted Federal Medical Assistance Percentage (FMAP)—the statutory formula that determines the federal share of Medicaid funding provided to

[18]The Urban Institute conducted sensitivity testing on this aspect of its modeling and found that the enrollee estimates did not change substantially when alternative participation rate assumptions were applied.

[19]These rates do not include Medicaid coverage of nursing home and home health services, which are mandatory services not covered by Puerto Rico, in accordance with its federally-approved state plan. Puerto Rico would have been required to cover these services as a state. If the additional costs of covering these services had led to additional costs incurred by Puerto Rico, it might have changed the extent to which it had covered optional eligibility groups.

[20]According to CMS data, per-capita Medicaid expenditures averaged $5,495 annually for the 50 states and D.C. and ranged from $2,754 in California to $9,128 in New York, based on enrollment estimates measured in terms of persons ever enrolled in Medicaid during fiscal year 2010. Puerto Rico's relatively low per-capita expenditure is a function, in part, of the statutory limit on federal Medicaid funding for Puerto Rico.

states and territories—to total Medicaid spending. For Puerto Rico, the predicted FMAP was 83 percent.[21] We assumed that the statutory limit on federal Medicaid funding to Puerto Rico would have been removed. We also estimated Puerto Rico's share of total Medicaid spending to show how it would change under statehood.

We did not incorporate all aspects of the Medicaid program into our spending model, including the cost of the Medicaid Disproportionate Share Hospital (DSH) program or potential savings resulting from Puerto Rico's participation in the Medicaid drug rebate program.[22] We did not incorporate Puerto Rico's Enhanced Allotment[23] into our model, as it would be likely eliminated under statehood and replaced with the Medicare low-income subsidy for prescription drugs.

SNAP

To estimate federal SNAP spending for 2011, the Urban Institute used TRIM3 to estimate (1) the number of household units that would have been eligible for SNAP benefits, (2) the number of eligible household units that would have participated in SNAP, and (3) aggregate SNAP benefits for participating household units.[24]

The Urban Institute based its eligibility estimates on program eligibility rules in the states (SNAP is currently unavailable to Puerto Rico residents), including income and resource limits, and rules related to participation in other means-tested programs, such as SSI and TANF. The Urban Institute calculated net income by subtracting various deductions from a household unit's gross income—such as those for earned income, dependent care expenses, medical care expenses, excess shelter costs, and a standard deduction. Where the rules for allowable deductions differ between (1) the 48 contiguous states and the

[21]CMS calculated that Puerto Rico's FMAP would have been 91 percent based on its per capita income; however, the federal FMAP limit is 83 percent. 42 U.S.C. 1395d(b).

[22]This program provides savings to state Medicaid programs through rebates for outpatient prescription drugs.

[23]The enhanced allotment provides financial assistance for certain beneficiaries' prescription drug costs.

[24]For SNAP, a household is generally a group of people who live together and buy food and prepare meals together. However, there are specific exceptions. For example, parents, and most children under age 22 who live together are included in the same household regardless of whether they purchase and prepare meals together. 7 U.S.C. §2012(n).

District of Columbia and (2) other states and territories, the estimates use the rules applicable to the 48 contiguous states and the District of Columbia. The Urban Institute imputed household units' resources by applying assumed annual rates of return on reported interest, dividends, and rent.

To estimate the number of eligible household units that would have participated in SNAP, we directed the Urban Institute to model four different scenarios, based on the following assumptions on household unit definitions and participation rates.

- Everyone in a household would have filed for SNAP as a single unit, unless the household contained at least one person who received TANF. If the household contained a TANF recipient, it was divided into as many filing units as possible, subject to the requirements involving married couples and children. This household unit definition was modeled using (1) a national probabilities estimate of SNAP participation, resulting in a household participation rate of 75 percent, and (2) full participation, which occurs in some states.[25]

- Assuming full participation, all related persons in a household would have filed for SNAP as a single unit. Unrelated individuals and subfamilies would have filed as separate units.

- Assuming full participation, with households that had more than one potential SNAP unit split into as many filing units as permitted.

For all scenarios, household units that reported receiving benefits under Puerto Rico's current federally-funded nutrition assistance program were assumed to have chosen to participate in SNAP if they had qualified.

To estimate aggregate SNAP benefits for participating household units, each participating household unit's benefit amount was determined by subtracting 30 percent of the household unit's net income from the maximum SNAP allotment for household unit size, using the maximum

[25]We used estimated participation rates because the actual rates for the current federally-funded nutrition assistance program in Puerto Rico was not estimated. A prior study on implementing SNAP in Puerto Rico used a participation rate of 89 percent. See U.S. Department of Agriculture, Food and Nutrition Service, *Implementing Supplemental Nutrition Assistance Program in Puerto Rico: A Feasibility Study* (Alexandria, VA: June 2010).

SNAP allotments for the 48 contiguous states and the District of Columbia.[26] This reduction from the maximum SNAP allotments is made because households are expected to spend 30 percent of their resources on food. We also determined the impact on SNAP benefits of replacing the Aid to the Aged, Blind, and Disabled (AABD) program with the higher-benefit SSI program, since an increase in cash aid could lower a person's SNAP benefits.

SSI

To estimate federal SSI spending for 2011, the Urban Institute used TRIM3 to estimate (1) the number of individuals who would have been eligible for SSI benefits, (2) the number of eligible individuals who would have participated in SSI, and (3) aggregate SSI benefits for participating individuals.

The Urban Institute based its eligibility estimates on program eligibility rules for individuals' age, blindness, or disability status, and income and resource limits. To qualify for benefits based on age, an individual must be at least 65 years old. Adults younger than 65 can qualify for benefits based on blindness or a permanent disability that prevents work; children can qualify based on a disability with conditions that severely limit their activities. To determine disability status, doctors examine prospective adult and child beneficiaries. Because the PRCS data do not precisely capture the same criteria that are assessed by doctors, assumptions were required to estimate potential SSI eligibility among the non-elderly. TRIM3 designated an adult as blind or disabled where the survey responses showed (1) that the adult did not work in the prior year or earned income less than the substantial gainful activity limit, and (2) at least one of the following was true:

- The adult indicated having a physical, remembering, or vision limitation.
- The adult was between 22 and 61 years old, not a widow, and reported Social Security income.

TRIM3 treated children ages 15 and older as adults for the disability eligibility determination since children are asked the same survey questions asked of adults. TRIM3 identified children younger than 15 as potentially disabled if they reported a remembering or vision disability.

[26]Eligible one and two-person households are guaranteed a minimum benefit.

The model was not used to estimate the number of children younger than age 5 who were potentially disabled, because the remembering limitation question is not asked of them. Instead a sufficient number of children under age 5 were included so that the portion of the total children's caseload that is under age 5 is the same as in the states.

Regardless of age or disability status, individuals must have limited assets and income to be eligible for SSI benefits. TRIM3 imposed the eligibility asset test of $2,000 for a unit with one eligible person and $3,000 for an eligible couple. Asset values were inferred from the level of reported asset-based income (interest, dividend, and rental income). Adults may qualify either individually or as couples. The simulation model found that 81 percent of eligible adults were either unmarried or married to an ineligible individual.

To estimate the number of eligible individuals who would have participated in SSI, we present two scenarios—with participation rates that varied by age group and disability status—assuming that eligible individuals would participate based on (1) national average participation rates, and (2) the average of participation rates for the five states with the highest three-year average poverty rate for 2009 to 2011.[27] For children younger than 5, the data were not sufficient to estimate a participation rate; instead, a sufficient number of children younger than 5 were included so that their share of all eligible children was the same as in the states. Individuals in the simulation determined to be participating in AABD, which SSI would replace, were included as participating in SSI.

To estimate aggregate benefits, we used participant benefits following the SSI program rules. To determine the actual benefit, the maximum SSI benefits (in 2011, $674 for individuals and $1,011 for couples) were reduced, based on countable income. In determining countable income, SSI program rules disregard the first $20 of most income per month, plus the first $65 of earned income and 50 percent of any additional earned income. One-third of child support is also disregarded. For an individual with a spouse who is not potentially eligible for SSI, the amount of the spouse's income to be deemed available is determined. For children, some income is deemed from their parents.

[27]These states were Mississippi, New Mexico, Louisiana, Arizona, and the District of Columbia.

CHIP

To estimate federal CHIP spending for 2011, the Urban Institute used the HPC Medicaid/CHIP model to estimate (1) the number of individuals who would have been eligible for CHIP, and (2) the number of eligible individuals who would have enrolled in CHIP. We then estimated total (federal and Puerto Rico) CHIP spending.

The Urban Institute estimated eligibility based on our input on eligibility rule assumptions. To qualify for federal CHIP funding, states' CHIP cannot cover children who are eligible for Medicaid. In 2011, states were required to provide Medicaid coverage to children with family incomes up to 100 percent and 133 percent of the federal poverty level (FPL), depending on a child's age. States have discretion in setting CHIP eligibility standards. Forty-five states and the District of Columbia covered children between 200 percent and 300 percent of the FPL in 2011.

Given required increases to Medicaid income eligibility limits under statehood, Puerto Rico residents enrolled in CHIP in 2011 would have qualified for Medicaid, but not for CHIP. To draw down federal CHIP funding, Puerto Rico would have needed to raise its CHIP income eligibility standards. When asked what income eligibility rules might be adopted under statehood, officials from Puerto Rico's Department of Health responded that it would be difficult for Puerto Rico to determine what income eligibility rules would be adopted. Ultimately, we chose to model three eligibility scenarios.

- Assuming Puerto Rico had opted to cover children up to 300 percent of the FPL.
- Assuming Puerto Rico had opted to cover children up to 200 percent of the FPL.
- Assuming Puerto Rico had opted to discontinue its version of CHIP.

To estimate enrollments, we followed a process similar to that for Medicaid. We assumed that all actual CHIP beneficiaries and individuals estimated to have received SSI and TANF benefits in 2011 would have enrolled.[28] As previously described for Medicaid, for all other eligible

[28]Estimated CHIP enrollment of individuals receiving SSI benefits is based on a scenario under which SSI participation is based on national participation rates (see the SSI section of this appendix).

individuals, we decided to apply participation rates observed for actual Puerto Rico Medicaid and CHIP enrollees in the top decile of the distribution of income-to-poverty ratio by subgroup (i.e., a matrix of age group, insurance coverage, and disability status), based on the assumption that newly eligible individuals would be more similar to higher-income eligible individuals than to lower-income eligible individuals.[29] The enrollment estimates are by geographic region in Puerto Rico.

To estimate total (federal and Puerto Rico) CHIP spending, we applied annualized per member per month rates paid for different categories of enrolled individuals to estimated enrollments. The annualized per member per month rates are the same as for Medicaid.

To estimate the federal share of total CHIP spending, we applied a predicted enhanced federal medical assistance percentage (enhanced FMAP) to total CHIP spending. The enhanced FMAP is the statutory formula that determines the federal share of CHIP funding provided to states and territories. For Puerto Rico, the predicted enhanced FMAP was 85 percent. We also estimated Puerto Rico's share of total CHIP spending to show how it would change under statehood.

Federal-Aid Highways Estimate

To estimate federal spending on Federal-Aid Highways for fiscal year 2013, we obtained estimates from the Federal Highway Administration (FHWA) on (1) Puerto Rico highway users' expected contribution to the Highway Account of the Highway Trust Fund (the Fund), and (2) Puerto Rico's expected apportionment—a division of authorized highway funding according to statutory formulas. Using these estimates, we determined Puerto Rico's net deficit for Federal-Aid Highways.

To estimate Puerto Rico highway user's expected contribution to the Fund for fiscal year 2013, FWHA multiplied Puerto Rico's reported number of gallons of motor fuel consumed on highways for fiscal year 2011[30] by the applicable federal tax rate.[31] We confirmed that FHWA

[29]The Urban Institute conducted sensitivity testing on this aspect of its modeling. It found that estimated enrollments did not change substantially when it applied alternative participation rate assumptions.

[30]Fiscal year 2011 data would have been used in the fiscal year 2013 apportionment calculations because fuel consumption data lags by 2 years.

calculated Puerto Rico highway user's expected contribution to the Fund with the same process it used for highway users in the states. We did not independently review FHWA's process for estimating state users' contributions into the Fund. However, we reviewed the process in the past, and FHWA made changes to the process as a result of that review.[32] Regarding the motor fuel data collected by Puerto Rico, FHWA officials were unaware of any specific limitations to the data.[33]

To estimate Puerto Rico's apportionment, FHWA officials ran Puerto Rico data through a series of formulas on our behalf. Under legislation passed in July 2012, apportionments for the states in fiscal year 2013 are virtually the same as apportionments for fiscal year 2012,[34] which, in turn, were based on apportionments for fiscal years 2009 and 2011.[35] Each state's apportionment for fiscal year 2009 was calculated using a series of 13 statutory formulas linked to sub-programs. The formulas rely on data elements—referred to as factors—such as total lane miles eligible for Federal-Aid Highways, and vehicle miles traveled on open Interstates.

Some factors were unavailable for Puerto Rico and were entered as zero in the calculations.[36] According to FHWA officials, the unavailable data had no effect on the estimated apportionment because of Equity Bonus computations. The Equity Bonus, in effect for fiscal year 2009, guaranteed that each state received at least a share of combined apportionments and High Priority Projects[37] equal to 92 percent of

[31]The rates for taxes going into the highway account of the Fund are 0.1544 cents for gasoline, and 0.2144 for special fuels, which include combined highway diesel and highway liquefied petroleum gas and alternative fuels.

[32]GAO, *Highway Funding: Problems with Highway Trust Fund Information Can Affect State Highway Funds*, GAO-RCED/AIMD-00-148 (Washington, D.C.: June 2000).

[33]Although FHWA assesses whether incoming motor fuel data are significantly out of line with past reporting, Puerto Rico has not been included in these reviews because its data are not used to calculate a Fund contribution, according to FHWA officials.

[34]See Moving Ahead for Progress in the 21st Century Act, Pub. L. No. 112-141, 126 Stat. 405 (2012). This law is the current authorization act for surface transportation programs. It will expire at the end of fiscal year 2014.

[35]Pub. L. No. 109-59, § 1101, 119 Stat. 1144, 1153 (2005).

[36]Factor data for the Recreational Trails Program (non-highway fuel use), the Railway-Highway Grade Crossings Program (public highway-rail grade crossings), and the Safe Routes to Schools Program (total school enrollment in primary and middle schools) were unavailable.

[37]High Priority Projects were funded by the High Priority Projects Program. Eligible projects were identified in prior legislation, in effect for fiscal year 2009.

contributions from highway users from that state to the Highway Account of the Fund. Similarly, as stated in prior work, the underlying data and factors are ultimately not meaningful for determining apportionments because they are overridden by other provisions that yield a predetermined outcome—in particular, the Equity Bonus under prior legislation.[38] The estimated Puerto Rico apportionment for fiscal year 2009 was adjusted to meet the 92 percent Equity Bonus minimum relative rate of return.

Given the overriding effect of Equity Bonus on the estimated Puerto Rico fiscal year 2009 apportionment—and, consequently, the fiscal year 2013 estimated apportionment—we did not verify the reliability of the Puerto Rico data that fed into the apportionment calculations. Additionally, we did not verify that the formulas FHWA used were consistent with the relevant statutes. However, we confirmed that FHWA used the same formulas and process for calculating state apportionments as were used for fiscal year 2009, which, by law, is the basis for fiscal year 2013 apportionments.

Potential Changes to Selected Sources of Federal Revenue

To evaluate potential changes to selected sources of federal revenue under Puerto Rico statehood, we reviewed federal laws and regulations related to the main sources of federal revenue in 2012—individual income tax (which accounted for 46.2 percent of federal revenue in 2012), employment tax (34.5 percent), corporate income tax (9.9 percent), excise tax (3.2 percent), customs duties (1.2 percent), and estate and gift taxes (0.6 percent).[39] We also estimated potential changes in revenue for individual and corporate income taxes—the two largest revenue sources that would be affected substantially by statehood.[40] As with our estimates of potential changes in federal spending, our estimates of potential changes in federal revenue involve uncertainty. To some extent, the

[38] GAO, *Federal-Aid Highways: Trends, Effect on State Spending, and Options for Future Program Design*, GAO-04-802 (Washington, D.C.: Aug. 31, 2004).

[39] Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal year 2014* (Washington, D.C.: Apr. 10, 2013). We did not evaluate potential changes to miscellaneous receipts—which accounted for 4.4 percent of total receipts in fiscal year 2012. About 77 percent of miscellaneous receipts in fiscal year 2012 derived from earnings deposited by the Federal Reserve; other types of miscellaneous receipts included fines, penalties, and forfeitures.

[40] Although certain of the various statutory exceptions from the definition of wages for employment taxes do not apply to Puerto Rico, federal employment taxes generally apply to residents of Puerto Rico on the same basis and for the same sources of income as to residents of the states. 26 U.S.C. §§ 3121(e), 3306(j).

various scenarios for estimates revenue capture how these assumptions would impact revenue. However, there may be sources of uncertainty and dynamic changes in economic activity that would affect revenue that we could not incorporate into our modeling.

Individual Income Tax

To estimate potential changes to individual income tax, we obtained data for all individuals who filed a Puerto Rico individual income tax return for tax year 2010, the most recent complete year of tax return data available when we began our work. We obtained these data from Puerto Rico's Department of Internal Revenue. The 2010 Puerto Rico individual income tax return generally includes information comparable to the federal individual income tax return. However, it does not include some items that are included on the federal return, and Puerto Rico law defines certain items differently. According to Puerto Rico officials, variations between the two returns include the following:

- Puerto Rico does not tax income from Social Security benefits or unemployment compensation. Thus, these items are not included on the Puerto Rico return. Under statehood, these forms of income would be subject to federal income tax.[41] Because we excluded these items, our estimates of aggregate individual income tax revenue under statehood could be understated.[42]

- Winnings from the Lottery of Puerto Rico and racetracks are exempt from Puerto Rico income tax. Under statehood, this income would be subject to federal income tax. Excluding these items could have resulted in understated estimates.

- Some federal income tax deductions—such as for taxpayers and their spouses who are blind—and some tax credits (such as for qualified expenses paid to adopt an eligible child) have no equivalent under Puerto Rico income tax law and therefore are not reported on Puerto

[41]Social Security benefits, including retirement, survivor, and disability benefits, as well as the Social Security-equivalent benefit portion of tier 1 railroad retirement benefits are reported on the federal individual tax return. Whether a taxpayer's Social Security benefits are taxable depends on the circumstances for that taxpayer, such as the amount of the taxpayer's income from other sources, if any.

[42]According to the Social Security Administration, around 800,000 Puerto Rico beneficiaries received an average of $8,600 in social security benefits in 2010. For that same year, the Department of Labor reported that nearly 119,000 Puerto Rico residents received an average of nearly $2,500 in unemployment benefits.

Rico returns. Excluding these items could have result in overstated estimates.

- Puerto Rico defines short-term capital gains as those from the sale or exchange of capital assets held for 6 months or less. In comparison, federal tax law defines short-term capital gains as those from capital assets held for one year or less. Under the federal income tax, short-term gains are taxed as ordinary income, at rates that may be higher than those at which long-term gains are taxed for some taxpayers. Because we used capital gain information as reported on the Puerto Rico returns, our estimates may be understated.[43]

- The Puerto Rico tax return does not distinguish between qualified and ordinary dividends. Qualified dividends generally are subject to a lower federal income tax rate than are ordinary dividends. For our estimate, we assumed that Puerto Rico qualified dividends would have comprised the same percentage of total dividends (74 percent) as for dividends reported on federal income tax returns in 2010.

- The federal tax system generally allows taxpayers to carry back and carry forward net operating losses for 2 and 20 years, respectively; in contrast, Puerto Rico only allows net operating losses to be carried forward for 10 years. Consequently Puerto Rico filers might have been able to reduce their federal tax liabilities to a greater extent than observed on the Puerto Rico tax returns we used.

We used the National Bureau of Economic Research's TAXSIM program—which models U.S. federal and state income tax systems—to estimate the aggregate federal income tax liability for 2010, as if each Puerto Rico individual income tax filer had filed a U.S. individual tax return per U.S. tax law as of January 2, 2013.[44] We also estimated payments in excess of tax liability for the three largest refundable tax credits: the American Opportunity Tax Credit (AOTC), child tax credit

[43]Essentially, assets held for more than 6 months, but less than one year—which would have qualified as long-term gains under Puerto Rico income tax law—would have been taxed as short-term gains at the federal level.

[44]The American Taxpayer Relief Act of 2012, enacted on January 2, 2013, increased the tax rates for some income categories and extended some expiring tax provisions. Pub. L. No. 112-240, 126 Stat. 2313.

(CTC), and earned income tax credit (EITC).[45] These three credits accounted for 94 percent of obligations from refundable credits in fiscal year 2012.

In addition to the variations between Puerto Rico and federal tax returns as described above, the estimates are based on the following assumptions:

- Puerto Rico filers would not have changed their behavior related to work, investment, or income reporting as a result of the imposition of federal tax requirements.
- All filers who would have been eligible for the refundable credits would have claimed them.
- Puerto Rico residents' compliance with tax laws would have remained constant under statehood.

Different assumptions would have resulted in different estimates. For example, some Puerto Rico residents who decided not to file a Puerto Rico return might have filed a federal return in order to receive payment from one or more of the refundable tax credits, had they been eligible. In addition, the Joint Committee on Taxation has noted that taxpayer compliance would likely increase under statehood because the federal Internal Revenue Service (IRS) has relatively more resources to enforce tax laws than does Puerto Rico's Department of Internal Revenue.[46] Under statehood, Puerto Rico filers may report their income at higher levels of compliance as a result.

We also developed an assumption to account for the possibility that Puerto Rico could change its own local income tax rates under statehood.

[45]For the AOTC, we report the refundable amount of the credit reported on Puerto Rico returns, as Puerto Rico taxpayers were only eligible for 40 percent of the AOTC amount, up to the maximum of $1,000. We imputed the nonrefundable amount of the credit. For the CTC, TAXSIM produces estimates for both the nonrefundable and refundable portions. For the EITC, TAXSIM produces only a total credit amount; we estimated that 90 percent of the total amount was refundable, based on a similar percentage for U.S. taxpayers.

[46]Joint Committee on Taxation, *An* Overview *of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options*, JCX-24-06, June 23, 2006.

Puerto Rico's local income tax rates would be relatively high compared to those of the states. For example, the highest marginal tax rate in Puerto Rico for 2010 was 33 percent. In comparison, the 2010 highest marginal tax rate in the states was 11 percent (Hawaii and Oregon). How Puerto Rico's government would respond to the imposition of federal income taxes is unknown. However, one possibility is that it would reduce its income tax rates to be more in line with those from other states. Puerto Rico's equivalent of a state income tax rate is relevant to estimates of aggregate tax liability and refundable credit payments because some filers would be able to deduct state and local taxes paid on their federal returns.[47] Accordingly, we developed an alternate scenario for estimating aggregate tax liability and refundable credit payments based on Puerto Rico reducing its income tax rates. Under this alternative scenario, we imputed amounts for the deduction for state and local taxes paid (using reported data from IRS's Statistics of Income program for 2010) based on the national average deduction as a percentage of adjusted gross income (3.3 percent).[48]

To determine the amount of federal income tax that Puerto Rico residents actually paid for 2010, we used data reported on Puerto Rico tax returns. We used these data because, although IRS publishes data on taxes collected by state (and for Puerto Rico) the amounts for individual and employment taxes are combined. According to IRS officials, the agency cannot separate the amounts for these two types of taxes at the state level. Instead, we used information reported on the Puerto Rico tax returns as a proxy for the amount of federal income tax paid. Puerto Rico allows a credit for taxes paid to the United States, its possessions, and foreign countries. According to officials from Puerto Rico's Department of Internal Revenue, most of these taxes would have been paid to the United States. As a result, we used the aggregate tax amount that taxpayers reported in calculating the credit as the upper bound of federal income tax that would have been paid for 2010.

