SOME ECONOMIC ASPECTS OF A FOREIGN-TRADE ZONE IN SAN JUAN

(A SUPPLEMENTARY REPORT)

WALTER JOELSON

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SOME ECONOMIC ASPECTS OF A FOREIGN-TRADE ZONE IN SAN JUAN

(A SUPPLEMENTARY REPORT)

1. INTRODUCTION

For about two decades plans to increase Puerto Rico's external trade by providing the island with free port facilities have been suggested, discussed, refuted, and defended. The tempting image of Puerto Rico serving as a commercial link between the Continents of Europe, Asia, and the Americas due to its unique geographical location has fascinated the minds of imaginative businessmen, government officials, and economists. To many the abandonment of customs and excise barriers was sufficient to transform San Juan into a thriving re-export and transshipment center. Others have been more skeptical and only a few have tried to present figures which allowed the appraisal of the prospects of a foreign-trade zone in San Juan. This paper will endeavor to fill some of the gaps in the past research and provide a quick survey of that which has already been developed.

11. THE FOREIGN-TRADE ZONE IDEA IN PUERTO RICO

Back in 1930 the Brookings Institution's study "Porto Rico and Its Problems" called attention to the island's favorable geographical position and its possibilities to serve as a warehousing and transshipment center for the Caribbean region. "The establishment of a free port in Porto Rico would aid in this development..." the report stated. After the enactment of the Celler Act (Foreign-Trade Zones Act) of June 1934 the Commissioner of the Interior submitted a preliminary report on the establishment of a foreign-trade zone in San Juan to the Governor of Puerto Rico. Shortly thereafter, R. García

MORENO PREPARED A STUDY ON FREE PORTS WITH THE CONCLUSION THAT THE
ISLAND ECONOMY WOULD BENEFIT FROM A FREE ZONE PROVIDED MANUFACTURING,
EXHIBITION, AND RETAILING WERE PERMITTED IN THE ZONE. IN JULY 1935
THE INSULAR LEGISLATURE AUTHORIZED THE GOVERNOR IN A JOINT RESOLUTION
TO MAKE AN APPLICATION FOR A GRANT TO ESTABLISH A FOREIGN-TRADE ZONE
IN THE PORT OF SAN JUAN. GOVERNOR WINSHIP FILED THE APPLICATION WITH
THE FOREIGN-TRADE ZONES BOARD IN SEPTEMBER. YET THE ECONOMIC EXHIBITS
WERE INCOMPLETE AND DID NOT PROVE CONVINCINGLY THE NECESSITY AND
DESIRABILITY OF A ZONE FOR THIS PORT. IN SEPTEMBER 1939 THE PHASE
OF ACTIVE GOVERNMENTAL INTEREST IN A ZONE WAS TERMINATED WHEN GOVERNOR
LEANY RECOMMENDED THAT THE PROJECT OF A FOREIGN-TRADE ZONE BE HELD IN
ABEYANCE FOR THE TIME BEING. IN 1944 GOVERNOR TUGWELL SAID THE SUCCESSFUL
OPERATIONS OF THE NEW YORK ZONE COULD NOT BE COMPARED WITH CONDITIONS
IN SAN JUAN. HE POINTED OUT THAT PUERTO RICO DOES NOT LIE IN DIRECT
SHIPPING LINE BETWEEN NORTH AND SOUTH AMERICA, THAT NOT MANY BULK
PRODUCTS WOULD BE HANDLED HERE FOR TRANSSHIPMENT, AND THAT, CONTRARY
TO THE NEW YORK ZONE, A ZONE IN SAN JUAN WOULD NOT BENEFIT IN A LARGE
DEGREE FROM THE STOCKPILING OF DUTIABLE GOODS PRIOR TO THEIR GRADUAL
ENTRY INTO THE CUSTOMS AREA.

