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6PM - Meeting with Governor
Rafael Hernandez-Colon of
Puerto Rico

Tuesday, March 25, 1975

March 25, 1975

M E M O R A N D U M

RE: Puerto Rico's Claim for Rebate of U.S. Excise Taxes on Gasoline

The basic law governing the relationship between the Commonwealth of Puerto Rico and the United States is the Puerto Rican Federal Relations Act, Pub.L. 600, 64 Stat. 319, enacted in 1950 "in the nature of a compact". Section 9 of the Federal Relations Act, which traces its origin to the Jones Act of 1917, 39 Stat. 951, provides that "all taxes collected under the internal revenue laws of the United States on articles produced in Puerto Rico and transported to the United States or consumed in the Island shall be covered into the Treasury of Puerto Rico." This "rebate" provision is one of the cornerstones of the fiscal relationship between Puerto Rico and the United States.

For many years, U.S. Internal Revenue taxes collected on Puerto Rican rum and tobacco sold in the U.S. have been rebated to Puerto Rico under this provision. Since 1956 substantial volumes of gasoline refined in Puerto Rico have been transported to the U.S. for consumption, but the U.S. Treasury Department has never rebated the 4¢ per gallon manufacturers excise tax, 26 U.S.C. § 4081. For fiscal years 1957-1974, Puerto Rico is due approximately \$352 million in gasoline tax rebates. Prospectively, the amount of rebates would be in the range of \$25-35 million per annum.

Puerto Rico's claim for rebate of such taxes was formally instituted by the Governor's letter to Secretary William E. Simon of September 13, 1974. Subsequently, the Governor met with Secretary Simon and later with Assistant Secretary Hickman and staff. Counsel for the Commonwealth filed two detailed briefs with the Treasury Department explaining the Congressional purpose, as exemplified by the statutory language and legislative history, that Congress intended all taxes similar to the gasoline tax to be rebated to Puerto Rico.

Secretary Simon wrote to the Governor on December 9, 1974 denying the Puerto Rican claim but inviting further discussions

of the subject. Such discussions occurred and additional legal memoranda were submitted to Treasury by Commonwealth counsel. Following this, however, Secretary Simon wrote a second letter to the Governor, dated February 11, 1975, again expressing the view, that notwithstanding the merit of the arguments advanced on behalf of Puerto Rico, the claim should be denied. But before rejecting the claim, however, Secretary Simon referred the matter to the Justice Department, Office of Legal Counsel, where it is now pending.

Essentially, the Treasury lawyers have made two contentions: (1) that the administrative construction of the rebate statute was to the effect that only taxes imposed upon manufacturers were to be rebated and that sales taxes were not to be rebated; (2) that Congress earmarked gasoline tax revenues for the Highway Trust Fund and thereby could not have intended such taxes attributable to Puerto Rican gasoline to be rebated. Treasury feels this is particularly so in light of the fact that Puerto Rico has received certain benefits from the Highway Trust Fund.

The Commonwealth has endeavored to demonstrate that neither of Treasury's grounds for denial are valid. While the gasoline tax is levied on the "sale" by the manufacturer rather than on the act of manufacturing itself, as theoretically is the case under the rum and tobacco taxes, for all practical purposes -- legal, administrative and economic -- the incidence and effect of the gasoline tax is no different from the rum and tobacco taxes.

While Puerto Rico's limited participation in the Highway Trust Fund may affect the way one views the equities of this claim, it has absolutely nothing to do with Puerto Rico's legal rights to rebate of gasoline taxes. Puerto Rico has received approximately \$150 million in benefits from the Highway Trust Fund since its inception. Puerto Rico is not included in the interstate program from whence the majority of the benefits flow. It undoubtedly would be possible to work out some reasonable accommodation should it be the view of the U.S. government that it is inequitable for Puerto Rico to receive rebate of gasoline taxes and at the same time to participate partially in the federal highway program.

THE WHITE HOUSE
WASHINGTON

Date: 9/25/75

TO:

JMC

FROM:

WARREN K. HENDRIKS, JR.

COMMENTS:

Unless you desire
to meet with the
Governor alone I
suggest Jim Falk
also attend.

He will plan
to be here at
6:00 PM. unless he
hears differently.
J.

THE WHITE HOUSE

WASHINGTON

March 25, 1975

MEMORANDUM FOR:

JIM CANNON

FROM:

JIM FALK



SUBJECT:

Your Meeting with Governor Rafael
Hernandez-Colon of Puerto Rico

The principal issues expected to arise are outlined below:

1. Economic Matters

- . The Governor received a report of January 22 from T.N.Hurd which recommended certain additional taxes on property and luxury items as well as an increase in University tuition on the revenue side and budget cuts on the spending side to reduce the FY '75-'76 fiscal deficit.
- . The Governor met with the Domestic Council and OMB about 2 months ago seeking additional Federal aid. The response to the Governor from Paul O'Neill is attached at Tab A.

