

Economic Development Administration
San Juan, Puerto Rico

April 29, 1958

MEMORANDUM

TO: Mr. Marco A. Rigau

FROM: Teodoro Moscoso

SUBJECT: Comments on memo by Dr. Fernós -- "Nuestra Unión Económica con Estados Unidos y La Autonomía Fiscal de Puerto Rico."

CONFIDENTIAL
CONFIDENTIAL

This is in response to your request, sent to us by Mr. Torregrosa on March 11, for comments on a March 4 memorandum by Dr. Fernós. The memorandum itself is very broad in scope, dealing with the historical development of various aspects of the Commonwealth-Federal relationship and suggesting that two aspects of the relationship should stand while seven others are changed.

Dr. Fernós' memo clearly illustrates that there are many points of inter-relationship existing among the multitude of specific matters that serve to make up the total complex of Commonwealth status. His approach suggests, and I agree, that changes in one specific matter should not be undertaken without considering possible repercussions in other areas. A full commentary on Dr. Fernós' memo would require, therefore, previous analysis of all the detailed aspects of the relationship in order to test against this composite picture a series of suggestions intended to make a net improvement in the relationship as a whole.

Moreover, since the matters dealt with in the memorandum are largely economic in character, the kind of prior analysis that would seem appropriate would be in the nature of comparisons of the economic costs and benefits flowing from each aspect of the relationship. The net balance for all the various areas could next be summed up in accordance with present conditions and then, by estimating the

effect on this aggregate of changes in particular matters, a set of changes could be worked out which would maximize benefits and minimize costs to both parties to the compact in what appeared to be the most equitable possible way.

It is my understanding that at least an approach to this overall analysis was made about 3 years ago in a study done under the auspices of the Planning Board. The attached memorandum "Puerto Rico's Position Under the U. S. Tariff and Sugar Acts" dated July 8, 1955 was done in this Administration as a part of the overall study. I am also enclosing a memorandum on the effects of U. S. Coastwise Shipping Laws which also includes some related observations on the possible effects of new cargo handling methods.

Material on other aspects of Commonwealth-Federal relationships prepared in the course of the 1955 Planning Board study is in your hands but has not been made generally available for study. My comments on Dr. Fernós' memorandum are limited, therefore, to observations on the judgments expressed therein and are made without having all the background analysis necessary for forming a well-based, overall judgment on the economic aspects of Commonwealth status. Moreover, since you have also requested comments from the Treasury, Planning Board and the Bank, I will not go at all deeply into matters which I expect they will cover more fully.

1. Money.

It is certainly advantageous for us to continue using the U. S. dollar. However, some of the "prevailing arrangements" for money supply might be improved. The Government Development Bank has been looking into such matters jointly with the Federal Reserve System.

2. Free Exchange of Goods.

I agree that the limitation on exports of refined sugar is detrimental to Puerto Rico. I do not agree, however, that this deserves "compensatory

measures." Rather than taking a position that two wrongs make a right, I believe that we should take vigorous measures to right the original wrong.

It is estimated that Puerto Rico is deprived of about \$16 million of Net Income by this restriction on sugar refining. Except for quarantine measures and regulations to implement price support, there exists no other restriction on the free movement of goods within the U. S. tariff area. On the contrary, free movement of goods in inter-state trade is protected and encouraged by a variety of Federal measures and institutions. The restriction on Puerto Rico's refined sugar is, thus, not only unjust to Puerto Rico but contrary to general U. S. internal trade policy. I personally believe that a concentrated public relations campaign would make this so evident to the Congress that it might be induced to lift the restriction. This could be done gradually over a period of years so that rising production in Puerto Rico could meet part or all of rising U. S. consumption and thus not curtail output of U. S. refiners.

In this connection, the Sugar Producers Association is now actively investigating the establishment of a Puerto Rican-owned refinery in the U. S. Such a venture would contribute less to net income in Puerto Rico yet it would probably cut more sharply into output of existing U. S. refineries than would the more gradual expansion envisaged above. Nevertheless, the seriousness with which a captive refinery is now being considered by the sugar industry is an indication of the vulnerability of the existing quota on refined sugar.

If our approach should be to get the quota on refined sugar removed, then the major basis for "compensatory" changes elsewhere in the compact is removed and it becomes simpler to evaluate each on its own merits. Moreover, while \$16 million is a sizable sum, it can not be stretched to cover several "compensatory" concessions having substantially greater dollar value, except by resort to rhetoric as a substitute for arithmetic.

3. Tariffs.

The accompanying memo on "Puerto Rico's Position Under the U. S. Tariff and Sugar Acts" demonstrates clearly the substantial advantage derived by Puerto Rico from being included within the U. S. tariff area. The \$74 million figure estimated for 1953-54 would be roughly \$100 million today because of the increase in trade which has occurred in the past 3 years.