2. POSTWAR DISCUSSIONS

IN 1945 THE QUESTION WAS REVIVED WHEN THE PROPELLER CLUB OF THE PORT
OF SAN JUAN TOOK UP THE PROJECT. ITS FREE TRADE COMMITTEE PREPARED
A STUDY ON FOREIGN-TRADE ZONES STATING THAT SUCH A ZONE WAS A NECESSITY
FOR SAN JUAN IF PUERTO RICO'S EXTERNAL TRADE WERE TO BE IMPROVED, THAT
IT WAS THE EASIEST WAY TO ELIMINATE THE CUMBERSOME EFFECTS OF CUSTOMS
DUTIES AND EXCISE TAXES. THE LATEST STUDY ON A FOREIGN-TRADE ZONE IN

1. RAFAEL GARCÍA MORENO, FOREIGN-TRADE ZONES OF FREE ZONES, REPORT TO
THE UNIVERSITY OF PUERTO RICO, DECEMBER, 1934.
San Juan has been made by W. C. Crosby within the framework of his recommendations for the development of the port of San Juan. For the first time the cost of operating a zone and the amount of tonnage required to cover this cost are estimated. An analysis of those goods which are likely to use a zone in San Juan is made and—without a trial to present a quantitative estimate—the conclusion drawn that the volume to be handled in the zone would be insufficient to make its operation profitable.

3. Scope of this paper

Early this year the Department of Economic Research of the Puerto Rico Industrial Development Company had decided to definitely clarify the question of whether a foreign-trade zone should be established in San Juan. After the work had been started, Mr. Crosby’s report was received and examined. His basic arguments appeared sound and his conclusion—that a foreign-trade zone in San Juan was unlikely to become a profitable enterprise—was shared. Nevertheless, this department was inclined to deviate from some points of his analysis. For example, it appeared that the superiority of foreign-trade zones over customs bonded warehouses deserved more emphasis. Furthermore, a comparison with the experience of the foreign-trade zone in New Orleans indicated that Crosby’s minimum requirement of tonnage to be handled in a successfully operated zone was too highly assessed. Moreover, the department believed that two major points required

1. It is estimated that the break-even point of this zone would have been reached in 1948 at a volume of 30,000 tons received. In 1946 Professor Charles J. Miller estimated that a zone in Seattle would cover its OPERATING cost at 29,275 tons for an average storage period of one month, and at 20,509 tons for an average storage period of two months. Ch. J. Miller, A Foreign-Trade Zone for Puget Sound: Its Economic Desirability and Feasibility, Seattle, 1947, pp 151 and 165.
FURTHER ANALYSIS: 1. THE EFFECTS OF INSULAR INTERNAL REVENUE TAXES ON THE OPERATION OF A ZONE IN SAN JUAN; 2. ADVANTAGES OF A FOREIGN-TRADE ZONE TO THE ISLAND ECONOMY AS A WHOLE OVER AND ABOVE ITS RENTABILITY AS A PRIVATE ENTERPRISE.

III. PUERTO RICO'S INTERNAL REVENUE TAXES AND THE FOREIGN-TRADE ZONE

1. Puerto Rico's Imports of dutiable merchandise

A foreign-trade zone that fails to increase total commerce of the region it serves may still prove useful to importers by permitting them to postpone, reduce, or sometimes even avoid duty payments. The economic legitimacy of a zone depends therefore largely on a hinterland with a vast consumption power of foreign dutiable goods. Puerto Rico's imports from foreign countries are small since most of its necessities are covered on the mainland. In the fiscal year 1946-47 the island imported only some 470,000 short tons of foreign merchandise. 363,000 tons consisted of petroleum and its products, 69,000 tons of lumber, plaster rock and gypsum, fish and its products, grains and preparations, and jute bags. Practically none of these commodities would go into a foreign-trade zone.

2. Puerto Rico's Imports of tax-able merchandise from the mainland

While the number of dutiable goods that would use a zone is small, the zone could be attractive for non-dutiable goods that originate on the continent and are subject to high insular excise taxes. The following table shows the volume of the most important items of taxable goods that were imported from the mainland during the calendar year 1948.
### Volume of Selected Taxable Goods Imported into Puerto Rico from the Mainland During the Calendar Year 1948

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<thead>
<tr>
<th>Merchandise Group</th>
<th>Number of Short Tons (Rounded Off)</th>
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</thead>
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<tr>
<td>Petroleum and its products</td>
<td>308,000</td>
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<tr>
<td>Automobiles, parts, accessories</td>
<td>25,000</td>
</tr>
<tr>
<td>Alcoholic beverages</td>
<td>22,000</td>
</tr>
<tr>
<td>Electrical apparatus, parts</td>
<td>6,100</td>
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<tr>
<td>Cigars, cigarettes, tobacco, matches</td>
<td>3,700</td>
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<tr>
<td>Soap, cosmetics</td>
<td>2,500</td>
</tr>
<tr>
<td>Sugar, raw and refined</td>
<td>2,500</td>
</tr>
<tr>
<td></td>
<td>362,800</td>
</tr>
</tbody>
</table>