2. Meeting with the Vice President

- . The Governor has requested and I have proposed a meeting for him with the Vice President this week at the convenience of the Vice President.
- . A copy of my memorandum to Ann Whitman is attached at Tab B.
- . He indicates he wants to talk about fiscal and economic matters and has requested about 40 minutes.
- . A copy of a recent letter from the Governor to the President is attached at Tab C.

3. Ad Hoc Status

- . A recent series of articles has been running in the Washington Post on Puerto Rican status and the third in the series appeared in today's paper.
- . Jose Cabranes, speaking for the Governor, is quoted as saying that a new Federal bureaucracy may be needed to deal with Puerto Rican issues.
- . This proposal should not be responded to until the work of the Ad Hoc committee is further along.
- . The Governor will likely propose that a White House official head a committee for Puerto Rican affairs. The Domestic Council staff would support such an idea at an appropriate time.

EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

DEC 5 1974

Honorable Rafael Hernandez-Colon
Governor of Commonwealth of Puerto Rico
La Fortaleza, San Juan, Puerto Rico

Dear Governor Hernandez-Colon:

Wally Scott, Frank Zarb and I all appreciate the opportunity to have met with you and the Resident Commissioner on October 17, to discuss the economic situation in Puerto Rico. We also appreciate the opportunity to comment on the most thoughtful study which you presented at our meeting.

The study vividly demonstrates the adverse impact on the economy of Puerto Rico of price increases, particularly for petroleum products, which have occurred over the last year. The steps which you have taken that are outlined in the study represent an impressive agenda to lessen the impact of the current economic situation.

Similarly, we on the Federal level have developed an agenda for the fight against inflation - an agenda which, like yours, includes budgetary restraint. Although I cannot provide you at this time with definite estimates of the impact that this budgetary restraint will have on the Commonwealth, I will address the specific recommendations made in your study and, where possible, will indicate how we are attempting to reconcile the requirements for fiscal discipline with the needs of the Commonwealth.

In connection with the discussion of the Puerto Rico budget, your study notes that Puerto Rico does not participate in General Revenue Sharing and, thus, cannot substitute these funds for reductions in categorical Federal programs. Although Puerto Rico does not participate in General Revenue Sharing, the Commonwealth could be considered to receive the ultimate measure of revenue sharing in the return to the Commonwealth of all Federal income tax and customs duties collected in Puerto Rico. The estimated revenues of \$171 million from these sources in fiscal year 1975 are most likely considerably higher than what the Commonwealth would receive were it to be included in the General Revenue Sharing formula.

At this time, we cannot provide the assurance requested in the study that \$1.5 million will be made available for the Corps of Engineers to start construction on the Portugues Bucana project. It may be necessary to propose deferral of some public works projects in order to achieve the \$300 billion outlay ceiling. The status of Portugues Bucana will be addressed in connection with overall needs, but you can be assured that this request will be given careful consideration.

The request in the study that the Economic Development Agency (EDA) provide \$5.1 million in public works grants has been discussed with that agency. EDA officials indicate that the \$3 million potentially available for public works projects in Puerto Rico is the result of favorable action on two projects at pre-application conferences. EDA presently does not have any formula type allocation of its funds, except for the very limited funding now being requested to implement the new supplementary grant allocation to States. Accordingly, all eligible recipients must compete for the available resources. To the extent that Puerto Rico proposes projects that are more worthy than the competition, it could receive additional funding.

The study cites a need for increased SBA and FmHA loan funds to be channeled into the food production and distribution sectors in order to meet the growing demand which is expected to result from implementation of the Food Stamp program. We share your concern on this issue and hope that the accelerated schedule for implementation of the Food Stamp program, which the Commonwealth proposed, will not have an adverse impact on the economy of Puerto Rico.

The Commonwealth's relative position regarding SBA loans appears to be excellent. In fiscal year 1974, the total number of SBA loans declined 68 per cent, while the number in Puerto Rico increased 22 per cent. Similarly, the situation for FmHA loans looks favorable. The Commonwealth's loans are expected to increase in fiscal year 1975 from \$27 million to \$45 million, including an increase of 50% in farm ownership and farm operating loans to \$4.5 million.