The suggestions of Dr. Fernós contemplate increasing this advantage by superimposing special rates for Puerto Rico on imports in which we have a special interest; for example, a lower tariff on rice and a higher tariff on metal furniture. Such changes would obviously be advantageous in and of themselves. Elimination of all tariffs on products obtainable from foreign sources might benefit Puerto Rican consumers by as much as \$20 million and protection might help in the development of a few new industries producing for the local market.

The \$20 million gain to consumers, however, would be eaten into to the extent that special protection was also provided to local producers of goods which would otherwise be imported. In other words, within the general protection of U. S. tariffs, a special system could be used to stimulate those few industries which can operate successfully in a local market as small as ours. However, transportation costs have already provided sufficient protection for nearly all the industrial development that can be sustained by the local consumer market. Further protection would amount to a tax on local consumers for the benefit of local producers. Thus, reduction of tariffs and lower prices for imported foreign merchandise is the principal advantage to be gained from Dr. Fernós' proposal.

It would seem to me highly unlikely, however, that U. S. generosity could be pushed to the point of abandoning protection for its producers selling in the Puerto Rican market while still continuing to permit free entry of Puerto Rican products into the U. S. market. If there is to be any choice, our interest, as

indicated above, is overwhelmingly on the side of free access to the U. S. market, both under present conditions and in the interest of further development of industry and agriculture.

Notwithstanding the foregoing, it might conceivably be possible to get special tariff treatment for a very few commodities of peculiar importance to the Puerto Rican consumer. This could not be done in the case of rice or wheat because U. S. import quotas on these commodities serve the same price-support purpose as does the sugar quota. We could scarcely ask for the one without being willing to forego the other. Moreover, bulk handling of these commodities, which is expected to start in about a year, should bring the price of U. S. wheat and rice below that of foreign imports, which for technical reasons must be shipped in bags.

This can be illustrated by the example of corn, which is not now subject to an import quota but which could be if the U. S. price were to be pushed down by imports. The tariff is 25¢ a bushel, except for Cuban corn on which it is 10¢.

Puerto Rico raises about 300,000 bushels per year, imports as much from the U. S., and buys about 1 million bushels from the Dominican Republic and Cuba. The cost of the Dominican corn is slightly less than that of the U. S. before duty and slightly higher after duty. Freight costs probably favor the U. S. Wholesale prices in Puerto Rico per 100 pounds sack are U. S., \$3.60; Dominican, \$4.60; local, \$7.00. The consumer pays a premium for non-U. S. corn because of a preference for small kernels and the mistaken belief that a quality difference exists.

This preference for small-kernel corn (even though cracked corn makes just as good poultry feed) means that U. S. corn receives, in effect, little or no practical benefit from tariff protection. The existing large differential in price may become as much as 50¢ a bushel greater when bulk imports are established on a regular basis by Nebraska Mills and perhaps by Tropical Foods whose first bulk shipment, made a short while ago, was sold out before arrival. U. S. corn is

today the lowest-priced corn in the local market and further reductions seem likely within the next year or so.

The tariff collections on Dominican and Cuban corn total about \$250,000 a year. Under current conditions this amounts to a tax paid mainly by local consumers of poultry, eggs and cockfighting, into the Commonwealth Treasury. Although a tax on food products can be objected to in principle, the burden of this one, which amounts to about 10¢ per person per year, is very light and probably no more regressive than our very heavy excises on tobacco and liquor. Even this tax will probably disappear as local poultrymen abandon their preference for small-kernel corn and increase their purchases of U. S. corn shipped in bulk and delivered at prices below that prevailing in some parts of the U. S. and in most countries of the world.

Apart from grains, codfish is about the only other commodity for which we could conceivably make a case for special tariff treatment. The tariff on dried codfish is already quite low; 1/2 cent a pound on that containing less than 43% moisture, which constitutes the bulk of our imports and 1/4 cent a pound on the remainder. Last year, our total tariff bill was \$144,000, an amount so small that it did not greatly burden consumers (less than 7¢ per person per year) nor, for that matter, did it greatly benefit our Treasury. It should also be mentioned that the feasibility of fishing off the Grand Banks in Puerto Rican vessels and processing in Puerto Rico is now being studied by a group of U. S. investors. Such an operation might put us on an export basis and reverse our interest in the U. S. tariff on codfish.

4. Inapplicability of Federal internal revenue laws.

We have long agreed to a principle which amounts to "limited taxation with limited representation." Might not payments "in lieu of taxes" be more

appropriate and flexible in some instances than taxation with consent? For example, the Commonwealth might pay to the Federal Government an amount equal to what the Federal gasoline tax would yield, if applied in Puerto Rico, in return for full participation in the Federal roads program. This would leave the Commonwealth free to raise the funds from a source of its own choosing which might fit better into our own tax structure.

