

1 EXECUTIVE COMMITTEE MEETING

2 WEDNESDAY, AUGUST 1, 1990

3 U.S. Senate

4 Committee on Finance

5 Washington, D.C.

6 The meeting was convened, pursuant to notice, at
7 10:10 a.m., in room SD 215, Dirksen Senate Office
8 Building, Hon. Lloyd Bentsen (chairman of the committee)
9 presiding.

10 Also present: Senators Moynihan, Baucus, Bradley,
11 Pryor, Rockefeller, Daschle, Breaux, Packwood, Danforth,
12 Chafee, Heinz, Durenberger, Armstrong, and Symms.

13 EACH EXECUTIVE COMMITTEE MEETING SHOULD INCLUDE:

14 Also present: Vanda McMurtry, Staff Director and
15 Chief Counsel; Ed Mihalski, Chief of
16 Staff, Minority, Ms. Miller, Mr. Palson,
17 Mr. Pestal, Mr. Gideon, Mr. Perlman,
18 Mr. Humphrey, Mr. Sessions, and
19 Mr. Richter.

20
21
22
23
24
25

PENGADU UJ. BATUNWE. N. J. U/0002 - LASEH BUNDU

1 Chairman Bentsen. Will you please cease conversation
2 and take your seats? This hearing will begin.

3 Ladies and gentlemen, the United States and Puerto
4 Rico have had a partnership for many years in which both
5 parties have benefited. I can think back to 1952, where,
6 as a young member of the House Interior Committee that had
7 the jurisdiction on this issue that I participated in
8 meetings when the U.S. went in with the great statesmen of
9 Puerto Rico in helping work out some of the details of
10 establishing the Commonwealth, 1952, 38 years ago.

11 I little thought at that time that I would be sitting
12 here as Chairman of the Finance Committee and working on
13 legislation to give the people of Puerto Rico a further
14 choice as to whether they retain the role of a
15 Commonwealth, become a state or become independent.

16 The latest effort we are looking at is this one with
17 S. 712, which would provide the people of Puerto Rico a
18 chance to make a decision as to what their political
19 status would be. Specifically, as reported out of the
20 Energy and Natural Resources Committee, the bill provides
21 for a referendum in which Puerto Rico would choose amongst
22 being a state or a Commonwealth or independent. S. 712 is
23 self-executing as reported out by that committee. That
24 is, any of these three options that receives a majority of
25 vote, that option would go into effect under the bill

1 without any further action necessary on the part of the
2 Congress.

3 As a result, the bill includes provisions that make
4 major changes in Federal law that would be necessary to
5 implement the voters' choice in that regard. Many of
6 those provisions address important issues that are within
7 the jurisdiction of this Committee, the Finance Committee.
8 We are talking about taxation; we are talking about
9 international trade; social welfare benefits as brought to
10 this Committee under the Social Security Act.

11 Now, the Senate Energy Committee has previously
12 marked up S. 712, and we received it on a sequential
13 referral limited to those parts of it that are within the
14 jurisdiction of this Committee. If this Committee fails
15 to act, then this committee can be discharged and the bill
16 goes directly to the full Senate with the provisions as
17 brought forth by the Energy Committee. If that was
18 allowed to happen, we have forfeited our authority, and, I
19 believe, our responsibility in not lending the area of
20 expertise that this Committee deals with and in trying to
21 improve on that piece of legislation.

22 Accordingly, the job of the Committee today is to try
23 to fashion an amendment to the limits that is within
24 the jurisdiction of this Committee. I want to emphasize
25 that in acting on that, we are not passing judgment on the

1 bill as a whole. My proposal is that we report out the
2 underlying bill with an amendment which the Committee
3 would recommend to the Senate to adopt but make it clear
4 that the Finance Committee is making no recommendation as
5 to whether or not the Senate should pass the underlying
6 bill.

7 Before we get into some of the specifics of the
8 amendment, I would like to make a few comments concerning
9 the basic outlines of the amendment.

10 First, the amendment is designed so that each of the
11 three options would be no worse than budget neutral. We
12 are in a real budget crunch in this country, so what it
13 says is it would be budget neutral to the Federal
14 government during the five-year revenue estimating period.

15 That is, that any spending increases that would
16 result from any of the three options would be fully paid
17 for by the revenues that are now effectively dedicated to
18 Puerto Rico.

19 The amendment provides for a level playing field
20 among the three status options so that the voters will be
21 making a choice as to which of these political statuses
22 that they prefer, rather than about the immediate economic
23 effect of the changes in Federal programs that would
24 result from their choice.

25 Particularly under the amendment, beneficiaries would

1 receive approximately the same benefits under entitlement
2 programs under both Commonwealth and statehood. Of
3 course, these programs would be funded differently, but
4 from the standpoint of the beneficiaries, the people that
5 would receive it, the programs under statehood and
6 Commonwealth would be the same.

7 What we are trying to do is make this a level playing
8 field for the people of Puerto Rico in trying to make
9 their choice in that regard. Whatever choice they make is
10 going to have a far-reaching economic impact on Puerto
11 Rico and the United States, and, therefore, it also
12 provides for a gradual transition for the significant
13 changes in the tax laws and the entitlement programs
14 provided under each of the three options.

15 With that, I would like to defer to Senator Packwood,
16 the Ranking Minority Member, for such comments that he
17 might have.

18 Senator Packwood. Mr. Chairman, you and I have
19 talked about this. I agree in the direction you are
20 going. All I want to do is make sure we don't prejudice
21 the vote so that the vote is so tilted in one direction
22 that there is no possible way for it to come out of that
23 direction.

24 Chairman Bentsen. Senator Moynihan?

25 Senator Moynihan. I simply would make the same

1 observations, with the proviso that the different statuses
2 that are available do imply different levels of
3 involvement with the Federal government, and they are not
4 to be avoided. I think the Chairman has worked very
5 seriously to see that there is no immediate break in
6 arrangements, no shock at the stations, and yet, over
7 time, there will be, and that is innate to the different
8 status positions.

9 Chairman Bentsen. Are there other my members who
10 wish to make comments?

11 (No response.)

12 Chairman Bentsen. If not, then staff will walk us
13 through this bill.

14 Mr. Humphrey?

15 Mr. Humphrey. Yes, Mr. Chairman. Each member of the
16 Committee should have a document in front of them. I will
17 go through the spending provisions, and then the others on
18 staff will go through the tax and the trade provisions.
19 We will start with a document that is dated August 1st
20 that has the heading. "S. 712: Puerto Rico Status
21 Legislation." It should be on the top of your document
22 there.

23 The first two pages basically explain, in some
24 detail, the present law of programs that operate in Puerto
25 Rico. I will start on page 3, with the heading, "Spending

1 Program Amendments Under Statehood and Commonwealth",
2 which describes the proposed Committee amendment to
3 S. 712.

4 The general approach on the Social Welfare Program
5 side for the programs in our jurisdiction would be to have
6 a five-year transition period which would begin after the
7 1991 plebiscite, and leading to the full status of either
8 enhanced Commonwealth or Statehood on January of 1996. I
9 am going to explain the Statehood and Commonwealth
10 provisions together since they are coordinated, and then
11 the independence provisions subsequently, since that is a
12 quite different approach.

13 The first year of the transition period, 1992, there
14 wouldn't be any changes made; that would be a period for
15 planning and developing whatever administrative capacity
16 was necessary to implement the changes. And then in 1993,
17 the changes would be implemented: 25 percent of the
18 changes in 1993; 50 percent in 1994, 75 percent in 1995,
19 and then starting in January of 1996, you would have the
20 full implementation of either the enhanced Commonwealth or
21 Statehood, depending on the result of the plebiscite, if
22 either of those two succeed.

23 The key Finance Committee program here is the
24 Supplemental Security Program for the aged, blind and
25 disabled or, under the current Commonwealth status in

1 Puerto Rico, this is operated as not SSI, but as a
2 Commonwealth-run program for aid to the aged, blind and
3 disabled.

4 The structure of the amendment would try to have the
5 benefit levels under the two programs, the Commonwealth
6 version or the Statehood version, both the same. However,
7 the Commonwealth would start to operate it as a
8 Commonwealth-operated program, whereas under the Statehood
9 option, it would be a Federal program as it is now, a
10 Federally-administered program as it is in the state.

11 The starting point here is that the amendment would
12 adopt a new general rule for the SSI program nationally,
13 which would provide that in no state could the SSI level
14 for an individual exceed 5 percent of the state's per
15 capita income based on the most recent information.

16 The current SSI level of \$386 would, in fact, turn
17 out to be about 90 percent of the per capita income in
18 Puerto Rico. With this generic limitation, the level
19 would be more like \$215, using, again, current rates, and
20 again, that would be phased in over the three years.

21 Now, the funding of the SSI program under Statehood
22 would be 100 percent Federal; under Commonwealth, it would
23 be 50 percent Federal and 50 percent State, or 50 percent
24 for the Commonwealth. Under present law, under
25 Commonwealth, there is a cap on the amount of Federal

1 funding so that the percentage matching under present law
2 doesn't mean anything. That cap would be eliminated under
3 this proposal, so that there would no longer be a specific
4 dollar cap; however, there would be a generic cap on all
5 the matching rates, Federal matching rates, under
6 Commonwealth that would be tied to the tax provisions so
7 that in no year could the Federal funding exceed the
8 paid-fors that will be described when the Tax Staff goes
9 through the tax side. So that is the basic SSI program.

10 The Aid to Families with Dependent Children Program
11 does operate currently in Puerto Rico, and the benefit
12 side of that is essentially operated there and in the
13 States. A State, each State, sets its own level of
14 assistance, and there is Federal matching. That would,
15 obviously, continue under either Commonwealth or
16 Statehood. What would change is the funding mechanism.

17 Currently, this cap on Federal funding applies so
18 that the matching rate is meaningless. Under Statehood,
19 it would be open-ended matching. At the Medicaid matching
20 rate, which would be 83 percent, and at least until per
21 capita income levels in the Commonwealth change, but under
22 current rules, it would be 83 percent.

23 Under the proposal for Commonwealth, the matching
24 rate would be 50 percent Federal, 50 percent Commonwealth,
25 and again, subject to no specific cap, but with this

1 overall limit that the Federal matching could not exceed
2 the paid-fors.

3 The Medicaid program operates quite differently
4 currently in Puerto Rico than it does in the states: In
5 the States, it is a freedom of choice program, where each
6 eligible recipient goes to the doctors and hospitals of
7 their choice, and then the Medicaid program reimburses
8 them. In Puerto Rico, it is a public health program where
9 an eligible individual goes to a public health facility,
10 and the government pays the cost of running that.

11 Under Statehood, the Medicaid program would operate
12 as it does in the States.

13 Under Commonwealth, our assumption is that the
14 Commonwealth government would continue to run a public
15 health facility-based program. So what would change here
16 is the matching rate, as would the cash benefit programs.
17 Currently, the matching, the Federal funding, is
18 constrained.

19 It is constrained to something, I believe, \$69 to \$79
20 million a year, even though the program would be running
21 at several hundred million dollars a year. Under this
22 proposal, that cap would be removed; it would be 50
23 percent matching with no cap, other than the overall
24 generic cap that is related to not exceeding what the tax
25 provisions generate in the way of budgetary savings.

1 During the transition period, we would assume that --
2 Well, the, for Statehood, they could begin to phase in to
3 the full program however they determine to be most
4 appropriate, but would be subject to caps so that the
5 funding would follow this 25-50-75 pattern during the
6 transition period, and a similiar phase-in would be
7 available to Commonwealth.

8 The Medicare program and the Social Security and
9 Medicare program are basically Federal programs, where the
10 Federal government had the relationship to the individuals
11 involved, and they operate in Puerto Rico pretty much the
12 same as they do in the States, so there is not a big
13 change here. The one area in which there would be a
14 change is that the hospital reimbursement under Medicare
15 is currently constrained in Puerto Rico.

16 This is based on or at least it is purportedly based
17 on an analysis of the difference in cost of medical care
18 there. What we would propose to do is to keep that rule
19 in effect but to direct that a study be done and that if,
20 in fact, the current rule does not properly reflect the
21 cost differentials that the Secretary would be directed to
22 come up with a proposed change to have an appropriate
23 recognition of cost differentials.

24 Now, the next item is not a programmatic change, but
25 there is in essence -- S. 712 as reported by the Energy

1 Committee has some generic provisions that create
2 expedited procedures for review of regulations and which
3 allow for a certain consolidation of grants that are
4 government-wide under the Commonwealth option.

5 What we would propose is to carve out the Finance
6 Committee programs so that we would maintain control of
7 Finance Committee programs, rather than having these
8 expedited procedures in effect with respect to anything
9 that touches the Social Security Act.

10 That is the Commonwealth and Statehood approach.

11 The Independence alternative is fairly simple on the
12 spending side. If the general approach would be that if
13 Puerto Rico should choose independence in the referendum,
14 the social welfare programs would continue through the end
15 of the fiscal year in which independence is proclaimed and
16 then would cease.

17 The amounts that Puerto Rico has in the Unemployment
18 Trust Fund would be given over to the Puerto Rican
19 government, and they would run their own social welfare
20 programs. There is, let me say, the Energy Committee did
21 make provision for some type of transition grants, but
22 those would not be in our jurisdiction, so as far as our
23 social welfare programs are concerned, they would
24 generally end.

25 The one problematic area is the Social Security

1 program, which, again, has sort of an earned right
2 individual relationship between the Federal government and
3 the individual. The solution to this would be for the new
4 government of Puerto Rico and the United States to work
5 out some type of coordinated system, as we do have with a
6 number of countries now, where people work in both
7 countries and there are coordinated Social Security
8 systems.

9 Pending that, the current system would be kept in
10 place for not more than five years while agreement was
11 worked out between the two governments as to how to deal
12 with it. That is the spending side. Mr. Richter will
13 describe the tax advantages.

14 Chairman Bentsen. Mr. Richter, if you would proceed?
15 You are discussing the tax side, Mr. Richter?

16 Mr. Richter. That is right, Mr. Chairman. I will be
17 referring to the documents that are labeled, "Revenue
18 Estimates Under Proposed Committee Amendment Under
19 S. 712", prepared by the Joint Tax Committee.

20 Table 1 on the Statehood option shows that there are
21 two principal sources of revenue to offset the increased
22 spending Mr. Humphrey has discussed.

23 Chairman Bentsen. Let us be sure which one we are
24 talking about. Is it this one?

25 Mr. Richter. No, it is the Revenue Estimates Tables,

1 entitled "Revenue Estimates Under Proposed Committee
2 Amendment." It is a document prepared by the Joint Tax
3 Committee. It is a very short. It is four pages long.