Corporate Income Tax

To estimate potential changes to corporate income tax revenue, we obtained data on net operating income or losses, losses carried forward from prior years, and credits for taxes paid to the United States for every

[47] Filers with eligible deductions in excess of the standard deduction would have been expected to itemize their deductions; state and local taxes paid is an itemized deduction.

[48] IRS's Statistics of Income program reports aggregate taxpayer data based on a sample of individual income tax returns.

entity that filed a business income tax return for tax year 2009, the most recent complete year of tax return data available when we began our work. We obtained these data from Puerto Rico's Department of Internal Revenue. We focused on these items because they are the best available proxies for the income and losses that would be taxed under the federal corporate income tax if Puerto Rico were to become a state. Net operating income or losses reported on Puerto Rico tax returns are computed in a manner broadly similar to how they are computed on federal returns (although the manner in which that income is taxed, if at all, can differ).[49]

We divided the Puerto Rico business entities into three categories based on the type of tax returns they filed.

- Regular corporations, which filed the standard corporate income tax return.
- Regular partnerships, which (in 2009) were subject to an entity-level income tax and filed returns largely identical to the regular corporate income tax return.[50]
- Exempt businesses, which had been granted partial or full exemptions of their business income under one of Puerto Rico's tax incentive laws, and filed special tax returns.[51]

Within the Puerto Rico tax return data, we could not always determine whether the filing entities were (1) branches of other corporations, (2) subsidiaries of other corporations, or (3) separate Puerto Rico entities. Likewise, officials from Puerto Rico's Department of Internal Revenue told

[49]Given the wide expected range of our estimates, we did not adjust the reported Puerto Rico data for any differences in details (such as depreciation schedules) or in inventory accounting rules between Puerto Rico and federal tax laws.

[50]Another type of business entity, called a special partnership, also operated in Puerto Rico during 2009. These partnerships were not taxed on their income at the entity level. Instead, their income and deductions were passed through to their partners, who included those amounts on their individual tax returns. Puerto Rico now treats all partnerships as pass-through entities for tax purposes, similar to the treatment of partnerships under federal tax law.

[51]Among the items that exempt businesses reported on these returns were measures of net operating income or losses and losses carried forward that were similar to the measures reported by regular corporations and partnerships.

us that the data would not provide sufficient or reliable information on the country of incorporation for any of the filing businesses or for their parent corporations. Consequently, we made a range of assumptions regarding the percentage of the filing entities' income attributable to either (1) branches or subsidiaries that would have been included in the consolidated federal corporate income tax return of a U.S. corporation, or (2) corporations that would have been taxed as separate entities under statehood. These distinctions mattered in terms of which tax rates we applied when making our estimates and how we treated accumulated losses.

In addition, we did not have data for the amount of state and local income taxes that the filing entities would have paid in Puerto Rico if it had been a state. As a result, we needed to estimate these amounts, because they represent an important deduction under the federal corporate income tax. As with the individual income tax, Puerto Rico's corporate income tax rates are relatively high compared to those in the states. For example, Puerto Rico's highest marginal tax rate in 2010 for regular corporations was 19 percent; the highest corporate tax rate in the states in 2010 was 12 percent (Iowa). How Puerto Rico's government would respond to the imposition of federal corporate income tax is unknown; however, if Puerto Rico were placed in the same fiscal relationship to the federal government as the 50 states, it might reduce its rates to be more in line with those from other states. Consequently, we assumed that under statehood, the effective rate of Puerto Rico's income tax would be similar to the average effective rate for income taxes levied in the states (the rate for profitable corporations was 3.8 percent of net income; for corporations with losses it was -1.0 percent).[52] We used data compiled by IRS to estimate this average rate for the states.

[52]The effective tax rate, which shows how much tax a corporation pays as a percentage of its taxable income, incorporates more aspects of the tax code than just the statutory tax rate; it also reflects, among other things, the impacts of tax credits, exemptions, deferrals, and other provisions that can reduce tax liability. As a sensitivity analysis, we examined how our estimates would change if we assumed, alternatively, that the effective rate of the Puerto Rico state corporate tax would have been twice as high as the average effective state rate (7.6 percent). Using this higher effective rate, we found that the estimate range changed from a range of $5.0 billion to $9.3 billion to a range of $4.6 billion to $9.0 billion. Incorporating the assumption that some corporations would relocate from Puerto Rico under statehood, the estimate range changed from a range of -$0.1 billion to $3.4 billion to a range of -$0.2 billion to $3.2 billion.

We also needed to make assumptions regarding which federal tax rates would have applied to these entities' net income under statehood. In the case of corporations taxed as separate entities, we assumed an effective tax rate falling within a broad range (from 15 percent to 35 percent) around the average effective tax rate that U.S. corporations paid for tax year 2009.[53] We used this range to reflect the possibility that the tax attributes of the typical corporation operating in Puerto Rico could have differed from those of the typical U.S. corporation.

On the advice of tax experts from the Joint Committee on Taxation, we used a different approach to determine tax rates for entities included in the consolidated returns of controlled groups of U.S. corporations. For these corporations, the applicable rate of tax depended not only on the Puerto Rico entities' net income, but also on the income and losses of other group members, and on the credits earned by the group as a whole. For these entities, we applied the marginal federal tax rate for the consolidated group to the net income (or losses) that the Puerto Rico entity would have added to the group's tax return. For entities in the financial services and social services industries, we applied the full 35 percent corporate marginal tax rate based on the assumption that these entities would not have qualified for the domestic production activities deduction.[54] For all other corporations, we reduced the marginal rate to 31.85 percent to reflect the effect of this deduction.

We estimated tax liabilities both before and after applying prior-year losses to offset income from 2009. We did so because the initial effect that these prior-year losses would have had on tax revenue may not have been representative of their effects over a longer time period. In the first year of statehood, when Puerto Rico subsidiaries of U.S. corporations

[53]We used data that IRS collected (from a sample of corporate tax returns filed for tax year 2009) to estimate the total tax, after credits that U.S. corporations paid as a percentage of their taxable income: that figure was 22.3 percent. The weighted average across all tax years from 2001 to 2010 was 24.6 percent.

[54]In general, the domestic production activities deduction allows a taxpayer to deduct an amount equal to nine percent (for years after 2009) of the lesser of the taxpayer's taxable income or its qualified production activities income. The deduction cannot exceed 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year. 26 U.S.C. § 199. Under current law, specific rules apply for determining whether Puerto Rico is considered part of the United States when calculating domestic production gross receipts and the wage limitation for a taxpayer. This temporary provision was enacted in 2006 and applied to tax years beginning before January 1, 2014. 26 U.S.C. § 199(d)(8).

first become subject to federal tax and are consolidated into their parent corporations' tax returns, large portions of their losses could be used to offset the taxable income reported on those returns, leaving only smaller amounts (or newly generated losses) available to offset income in subsequent years.

We also made assumptions to account for the potential relocation, under statehood, of businesses with activities in Puerto Rico. Tax experts at the U.S. Department of the Treasury and the Joint Committee on Taxation suggested that the changes in tax treatment that would occur under statehood likely would motivate some businesses to move their operations from Puerto Rico to lower-tax foreign locations—particularly those with substantial amounts of income derived from intangible (and therefore mobile) assets. For 2009, exempt corporations in the pharmaceutical and the medical equipment and supplies industries accounted for over 70 percent of the net income (and about 20 percent of accumulated losses) of the full population of exempt corporations. In addition, other industries with potential income from intangible assets accounted for significant shares of total net income.

Using the other assumptions described above, we produced an alternative set of estimates to account for the potential relocation, under statehood, of businesses with activities in Puerto Rico. The first set of estimates assumes that all filing businesses would have maintained their activities in Puerto Rico. The second set of estimates assumes that (1) all filing businesses in the pharmaceuticals and the medical equipment and supplies industries would have relocated away from Puerto Rico, and (2) other filing business would have maintained their activities in Puerto Rico.

To determine the amount of federal corporate income tax that entities with activities in Puerto Rico actually paid in 2009, we used data that U.S. corporations reported to IRS on Form 1118 on income they received in 2009 from their Puerto Rico branches or subsidiaries. To estimate the amount of tax that would have been paid, we applied a tax rate of 31.85 percent (the 35 percent corporate tax rate reduced to account for the domestic production activities deduction) to the remaining income.[55]

[55]We could not determine industrial classifications for the corporations filing Form 1118 because the data did not include such information. Since a large majority of the income of exempt corporations (which include the corporations affiliated with a U.S. parent corporation) was earned by the corporations that were deemed to have qualified for the domestic production activities deduction, we used the 31.85 rate that incorporates the deduction for our estimate of actual taxes paid.

Separately, published IRS data show that the agency collected about $145 million (net of refunds) in business income taxes from entities in Puerto Rico in fiscal year 2009.[56] However, this amount included taxes collected from any tax year, and we could not determine whether any of the amounts collected overlapped with amounts we estimated based on Form 1118 (any taxes paid by businesses incorporated in Puerto Rico on their U.S.-source income would not overlap with those amounts). Consequently, we did not include any of the $145 million in our estimate of the amount paid in corporate income tax by entities with activities in Puerto Rico.

We took several steps to assess the reliability of the Puerto Rico tax return data we used for our individual and corporate income tax estimates. For example, to identify possible outliers that could reflect data errors, we checked maximum and minimum amounts reported for each tax return line item we used. We also discussed the data with officials from Puerto Rico's Department of Internal Revenue, and, in some cases, adjusted the data to address errors and inconsistencies.[57] Based on our assessment, we determined that the data were sufficiently reliable for our purposes. We also discussed our methodology for estimating tax revenue with tax experts from the Department of the Treasury and the Joint Committee on Taxation, who generally agreed with our estimation approaches.

Factors That Could Affect Federal Spending and Revenue

To identify factors under statehood that could influence changes in federal spending and revenues, we reviewed economic data from the Puerto Rico government and reports on the Puerto Rico economy, such as those from the Federal Reserve Bank of New York[58] and the Congressional Budget Office.[59] We also interviewed officials from the

[56]Business income taxes included those for corporations; farmers' cooperatives; and tax-exempt organizations, which generally are required to pay tax on income from regular trade or business activities not substantially related to their exempt purposes.

[57]For example, out of over 1 million Puerto Rico individual tax returns, 162 records had errors in the date of birth information or were missing such information. We dropped these individuals from our analysis as the date of birth is important for determining certain federal tax credit or deduction with eligibility based on age.

[58]Federal Reserve Bank of New York, *Report on the Competitiveness of Puerto Rico's Economy* (New York, June 29, 2012).

[59]Congressional Budget Office, *Potential Economic Impacts of Changes in Puerto Rico's Status under S. 712* (Washington, D.C.: April 1990).

current and past Puerto Rico government administrations and Puerto Rico business associations representing large economic sectors in Puerto Rico to obtain their views on the potential impacts of statehood on Puerto Rico's economy and public finances.

We conducted this performance audit from June 2012 to March 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Details on Potential Changes to Selected Federal Programs under Puerto Rico Statehood

Programs Included in this Appendix

Appendix Overview

Of the 29 federal programs we reviewed, 11 programs would likely be affected if Puerto Rico became a state. We describe how those 11 programs would be affected in the following pages of this appendix.

For each of the 11 programs, we provide an overview of the program in the states and in Puerto Rico, and of potential changes under statehood. We do not cover all components of the programs; rather we focus on key aspects that would be likely to be affected by statehood. For 6 of the 11 programs, we also provide estimates of federal spending under statehood. For the other 5 programs, we did not estimate federal spending under statehood.

For programs for which we developed estimates of spending under statehood, we developed the estimates for a single year in the past, as if Puerto Rico were treated the same as the states in that year. The estimate year varies by program, based on the data available when we began our work. Except for Federal-Aid Highways, the estimates are presented as ranges, based on various assumptions we made, which are described in detail in this appendix. For Federal-Aid Highways, we present a single estimate, which the Federal Highway Administration developed for us. Except for Federal-Aid Highways, the estimates are in calendar-year terms, because the eligibility and other data we used to develop the estimates were in calendar-year terms. The estimate for Federal-Aid Highways is in fiscal year-terms. The actual spending data for each program to which we compare the estimates are in fiscal-year terms, because the spending data were reported in fiscal-year terms.

Program Changes: Cost Estimate

Program Description

Medicare is the federally-financed health insurance program for individuals age 65 and older, the disabled, and individuals with end-stage renal disease. Through Medicare, beneficiaries can obtain insurance coverage for hospital and other services from one of two options.

- Medicare fee-for-service (Medicare FFS), through which most beneficiaries are automatically entitled to hospital and other inpatient services, and to certain home health and hospice services—known as Medicare Part A—and to optional coverage for hospital outpatient, physician, and certain other services and items—known as Medicare Part B.
- Medicare Advantage (MA)—known as Part C—a private plan alternative to Medicare FFS. MA plans must cover all services covered by Medicare FFS Parts A and B, except for hospice care.

An optional prescription drug benefit—known as Medicare Part D—is available to all Medicare beneficiaries, whether they have coverage through Medicare FFS or MA.

The Centers for Medicare & Medicaid Services (CMS) administers the program.

Size of the Program

- Total federal obligations, fiscal year 2010: $524.3 billion.
- Medicare payments for Puerto Rico beneficiaries, fiscal year 2010: $4.5 billion.
- Number of Medicare FFS and MA Medicare beneficiaries in Puerto Rico, 2010: 670,019.

Medicare

Summary

If Puerto Rico were treated as a state,

- Under Medicare FFS,
  - Puerto Rico acute care hospitals would likely receive larger payments per hospital stay.
  - Puerto Rico beneficiaries could participate in Medicare Savings Programs (MSPs).
  - Puerto Rico residents generally would be enrolled automatically for Medicare Part B coverage when they initially become eligible for Medicare Part A (unless they opted out).
- Under MA, private plans would receive lower payments—regardless of statehood—because of provisions in the Patient Protection and Affordable Care Act (PPACA).
- For the Medicare prescription drug benefit, Puerto Rico beneficiaries would be eligible to receive the low-income subsidy, and Puerto Rico's enhanced Medicaid allotment to help beneficiaries pay for prescription drugs would be discontinued.

According to our modeling estimates, if Puerto Rico had been a state in 2010,

- Federal Medicare spending would have ranged from $4.5 billion to $6.0 billion, compared to actual federal spending for Medicare in Puerto Rico of $4.5 billion in fiscal year 2010.

Size of Medicare Fee-for-Service

Medicare FFS Part A

- Payments for Medicare FFS Part A beneficiaries in Puerto Rico, fiscal year 2010: $232.5 million.
- Number of Medicare FFS Part A beneficiaries in Puerto Rico, 2010: 237,605.

Medicare FFS Part B

- Payments for Medicare FFS Part B beneficiaries in Puerto Rico, fiscal year 2010: $214.4 million.
- Number of Medicare FFS Part B beneficiaries in Puerto Rico, 2010: 106,305.

Medicare Fee-for-Service

Most U.S. residents age 65 or older are automatically entitled to coverage for Medicare Part A services. Residents younger than age 65 can qualify if they meet certain medical or disability requirements. Beneficiaries do not have to pay premiums—unless they or their spouses have worked fewer than 40 quarters in their lifetimes—but must pay required deductibles, coinsurance, and copayments.

Beneficiaries who opt for Medicare Part B insurance coverage must pay a monthly premium, and are responsible for deductibles, coinsurance, and copayments.

Overview of Medicare Fee-for-Service in the States

About 76 percent of beneficiaries in the states received Medicare Part A benefits through Medicare FFS in 2010, according to CMS data. Some salient features of Medicare Part A under Medicare FFS in the states include the following:

- **Acute care hospitals.**[1] Medicare FFS pays most acute care hospitals an amount for each patient discharge based on a national rate. This rate is adjusted to account for factors that affect a hospital's costs of providing care, such as the hospital's geographic location and the patient's diagnoses as determined under the Inpatient Prospective Payment System (IPPS). Medicare FFS generally pays acute care hospitals predetermined amounts for designated outpatient services under the Outpatient Prospective Payment System (OPPS). The OPPS establishes national payment rates that are standardized for geographic differences in wages.[2]
- **Disproportionate Share Hospital (DSH) program.** Under this program, Medicare makes additional payments to hospitals that serve a large number of low-income patients. Hospitals that have a DSH patient percentage of more than 15 percent are eligible for DSH payments.[3] The DSH patient percentage considers the sum of the percentage of Medicare inpatient days for patients eligible for both Medicare FFS Part A and Supplemental Security Income (SSI), and the percentage of total inpatient days for patients eligible for Medicaid but not Medicare. For discussion of how DSH payments will be affected by provisions in PPACA, see appendix IV.
- **MSPs.** Under these programs, state Medicaid programs pay for some or all of certain Medicare Part A and Medicare Part B costs under Medicare FFS for eligible low-income beneficiaries. For example, MSPs pay for premiums, out-of-pocket costs, such as

[1]An acute care hospital provides general, short-term care for a broad range of medical conditions. See MedPAC, *Report to the Congress: Medicare Payment Policy* (Washington, D.C.: March 2009).

[2]Certain types of services are excluded from OPPS.

[3]Large urban hospitals that receive more than 30 percent of their total net inpatient care revenues from state and local government payments for indigent care (other than Medicare or Medicaid) may also be eligible for DSH payments. According to CMS officials, only 10 hospitals in the country qualify for DSH under this eligibility method, and no hospitals in Puerto Rico receive DSH payments using this method.

hospital deductibles, and services not covered under Medicare for eligible beneficiaries.[4]

About 70 percent of beneficiaries in the states received Medicare Part B benefits through Medicare FFS in 2010, according to CMS data. One salient feature of Medicare Part B under Medicare FFS in the states is

- **Optional coverage.** Individuals who receive their Medicare Part A benefits through Medicare FFS generally are enrolled automatically in Part B, but can opt out if they choose. In 2010, about 9 percent of beneficiaries enrolled in Medicare Part A under Medicare FFS were eligible for, but did not enroll in, Medicare Part B. Subject to certain exceptions, Medicare enrollees who initially opt out of Medicare Part B but subsequently enroll face a late enrollment penalty that increases their lifetime premiums.[5]

Overview of Medicare Fee-for-Service in Puerto Rico

About 35 percent of beneficiaries in Puerto Rico received Medicare Part A coverage through Medicare FFS in 2010, according to CMS data. Some salient features of Medicare Part A under Medicare FFS in Puerto Rico include the following:

- **Acute care hospitals.** Hospitals in Puerto Rico are not reimbursed under the IPPS or OPPS that apply to hospitals in the states. Instead, there is a prospective payment system for Puerto Rico hospitals that applies a unique Medicare FFS reimbursement formula, based on the sum of 75 percent of the national payment rate used in the states and 25 percent of a lower, Puerto Rico specific rate.[6] According to CMS officials, the Puerto Rico specific rate was created to reflect patterns of hospital utilization in Puerto Rico, which differ from those in the states.
- **DSH program.** Puerto Rico and the states use the same formulas to determine DSH patient percentages and payments. However, because Puerto Rico residents are ineligible for SSI, it is more difficult for hospitals in Puerto Rico to reach the 15 percent DSH patient percentage required to receive DSH payments.[7]
- **MSPs.** Financial assistance under MSPs is unavailable in Puerto Rico. While states' Medicaid programs are required to have MSPs, MSPs are optional in Puerto Rico.[8] Puerto Rico has chosen not to offer MSPs, likely because of the Medicaid funding cap (as

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[4]For three of the four types of MSPs, state Medicaid programs receive federal matching funds for these costs in accordance with their matching rate, which can range from 50 percent to 83 percent of expenditures. The remaining MSP is 100 percent federally funded, up to a limit.

[5]Monthly premiums increase 10 percent for each 12-month period during which eligible individuals do not enroll.

[6]42 U.S.C. § 1395ww(d)(9); 42 C.F.R. § 412.204.

[7]In 2010, Puerto Rico hospitals received $9 million in DSH payments—about 5 percent of payments to Puerto Rico acute care hospitals (and about 0.2 percent of total federal Medicare payments for Puerto Rico beneficiaries). Payments to hospitals nationwide were about $10.7 billion—about 9 percent of payments to nationwide acute care hospitals (and about 2 percent of total federal Medicare spending).

[8]42 U.S.C. § 1396d(p)(4)(a).

described in the Medicaid section of this appendix), according to a Department of Health and Human Services report.[9]

About 16 percent of beneficiaries in Puerto Rico received Medicare Part B coverage through Medicare FFS in 2010, according to CMS data. There are several possible reasons for relatively low enrollment in Medicare Part B under Medicare FFS in Puerto Rico.

- Monthly premiums—$96.40 or $110.50 in 2010, depending on the beneficiary—are relatively high compared to average income in Puerto Rico.[10]
- MA plans may provide beneficiaries with less expensive options for receiving services, as discussed in the MA section below.
- Puerto Rico residents must elect to enroll in Medicare Part B under Medicare FFS, as discussed below.

One salient feature of Medicare Part B under Medicare FFS in Puerto Rico is

- **Optional coverage.** Puerto Rico residents must elect to enroll in Medicare Part B under Medicare FFS during their initial Medicare enrollment period, unlike residents in the states, who generally are enrolled automatically.[11] In 2010, about 55 percent of beneficiaries enrolled in Medicare Part A under Medicare FFS were eligible for, but did not enroll in, Medicare Part B under Medicare FFS. Also, about 4 percent of Puerto Rico Medicare beneficiaries were paying the penalty for late enrollment in Medicare Part B under Medicare FFS in that year—a higher percentage than in all but 4 states.[12]

Potential Changes to Medicare Fee-for-Service under Statehood

Under statehood, if Puerto Rico were treated like other states

- Payments to Puerto Rico acute care hospitals would no longer incorporate a Puerto Rico specific rate, and therefore would likely increase.
- DSH payments could increase because, under statehood, Puerto Rico residents would be eligible for SSI, and patients receiving SSI benefits are included in the DSH patient percentage formula.
- Certain low-income Puerto Rico Medicare beneficiaries would be required to be eligible for MSPs established by Puerto Rico's Medicaid program. The MSPs could potentially further increase enrollment in Medicare FFS Part B under Medicare FFS in Puerto Rico because of the cost assistance they provide.
- Enrollment in Medicare Part B under Medicare FFS would become automatic for Puerto Rico residents, unless they opted out.

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[9]U.S. Department of Health and Human Services, *Medicare Part B Enrollment in Puerto Rico For the President's Task Force on Puerto Rico's Status* (New York, NY: April 2013).

[10]Medicare Payment Advisory Commission, *Report to Congress: Improving Incentives in the Medicare Program*, (Washington, D.C.: June 2009).

[11]42 C.F.R. § 407.17(a)(1).

[12]U.S. Department of Health and Human Services, *Medicare Part B Enrollment in Puerto Rico For the President's Task Force on Puerto Rico's Status* (New York, NY: April 2013).

Puerto Rico may also be impacted by certain PPACA provisions (see appendix IV).

Medicare Advantage

Size of Medicare Advantage

- Amount spent on Puerto Rico beneficiaries, fiscal year 2010: $3.6 billion.
- Number of MA beneficiaries in Puerto Rico, 2010: 432,043.

MA plans are paid a monthly per-person amount to provide all benefits covered under Medicare FFS, except for hospice care. MA plans may be required to offer additional benefits compared to Medicare FFS, including reduced copayments or deductibles, reduced premiums, or the provision of benefits not covered under Medicare FFS.