3. The value of a zone for taxable goods

As soon as taxable goods enter the island, the importer has to pay excise taxes no matter when he actually sells the merchandise. If he could import his goods through a foreign-trade zone, he would be able to delay his tax payments until he actually ships the merchandise from the zone into the island. Consequently, he would not have to tie up as much capital and would improve his credit position.

Moreover, an importer who decides to re-export taxable goods may not claim any tax refund once the merchandise in question has been stored on the island for more than six months. This regulation obviously thwarts any desire Puerto Rico may have to become a distribution center for the Caribbean area. The existence of a foreign-trade zone would eliminate this hindrance. Internal revenue taxes would only have to be paid when the goods enter the island from the zone. If they were re-exported instead, after having been held in the zone, no tax would have to be paid at all.
To learn whether a foreign-trade zone would actually cure these two evils of the excise laws, it was desirable to find out from potential users of the zone:

1. To what extent they expected to store taxable goods in the zone;

2. Whether they thought the existence of a zone would enlarge their re-export and transshipment trade.

The managers of three large oil companies agreed that storage of oil in a zone would be economical since excise taxes on that part of their product that evaporates could be saved and also since tax payments could be postponed. However, all three companies are building or are going to build tanks in Cataño and will not need additional storage facilities in the San Juan area. They also stated that there was no base for San Juan's becoming a distribution center for oil in the Caribbean. Distribution from their present centers (Venezuela, Aruba, Curacao) works satisfactorily. Besides, double handling cost would not be offset by any sizeable advantages. These companies felt a foreign-trade zone in San Juan would not affect their business very much.

An importer of automobiles maintained car dealers would not make much use of zone facilities. He admitted that for the re-export business an instrument like a foreign-trade zone was indispensable since present insular excise taxes make re-export virtually impossible. Yet re-export of cars is rare. Double handling cost, the damage frequently caused by the transportation of cars, the allocation of a certain region to a certain dealer make the distribution of cars
from Puerto Rico to other islands the exception rather than the rule. Besides, dealers usually own warehouse facilities and would not incur extra storage cost in a zone in order to delay tax payments.

The attitude of a large importer of electrical appliances was similar. He doubted that storage fees in a zone would be paid in order to postpone the payment of taxes. Normally his firm has got warehouse space for its inventories. He did not think the establishment of a free zone in San Juan would induce him to make Puerto Rico a West Indies' distribution center for his products. To avoid double handling cost, he would have orders from other islands executed directly on the continent. He also pointed out that, by and large, shipping connections, especially with South America, were better in New York than in San Juan.

Three merchants whose firms import sundry merchandise from the continent and from foreign countries were contacted. Two of them were in favor of a foreign-trade zone. However, they could think only of one merchandise group that would be stored advantageously in a zone: alcoholic beverages, preferably European wines. The advantage would be the postponement of tax and duty payments.

The sample of persons interviewed is small and not entirely representative. Yet it is interesting to note that the reasons for a skeptical appraisal of the benefits of a zone were virtually the same among host importers. They felt that:
1. Since most of them have own warehouse space available, additional storage fees in a zone would be costlier than the immediate payment of duties and taxes.

2. Many imported goods, like fish, soap, and cosmetics move so fast from importer to dealer that they would not become eligible for storage in a zone.

3. Double handling cost and poor shipping service are not offset by sizeable advantages to make transshipment profitable — even with the help of a foreign-trade zone.

In view of these statements and with regard to Puerto Rico's import pattern it can be assumed that a foreign-trade zone in San Juan would not likely handle the minimum tonnage of, say, 30,000 tons required to avoid operating losses.

IV Effects of a Foreign-Trade Zone on the Island Economy

The probability that a foreign-trade zone in San Juan would be bound to operate at a deficit does not yet answer the question of whether it would be desirable for Puerto Rico to provide its business community with the facilities of a zone. Public enterprises of unquestionable value to the community frequently do not operate at a profit. The question, therefore, arises whether the advantages of a foreign-trade zone to the island as a whole are such that operating losses and subsidies out of public funds should be tolerated.