4 Chairman Bentsen. All right. Does everyone have
5 theirs now? If you would proceed, Mr. Richter?

6 Mr. Richter. Table 1, under the Statehood options,
7 reflects that there are two principal sources of revenue
8 to offset the increased spending that.

9 Mr. Humphrey. Described that would occur under the
10 Statehood option.

11 The first one is to phase out Section 936, which is
12 the tax incentive that is designed to encourage
13 U. S. corporations to operate in Puerto Rico and permits
14 them to shelter their active and passive business income
15 down there.

16 The second source of income is a choice of revenues
17 and is the imposition of Federal excise and income tax
18 liabilities on Puerto Rican citizens and corporations who,
19 before now, have been exempt from Federal taxes. But what
20 the mark proposes to do is phase out the Section 936
21 benefit 25 percent a year, beginning one and a half years
22 after the plebiscite, assuming a 1991 plebiscite that
23 chooses Statehood. Line one on the Statehood option table
24 reflects the revenue to be generated by that on a 25
25 percent, 50 percent, 75 percent basis on the first line.

1 These revenues alone more than pay for the increased
2 Statehood social spending proposed under the mark, and the
3 second line shows essentially the surplus that would be
4 generated as a result.

5 These surplus revenues from Section 936, plus the new
6 Federal tax collections which are reflected on this next
7 page, page 2, also titled "The Statehood Option". That
8 page shows the amount of individual income taxes newly
9 collected under the Statehood option for individual income
10 taxes, corporate income taxes and excise taxes.

11 These amounts, plus the surplus reflected on the
12 previous page, would be proposed to be returned to the
13 Puerto Rican government to assist in the transition.

14 The amounts of these Federal tax revenues that would
15 be transferred to the Puerto Rican government may have to
16 later be reduced in order to accommodate whatever action
17 the Agriculture Committee might take on the Food Stamps
18 Program, but that is the general structure of the
19 Statehood option.

20 The current transfer of Rum excise tax revenues and
21 Customs revenues, which currently are collected by the
22 U. S. government under current law and also refunded to
23 the Puerto Rican government, they would remain untouched
24 over the transition period; however, that would be
25 eliminated at the end of the transition period.

1 I would ask you now to skip to table number 3 and to
2 look at the Commonwealth option. Under Commonwealth,
3 there are also two principal sources of revenue. One is
4 the curtailment of Section 936, and the second source of
5 revenue that would increase Federal benefits that are
6 proposed is the elimination of the refund of Puerto Rican
7 rum excise taxes and Customs duties that the
8 U. S. government now transfers to Puerto Rico.

9 The amount of spending that needs to be offset is
10 identified at the bottom line of that Commonwealth option
11 table 3, and the proposal is to reduce the amount of the
12 rum excise tax and Customs duties refunds to the Puerto
13 Rican government as necessary to fund these increased
14 Federal benefits.

15 In both of these instances, the net result is to have
16 a proposal that is budget neutral to the Federal
17 government. Under Commonwealth, the excise tax, the rum
18 excise tax and Customs duties cover-over source of revenue
19 is exhausted.

20 There is a slight curtailment of 936 proposed, and
21 that is reflected in item one on the commonwealth Option
22 Table. What that proposal would do is increase the amount
23 of active business income that a non-Section 936 company
24 must earn to be available for the Section 936 credit.
25 These companies are currently required to earn 75 percent

1 of their active business income in Puerto Rico to be
2 eligible for the tax credit.

3 This proposal would be effective in 1995, going --

4 Chairman Bentsen. Would you tell me the amount of
5 money we are talking about when we are talking about 936?

6 It is not an insignificant item, obviously. Would you
7 give us ball park numbers, there?

8 Mr. Richter. The 936 tax expenditure, in total, is
9 on the order of two and a half to \$3 billion dollars a
10 year. This would, as line one on that table shows,
11 essentially take only \$30 million out of it in the fifth
12 year by increasing this threshold requirement for active
13 business income.

14 However, that number would increase, we would expect,
15 outside the window to continue to ensure, to the extent
16 that we can, a budget-neutral proposal. That is, the
17 increased Federal spending benefits would be fully funded
18 by both the reduction in the cover-over of excise taxes
19 and Customs duties and this moderate change to Section
20 936.

21 Table 2, then, on the previous page, for
22 Commonwealth, headed "the Independence option" is the only
23 option that generates the net surplus to the government,
24 the United States government.

25 Senator Moynihan. Mr. Richter, just a moment. We

1 don't have, in this set of papers, any line that tells us
2 what the cost to the Federal Treasury is, the tax
3 expenditure, of 936. But we know it is somewhere between
4 \$2 and \$3 billion, and you just mentioned that. Are we to
5 understand that by adjusting the active income over the
6 whole period that there will only be an extra \$30 million
7 to go to benefit in the Commonwealth?

8 Mr. Richter. The proposal is structured to only pay
9 for the increased spending proposed under the mark on
10 programs within the Finance Committee's jurisdiction.
11 Those amounts are not -- are exactly paid for by only a
12 very small change in 936 that is effective only four years
13 into the transition period.

14 Senator Moynihan. Is that all that is required?

15 Mr. Richter. That is all that is required.

16 Senator Moynihan. But in the meantime, how much of
17 this strange term, "cover-over", what does that means to
18 revenues collected on rum excise, that most ancient of
19 taxable sources, just give it to the government for a
20 break-up?

21 Mr. Richter. That is right. That amounts to roughly
22 \$20 million a year.

23 Senator Moynihan. Are we not going to be giving that
24 to the government any longer?

25 Mr. Richter. We will be giving that, any of whatever

1 the increased spending will be.

2 Senator Moynihan. What will that be? That is a cost
3 to the Commonwealth government; that is revenue they won't
4 have. Individuals will receive it through social welfare
5 benefits. Isn't that the point?

6 Mr. Richter. That is correct. They will have the
7 amount of their cover-over reduced, but Senator, Puerto
8 Rico will have spending decreased.

9 Senator Moynihan. How much?

10 Mr. Richter. It would be represented by the amount
11 on the bottom line on table 3 entitled "The Commonwealth
12 Option". In 1993, it will be \$133 million

13 Senator Moynihan. All right. There it is. That is
14 the number?

15 Mr. Richter. Those are the numbers.

16 Senator Moynihan. In other words, that is what the
17 government of Puerto Rico, that is the cost the government
18 will incur in order for them to have an increase, a
19 so-called enhanced benefit?

20 Mr. Richter. That would be a net reduction in the
21 Puerto Rican government's receipts.

22 Mr. Humphrey. Senator Moynihan, they would also have
23 some additional costs for paying their 50 percent share of
24 the benefits.

25 Senator Moynihan. Thank you.

1 Chairman Bentsen. You may proceed.

2 Mr. Richter. Moving to the independence option,
3 table 2 reflects the consequences of independence from the
4 tax side. Line 12 shows that the Section 936 benefit on a
5 phase-out pattern that is identical to State under the
6 Statehood option.

7 The phase-out would begin in the second taxable year
8 after certification and would raise the revenue as
9 restructured there and would be gone five years after the
10 proclamation of independence.

11 In addition, the cover-overs, the refunds to the
12 Puerto Rican government of the rum excise tax, Customs
13 duties, would also cease; it would be phased out over a
14 five-year period as reflected on line 2 of that table.

15 Line 3 refers to the fact that the current U. S. tax
16 has been taxing U. S. citizens where they reside in the
17 world, and Puerto Rico, virtually, the entire population
18 of Puerto Rico are U. S. citizens in addition to being
19 Puerto Rican citizens, and would, therefore, become
20 subject to U. S. taxation under the normal rules.

21 The mark proposes to exempt those citizens from the
22 U. S. that have never been in the U. S. tax system that
23 are citizens of Puerto Rico by virtue of being born there
24 or born of parents that are U. S. citizens and have
25 moderate income.

1 We don't want to put them into the U. S. tax system
2 if they have never been there before. The last point
3 under the independence option is one that is not reflected
4 on the table, and that is, the mark proposes to extend the
5 current authority that Puerto Rico has for five years
6 after independence to issue tax-exempt bonds.

7 That concludes the description of the tax portion.

8 Chairman Bentsen. Let me ask Mr. Gideon. What is
9 the Administration's position on this?

10 Mr. Gideon. We have several subjects, Senator, if I
11 could just go through them. The first has to do with not
12 a tax issue, but Statehood under the option. We would
13 like to see Puerto Rico admitted as a state, if that is,
14 in fact, the option that the voters select, as soon as is
15 feasible after that vote and in any event, within a year
16 after that vote.

17 Let me move to the general idea of matching up the
18 benefits in the Statehood and Commonwealth options. We
19 find the general idea of making those match from a revenue
20 standpoint acceptable, and we are willing to go along with
21 it. We haven't had as much time to look at these specific
22 numbers as we would like, and we would like to have a
23 chance to view that it is, in fact, budget neutral in this
24 context.

25 We have one concern about the transitional formula

1 that is provided in the Statehood option; in other words,
2 this 50 percent per capita limitation, that shows the
3 benefits to be limited during the period. We have some
4 concern about what effect that is going to have in the out
5 years. Statehood, remember, is leading to a total
6 phase-out of 936. In the out years, that is going to
7 produce a significant amount of money. To the extent that
8 in the Statehood option they are not getting the benefits
9 in the out years because of this 50 percent option that
10 would match what they have given up in terms of the 936
11 tax expenditure that will no longer be there in the out
12 years, it seems to us that some adjustment in that period
13 in this limitation may be appropriate in order to level
14 the playing field specification.

15 But with that kind of reservation, we are sure, in
16 fact, that we are getting a matching of tax expenditures
17 given up with benefits provided is an acceptable toll.

18 Senator Bentsen: What we are looking at a is
19 dramatic effect on the economics of three million people.
20 You are looking at a differential on SSI of \$42 million
21 under Statehood and \$386 million insofar as the United
22 States. The question, "What kind of effect that can have
23 on an election and whether they are voting for status or
24 differential in benefits," that has been one of the
25 concerns. That is one of the reasons that the Chairman

1 has received that kind of a 50 percent of whatever the per
2 capita income is in trying to reach a compromise with all
3 that is equitable in that regard.

4 Senator Moynihan. Mr. Perlman, did you have some
5 comments as far as this question?

6 Mr. Perlman. The only comment I would like to make,
7 going to the effective date, clearly, at least from our
8 standpoint, we understand the five-year phase-out.

9 We have to remember that we have this serious
10 constitutional issue that was presented in the Finance
11 Committee in its hearing, and the five-year phase-in was
12 heavily influenced by the desire to try to avoid
13 constitutional problems. There are, obviously, also
14 economic dislocation issues that are ameliorated by the
15 five-year phase-in, but I think that the great difficulty
16 with rushing to a quicker date on Statehood is the threat
17 that you then face this very serious constitutional
18 question, which the Chairman has mark, we believe, as best
19 we could consult with the constitutional experts, may, in
20 fact, avoid.

21 Beyond that, Mr. Chairman, we have no other comment.

22 Chairman Bentsen. Further comments from staff? May
23 I ask the members for comments?

24 Senator Moynihan. Mr. Chairman?

25 Chairman Bentsen. Senator Moynihan.

1 Senator Moynihan. Mr. Chairman, just to follow up on
2 the point that Mr. Perlman made, you have struggled with
3 the sometime thankless effort to know what is or will not,
4 what is or is not subject to the Uniformity Clause in the
5 Constitution, which, clearly is, on day-to-day matters,
6 the answer is clear, but on this very special matter of
7 the admission of a state, it is not clear, because
8 Congress has what we believe total power with respect to
9 that so long as the specifications are that it be a
10 republic and so forth are met.

11 I would like to then suggest that we move to resolve
12 this with a simple provision that -- and I will offer it
13 in an amendment when you are ready -- specifically, it
14 will say that the effective date for Statehood would be,
15 and Mr. Chairman, I don't know, could you ask about this?
16 It would be January 1, 1992, as reported by the Energy
17 Committee, and that would include full representation in
18 Congress.

19 But then, as regards to the transition, a phasing out
20 of the 936 benefits, as such, we would provide for what is
21 generally termed expedited review of the constitutionality
22 by the court, and in a fairly short order, the court will
23 tell you whether this is acceptable or not, and for what
24 it is worth, I offer no view of my own, but the Justice
25 Department, Mr. Chairman, thinks it would be acceptable.

1 They have so testified and a Deputy Assistant Attorney,
2 Mr. Bruce Navaro, is here, if you want to ask him his view
3 on that.

4 That seems to me to be one of the useful arrangements
5 we have in this country. If you want to know whether
6 something is Constitutional, sooner or later, the Supreme
7 Court will tell you. This means we will get off on the
8 right shoe, and we will all know we are playing from the
9 basic document that we are working on.

10 Chairman Bentsen. Let me say something. My deep
11 concern has been that you are going to have severe
12 economic changes here, and having an appropriate
13 transition period to take care of that and make those
14 adjustments, I felt, was basic and essential. That is why
15 I wanted a phase-in period.

16 Now, then, of course, we are concerned about the
17 constitutional question on 936. If we could get an
18 expedited review and we do not change the phase-in period,
19 whether it would become a State in 1992 or it would become
20 a State at the end of five years, if we could do that
21 without the constitutional problem on uniformity among
22 States, that could satisfy my concern. That is a new
23 wrinkle to the problem.

24 Senator Moynihan. Could I say, sir, that you are
25 absolutely right. The 936 directly provides about 30

1 percent of the employment in the Commonwealth and
2 indirectly, perhaps half, so it is no small matter. You
3 are right. I would hope that the requirement would say,
4 well, obviously, in this one-time event, that the Congress
5 would make this one-time proposal, but I do not know that.

6 Chairman Bentsen. Well, I don't either, in that
7 period, but I think we may have room for compromise, I am
8 saying, and that enhances my concern on that point. Are
9 there further comments?

10 Senator Bradley. Mr. Chairman?

11 Chairman Bentsen. Yes.

12 Senator Bradley. Mr. Chairman, I would like to ask
13 Senator Moynihan, on his proposal, as I understand it,
14 there would be an expedited review so that we would know
15 whether, if Statehood were voted, Puerto Rico would be
16 able to have 936 phased out. Is that not correct?

17 Senator Moynihan. I don't think that we would hear
18 from the court before January 1, but it would be very
19 shortly thereafter.

20 Senator Bradley. But the purpose, as it --

21 Senator Moynihan. Phase-out doesn't begin until
22 1993?

23 Chairman Bentsen. That is correct.

24 Senator Moynihan. So we would know.

25 Senator Bradley. So we would know, and we wouldn't

1 be in a circumstance where Puerto Rico would vote for
2 something with the expectation that it was going to be
3 able to have a phase-out and then discover that the
4 phase-out was in violation of the Constitution because of
5 the uniformity clause if they voted for Statehood.