Overview of Medicare Advantage in the States

About 23 percent of Medicare beneficiaries in the states were enrolled in a MA plan in 2010, according to CMS data. Some salient features of MA in the states include the following:

- **Payment amounts.** To establish payment amounts, MA plans submit bids to Medicare with their estimated revenue requirements for providing services covered by Medicare FFS Part A and Part B to average enrollees in their service areas. The payment to each plan is determined by the bid and a benchmark—the maximum amount Medicare will pay in each county within a plan's service area. Depending on how a bid compares to the benchmark, a plan may receive additional payments that they are required to use to reduce premiums or cost sharing, or to provide additional coverage.

  Because the benchmarks are generally greater than spending in Medicare FFS, even plans that bid less than Medicare FFS spending levels in their service areas are paid more than Medicare FFS spending amounts. In 2010, the average payment to MA plans was 109 percent of Medicare FFS spending. PPACA includes provisions that will phase in benchmark reductions from 2012 to 2017 to bring the benchmarks more in line with Medicare FFS spending (see appendix IV).
- **Special Needs Plans (SNP) and dual-eligible beneficiaries.** MA plans designated as SNPs offer specialized services targeted to the needs of certain groups of beneficiaries, including dual-eligible beneficiaries eligible for both Medicare and Medicaid. Dual-eligible beneficiaries account for disproportionate spending in Medicare and Medicaid, largely because they are more likely than other Medicare beneficiaries to be disabled and to report poor health status. Dual-eligible beneficiaries may obtain their Medicare-covered services through Medicare FFS, a SNP, or a non-SNP MA plan. In 2010, about 9 percent of MA beneficiaries in the states were enrolled in a SNP; according to CMS data about 20 percent of Medicare beneficiaries in the states were dual-eligible beneficiaries.

Overview of Medicare Advantage in Puerto Rico

In 2010, about 64 percent of Medicare beneficiaries in Puerto Rico were enrolled in an MA plan, according to CMS data—almost three times the percentage nationally. Some salient features of MA in Puerto Rico may account for this difference.

- **Payment amounts.** For counties representing more than 95 percent of MA beneficiaries, Puerto Rico's benchmark in 2010 resulted in payments to MA plans at about 180 percent of Medicare FFS spending, according to CMS officials. The high level of payments enables Puerto Rico MA plans to offer lower premiums and additional benefits relative to Medicare FFS in Puerto Rico.

- **SNPs and dual-eligible beneficiaries.** MA beneficiaries in Puerto Rico have a high participation rate in SNPs. In 2010, 59 percent of Puerto Rico MA beneficiaries were enrolled in a SNP. Also, Puerto Rico has a relatively large population of dual-eligible beneficiaries, nearly all of whom are enrolled in MA. In 2010, dual-eligible beneficiaries in Puerto Rico represented about 33 percent of Medicare beneficiaries in Puerto Rico, according to CMS data.

Potential Changes to Medicare Advantage under Statehood

Payment amounts. Regardless of whether Puerto Rico becomes a state, PPACA provisions will result in a lower benchmark for Puerto Rico. PPACA established new benchmarks underlying payments to MA plans to be phased in from 2012 to 2017. When PPACA is fully phased-in in 2017, generally, the benchmark for Puerto Rico will fall to 115 percent of Medicare FFS spending, according to CMS officials.

From 2012 to 2017, Puerto Rico's benchmark generally will be calculated by blending the benchmark as it would have been calculated absent PPACA with the 115 percent of Medicare FFS spending benchmark. For example, for 2014, the benchmark generally is an average of the pre-PPACA benchmark of 180 percent of Medicare FFS spending and the fully phased-in benchmark of 115 percent of Medicare FFS spending, resulting in a benchmark of 147.5 percent of Medicare FFS spending, according to CMS officials.[13]

The precise impact of the decrease in benchmarks is unknown. However, the premiums and benefits MA plans will be able to offer could be affected, which could result in some Medicare beneficiaries in Puerto Rico switching from MA to Medicare FFS.

SNPs and dual-eligible beneficiaries. Under statehood, the number of dual-eligible beneficiaries will likely change, as the number of individuals who would enroll in Medicaid would likely change (see the section on Medicaid in this appendix). Given that changes to MA payment amounts could affect MA enrollment, it is unclear whether most dual-eligible beneficiaries would continue to enroll in SNPs or MA plans.

Size of the Medicare Prescription Drug Benefit

- Amount spent on Puerto Rico beneficiaries, fiscal year 2010: $416 million.
- Number of Prescription drug beneficiaries in Puerto Rico, 2010: 467,057.

Medicare Prescription Drug Benefit

Medicare prescription drug beneficiaries obtain coverage from MA plans—which offer prescription drug coverage that is integrated with the health care coverage they provide to MA beneficiaries—or other private prescription drug plans.

Overview of the Medicare Prescription Drug Benefit in the States

About 59 percent of Medicare beneficiaries in the states were enrolled in a prescription drug plan in 2010, according to CMS data. Some prescription drug beneficiaries receive a subsidy, referred to as the low-income subsidy, which covers all, or a portion of, a beneficiary's prescription drug benefit plan premiums, as well as deductibles, copayments, and other out-of-pocket costs.

Subsidy eligibility. To qualify for the full low-income subsidy, prescription drug beneficiaries must meet at least one of the following criteria: 1) be a full benefit dual-eligible beneficiary, 2) be a SSI beneficiary, 3) be enrolled

[13] As above, the 2014 benchmark of 147.5 percent is for counties that represent more than 95 percent of MA beneficiaries enrolled in Puerto Rico, according to CMS officials.

in an MSP, or 4) have family income less than 135 percent of the federal poverty level (FPL) and have resources that do not exceed certain limits. Individuals may also qualify for a partial subsidy if they have family income that is less than 150 percent of the FPL, and have resources that do not exceed certain limits. Medicare beneficiaries who meet one of the first three criteria listed above automatically qualify for the low-income subsidy. Other beneficiaries must apply for the subsidy.

Overview of the Medicare Prescription Drug Benefit in Puerto Rico

In 2010, about 70 percent of Puerto Rico Medicare beneficiaries were enrolled in a prescription drug plan, according to CMS data. Medicare beneficiaries in Puerto Rico are ineligible to receive low-Income subsidy payments, according to statute.[14] Instead, Puerto Rico receives an increase to its allotment for its Medicaid program to assist certain beneficiaries with drug costs.[15]

Allotment eligibility. The enhanced allotment can only be used to assist dual-eligible beneficiaries. For fiscal year 2010, Puerto Rico received an enhanced allotment of $54.7 million, of which it spent $49.3 million.[16] The enhanced allotment, implemented through Puerto Rico's Medicaid program, provides full subsidies for (1) drugs covered under a Medicare prescription drug benefit plan, and (2) drugs that are not covered under a Medicare prescription drug benefit plan but are available under Medicaid.

Potential Changes to the Medicare Prescription Drug Benefit under Statehood

Under statehood, Puerto Rico residents would be eligible to receive the low-income subsidy, and Puerto Rico's enhanced allotment for prescription drugs benefits would likely be discontinued. Certain Puerto Rico residents eligible for SSI or an MSP—which would be newly available to them under statehood—could receive the subsidy. According to a CMS estimate based on 2010 data, 493,984 Medicare beneficiaries in Puerto Rico would have been eligible for the low-income subsidy if it were available. The subsidy could result in more Puerto Rico residents participating in Medicare prescription drug benefit plans, as those who are eligible for the subsidy generally are enrolled automatically.

Estimated Federal Spending under Statehood

According to our modeling estimates, under statehood, federal Medicare spending in 2010 would have ranged from $4.5 billion to $6.0 billion, compared to actual federal spending for Medicare in Puerto Rico of $4.5 billion in fiscal year 2010. In isolation, reduced payments to MA plans resulting from lower benchmarks would have resulted in reduced federal spending on Medicare. However, the impact of reduced payments to MA plans may be outweighed by other changes, such as increased spending related to the increase in dual-eligible beneficiaries.

The estimates are based on various assumptions, as described below.

- Puerto Rico beneficiaries' utilization of Medicare-covered procedures would have been the same under statehood as actual utilization in 2010 (which was about 78 percent of utilization in the

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[14] 42 U.S.C. § 1395w-114(a)(3)(F).

[15] 42 U.S.C. § 1396u-5 (e). Puerto Rico elected to provide Medicaid coverage for the provision of Part D drugs, and therefore was eligible for an increase in its Medicaid allotment.

[16] This amount includes $12.6 million that Puerto Rico received under the American Recovery and Reinvestment Act of 2009.

Caveats for GAO's Estimates

- We did not take into account all potential Medicare changes under statehood, as statehood could result in unknown, dynamic changes to the provision of health care in Puerto Rico. The caveats listed below are examples of how our estimates could differ from actual changes in federal Medicare spending under statehood.
- We adjusted our estimate using the wage index for Puerto Rico for Medicare FFS Part A and the Geographic Practice Cost Index for Medicare FFS Part B to account for different costs of providing health care services in Puerto Rico. However, there may be other ways in which costs in Puerto Rico differ from those in the states for which we did not account.
- The assumptions we made for Puerto Rico beneficiaries' (1) utilization of Medicare-covered procedures, (2) enrollment in Medicare FFS Part B among Medicare FFS Part A beneficiaries, (3) enrollment in MA plans, and (4) enrollment in the low-income subsidy may differ from actual beneficiary utilization and enrollment under statehood.
- Except for MA, our estimates do not include the potential effects of PPACA. We considered the PPACA MA benchmarks changes because they are known and do not have the same uncertain outcomes as other PPACA provisions (see appendix IV).

states, as measured by the number of procedures per 1,000 beneficiaries).

- The ratio of Puerto Rico beneficiaries enrolled in Medicare FFS Part A who also would have enrolled in Medicare FFS Part B compared to enrollment in Medicare FFS Part B of such beneficiaries in the states would have been the same under statehood as the actual ratio in 2010 (about 49 percent).
- The percentage of Medicare beneficiaries in Puerto Rico enrolled in a MA plan is modeled using two different assumptions: (1) the enrollment percentage in Puerto Rico in 2010 (about 64 percent), and (2) the highest enrollment percentage in the states (about 42 percent).
- The benchmark underlying payments to MA plans in Puerto Rico is modeled using two different assumptions: (1) using the benchmark for Puerto Rico for fiscal year 2014 (147.5 percent), and (2) using the benchmark that will apply when PPACA is fully phased-in in 2017 (115 percent).
- The number of Medicare beneficiaries who would have been dual-eligible beneficiaries is modeled based on two different modeling estimates for Medicaid. Those estimates result in a lower and higher number of Medicaid enrollees and, accordingly, a lower and higher number of estimated dual-eligible beneficiaries.
- The percentage of eligible Puerto Rico Medicare beneficiaries who would have enrolled in the low-income subsidy would have been the same as the percentage for all Medicare beneficiaries (about 77 percent).

The results of our modeling are shown in table 1. For each scenario in table 1, we held constant the assumptions as described above, other than those for enrollment in MA plans, MA benchmarks, and dual-eligible beneficiaries, as reflected in the table.

Table 1: Actual Federal Medicare Spending in Puerto Rico and Estimated Federal Medicare Spending under Puerto Rico Statehood, 2010

Scenario	Total federal spending (dollars in billions)	
Actual federal Medicare spending[a]		$4.5
Estimated spending scenario[b]	Assuming lower dual-eligible beneficiaries estimate	Assuming higher dual-eligible beneficiaries estimate
42% MA enrollment / 115% benchmark	$4.5	$5.7
42% MA enrollment / 147.5% benchmark	$4.8	$5.8
64% MA enrollment / 115% benchmark	$4.7	$5.7
64% MA enrollment / 147.5% benchmark	$5.0	$6.0

Source: GAO analysis.

[a]Actual spending is for fiscal year 2010.

[b]Estimated spending scenarios assume various levels of enrollment in MA plans and MA benchmarks for lower and higher estimates of dual-eligible beneficiaries.

Program Changes: Cost Estimate

Medicaid

Program Description

Medicaid is a joint federal-state program that finances health care coverage for low-income individuals, including children, pregnant women, and elderly or disabled individuals.

States and the federal government share in the cost of the program. The federal government provides matching funding to states based on a statutory formula known as the Federal Medical Assistance Percentage (FMAP). Each state's Medicaid program is distinct, with individual eligibility criteria and benefits provided in accordance with broad federal requirements.

The Centers for Medicare & Medicaid Services (CMS) oversees the program at the federal level; states administer their respective programs' day-to-day operations.

Size of the Program

- Total federal obligations, fiscal year 2011: $295.8 billion, including $14.6 billion in American Recovery and Reinvestment Act of 2009 (Recovery Act) funds.
- Federal spending in Puerto Rico, fiscal year 2011: $685 million.
- Number of federal Medicaid beneficiaries in Puerto Rico: 918,791 as of June 2011; about 1.2 million after Puerto Rico expanded Medicaid coverage in July 2011, according to CMS estimates.

Summary

If Puerto Rico were treated as a state, it would

- Receive federal funding based on a higher matching rate and would not be subject to a cap on overall federal matching funds.
- Be required to extend eligibility to additional low-income individuals.
- Potentially receive additional funding for hospitals that serve a large number of Medicaid and low-income uninsured patients (referred to as a Medicaid Disproportionate Share Hospital (DSH) allotment), according to CMS officials.

According to our modeling estimates, if Puerto Rico had been a state in 2011,

- Federal Medicaid spending would have ranged from $1.1 billion to $2.1 billion, compared to actual federal spending on Medicaid in Puerto Rico of $685 million in fiscal year 2011.
- Medicaid would have covered between 1.0 million to 2.1 million beneficiaries throughout 2011, compared to the 0.9 million covered as of June 2011 or the estimated 1.2 million covered (according to CMS estimates) after Puerto Rico expanded coverage in July 2011.

Overview of the Program in the States

Eligibility requirements. To obtain federal matching funds, states must cover certain mandatory categories of individuals. For example, in 2011, states were required to cover (1) pregnant women, infants, and children under age 6 with family incomes at or below 133 percent of the federal poverty level (FPL),[1] (2) children from 6 to 18 years old with family incomes at or below 100 percent of the FPL, and (3) elderly individuals who received Supplemental Security Income (SSI) payments. Beginning January 1, 2014, the Patient Protection and Affordable Care Act (PPACA) requires states to cover children ages 6 to 18 in households with incomes at or below 133 percent of the FPL.[2]

States may also cover optional categories, which include individuals whose income and assets exceed the levels for the mandatory categories. For example, states could opt to cover infants with family incomes between 133 percent and 185 percent of the FPL. PPACA provides states the option to expand Medicaid coverage to non-pregnant, non-elderly

[1]Federal poverty levels are based on the federal poverty guidelines that the Department of Health and Human Services publishes on an annual basis. These guidelines provide income thresholds that vary across states and by family size. In 2011, 100 percent of the federal poverty level was $22,350 per year for a family of four in the 48 contiguous states and the District of Columbia.

[2]PPACA also provides for a 5 percent income disregard when calculating modified adjusted gross income for determining Medicaid eligibility, which effectively increases this income level to 138 percent of the FPL.

adults with incomes not exceeding 133 percent of the FPL on or before January 1, 2014 (see appendix IV).[3]

Coverage requirements. Under federal law, states generally must cover select health care services, known as mandatory services, such as inpatient and outpatient hospital services, and physician services. States may also cover certain optional services such as physical therapy and hospice care. For both mandatory and optional services, states generally can define the amount, duration, and scope of the coverage, and may impose certain other limits (such as requiring that the services be medically necessary). Finally, a state must define how it will operate its Medicaid program, including which populations and services are covered, through a state Medicaid plan.

Federal funding. The federal government matches state Medicaid expenditures—through reimbursement of state expenditures—using the FMAP, which is calculated based on state per-capita income in relation to national per-capita income. The federal government pays a larger portion of expenditures (i.e., uses a higher FMAP) in states with low per-capita incomes than in states with high per-capita incomes, relative to the national average. Federal law specifies that the FMAP will be no lower than 50 percent and no higher than 83 percent, subject to certain exceptions. For fiscal year 2013 the highest FMAP for a state was 73.4 percent. Federal Medicaid funding for the states generally is not subject to a cap. To qualify for federal reimbursement for a portion of their Medicaid expenditures, states must meet certain federal requirements, including providing the non-federal share of Medicaid expenditures in their state.

DSH program. States are required to make DSH payments to hospitals that serve a large number of Medicaid and low-income uninsured patients. States receive an annual DSH allotment that CMS calculates using a statutorily-defined formula. States make DSH payments to eligible hospitals from this allotment, and cannot claim federal matching funds for DSH payments made in excess of such allotment.

Overview of the Program in Puerto Rico

Eligibility requirements. Unlike the states, which must use the FPL to determine eligibility for mandatory categories, Puerto Rico uses its own local poverty level.[4] For example, Puerto Rico's Medicaid program covers pregnant women, children up to age 20, parents, and elderly or disabled individuals up to 100 percent of the local poverty level.[5] CMS approved Puerto Rico's request to extend eligibility to childless, non-elderly, non-disabled adults in households earning up to 100 percent of the local poverty level—as permitted under PPACA—effective July 1, 2011.

[3]PPACA also provides for a 5 percent income disregard when calculating modified adjusted gross income for determining Medicaid eligibility, which effectively increases this income level to 138 percent of the federal poverty level.

[4]The federal poverty guidelines do not apply to Puerto Rico or other outlying jurisdictions. In cases where a federal program using the poverty guidelines serves any of these jurisdictions, the agency that administers the program is generally responsible for deciding whether to use the federal guidelines or to follow some other procedure. For Medicaid, Puerto Rico has decided to use an alternative procedure, defining its income eligibility standards based on a local poverty level—approved by CMS—in its state Medicaid plan.

[5]In 2011, 100 percent of the local poverty level in Puerto Rico was $8,220 per year for a family of four. Puerto Rico's local poverty level has remained unchanged since 1998, according to officials from Puerto Rico's Department of Public Health.

Puerto Rico provides health insurance coverage to other low-income populations beyond those it covers through Medicaid.

- Infants and children up to age 18 living in households with income between 100 percent and 200 percent of the local poverty level are eligible for Puerto Rico's Children's Health Insurance Program (CHIP)—a joint federal-state program that provides states with financial assistance for health care coverage for lower-income individuals, primarily children 18 years of age and younger, whose household incomes exceed the eligibility requirements for Medicaid and who generally do not have other health insurance, subject to certain exceptions.
- Individuals not eligible for Medicaid or CHIP with incomes up to 200 percent of the local poverty level are eligible for coverage through Puerto Rico's local health insurance program, which is funded solely by Puerto Rico. As of June 2011, Puerto Rico covered about 335,850 of such individuals through its local health insurance program, according to CMS data.[6]

Coverage requirements. In accordance with its approved state plan, Puerto Rico does not cover all mandatory services, namely (1) nursing home services, and (2) home health services.[7] There is no existing infrastructure to support Medicaid coverage of nursing home services in Puerto Rico, according to CMS.

Federal funding. The FMAP for Puerto Rico is set by statute at 55 percent.[8] Additionally, in contrast to the states, the federal contribution to Puerto Rico's Medicaid program generally is limited by statute, although the Recovery Act and PPACA provide funding above this limit.[9] For example, in fiscal year 2011 the statutory cap for spending in Puerto Rico was $290.6 million. However, according to CMS officials, Puerto Rico received an additional $65.4 million and $214.2 million as a result of funding made available under the Recovery Act and PPACA, respectively.

DSH program. Puerto Rico does not qualify for a federal Medicaid DSH allotment.[10]

Potential Changes to the Program under Statehood

Eligibility requirements. Under statehood, Puerto Rico would be required to change its eligibility rules for some mandatory categories to meet minimum federal requirements. For example, it would be required to increase coverage for pregnant women as well as children under age 6 to those with incomes up to 133 percent of the FPL, up from the current level

[6]Puerto Rico's local health insurance program also covers other individuals, such as Puerto Rico government employees.

[7]According to CMS officials, while Puerto Rico is required to offer these mandatory services, it has not complied with this requirement.

[8]PPACA increased Puerto Rico's FMAP from 50 to 55 percent, effective July 1, 2011. Pub. L. No. 111-148, § 2005(c), 124 Stat. 119, 283 (2010), as amended by Pub. L. No. 111-152, § 1204(b)(2)(B), 124 Stat. 1029, 1055 (2010).

[9]Puerto Rico may also claim federal matching funds in excess of the statutory limit for expenditures related to the establishment and operation of its claims processing and information retrieval systems and for payments to providers to encourage the adoption and use of electronic health record technology.

[10]42 U.S.C. § 1396r-4(f)(9).

of 28 percent of the FPL—the FPL equivalent of 100 percent of Puerto Rico's local poverty level for a household of four. Because of these changes, Puerto Rico's current population of CHIP beneficiaries and certain beneficiaries of Puerto Rico's local health insurance program would become covered by Medicaid under statehood.

Coverage requirements According to CMS officials, Puerto Rico would continue to be required to cover all mandatory Medicaid services under statehood, including nursing home facilities and home health care services.

Federal funding. Under statehood, the statutory limit on federal Medicaid funding to Puerto Rico would be removed and the FMAP would increase from 55 percent to 83 percent, based on its per-capita income in relation to the national per-capita income. This change would result in the federal government increasing its share of Medicaid spending and Puerto Rico decreasing its share of Medicaid spending.

DSH program. Under statehood, Puerto Rico would become eligible for Medicaid DSH funding. As the current statutory allotment calculation is based on prior year allotments, it is unclear whether Puerto Rico would receive funding unless specifically stipulated by Congress, according to CMS officials (see appendix IV for a description of DSH changes under PPACA).

Estimated Federal Spending under Statehood

According to our modeling estimates, if Puerto Rico had been a state in 2011, federal Medicaid spending would have ranged from $1.1 billion to $2.1 billion, compared to actual federal spending on Medicaid in Puerto Rico of $685 million in fiscal year 2011. These estimates are based on two sets of eligibility rule assumptions.

- Puerto Rico would have covered only mandatory categories of individuals. Under this scenario, Medicaid eligibility would have increased for some categories (such as pregnant women and children). Optional categories (such as childless, non-elderly, non-disabled adults) would no longer be covered. This scenario represents the lower bound of potential federal Medicaid spending under statehood.
- Puerto Rico would have covered mandatory categories of individuals and expanded coverage levels for the optional categories it actually covered in 2011.[11]

Our estimates based on these assumptions are shown in table 2.

[11] For this scenario we assumed that, where permitted by law, Puerto Rico would have adopted optional rules to expand coverage to individuals that were eligible for Puerto Rico's Medicaid or local health insurance program in 2011. We also assumed that if Puerto Rico had been a state at the beginning of 2011, it would have exercised its early expansion option by the beginning of the year to begin covering childless, non-disabled, non-elderly adults with incomes up to the FPL equivalent of 200 percent of the local poverty level—as permitted under PPACA. This population of beneficiaries would otherwise have been covered through Puerto Rico's local health insurance program (although as of July 1, 2011, Puerto Rico began covering the part of this population with incomes at or below 100 percent of the local poverty level through Medicaid).