The proposal in the study that business and industrial loans be made to the Commonwealth for the purpose of being reloaned to small farmers unfortunately cannot be adopted. FmHA is prohibited by law from making loans which would subsequently be reloaned by the borrower to other borrowers. The request that the FmHA interest rate for business and industrial loans be reduced below the rate on Federal notes also cannot be adopted. The interest rate formula for this program is statutorily prescribed, and it is designed to produce an interest rate to borrowers that approximates market rates. The ongoing farm ownership and farm operating loan programs at 5% and 8-1/2% respectively are designed to serve small farmers of the kind discussed in your study.

In regard to the recommendations on housing, a major review of Federal housing policy has indicated that the Nation's housing needs can be met more effectively, efficiently, and equitably under a revised public housing leasing program than under the Homeownership Assistance program which makes families eligible with the same income level as were eligible under the Section 235 program and the conventional public housing program. Accordingly, the Lower Income Housing Assistance program is being relied on to provide housing assistance in lieu of these programs. Most of the commitments under this program will be for construction of new housing units. Puerto Rico's housing needs will be carefully considered by HUD in the processing of applications for the new Lower Income Housing Assistance Program. The



recently enacted Emergency Home Purchase Assistance Act does not designate Puerto Rico as a high cost area. However, the Act does allow support for conventional mortgages of up to \$42,000.

Obviously, the housing problems of Puerto Rico and many other areas must ultimately be resolved by the private housing industry and indeed the Federal component must remain only a supplement to the private effort. We do appreciate the information on the housing needs of Puerto Rico.

The study concludes with some comments regarding Federal human resources programs and recommends that special attention be given to Puerto Rico and that ameliorative measures be devised. Two such ameliorative measures include:

- The conversion from commodity distribution to the Food Stamp Program should provide significant additional assistance to the low-income population of Puerto Rico. We are confident that, while the scheduled phased-conversion to food stamps during 1974-75 has been abandoned in favor of complete implementation by November 1, 1974, the economic assessment of feasibility has proved positive; thus, minimizing concerns of possible adverse impacts due to bottlenecks in the commercial food distribution system.
- The National Employment Assistance Act (NEAA), proposed by President Ford in his recent address on the economy, should provide significant assistance to the Commonwealth. Should the triggering conditions be met, Puerto Rico would be eligible for both extended unemployment insurance benefits (an additional 10 weeks for covered employees, 20 weeks for uncovered) and for participation in the Community Improvement Corps. At the national 6 per cent unemployment rate trigger, Puerto Rico could receive about \$28 million out of the \$500 million to be made available under the Community Improvement Corps.

In conclusion, we appreciate the opportunity both to have met with you and also to have reviewed the study which you submitted. Such dialogue with knowledgeable and responsible people like yourself is indispensable to good government. If we can provide additional information on Federal programs affecting Puerto Rico, please let us know.

Warmest regards,

Sincerely,

cc: Official File-HRD/IM

Director's Copy Mr. Edtheredge

Mr. O'Neill Mr. Meyer

Mr. Fischer Mr. Tryck

Mr. Rotherham Mr. Speshock

Mr. Barry Mr. Hanna

Mr. Smolkin

Mr. Parras

Mr. Landis

Mr. Hamm

Paul H. O'Neill
Associate Director for
Human and Community Affairs

HRD/IM:JRotherham:fv 11-14-74



B

THE WHITE HOUSE

WASHINGTON

March 19, 1975

MEMORANDUM FOR:

ANN WHITMAN

FROM:

JIM FALK *JF*

SUBJECT:

Proposed Meeting for the Vice President
with Governor Hernandez Colon of Puerto
Rico

Governor Colon has requested a meeting with the Vice President during the week of March 24 at the convenience of the Vice President. His staff indicates that he wants to talk about fiscal and economic matters and requests approximately 40 minutes.

In recent correspondence, the Governor has indicated that Puerto Rico is feeling the impact of inflation to a greater degree than is generally felt in the U.S. He indicates that 60% of Puerto Rican families are below the poverty level with incomes that are less than \$4,000 and that their efforts to curb inflation are not very effective because Puerto Rico imports over 75% of what it consumes.

Recommendation: That his request be approved.

Approve _____

Disapprove _____

C



FEB 20 1975

*James
Frank*

The President
The White House
Washington, D. C. 20500

Dear Mr. President:

Thank you for your letter concerning the steps being taken by the Federal Government to check inflation and your request that the States and the Commonwealth of Puerto Rico undertake their own share of actions.