6 Chairman Bentsen. I think the point, Senator, we are
7 talking about is that unless we could get this decision by
8 the Supreme Court under expedited proceedings and get that
9 before they become a State so that they understand it,
10 that they don't become a State.

11 Senator Bradley. What would happen under your
12 proposal if the Supreme Court said that they couldn't
13 phase-out?

14 Senator Moynihan. Well, I want to be very clear that
15 this is a proposal that would give representation in the
16 Congress directly. At that point, we would have a
17 problem, but we would also have representatives from
18 Puerto Rico in the Senate and in the House to work on the
19 problem with us.

20 Chairman Bentsen. Oh, no. No, no.

21 (Laughter.)

22 Senator Moynihan. Mr. Chairman, Mr. Chairman.

23 Chairman Bentsen. You are not a state but you have
24 Senators and Congressmen?

25 Senator Moynihan. No, sir. I wanted to make that

1 clear, because I wasn't certain you followed the proposal.

2 Chairman Bentsen. Well, I hadn't heard that part of
3 the proposal.

4 (Laughter.)

5 Senator Moynihan. I did say, I swear to you,
6 Senator, I wrote it and said, "Effective said date of
7 Statehood, including full representation in Congress,
8 would be January 1."

9 Chairman Bentsen. Oh, I understood all of that, but
10 my understanding was that you would have had the expedited
11 procedure and that the Supreme Court would have decided
12 that the uniformity clause did not prohibit the phasing
13 out of 936 over the five years. That was my assumption,
14 that you would have had that decision already made for
15 you.

16 Senator Moynihan. But not before the plebiscite.

17 Chairman Bentsen. Otherwise, you go out -- No, of
18 course not.

19 But otherwise, you go out five years, you don't
20 become a state until five years later, which is what the
21 original proposal, in my mind, was. See, the question of
22 Statehood and becoming a State and a phase-in period is
23 not an unusual procedure. You look at what happened to
24 Hawaii. They had the first plebiscite, voted 2 to 1. As
25 I recall, it was some 19 years later they became a state.

1 If you look at Alaska, they won by a substantial majority
2 of being a State. I think it was 13 years later, but I'm
3 not looking for that, and I don't want that for Puerto
4 Rico.

5 But I do want an orderly transition period from the
6 economic impacts that we are talking about, and I don't
7 see how you could have Senators and Congressmen, as much
8 as I know that there are several of them sitting out
9 there, who would expect to be Senators and Congressmen.

10 Mr. Heinz. Would the Senator from New York yield?

11 Senator Moynihan. Yes.

12 Mr. Heinz. Just to be clear, if the Supreme Court,
13 under expedited review says, you cannot have the
14 phase-out, what you are saying is that will be up to a new
15 Congress to wrestle with. That might cause immediate
16 cut-off of all 936 benefits. There might be economic
17 dislocation and under that kind of pressure, we would come
18 up with some kind of solution. Is that what the Senator
19 from New York is saying?

20 Senator Moynihan. That would be my assumption. I
21 would also want to say that if the Chairman wanted to move
22 representation to, say, 1993, that is fair, too. But I
23 think that Statehood people have made clear, and we are
24 just trying to represent what they would like to have on
25 the ballot. Their first priority is Statehood, which,

1 obviously, it should be if Statehood is the option.

2 Chairman Bentsen. We could go "whereby", and modify
3 the Chairman has mark, "whereby" the expedited procedure
4 would have had to take place and would have had to have
5 found that the Uniformity Clause would not put a
6 prohibition on the phasing out of 936 in the findings of
7 what we are talking about. And if they find that it is a
8 prohibition, then they would become a state, and they
9 would be able to elect their Congressmen and their
10 Senators. But if they find to the contrary, then you have
11 the phasing in and out taking place over five years, and
12 at the end of that period of time it becomes a state.

13 Senator Moynihan. That makes sense. That makes
14 sense.

15 Chairman Bentsen. Okay?

16 Senator Bradley. Mr. Chairman?

17 Chairman Bentsen. Yes.

18 Senator Bradley. Just so that I understand what you
19 have stated, with an expedited procedure before the
20 Supreme Court would make a decision, should they make the
21 decision that 936 could not be phased out, the uniformity
22 clause applied and this decision took place two years
23 after a plebiscite, is it your view that on the date that
24 is in the bill that they would have representation whether
25 they had 936 or not?

1 Chairman Bentsen. No, that they would not have
2 representation early unless, of course, they found that
3 the uniformity clause did not apply.

4 Let me ask.

5 Senator Moynihan. I am trying do prevent discussion.

6 Chairman Bentsen. Absolutely right. Let me see if
7 Mr. Sessions has anything further to add to this.

8 Mr. Sessions: Well, I would just follow up on what
9 the Chairman said. The proposal, as it was described to
10 us last night, is strong along the lines of what you were
11 describing, Mr. Chairman, under which the effective date
12 of Statehood would be January the 1st, 1993, and then
13 there would be an expedited review before then. If the
14 Supreme Court held that the uniformity clause was
15 consistent with the phase-out, the phase-out was
16 consistent with the uniformity clause, then we would keep
17 the effective date of Statehood of 1993. If not, then the
18 effective date of Statehood would go to 1996, as in the
19 Chairman has mark.

20 We just found out about this last night and have
21 attempted to consult with various constitutional
22 authorities on this issue, and they seem generally
23 favorable on that approach. It is a new idea, and so we
24 can't say for sure that it works, but the people we talked
25 to suggest that it does work, and it doesn't raise some of

1 the problems that perhaps the original proposal might
2 raise of Statehood and then, there is a question of what
3 the remedy would be through the Supreme Court, if the
4 Supreme Court were to hold the uniformity clause to be
5 violated, whereas Statehood had come into effect.

6 There are a lot of different possibilities. The bill
7 could become invalid, Statehood could be revoked and 936
8 benefits could be revoked. It is just unclear.

9 The second proposal is a lot clearer and has a more
10 predictable outcome.

11 Chairman Bentsen. So let me say this: As I recall,
12 under the Flag amendment, that was probed as a
13 possibility, an expedited proceeding, apparently, wasn't
14 it, and apparently, whomsoever was researching it came to
15 the conclusion that that was an appropriate procedure.

16 So I think that there is some credibility to what you
17 are talking about, Senator. I just want to be sure we can
18 fit these proposals together.

19 Senator Bradley. Mr. Chairman?

20 Chairman Bentsen. Yes.

21 Senator Bradley. If I could, just to make sure that
22 I understand what Mr. Sessions said, under this new
23 proposal, if there is a vote for Statehood, that Statehood
24 with full representation will occur in 1993, unless the
25 uniformity clause is not to apply, right?

1 Mr. Sessions: That is right.

2 Senator Bradley. In which case, full Statehood would
3 occur in 1996?

4 Mr. Sessions: Right.

5 Senator Bradley. So in any event, a vote for
6 Statehood would mean that Puerto Rico would be a state
7 either in 1993 or in 1996.

8 Mr. Sessions. That is correct.

9 Chairman Bentsen. Well, let me see if that is quite
10 right. As I understood it, the way he phrased it, it
11 would take place unless the Supreme Court had determined
12 Uniformity Clause did not apply; is that correct?

13 Mr. Sessions. That is right.

14 Chairman Bentsen. That means if they refuse to hear
15 an option in which you suggested that there be this
16 phase-in period and at the end of x years, whatever it
17 was, January 1st, 1996, if they had voted for Statehood,
18 that is when it would take effect.

19 But I have qualms and reluctance in viewing favorably
20 the proposal that they have Statehood in such-and-such,
21 1992 and 1993, whatever it is. However, if the Supreme
22 Court, in an advisory opinion, should render a negative
23 judgment, then the Statehood would be postponed.

24 Chairman Bentsen. What I am trying to get to, the
25 very problem you are talking about concerns me, and that

1 is why I am saying, they don't become a state until there
2 is an affirmative action by the Supreme Court.

3 Senator Chafee. But in that case, where people had
4 planned on Statehood being at January 1st, 1996 and the
5 Supreme Court comes in with an advisory opinion that holds
6 favorably on this particular clause, then the Statehood
7 would be moved up under the proposal to January 1st, 1993.
8 Am I not correct?

9 Senator Bentsen. If they found affirmatively with
10 the Uniformity Clause, it would mean that.

11 Senator Chafee. I just find it unsatisfactory. I
12 think we should have some type of definiteness here. If
13 it is 1996, fine. I would much rather go with that than
14 go with some proposal that if certain events occur, then
15 it will occur earlier. I think people have plans to make,
16 and so that is why I have difficulty with it.

17 Senator Moynihan. Could I speak to that,
18 Mr. Chairman?

19 Senator Chafee. Also, I might say, it obviously puts
20 tremendous pressure on the Supreme Court. Now, they are
21 not unused to pressure, but somehow, the idea of a matter
22 like this beings in the hands of the Supreme Court for a
23 decision, again, isn't totally appealing to me.

24 Senator Moynihan. Could I just say, then, Senator
25 Chafee, there is, in fact, great certainty in this

1 management. In the State option is the one certain fact
2 immediately is that 936 benefits will be phased out over a
3 five-year period. That, you know.

4 You also know that during that period, either in the
5 middle of it on 1 January 1993 or at the end of it on 1
6 January 1996, there will be representation. All those
7 three things, and to the degree that people are planning
8 other than their own political campaigns, the economic
9 planning is guaranteed; you know how that sequence will
10 go.

11 Senator Chafee. Yes, except there are a lot of plans
12 individuals make that don't revolve around 936, I should
13 imagine.

14 Chairman Bentsen. Further comments?

15 Senator Daschle?

16 Senator Daschle. Sir, I have no comments about this
17 particular section, but I do have a question pertaining to
18 parity and whether or not, as we discussed yesterday, we
19 have been able to establish parity here. Yesterday, as we
20 talked about this, the answer was, to the degree to which
21 we have jurisdiction, we have now created parity between
22 the options of Statehood and Commonwealth.

23 I guess my question is: Number one, is that still
24 the consensus of the staff here, as this has been
25 discussed in the last 24 hours? But secondly, I am still

1 concerned about the qualifier to the degree that the
2 Finance Committee can create parity. That leaves me
3 wondering to what degree we still have not arrived at
4 parity because other areas in which we might address the
5 issue of parity fall outside the area of responsibility of
6 the Finance Committee.

7 I would like the staff to address both questions, if
8 they could.

9 Mr. Humphrey. Senator Daschle, and I think it is the
10 legal business of the staff that the proposal achieves,
11 within our own Committee's jurisdiction, parity as far as
12 the definable benefit levels are concerned. It does not
13 create parity as far as the financing underlying the
14 benefits, but it creates parity as far as how much an
15 individual in Puerto Rico could anticipate getting in
16 benefits.

17 So there is some areas where it is difficult for us
18 to actually create parity, for example, in the medical
19 program. The current Puerto Rican government's Medicaid
20 program is operated by a government of the state or the
21 Commonwealth. The current Puerto Rican government had
22 chosen to continue their traditional public health
23 facility-based program.

24 Our assumption is they would continue to do that,
25 whereas our assumption is on the basis of what we have

1 heard that Statehood would change the nature of the
2 program. But as far as what is available, it is as equal
3 as we can make it.

4 Now, the big ticket items are the benefit levels, and
5 the one where the government sets the level is the SSI
6 program. We have established parity there throughout the
7 transition period and at the end, so that as far as the
8 individual is concerned, what he can look for in terms of
9 benefits is the same.

10 In the AFDC program, we have tried to create a
11 funding situation where credibly, Commonwealth or
12 Statehood could promise the same thing. Now, they do set
13 the level, so it might turn out than one would set a
14 different level than another, but this is a locally-set
15 level, and without getting into something that is totally
16 new in Federal standards for this program, we couldn't do
17 better than that, was our judgment.

18 The second question you raise is outside our
19 jurisdiction. The major area there is the Food Stamp
20 program, which has been the jurisdiction of the
21 Agriculture Committee. Basically, we are without ability
22 to guarantee that they will come up with something that
23 has parity, also.

24 What we have suggested in the staff document is that
25 the Committee would undertake, although we can't directly

1 do anything, as a part of reporting this bill in our
2 report language suggesting that we will, to the extent
3 that the Agriculture Committee does follow our type of
4 approach, of providing parity, that we will attempt to
5 adjust the Tax Provisions to provide the financing to
6 enable them to do that.

7 That seems to us about as far as it is possible for
8 this Committee to go.

9 Senator Daschle. So the only outstanding decision
10 outside the purview of this Committee is the Food Stamp
11 question, and is it my understanding that if we resolve
12 the Food Stamp issue and create parity in the Food Stamp
13 program, then we could say with some satisfaction that we
14 created parity as this bill comes to the floor?

15 Mr. Humphrey. That is our judgment, and as far as we
16 know from our conversations with the parties, those are
17 the issues that are concerned as far as having a level
18 playing field.

19 Senator Rockefeller. Mr. Chairman?

20 Chairman Bentsen. Yes.

21 Senator Rockefeller. I will put a question to the
22 staff, just taking off from Senator Daschle's question.
23 If parity is established between the Commonwealth and
24 state within the context of what we have before us, is it,
25 nevertheless, true that expenditures on behalf of or by

1 the United States government over the longer haul will,
2 within that parity, nevertheless be substantially greater
3 than they are at this day?

4 Mr. Humphrey. The direct expenditures for benefits
5 by the United States government, under either option, will
6 be greater. I mean, this does involve increased benefits.

7 Now, there are offsetting items on the tax side which
8 attempt to pay for these and, to some extent, may more
9 than pay for them. There shouldn't be a net budgetary
10 loss to the Federal government under this proposal.

11 Senator Rockefeller. That is in the short term, but
12 over the longer term, am I not correct in understanding
13 that this really cannot be looked at as a budget-neutral
14 matter?

15 Mr. Humphrey. Actually, to some extent, we are
16 handicapped by the fact that we can only get the cost
17 estimators to give us cost estimates over a five-year
18 window, and there are economic effects that could result
19 in lots of changes beyond that five-year window,
20 particularly with the elimination of the 936 and so forth.

21 But on a kind of static basis, what should happen
22 under the Commonwealth option is that we would cap the
23 increase and benefit costs so that they could never exceed
24 what the growth in the tax revenues that this bill would
25 generate are. So abstracting from the possibility of

1 future legislation, this bill, in and of itself, should,
2 on the Commonwealth option, be budget neutral basically in
3 perpetuity.