Caveats for GAO's Estimates

- We did not take into account all of the potential changes to Medicaid, such as potential changes in spending for DSH or the effect on Puerto Rico's participation in the Medicaid drug rebate program, which provides savings to state Medicaid programs through rebates for outpatient prescription drugs.
- We did not account for the cost of nursing home and home health services in Puerto Rico due to the lack of available cost data and because Puerto Rico lacks an infrastructure of nursing home facilities, according to CMS officials. If these services became available, Medicaid spending would likely increase.
- Puerto Rico could opt to expand Medicaid eligibility to additional optional populations, which would result in increased federal spending. We do not account for this possibility.
- Changes to eligibility rules could result in changes to characteristics of eligible individuals, such as participation rates and average enrollee costs.
- Estimated Medicaid enrollment of individuals receiving SSI benefits assumes that those who would have been eligible for SSI benefits would have obtained them based on national participation rates (see the SSI section of this appendix). Different SSI participation assumptions would affect Medicaid enrollment.

Table 2: Actual Federal Medicaid Spending and Medicaid Enrollment in Puerto Rico and Estimated Federal Medicaid Spending and Medicaid Enrollment under Puerto Rico Statehood, 2011

Scenario	Total federal spending (dollars in billions)	Enrollees (in millions)
Actual	$0.7 [a]	0.9 (as of June 2011) [b] About 1.2 (as of July 2011)[b]
Estimate based on coverage of only mandatory categories	$1.1 [c]	1.0
Estimate based on coverage of mandatory and existing optional categories	$2.1 [d]	2.1

Source: GAO analysis.

[a]Actual spending is for fiscal year 2011.

[b]Actual enrollments for the federal Medicaid program in Puerto Rico were 918,791 in June 2011. CMS estimated that Puerto Rico's early expansion in July 2011 resulted in about 300,000 additional individuals being covered by the federal Medicaid program.

[c]$127 million of this amount is for covering individuals who previously would have received health insurance coverage through CHIP. Under this scenario, Puerto Rico's share of Medicaid spending would have decreased by $358 million.

[d]$127 million of this amount is for covering individuals who previously would have received health insurance coverage through CHIP. Under this scenario, Puerto Rico's share of Medicaid spending would have decreased by $152 million (this estimate is subject to a high level of statistical imprecision, with a margin of error of plus or minus 14.5 percent of the estimate). Spending for its local program would have decreased as well.

Supplemental Nutrition Assistance Program

Program Changes: Cost Estimate

Program Description

The Supplemental Nutrition Assistance Program (SNAP) is intended to improve the nutrition levels of low-income households by ensuring access to nutritious, healthful diets through the provision of nutrition assistance. The federal government pays the full cost of SNAP benefits and shares administrative costs with the states.

SNAP is provided in all 50 states, the District of Columbia, Guam, and the U.S. Virgin Islands. The U.S. Department of Agriculture (USDA), Food and Nutrition Service (FNS), oversees the administration of the program.

In Puerto Rico, FNS oversees the federal block grant to fund the Nutrition Assistance Program (NAP), a separate food-assistance program implemented in 1982 in lieu of SNAP, then known as the Food Stamp Program. Puerto Rico and the federal government equally share administrative costs.

Size of the Program

SNAP:

- Total federal obligations, fiscal year 2011: $75.7 billion, including $11.9 billion in American Recovery and Reinvestment Act of 2009 (Recovery Act) funds.

NAP:

- Federal benefit spending in Puerto Rico, fiscal year 2011: $1.9 billion, including $0.3 billion in Recovery Act funds.
- Average monthly number of households enrolled in Puerto Rico, fiscal year 2011: 644,176.

Summary

If Puerto Rico were treated as a state,

- SNAP benefits would be available to Puerto Rico residents.
- Federal funding for Puerto Rico's NAP would cease.

According to our modeling estimates, if Puerto Rico had been a state in 2011,

- Aggregate SNAP benefits would have ranged from $1.7 billion to $2.6 billion, compared to actual federal spending on NAP of $1.9 billion in fiscal year 2011.
- Average monthly SNAP coverage would have ranged from 486,000 households to 1,140,000 households, compared to 644,176 households covered by NAP in fiscal year 2011.
- Average monthly household SNAP benefits would have ranged from $193 to $286, compared to $247 under NAP in fiscal year 2011.
- Average monthly individuals participating in SNAP would have ranged from 1.3 million to 2.0 million, compared to 1.4 million individuals who participated in NAP in fiscal year 2011.

Overview of the Program in the States

SNAP eligibility and benefits are calculated on a household basis.[1] Eligibility is determined through one of the following two paths.

Regular eligibility. Most applicant households must meet gross income, net income, and resources tests. Specifically, household gross monthly income—excluding income from certain sources—generally must be at or below 130 percent of the applicable federal poverty level. Household net monthly income—computed by subtracting specified deductions, such as dependent care and certain medical expenses—must not exceed 100 percent of the federal poverty level.[2] Additionally, household resources—excluding certain resources, such as a home—generally must be below various requirements. For example, in general, a household's resources cannot exceed $2,000.[3]

Categorical eligibility. SNAP eligibility is automatic for some applicants who participate in other means-tested programs, such as Supplemental

[1] In SNAP, a household is generally a group of people who live, buy food, and prepare meals together. However, there are specific exceptions. For example, parents and most children under age 22 who live together are included in the same household regardless of whether they purchase and prepare meals together. 7 U.S.C. §2012(n).

[2] While households that include an elderly or disabled member do not have to meet the gross income limit, they must meet the net income limit.

[3] While the resource limit is subject to an inflation adjustment, it was $2,000 for the period for which we made our estimate (fiscal year 2011). It remained at that level through fiscal year 2013. Households that include an elderly or disabled member have a higher resource limit.

Security Income (SSI) and Temporary Assistance for Needy Families (TANF). However, cash benefits from these programs may reduce the dollar amount of SNAP benefits provided.

States have some policy and administrative options regarding the program. For example, states can choose to make certain households categorically eligible for SNAP if they qualify for a non-cash TANF benefit.[4]

Benefit determination. For both paths, a household's monthly SNAP benefit amount is calculated based on household net income and the maximum allotment for the household (a figure that is based on the current value of the Thrifty Food Plan, a USDA annual estimate of how much it costs to buy food to prepare nutritious, low-cost meals for a household). In 2009, the Recovery Act temporarily increased maximum monthly benefit levels by an average of 13.6 percent.[5] Subsequent legislation extended the increase through October 31, 2013.[6]

Program variation. There are five different maximum shelter deductions—used in determining net income and SNAP benefits—one for the 48 contiguous states and the District of Columbia, and one for each of Alaska, Hawaii, Guam, and the U.S. Virgin Islands. Also, the 48 contiguous states, the District of Columbia, Guam, and the U.S. Virgin Islands have the same net and gross income eligibility levels, while these levels differ for Alaska and Hawaii. The different income eligibility levels for Alaska and Hawaii result in different standard deductions for those two jurisdictions while the standard deduction for Guam is calculated under a statutory provision applicable only to Guam.

Overview of the Program in Puerto Rico

History. Beginning in 1974, Puerto Rico received nutrition assistance through the Food Stamp Program (the precursor to SNAP). Effective in 1982, Congress replaced the Food Stamp Program in Puerto Rico with a block grant,[7] allowing Puerto Rico more administrative authority, while controlling costs to the federal government. Puerto Rico used the block grant to fund NAP. For fiscal years 2004 and beyond, the amount of the block grant has been adjusted based on changes to the SNAP Thrifty Food Plan. In 2009, the Recovery Act and subsequent legislation increased the Thrifty Food Plan, on which NAP funding is adjusted, by 13.6 percent through October 31, 2013.

Program characteristics. The overall program structure and operational processes of NAP are similar to those of SNAP. Like SNAP, NAP provides nutrition assistance to households that meet certain eligibility criteria, such as income and resources. For example, the resource eligibility limit is similar. However, Puerto Rico established different income levels, benefit levels, and administrative processes for NAP. See table 3 for a comparison of selected program characteristics.

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[4]This option is known as broad-based categorical eligibility.

[5]Pub. L. No. 111-5, § 101(a), 123 Stat. 115, 120.

[6]The Healthy, Hunger-Free Kids Act of 2010 set the end date for Recovery Act increases in SNAP benefits to October 31, 2013. Pub. L. No. 111-296, § 442, 124 Stat. 3183, 3265 (2010). Under this extension, the provision in the Recovery Act providing the 13.6 percent increase over fiscal year 2009 levels only applied if it resulted in benefits and grants higher than would have be the case in the absence of the provision.

[7]7 U.S.C. § 2028. Puerto Rico is not considered a state for the purposes of the SNAP program. 7 U.S.C. § 2012(s).

Table 3: Comparison of NAP and SNAP Selected Program Characteristics, Fiscal Year 2011

Program characteristic	NAP	SNAP[a]
Resource eligibility limit	$2,000 or $3,000 (household with elderly or disabled)	$2,000 or $3,000 (household with elderly or disabled)
Monthly gross income eligibility limit (four person household)	None	$2,389
Monthly net income threshold for benefit determination (four person household)	$713	$1,838
Maximum monthly household benefit (four person household)	$410	$668
Cash benefit redemption allowed[b]	up to 25% of monthly benefit	none

Source: GAO analysis of FNS and Puerto Rico documents.

[a]SNAP characteristics are for the 48 contiguous states and the District of Columbia.

[b]Cash redemption allows participants to purchase food from non-certified retailers.

Potential Changes to the Program under Statehood

If Puerto Rico became a state and was treated like the other states, NAP would be discontinued and Puerto Rico would operate SNAP. As a state, Puerto Rico would need to choose among various SNAP state policy options. These changes would affect both eligibility and benefits determinations. In addition, Congress would need to decide whether Puerto Rico should be treated like the 48 contiguous states and the District of Columbia for various deductions and benefit determination components, or should be treated differently, as are Alaska, Hawaii, Guam, and the U.S. Virgin Islands.

Differences between SNAP and NAP would affect eligibility and benefit determinations for Puerto Rico households. For example, to qualify for SNAP, Puerto Rico households would have to meet a gross income test, could qualify with higher net income, and could receive a greater benefit payment than under NAP. Under SNAP, Puerto Rico households would not be able to redeem any of their benefit payment for cash, as they can under NAP.

According to FNS officials, if Puerto Rico were a state it would be able to receive additional federal SNAP funding for employment and training, outreach, and education programs, as well as additional funding during presidentially-declared disasters.

Estimated Federal Spending under Statehood

According to our modeling estimates, if Puerto Rico had been a state in 2011, federal benefit spending for SNAP would have ranged from $1.7 billion to $2.6 billion, compared to actual federal spending on NAP of $1.9 billion in fiscal year 2011.

The estimates are based on different household unit definitions and participation assumptions:

- Everyone in a household would have filed together for SNAP as a single unit, unless the household contained a person receiving TANF. We modeled this assumption based on both a national participation average and at full participation.

Caveats for GAO's Estimates

- As a state, Puerto Rico would be able to choose among various SNAP policy options, which could affect the estimates. We have incorporated state options based on our discussion with FNS officials. Puerto Rico officials did not indicate which state options they might choose. The actual options that Puerto Rico would select under statehood could differ from those used in our analysis.
- Where deductions and components of benefit determinations differ between the 48 contiguous states and the District of Columbia and other states and territories receiving SNAP, we have used the 48 contiguous states and the District of Columbia criteria. If Congress allowed Puerto Rico to use different amounts for deductions or benefits, estimated program spending would differ.
- Because the participation rate among those eligible for NAP was not estimated, a national probabilities estimate of SNAP participation was used, equating to 75 percent of eligible households. We also presented estimates for full participation. Participation rates vary among the states, ranging from 55 percent to virtually full participation among those eligible.
- Estimated SNAP enrollment of individuals receiving SSI benefits assumes that those eligible for SSI benefits would have obtained them based on national average participation rates (see the SSI section of this appendix). Different SSI participation assumptions would affect SNAP participation and benefits.

- Unrelated individuals and subfamilies would have filed as separate units at full participation.
- Households would have split into as many units as possible.

Our estimates based on these assumptions are shown in table 4.

Table 4: Actual Puerto Rico NAP Data and Estimates of SNAP Implementation under Puerto Rico Statehood, 2011

Household unit definition	Total benefit (billions of dollars)	Average monthly participating household units	Average monthly household benefit	Average monthly participating individuals
NAP actual data[a]	$1.9	644,146	$247	1,353,000
SNAP estimates				
TANF recipients in households file as separate units (75% participation)	$1.7	486,000	$286	1,276,000
TANF recipients in households file as separate units (100% participation)	$2.0	648,000	$254	1,636,000
Unrelated individuals and subfamilies file as separate units (100% participation)	$2.0	676,000	$247	1,653,000
Households are split into as many units as possible (100% participation)	$2.6	1,140,000	$193	2,010,000

Source: GAO analysis and Puerto Rico NAP data.

[a]NAP data are for fiscal year 2011.

In addition to household definitions and rates of participation, another factor included in the estimates is the impact of Supplemental Security Income (SSI). Under statehood, Puerto Rico residents would also be eligible for benefits through SSI, which would replace the existing Aid to the Aged, Blind, and Disabled (AABD) program;[8] SSI income can reduce a household's SNAP benefits. For example, under the scenario where TANF recipients in households file as separate units, assuming national participation rates (75 percent participation), estimated total benefits would have been $151 million to $321 million greater at 95 percent confidence if the AABD program had been in place instead of the SSI program, even though the number of households participating would have been similar.

[8]The AABD program in Puerto Rico provides cash benefits for qualifying low-income individuals. Puerto Rico and the federal government share in benefit funding and administrative costs. Under statehood, if Puerto Rico were treated like other states, federal funding for the AABD program would cease.

Program Description

The Supplemental Security Income (SSI) program provides monthly cash assistance to people who are disabled, blind, or age 65 or over and lack sufficient income and resources to maintain a standard of living at the established federal minimum income level. SSI benefits are provided to residents of all 50 states, the District of Columbia, and the Northern Mariana Islands. SSI is a federal entitlement program funded by general revenues and administered by the Social Security Administration (SSA).

The Aid to the Aged, Blind, and Disabled (AABD) program in Puerto Rico provides cash benefits for qualifying low-income individuals. Puerto Rico and the federal government share in benefit funding and administrative costs. Puerto Rico operates the program and federal oversight is provided by the Department of Health and Human Services, Administration for Children and Families.

Size of the Program

SSI:

- Total federal obligations, fiscal year 2011: $56.0 billion, including $5.1 million in American Recovery and Reinvestment Act of 2009 (Recovery Act) funds.

AABD:

- Federal benefits spending in Puerto Rico, fiscal year 2011: $24 million.
- Average monthly number of individuals enrolled in Puerto Rico, fiscal year 2011: 34,401.

Supplemental Security Income

Summary

If Puerto Rico were treated as a state,

- SSI benefits would be available to Puerto Rico residents.
- Federal funding for Puerto Rico's AABD program would cease.

According to our modeling estimates, if Puerto Rico had been a state in 2011,

- Federal spending for SSI benefits would have ranged from $1.5 billion to $1.8 billion, compared to actual spending on AABD benefits of about $24 million in fiscal year 2011.
- Average monthly participation in SSI would have ranged from 305,000 to 354,000 individuals, compared to 34,401 individuals in the AABD program in fiscal year 2011.

Overview of the Program in the States

Criteria and benefits. Eligibility requirements and federal payment amounts are nationally uniform for SSI. To qualify for SSI, applicants must be aged, blind, or disabled with limited assets and income.[1] In most cases, assets are limited to $2,000 for an individual and $3,000 for a couple. After determining countable income, the maximum SSI benefit is reduced by the amount of countable income to compute a monthly payment amount.[2] In 2011, the maximum monthly SSI benefit was $674 for an individual and $1,011 for a couple. Maximum SSI benefits are slightly less than three-fourths of the federal poverty level (FPL) for a single person and slightly more than 80 percent of the FPL for a couple. Many states supplement the federal SSI benefit with additional funding.

SSI recipients may also get noncash forms of assistance. In most states, anyone who receives SSI benefits is automatically eligible for Medicaid. SSI recipients may also qualify for the Supplemental Nutrition Assistance Program (SNAP). However, most states do not allow individuals to receive both SSI and Temporary Assistance to Needy Families (TANF) benefits. Under the Recovery Act, SSA made one-time Economic Recovery Payments of $250 to people eligible for various benefits, including people eligible for SSI benefits.[3]

[1] To qualify for benefits based on age, an individual must be 65 years or older. Adults under age 65 can qualify for benefits based on blindness or a disability that results in the inability to do any substantial gainful activity and can be expected to result in death or has lasted or can be expected to last for a continuous period of not less than 12 months. Children can qualify based on a disability with conditions that result in marked and severe functional limitations and the condition(s) generally must have lasted or be expected to last for a continuous period of at least 12 months or be expected to result in death. Medical assessments must be made to determine disability status for both adults and children.

[2] Countable income is the amount of income, after considering exclusions and deductions as part of the SSI benefit computation. 20 C.F.R. § 416.1104.

[3] Pub. L. No. 111-5, div. B, § 2201(a), 123 Stat. 115, 450 (2009). The one-time payments were for individuals who were eligible for SSI in any month from November 2008 to

Overview of the Program in Puerto Rico

History. The Social Security Amendments of 1972 created SSI to replace federal grant programs providing economic assistance to low-income adults in the states who are aged, blind, or disabled. Puerto Rico was not included as eligible for SSI.[4] It continues to receive federal AABD grants under the program that existed before SSI was created. Federal AABD grants to the states discontinued once SSI was implemented.

Criteria and benefits. The AABD program in Puerto Rico provides cash assistance to qualifying blind individuals of any age and to disabled adults and the aged.[5] According to documents provided by Puerto Rico officials, eligibility and benefit determination is made for each individual based on the individual's available resources (no more than $2,000 in assets) and income, considering various income exclusions and deductions. The maximum individual basic monthly benefit is $64. The basic monthly benefit amount is reduced by the amount of the remaining income after exemptions and deductions. An individual may qualify for an additional monthly payment of up to $100 for family shelter costs. The average AABD payment in fiscal year 2011 was $77 a month ($58 of this amount was from federal funds and $19 was from Puerto Rico funds, based on the cost share described below). A majority of recipients—60 percent—qualified because they were disabled or blind.

Cost share. The federal government provides 75 percent of AABD benefit costs and 50 percent of program administrative costs. Federal funding is subject to a funding ceiling, which also includes such programs as TANF, Foster Care, and Adoption Assistance programs (for more information, see the section on TANF in this appendix).

Potential Changes to the Program under Statehood

Under statehood, if Puerto Rico were treated like other states, qualifying Puerto Rico residents would be able to participate in the SSI program. The federal government would pay SSI benefit and administrative costs. While federal funding for the AABD program would cease, Puerto Rico could provide state supplementation of federal SSI payments, as other states have done.

Estimated Federal Spending under Statehood

According to our modeling estimates, if Puerto Rico had been a state in 2011, federal spending for SSI benefits would have ranged from $1.5 billion to $1.8 billion, compared to actual federal spending on AABD benefits of about $24 million in fiscal year 2011.[6]

These estimates are based on two sets of participation assumptions.[7]

January 2009. Most of the payments were received in 2009, but some were not received until 2010.

[4]42 U.S.C. §§ 301 to 306, 1301(a)(1), 1382c(e).

[5]According to a Puerto Rico official, these benefits are provided as part of the Economic Assistance Program, and are administered through the Department of the Family, Administration for Socioeconomic Development of the Family.

[6]Total federal expenditures in fiscal year 2011 for Puerto Rico's AABD program was $27.4 million, which included $3.5 million in administrative costs and $23.8 million in benefit costs (figures do not sum to total because of rounding).

[7]Participation rates do not include children under 5 because of the difficulty of determining eligibility for this age group; however they are included in the estimates (see appendix I for more information).

Caveats for GAO's Estimates

- The survey data we used to estimate eligibility did not precisely capture the same criteria that are assessed by doctors in determining eligibility based on disability status. As a result, we made assumptions to estimate potential eligibility for individuals based on disability status: their actual eligibility could have differed from our assumptions.
- Estimated participation rates for eligible households were based on participation rates in other states. Actual participation rates in Puerto Rico could differ from the rates we used.
- The estimates do not include changes in SSA's administrative costs related to the SSI program in Puerto Rico.

- Puerto Rico SSI participation rates would have been the same as national participation rates for various groups of beneficiaries, resulting in an overall participation rate of 65.6 percent.
- Puerto Rico SSI participation rates would have been the same as the average participation rates for the five states with the highest 3-year average poverty rates for 2009 to 2011[8] for various groups of beneficiaries, resulting in an overall participation rate of 75.9 percent.

Our estimates based on these assumptions are shown in table 5.

Table 5: Actual Puerto Rico AABD Data and Estimates for SSI Implementation under Puerto Rico Statehood, 2011

Estimate description	Total federal benefit (dollars in billions)	Average monthly participating individuals	Average monthly federal individual benefit
AABD actual data[a]	$0.02	34,401	$58[b]
SSI estimate based on national participation rates	$1.5	305,000	$422
SSI estimate based on high-poverty states' participation rates	$1.8	354,000	$418

Source: Puerto Rico and GAO

[a]Actual benefits are for fiscal year 2011.

[b]The total AABD average monthly total benefit of $77 includes $58 in federal funds and $19 in Puerto Rico funds.

[8]Poverty rates are from the U.S. Census Bureau.

Program Changes: Cost Estimate

Program Description

The Federal-Aid Highway Program is an umbrella term that refers to highway programs funded from contract authority out of the Highway Account of the Highway Trust Fund (the Fund), plus any supplemental appropriations.

Funding assistance is provided to states and territories for the planning, construction, maintenance and operations of the Interstate System, highways, bridges on eligible routes, and other authorized purposes.

The Department of Transportation's Federal Highway Administration (FHWA) administers the program.

Size of the Program

- Total federal obligations, fiscal year 2013: $41.0 billion.
- Authorization for Puerto Rico, fiscal year 2013: $149.7 million. Allocation to Puerto Rico, fiscal year 2013: $129.3 million.

Federal-Aid Highways

Summary

If Puerto Rico were treated as a state,

- Federal excise taxes on motor fuel sold in Puerto Rico would be required, increasing taxes paid into the Highway Account of the Fund.
- Puerto Rico would receive an annual apportionment, instead of receiving Puerto Rico Highway Program funding.

According to FHWA estimates, if Puerto Rico had been a state in fiscal year 2013,

- The net deficit—considering estimated motor fuel taxes and apportionment—to the federal government for Federal-Aid Highways in Puerto Rico would have been $33 million.

In comparison, $149.7 million in federal funds were actually authorized for Puerto Rico for fiscal year 2013.

Overview of the Program in the States

Funding authority. States receive an annual apportionment—a division of authorized funding according to statutory formulas—from the Fund for use on eligible highway projects. The Fund—which contains both the Highway and Mass Transit Accounts—is funded primarily by federal excise taxes on motor fuel for highway use.[1] Through fiscal year 2016, the federal gasoline fuel tax rate is 18.4 cents per gallon; 15.44 cents per gallon of the tax is distributed to the Highway Account of the Fund.

Funds distribution. The Moving Ahead for Progress in the 21st Century Act (MAP-21)[2] authorized a single annual amount for fiscal years 2013 and 2014 to fund five core programs within the Federal-Aid Highway Program.[3] Each state's fiscal year 2013 apportionment was the same as its 2012 apportionment.[4] For fiscal year 2014, the funding for the states also will be divided proportionally, based on the apportionment each state received for fiscal year 2012, and adjusted to ensure a guaranteed return of at least 95 percent of the tax payments attributable to highway users in each state to the Highway Account of the Fund.[5] Adjustments will be

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[1]Federal excise taxes on truck tires, heavy vehicle use, and truck and trailer sales also contribute to the Fund.

[2]Pub. L. No. 112-141, § 1101(a)(1), 126 Stat. 405 (2012).