5. Partial application of Federal (Personal) Income Tax.

I agree with Dr. Fernós' position in this section. Would it also be logical, though of little practical importance, to collect Commonwealth personal income taxes from Commonwealth Government employees working in the United States and have the amount collected creditable against their Federal tax?

6. Payment of Federal excise taxes on Puerto Rican products to the Commonwealth Treasury.

I have considerable doubts about raising this issue at all and I further doubt that the change proposed by Dr. Fernós would obviate or even reduce the risks involved. Return of rum and cigar taxes is "compensatory" in only a very remote sense. It is no different in itself than would be the return of Commonwealth excises on bourbon whisky and cigarettes to the Federal Treasury. (Actually, the parenthetical corollary proposed by Dr. Fernós at the end of his proposal #6 would greatly alter the present situation by shifting much of our automobile, cigarette and liquor excises into the Federal Treasury.)

The difficulty does not appear to be solved by Dr. Fernós' suggestion of returning to the jurisdiction in which the goods are produced only an amount equal to its own excise on a particular product. As I see it, this would amount to our undertaking to pay Federal excises on cigarettes, autos and many other items, and collecting less than we now do on rum and cigars. There would be an offset if we

could collect our excise tax on gasoline sold in the States but this would price it out of the market since our tax is higher than the Federal.

7. Payment of expenses of the two governments out of their respective incomes.

This appears to be a desirable clarification of language.

8. Cabotage.

Application of the U. S. Coastal Shipping Laws to Puerto Rico is a matter of mixed and uncertain elements of cost and benefit. The attached memorandum is an attempt to put the issues involved in clearer perspective than they have previously been.

Foreign flag vessels in the U. S.-Puerto Rican trade would have operating costs estimated to be 25% below U. S. flag vessels. If reflected in lower rates, this would mean an estimated saving of about \$13 million in our annual general-cargo shipping bill and would provide a stimulus to export industries and agriculture. Obtaining this preferred position for Puerto Rico would be, at the very least, a lengthy process, probably necessitating unwelcome concessions in other areas. Even then, the "natural" monopolistic tendency of the industry, which is pointed out in the attached memorandum, would make problematical the realization of lower operating expenses in the form of stable, lower costs to Puerto Rican shippers and consumers.

A somewhat larger theoretical economy (\$15 million) and one that is immediately available in part can be derived from the introduction of U. S. flag trailerships. Simultaneous efforts to introduce U. S. trailerships, foreign flag vessels (trailership or conventional) and a Commonwealth merchant marine of any kind would necessarily be diffused and partly self-defeating. In my judgment, our efforts should be concentrated on getting the trailership service, which has already been offered to us, into operation as soon as possible.

There is little doubt in my mind that the U. S. Coastal Shipping Laws place some net burden, probably a rather small one, on the economy of Puerto Rico. Unlike the restriction on refined sugar, however, they are not discriminatory. All coastal traffic within the U. S. tariff area is subject to them. In comparison with the refined sugar restriction, therefore, they are not only less of an economic burden, but they are politically innocuous instead of offensive.

Apart from a general overstatement of the case against cabotage, Dr. Fernós' section on this subject has a specific point that should be corrected. He suggests that, because of rail and truck competition, no rate subsidy is involved for shipping lines operating between Mainland ports. This is not true because railroads and trucking lines can't compete for some classes of cargo. His general point that Puerto Rico is the most seriously affected of any single area may be correct but my guess would be Alaska because of its even greater dependence on shipping.

9. Social Security.

I heartily agree with Dr. Fernós' position on this point both for the reason he mentions and because I believe there may be a valid "equation" between Social Security and minimum wage legislation. Fuller social security protection should provide a hedge against the possibilities that at some time and in some industries employment may be inhibited by the minimum wage program.

Dr. Fernós follows the suggestions commented on above with a list of 9 "equations." I have some doubt about the validity of equations unless and until they are shown to have equal and balancing quantitative values. The notion that migration of people to the U. S. "compensates" for migration of capital to Puerto

MEMORANDUM TO: Mr. Marco A. Rigau
April 29, 1958
Page 10

Rico seems especially dubious. In both cases the relatively plentiful "resource" is moving to an economy or a part of an economy where it is relatively scarce. Neither movement causes the other; instead they tend to inhibit each other. Both movements, in themselves, help both economies. I find it hard to think of this as an "equation" -- 50,000 people = annual return on investment of \$125 million.

Teodoro Moscoso
Administrator

Enclosures

TM/HCB:lrf