4 On the Statehood option, actually, since what you
5 have got is a very substantial tax expenditure that would
6 go away, the 936 under Statehood eventually disappears
7 altogether. That, combined with the tax revenues from
8 imposing income taxes in Puerto Rico, as far as we can
9 project, without assuming any economic decline, should
10 more than pay for the benefit costs.

11 So there would be substantial increased benefit
12 costs, but as far as we can tell, it is benefit neutral.

13 Senator Rockefeller. I just want to pursue that,
14 Mr. Chairman, to set the context, because this, I guess,
15 is not being said. I guess I want to say it for the
16 benefit, and I will address this to the staff.

17 You talked about the static basis, a micro basis. I
18 would like to talk about a dynamic basis, which is like a
19 macro basis. If 936 goes, is phased out or whatever, you
20 are going to have enormous disruption in the Puerto Rican
21 economy, and it would seem to me that saying that this is
22 not going to be at substantially more cost.

23 Even with more taxes, not to speak of the Statehood
24 situation, in which case, all kinds of different
25 situations open up because of representation and,

1 therefore, more political power or whatever, that the cost
2 to the government is going to substantially increase in
3 the out years, and I just have to lay a philosophical
4 predicate.

5 I understand the Chairman in these amendments, not
6 necessarily this particular one that we are faced with,
7 but in these amendments in general, what he is proposing
8 is trying to correct some of the silliness which the
9 Energy Committee put forth for reasons which are unclear
10 to me.

11 I was, therefore, very glad to vote against the
12 Energy Committee bill, that we are not just talking about
13 a budget-neutral situation. In my judgment, and as I have
14 said many, many times and represent a state that is
15 deficient in terms of government services, particularly
16 after the last ten or eleven years, starting in the last
17 Carter year, actually, a state which had just been savaged
18 microeconomically, macroeconomically, dynamically,
19 statically, however you phrase it, and I am unable to
20 separate my representation to my state in the Senate to
21 this particular set of amendments, as well as final
22 disposition on the Floor should not have happened.

23 I do make it clear that I voted against the Energy
24 Committee bill, very, very strongly and very, very easily.
25 I understand that some of the amendments that are

1 forthcoming today are to make that more of a balance, is
2 for more parity. I understand that, but I would like to
3 have a philosophical predicate at least placed on the
4 table by this particular Senator from a state that is not
5 wealthy.

6 Chairman Bentsen. I tell you what my plans are here,
7 because I know we have votes. I would like to vote on the
8 Chairman has mark, and then we would have a vote on
9 Senator Moynihan's and if anyone else has something they
10 want to vote on. But I understand Senator Heinz wanted to
11 make a comment?

12 Senator Heinz. Mr. Chairman, I have a comment and a
13 question. First, I think we all recognize that we are
14 engaged in a delicate exercise, trying to create a level
15 playing field, which I guess assumes that the playing
16 level is pretty level between the various contingent
17 parties in Puerto Rico to begin with.

18 Whether that is true or not, I think everybody is
19 trying to do a good job of being equitable. I don't know
20 that all of us have heard, however, from the contending
21 parties, and that doesn't mean we shouldn't finish our
22 work, but I hope that we will have the opportunity to hear
23 before we go to the Floor, whether or not we have
24 succeeded in our goal.

25 I do have a question, though, related to our revenue

1 estimates for 936. On Table 1 of the Statehood option,
2 option, we hope to realize a considerable amount of money
3 by phasing out Section 936, \$3.6, billion between 1992 and
4 1995.

5 Those savings will be realized if the companies are
6 there to be taxed. I have a CBO study that I assume is
7 available to everybody that looked at a slightly different
8 option and looked at a ten-year phase-out of 936 as
9 opposed to the five-year
10 phase-out of 936.

11 But they have concluded that at the end of the
12 phase-out period, there would be a loss of between 46 and
13 47 percent of the capital and production of Section 936
14 corporations at the end of the phase-out period.

15 Now, if that is directionally correct, as opposed to
16 arithmetic perfection, it would suggest that there are
17 going to be
18 companies leaving, going out of business, taking actions
19 to minimize taxes and to reduce our revenues and, perhaps,
20 employment in Puerto Rico.

21 My question to the staff, whether it is to
22 Mr. Gideon,

23 I don't know, or the Committee staff is: What weight
24 has been given in our estimates to these projections?

25 Mr. Perlman. Senator, let me comment on the number

1 you have in front of you. The number you have in front of
2 you was prepared by the Joint Revenue Committee. Let me
3 indicates that it does assume a behavioral response. It
4 does assume there will be some decline in economic
5 activity.

6 Senator Heinz. How much?

7 Mr. Perlman. Our estimate is that with the full
8 elimination of 936, that is, after the phase-in, that
9 there will be approximately a 20 percent decline in
10 economic activity in Puerto Rico, and that is based on an
11 economic model that we have been working with for some
12 time.

13 Let me also say --

14 Senator Heinz. Is that the one that projected tax
15 receipts for this year?

16 Mr. Perlman. We don't project tax receipts for this
17 year, Senator.

18 Senator Heinz. In the United States?

19 Mr. Perlman. To my understanding, CBO does not
20 estimate the 936 effects. They have not estimated revenue
21 receipts of the appeal of that.

22 Senator Heinz. No, they have estimated an economic
23 effect, that is correct.

24 Mr. Perlman. I think I can say to you that, yes, the
25 estimate does take into effect, and as you know and we all

1 know, the estimate could be wrong; the projection could be
2 wrong, but clearly, the reduced economic activity in
3 Puerto Rico has been taken into account in making this
4 estimate.

5 Mr. Chairman, perhaps it. Would be worth asking
6 Joint Tax to make one or more estimates at a higher level
7 of reduced economic activity so we can see how sensitive
8 those numbers are, let us say, at a 30 percent or 40
9 percent loss, which is what CBO suggested at the end of a
10 phase-out period.

11 Mr. Gideon. I think you need to take into account in
12 estimating the revenue gain of eliminating 936 not just
13 estimating the effect on Puerto Rico, but where that
14 activity goes. In other words, if companies go to the
15 United States and become fully taxable, we get a revenue
16 gain there, as well.

17 We have numbers, by the way, that are quite similar
18 to the Joint Committee, and we show slightly higher
19 revenue from the phase-out.

20 Senator Heinz. Obviously, where a company goes is
21 important, but it is also important to analyze that at
22 reduced levels of economic activity for Puerto Rico's
23 sake, as well as for revenue's sake.

24 Mr. Chairman, one last quick question, which is on
25 page 4, table 3, where there are estimates of the

1 increased Section 936 active income realized by changing
2 the percentages. Do we know how many companies will be
3 affected by that?

4 Mr. Perlman. Just a minute, sir.

5 No, we cannot give you an estimate of the number of
6 companies affected. This is an estimate; we only have
7 information on aggregate activity. We can tell you that
8 we think approximately 15 percent of this activity is
9 related to QIPSI; that is, the exemption and the
10 reinvestment of earnings in Puerto Rico.

11 We cannot tell you on a number of companies basis how
12 many companeis will be affected.

13 Senator Heinz. Mr. Chairman, thank you.

14 Chairman Bentsen. Yes, would someone move the
15 Chairman has mark?

16 Senator Moynihan. I move the Chairman has mark.

17 Chairman Bentsen. All in favor indicate by saying
18 "aye".

19 (A chorus of ayes.)

20 Chairman Bentsen. Opposed?

21 (No response.)

22 Chairman Bentsen. Carried.

23 Senator Moynihan, you had an amendment you wanted to
24 discuss?

25 Senator Moynihan. We are typing it up at this moment

1 and will have it in a second. I can describe the
2 amendment in very simple detail; that the Statehood will
3 proceed as follows: The Statehood will take place fully
4 on January 1, 1996, which there will have been a four-year
5 phase-out of the 936 provisions so that there will be 100
6 percent: Twenty-five percent in 1992; 25 percent in 1993;
7 25 percent in 1994; 25 percent in 1994 and then zero in
8 1996.

9 However, it is also further provided that the Supreme
10 Court will be requested to make an expedited review on the
11 question of whether the Uniformity Clause would prohibit
12 this phase-out.

13 If the court decides that no, this is entirely
14 Constitutional, then Statehood, representation, will begin
15 on January 1, 1993. If the court fails to hear the case,
16 that would be the equivalent of a negative ruling.

17 If they say, "We cannot do it," then we go back to
18 our January 1, 1992 date.

19 Senator Danforth. Mr. Chairman, I think that this
20 amendment is a very serious mistake. I don't think the
21 issue before us should be one of Constitutionality. I
22 think the question is one of public policy. Whether the
23 Supreme Court rules that the Uniformity Clause is violated
24 or not is a legal question.

25 The question of public policy is: Should one state

1 be allowed to proceed for any length of time with a tax
2 benefit that is peculiar to that state? I think that if
3 we establish that precedent that a state can receive
4 beneficial special tax treatment then it is going to be a
5 constant battle in Congress, seeding the kind of
6 provincialism exists on many tax matters, to bring home
7 special bacon for particular states because of particular
8 economic consequences that exist.

9 I think that this would open the door to something
10 that would create vulcanization of tax policy and that it
11 would be a very, very serious mistake.

12 Chairman Bentsen. Are there further comments?

13 Senator Packwood. Mr. Chairman, before we vote, I
14 request the statement of Senator Durenberger to be placed
15 in the record.

16 (The prepared statement of Senator Durenberger
17 follows:)

18

19

20

21

22

23

24

25

Dave Durenberger
2-1-90

STATEMENT OF SENATOR DAVE DURENBERGER

Mr. Chairman, I just want to say that I think you have done the best job you possibly could have in crafting a package that is both balanced and fair. Unlike the legislation reported from the Energy Committee, this package tilts neither in favor of statehood nor commonwealth. Instead, it presents the citizens of Puerto Rico with a balanced choice.

Mr. Chairman, I know that there are many officials in Puerto Rico who object to the idea of a delayed entry into the union in the event that the citizens of Puerto Rico opt in favor of statehood. Yet, I think it would be short-sighted and ill-advised if we adopted the proposal to immediately terminate the tax benefits associated with Section 936 as the price of instant admission into the union.

For better or worse, the economy of Puerto Rico is heavily dependent on the 936-subsidized investments of American corporations. An overnight elimination of 936 could precipitate an economic catastrophe in Puerto Rico that would only exacerbate economic instability in the island's fragile economy. Your approach is consistent with the approach taken by the Energy Committee in recognizing that if Section 936 benefits must be ended, they should not be eliminated "cold turkey," but need to be phased out incrementally over several years.

Moreover, Mr. Chairman, I believe that you should be commended for taking a fiscally sound and responsible approach in attempting to make this legislation revenue neutral during the phase-in period. While I recognize that electoral representation

in the Congress of the United States is a wonderful ideal, a goal that is to be cherished, we cannot ignore the economic realities that inevitably would result if Puerto Rico becomes the 51st State.

If and when Puerto Rico is admitted into the union, it would become the poorest State in the union, by far. It's per capita income is currently less than half that of the poorest state (Mississippi). Transfer payments to individuals, including pension and welfare and social security entitlements, comprise 21 percent of Puerto Rico's personal income. In the States, similar transfers to individuals are about 13.7 percent. And the General Accounting Office estimates that if the citizens of Puerto Rico become subject to federal income taxation, about 43 percent would have zero tax liability.

Mr. Chairman, the economics of becoming the 51st state are clear. Federal transfer payments, medicaid and welfare spending will clearly have to rise to meet the economic needs of the citizens of Puerto Rico. The statehood supporters clearly are aware of these economic facts of life and will use these economic enhancements as a reason to encourage citizens of Puerto Rico to opt for statehood.

At a time when our fiscal house is in serious disorder, when the real budget deficit, not counting the Social Security surplus and factoring in the costs of the S&L bailout, is more than \$300 billion, it would be irresponsible for us to ignore the economic costs of admitting Puerto Rico as the 51st state. That is why I commend you, Mr. Chairman, for coming forward with a

balanced and fiscally responsible package on which the citizens of Puerto Rico can make a fair judgment.

Mr. Chairman, I do not believe that the citizens of Puerto Rico will be voting on Statehood or Commonwealth solely based on deep-seated convictions about Jeffersonian democracy. Like the citizens of Latvia, Poland, Czechoslovakia and all of Eastern Europe who voted to overturn the old regimes, economics-- especially the failure of their economies--was as much the driving force in their choice as their belief in the ideals of representative democracy. Let us then be realists about the economic realities that will be serve as the political lightning rod in the upcoming referendum. And let us also realize the economic costs to all of the 50 states that will result if and when Puerto Rico is admitted to the union.

Finally, Mr. Chairman, I want to express my serious reservations about the self-executing nature of the legislation that has been crafted by the Energy Committee. I know that this is not a matter that is within the jurisdiction of this Committee, but I believe that when this bill reaches the floor we should seriously consider amending the bill so as to take a two-step approach to the issue of statehood.

1 Chairman Bentsen. Mr. Perlman, did you have
2 something to say?

3 Mr. Perlman. Mr. Chairman, before we vote, we just
4 need to get the effective date of Senator Moynihan's
5 amendment clarified.

6 Senator, it would be consistent with the Chairman has
7 mark? Can we assume your amendment says that the
8 effective date, if the Supreme Court were to hold that
9 there is not a constitutional problem, would be January 1
10 of the first calendar year beginning after certification
11 of the referendum?

12 The reason I say that is, if you fix a certain date,
13 and if the --

14 Senator Moynihan. It should be that, should it not?
15 Yes. Yes. It should be that.

16 Mr. Perlman. Thank you.

17 Chairman Bentsen. Are there further comments?

18 Senator Bradley. Mr. Chairman?

19 Chairman Bentsen. Yes.

20 Senator Bradley. If I could respond to Senator
21 Danforth, I think that this is a very specific and narrow
22 case, where tax benefits now flow to essentially a
23 Commonwealth that seeks, perhaps, to change its status,
24 and we cannot ignore the existence of those tax benefits,
25 I believe, in our ultimate decision.

1 So I would think that Senator Moynihan's approach is
2 a prudent approach.

3 Chairman Bentsen. Are there further comments?

4 Senator Chafee. Mr. President?

5 Chairman Bentsen. Senator Chafee?

6 Senator Chafee. Mr. Chairman, I find this is a
7 strange amendment. What we are going to do is, what the
8 situation is going to be in Puerto Rico, is people will be
9 campaigning and not even know what they are campaigning
10 for; those who will foresake campaigning for Statehood in
11 1993 perhaps, or perhaps in 1996, depending on how the
12 Supreme Court decides matters.