[3]The 5 programs include the National Highway Performance Program (23 U.S.C. § 119), the Surface Transportation Program (23 U.S.C. § 133), the Highway Safety Improvement Program (23 U.S.C. § 148), the Congestion Mitigation and Air Quality Improvement Program (23 U.S.C. § 149), and the Metropolitan Transportation Planning Program (23 U.S.C. § 134).

[4]The combined fiscal year 2012 apportionments exceeded the total amount authorized under MAP-21 for fiscal year 2013. Therefore, the fiscal year 2013 apportionments were reduced proportionally in order not to exceed the MAP-21 authorization.

[5]In recent years, under previous law, every state has received more funding for highway programs than its highway users contributed to the Highway Account of the Fund. This was possible because more funding was authorized and apportioned than was collected from

based on the most recent year for which motor fuel data are available, which is typically 2 years prior.

Use of funds. States' apportionments are divided among the core programs, based on statutory formulas, although states can transfer some funds among programs. Funds are available for obligation for 3 years after the year of their authorization, and lapse if not obligated by that time. In some instances, the amount of funding made available may be reduced, or be required to be spent for a particular purpose, if a state does not meet minimum Congressionally-imposed maintenance or safety standards—such as setting the minimum legal drinking age at 21.

Overview of the Program in Puerto Rico

Funding authority. With some exceptions, the Foraker Act[6] exempted Puerto Rico imports and exports from federal excise taxes.[7] Thus, Puerto Rico highway users do not contribute to the Fund. Instead, Puerto Rico receives an annual allocation through the Puerto Rico Highway Program.[8]

Funds distribution. Puerto Rico's allocation is available for the same activities as is funding apportioned to the states, and is subject to the same penalties for noncompliance. For fiscal year 2013, Puerto Rico was authorized $149.7 million,[9] which is the figure most comparable to an apportionment.[10] Puerto Rico's authorization was reduced after approximately $5.8 million was subtracted because of obligation limitations on highway program funding.[11] Additionally, approximately $14.7 million in penalties were withheld or reserved, giving Puerto Rico about $129.3 million in contract authority. Funds were withheld from Puerto Rico under a provision requiring states to have a minimum legal drinking age of 21 and funds were reserved under provisions requiring states to have a statute banning open containers of alcoholic beverages in vehicles, and a statute penalizing repeatedly intoxicated drivers.

Use of funds. Under MAP-21, the Puerto Rico Highway Program has some flexibility unavailable to the states. For example, its funding is broken into three components of spending and is not subject to set-asides, whereas state apportionments are divided among five programs, and some funds are set aside for specific purposes.

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the states, and the fund was augmented with about $30 billion in general revenues since fiscal year 2008. See GAO, *Highway Trust Fund: All States Received More Funding Than They Contributed in Highway Taxes from 2005 to 2009*, GAO-11-918, (Washington, D.C.: Sept. 8, 2011).

[6]Act of Apr. 12, 1900, ch. 191, §§ 3, 14, 31 Stat. 77 (1900), as amended by the Act of May 17, 1932, ch. 190, 47 Stat. 158, codified at 48 U.S.C. § 738.

[7]Puerto Rico's own gasoline fuel tax rate is 16 cents per gallon.

[8]23 U.S.C. § 165.

[9]This amount incorporates a 0.2 percent across-the-board rescission. Consolidated and Further Continuing Appropriations Act, 2013, Pub. L. No. 113-6, § 3004, 126 Stat. 405, 436–437 (2012).

[10]Puerto Rico's authorization (prior to subtractions for penalties and subtractions for obligation limitations) and its estimated apportionment (prior to subtractions for penalties) are comparable numbers, according to FHWA officials.

[11]There are statutory obligation ceilings placed on the amount of contract authority for highway programs that can be obligated each fiscal year. Contract authority is the authority to incur an obligation in advance of appropriations.

Potential Changes to the Program under Statehood

Under statehood, if Puerto Rico were treated like the other states, motor fuels sold in Puerto Rico would not be exempt from federal excise taxes.[12] According to FHWA officials, Puerto Rico Highway Program likely would end under statehood, pending Congress modifying the applicable statute. Puerto Rico then would be given an annual apportionment.

According to FHWA officials, if Puerto Rico were granted statehood, a transition period to establish apportionment levels would likely be necessary, given that apportionments under MAP-21 reflect, in part, apportionments in prior years, and there are no recent data on prior Puerto Rico apportionments. How to establish apportionments for Puerto Rico as a state would be up to Congress.

Caveats for FHWA's Estimate

- MAP-21 provides for state apportionments only through fiscal year 2014. Caution should be taken in extrapolating the estimate beyond that year, as formulas for apportionment may change.
- FHWA's estimate for Puerto Rico highway users' contribution to the Fund did not include federal excise taxes on truck tires, heavy vehicle use, and truck and trailer sales. Had those taxes been included, Puerto Rico highway users' contribution likely would have been higher, reducing the net deficit.
- As a state, Puerto Rico or its localities could decide to change their per gallon gasoline tax rates, which would affect costs of and, potentially, demand for fuel.
- Motor fuel consumption data from 2011 were collected when Puerto Rico was in an economic recession. To identify the potential impact of the recession on the data, we reviewed data from 2005 to 2011. We found that 2011 represented the second lowest amount of gallons reported, while 2005, just prior to the recession, represented the highest amount. During non-recession years, it is possible that motor fuel consumption would increase, therefore increasing Puerto Rico's contribution to the Fund.

Estimated Federal Revenues and Spending under Statehood

According to FHWA estimates, if Puerto Rico had been a state in fiscal year 2013, the net deficit—considering estimated motor fuel taxes and apportionment—to the federal government for Federal-Aid Highways in Puerto Rico would have been about $33 million.

- Puerto Rico highway users' contribution to the Fund would have been about $232 million, according to FHWA's calculations.[13]
- Puerto Rico's estimated apportionment would have been about $265 million, before potential penalties,[14] according to FHWA's estimate (based on available Puerto Rico data and state apportionment formulas). This estimate includes an adjustment for an Equity Bonus in fiscal year 2009—which was a program used in apportionment formulas prior to MAP-21—that guaranteed that each state receives at least a share of apportionments and High Priority Projects[15] equal to 92 percent of its share of highway users' contribution to the Fund.[16]

[12]Truck tires, heavy vehicle use, and truck and trailer sales also would not be exempt from federal excise taxes.

[13]In 2011, the year of data FHWA used for fiscal year 2013 Fund contribution calculations, Puerto Rico reported consumption of more than one billion gallons of gasoline for highway use. This consumption would have been taxed at the 15.44 cents per gallon rate under statehood. Puerto Rico reported 253.2 million gallons of special fuel use, which would have been taxed at 21.44 cents per gallon.

[14]The estimate incorporates the 0.2 percent across-the-board rescission as described previously.

[15]High Priority Projects were funded by the High Priority Projects Program. Eligible projects were identified in prior legislation, in effect for fiscal year 2009.

[16]Although the Equity Bonus adjustment is not part of MAP-21, it is relevant because states' fiscal year 2013 apportionments were ultimately based on apportionments for fiscal year 2009, which were made under prior law.

Program Description

The State Children's Health Insurance Program (CHIP) is a joint federal-state program that provides states with financial assistance for health care coverage for lower income individuals—primarily children 18 years of age and younger—whose household incomes exceed the eligibility requirements for Medicaid and who generally do not have other health insurance, subject to certain exceptions.

The Centers for Medicare & Medicaid Services (CMS) oversees the program at the federal level; states administer their respective programs' day-to-day operations.

Size of the Program

- Total federal obligations, fiscal year 2011: $8.8 billion.
- Federal spending in Puerto Rico, fiscal year 2011: $99.6 million.
- Number of CHIP beneficiaries in Puerto Rico, June 2011: 119,073.

Children's Health Insurance Program

Summary

If Puerto Rico were treated as a state, it would

- Need to increase income eligibility standards to continue receiving federal CHIP funds, since its current CHIP-eligible population would instead receive benefits through Medicaid.
- Receive federal CHIP funding based on a higher matching rate, up to its federal allotment.

According to our modeling estimates,[1] if Puerto Rico had been a state in 2011,

- Estimated federal CHIP spending would have ranged from $0 to $73.2 million, compared to actual federal spending on CHIP in Puerto Rico of $99.6 million in fiscal year 2011.
- The number of children enrolled in CHIP would have ranged from 0 to 59,000, compared to 119,073 covered in June 2011.

Overview of the Program in the States

Eligibility and coverage requirements. To obtain federal CHIP funding, states generally must comply with certain minimum federal requirements, such as covering certain populations and particular services. For example, states' CHIP cannot cover children who are eligible for Medicaid. Under Medicaid, in 2011, states were required to cover—at a minimum—children under age 6 from households with income up to 133 percent of the federal poverty level (FPL) and children ages 6 to 18 from households with incomes up to 100 percent of the FPL.[2] Beginning January 1, 2014, the Patient Protection and Affordable Care Act (PPACA) requires states to cover children ages 6 to 18 in households with incomes up to 133 percent of the FPL.[3] Accordingly, states' CHIP may only cover children from households with incomes that exceed these levels.

Beyond these broad federal parameters, states have discretion in setting CHIP eligibility standards. For example, in 2011, 3 states covered children at less than 200 percent of the FPL, 18 states covered children at 200 percent of the FPL, 9 states covered children from 201 to 299 percent of the FPL, 18 states and the District of Columbia covered children at 300 percent of the FPL, and 2 states covered children above 300 percent of the FPL.

[1] See later in this section for more information on the reliability of our CHIP estimates.

[2] Federal poverty levels are based on the federal poverty guidelines that the Department of Health and Human Services publishes on an annual basis. These guidelines provide income thresholds that vary across states and by family size. In 2011, 100 percent of the federal poverty level was $22,350 per year for a family of four in the 48 contiguous states and the District of Columbia.

[3] PPACA also provides for a 5 percent income disregard when calculating modified adjusted gross income for determining Medicaid eligibility, which effectively increases this income level to 138 percent of the FPL.

States have three options for implementing CHIP: (1) expand their Medicaid programs, (2) create separate child health programs, or (3) a combination of both. States that implement CHIP by expanding their Medicaid programs must extend Medicaid-covered services to CHIP-eligible individuals.

Federal funding. The federal government matches state expenditures for most services provided to CHIP beneficiaries using an enhanced CHIP Federal Medical Assistance Percentage (FMAP).[4] The enhanced CHIP FMAP is set by statutory formula and generally is a state's Medicaid FMAP plus 30 percent of the difference between the state's FMAP and 100 percent.[5] In fiscal year 2011, the lowest FMAP was 65 percent; the highest FMAP was 82.3 percent.[6]

Federal CHIP funding for states generally is subject to an annual limit, known as the CHIP allotment. Fiscal year 2011 allotments were determined, in part, on each state's prior year expenditures and the annual percentage increase, if any, in the population of children in the state. A state that exhausts its allotment may obtain additional funding if there are unused allotments from other states available for redistribution, the state has additional qualifying expenses, and the state has contributed its required share of funds.[7] In fiscal year 2011, $1.1 billion in unused allotments were available for redistribution, according to CMS officials. In addition to redistributed funds, states may also have qualified for increased allotments in fiscal years 2010 and 2012 if they had expanded eligibility or benefits for children. Potential allotment increases are also available for fiscal year 2014 under these parameters. Any redistributed funding or funding from an expansion of eligibility or benefits is incorporated into the next year's allotment calculation, which is based on prior year funding.

Overview of the Program in Puerto Rico

Eligibility and coverage requirements. Puerto Rico has implemented CHIP as an expansion of its Medicaid program. Puerto Rico's CHIP covers children who would not otherwise be eligible for Medicaid and live in families earning up to 200 percent of the local poverty level ($16,440 for a family of four in 2011).[8] Because Puerto Rico implements CHIP as an

[4]See the section on Medicaid in this appendix for a description of the FMAP calculation.

[5]Because federal law establishes the minimum Medicaid FMAP at 50 percent, the enhanced CHIP FMAP may be no less than 65 percent. Federal law also caps the enhanced CHIP FMAP at 85 percent, with the exception of the time period of October 2015 through September 2019. During this time, each state's enhanced CHIP FMAP will increase by 23 percentage points and will apply to most CHIP expenditures.

[6]States qualify for funds at the enhanced matching rate to cover children living in households earning up to 300 percent of the FPL ($67,050 for a family of four in 2011). States covering children in families with incomes above 300 percent of the FPL qualify for federal matching funds based on the states' Medicaid FMAP. This limitation does not apply to grandfathered states—that is, states that had CMS approval to cover these children or had enacted a state law to seek CMS approval to cover these children as of February 4, 2009.

[7]Any funding allotted to a state that remains unused after 2 years becomes available for redistribution to other states.

[8]CMS allows Puerto Rico to set its income eligibility rules based on its own local poverty level.

expansion of its Medicaid program, it is required to provide Medicaid-covered services to CHIP-eligible children.[9]

Federal funding. The federal government matches spending in Puerto Rico using an enhanced CHIP FMAP of 68.5 percent.[10] CMS calculates an annual allotment for Puerto Rico using the same methodology as for the states, according to CMS officials. In fiscal year 2011, Puerto Rico received an allotment of $99.6 million, and used the entire allotment. Because Puerto Rico's spending did not exceed its available allotment, it did not qualify for any portion of the $1.1 billion in unused allotments available for redistribution.[11]

Potential Changes to the Program under Statehood

Eligibility and coverage requirements. Under statehood, changes to Medicaid would affect CHIP eligibility rules in Puerto Rico. Given required increases to Medicaid income eligibility standards, children currently eligible for CHIP would instead qualify for Medicaid.[12] To draw down federal CHIP funding, Puerto Rico would need to increase its minimum CHIP income eligibility standards. If Puerto Rico continued to implement CHIP as an expansion of its Medicaid program, it would be required to provide required Medicaid-covered services to CHIP-eligible children.

Federal funding. Under statehood, Puerto Rico's enhanced CHIP FMAP would increase from 68.5 percent to 85 percent, based on the statutory formula for the enhanced CHIP FMAP in the states. Puerto Rico's calculated allotment would not be likely to have changed for fiscal year 2011 because the allotments were calculated using amounts for the prior fiscal year, according to CMS officials. However, Puerto Rico could potentially qualify for an increased allotment if it increased program income eligibility rules or expanded benefits (as described above, Puerto Rico would need to increase income eligibility standards to receive federal CHIP funding). Puerto Rico would continue to qualify for redistributed funding from other states if its CHIP spending exceeded its allotment.

Estimated Federal Spending under Statehood

According to our modeling estimates, if Puerto Rico had been a state in 2011, federal CHIP spending would have ranged from $0 to $73.2 million, compared to actual federal spending on CHIP in Puerto Rico of $99.6 million in fiscal year 2011.

Our CHIP estimates reflect Puerto Rico's actual population of CHIP beneficiaries in 2011 receiving health insurance coverage through Medicaid, and are based on three eligibility standards assumptions:

- Puerto Rico would have opted to cover children up to 300 percent of the FPL.

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[9]See the section on Medicaid in this appendix for a description of Medicaid-covered services.

[10]Puerto Rico's Medicaid FMAP was increased from 50 to 55 percent, effective July 1, 2011, as a result of PPACA. This increase resulted in Puerto Rico's enhanced CHIP FMAP increasing from 65 to 68.5 percent at the same time.

[11]In fiscal year 2012, Puerto Rico received $23.7 million in funding above its allotment, due to prior year funding from other states being available for redistribution and Puerto Rico spending more than its fiscal year 2012 allotment.

[12]PPACA requires states to maintain Medicaid and CHIP eligibility standards for adults and for children until 2014 and 2019, respectively. However, according to CMS, this requirement would not prohibit Puerto Rico from discontinuing CHIP if all the currently covered children were newly eligible for Medicaid.

Caveats for GAO's Estimates

- The income eligibility standards selected for modeling were not based on known inputs, but rather on options available for Puerto Rico. Puerto Rico Department of Health officials said it would be difficult to predict what income eligibility standards it would adopt without knowing the financial impact of its various options.
- Changes to program eligibility standards could result in changes to characteristics of eligible children, such as participation rates and average enrollee costs.
- The estimates for the two modeling scenarios in which Puerto Rico raises its eligibility standards have high levels of statistical imprecision. The estimates of federal enrollments and expenditures have margins of error ranging from plus or minus 10 percent of the estimate to plus or minus 27 percent of the estimate.

- Puerto Rico would have opted to cover children up to 200 percent of the FPL.
- Puerto Rico would have opted to discontinue its program, given that its beneficiaries would have met Medicaid income eligibility standards, which would have exceeded CHIP income eligibility standards.

Our estimates based on these assumptions are shown in table 6.

Table 6: Actual Federal CHIP Spending and CHIP Enrollment in Puerto Rico and Estimated Federal CHIP Spending and CHIP Enrollment under Puerto Rico Statehood, 2011

Scenario	Federal CHIP spending (dollars in millions)	CHIP Enrollees
Actual	$99.6[a]	119,073[b]
Estimate based on income eligibility set at 300% of the FPL	$73.2[c]	59,000[d]
Estimate based on income eligibility set at 200% of the FPL	$58.3[e]	47,000[f]
Estimate based on CHIP discontinuation	$0[g]	0

Source: GAO analysis.

[a]Actual spending is for fiscal year 2011.

[b]Enrollees are as of June 2011. Under statehood, all 119,073 enrollees would have instead received benefits through Medicaid.

[c]The margin of error for this estimate is plus or minus 27 percent. Under this scenario, Puerto Rico's share of total CHIP spending would have decreased by $40.7 million.

[d]The margin of error for this estimate is plus or minus 10 percent.

[e]The margin of error for this estimate is plus or minus 18 percent. Under this scenario, Puerto Rico's share of total CHIP spending would have decreased by $43.3 million.

[f]The margin of error for this estimate is plus or minus 13 percent.

[g]Under this scenario, Puerto Rico's share of total CHIP spending would have decreased by $53.6 million.

Program Changes: Description

Pell Grants and the Federal Direct Student Loan Program

Program Descriptions

Authorized by Title IV of the Higher Education Act of 1965, as amended, Pell Grants and Stafford or PLUS loans made through the Federal Direct Student Loan Program (Direct Loans) provide funds to students attending postsecondary education institutions. Students must meet general requirements for all Title IV federal student aid as well as specific program eligibility requirements, and must attend institutions eligible to participate in federal student aid programs.[1]

The Department of Education's (Education) Office of Federal Student Aid administers both programs.

Size of the Programs

Pell Grants:

- Total federal obligations, fiscal year 2010: $32.9 billion, including $7.8 billion in American Recovery and Reinvestment Act of 2009 funds.
- Pell Grants awarded to Puerto Rico residents, fiscal year 2010: $1.0 billion.
- Number of Puerto Rico residents awarded Pell Grants, fiscal year 2010: 232,668.

Direct Loans:

- Total federal obligations, fiscal year 2010: $3.5 billion.
- Direct Loans awarded to Puerto Rico residents, fiscal year 2010: $301 million.
- Number of Puerto Rico residents awarded Direct Loans, fiscal year 2010: 42,298.

Overview of the Programs in the States

Pell Grants. Award amounts are typically given to undergraduate students who have a financial need, up to the maximum Pell Grant allowed under the Higher Education Act of 1965, as amended.[2] The amount of need is defined in the act as the difference between the cost of attendance and the expected family contribution and other estimated financial assistance.

The expected family contribution is determined under a statutory formula that considers, among other factors, income, assets, and the number of dependents in a student's family. In the formula, a percentage of the parents' and students' incomes are protected—by an allowance for state and other taxes—from being considered available for postsecondary education expenses. For each state, Education uses annual Internal Revenue Service (IRS) data to determine the percentage of income protected.

Direct Loans. Undergraduate students with financial need are eligible for subsidized Stafford loans for which the federal government pays interest while the student is in school at least half-time and during grace and authorized deferment periods.[3] As with Pell Grants, students' expected family contributions—calculated using IRS data to determine state income percentages—are considered when determining financial need for subsidized Stafford loans. Undergraduate, graduate, and professional students without financial need can receive unsubsidized Stafford loans. PLUS Loans are non-need based and are available to graduate and professional students and parents of dependent undergraduate students.

Overview of the Programs in Puerto Rico

For both programs, institutions and students in Puerto Rico are subject to the same statutory and regulatory requirements as institutions and students in the states. However, Puerto Rico residents generally are not required to pay federal income taxes on Puerto Rico-source income, and Puerto Rico is not subject to the analysis that is conducted to determine state tax allowances. Rather, Education allows a nominal allowance for Puerto Rico residents.[4]

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[1] Institutions eligible to participate in federal student aid programs authorized by Title IV of the Higher Education Act of 1965, as amended, include public, private non-profit, and proprietary institutions of higher education that meet certain legal, accreditation, and eligibility standards.

[2] For the 2012-2013 award year, students could receive up to $5,550.

[3] The grace period is the 6-month time period after a student is no longer enrolled at least half time in his or her program. During this time, a student is not required to make loan payments. Deferment is a postponement on the repayment of a loan.

[4] For the 2012-2013 award year, Puerto Rico's allowances were: (1) 3 percent for parents and independent students with non-spouse dependents with incomes less than $15,000, and (2) 2 percent for those with incomes greater than $15,000. For students without dependents (other than a spouse), the allowance was 3 percent. In the states, allowances were from 1 to 10 percent.

Potential Changes to the Programs under Statehood

Under statehood, Puerto Rico would be included in the annual IRS analysis on state tax allowances. This inclusion would likely produce a different rate, thus affecting residents' expected family contribution. If the state tax allowance increased under this analysis, in general, Pell Grant and Direct Loan eligibility could increase, according to Education officials.

Program Changes: Description

Temporary Assistance for Needy Families

Program Description

Temporary Assistance for Needy Families (TANF) provides grants to states to operate programs providing cash and other assistance to families meeting state eligibility requirements. The program was established in 1996, ending the Aid to Families with Dependent Children program. TANF funding is provided primarily through State Family Assistance Grants.

TANF is administered by the Administration for Children and Families (ACF), Department of Health and Human Services (HHS).

Size of the Program

- Total federal obligations, fiscal year 2010: $17.0 billion.
- TANF funding to Puerto Rico, fiscal year 2010: $71.6 million.
- Average monthly number of Puerto Rico families receiving TANF benefits, fiscal year 2010: 13,304.

Overview of the Program in the States

Each state's allocation is based on its funding level from the 1990s under the Aid to Families with Dependent Children program and other programs that preceded TANF. States may use grants in any manner reasonably calculated to achieve TANF's statutory purpose, including providing cash benefits and services primarily targeted to needy families and paying administrative expenses; the amount does not vary according to the number of cash assistance recipients. States that meet certain criteria can apply for assistance from the TANF Contingency Fund. This capped fund helps states meet increased need under certain conditions.[1]

States are given flexibility in setting TANF policies. For example, states generally determine cash assistance benefit levels and eligibility requirements. This determination includes deciding, as most states have, that Supplemental Security Income (SSI) recipients cannot also receive TANF benefits. States generally can also spend TANF funds on other services, as long as the services meet TANF purposes.[2] Federal law sets some conditions for states receiving federal funds for TANF. For example, states are required to maintain a specified level of their own past spending on certain welfare programs to receive all of their current federal TANF funding. In addition, states must ensure that a minimum percentage of families on cash assistance meet work participation requirements set in law.