We in Puerto Rico are feeling the impact of inflation to an even greater degree than in generally felt in the United States. Sixty percent of our families are below the poverty level with incomes of less than \$4,000. The consumer price index for wage earners in Puerto Rico increased by 30 per cent in 1974. Our efforts to curb inflation are offset because we import over 75% of what we consume. We are affected by the increase in prices on the mainland and by the dramatic rise in the price of the oil we import which comes mainly from Venezuela.

In addition, Puerto Rico has been very hard hit by recession. Our major exports are to the United States. Any slowdown in the United States economy affects the export of these products and causes a reduction in employment. Unemployment in Puerto Rico is now approximately 14%. This number is an official figure which does not include a large number of unskilled young people who are not seeking jobs at present.

The Commonwealth Government already has adopted and implemented a vigorous and diversified program to lessen and mitigate the effects of inflation.

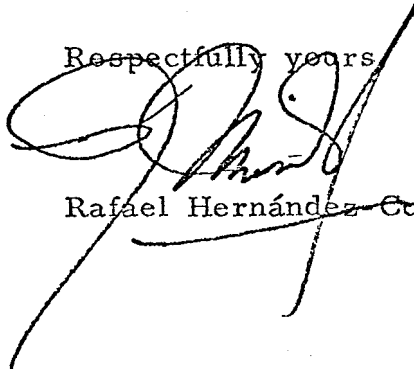
Due to the economic circumstances particular to Puerto Rico, actions of the Commonwealth have focused primarily on containing unemployment and promoting industrial and agricultural production. The most significant measures taken in order to reduce unemployment include an emergency public work training program; subsidies for low and middle income housing; and an acceleration of public works. In order to curb inflation and the effects it has primarily on middle and low income families our government has established a subsidy for electricity users which maintain a low level of consumption. Also, the Consumer Affairs Department is actively taking actions for controlling prices on essential consumer goods. Other measures have been taken to increase industrial production and improve food distribution systems.

The increase in government expenditures for financing employment and anti-inflation programs, combined with the reduction in Treasury revenues has caused a strain on the resources of the Commonwealth. As a result, we have had to raise taxes on property, gasoline, corporations, liquor, cigarettes and other items. In spite of our efforts we are feeling the effects of a severe economic recession.

I have carefully considered the measures proposed in your letter and have submitted them to my Finance Council. I have given instructions so that the measures be studied on how they might be implemented in Puerto Rico.

We appreciate your interest and help. You can count on our fullest cooperation in the common cause against inflation and recession.

Respectfully yours,



Rafael Hernández Colón

March 27, 1975

MEMORANDUM FOR:

JIM FALK

FROM:

JIM CANNON

SUBJECT:

Meeting with Governor
Hernandez-Colon of Puerto Rico

The attached material from Lynn Coleman follows our meeting with Governor Colon Tuesday afternoon.

Would you and Norm Ross please review this material and provide me with your analysis as well as any recommendations or suggestions for further action.

Many thanks.

Attachment

with implementation of drastic cost cutting and tax measures, as Mr. Hard concludes, a substantial revenue-expenditures gap will remain in fiscal 1976 which, as a practical matter, can only be met by increased federal assistance. In this connection, I invite your attention to pages 16-17 of the Hard report.

I enjoyed very much having the opportunity to meet you yesterday and look forward to working with you and your staff on a solution to these problems.

Sincerely,
[Signature]



March 26, 1975

Honorable James Michael Cannon
Executive Director and Assistant
to the President for Domestic Affairs
The White House
Washington, D. C. 20500

Re: Meeting with Governor Hernandez-Colon of
Puerto Rico on March 25, 1975

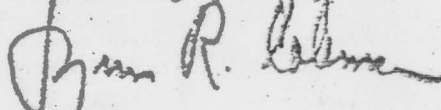
Dear Mr. Cannon:

On behalf of the Governor of Puerto Rico, I enclose a memorandum which briefly describes Puerto Rico's economic and fiscal crisis. I also enclose a copy of a recent report to him by Mr. T. N. Hurd.

The Hurd report provides a description of Puerto Rico's current economic problems, the extreme fiscal difficulties of the Commonwealth government together with a discussion of possible solutions. As you will appreciate from reading the report after the Governor's presentation yesterday, many of the steps mentioned in this report have already been taken. However, even with implementation of drastic cost cutting and new tax measures, as Mr. Hurd concludes, a substantial revenue-expenditures gap will remain in fiscal 1976 which, as a practical matter, can only be met by increased federal assistance. In this connection, I invite your attention to pages 16-17 of the Hurd report.

I enjoyed very much having the opportunity to meet you yesterday and look forward to working with you and your staff on a solution to these problems.