13 I think the proposal, if we want to continue the 936,
14 fine, go ahead and have the effective date of the
15 Statehood, if, indeed, they should vote for Statehood, and
16 they should know in advance what they are voting for and
17 when they are voting for it, to be January 1st, 1996.

18 I think this is kind of a Ruth Goldberg proposal.
19 What if the Supreme Court says, "Well, the Uniformity
20 Clause doesn't does apply here except if certain
21 modifications are made."

22 Then where are we?

23 I just think we ought to have some Department on this
24 in a serious matter on voting on this.

25 Chairman Bentsen. That Senator Pryor?

1 Senator Pryor. Mr. Chairman, if I could, not on the
2 Moynihan amendment, but I do have an amendment that I
3 would like to discuss immediately thereafter.

4 Chairman Bentsen. All right. Are there further
5 comments? Senator Moynihan, are you prepared to vote?

6 Senator Moynihan. I am prepared to vote. As I say,
7 Mr. Chairman, to my friend from Rhode Island, the purpose
8 of this amendment is to address, what seems to be
9 legitimate concern of Statehood advocates, if they would
10 be asking persons to vote for a Statehood far in the
11 distance. They do know, if Statehood is approval, that it
12 will come on a date certain, January 1, 1991, but it could
13 come earlier.

14 In the meantime, they do know there will be a
15 transitional on 936.

16 Chairman Bentsen. Mr. Gideon, does the
17 Administration have a comment on the amendment?

18 Mr. Gideon. We have consistently preferred the
19 Statehood date because of the views the Justice Department
20 expressed that the transition would be constitutional.

21 I will say, however, that we find Senator Moynihan's
22 approach acceptable, assuming that we can't get what we
23 would have preferred.

24 Chairman Bentsen. Okay. Is there a motion made on
25 the amendment?

1 Senator Bradley. I move it.

2 Chairman Bentsen. So moved.

3 All in favor of the amendment --

4 Senator Chafee. May we have a roll call vote,

5 Mr. Chairman?

6 Chairman Bentsen. Yes. Of course, a roll call will

7 be made, and the question occurs on the amendment made.

8 The Clerk. Mr. Moynihan?

9 Senator Moynihan. Aye.

10 The Clerk. Mr. Baucus?

11 Chairman Bentsen. Baucus by proxy, no.

12 The Clerk. Mr. Boren?

13 Chairman Bentsen. Mr. Boren by proxy, aye.

14 The Clerk. Mr. Bradley?

15 Senator Bradley. Aye.

16 The Clerk. Mr. Mitchell?

17 Chairman Bentsen. Mr. Mitchell by proxy, aye.

18 The Clerk. Mr. Pryor?

19 Senator Pryor. No.

20 The Clerk. Mr. Reigle?

21 Chairman Bentsen. Proxy, no.

22 The Clerk. Mr. Rockefeller?

23 Senator Rockefeller. No.

24 The Clerk. Mr. Daschle?

25 Senator Daschle. No.

1 The Clerk. Mr. Breaux?

2 Senator Breaux. No.

3 The Clerk. Mr. Packwood?

4 Senator Packwood. No.

5 The Clerk. Mr. Dole?

6 Senator Packwood. No.

7 The Clerk. Mr. Roth?

8 Senator Packwood. No.

9 The Clerk. Mr. Danforth?

10 Senator Danforth. No.

11 The Clerk. Mr. Chafee?

12 Senator Chafee. No.

13 The Clerk. Mr. Heinz?

14 Senator Heinz. No.

15 The Clerk. Mr. Durenberger?

16 Senator Packwood. No.

17 The Clerk. Mr. Armstrong?

18 Senator Armstrong. No.

19 The Clerk. Mr. Symms?

20 Senator Armstrong. No by proxy.

21 The Clerk. Mr. Chairman?

22 Chairman Bentsen. Aye. The votes are five in favor,
23 15, opposed.

24 Senator Moynihan. Mr. Chairman, I knew I was in
25 trouble when the Administration started agreeing with me.

1 (Laughter.)

2 Chairman Bentsen. Just an old friend. The Chairman
3 voted with you.

4 Chairman Bentsen. Senator Pryor?

5 Senator Pryor. Mr. Chairman, I would like to make
6 this very brief. If I could pose two very quick questions
7 to Mr. Richter, and this is only about 936. I have been
8 trying to figure 936 out for a long time.

9 Let me ask this question: If there there is a
10 company hiring 100 employees in Puerto Rico that has shown
11 profits, am I correct in saying it would not benefit in
12 936 as the program is now implemented; is this correct?

13 Mr. Richter. If taxable income is zero, which is
14 very close to profits, obviously, if that is zero, the
15 answer is yes.

16 Senator Pryor. If a company has one employee, one
17 employee in Puerto Rico that stays there, but now has \$1
18 million in profits, what would be their tax credit?

19 Mr. Richter. Thirty-four percent of \$1 million
20 dollars of taxable income; that is, \$340,000 worth of tax
21 credit.

22 Senator Pryor. So there would be, for one employee,
23 a \$340,000 tax credit?

24 Mr. Richter. Yes.

25 Senator Pryor. Mr. Chairman, I have an amendment

1 that I have been working on, and I have worked very
2 carefully with some of the members of our staff and
3 others. I am not going to offer it now, but I will at a
4 later date. We have a situation with 936 that has evolved
5 into a profit- or an income-based tax credit. I am going
6 to attempt to replace this with a wage credit of wages
7 paid. I think that is a much fairer approach.

8 We have, for example, according to the March 1989
9 U. S. Department of the Treasury report, we have, for
10 example, pharmaceutical firms going up, setting up
11 operations to transfer pharmaceuticals in Puerto Rico, and
12 I was troubled at this figure. They are getting a \$57,761
13 tax credit per employee. Every time they hire someone,
14 they get a \$57,000 or, say, \$58,000 tax credit.

15 According to the final table, the tax benefit as a
16 percentage of employee compensation is 264 percent. Now,
17 I don't see any equity in this, Mr. Chairman. I know that
18 936 had an original purpose, and that purpose was to
19 create opportunities and jobs there, but I truly think it
20 has become a tax dodge for some of the wealthier, more
21 profitable corporations of our country, especially with
22 the pharmaceutical manufacturers, and at the proper time,
23 not today, I will offer an amendment to substitute the
24 profit-based credit for an income-based credit, and I hope
25 that my colleagues will begin thinking with me along this

1 line.

2 Senator Packwood. Could I ask you a question?

3 Wasn't this the approach the Administration was suggesting
4 that Treasury wanted during tax reform?

5 Mr. Gideon. It certainly was the approach suggested
6 in the prior Administration.

7 (Laughter.)

8 Mr. Gideon. The EOR.

9 Chairman Bentsen. With that, I will entertain a
10 motion to report out the bill.

11 Senator Packwood. So moved.

12 Chairman Bentsen. All right. The motion is made and
13 seconded. All in favor indicate it by saying aye.

14 (A chorus of ayes.)

15 Chairman Bentsen. All opposed?

16 (No response.)

17 Mr. Sessions: Could we have discretionary normal
18 drafting authority for staff?

19 Chairman Bentsen. Oh, yes. Without objection, that
20 will be done. Thank you very much. We will stand
21 adjourned.

22 (Whereupon, at 11:35 a.m., the Committee was
23 recessed, subject to the call of the chair.)

24

25

C E R T I F I C A T E

1
2 This is to certify that the foregoing proceedings of
3 an Executive Committee Meeting of the United States Senate
4 Finance Committee, held on Friday, January 27, 1989, were
5 transcribed as herein appears and that this is the
6 original transcript thereof.
7

8
9 

10 LuAnne Dawson
11 Official Court Reporter

12 My commission expires November 30, 1990.
13
14
15
16
17
18
19
20
21
22
23
24
25

UNITED STATES SENATE
COMMITTEE ON FINANCE

Executive Session

Wednesday, August 1, 1990 - 10:00 AM
SD-215 Dirksen Senate Office Building

A G E N D A

S. 712, Puerto Rico Status Referendum Act

Joint Committee on Taxation
August 1, 1990
JCX-22-90

PRESENT-LAW TAX RULES AND PROPOSED COMMITTEE AMENDMENT
UNDER S. 712,
PUERTO RICO STATUS REFERENDUM ACT¹

(Markup Consideration by Senate Committee on Finance
on August 1, 1990)

A. Present-Law Tax Rules

Taxation of individuals

U.S. residents and citizens in general

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. All U.S. citizens and residents whose gross income for a taxable year is not less than the sum of the personal exemption amount and the basic standard deduction are required to file an annual U.S. individual income tax return.

Nonresident alien individuals are subject to U.S. tax, at ordinary rates, on their net income effectively connected with the conduct of a trade or business in the United States. Such individuals are also subject to a tax (at different rates computed on the basis of gross income) on certain other types of U.S. source income. Generally, Puerto Rico is not included within the United States for purposes of the Internal Revenue Code.

Treatment of foreign source income

In general, U.S. persons (e.g., U.S. residents and U.S.

¹ S. 712 was reported by the Senate Committee on Energy and Natural Resources on September 6, 1989 (S. Rept. No. 101-120, 101st Cong., 1st Sess.). S. 712 was jointly referred to the Senate Committees on Finance and on Agriculture, Nutrition, and Forestry. The Senate Committee on Finance held hearings on the bill on November 14-15, 1989 and April 26, 1990. (For a more detailed description of present-law tax rules, S. 712 as reported by the Senate Committee on Energy and Natural Resources, and related issues, see Joint Committee on Taxation, Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence, and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act) (JCS-19-89), November 14, 1989.)

citizens no matter where they reside) are taxed on all their income whether from U.S. or foreign sources. A credit, with limitations, may be claimed for foreign income taxes paid or accrued, or alternatively foreign taxes may be treated as a deduction. For purposes of the Code, Puerto Rico generally is treated as a foreign country, with significant exceptions discussed below.

Code section 911 provides that a U.S. citizen or resident with a tax home abroad may under certain circumstances elect to exclude an amount of foreign earned income from gross income. The maximum exclusion generally is limited to \$70,000 per year plus certain housing costs. No deductions, exclusions, or credits are allowed for amounts allocable to this excluded income.

Taxation of U.S. persons residing in Puerto Rico

Under the Jones Act, Puerto Rico is deemed to be a part of the United States for purposes of acquiring U.S. citizenship by place of birth. Thus, a person born in Puerto Rico is typically a U.S. person for U.S. tax purposes. However, section 933 of the Code provides that income derived from sources within Puerto Rico by an individual who is a resident of Puerto Rico generally will be excluded from gross income and exempt from U.S. taxation, even if such resident is a U.S. citizen. Such income generally will be subject to taxation by Puerto Rico. Items of income earned from sources outside of Puerto Rico by U.S. persons who reside in Puerto Rico generally are subject to U.S. taxation.

Estate and gift tax

Under a special rule, a U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes only if citizenship was acquired solely by reason of citizenship of, or birth or residence within, the possession. Estate and gift transfers by residents of Puerto Rico that are exempt from Federal estate and gift taxation under these provisions (e.g., transfers of property not situated in the United States) generally are subject to estate and gift taxation in Puerto Rico. Estates of decedents qualifying under this rule are allowed a credit against the estate tax equal to the greater of \$13,000 or that proportion of \$46,800 which the value of that part of the decedent's gross estate which at the time of death was situated in the United States bears to the value of the entire gross estate wherever situated.

Taxation of corporations

Puerto Rico corporations

A corporation organized under the laws of Puerto Rico is

a foreign corporation and is subject only to those U.S. taxes imposed on foreign corporations in general. However, Puerto Rico corporations generally are subject to income taxes in Puerto Rico. Currently, the minimum rate is 22 percent, and the highest marginal rate for 1990 is 39 percent, for 1991 is 37 percent, and for 1992 and beyond is 35 percent.

U.S. corporations--in general

U.S. corporations are subject to U.S. income tax on their worldwide income. Foreign income taxes paid or accrued are creditable, with limitations, against U.S. tax liability or alternatively may be deducted in calculating taxable income. Special rules apply to income derived in U.S. possessions by certain domestic corporations.

Possession tax credit (section 936)

Under present law, certain domestic corporations with business operations in U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect under Code section 936 to generally eliminate the U.S. tax (including the alternative minimum tax) on certain foreign source income which is related to their operations in the possessions. Currently, a majority of corporations that benefit from the possession tax credit have established operations in Puerto Rico. Income that is not subject to U.S. tax under this provision includes income that is derived either from the active conduct of a trade or business within a U.S. possession or from certain investments in the possessions or in certain Caribbean Basin countries, which investments generate qualified possession source investment income ("QPSII"). The section 936 credit spares the electing corporation U.S. tax whether or not it pays income tax to the possession.

In order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession over a three-year period, and at least 80 percent of the corporation's gross income must be derived from sources within a possession during that same period.

Three alternative methods are provided for allocating income from intangible property between a corporation electing section 936 treatment and its U.S. shareholders. These methods include (1) a general rule that prohibits an electing corporation from earning any return on intangible property, (2) a cost sharing method which requires an electing corporation to reimburse other members of its affiliated group of corporations for a portion of the current research and development expenses incurred by the group, and (3) a profit split approach which generally permits no more

than 50 percent of an affiliated group of U.S. corporations' combined taxable income derived from sales of products which are manufactured in a U.S. possession to be allocated to the electing corporation. For purposes of computing the cost sharing amount under the cost sharing method, an electing corporation's current share of the affiliated group's research and development expenses is the greater of the total amount of such expenses in the electing corporation's product area multiplied by 110 percent of the proportion of its sales as compared to total product area sales of the group, or the amount of the royalty payment or inclusion that would be required under sections 367(d) and 482 with respect to intangible assets which the electing corporation is treated as owning under the cost sharing method, were the electing corporation a foreign corporation.

Dividends paid by a corporation that has elected section 936 treatment to its U.S. shareholder may qualify for the deduction for dividends received from a domestic corporation (sec. 243). In cases where at least 80 percent of the stock of the electing corporation is owned by a single domestic corporation, the electing corporation's possession source income generally can be distributed without incurring any regular U.S. income tax. However, such a dividend constitutes adjusted current earnings of the shareholder for purposes of computing the alternative minimum tax.

U.S. taxation of Puerto Rico obligations

Section 103 of the Code provides that the interest on a bond issued by the Commonwealth of Puerto Rico or its municipalities generally is exempt from U.S. income tax in the same manner as interest on a bond issued by a State. The exemption does not apply to any bond that is a non-qualified private activity bond (within the meaning of section 141).