Overview of the Program in Puerto Rico

Puerto Rico has the same flexibilities as the states to run its TANF program, and is subject to the same penalties and requirements. Puerto Rico may receive federal funds not to exceed about $107.3 million to operate TANF; Aid to the Aged, Blind, and Disabled (AABD); foster care and adoption programs; and a Matching Grant.[3] In fiscal year 2010, Puerto Rico claimed $102.4 million for these programs, about $71.6 million of which was for TANF (as calculated by HHS, the maximum TANF Family Assistance Grant for Puerto Rico is set by statute at $71.6 million). Puerto Rico's government has discretion on how to divide the non-TANF portion of the available grant funds and amounts unused for TANF among AABD and foster care and adoption programs. By statute, Puerto Rico is

[1]States are eligible if they are determined to be a needy state by satisfying either an unemployment trigger or a Supplemental Nutrition Assistance Program trigger. In fiscal year 2013, the fund was $610 million.

[2]TANF funds may be used for a broad array of non-cash services, ranging from job preparation activities to emergency aid for housing, energy, food, and clothing.

[3]42 USC §1308(a)(1), (c)(4). The Matching Grant, under section 1108(b) of the Social Security Act, is appropriated separately from the other programs in the Family Assistance Grant. It has a federal matching rate of 75 percent. The Matching Grant may be used for TANF, foster care, adoption, and independent living programs. The use of the Matching Grant is optional; Puerto Rico has never used it.

not eligible for assistance from the Contingency Fund.[4]

Potential Changes to the Program under Statehood

Under statehood, Puerto Rico would receive a Family Assistance Grant of $71.6 million for TANF. With respect to the amounts for the other programs, combined with TANF, that are now capped at $107.3 million, Puerto Rico would not be subject to the statutory cap, unless Congress subjected Puerto Rico to a cap not applicable to any other state. Funding for AABD under the grant would be discontinued, and funding for foster care and adoption would be distributed through a formula, as it is for the states. Once the SSI program is available to residents, Puerto Rico would have to decide whether SSI recipients could also receive TANF benefits.

Also, Puerto Rico would be eligible to receive assistance from the Contingency Fund. According to ACF officials, the total funds available to all states would be unlikely to increase, meaning that if Puerto Rico were to access the funding, all other states would have a smaller share.[5]

[4] 42 U.S.C. § 603(b)(7).

[5] In a typical year, the funds are exhausted within 6 months, according to ACF officials.

Program Changes: Description

Program Description

Title I, Part A of the Elementary and Secondary Education Act of 1965, as amended, authorizes funding to provide instruction and instructional support for disadvantaged children in pre-kindergarten through grade 12 to assist them with mastering curricula and meeting state academic achievement standards.

Title I funding is flexible in that local and state educational agencies may use it as they deem best, within possible permissible uses. The Department of Education (Education) allocates Title I funds to state educational agencies, which in turn allocate the funds to local educational agencies (LEAs).

Size of the Program

- Total federal obligations, fiscal year 2010: $14.5 billion.
- Grants to Puerto Rico, fiscal year 2010: $546.1 million.

Title I Grants to Local Educational Agencies

Overview of the Program in the States

Federal funds are currently allocated through four statutory formulas that are based primarily on U.S. Census Bureau poverty estimates and the cost of education in each state.

- **Basic Grants formula.** Considers the number of eligible children[1] in each LEA, multiplied by an adjusted state per-pupil expenditure factor, subject to available appropriations and LEA and state minimums. Basic Grants contain the largest proportion of funds of the four types, and are the easiest for which LEAs can qualify.
- **Concentration Grants formula**. Similar to that for Basic Grants, but has a higher eligibility threshold, among other differences.
- **Targeted Grants formula.** Also similar to that for Basic Grants; however, a weight—a number based on a LEA's school-age child poverty rate and the number of children in poor families—is applied to the eligible child count.
- **Education Finance Incentive Grants formula.** Based on the number of eligible children in a state and several factors—expenditure, effort, and equity—and adjusted by a state minimum. The expenditure factor is based on the average per-pupil expenditure of the state, subject to certain limitations. The effort factor is based on a comparison of the per-pupil expenditure to the per-capita income level of the state, limited to a certain range. The equity factor is based on the variation in per-pupil expenditures among LEAs. LEAs receive an adjusted share of a state's Education Finance Incentive Grant based on a weighted population factor, compared to the total for LEAs in that state.

Annual appropriations bills specify portions of each year's Title I grants appropriation to be allocated across the four formulas.

Overview of the Program in Puerto Rico

Formula variations. While the Basic and Concentration Grants formulas treat Puerto Rico the same as the states, the formulas for Targeted and Education Finance Incentive Grants treat Puerto Rico differently.[2] These differences likely result in lower funding for Puerto Rico than it would receive if treated the same as other states. In the formula for Targeted Grants, the weight for Puerto Rico's LEA is capped, unlike the states' weights, which are not capped.[3] The cap was intended to provide

[1]Eligible children are those ages 5 to 17 who live in (1) families with income at or below the Census Bureau federal poverty level; (2) families with income above the federal poverty level but that receive assistance via Temporary Assistance for Needy Families; (3) certain locally-operated institutions for neglected or delinquent children; or (4) certain foster homes.

[2]Under current law, Puerto Rico is considered a state for all of these grant programs. 20 U.S.C. § 6332(e). However, certain statutory caps or limits apply to the Targeted and Education Finance Incentive Grants to Puerto Rico that do not apply to grants to other states.

[3]20 U.S.C. § 6335(c)(1)(D).

Targeted Grants for Puerto Rico that are approximately equal to its share of Basic and Concentration Grants for fiscal year 2001. For fiscal year 2010 allocation purposes, Puerto Rico's weighted eligible child count under the Targeted Grant formula was 744,358, according to Education officials.

Formula factors. In the formula for the Education Finance Incentive Grants, the effort factor—which is multiplied by the number of eligible children in the state and other factors—for Puerto Rico must equal the lowest factor used in the states, according to statute.[4] Another factor in the formula—the equity factor—is set by statute for states with only one LEA for purposes of Education-determined Title I allocations.[5] According to Education officials, this difference is because such states do not have disparities in spending among LEAs. Puerto Rico has one LEA.

Potential Changes to the Program under Statehood

Under statehood, if Puerto Rico had been treated the same as the states in fiscal year 2010, the cap on the weighted eligible child count in the Targeted Grants formula would not apply and Puerto Rico's count would have gone up to 1,203,805 (from 744,358), according to Education officials.[6] Also, without the cap, Puerto Rico's grant funding would be higher, according to the Congressional Research Service (CRS).[7]

If Puerto Rico was treated the same as the states, the effort factor in the Education Finance Incentive Grants formula would likely increase from 0.95 to 1.05, according to an Education estimate. This change could result in increased funding for Puerto Rico. The statutorily-set equity factor for the Education Finance Incentive Grants would apply if Puerto Rico became a state and maintained only one LEA.

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[4] 20 U.S.C. § 6337(b)(2)(B).

[5] 20 U.S.C. § 6337(b)(3)(B).

[6] If Puerto Rico were treated as a state, the weights would be based on the numbers and percentages that applied to LEAs in section 6335(b)(c) of title 20, United States Code.

[7] CRS, *Elementary and Secondary Education Act: An Analytical Review of the Allocation Formulas*, (Washington, D.C.: Jan. 26, 2010).

Program Changes: Description

Program Description

The Post-9/11 Veterans Educational Assistance Act of 2008, as amended, (commonly known as the Post-9/11 GI Bill)[1] provides financial support for education or training to veterans with at least 90 days of service performed after September 10, 2001. Veterans who were discharged with a service-connected disability after 30 days are also eligible. The program is administered by the Department of Veterans Affairs (VA).

Size of the Program

- Total federal obligations, fiscal year 2010: $5.3 billion, according to VA officials.
- Funding to veterans attending Puerto Rico schools, fiscal year 2010: not known.[2]
- Veterans in the program attending educational programs in Puerto Rico, fiscal year 2010: 957, according to VA officials.

Post-9/11 GI Bill

Overview of the Program in the States

Eligibility guidelines. To receive benefits, veterans must participate in an approved program,[3] such as those for undergraduate and graduate degrees, vocational/technical training, and other programs in the United States or abroad. Eligible veterans can receive benefits for up to 36 months and, in general, can use their benefits for up to 15 years after release from active duty. Benefits can cover tuition and fees, a monthly housing allowance, a stipend for books and supplies, and, for some veterans, a one-time benefit for re-locating to attend an educational institution.

Housing allowance. The monthly housing allowance is typically equal to the Basic Allowance for Housing for an enlisted service member with a rank of E-5 with dependents. The Department of Defense sets the Basic Allowance for Housing, which, in the states, is based on the zip code for the school the veteran is attending. For the 2012-2013 academic year, the average monthly Basic Allowance for Housing was $1,368, according to VA officials.[4]

Overview of the Program in Puerto Rico

Benefit comparison. Basic benefits in tuition and fees in Puerto Rico are consistent with those in the states, according to VA officials. However, the monthly housing allowance differs, as the Basic Allowance for Housing used in the states does not include rates for the territories. Rather, the monthly housing allowance for veterans who attend schools in Puerto Rico is equal to the Overseas Housing Allowance rate for an enlisted service member with a rank of E-5 with dependents.

Housing allowance. The Department of Defense sets Overseas Housing Allowance rates. As of July 2013, monthly housing allowances in Puerto Rico ranged from $2,450 per month to $2,700, depending on location.[5] Prior to August 3, 2012, program participants attending schools in Puerto Rico received a monthly housing allowance that was the average of the Basic Allowance for Housing, according to VA officials. According to VA officials, the agency made an administrative decision to switch to the Overseas Housing Allowance, which is higher than the Basic Allowance.

[1] Pub. L. No. 110-252, title V, 122 Stat. 2323, 2357-86, *codified at* 10 U.S.C. §§ 16132a, 16163a; 38 U.S.C. §§ 3015, 3020, 3301—3324, 3674.

[2] Current systems for the Post-9/11 GI Bill do not readily capture and report on the amount of assistance paid out by state or territory where the veteran is attending school, according to VA officials.

[3] VA contracts with state approving agencies—which are staffed by state employees but are federally funded—to determine whether schools and training programs offer education of sufficient quality for the Post-9/11 GI Bill.

[4] The academic year is August 1, 2012 to July 31, 2013. The average does not include housing allowances from the territories. For the 2011-2012 academic year, the average was $1,347, which included allowances from the territories, according to VA officials.

[5] These figures include rent, and allowance for utilities and maintenance.

Potential Changes to the Program under Statehood

Under statehood, the Basic Allowance for Housing would apply. Whether or not program participants attending Puerto Rico schools would receive more under the Overseas Housing Allowance rate than they would under the Basic Allowance for Housing could vary, depending on how the Department of Defense sets rates each year, according to VA officials.

Appendix III: Details on Potential Changes to Selected Federal Revenue Sources under Puerto Rico Statehood

Revenue Sources Included in this Appendix

Individual income tax

Corporate income tax

Appendix Overview

All of the 6 federal revenue sources we reviewed could change if Puerto Rico became a state. In this appendix, we describe those changes for the 2 largest revenue sources that would change substantially under statehood—individual and corporate income taxes. For both revenue sources, we provide an overview of the revenue source in the states and in Puerto Rico, and of potential changes under statehood.

We also provide estimates of federal revenue under statehood for individual and corporate income taxes as if Puerto Rico were treated the same as the states in a single year in the past. The estimates are based on the most recent year of Puerto Rico tax return data when we began our work. The estimates are presented as ranges, based on various assumptions we made, which are described in detail in this appendix.

Revenue Source Description

Under the Internal Revenue Code, income above certain thresholds generally is subject to income tax. Certain tax provisions, such as deductions and credits, can reduce taxpayers' income tax liabilities. Some tax credits are refundable in that individuals can receive payments in excess of their income tax liabilities.

Taxpayers report their income and resulting tax liabilities to the Internal Revenue Service (IRS) on an individual income tax return.

Size of the Revenue Source

- Total federal individual income tax receipts, fiscal year 2010: $899 billion.
- Total federal obligations from refundable tax credits, fiscal year 2010: $96 billion.
- Federal individual income tax reported by Puerto Rico filers, 2010: as much as $20 million.

Individual Income Tax

Summary

If Puerto Rico were treated as a state, its residents

- Would be required to report and pay federal individual income tax on income from Puerto Rico sources.
- If eligible, could receive payments for refundable tax credits in excess of their tax liabilities.

According to our modeling estimates, under federal tax laws as of January 3, 2013, if Puerto Rico had been a state in 2010

- Estimated revenues would have ranged from $2.2 billion to $2.3 billion, taking into account both tax liability and refundable credits payments.
- In comparison, Puerto Rico filers reported paying as much as $20 million in federal income tax for 2010.

Overview of the Revenue Source in the States

Reporting and filing requirements. Generally, individuals who receive income exceeding a specific threshold are required to report and pay taxes on that income, unless it is tax-exempt. Taxable income can be from both U.S. and non-U.S. sources; the income threshold depends on a taxpayer's filing status (for example, single or married filing jointly) and age.[1]

Tax liability reduction. Individuals may be eligible to claim various tax provisions, including deductions, exclusions, and credits, that can lower or eliminate the amount of taxes they owe. For example, individuals can deduct the amount of qualified mortgage interest paid on their residences. Some tax credits are refundable: if the amount of credit a taxpayer can claim exceeds the amount of tax they owe, this can result in a payment from the federal government. For fiscal year 2012, the three credits with the largest obligation amounts—the American Opportunity Tax Credit (AOTC),[2] child tax credit (CTC),[3] and earned income tax credit (EITC)[4]—

[1]Generally, for each filing status, the threshold for reporting gross income is higher for individuals age 65 and older. For example, for single individuals in 2012, the threshold for reporting was $9,750 for those under 65 years old and $11,200 for those 65 years or older.

[2]The AOTC provides a credit of up to $2,500 for qualified education expenses paid for an eligible student for the first four years of higher education. Up to 40 percent, or $1,000, of the credit may be refundable. The credit is available through the end of 2017. 26 U.S.C. § 25A(i).

[3]The CTC provides taxpayers with a credit of up to $1,000 for each of their qualifying children. The refundable portion of the credit—known as the additional child tax credit—is available to taxpayers who had insufficient tax liability to utilize the full amount of their child tax credit. Certain CTC provisions expire at the end of 2017. 26 U.S.C. § 24.

[4]The EITC provides a credit to working taxpayers with earned income below certain thresholds. The amount of the credit beyond a taxpayer's tax liability is refundable. For tax year 2012, the maximum credit available was $5,891. Certain EITC provisions expire at the end of 2017. 26 U.S.C. § 32.

accounted for 94 percent of all obligations for refundable credits. For fiscal year 2010, these credits accounted for 84 percent of all obligations for refundable credits (the temporary Making Work Pay credit, which expired at the end of 2010, accounted for an additional 14 percent).

Overview of the Revenue Source in Puerto Rico

Reporting and filing requirements. For bona fide Puerto Rico residents, income from Puerto Rico sources is exempt from federal income tax.[5] Income from U.S. and worldwide sources are federally taxable and must be reported to IRS.[6]

Tax liability reduction. Puerto Rico residents are eligible for some federal tax provisions that can reduce tax liabilities, such as tax credits, but are not eligible for others. For example, Puerto Rico residents can claim a refundable credit equal to 40 percent of AOTC-eligible expenses against their Puerto Rico income tax; the federal government will reimburse Puerto Rico's government for the refundable portion of the credit. Puerto Rico residents with three or more children are generally eligible for the refundable CTC, to the extent the filing individuals have paid certain payroll taxes in excess of their income earned from non-Puerto Rico sources.[7] Puerto Rico residents are not eligible for the EITC.

Potential Changes to the Revenue Source under Statehood

Under statehood, Puerto Rico residents' Puerto Rico-source income would be subject to federal income tax. Residents would also be eligible for the various deductions, exclusions, credits, and other provisions that can lower or eliminate the amount of taxes owed. For example, Puerto Rico residents who itemize deductions would be able to deduct state and local taxes on their federal tax returns. They would also become fully eligible for the AOTC, CTC, and EITC. Puerto Rico residents would be required, as applicable, to file federal income tax returns in addition to filing Puerto Rico income tax returns.

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[5]26 U.S.C. § 933. Whether or not an individual qualifies as a bona fide resident can depend on various facts, including the number of days spent in Puerto Rico in the last year or last three years, the location of a tax home in Puerto Rico or elsewhere, whether the individual is a student or government official, and the connection the individual has to Puerto Rico, as established by the location of the individual's family, personal belongings, and social contacts, among other factors. Special rules apply to the tax year in which a taxpayer moves to Puerto Rico. 26 C.F.R. §§ 1.933–1, 1.937–1. For the purpose of this report section, references to Puerto Rico residents refer to bona fide residents.

[6]Puerto Rico residents who are federal employees are required to report and pay applicable taxes on their income received for their federal service to both IRS and the Puerto Rico Department of Internal Revenue. Puerto Rico residents are also required to file Puerto Rico tax returns if their gross income exceeds the applicable filing thresholds ($3,300 or $6,000 in 2010, depending on the residents' filing status). Some sources of income are taxed differently in Puerto Rico than in the states. For example, Puerto Rico taxpayers under age 60 can exclude up to $11,000 from their taxable pension income; the exclusion is $15,000 for taxpayers age 60 and over. Because of differences such as this, for 2010, Puerto Rico filers' adjusted gross income for federal tax purposes (about $32.1 billion, based on our estimates) would have been higher than that for Puerto Rico tax purposes (about $28.2 billion, according to Puerto Rico Department of the Treasury data).

[7]Federal employees in Puerto Rico are eligible for the refundable and nonrefundable portions of the CTC.

Estimated Federal Revenue under Statehood

According to our modeling estimates, if Puerto Rico had been a state under federal tax laws as of January 3, 2013, residents who filed Puerto Rico tax returns for 2010 would have

- Had an aggregate federal individual income tax liability ranging from $2.8 billion to $3.0 billion, before taking refundable tax credits into account.
- Been eligible for at least $580 million in payments for refundable tax credits from the 3 largest refundable credits.

Taking both tax liability and refundable credits payments into account, estimated revenues would have ranged from $2.2 billion to $2.3 billion; in comparison, Puerto Rico filers reported paying as much as $20 million in federal income tax for 2010.[9]

Our estimates are based on two assumptions related to deductions for state and local taxes Puerto Rico filers could have taken on their federal tax returns (if they itemized deductions).

- Filers would have deducted the tax amounts they reported on their Puerto Rico tax returns.[10]
- Filers would have deducted a tax amount we imputed based on the average state and local deduction as a percentage of adjusted gross income for the states. We include this scenario because Puerto Rico's tax rates for 2010 were significantly higher than those for the states.[11]

Our estimates based on these assumptions are shown in table 7.

Caveats for GAO's Estimate

- The revenue estimates are based on the federal tax code as of January 2, 2013. We did not take into account any provisions that took effect after that date. We do not make assumptions about how the tax code might change in the future, including whether temporary provisions would be extended.
- The 2010 Puerto Rico tax return data reflect the economic conditions at the time, including an unemployment rate that peaked around 17 percent. Puerto Rico incomes and tax liabilities may change under different economic conditions.
- Not all sources of income that would be taxable at the federal level—such as taxable Social Security benefits—are included on the Puerto Rico tax return. As a result, our estimates could understate estimated revenues.
- Puerto Rico tax return data do not contain the information necessary to estimate all federal tax provisions that could reduce Puerto Rico filers' tax liabilities, such as deductions for taxpayers and their spouses who are blind or for the adoption credit.
- Our estimate assumes that Puerto Rico residents' compliance with tax laws would have remained constant under statehood. However, the Joint Committee on Taxation has noted that because IRS has relatively more resources to enforce tax laws than Puerto Rico's Department of Internal Revenue, taxpayer compliance would likely increase under statehood.[8]

(continued on the next page)

[8] Joint Committee on Taxation, *An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options*, JCX-24-06, June 23, 2006.

[9] Puerto Rico residents report and claim a credit for aggregate taxes paid to the United States, its possessions, and foreign countries. According to officials from Puerto Rico's Department of Internal Revenue, most of these payments would have been to the United States.

[10] When computing their federal taxes, taxpayers either claim a standard deduction or itemize deductions, and these deductions are subtracted from adjusted gross income in determining taxable income. Taxpayers generally claim the type of deduction that is larger to minimize their taxable income. Under this scenario, an estimated 16 percent of the over 1 million Puerto Rico filers in 2010 would have been expected to itemize deductions; other filers would have been expected to take the standard deduction.

[11] Under this scenario, an estimated 13 percent of the over 1 million Puerto Rico filers in 2010 would have been expected to itemize deductions; other filers would have been expected to take the standard deduction.

- Some Puerto Rico residents who did not file Puerto Rico tax returns in 2010 (either due to noncompliance or because they had gross income below the thresholds for filing a Puerto Rico return) may have elected to file a federal tax return in order to receive refundable tax credits, which would have been available to eligible filers.
- In 2011, Puerto Rico made changes intended to reduce individual income taxes. These changes could reduce the amount of state and local taxes Puerto Rico residents deduct on their federal tax returns.

Table 7: Estimated Aggregate Individual Income Tax Liability, Payments for Refundable Credits, and Net Revenue under Puerto Rico Statehood—Puerto Rico Individual Tax Return Filers, 2010

	Regular scenario[a] (dollars in millions)	Alternative scenario[b] (dollars in millions)
Tax liability before refundable credit payments	$2,774	$2,926
Refundable credit payments[c]	$580	$580
AOTC[d]	$23	$23
CTC[e]	$85	$85
EITC[f]	$473	$473
Net revenue	$2,194	$2,346

Source: GAO analysis of Puerto Rico tax return data for 2010.

[a]The regular scenario assumes Puerto Rico filers would have deducted state and local taxes paid based on the amounts of Puerto Rico tax they reported on their returns.

[b]The alternative scenario assumes Puerto Rico filers would have deducted a tax amount imputed based on the average state and local deduction as a percentage of adjusted gross income for the states.

[c]Refundable credit payments include only the three largest credits in effect as of January 3, 2013. The sum of the three largest refundable credit payments do not sum to the total of refundable credit payments because of rounding.

[d]Including the nonrefundable amount, total AOTC was an estimated $56 million.

[e]Including the nonrefundable amount, total CTC was an estimated $137 million.

[f]Including the nonrefundable amount, total EITC was an estimated $525 million.

Revenue Changes: Estimate

Corporate Income Tax

Revenue Source Description

Under the Internal Revenue Code, corporations generally are subject to federal tax on the net income they earn in the states. Whether or not they are subject to federal tax on income they earn in foreign locations—including in Puerto Rico—depends on where they are incorporated. The timing of when foreign income becomes taxed also depends on the form of a corporation's foreign operations, as well as the type of income earned.

Corporations report their income and resulting tax liabilities to the Internal Revenue Service (IRS) on a corporate income tax return.

Size of the Revenue Source

- Federal corporate income tax receipts, fiscal year 2009: $138 billion.
- Estimated federal corporate income tax paid by corporations with activities in Puerto Rico, 2009: about an estimated $4.3 billion.

Summary

If Puerto Rico were treated as a state,

- Corporations organized in Puerto Rico would be subject to federal tax on their worldwide income under the same conditions that apply to corporations organized in the states.
- U.S. corporations with Puerto Rico subsidiary corporations included in their consolidated federal tax returns would owe federal tax on income earned by those subsidiaries in the year it is earned.
- Foreign corporations operating in Puerto Rico would be subject to federal tax on income that they earn in Puerto Rico in the year it is earned.
- Corporations from certain industries that derive much of their income from mobile assets—such as patents—might relocate their activities to lower-tax foreign locations. The extent to which such corporations might relocate from Puerto Rico is unknown.