The possibility of giving liquor dealers opportunity to postpone their tax payments is obviously not of island-wide interest. The contrary may be the case. However, while advantages to present importers may be disregarded, advantages of a zone to prospective
IMPORTERS MIGHT BE VALUABLE TO THE COMMUNITY. IF THE EXISTENCE OF
A FOREIGN-TRADE ZONE IN SAN JUAN WERE TO MAKE HIS OPERATIONS MORE
ECONOMICAL, A CONTINENTAL MANUFACTURER MIGHT DECIDE TO TRANSFER
HIS PLANT TO THIS ISLAND. IN OTHER WORDS, A FOREIGN-TRADE ZONE
MIGHT SERVE AS A CATALYZER TO THE ISLAND'S INDUSTRIALIZATION PROGRAM.
IF THIS WERE AN ACTUAL POSSIBILITY ITS ESTABLISHMENT WOULD BE DESIRABLE,
INDEPENDENT OF ITS OPERATING RESULTS.

1. MANUFACTURING IN
A ZONE

How significant could this function of the zone be? The number of
industries a zone might attract to the island is, of course, unpredictable.
Yet some reflections prompt one to believe that no too much
should be expected from the magic power of a zone. Even if manufactur-
ing were allowed, only a limited number of producers would be poten-
tial users of a zone. Those whose raw materials are imported from the
mainland, would not depend on a zone, since their goods are exempt
from excises and are, of course, not subject to customs duties. If
raw materials were imported from foreign countries and the finished
products were sold within the United States Customs territory, the zone
could not be useful either. Duties might be saved on imported raw
materials, but they would have to be paid on the finished product
upon importation into the customs area. Since the tariff on finished
products is normally higher than on raw materials, the manufacturer
would lose more than he would gain. Thus there remains only the case
of the manufacturer whose imports originate abroad and whose product
is exported to foreign countries. He, indeed, might want to set up

1. THE CELLER AMENDMENT TO THE FOREIGN-TRADE ZONES ACT THAT WOULD
PERMIT MANUFACTURING AND EXHIBITING IN A ZONE HAS BEEN PENDING
IN CONGRESS FOR MORE THAN FOUR YEARS.
TWO FOREIGN TRADE ZONES IN ORDER TO REDUCE HIS DUTY

RISKS. IS THIS THIRD TYPE OF MANUFACTURING LIKELY TO BECOME

IMPORTANT IN PUERTO RICO?

IN HIS RECENT STUDY ON PUERTO RICO'S ECONOMIC FUTURE, PROFESSOR
PERLOFF TRIES TO ANTICIPATE THE INDUSTRIAL PATTERN OF THE ISLAND.