Low-income housing credit

A low-income housing credit is allowed against U.S. income tax liability. The credit is allowed in annual installments over 10 years to the owners of qualified low-income rental housing, including housing located in a U.S. possession. In addition to maintaining prescribed percentages of low-income units and satisfying other requirements, the building owners must receive a credit allocation from the appropriate credit authority (such as a State or Puerto Rico), except in the case of housing projects financed with tax-exempt bonds. In general, the authority of housing credit agencies to allocate low income housing credits expires December 31, 1990.

Excise taxes

U.S. Excise taxes on Puerto Rican goods imported

into the United States

U.S. excise taxes generally do not apply within Puerto Rico. However, U.S. excise taxes equal to the taxes on domestically produced articles are imposed on articles brought into the United States from Puerto Rico.

Cover overs of excise taxes on Puerto Rican products

Revenues collected from the tax on certain articles coming into the United States from Puerto Rico generally are "covered over" (i.e., paid) to the Puerto Rican Treasury. With respect to otherwise eligible excise taxes imposed on articles not containing distilled spirits, revenues are covered over to Puerto Rico only if the cost or value of materials produced in Puerto Rico plus the direct costs of processing operations performed in Puerto Rico equal at least 50 percent of the value of the article at the time it is brought into the United States (sec. 7652(d)(1)). Moreover, no cover over is permitted on such articles if Puerto Rico provides a direct or indirect subsidy with respect to the article which is unlike the subsidies which Puerto Rico generally offers to industries producing articles not subject to Federal excise tax (sec. 7652(d)(2)).

With respect to Federal excise taxes imposed on articles containing distilled spirits that are manufactured in Puerto Rico and shipped into the United States, revenues are covered over to the Puerto Rican Treasury only if at least 92 percent of the alcoholic content of such articles is attributable to rum (sec. 7652(c)). The amount of excise taxes covered over to Puerto Rico from such articles cannot exceed \$10.50 per proof gallon (sec. 7652(f)).

A special excise tax rule also applies when articles manufactured in the United States are shipped to Puerto Rico (sec. 7653). In such cases, the articles are exempt from Federal excise taxes and, upon being entered in Puerto Rico, are subject to a tax equal in rate and amount to the excise tax imposed in Puerto Rico upon similar articles of Puerto Rican manufacture.

Cover overs of excise taxes on rum imported from other countries

A provision of the Code added by the Caribbean Basin Economic Recovery Act (Caribbean Basin Initiative) provides a special rule for excise taxes collected on rum imported into the United States from any country. Such excise taxes are covered over to the treasuries of Puerto Rico and the Virgin Islands, under a formula prescribed by the U.S. Treasury Department for the division of such tax collections between Puerto Rico and the Virgin Islands (sec. 7652(e)). This formula currently results in approximately 88 percent of

revenues from rum excise taxes being covered over to Puerto Rico and the remainder of such revenues being covered over to the Virgin Islands.

Tax treaties

There are no bilateral tax treaties between Puerto Rico and any foreign country. In addition, U.S. treaties typically do not include Puerto Rico in the definition of "United States" for treaty purposes. Moreover, although Puerto Rican individuals are typically U.S. citizens, U.S. treaties often do not extend to them the same reductions of foreign source country tax to which a resident of one of the 50 States or the District of Columbia would be entitled under a U.S. tax treaty.

B. Description of S. 712 and Explanation of Amendment

1. In general

The bill (S. 712), as reported by the Senate Committee on Energy and Natural Resources, provides for a referendum to be held on June 4, 1991 (and if necessary for a runoff referendum to be held on August 6, 1991), or on a date (or dates) during the summer of 1991 as may be mutually agreed by the three principal political parties of Puerto Rico. The purpose of the referendum will be to determine whether Puerto Rico is to become a U.S. State, become an independent country, or remain in a commonwealth relationship with the United States. The procedures for implementing whichever status option receives a majority (as certified to the President and the Congress of the United States by the Governor of Puerto Rico) are detailed in titles II (which applies if statehood is chosen), III (independence), and IV (commonwealth) of the bill.

The proposed Committee amendment ("the amendment") replaces those provisions of the bill that are within the jurisdiction of the Finance Committee. In addition, where a bill provision relates to matters both within and without the Finance Committee's jurisdiction, the amendment provides modifications with respect to matters within the Finance Committee's jurisdiction. This markup document describes those bill provisions that are modified but not deleted, and describes all provisions of the Finance Committee amendment.

It is expected that the Chairman of the Finance Committee will offer an amendment to the bill on the Senate floor to accommodate action by the Senate Committee on Agriculture, Nutrition, and Forestry with respect to the Food Stamps Program, to the extent consistent with the approach adopted by the Finance Committee.

2. Title II (Statehood)

Description of the bill

Should statehood be certified as having obtained a majority of the votes cast in the referendum, the Commonwealth of Puerto Rico would be admitted as a State on an equal footing with the other States (bill sec. 201). Upon admission of Puerto Rico into the Union, all of the local laws then in force in Puerto Rico would continue in force and effect (except as modified or changed by the bill) subject to repeal or amendment by the Puerto Rican legislature (bill sec. 208(a)).

Explanation of Amendment

In general

Under the amendment, the date on which Puerto Rico would be admitted as a State would be changed to the first day of January of the fifth calendar year beginning after the certification of the referendum in favor of statehood. Thus, for example, if such certification occurred during 1991, Puerto Rico would become a State as of January 1, 1996. In conformity with this provision of the amendment, the date on which the persons elected to represent Puerto Rico as U.S. Senators and members of the U.S. House of Representatives would be entitled to seats in Congress and to all the rights and privileges of Senators and Representatives of the other States in Congress would be changed to the date on which Puerto Rico's admission as a State becomes effective.

Application of U.S. tax laws to Puerto Rico

The amendment would provide for a transition period, ending on admission of Puerto Rico to statehood, immediately following which the Federal internal revenue laws not presently applicable to Puerto Rico would be fully applicable to Puerto Rico. The effect of these laws generally would be phased in ratably during the transition periods set forth below.

Excise taxes.--In the case of excise taxes, the transition period would commence with the second calendar year beginning after the certification of the referendum. Thus, excise taxes would be imposed on articles sold on or after the first day of that year. With respect to the imposition of U.S. excise taxes on goods consumed in Puerto Rico, a special rule would apply for goods which are manufactured in or imported into Puerto Rico before the first day of the second calendar year beginning after certification of the referendum, and which are held on such date for sale by any person beyond the point tax generally would have been imposed (i.e., applicable floor stocks taxes).

Income and employment taxes.--In the case of income and

employment taxes, the transition period would commence with a taxpayer's second taxable year beginning after the certification of the referendum.

Estate and gift taxes.--In the case of estate and gift taxes, there would be no transition period under the amendment. Thus, estate and gift taxes would be imposed with respect to decedents dying on or after, or for gifts made on or after, the first day of January of the fifth calendar year beginning after the certification of the referendum.

If, for example, the certification of the referendum in favor of statehood occurs on October 31, 1991, the imposition of Federal excise taxes on goods consumed in Puerto Rico would begin as of January 1, 1993. The imposition of Federal income taxes in this case would commence with a taxpayer's second taxable year that begins after October 31, 1991; thus, in the case of a corporation with a taxable year that begins on November 1, these taxes would first be imposed with respect to its taxable year beginning November 1, 1992. The U.S. estate and gift taxes in this case would apply to decedents dying, or for gifts made, on or after January 1, 1996. This provision of the amendment would be applicable, for example, to the U.S. individual income tax and the U.S. estate and gift taxes on individuals resident in Puerto Rico, to the U.S. corporate income tax on companies organized under the laws of Puerto Rico, and to the U.S. excise taxes on goods consumed in Puerto Rico.

Transition periods

In general.--The phase-in of the Federal internal revenue laws generally would be implemented as follows: During the first year that a tax would apply (under the rules as described above), Puerto Rico and its residents would be treated no differently than the United States and its residents to the extent of 25 percent of full U.S. tax liability on income not currently taxed by the United States. (For example, assume a U.S. resident earning \$100 of U.S. wages would pay \$28 of U.S. tax. Under the amendment, a Puerto Rico resident with the same Puerto Rico wages would pay \$7 of U.S. tax under this rule.) The amendment does not otherwise affect the tax treatment of Puerto Rico persons or Puerto Rico source income; for example, it does not otherwise affect items such as income of a Puerto Rico resident from sources outside Puerto Rico, or income of a U.S. resident from sources within Puerto Rico.

Generally, the percentage referred to above would be increased to 50 percent for the second year of the transition period, to 75 percent for the third year of the transition period, and to 100 percent for the fourth year of the transition period and thereafter.

A special rule applies in the case of income tax, however, if some portion of the third taxable year of the transition period falls after statehood becomes effective. Under this special rule, a pro-rata portion of income from that year is subject to 100-percent taxation under the Internal Revenue Code. Thus, for a fiscal year taxpayer with a taxable year ending June 30, one-half of the income from the third year of the transition period would be subject to full Federal income tax if that year ended after statehood became effective. This special rule would only affect taxpayers whose taxable years end between January 1 and the day of the year on which certification of the referendum results occurs.

Similar phase-in rules would apply during the transition period to refundable tax credits, such as the earned income tax credit.

Section 936.--The amendment would provide for a similar transition period for the phase-out of the possession tax credit as it applies to section 936 corporations with operations in Puerto Rico. Under this provision of the amendment, the section 936 credit generally would be phased out ratably over a four-year period commencing in the section 936 corporation's second taxable year that begins after the certification of the results of the referendum. That is, the amount of the section 936 credit available with respect to income or investments from activity in Puerto Rico would be reduced to 75 percent of the amount of the credit available under present law for a section 936 company's second taxable year beginning after such certification. The applicable percentage would be 50 percent for the third taxable year, and generally 25 percent for the fourth taxable year beginning after such date. Commencing with the fifth taxable year beginning after certification of the referendum, the section 936 credit would no longer be available with respect to such income or investments.

A special rule would apply, however, if some portion of the taxpayer's fourth taxable year beginning after certification of the referendum falls after statehood becomes effective. Under this special rule, the section 936 credit would not be available with respect to a pro-rata portion of income attributable to operations in Puerto Rico for such a year. Thus, for a fiscal year taxpayer with a taxable year ending June 30, one-half of the income from the fourth taxable year beginning after certification of the referendum would not qualify for any section 936 credit, if that year ended after statehood became effective. This special rule would only affect taxpayers whose taxable years end between January 1 and the day of the year on which certification of the referendum results occurs.

The section 936 credit would be available only to

corporations that are entitled to section 936 benefits for the taxable year that includes the date of certification of the referendum. Moreover, the amount of allowable section 936 credits (before reduction by the applicable phase-out percentage) would be limited to 130 percent of the average amount of section 936 credits taken by the taxpayer in the three most recent taxable years ending prior to August 1, 1990 (or such shorter period for which credits were taken in the case of a taxpayer that did not exist or did not take section 936 credits during those three years).

Cover overs of taxes

The amendment would provide that the present cover over of excise taxes and customs duties by the United States Treasury to Puerto Rico would continue during years prior to Puerto Rico's admittance as a State. The amendment would further provide that during the transition period for imposition of the U.S. income and excise taxes, any newly imposed income or excise taxes would be covered over to Puerto Rico. Moreover, a portion of the revenues generated during the transition period from the phase out of section 936 may be covered over to Puerto Rico. The portion so covered over for any year during the transition period would be an amount (if any) necessary to make the provisions of the bill related to statehood revenue neutral to the U.S. Treasury for that year.²

Other rules

In order to implement the various phase-ins and phase-outs described above, the amendment provides certain special rules.

Treatment of Puerto Rico as a State for tax purposes

The amendment provides that beginning in the year during which application of the Federal tax laws are extended to Puerto Rico, Puerto Rico generally would be considered a State for purposes of the Internal Revenue Code to the extent of the phase-in. Thus, for example, corporations incorporated under the laws of Puerto Rico would be considered U.S. corporations and would be subject to U.S. tax (at the appropriate phase-in level) on their worldwide

² It is anticipated that, prior to any cover over of revenues generated during the transition period from the phase out of section 936, the revenues would first be utilized for the purpose of funding any expansion of the Food Stamps program in Puerto Rico which may result from amendments to S. 712 by the Committee on Agriculture, Nutrition, and Forestry.

income. If, however, the stock of a Puerto Rico corporation were owned by a U.S. person or persons, the portion of the earnings of the corporation not subject to U.S. tax because of the phase-in rules would continue to be subject to the various anti-deferral statutes of the Code such as the subpart F income rules, the foreign personal holding company rules, or the passive foreign investment company rules.

Sourcing of income

Income earned from sources within Puerto Rico generally would be considered U.S. source income for purposes of the U.S. tax liability being phased in (except where necessary to properly implement the phase-out of the possession tax credit). This rule, for example, would cause income earned from sources within Puerto Rico by Puerto Rico residents or other non-U.S. residents to become subject to U.S. taxing jurisdiction (although the overall U.S. tax liability on such income would be limited by the phase-in rules).

Treatment of taxes paid to Puerto Rico

Taxes paid to Puerto Rico during the transition period would be treated as taxes paid to a State for purposes of the U.S. tax liability being phased in. Thus, no foreign tax credit would be allowed for such taxes in determining U.S. tax liability under the phase-in percentage. However, a deduction for the amount of such taxes generally would be permitted for that purpose to the extent provided under Code section 164.

Code section 933

For purposes of application of the U.S. individual income tax to a person resident in Puerto Rico, the amendment would repeal Code section 933, effective as of that person's second taxable year beginning after the certification of the referendum. As a result, such a person would be required to include income from sources within Puerto Rico in his or her U.S. individual income tax return. The tax on that income, however, would be limited pursuant to the phase-in rules.

Treatment of persons residing in Puerto Rico for U.S. estate and gift tax purposes

Additionally, the amendment would provide that the special rules contained in Code sections 2209 and 2501(c) (which treat certain U.S. citizens who reside in U.S. possessions as neither residents nor citizens of the United States for purposes of the estate and gift taxes) would be amended so that such treatment would not be granted to persons residing in Puerto Rico. This provision of the amendment would be effective for decedents dying after, or for gifts made after, the first day of the fifth calendar

year beginning after the certification of the results of the referendum.

Excise taxes on goods shipped between the United States and U.S. possessions

The amendment also would terminate application to Puerto Rico of the special rules of sections 5001, 5314, and 7653 of the Code, which pertain to the excise taxation of goods shipped between the United States and specified U.S. possessions. This provision of the amendment would be effective as of the first day of the second calendar year beginning after the certification of the results of the referendum.

Authority to develop other transitional rules

In addition to the special rules specified above, the amendment contains a provision that would permit Congress to explicitly reserve the authority to enact any appropriate transitional rules that would be necessary to properly implement the phase-in of the U.S. tax system in Puerto Rico and the phase-out of the section 936 tax credit. Moreover, the amendment would authorize Treasury to promulgate and implement such regulations as are necessary for this purpose.