According to our modeling estimates, under federal tax laws as of January 3, 2013, if Puerto Rico had been a state in 2009,

- Estimated revenue would have ranged from $5.0 billion to $9.3 billion, depending on assumptions about the extent of U.S. ownership of corporations organized in Puerto Rico, applicable tax rates, and the extent to which corporations would use prior-year losses to offset income. If the potential for corporations to relocate is taken into account, estimated revenue would have ranged from slightly less than zero to $3.4 billion.
- In comparison, corporations with activities in Puerto Rico paid about an estimated $4.3 billion in corporate income tax for 2009.

Overview of the Revenue Source in the States

Taxable income. Generally, corporations created or organized under federal law or the laws of a state are subject to federal tax on their worldwide income, including income earned in Puerto Rico.[1] To mitigate double taxation, these corporations can reduce or eliminate federal tax liability on foreign-source income through a credit for foreign taxes paid on that income. U.S. corporations generally can deduct state and local taxes paid from their federal taxable income.[2] Foreign corporations are subject to federal tax on income that is effectively connected with the conduct of a trade or business in the states.[3] Foreign corporations are also subject to a 30 percent withholding tax on investment income[4] from U.S. sources, to

[1]In this appendix, we refer to a corporation created or organized under federal law or the laws of a state as a U.S. corporation, and a corporation created or organized under Puerto Rico law as a Puerto Rico corporation.

[2]While credits reduce tax liability dollar-for-dollar, deductions reduce the amount of income subject to tax.

[3]Foreign corporations operating in the states may also be subject to a branch profits tax.

the extent that such income is not effectively connected to a trade or business in the states.

Timing of when foreign-source income is taxed. The income a corporation earns from a foreign business operation that is not organized as a separate legal entity is taxed currently. Income from the active conduct of a business operation organized as a separate entity under the laws of a foreign country generally is not taxed to the parent corporation in the states until it is repatriated as dividends, unless anti-deferral rules apply. Certain forms of passive income, such as interest, royalties, and rent, are taxed immediately, even when earned by a separate business, if certain ownership thresholds are met.

Tax rates. Federal corporate tax rates vary depending on the amount of a corporation's taxable income. Corporations with $18.3 million or less in net taxable corporate income are subject to different tax rates, depending on the amount of income earned. For corporations with taxable income over that amount, a flat rate of 35 percent applies to all taxable income.

Overview of the Revenue Source in Puerto Rico

The federal tax treatment of corporations operating in Puerto Rico varies by corporation type.

- Puerto Rico corporations are generally treated as if they were organized under the laws of a foreign country for federal tax purposes. Such corporations are subject to federal tax on income they earn from activities effectively connected to a trade or business in the states. Taxes apply to such income in the year it is earned. Investment income from sources in the states and not connected to a trade or business is subject to a withholding tax.[5]
- U.S. corporations that own Puerto Rico subsidiary corporations are generally subject to federal tax only on income distributed to them as dividends. In certain cases, anti-deferral rules apply, in which case certain forms of passive income earned by the subsidiary—such as royalties and interest—will be imputed to the U.S. corporation organized in the states and taxed accordingly.
- U.S. corporations that have branch operations in Puerto Rico are subject to federal tax on all income from their branch operations in the year it is earned.[6]
- Foreign-owned corporations operating in Puerto Rico are not subject to federal income tax on their Puerto Rico-source or foreign-source income.

U.S. corporations that pay federal income tax on their Puerto Rico-source income can reduce their federal tax liability through a tax credit for any Puerto Rico tax paid on that income.

Potential Changes to the Revenue Source under Statehood

Under statehood, the federal tax treatment of the different types of corporations operating in Puerto Rico would change.

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[4]The withholding tax generally applies to fixed or determinable annual or periodic gains, profits, and income.

[5]The applicable withholding rate for payments made to Puerto Rico corporations is 10 percent rather than 30 percent. 26 U.S.C. § 881(b)(2).

[6]Branches, unlike subsidiaries, are not separately incorporated.

- Puerto Rico corporations would be subject to federal tax on their worldwide income under the same conditions that apply to corporations organized in the states.
- U.S. corporations with Puerto Rico subsidiary corporations included in their consolidated federal tax returns would owe federal tax on income earned by those subsidiaries in the year it is earned.
- Foreign corporations operating in Puerto Rico would be subject to federal tax on income they earn that is effectively connected to a trade or business in Puerto Rico.

U.S. corporations would no longer receive a foreign tax credit against their federal tax liabilities for income taxes paid to Puerto Rico; however, they would be able to deduct such taxes from their federal taxable income.

According to tax policy experts at the Department of the Treasury and the Joint Committee on Taxation, the changes in businesses' tax treatment that would occur under statehood are likely to motivate some businesses with substantial amounts of income derived from intangible (and therefore mobile) assets—such as patents—to move their operations from Puerto Rico to lower-tax foreign locations. In particular, businesses in the pharmaceuticals and in the medical equipment and supplies industries could be motivated to relocate;[7] businesses in these two industries accounted for much of the aggregate net income of Puerto Rico business filers for 2009. Other industries for which intangible assets could have been significant accounted for additional shares of total net income.

Estimated Federal Revenue under Statehood

According to our modeling estimates, if Puerto Rico had been a state under federal tax laws as of January 3, 2013, the federal corporate income tax liability for businesses that filed Puerto Rico tax returns for 2009 would have ranged from $5 billion to $9.3 billion. If the potential for corporations to relocate is taken into account, estimated revenue would have ranged from slightly less than zero to $3.4 billion. In comparison, corporations with activities in Puerto Rico paid about an estimated $4.3 billion in corporate income tax for 2009.[8]

The estimates are based on the following assumptions:

Business type and ownership. We could not always determine whether the filing businesses were (1) branches of other corporations, (2) subsidiaries of other corporations, or (3) separate Puerto Rico entities.

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[7]Taxes are only one of various factors corporations generally take into account when determining where to locate their operations.

[8]This estimate is based on IRS data on income U.S. corporations received from Puerto Rico subsidiaries or branches. Most of the $4.3 billion in tax U.S. corporations paid is attributable to an unusually large amount of dividends that were repatriated from Puerto Rico in 2009 (compared to amounts repatriated in earlier years or in 2010). In the absence of that spike in dividends, the federal taxes these corporations would have paid for 2009 would have been about $1.4 billion. For various reasons, we could not determine the precise amount of corporate income tax paid directly by businesses in Puerto Rico in addition to the $4.3 billion (although based on IRS data, the amount would have been no more than about $145 million).

Likewise, we could not determine the country of incorporation for any of the filing businesses or their parent corporations. As a result, we made a range of assumptions regarding the percentage of the filing businesses' income attributable to either (1) branches or subsidiaries that would be included in the consolidated federal corporate income tax return of a U.S. corporation, or (2) corporations that would be taxed as separate entities under statehood. These distinctions mattered in terms of which tax rates we applied when making our estimates and how we treated accumulated losses.

Tax rates. For corporations included in U.S. consolidated tax returns, we applied the marginal federal tax rate for the consolidated group to the net income (or losses) that the Puerto Rico entity would have added to the group's tax return. For entities in the financial services and social services industries, we applied the full 35 percent corporate marginal tax rate based on the assumption that these entities would not have qualified for the domestic production activities deduction.[9] For all other corporations included in U.S. consolidated tax returns, we reduced the marginal rate to 31.85 percent to reflect the effect of this deduction. For separate entities we applied after-credit rates that ranged from 15 percent to 35 percent (to allow for the possibility that the tax attributes of corporations in Puerto Rico would have differed from typical U.S. corporations).

Accumulated losses. We estimated tax liabilities before and after prior-year losses would have been used to offset current-year income. Assuming corporations would have used prior year losses to the maximum extent results in estimates that represent the lower bounds of potential federal revenue under statehood within the various scenarios we modeled. The amount of accumulated losses that corporations have available for use in the first tax year after statehood could be significantly larger that the amounts they would be able to use in subsequent years.[10]

Business relocation. Using the assumptions described above, we produced an alternative set of estimates to account for businesses with activities in Puerto Rico potentially relocating under statehood.

- The first set of estimates assumes that all filing businesses would have maintained their activities in Puerto Rico.
- The second set of estimates assumes that (1) all filing businesses in the pharmaceuticals and the medical equipment and supplies industries—which derive much of their income from mobile assets—

[9]In general, the domestic production activities deduction allows a taxpayer to deduct an amount equal to nine percent (for years after 2009) of the lesser of the taxpayer's taxable income or its qualified production activities income. The deduction cannot exceed 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year. 26 U.S.C. § 199. Under current law, specific rules apply for determining whether Puerto Rico is considered part of the United States when calculating domestic production gross receipts and the wage limitation for a taxpayer. 26 U.S.C. § 199(d)(8).

[10]In the first year of statehood, when Puerto Rico subsidiaries of U.S. corporations first become subject to federal tax and are consolidated into their parent corporations' tax returns, large portions of their accumulated losses could be used to offset the taxable income reported on those returns, leaving only smaller amounts (or newly generated losses) available to offset income in subsequent years. In one of the scenarios we modeled, the accumulated losses reduced the taxes paid by the consolidated groups to such an extent that those reductions more than offset the positive amounts of taxes paid by other corporations operating in Puerto Rico, and resulted in a net revenue effect that was slightly less than zero (see table 9).

Caveats for GAO's Estimates

- The data that underlie our estimates are for 2009, when the U.S. and global economies were in recession. Consequently, the incomes and losses reflected in these data may differ from those that would be observed during more robust economic periods. Also, the losses that corporations accumulated in the immediately preceding years (which could have been used to offset income from 2009) may have been atypically large.
- Patterns of corporate income changes during the past decade are difficult to sort out for Puerto Rico; in addition to the recession, corporations were in the process of responding to the phase out of the possessions tax credit, which had provided incentives to invest in Puerto Rico.
- Under statehood, federal tax treatment of corporations operating in Puerto Rico would differ in important ways depending on their form and ownership. The tax return data we used had only limited information concerning these characteristics. The assumptions we made on how incomes and losses were distributed across different types of corporations could differ from the actual distribution.
- As businesses respond to significantly higher tax burdens, a sizable portion of the potential federal corporate income tax base in Puerto Rico could depart. Consequently, data on past corporate income provide only a remote starting point for revenue estimates. The uncertainty surrounding the size of the behavioral response leaves considerable uncertainty around the revenue effects.

would have relocated from Puerto Rico, and (2) other filing business would have maintained their activities in Puerto Rico.

The results of our modeling estimates are shown in tables 8 and 9.

Table 8: Estimated Aggregate Corporate Income Tax Liability for Puerto Rico Business Tax Return Filers under Statehood—Assuming All Filers Maintained Activities in Puerto Rico, 2009

Scenario	Excluding prior-year losses (dollars in billions)	Including maximum prior-year losses (dollars in billions)
Upper-bound assumptions regarding U.S. ownership[a]		
Lower-bound tax rate	$7.5	$5.0
Upper-bound tax rate	$8.1	$5.6
Lower-bound assumptions regarding U.S. ownership[b]		
Lower-bound tax rate	$5.8	$5.5
Upper-bound tax rate	$9.3	$8.9

Source: GAO analysis of Puerto Rican business tax return data.

[a]Upper-bound ownership assumptions imply a greater extent of U.S. ownership of Puerto Rico businesses.

[b]Lower-bound ownership assumptions imply a lesser extent of U.S. ownership of Puerto Rico businesses.

Table 9: Estimated Aggregate Corporate Income Tax Liability for Puerto Rico Business Tax Return Filers under Statehood—Assuming Pharmaceuticals and Medical Equipment and Supplies Businesses Relocated, 2009

Scenario	Excluding prior-year losses (dollars in billions)	Including maximum prior-year losses (dollars in billions)
Upper-bound assumptions regarding U.S. ownership[a]		
Lower-bound tax rate	$2.3	-$0.1[b]
Upper-bound tax rate	$2.4	$0.1
Lower-bound assumptions regarding U.S. ownership[c]		
Lower-bound tax rate	$2.0	$1.7
Upper-bound tax rate	$3.4	$3.0

Source: GAO analysis of Puerto Rican business tax return data.

[a]Upper-bound ownership assumptions imply a greater extent of U.S. ownership of Puerto Rico businesses.

[b]In this scenario, the accumulated losses from the Puerto Rico affiliates included in the consolidated federal corporate income tax returns of U.S. corporations reduced taxes paid by the consolidated groups to such an extent that those reductions more than offset the positive amounts of taxes paid by other corporations operating in Puerto Rico, and resulted in a net revenue effect that was slightly less than zero.

[c]Lower-bound ownership assumptions imply a lesser extent of U.S. ownership of Puerto Rico businesses.

Appendix IV: Potential Effects of the Patient Protection and Affordable Care Act on Federal Spending for Medicare, Medicaid, and the State Children's Health Insurance Program under Puerto Rico Statehood

The Patient Protection and Affordable Care Act (PPACA), enacted in March 2010,[1] makes substantial changes to Medicare and Medicaid, as well as other components of the federal budget. There are significant uncertainties surrounding the effects of PPACA on health care spending and on other factors that influence future health care costs more generally—such as how the development and deployment of medical technology, future policy decisions, and cost and availability of insurance affect growth in per-capita health care spending. These factors could influence our estimates of federal spending for Medicare, Medicaid, and the State Children's Health Insurance Program (CHIP) under Puerto Rico statehood. Below we summarize selected PPACA provisions that may affect federal Medicare, Medicaid, and CHIP spending in Puerto Rico.

Medicare

PPACA is projected to decrease direct Medicare spending by almost $400 billion from fiscal years 2010 to 2019, according to the Congressional Budget Office (CBO).[2] The following table summarizes selected PPACA provisions that have affected, or could potentially affect, federal Medicare spending in Puerto Rico.

[1] Pub. L. No. 111-148, 124 Stat. 119 (2010), as amended by the Health Care and Education Reconciliation Act of 2010 (HCERA), Pub. L. No. 111-152, 124 Stat. 1029 (2010). In this report, references to PPACA include amendments made by the HCERA, unless otherwise indicated.

[2] Congressional Budget Office, *H.R. 4872, Reconciliation Act of 2010 (Final Health Care Legislation)* (Washington, D.C.: Mar. 20, 2010).

Table 10: Selected PPACA Provisions and Their Potential Affect on Federal Medicare Spending in Puerto Rico under Statehood

PPACA provisions (legal citation)	Effective date	Potential effects on spending[a]
Medicare fee-for-service (Medicare FFS) Part A		
Starting in fiscal year 2014, hospitals receiving Disproportionate Share Hospital (DSH) program payments will receive 25 percent of the previous amount received under the current Medicare DSH payment statutory formula.[b] These hospitals will also receive additional payments based on three factors, including their share of the total amount of uncompensated care for all Medicare DSH hospitals for a given time period. PPACA, § 3133 (as amended by HCERA, § 1104) (*codified at* 42 U.S.C. § 1395ww(r)).	October 1, 2013.	This provision is estimated to save the Medicare program approximately $22.1 billion from fiscal years 2014 to 2019. Although Medicare DSH payments are expected to decrease, hospitals are expected to receive additional revenue from other sources, such as from an expected increase of insured individuals. The Centers for Medicare & Medicaid Services (CMS) determined that Puerto Rico hospitals eligible for Medicare DSH payments are eligible to receive empirically justified Medicare DSH payments and uncompensated care payments under the new payment methodology. CMS expects that in fiscal year 2014, Puerto Rico hospitals will receive a 41.3 percent increase, or about $74 million, in Medicare DSH payments.
Payment updates will be reduced for many Medicare services, in accordance with a productivity adjustment.[c] PPACA, §§ 3401, 10316(a), 10319(b), (d), (e), 10319(f), (g) (as amended by HCERA, §§ 1105(a)(2), 1105(b), (d), (e)) (*codified at* 42 U.S.C. §§ 1395f(i)(1)(C), 1395l(i)(2)(D), (h)(2)(A), (t)(3), 1395m(a)(14), (h)(4), (l)(3), 1395u(s)(1), 1395rr(b)(14)F), 1395ww(b)(3)(B), (m), 1395yy(e)(5)(B), 1395fff(b)(3)(B)).	Varies depending on the Medicare service.	This provision is estimated to save the Medicare program approximately $156.6 billion from fiscal years 2010 to 2019. This provision would not be affected by statehood, as Puerto Rico providers are currently subject to the payment updates, according to CMS.
A Readmissions Reduction Program will reduce payments to acute care hospitals if there are excess readmissions of patients. PPACA, §§ 3025(a)10309) (*codified at* 42 U.S.C. § 1395ww(q)).	October 1, 2012.	This provision is estimated to save the Medicare program $7.1 billion from fiscal years 2010 to 2019 due to reduced payments. Under statehood, Puerto Rico hospitals would be newly subject to the program. The effect on spending in Puerto Rico is unknown.

PPACA provisions (legal citation)	Effective date	Potential effects on spending[a]
Medicare Advantage (Medicare Part C)		
Changes benchmarks underlying payments to Medicare Advantage (MA) plans to align more closely with Medicare FFS spending. The new benchmarks will be phased in from 2012 to 2017 and blended with old benchmarks. In 2017, county benchmarks will be one of four values: 95 percent, 100 percent, 107.5 percent or 115 percent of Medicare FFS spending. Benchmarks could be increased for certain plans if they are new, demonstrate indicators of plan quality, or have low enrollment. PPACA, § 3201 (as amended by HCERA, § 1102) (*codified at*, 42 U.S.C. § 1395w-23(n)).	Phased-in from 2012 to 2017.	This provision is estimated to reduce payments to MA plans by about $136 billion from fiscal years 2010 to 2019. These reductions could result in reduced benefits and enrollments. When fully phased in 2017, benchmarks for Puerto Rico generally will be 115 percent of Medicare FFS spending plus any quality bonus payments. In the long term, the reduction will result in plans receiving lower payments. Given the high enrollment in MA in Puerto Rico, these changes could significantly affect Medicare spending.
Medicare prescription drug benefit (Medicare Part D)		
Higher premiums will be charged for beneficiaries who exceed certain income thresholds. PPACA, § 3308 (*codified at* 42 U.S.C. § 1395w-113(a)(7)).	January 1, 2011.	This provision is estimated to provide an additional $10.7 billion in Medicare funding from fiscal years 2010 to 2019. Although Puerto Rico could benefit from additional funding, relatively few Puerto Rico Medicare beneficiaries may end up paying the higher premiums given relatively low incomes in Puerto Rico. This provision would not be affected by statehood.

PPACA provisions (legal citation)	Effective date	Potential effects on spending[a]
Discounts and additional subsidies must be provided to Part D beneficiaries who purchased covered drugs during the coverage gap, or "donut hole."[d] Beneficiaries who receive the Part D low-income subsidy would not benefit from this provision, as they already receive assistance with costs in the coverage gap. In addition, one-time payments of $250 were provided to certain individuals who incurred costs for covered Part D drugs exceeding the coverage limit in 2010. PPACA, §§ 3301, 3315 (as amended by HCERA, § 1101) (codified at, 42 U.S.C. §§ 1395w-152(c), 1395w–153, 1395w–114a).	January 1, 2010	This provision is expected to increase Medicare spending by $42.6 billion from fiscal years 2010 to 2019. As of March 2013, Part D beneficiaries in Puerto Rico have saved $143 million under this provision, according to CMS.[e] This provision would not be affected by statehood.

Source: GAO analysis.

[a]Unless otherwise noted, projections are from: Congressional Budget Office, *H.R. 4872, Reconciliation Act of 2010-- Final Health Care Legislation*, (Washington, D.C.: Mar. 20, 2010).

[b]Disproportionate Share Hospitals' eligibility is based on a formula that includes certain factors, such as the number of treated patients who are enrolled in Medicaid or receive Supplementary Security Income benefits.

[c]Many Medicare provider categories that are reimbursed on a fee-for-service basis receive annual payment increases based on the Consumer Price Index or market basket updates; both measure the increase in prices that each provider category must pay for the goods and services in order to serve patients. PPACA required that payment updates for these provider categories be reduced by a productivity adjustment, defined as a 10-year average of changes in annual economy-wide private productivity.

[d]The donut hole refers to the point when standard Part D plans provide coverage for costs over $2,970, until out-of-pocket costs reach $4,750 (for 2013), when the plan covers most costs.

[e]CMS provides online state-by-state information on donut hole savings, including for Puerto Rico. Centers for Medicare & Medicaid Services, *Donut Hole Savings by* State, accessed December 2013 http://downloads.cms.gov/files/DonutHoleSavingsSummary-March2013.pdf.

Medicaid and CHIP

CBO estimated that PPACA will increase federal spending on Medicaid and CHIP by $642 billion over fiscal years 2012 to 2022.[3] The following table summarizes selected PPACA provisions that have affected, or could potentially affect, federal Medicaid and CHIP spending in Puerto Rico.

[3]Congressional Budget Office. *Estimates for the Insurance Coverage Provisions of the Affordable Care Act Updated for the Recent Supreme Court Decision* (Washington, D.C.: July 2012).

Table 11: Selected PPACA Provisions and Their Potential Affect on Federal Medicaid and CHIP Spending in Puerto Rico under Statehood

PPACA provisions (legal citation)	Effective date	Potential effects on spending[a]
Increased Puerto Rico's federal matching assistance percentage (FMAP) from 50 percent to 55 percent, as of July 1, 2011. PPACA, § 2005(c) (as amended by HCERA, § 1204(b)(2)(B)) (*codified at* 42 U.S.C. § 1396d(b)).	July 1, 2011.	As a state, Puerto Rico's FMAP would be 83 percent regardless of this provision.
Authorized a $6.3 billion increase in Medicaid funding for the territories between July 1, 2011, and September 30, 2019. The funding available for each territory must be distributed in proportion to the federal Medicaid funding it received relative to other territories. PPACA, § 2005(a)(3) (as amended by HCERA, § 1204(b)(1)(B)) (*codified at* 42 U.S.C. § 1308(g)(5)).	July 1, 2011.	According to CMS, this provision qualifies Puerto Rico for a total of $5.5 billion in additional funding between July 1, 2011, and September 30, 2019.
Appropriated $925 million to Puerto Rico for either (1) premium and cost sharing assistance (which are subsidies intended to help individuals pay for premiums and out-of-pocket expenses, such as deductibles and copays) for residents if Puerto Rico decides to establish an exchange through which residents can obtain health insurance; or (2) an increase in the funding allocation for Puerto Rico's Medicaid program from 2014 through 2019, if Puerto Rico does not establish an exchange. PPACA, § 1323 (as amended by HCERA, § 1204(a)) (*codified at* 42 U.S.C. § 18043).	January 1, 2014.	Puerto Rico decided not to establish an exchange; the $925 million will be added to Puerto Rico's Medicaid funding from January 1, 2014 to December 31, 2019. Under statehood, either Puerto Rico or the federal government likely would be required to establish a health insurance exchange in Puerto Rico, according to CMS.
PPACA provides for states to expand Medicaid coverage to most non-pregnant, non-elderly individuals with incomes up to 133 percent of the federal poverty level (PPACA also provides for a 5 percent income disregard when calculating modified adjusted gross income for determining Medicaid eligibility, which effectively increases this income level to 138 percent of the federal poverty level). The federal government will pay the full cost of covering newly eligible beneficiaries until 2017, after which the federal share gradually will decline to 90 percent by 2020. PPACA, § 2001(a)(1), (3) (as amended by HCREA, § 1201(1)(B)) (*codified at* 42 U.S.C. §§ 1396a(a)(10)(A)(i)(VIII) 1396d(y)).	January 1, 2014.	Under statehood, if Puerto Rico opts to expand its Medicaid program, the federal government would pay the full cost of expansion until 2017, and would reduce its share of costs to 90 percent by 2020.