Sincerely yours,



Lynn R. Coleman

LRC:slg
Enclosures



CONFIDENTIAL

TO: Hon. James Michael Cannon
Executive Director and
Assistant to the President
for Domestic Affairs

FROM: Governor Rafael
Hernandez-Colon

RE: Puerto Rico's Economic
and Fiscal Crisis

DATE: March 26, 1975

The Crisis

Puerto Rico is undergoing its severest economic recession since Operation Bootstrap was started 30 years ago. Unemployment has shot up to an official level of 17%. Government resources have fallen, creating a gap for the next fiscal year of over \$300 million in a budget of \$1.4 billion.

The Reasons

The basic reasons for Puerto Rico's economic plight are three:

(1) We are totally dependent on imported oil as our only source of energy. We are without oil, gas, or coal of our own.

(2) The stateside recession has substantially affected the Mainland demand for products of the bootstrap factories and has weakened tourism.

(3) As we purchase over 60% of our products from the Mainland, we have also been importing Mainland recession.

What This Forces Puerto Rico To Do.

-- Over the past two years we have been forced to legislate new taxes or increases to existing taxes in order



to generate nearly 20% of the revenues for our budget. To my knowledge, no tax effort of this magnitude has ever been made by the Federal Government or by any state government over a two year period.

-- Automatic salary increases for next year for teachers and government employees must be repealed by legislation.

-- The government will not purchase any new equipment at all during next fiscal year.

-- The hours of work of government employees will be reduced in order to meet the requirements of the new federal minimum wage law.

-- In addition to all of this, each government agency's budget will be cut by 11%.

-- To illustrate the effect of this 11% cut on one of our agencies -- the Department of Education -- the following measures which will have to be taken:

1. Stop all purchases of equipment, textbooks, and educational material.
2. Stop all training programs including leaves of absence and scholarships -- both for students and teachers.
3. Postpone opening of 17 new schools built this year.
4. Stop all medical services for students.



5. Close down the educational radio and television station.
6. Close down the community education program.
7. Cut in half all travel expenses.
8. Reduce, by nearly half, the adult education program.
9. Lay off about 6,000 employees (not less than 4,000 classroom teachers will have to be laid off).
10. The possibility of closing schools that are now in operation is very real and, of course, the lay off of school lunch employees will also mean that thousands of children will be deprived of this essential service.

Federal Response

Puerto Rico does not participate in Federal revenue-sharing programs. Thus, it has no Federal "cushion" in a time when its own revenues are falling sharply. Unlike the Federal government, it cannot engage in deficit spending. Its borrowing authority is stretched virtually to the limit.

The Federal government can help by:

- (1) Assuring that Puerto Rico is given a fair share of Federal spending, both for capital improvement and on-going programs, in all of the anti-recessionary measures being considered by Congress.



Hon. James Michael Cannon

March 27, 1975

Page 4

(2) Reaching agreement with Puerto Rico on the rebate of excise taxes collected on gasoline refined in Puerto Rico and shipped to the U.S. Mainland, both in the past and prospectively.



THE WHITE HOUSE
WASHINGTON

April 18, 1975

MEMORANDUM FOR:

DICK DUNHAM
DICK PARSONS

FROM :

JIM CANNON

SUBJECT : Meeting with Governor Hernandez Colon
of Puerto Rico

I think Parsons should follow this one.

Attachment - Meeting with Governor Hernandez Colon
of Puerto Rico briefing paper.

THE WHITE HOUSE
WASHINGTON

April 16, 1975

MEMORANDUM FOR: JIM CANNON
FROM: JIM FALK *J*
SUBJECT: Meeting with Governor Hernandez Colon of Puerto Rico

BACKGROUND

I have reviewed the material submitted by the Governor and Congressman Jaime Benitez through Lynn Coleman following our meeting with them. I have reviewed the issue with Norm Ross and have also spoken with Dick Parsons about it.

It is my understanding that once Justice reviews the issue, a memorandum will be provided to the Treasury Department. At that time a policy review may well be appropriate.

In the interim, Jaime Benitez, the Resident Commissioner, has requested an opportunity to meet with the Vice President and if such a meeting is approved, I recommend that you participate.

THE ISSUE

Will the Federal government reach a voluntary agreement with Puerto Rico on the rebate of taxes on gas refined in Puerto Rico and shipped to the United States mainland, both in the past and prospectively? In the alternative, litigation will probably result.

RECOMMENDATION

That no Domestic Council action be taken pending an opinion by the Justice Department Office of Legal Counsel as to the legality of the Puerto Rican request.

cc: Dick Parsons
Norm Ross