3. Title III (Independence)

Description of the Bill

Should independence be certified as having obtained a majority of the votes cast in the referendum, Puerto Rico would convene a constitutional convention for the purpose of drafting a constitution for post-independence Puerto Rico (to be known as the "Republic of Puerto Rico") (bill sec. 301). Subsequent to the ratification of the resulting constitution by the people of Puerto Rico, and the election of such officers as may be provided for in such constitution, the President of the United States would by proclamation withdraw U.S. sovereignty over the territory and people of Puerto Rico, effective upon the issuance of a Proclamation of Independence by the Republic of Puerto Rico (bill sec. 307). Upon the issuance of such Proclamation of Independence, the Republic of Puerto Rico would become a sovereign country.

Upon the certification of the referendum in favor of independence, Puerto Rico would no longer be treated as part of the United States for purposes of acquiring U.S. citizenship by place of birth under the Jones Act and the Immigration and Nationality Act (bill sec. 311(b)). In addition, an individual born outside the United States would not acquire U.S. citizenship at birth if the parents of that individual acquired U.S. citizenship solely by virtue of being born in Puerto Rico prior to the Proclamation of

Independence pursuant to the provisions of the Jones Act and the Immigration and Nationality Act (bill sec. 311(c)).

Explanation of Amendment

General tax treatment

The amendment generally would treat the Republic of Puerto Rico as a foreign country and not as a part of the United States for all tax purposes, effective upon Proclamation of Independence, except as specifically provided. Accordingly, Puerto Rico generally would be excluded from tax treatment in the Code that currently pertains specifically to Puerto Rico or other U.S. possessions.

Phaseout of section 936

The amendment generally would permit the existing benefits of section 936 of the Code to Puerto Rico operations and investments to be phased out on a straight-line basis over a four-year period (beginning with the second taxable year that begins after the certification of the referendum in favor of independence). For example, if the referendum is certified in favor of independence during calendar year 1991, the amount of the tax credit allowed to a calendar-year taxpayer under section 936 would be reduced by 25 percent during 1993, by 50 percent during 1994, and by 75 percent during 1995, and would be eliminated entirely beginning in 1996.

Benefits described above would be available only to corporations that are entitled to section 936 benefits for the taxable year that includes the date of certification of the referendum. Moreover, the amount of allowable section 936 credits (before reduction by the applicable phaseout percentage) would be limited to 130 percent of the average amount of section 936 credits taken by the taxpayer in the three most recent taxable years ending prior to August 1, 1990 (or such shorter period for which credits were taken in the case of a taxpayer that did not exist or did not take section 936 credits during those three years).

Treatment of certain U.S. citizens resident in Puerto Rico

Under the amendment, an individual who is a bona fide resident of the Republic of Puerto Rico after independence would continue to be eligible, under certain circumstances, for the exclusion currently provided under section 933 of the Code for income from sources within Puerto Rico. The benefits of section 933 would be available for a taxable year only for such a resident of the Republic of Puerto Rico (1) who is a citizen of the United States solely by virtue of either being born in Puerto Rico pursuant to the provisions

of the Jones Act and the Immigration and Nationality Act, or being born to parents who themselves are citizens of the United States solely by virtue of being born in Puerto Rico pursuant to the provisions of the Jones Act and the Immigration and Nationality Act, or both; and (2) whose taxable income for the taxable year comprises earned income of an amount not exceeding the limitation on the foreign earned income exclusion applicable for that year, and unearned income of an amount not exceeding the sum of the applicable standard deduction and the applicable personal exemption(s). In all other cases, a resident of Puerto Rico would be ineligible for treatment under section 933 for any period, after the date of the Proclamation of Independence, during which the foregoing thresholds are exceeded.

For estate and gift tax purposes, all U.S. citizens resident in the Republic of Puerto Rico would be treated the same as U.S. citizens resident in any other foreign country.

Application of U.S. excise taxation

Under the amendment, the cover over to the Treasury of Puerto Rico of excise taxes collected by the United States on articles coming into the United States from Puerto Rico and on rum imported into the United States would be phased out over five years (the first five years beginning after the certification of the referendum). For example, if the referendum is certified in favor of independence during 1991, the amount of excise tax covered over to Puerto Rico would be 80 percent of the amount otherwise due during 1992, 60 percent during 1993, 40 percent during 1994, 20 percent during 1995, and none beginning in 1996.

Application of low-income housing credit

The amendment would grandfather low-income housing credits for projects located in Puerto Rico that (1) receive credit allocations from the Puerto Rico housing credit ceiling prior to the end of the calendar year during which the referendum is certified, or (2) would have required such an allocation but for their use of tax-exempt bond financing issued prior to the end of the calendar year during which the referendum is certified. Regardless of any possible future extension of the low-income housing credit generally, no low-income housing credit amount would be available for allocation (other than a carryover credit allocation) after the end of the calendar year during which the referendum is certified, and no credit would be available for projects financed with tax-exempt bonds issued after the end of the calendar year during which the referendum is certified.

Treatment of tax-exempt bonds issued by Puerto Rico

The amendment would provide that interest on originally

tax-exempt bonds issued by Puerto Rico and its local governments prior to the date of certification of the referendum and outstanding on the date of certification of the referendum would remain tax-exempt in the same manner as if Puerto Rico were a State or a commonwealth.

In addition, the amendment would permit Puerto Rico to continue to issue tax-exempt bonds (both governmental and qualified private activity) as provided under present law for a period of five years, beginning on the date of certification of the referendum.

4. Title IV (Commonwealth)

Description of the Bill

The bill generally would amend the rules of both the House and the Senate to expedite review of certain recommendations of the Puerto Rican Government (where such recommendations are adopted by the Puerto Rico legislature and that fact is certified by the Governor to the Speaker of the U.S. House of Representatives and the President of the Senate) that particular Federal laws should not apply to Puerto Rico (bill sec. 403(a) and (b)).

These provisions would not apply, however, to any Federal statutory law (1) establishing grants or services to individual U.S. citizens, (2) relating to citizenship, or (3) pertaining to foreign relations, defense, or national security (bill sec. 403(c)).

The bill also sets forth a mechanism under which the Governor of Puerto Rico could require agency review and judicial review of Federal regulations which apply to Puerto Rico but which the Governor determines are inconsistent with the policy, set forth in the bill, of enhancing the Commonwealth relationship to enable the people of Puerto Rico to accelerate their economic and social development, to attain maximum cultural autonomy, and in matters of government to take into account local conditions in Puerto Rico (bill secs. 402(b) and 404).

The bill provides that the Governor of Puerto Rico may enter into international agreements to promote the international interests of Puerto Rico as authorized by the President of the United States and consistent with the laws and international obligations of the United States (bill sec. 403(d)).

Explanation of Amendment

The amendment would provide that the provisions regarding expedited Congressional review (bill sec. 403(a) and (b)), the provision regarding Puerto Rican international

agreements (bill sec. 403(d)), and the provisions regarding regulatory review (bill sec. 404) would not apply to any Federal law or provision thereof, or any agency action, relating to matters that would be within the jurisdiction of the Senate Finance Committee if they were the subject of legislation.

The amendment would change the requirement that, in order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession over a three-year period (Code sec. 936(a)(2)(B)). Effective for a corporation's fourth taxable year beginning after certification of the referendum in favor of commonwealth, the applicable percentage under the amendment is 80 percent. Effective for taxable years beginning after a corporation's fourth taxable year beginning after certification of the referendum, the applicable percentage under the amendment is 85 percent.

The amendment further would provide that cover overs from the United States to Puerto Rico of excise taxes collected by the United States on articles coming into the United States from Puerto Rico, and on rum imported into the United States, as provided under current law, and cover overs from the United States to Puerto Rico of customs duties and equivalency payments on alcohol, would be phased out over a period beginning after certification of the referendum. For each year prior to full elimination of the cover over, the total cover over would be reduced by an amount sufficient to equal the sum of the increases in social spending programs covered by the amendment, less the increases in federal tax revenues due to the change in the active business requirement in section 936 (as applied to section 936 as then in force) as described above. After 3 such years of reductions in the cover over, the cover over would be eliminated.

Finally, the amendment would provide for an annual limit on incremental spending for years in which the cover over has been eliminated. The annual cap would be the limit on each year's excess of the levels of federal funding for programs affected by the bill over the spending under such programs under the law in effect on August 1, 1990. The cap would be set by reference to estimates to be regularly computed by the Treasury Department. Each year's cap would equal the sum of the increases in federal tax revenues for that year (as so estimated) due to: (1) the change in the active business requirement in section 936 (as applied to section 936 as then in force) as described above; and (2) the elimination of the cover overs as explained above.

REVENUE ESTIMATES OF PROPOSED COMMITTEE AMENDMENT
UNDER S. 712,
PUERTO RICO STATUS REFERENDUM ACT

(Markup Consideration by Senate Committee on Finance
on August 1, 1990)

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

August 1, 1990

JCX-23-90

TABLE 1. STATEHOOD OPTION

Revenue Table^{1,2}

	Fiscal Years				
	[Millions of Dollars]				
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1992-95</u>
(1) Pro-rata 4-year Phase-out of Section 936 Credits Effective for Taxpayers' Second Taxable Year After Certification . . .	0	453	1231	1913	3597
(2) Targeted Cover-over of Phased Out Section 936 Credits ³	0	-28	-381	-638	-1047
Subtotal of lines (1) and (2): Increase in Receipts From Section 936 Phase-out Less Cover-over of Phased -out Section 936 Credits . . .0		425	850	1275	2550

TABLE 1. STATEHOOD OPTION (continued)

Revenue Table^{1,2}

	Fiscal Years				
	[Millions of Dollars]				
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1992-95</u>
(3) Pro-rata 4-year Phase-in of Income and Excise Taxes					
Individual ⁴	0	85	269	423	777
Corporate	0	150	407	578	1135
Excise	0	177	278	297	752
(4) Cover-Over of Income and Excise Taxes ²					
Individual	0	-85	-269	-423	-777
Corporate	0	-150	-407	-578	-1135
Excise	0	-177	-278	-297	-752
Subtotal of Lines (3) and (4): (3) Phase-in of Income and Excise Taxes Net of (4) Cover-Over of Income and Excise Taxes	0	0	0	0	0
Total of Lines (1) through (4): Increased Receipts and Cover-overs Under Statehood Option	0	425	850	1275	2550

-
1. Estimates assume results of election are certified during calendar year 1991.
 2. Estimates are not provided for the post-1995 period.
 3. Cover-overs are eliminated for years after 1995.
 4. Includes earned income tax credit.

TABLE 2. INDEPENDENCE OPTION

Revenue Table^{1,2}

	Fiscal Years				
	[Millions of Dollars]				
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1992-95</u>
(1) Pro-rata 4-year Phase-out of Section 936 Credits Effective for Taxpayers' Second Taxable Year After Certification	0	453	1231	1913	3597
(2) Phase-out of Cover-over of Excise Taxes to Puerto Rico	54	109	163	218	544
(3) Increase in Individual Taxes on U.S. Citizens in Puerto Rico	3	5	7	8	23

1. Estimates assume results of election are certified during calendar year 1991.

2. Estimates are not provided for the post-1995 period.

TABLE 3. COMMONWEALTH OPTION

Revenue Table^{1,2}

	Fiscal Years				
	[Millions of Dollars]				
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1992-95</u>
1) Increase Section 936 Active Income Percentage from 75% to 80% in 1995 and 85% in all years after 1995 ³	0	0	0	30	30
2) Targeted Amount of Reduced Cover-over of Excise Taxes and Customs Duties ⁴	0	133	265	368	766
Total Increased Receipts and Reductions in Cover-overs Under Commonwealth Option	0	133	265	398	796

-
1. Estimates assume results of election are certified during calendar year 1991.
 2. Estimates are not provided for the post-1995 period.
 3. The active trade or business percentage is increased to 85% in 1996. The increased revenues from this change are not reflected in this table.
 4. Cover-overs of excise taxes and customs duties are fully eliminated after 1995.

FINANCE COMMITTEE MARKUP OF S. 712

August 1, 1990

TRADE ISSUES

I. Current Law

Under current law, Puerto Rico is part of the customs territory of the United States. Thus, trade between Puerto Rico and the fifty states is domestic in nature, and is not subject to tariffs or any restrictions or requirements applicable to trade with foreign countries. Likewise, trade between Puerto Rico and foreign countries is generally governed by the same U.S. trade laws applicable to U.S. trade with foreign countries. Imports into Puerto Rico are subject to U.S. duties and trade restrictions, and all obligations of the United States under bilateral and multilateral trade agreements, including the GATT, apply to Puerto Rico's trade.

In three respects, however, current U.S. trade law provides special treatment for Puerto Rico. First, all import duties collected in Puerto Rico, less the cost to the Customs Service of collecting the duties, are paid to Puerto Rico, rather than retained by the Federal Treasury. Second, Puerto Rico is authorized by statute to impose its own duty on coffee, whether imported directly into Puerto Rico or through the United States. Third, although Puerto Rico is not an eligible country under the Caribbean Basin Initiative (CBI), the CBI legislation includes specific provisions relating to the treatment of Puerto Rican content in determining whether a product qualifies for duty-free treatment under the CBI. Thus, Puerto Rico benefits indirectly from CBI trade preferences.

II. Statehood

Under the Statehood option, Puerto Rico's special trade arrangements would be eliminated, *i.e.*, Puerto Rico would be treated like any other state. Thus, customs duties collected in Puerto Rico would no longer be remitted back to Puerto Rico; Puerto Rico would not be allowed to impose its own duty on coffee imports; and, the special rule regarding the treatment of Puerto Rican content under the CBI would be eliminated.

Consistent with the transitional arrangements of this amendment, the customs duties remittance "cover over" and the coffee import tariff would be phased out over the five-year transition period. The special treatment accorded Puerto Rico under the CBI would expire at statehood.

III. Commonwealth

Under the enhanced commonwealth option, the amendment would maintain current law with respect to Puerto Rico's special trade arrangements relating to coffee and treatment under the CBI. The treatment of Puerto Rico's duties remittance "cover over" would be phased out in the same manner as the rum excise tax "cover over," described in the previous section on tax provisions.

