APPENDIX B

Memorandum to: John Pershing, Jr.

From: Henry C. Wallich

Subject: Debt Limit

You asked for comments on the appropriateness of a change in the Commonwealth debt limit, and I am putting down some general thoughts. The subject is very complex, and I am not here trying to arrive at a quantitative answer. All that is attempted is to state some of the basic considerations and to see what they mean for the Commonwealth.

1. Nature of Debt Limit. The idea of a debt limit, as an indication of maximum debt capacity, makes less and less sense as we move from the level of the district or municipality toward that of the sovereign state. The small political units have limited functions and limited sources of revenue Debt capacity here means something fairly specific. The states are one step further along the way, because their tax powers are broader. Debt performance here depends as much upon the will as upon ability. At the level of the Federal Government, finally, the ability to service debt is, up to very large figures, much more a matter of will than of financial capacity. Given the will to pay--without inflation--taxes can always be raised another notch. The Federal debt limit is simply a means of limiting deficit spending, not an indication of the maximum debt we can bear. Puerto Rico has far broader tax powers than the states. On the other hand, Puerto Rico has no central bank. It cannot count on the note issue power as the ultima ratio of maintaining the public credit. Puerto Rico's position thus seems to be somewhere between the states and the Federal Government, probably considerably closer to the former than to the latter.

2. <u>Debt Service vs. Level of the Debt.</u> Debt limits usually are defined in terms of the principal of the debt. It would be more logical to define them in terms of annual debt service. At the level of the Federal Government, this distinction is especially important because of the relative ease of refunding. The interest burden is the main consideration. For Puerto Rico, the concept of debt service must include both interest and repayment of principal, since refunding is more difficult. Thus both interest rate and maturity schedule enter in. While it would be too complicated to state the statutory debt limit in such terms, these factors ought to be considered in fixing it. By the same token, a given debt limit means very different things depending on whether the debt is short or long, and the interest rate high or low.

3. <u>Other Debt.</u> Other forms of debt resting upon the same income base affect the debt limit. Puerto Rico is free from the burden of the federal debt. There is also less overlapping of local debt-issuing bodies in Puerto Rico than is customary elsewhere. The importance of private debt in Puerto Rico can only be guessed at. It is clearly relevant, because fixed obligations of business and consumers limit their tax capacity.

4. <u>National Income and Per Capita Income.</u> Debt capacity rises when national income rises. The extent of the increase, however, depends on whether and to what degree a higher national income also implies a higher per capita income. If national income gains merely in proportion to population growth, with no per capita gain, dept capacity rises, <u>ceteris paribus</u>, at the same rate as income. If there is a per capita gain, debt capacity rises more than in proportion to the gain in national income. People with higher

per capita incomes have a more than proportionately higher tax capacity. Under a progressive tax system, they do indeed pay more than proportionately higher taxes. For Puerto Rico this means that debt capacity is relatively low, because per capita income is low. A debt limit based upon assessed valuation may therefore be misleading. If it should turn out that the ratio of national income to assessed valuation is much lower in Puerto Rico than elsewhere, the present debt limit would mean a heavier burden upon Puerto Rico than upon a community with a higher per capita income.

On the other hand, Puerto Rico's income has been rising not only in the aggregate, but also per capita. Debt capacity, therefore, is probably rising at a rate more than proportionate to rising income.

5. Foreign vs. Domestic Debt. A debt held within the economy is obviously easier to bear than one held by outside creditors. If the debt is held locally, the interest goes back to local tax payers. There is no net loss of resources, but only a redistribution via the tax system, which may of course be painful enough. Moreover, an internally held debt does not constitute a burden upon the balance of payments.

This point has often been stressed, probably far in excess of its true merit, in connection with the federal debt. In connection with state and municipal debt it rarely comes up. Usually there is no way of knowing what part of the debt is held inside or outside of the state--in most cases the bulk is probably outside. The integration of most states into the general United States economy is so complete that people are largely unconscious of balance of payments effects.

Puerto Rican debt of most forms is predominantly held on the mainland. There are excellent reasons for placing as much of it there as possible. Nevertheless it is true that this form of borrowing has narrower limits than borrowing from Puerto Rican residents--if these could supply the funds.

For the present, and into the foreseeable future, the "foreign debt" aspect has no more than theoretical interest. Puerto Rico's other balance of payments operations are so tremendous in relation to the debt service that a gradual increase in the latter is in no way decisive. Likewise, so long as Puerto Rico's debt relations with the mainland imply that more money is coming in as new capital than is going out for debt service, the predominance of foreign debt means an easing, not a burden. This is true both from the viewpoint of the balance of payments and from that of adding or subtracting real resources to the national economy.

6. Assessed Valuation as a Basis for the Debt Limit. Assessed valuation is a logical basis for the debt limit when property taxes are the main source of revenue. In Puerto Rico, this is not the case. Total government revenues, or a formula taking into account both national income and per capita income would seem a more logical yardstick. Nevertheless, a debt limit based upon assessed valuation may still prove satisfactory if by chance it should turn out that assessed valuation happens to increase at about the same rate as government revenues or the value computed by formula. The figures cited by McCarthy suggest that this may be approximately the situation. Since in practice it will be very difficult to get

away from assessed valuation, this would be a very fortunate coincidence. It would still be necessary to find a reasonable percentage of assessed valuation to which the present debt limit could be raised. I would not say without further inspection of the data that it should be raised, but the chances are that it should.

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This memo has become more academic than I had anticipated. The conclusion that to me seems to follow is that a good deal of work needs to be done on this topic.