DUE TO THE ISLAND'S PECULIAR ECONOMIC CONDITIONS, HE BELIEVES THAT

THE FOLLOWING INDUSTRIES WILL DETERMINE THE ECONOMIC STRUCTURE OF

THE ISLAND: SUGAR AND RELATED PRODUCTS, CANNING AND PRESERVING OF

FRUITS AND VEGETABLES, OTHER FOOD PROCESSING, TOBACCO, NEEDLEWORK AT

HOME, TEXTILE PRODUCTS, LUMBER, FURNITURE, AND OTHER WOOD PRODUCTS,

PAPER AND ALLIED PRODUCTS, PRINTING AND PUBLISHING, CHEMICALS, LEATHER

AND LEATHER PRODUCTS, STONE, GLASS AND CLAY PRODUCTS, METAL PRODUCTS,

MACHINERY AND EQUIPMENT. IT WILL BE SEEN THAT BY FAR THE LARGEST

AMOUNT OF RAW MATERIALS REQUIRED BY THESE INDUSTRIES ORIGINATED IN

THE UNITED STATES CUSTOMS TERRITORY (EITHER IN PUERTO RICO ITSELF

OR ON THE MAINLAND). ONLY HIDES, SKINS, LEATHER, PLASTER ROCK AND

GYPSUM, LUMBER AND WOOL, IRON, AND CHEMICALS ARE IMPORTED FROM

FOREIGN COUNTRIES. MOST PRODUCTS MADE OUT OF THESE RAW MATERIALS

ARE LIKELY TO BE CONSUMED IN PUERTO RICO ITSELF. THUS IT APPEARS

THAT PUERTO RICO'S INDUSTRIES WILL LARGELY DEPEND ON CONTINENTAL AND

HOME RAW MATERIALS AND WILL PRODUCE MOST OF THEIR PRODUCTS FOR HOME

CONSUMPTION OR FOR EXPORTATION TO THE PROTECTED MARKET ON THE MAIN-

LAND. CONSEQUENTLY, THE THIRD TYPE OF INDUSTRY, FOR WHICH A FOREIGN-

TRADE ZONE WOULD BE A SUBSTANTIAL HELP, WOULD NOT PLAY A SIGNIFICANT

PART.

1. HARVEY S. PERLOFF, PUERTO RICO'S ECONOMIC FUTURE, SOCIAL SCIENCE
RESEARCH CENTER, UNIVERSITY OF PUERTO RICO, PART IV P. 172, TABLE
55 (UNPUBLISHED).
In addition, it should be borne in mind that due to higher rental fees every activity is more expensive within a zone than outside the zone. It is therefore questionable whether manufacturers would find sufficient incentives to open a plant in the zone of San Juan instead of in the country of origin of their raw materials or in the country of destination of their final products. It is therefore not expected that much manufacturing would be done in a Puerto Rican free zone.

The question has been posed whether it would be feasible to set up assembly plants in the San Juan Port area. The transportation of unassembled parts is sometimes cheaper than that of assembled. Since, at the same time, Puerto Rico enjoys a labor cost differential, it might be economical for some mainland companies to assemble those products which are bound for export to South America or the Caribbean area in Puerto Rico.

As long as only continental firms assemble their products in Puerto Rico, such operations obviously do not affect the demand for a foreign-trade zone. Only if foreign companies were to become interested in assembling their products in Puerto Rico prior to exportations to Latin America, the existence of a free zone in San Juan might be a necessary condition for such plans. For the time being, there is little evidence that such a possibility is more than a vague speculation. By and large, it seems that other islands in the Caribbean offer more advantages to foreign companies than Puerto Rico. Some of them are

1. Shoe and furniture industries might be interested in producing in a zone, once their exports to foreign countries become significant.
2. Perloff, op.cit, p.150
2. Storage of raw materials in a zone

Closer to South American customers and most of them have a political status and a currency system which are preferable to most foreign producers.

Sometimes it is convenient for a manufacturer to postpone duty payments by storing raw materials in a foreign-trade zone. However, such a convenience is not weighty enough to influence location plans of continental industrialists. In those cases in which it were desirable to postpone duty payments on imported raw materials customs bonded warehouses might be easily used without major disadvantages.

The value of a foreign-trade zone is generally higher for importers and merchandisers than for manufacturers. The manufacturer would not have much reason to build his plant within the boundaries of a Puerto Rican foreign-trade zone. Transforming of dutiable raw materials into products to be exported is bound to be small in Puerto Rico.

Savings out of postponements of duty payments are too incidental in order to attract new industries to the Island. As has been shown by Crosby and partly also in this report, a foreign-trade zone by itself would not increase Puerto Rico’s transshipment trade notably. The net value of a zone for the Island would therefore be too small to warrant public expenditures for its maintenance.

V SUMMARY AND CONCLUSIONS

Foreign-trade zones and free ports are instruments which eliminate some of the detrimental effects of customs and excise barriers on international trade without depriving these devices of their protective functions. Being ‘‘dryports’’ in which merchandise may be stored free of duty and excise, foreign-trade zones greatly facilitate re-export and transshipment trade.
STORING, MANIPULATING, AND MANUFACTURING OF FOREIGN MERCHANDISE IN THIRD COUNTRIES PRIOR TO THEIR FINAL EXPORTATION FREQUENTLY PERMIT A MORE ECONOMICAL PRODUCTION OF THE FINAL PRODUCT, PROVIDED THAT THESE ACTIVITIES CAN BE EXECUTED DUTY FREE. THUS IT HAS BEEN MORE AND MORE WIDELY ACKNOWLEDGE THAT FOREIGN-TRADE ZONES ARE AN IMPORTANT MEANS TO FOSTER A COUNTRY’S FOREIGN TRADE.