PPACA provisions (legal citation)	Effective date	Potential effects on spending[a]
Provides that Medicaid payments to primary care physicians for services provided in 2013 and 2014 will not be less than the greater of the Medicare rates in those years or the payments rates that would be applicable in those years using the 2009 Medicare physician fee schedule conversion factor. The federal government must provide a 100 percent match for any increased payments. The territories, however, are not required to provide these increased payments to primary care physicians, nor are they eligible for this enhanced federal match. HCERA § 1202 (*codified at* 42 U.S.C. §§ 1396a(a)(13)(C), 1396d(dd), 1396u-2(f)).	January 1, 2013.	This provision is expected to increase federal Medicaid spending by $8.3 billion. Puerto Rico is not eligible for this enhanced federal match. Under statehood Puerto Rico would be required to make these increased payments to primary care physicians and would receive an enhanced match for qualified payments, increasing federal and Puerto Rico Medicaid spending.
Medicaid DSH payments will be reduced under a specified methodology for 2014 through 2020. PPACA, §§ 2551, 10201(e)(1)(B) (as amended by HCERA, § 1203) (*codified at* 42 U.S.C. § 1396r-4(f)(7)).	October 1, 2013.	This provision is expected to result in $14.1 billion in savings to the federal government from fiscal years 2014 to 2019.[b] Since Puerto Rico does not qualify for a DSH allotment as a territory, there is no direct effect from this provision on actual federal spending in Puerto Rico. Under statehood, Puerto Rico would become eligible for a DSH allotment; however, according to CMS officials, the methodology for calculating that allotment is unclear because a state's allotment is based on its prior year allotment.
Beginning October 1, 2015, the enhanced FMAP for CHIP will increase by 23 percentage points, not to exceed 100 percent, which will continue until September 30, 2019. PPACA, §§ 2101(a), 10203(c)(1) (*codified at* 42 U.S.C. § 1397ee(b)).	October 1, 2015.	Under statehood, the increased enhanced FMAP may impact the level of CHIP coverage that Puerto Rico would select.

Source: GAO analysis.

[a]Unless otherwise noted, projections are from Congressional Budget Office, *H.R. 4872, Reconciliation Act of 2010 (Final Health Care Legislation)* (Washington, D.C.: Mar. 20, 2010).

[b]The Bipartisan Budget Act of 2013 amended the reduction of Medicaid DSH payments. Specifically, it delayed the reductions for two years until October 1, 2015 and doubled the reduction that otherwise would have applied in that year. Additionally, it added another special rule for calculating Medicaid DSH allotments in 2023. Pub. L. No. 113-67, § 1204, 127 Stat. 1165, 1199.

Appendix V: Comments from the Governor of Puerto Rico

COMMONWEALTH OF
PUERTO RICO
GOVERNOR
ALEJANDRO J. GARCÍA-PADILLA

February 10, 2014

Mr. Stanley J. Czerwinski
Director
Mr. Jeffrey L. Arkin
Assistant Director
United States Government Accountability Office
Washington, DC 20548

Gentlemen:

Thank you for the many months of hard work preparing a comprehensive report on the potential effects of Puerto Rico statehood on federal spending and revenues. As discussed, below are my main comments to the report.

I. Federal Revenues from Individuals.

The report notes the large effect in federal tax collections from individuals – between $2.2 and $2.3 billion dollars – that statehood will cause. There are two factors, however, omitted in the report that if taken under consideration, I believe will have a significant increase on the estimates in the report regarding the amount of federal tax collections from individuals.

First, as you know, in Puerto Rico individual income of $9,000 or less is tax exempt and amounts above that and between more than $9,000 and less than $25,000 is subject to a 7 percent rate; however, tax credits for individuals earning $20,000 or less effectively make most of such income tax free. In the federal sphere those same levels of income would be subject to higher federal tax rates. As you know, single filers earning $8,925 or less are subject to a 10 percent tax rate and amounts above that and between more than $8,925 and less than $36,250 are subject to a 15 percent tax rate. The different federal thresholds and rates would undoubtedly have the effect of covering a much greater number of people and increasing the amount of federal taxes paid by individuals.

Second, the Commonwealth of Puerto Rico does not tax social security payments, which are a vital source of income for a large sector of our population. Under statehood such income would be taxable because, as you know, the federal government taxes social security payments.

If the assumptions in the report were modified to take into account the two aforementioned factors, the negative financial impact of statehood on individual tax payers would be considerably greater.

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Messrs. Czerwinski and Arkin
Page 2
February 10, 2014

II. Federal Revenues from Puerto Rico Owned Corporations.

As the reports pointedly notes, statehood is likely to force many U.S. corporations, particularly pharma and medical devices, that do business in Puerto Rico to relocate to foreign low tax jurisdictions. In addition to offshoring high wage paying American businesses, it is safe to assume, that Puerto Rico owned businesses would also be negatively affected by the new federal tax burden imposed by statehood, a fact not considered by the report. The increased tax burden is likely to reduce the profits of Puerto Rico owned businesses hampering their ability to grow and causing them to close or lay off workers (which in turn reduces federal revenues). To counter the effect of increased taxes, the report suggests that the Government of Puerto Rico reduce the corporate tax rate to 3.8 percent on par with the average level in the states. Such assumption, however, is unrealistic given our level of corporate tax rates and overlooks the current fiscal situation of Puerto Rico.

The report should note the effects that a reduction in the workforce and a weaker business sector will have on federal revenues. Creating good jobs and bolstering local entrepreneurs is a centerpiece of my Administration's agenda, reason why including in the report an assessment of the aforementioned matter is of particular importance.

III. Characterization of the 2012 Plebiscite.

Please note that the characterization in the report of the percent of votes received by statehood in the plebiscite is inaccurate. The pro-statehood party, which was in power in 2012, divided the plebiscite into two questions to create an artificial majority for statehood. The first question asked voters if they favored Puerto Rico's current status and defined it in a manner that was offensive to Commonwealth supporters. The second question asked voters to choose one of the following alternatives: statehood, independence or free association, that is, it excluded the commonwealth option. As noted in a footnote in the report, 27 percent of ballots cast in the second question were left blank. I requested voters to leave such ballot blank as an act of protest against the biased plebiscite. If the 27 percent of voters who left their ballots blank are considered, then statehood only received 44.4 percent of the votes. For these reasons, the body of the report should explain further the structure and outcomes of the plebiscite.

Again, thank you for the effort and time invested in the report. I look forward to reading the final copy.

Cordially,

The Governor of the Commonwealth of Puerto Rico,

Alejandro J. García Padilla

Appendix VI: Comments from the Resident Commissioner from Puerto Rico

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Congress of the United States
House of Representatives
Washington, DC 20515-5401

COMMITTEES:
ETHICS
JUDICIARY
NATURAL RESOURCES

February 24, 2014

The Honorable Gene L. Dodaro
The Comptroller General of the United States
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Dodaro:

I write regarding the U.S. Government Accountability Office (GAO) report, GAO-14-31, entitled *Puerto Rico: Information on How Statehood Would Potentially Affect Selected Federal Programs and Revenue Sources*. I thank the GAO for providing me with an opportunity to review and comment on the report in draft form. This report will inform the public policy debate surrounding the increasingly realistic prospect of the U.S. territory of Puerto Rico becoming a U.S. state.

Since the GAO commenced work on this report in April 2011, a series of important events have occurred. First, in a November 6, 2012 referendum held in Puerto Rico pursuant to local law, a majority of voters rejected the current territory status and more voters favored statehood than any other status option. Accordingly, the U.S. citizens of Puerto Rico are being governed without their consent. Second, in response to this historic vote, Congress recently approved—and the President signed into law—legislation that appropriates funding for the first federally-sponsored political status vote in Puerto Rico's history, to be held among one or more options that would "resolve" Puerto Rico's ultimate political status and that are consistent with U.S. law and public policy. See *Consolidated Appropriations Act, 2014* (P.L. 113-76). Finally, virtually identical bills are pending in the U.S. House of Representatives (H.R. 2000) and the U.S. Senate (S. 2020) that provide a blueprint for how the vote conducted pursuant to the recently-enacted appropriations law could—and should—be structured. The bills outline the rights and responsibilities of statehood and provide for a vote in Puerto Rico on the territory's admission as a state. If a majority of voters affirm that they want Puerto Rico to become a state, the bills require the President to transmit legislation to Congress to admit Puerto Rico as a state following a reasonable transition period. The bills also express Congress's commitment to act on that legislation. In light of all of the foregoing, this report is particularly timely.

There are two major takeaways from the GAO report.

First, the report confirms that, as a territory, Puerto Rico is significantly underfunded under key federal spending programs and excluded entirely from other important federal spending

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programs. The report further confirms that, as a state, Puerto Rico would receive equal treatment under all of these programs. As expected, GAO has estimated that such equality, in the aggregate, would translate into billions of dollars of additional federal funding for Puerto Rico and its residents each year. Disparate treatment under federal programs is the primary reason why territory status is exacting such a terrible toll on Puerto Rico's economic and fiscal condition, and causing residents to relocate to the states in unprecedented numbers.

Second, this report serves to debunk any argument that statehood for Puerto Rico would have an adverse fiscal impact on the U.S. Treasury by resulting in a situation whereby new federal outlays would far outpace new federal revenues. There is a myth propagated in certain quarters that statehood is a zero-sum game, with any gain to one "side" translating into a corresponding loss for the other "side." That notion is categorically false. The reality is that both Puerto Rico and the United States as a whole are harmed by the current territory relationship, economically as well as morally, and both would derive substantial benefits from statehood. The GAO report demonstrates that, if Puerto Rico were a state, the U.S. Treasury would collect more corporate income taxes and, to a lesser extent, individual income taxes from Puerto Rico. However, it is important to bear in mind that individuals of modest means in Puerto Rico would have little or no federal tax liability and many of those individuals would receive refundable tax credits under the Earned Income Tax Credit (EITC) program and the Child Tax Credit (CTC) program that they are currently denied because they reside in a territory. Over time, as Puerto Rico's economy prospers, as it inevitably would under statehood, take-home pay for Puerto Rico workers will rise, business activity will increase, the corporate tax base will grow, and federal tax collections will expand even further. Simultaneously, the Puerto Rico government would almost certainly reduce its (very high) local individual and corporate income tax rates. If Puerto Rico were treated equally under federal programs, the Puerto Rico government would no longer be compelled to fund public services predominately through locally-raised revenue and excessive borrowing to compensate for the shortfall in federal funding.

In sum, to the extent this GAO report was requested as part of an effort to make Puerto Rico statehood appear less attractive to either U.S citizens living in the states or U.S. citizens living in Puerto Rico, the report proves precisely the opposite point. Moreover, as GAO recognizes, statehood would not occur immediately, from one day to the next. Instead, there would be a meaningful and orderly transition period, with equal treatment under both federal spending programs and federal tax law being proportionately phased in, thereby minimizing disruption and maximizing the opportunity for the federal and Puerto Rico governments to undertake appropriate budget planning.

Having offered these broad comments on the report, I now make some more specific points to underscore what the report does, and does not, say.

In General

- As GAO indicates, the report seeks only to estimate the fiscal impact that Puerto Rico statehood would have on the federal government—that is, on federal outlays and revenues. The conclusions in the report serve as a compelling *economic* argument for statehood, whether viewed from the perspective of Puerto Rico or the U.S. as a whole.

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What this report does not do—and, indeed, what no report can adequately do—is address the profound *moral* argument for statehood. Puerto Rico's territory status cannot be reconciled with the principles our nation strives to uphold at home and promotes abroad. Puerto Rico has more U.S. citizens—3.6 million—than 21 states. Its sons and daughters have served in the Armed Forces in large numbers, from World War I to Afghanistan. Still, Puerto Rico's residents cannot vote for President and Vice-President, and are not represented in the U.S. Senate. They send one nonvoting delegate to the U.S. House of Representatives, known as the Resident Commissioner, a position I have held since 2009. Statehood, unlike territory status, would provide Puerto Rico with democracy at the national (federal) level. Equality, democracy, and justice are principles that cannot be measured in dollars and cents, like items on a balance sheet.

- As GAO acknowledges, the report's estimate of the fiscal impact of statehood on the federal government is limited in scope because it is—by necessity—static rather than dynamic. GAO notes how much federal funding Puerto Rico actually received in a particular fiscal year in the past (usually 2010 or 2011) under a specific federal program (or how much Puerto Rico paid in federal individual or corporate income taxes in a particular fiscal year), and then estimates how much Puerto Rico would have received (or paid) in that fiscal year if it had been a state, providing a "low end" estimate and a "high end" estimate. This "snapshot in time" approach has some utility, to be sure, but it also has inherent limitations. It cannot tell the full story of the fiscal impact that statehood is likely to have on the federal government. As noted above, if the experience of other territories that became states is a guide, Puerto Rico's economy would grow substantially under statehood. As individuals and corporations earn more, they will pay more in taxes to the federal government. Likewise, federal outlays for means-tested programs like Medicaid, Supplemental Security Income (SSI), and the Supplemental Nutrition Assistance Program (SNAP) will decline as fewer individuals depend upon those programs. As GAO acknowledges, its methodology does not capture this dynamic, positive change.

- The GAO report examines 29 large federal spending programs, finding that Puerto Rico's treatment under roughly half of those programs would change for the better if the territory were to become a state. However, GAO does not examine scores of "smaller" but nevertheless very significant federal spending programs under which Puerto Rico is treated unequally as a territory. If Puerto Rico were a state, it would receive equal treatment under these programs as well—a fact the report does not attempt to quantify.

- The GAO report observes that, in recent years, the level of migration from Puerto Rico to the states has been extraordinarily high, but does not attempt to measure the fiscal impact such migration has had on the federal government. That impact is real and substantial, since individuals who move from Puerto Rico to the states qualify for equal treatment under all federal programs, which has a cost for the federal government in the form of additional spending. In short, the report does not attempt to calculate the major adverse impact that Puerto Rico's *current* status is having on the U.S. Treasury.

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- As GAO expressly acknowledges, many of the major federal benefits provided under the 2010 *Affordable Care Act* (ACA)—including subsidies to help lower-income individuals purchase insurance through a health care exchange—are not available to residents of the U.S. *territory* of Puerto Rico, but would be available to residents of the U.S. *state* of Puerto Rico. Nevertheless, this fact is not reflected in all of the report's estimates of federal spending under statehood. It is critical to underscore these omissions, because equal treatment under the ACA would mean billions of additional federal dollars for Puerto Rico.

Federal Spending

- **Medicare**: GAO uses Fiscal Year 2010 as the relevant year. The report estimates that actual federal spending on Medicare in Puerto Rico in FY 2010 was **$4.5 billion**. The report estimates that, if Puerto Rico had been a state in FY 2010, the federal government would have spent between **$4.5 billion (low end)** and **$6.0 billion (high end)**. The high-end estimate—a $1.5 billion increase under statehood—makes intuitive sense, since GAO explains that, as a territory, Puerto Rico is treated unequally under Medicare in various respects. But the low-end estimate is difficult to understand, begging the question: How could it be possible that Puerto Rico, as a state, would receive the same level of federal funding under Medicare as it did as a territory? GAO provides two responses to that query. First, GAO assumes that Puerto Rico would be treated equally under *Medicaid* as well, which means that, for certain individuals, Medicaid rather than Medicare will become the primary payer of their health care. For those individuals, reduced federal payments under Medicare would be offset by increased payments under Medicaid. Second, the ACA reduces payments to Medicare Advantage (MA) plans, which currently cover over 70 percent of the Medicare population in Puerto Rico. Thus, total federal funding for Medicare in Puerto Rico is on a downward trend, irrespective of Puerto Rico's political status. Nevertheless, GAO does not take the downward trend into consideration when calculating the actual FY 2010 number, but does take it into account when calculating the estimate of what Puerto Rico would have received if it had been a state in 2010. In a sense, this analysis is a bit like comparing apples to oranges. The upshot is that, going forward, federal spending on Medicare in Puerto Rico under statehood would be significantly higher than it would be if territory status were to continue.

- **Medicaid**: GAO uses Fiscal Year 2011 as the relevant year. This is not necessarily an ideal year to use because, in 2011, the increased Medicaid funding that Puerto Rico became eligible to receive under the ACA had only partially taken effect. Regardless, the report estimates that actual federal spending on Medicaid in Puerto Rico in FY 2011 was **$685 million**. The report estimates that, if Puerto Rico had been a state in FY 2011, the federal government would have spent between **$1.1 billion (low end)** and **$2.1 billion (high end)**. The report further estimates that Puerto Rico's FMAP (the federal contribution to total Medicaid spending) would increase from 55 percent to 83 percent, reducing the *Puerto Rico government's* annual contribution by **$152 million (low end)** to **$358 million (high end)**, thereby easing the fiscal pressure placed on the local government. As GAO notes, the estimate of federal Medicaid spending under statehood

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does not include an estimate of Long-Term Care (LTC), an important service that the Puerto Rico government currently cannot afford to provide to its Medicaid beneficiaries as a result of the territory's Medicaid cap, but which the Puerto Rico government would provide under statehood. If the LTC cost were taken into account, federal Medicaid spending under statehood is likely to be substantially more than the high-end estimate of $2.1 billion.

- **Supplemental Security Income (SSI)**: GAO uses Fiscal Year 2011 as the relevant year. The report estimates that actual federal spending in Puerto Rico—through an alternative SSI program that applies in the territory known as Aid to the Aged, Blind, and Disabled (AABD)—was **$24 million** in FY 2011. The report estimates that, if Puerto Rico had been a state in FY 2011, the federal government would have spent between **$1.5 billion (low end)** and **$1.8 billion (high end)** in monthly SSI cash payments to blind, disabled or elderly individuals who have limited or no income. Of all the disparities that Puerto Rico faces because of its territory status, perhaps none is as harmful or unprincipled as its exclusion from SSI. While SSI beneficiaries in the states receive between $400 and $600 per month directly from the federal government, AABD beneficiaries in Puerto Rico receive an average of just $70 a month from the government of Puerto Rico.

- **Nutrition Assistance**: GAO uses Fiscal Year 2011 as the relevant year. The report estimates that actual federal spending on nutrition assistance in Puerto Rico in FY 2011 was **$1.9 billion**. The report estimates that, if Puerto Rico had been a state in FY 2011, the federal government would have spent between **$1.7 billion (low end)** and **$2.6 billion (high end)** under the Supplemental Nutrition Assistance Program (SNAP) in lieu of the federally-capped block grant known locally as PAN. The high-end estimate, which would mean an additional $700 million a year, is roughly on par with the estimate provided by the U.S. Department of Agriculture when it examined this issue in a 2010 report. That report concluded that inclusion in SNAP would increase federal funding to Puerto Rico by $457 million a year and would enable 220,000 additional individuals to receive assistance. It is important to clarify the GAO's low-end estimate of $1.7 billion. GAO takes into consideration the fact that, under statehood, Puerto Rico residents would become eligible for SSI payments and that such payments, by increasing an individual's income, could reduce their monthly SNAP benefits. The overarching point is this: under statehood, low-income residents of Puerto Rico would receive far more federal support under the combination of the various social safety-net programs. In addition, as GAO indicates, application of SNAP to Puerto Rico would enable the Puerto Rico government to receive additional federal funding to support employment and training, outreach, and educational programs for SNAP participants and extra help for residents in the event of a federally-declared disaster—benefits that Puerto Rico is presently denied under territory status.

- **Federal Highway Funding**: GAO uses a combination of Fiscal Year 2013 (for the federal spending portion of the equation) and Fiscal Year 2011 (for the federal tax portion of the equation) to make estimates regarding federal highway funding. In FY 2013, the Puerto Rico government was authorized to receive **$149.7 million** in federal highway

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funding, although it was actually allocated only **$129.3 million** as a result of the imposition of certain federal penalties. GAO, using estimates provided by the U.S. Department of Transportation, concludes that, if Puerto Rico had been a state in FY 2013, it would have been apportioned **$265 million** in federal funds to improve roads, highways, bridges, and other important transportation infrastructure, an increase of over $115 million annually. The GAO also correctly notes that, if Puerto Rico were a state, motor fuel sold on the island would become subject to the federal gas tax. However, the Puerto Rico government currently assesses a local tax on motor fuel, which would almost certainly be reduced if Puerto Rico were to become a state, thereby resulting in minimal or no change in the total amount of government taxes assessed on motor fuel in Puerto Rico under statehood.

Federal Revenue

- **Corporate Income Taxes**: GAO uses Fiscal Year 2009 as the relevant year. The report estimates that actual corporate income tax receipts in FY 2009 were **$4.3 billion**. The report estimates that, if Puerto Rico had been a state in FY 2009, the federal government would have collected between **$5.0 billion (low end)** and **$9.3 billion (high end)** in corporate income taxes, which is $700 million to $5.0 billion more than the actual figure. The fact that this range is so large illustrates the difficulty of making a precise estimate in this area. As GAO notes, an important but unquantifiable benefit of statehood is that it would foster a business climate characterized by certainty and stability. Under the current status, corporations already investing or considering investing in Puerto Rico do not know whether and how the federal government might change current corporate tax laws in the territory. Under statehood, corporations will be placed on a surer footing. It is worth noting that corporate investment in Alaska and Hawaii (both domestic and foreign) dramatically increased after those territories became states.

- **Individual Income Taxes**: GAO uses Fiscal Year 2010 as the relevant year. The report states that actual individual income tax receipts in FY 2010 was **$0.02 billion**. The report estimates that, if Puerto Rico had been a state in FY 2010, the federal government would have collected between **$2.2 billion (low end)** and **$2.3 billion (high end)** in individual income taxes. It must be noted that these estimates are significantly higher than previous GAO estimates. See, e.g., GAO/GGD-96-127, *Analysis of Certain Potential Effects of Extending Federal Income Taxation to Puerto Rico* (April 1996) (finding that, if Puerto Rico were a state in 1995, its residents would have an aggregate federal tax liability of $623 million, minus $574 million in tax credits under the Earned Income Tax Credit (EITC), for a total of $49 million in aggregate net federal income tax liability). The difference between the estimates provided in this GAO report and the previous GAO report reflect the inherent challenges associated with modeling federal tax tables based on local tax receipt data. Moreover, the Puerto Rico government currently assesses local income taxes that are far higher than that of any state. If Puerto Rico were to become a state, the Puerto Rico government would almost certainly reduce its local rates. For many residents of Puerto Rico, the result would be a total tax liability (federal and state taxes) that is not meaningfully different than what they pay now. And, as noted, individuals of modest means in Puerto Rico would have little or no federal tax liability

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and many of those individuals would receive refundable tax credits under the EITC and the Child Tax Credit (CTC) programs that they are currently denied because they reside in a territory. Indeed, the GAO estimates that, under statehood, $473 million would be paid to Puerto Rico's taxpayers through the EITC and $108 million in additional funding would be paid through the CTC. These tax credits would help lower-income individuals meet their needs and inject money into the local economy.

In closing, I want to thank GAO for its efforts in preparing this report. The report serves to underscore the numerous ways in which territory status harms Puerto Rico's economy and undermines the quality of life of its residents. The report also confirms that, under statehood, Puerto Rico would receive equal treatment under all federal programs, resulting in billions of dollars in additional federal funding each year. Finally, the report serves to lay to rest any argument that statehood would impose unreasonable or unmanageable fiscal demands on the U.S. Treasury. To the contrary, the report concludes that the federal government would likely benefit from additional revenues under statehood, which would help counter-balance the additional outlays. Over time, under statehood, Puerto Rico's economy will prosper, and that in turn will benefit the United States as a whole.

Sincerely,

Pedro R. Pierluisi
Member of Congress

cc: Mr. Stanley J. Czerwinski, Director of Intergovernmental Relations,
U.S. Government Accountability Office

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Appendix VII: GAO Contact and Staff Acknowledgments

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