IV. Independence

The amendment provides for future consideration of the trade relationship between the United States and an independent Puerto Rico. Specifically, the amendment would:

- (1) express the sense of the Congress that the United States should continue to maintain an open trade relationship with Puerto Rico both until and after independence, and that the President should encourage other countries to maintain open trading relationships with Puerto Rico and give favorable consideration to including Puerto Rico under any preferential trade arrangements they maintain;
- (2) require that the Joint Transition Commission establish a Task Force on Trade to consider the manner in which trade between the United States and Puerto Rico will be governed after independence, and submit recommendations to the President and the Finance and Ways and Means Committees regarding the future trade relationship;
- (3) provide unconditional most-favored nation treatment for an independent Puerto Rico;
- (4) provide authority for the President to designate an independent Puerto Rico as a beneficiary under the CBI; and,
- (5) provide the President with specific authority to negotiate a free trade agreement with an independent Puerto Rico, and to have any implementing legislation for such an agreement considered through fast track legislative procedures during the five-year period after independence takes effect.

(prepared by the staff of the Committee on Finance)
 August 1, 1990

Benefit Programs Under Proposal:
 Cost When Fully Effective
 (millions)

STATEHOOD

	<u>Total</u>	<u>Federal</u>		<u>State</u>			
		Current	New	Current	New		
Aged, Blind, Disabled	460	460	13	447	0	4	0
AFDC	170	130	69	90	40	101	-61
Medicaid	1525	1279	79	1200	246	675	-429
Total:	2155	1869	161	1737	286	780	-490

COMMONWEALTH

	<u>Total</u>	<u>Federal</u>		<u>State</u>			
		Current	New	Current	New		
Aged, Blind, Disabled	460	230	13	217	230	4	226
AFDC	170	85	69	16	85	101	-16
Medicaid	754	377	79	298	377	675	-298
Total:	1384	692	161	531	692	780	-88

(prepared by the staff of the Committee on Finance)

August 1, 1990

S. 712: PUERTO RICO STATUS LEGISLATION

Spending Programs Under Present Law

In General

Under present law, Puerto Rico operates social welfare programs which are quite different from the programs in effect in the States. A major difference, not in Finance Committee jurisdiction, is the Nutrition Assistance Program. This is the Puerto Rico equivalent of the Food Stamp program. In the States, the Food Stamp program operates as a nutritional supplement to other sources of income support and is provided in the form of coupons redeemable for food. In Puerto Rico, this program is operated as a \$1 billion block grant from the Federal Treasury to the Government of Puerto Rico, which in turn uses the funds for direct cash payments to needy individuals and families (about 43 percent of the population receive payments). By contrast, the Social Security Act cash public assistance programs in Puerto Rico are capped at an annual Federal funding level of \$82 million. Programs in Finance Committee jurisdiction are described in more detail in the sections which follow.

Old-Age, Survivors, and Disability Insurance

This basic social security program operates in Puerto Rico under essentially the same rules and conditions as apply elsewhere in the United States.

Medicare

Medicare eligibility and benefits are the same for social security beneficiaries in Puerto Rico as in the States. However, hospitals are reimbursed under a separate prospective payment schedule which results in a generally lower reimbursement than would apply to a hospital in the States for the same procedure. A substantial proportion (35 percent) of the Medicare eligible population has not elected coverage under Part B of Medicare.

Unemployment Compensation

Puerto Rico is treated as a State for purposes of the Federal-State program of unemployment compensation. As in the States, benefit levels are set by the "State" government and regular benefits are funded by "State" payroll taxes on employers. Because of chronic high unemployment, Puerto Rico (unlike nearly all States) is frequently triggered onto the extended benefits program which provides an additional 13 weeks of benefits funded half from Commonwealth payroll taxes and half from the Federal unemployment tax.

Aid to the Aged, Blind, and Disabled

In the States, needy aged, blind, and disabled individuals receive Federal payments under the Supplemental Security Income (SSI) program sufficient to maintain their income at a level of \$386 per month for an individual and \$579 for a couple. In a number of States, higher levels are provided through supplementary State-funded payments. The SSI program does not apply to residents of Puerto Rico. Instead, a program of aid to the aged, blind, and disabled is operated with Commonwealth and Federal funds. A combined Federal funding limit of \$82 million annually applies to this program and to the Aid to Families with Dependent Children program. Assistance levels are determined by the Government of Puerto Rico. For an aged, blind, or disabled individual with average shelter costs and no other income, the monthly assistance payment would be about \$42. (In addition, such an individual would typically receive a monthly payment from the Nutrition Assistance Program of roughly \$75.)

Aid to Families with Dependent Children

In the States and in Puerto Rico, assistance is provided under a program of Aid to Families with Dependent Children pursuant to title IV of the Social Security Act. Assistance levels are set by each State, and funding is shared between the State and the Federal government. In the States, funding is available on an open-ended basis with Federal matching rates ranging from 50 to 83 percent depending on State per capita income. In Puerto Rico, there is a maximum Federal matching rate of 75 percent but Federal funding is actually controlled by the \$82 million Federal funding cap which jointly covers this program and the program of Aid to the Aged, Blind, and Disabled. The 1990 maximum AFDC payment for a 3-person family in Puerto Rico is \$90. (Such a family would typically also receive a payment of roughly \$200 under the Nutrition Assistance Program.)

Medicaid

In the States, recipients of assistance under the SSI and AFDC programs along with certain other eligible individuals are entitled to have their medical costs paid by medicaid programs established under State plans in accord with the requirements of title XIX of the Social Security Act. Federal funding is provided on an open-ended basis at rates generally ranging from 50 to 83 percent depending on State per capita income. Recipients generally are free to select any medical provider of their choice. In Puerto Rico, the medicaid program as it is understood in the States does not exist. Instead, Puerto Rico operates a system of public health facilities which are available to the population generally. The Federal Government reimburses Puerto Rico under the medicaid program at a theoretical 50 percent matching rate. In practice, Federal matching is controlled by an overall cap on annual Federal funding which is set at \$79 million.

Social services

Under title XX of the Social Security Act, a block grant is made to States to help them provide a wide variety of social services. Great flexibility is left to the States to determine what services will be funded with these grants. The national funding level for this program is \$2.8 billion per year and each State receives a share of that total on the basis of its relative population. Puerto Rico receives title XX funds under a separate formula. Under the population formula Puerto Rico would qualify for about \$35 million rather than the approximately \$15 million it receives under the current formula.

Other programs

The Child Welfare Services and Child Support enforcement programs operate in Puerto Rico generally as in the States. The Foster Care and Adoption Assistance program is not implemented in Puerto Rico. Puerto Rico is eligible to participate in this program but would receive no additional Federal funding since the \$82 million cap on Federal funding for AFDC and aid to the aged, blind, and disabled also covers this program. (In fact, present law appears to mandate Puerto Rico participation in this program, but this mandate has never been enforced.)

Spending Program Amendments Under Statehood and Commonwealth

In General.--If either the Commonwealth or the Statehood choice wins the plebiscite in 1991, there would be a 5-year transition period leading to full implementation of either enhanced Commonwealth or Statehood as of January 1, 1996. In the social welfare programs under Finance Committee jurisdiction, the proposal would aim to achieve a high degree of parity between the benefits available under either political status both during the transition period and upon full implementation.

Transition period.--No changes would be made during 1992 in social welfare benefit programs in order to allow time for planning and development of the necessary administrative capacity. In 1993, benefit enhancements would begin under both the Commonwealth and Statehood options at levels which represent 25% of the full increase in benefits that will take place after the transition. In 1994, 50% of the increased benefits will be implemented and 75% in 1995. On January 1, 1996 the benefits will be fully implemented as described below.

Supplemental Security Income and Aid to the Aged, Blind, and Disabled.--Under the Statehood alternative, the Federally administered program of Supplemental Security Income would be implemented starting on a partial basis in 1993. Under the Commonwealth alternative, the existing program of aid to the aged, blind, and disabled would be retained but minimum benefit levels would be established starting in 1993. These minimum benefit levels would be the same as the benefit levels applicable under the SSI program as it would apply under the Statehood option.

The general rules of the SSI program as applicable in all States would be modified to provide that benefit levels will be limited in such a way that the amount payable to an individual with no other income may not exceed 50 percent of the average per capita income (based on the most recent available data) in the State of residence. Benefits for a couple would, as under present law, be 150 percent of the benefit for an individual. Based on current income and benefit levels, the full-rate SSI benefit of \$386 per month represents about 90 percent of Puerto Rico average per capita income. Under this rule, the monthly benefit rate would be approximately \$215. This at current benefit levels (i.e., ignoring the impact of future COLAs) would result in an approximate doubling of the assistance levels in 1993 from the present rate of \$42 to about \$85. The rate would increase then to about \$128 in 1994, \$171 in 1995, and \$215 in 1996.

Both during the transition period and after Statehood takes effect, the SSI program would be fully Federally funded. The program of aid to the aged, blind, and disabled under the Commonwealth alternative would be funded with 50% Federal and 50% Commonwealth funds starting in 1993. The present law cap on Federal funding would no longer apply. However, as explained in the tax part of the document, aggregate Federal funding for aid to the aged, blind, and disabled, for AFDC, and for medicaid in excess of present cap levels could not in any year exceed the estimated offsetting revenue changes.

Aid to Families with Dependent Children--As under present law, the level of benefits for the AFDC program would be set by the government of Puerto Rico under either Statehood or Commonwealth. The matching rate under Statehood would be increased to the full medicaid match. At current per capita income levels, this would result in 83 percent Federal and 17% Puerto Rico matching. Under Commonwealth, the matching rate would be set at 50% each. At full implementation in 1996, the funding cap would be eliminated under both Statehood and Commonwealth, subject, however, under Commonwealth to the general requirement that the tax offsets must cover the additional social welfare funding. During the transition period, the current law caps would be retained under both Commonwealth and Statehood but would be increased from the present \$82 million to \$94 million in 1993, \$106 million in 1994, and \$118 million in 1995 under Statehood. Equivalent caps based on a 50% matching rate would be provided under Commonwealth.

Medicaid--Under Statehood, the medicaid program would operate under the rules and requirements applicable to the regular medicaid program in other States effective on January 1, 1996. It is anticipated that, under the Commonwealth alternative, the government of Puerto Rico would continue to operate the current type of medicaid program which provides care through publicly operated facilities. Matching under the Statehood alternative would follow the regular medicaid rules which will result in an 83 percent Federal matching rate under existing per capita income levels. Under Commonwealth the matching rate would be 50% subject to the general requirement that new Federal funding not exceed the offsetting new revenues under the tax provisions.

During the transition period, under the Statehood option, the government of

Puerto Rico could continue to operate the current medicaid program with such modifications as might be appropriate to phase into the regular medicaid program upon full implementation. Federal matching starting in 1993 would be at the 83% medicaid matching rate subject to a cap which would constrain new Federal costs to \$300 million in 1993, \$600 million in 1994, and \$900 million in 1995. Under Commonwealth, the matching rate would be set at 50% in 1993 with a cap to constrain new Federal costs to \$75 million in 1993, \$149 million in 1994, and \$224 million in 1995.

Medicare--The Prospective Payment Assessment Commission would be directed to examine the current levels of reimbursement under the Hospital Insurance program and to advise the Secretary of Health and Human Services whether the current system appropriately reflects cost differentials between Puerto Rico and the States. The Secretary would be directed to propose appropriate legislative changes to the Congress if this study determines that the current system is not designed to achieve that objective. Pending such legislation, the current system would be kept in place.

Title XX--Effective in 1996, the title XX statute would be amended under the Statehood option to place Puerto Rico on the same footing as other States in the allocation of funds under the program. This would not result in additional costs since this is a capped entitlement program with a fixed overall cost level. The net effect for Puerto Rico would be to approximately double its allocation. As with other States, the program would operate on a 100% Federal basis. Commonwealth would receive the same overall allocation; however, in the case of Commonwealth, the allocation would be on a 50% Federal, 50% Commonwealth basis. The changes in this program would not be phased in, but would become fully effective in 1996.

Expedited procedures and consolidation of grants--The proposed Committee amendment would specifically exempt programs within the jurisdiction of the Committee on Finance from the application of provisions in S. 712, as reported from the Committee on Energy and Natural Resources, which would allow the Commonwealth of Puerto Rico to instigate expedited review of statutes and regulations and to consolidate certain grant programs.

Spending Programs Under Independence Alternative

General approach--If Puerto Rico should choose independence in the referendum, social welfare programs within the jurisdiction of the Finance Committee would continue under existing terms and conditions through the end of the fiscal year in which independence is proclaimed and would cease thereafter. Amounts in Puerto Rico "state" account in the unemployment trust fund would be transferred to the treasury of Puerto Rico.

Social security--By way of exception, the social security program would continue in effect until a time mutually agreed upon by the Puerto Rico and U.S. Governments,

but not beyond December 31, 1996. Individuals who had already applied for and met the eligibility requirements for benefits as of that date would continue to receive benefits under the terms and conditions applicable to all U.S. social security beneficiaries. Such individuals would also retain their eligibility for Medicare benefits when they are within the United States. Prior to December 31, 1996, the Governments of Puerto Rico and the United States would establish a Joint Task Force to seek to reach agreement on a coordination of the U.S. and Puerto Rico social security systems. (The exact details of the agreement would be worked out by the task force. The U.S. has similar agreements with several other countries under which each country pays a proportionate benefit under its program to individuals who have worked under both systems.)

Mr. Pryor

AMENDMENT TO REPEAL SECTION 936
AND REPLACE IT WITH A WAGE CREDIT

THE AMENDMENT REPEALS THE INCOME BASED SECTION 936 CREDIT AND REPLACES IT WITH A PERMANENT WAGE CREDIT. UNDER THE AMENDMENT, A U.S. CORPORATION COULD ELECT A WAGE CREDIT EQUAL TO 80 PERCENT OF WAGES, UP TO THE FEDERAL MINIMUM WAGE AMOUNT, PAID TO PERSONS EMPLOYED IN THE POSSESSIONS BY A COMPANY ENGAGED IN MANUFACTURING, PLUS 30 PERCENT OF SUCH WAGES PAID ABOVE THE FEDERAL MINIMUM WAGE AMOUNT, SUBJECT TO AN OVERALL CAP PER EMPLOYEE OF FOUR TIMES THE FEDERAL MINIMUM WAGE AMOUNT. CORPORATIONS ELECTING THE WAGE CREDIT WOULD BE REQUIRED TO REDUCE THEIR OTHERWISE ALLOWABLE DEDUCTION FOR WAGES PAID BY THE AMOUNT OF THE WAGE CREDIT CLAIMED.

THE CREDIT COULD BE USED TO OFFSET THE U.S. TAX ON ANY INCOME, WITHOUT REGARD TO WHETHER SUCH INCOME MAY HAVE ARISEN FROM SOURCES IN A POSSESSION. THE CREDIT WOULD NOT BE REFUNDABLE, BUT COULD BE CARRIED FORWARD FOR 15 YEARS.