ONE UNDESIRABLE BY-PRODUCT OF OUR TARIFF SYSTEM IS ITS FINANCIAL STRAIN ON IMPORTERS WHO DO NOT SELL THEIR MERCHANDISE IMMEDIATELY UPON IMPORTATION. INSTEAD OF TIEING UP LARGE AMOUNTS OF MONEY INTO CUSTOMS PAYMENTS, USERS OF FOREIGN-TRADE ZONES MAY PAY THEIR DUTIES AS THEY GO, I.E., WHEN THEY SELL THEIR GOODS. THIS SECOND FUNCTION OF A ZONE BRINGS ABOUT ADVANTAGES TO PRIVATE PERSONS RATHER THAN TO THE ECONOMY AS A WHOLE.

THESE BASIC FUNCTIONS OF A ZONE — NOT TO SPEAK OF ITS INCIDENTAL ADVANTAGES — ARE NOT OFFSET BY ANY DISADVANTAGES. HOWEVER, THE COST OF ESTABLISHING, OPERATING, AND MAINTAINING A ZONE HAVE TO BE CONSIDERED. TO THE COST OF CONSTRUCTING, RUNNING, AND MAINTAINING NORMAL TERMINAL FACILITIES THE COST OF FENCING, GUARDING, AND PROMOTING A ZONE HAVE TO BE ADDED. WHENEVER THESE COST ARE MINOR IN RELATION TO THE REVENUES AND THE INDIRECT BENEFITS OF A ZONE, THE ESTABLISHMENT OF FOREIGN-TRADE ZONE SHOULD BE CONSIDERED.

IT HAS BEEN ESTIMATED THAT THIS ADDITIONAL COST OF A FREE ZONE IN SAN JUAN WOULD AMOUNT TO ABOUT $40,000 TO $50,000 A YEAR AND THE INITIAL INVESTMENT COST FOR FENCING TO SOME $25,000 TO $30,000. TO PERMIT THE ZONE OPERATOR TO BREAK EVEN SOME 30,000 TONS SHOULD BE HANDLED PER YEAR. (CROSBY HOLDS THAT 40,000 TONS ARE REQUIRED.)
A sober analysis of Puerto Rico's external trade structure suggests that the amount of goods to be handled in a zone would be short of the break-even volume. The possibility of developing a major transshipment trade in Puerto Rico is remote — even if a zone were available — since

1. Due to double handling and loading costs, manipulations of foreign merchandise in a Puerto Rican free zone prior to exportation would not be economical (Crosby);

2. Puerto Rican goods are unlikely to be combined with foreign goods before they are exported (Crosby);

3. Generally speaking, double handling cost and poor shipping service make it uneconomical to distribute merchandise from San Juan to other Caribbean islands rather than shipping them directly from the port of origin.

The storage of dutiable and taxable goods in a zone with the purpose of postponing duty and excise payments is, at best, doomed to smallness. Puerto Rico's consumption power, and consequently its imports of dutiable and taxable merchandise, is small. Even the few goods that might enter a zone, would likely be imported directly into the island. Because of the wide-spread practice of using private warehouses, additional storage cost in a Puerto Rican zone would outweigh the savings out of tax and duty postponements.

The economic welfare of the whole island would not be affected very much by the establishment of a foreign-trade zone in San Juan.

Considering the economic structure of Puerto Rico, it is unlikely that a zone would attract foreign or continental manufacturers and thus help increasing the island's industrial capacity. Nor would the island's external trade with all its secondary benefits be much stimulated by
THE EXISTENCE OF FREE ZONE FACILITIES. IN VIEW OF THIS LACK OF INSULAR ECONOMIC ADVANTAGES IT DOES NOT SEEM JUSTIFIED TO COVER ZONE DEFICITS OUT OF PUBLIC FUNDS.

AT THE PRESENT TIME CAPITAL IS TOO SCARCE AND TOO PRECIOUS IN PUERTO RICO TO BE INVESTED IN A VENTURE THAT PROMISES AS LIMITED ECONOMIC RETURNS AS A FOREIGN-TRADE ZONE. IT IS, THEREFORE, SUGGESTED THAT PLANS TO ESTABLISH A ZONE IN SAN JUAN BE ABANDONED FOR THE TIME BEING.
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**Productos**

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"Abreviatura de Origen español"