ECONOMIC AND FISCAL RECONSTRUCTION ADVISORY COUNCIL

REPORT TO THE GOVERNOR OF THE COMMONWEALTH OF PUERTO RICO on FISCAL RECONSTRUCTION

EXECUTIVE SUMMARY

A. INTRODUCTION

- Puerto Rico is going through one of the worst economic and fiscal crises of its history. The global economic and financial crisis, the local economic recession of the last three years, and our government's long record of spending beyond its means, and using non-recurring funds or financing to pay expenses have all combined to put our government in a critical situation that requires that the current administration take serious and immediate measures to correct it.

- There are only three ways to address the gap between revenues and expenses: increase revenues, reduce expenses or finance the deficit. This last option is currently available only to a very limited extent due to the current contraction of the capital markets, and only to the extent it is accompanied by measures aimed at addressing the deficit through revenue increases and expenditure decreases. Expecting to finance the deficit indefinitely without such complementary measures would result in the downgrade of the credit rating of our debt, which would have devastating consequences.

- When designing its recommendations, the Council sought the following objectives: to achieve a balanced budget by fiscal year 2011-12; to reduce the overall level of government expenditures; to increase recurring revenues to the General Fund and achieve a significant reduction in tax evasion; and to distribute the impact of the measures broadly, so that all citizens, in one way or another, support the government shift toward fiscal health.

- We acknowledge the difficulties of submitting measures that involve either tax increases or job reductions in the government sector, in particular when the Island is going through the third year of a recession. We also acknowledge the difficulties and social impact of any measure that involves cuts in welfare benefits, such as the government health insurance. Nevertheless, these adjustments are unavoidable when we take into account that any fiscal reconstruction program that involves a significant reduction in government revenues must necessarily affect the size of the government payroll, which represents around 70% of the government's budget, and the government health insurance plan, which accounts for almost 20%

of government revenues, and is a budget item that continues to grow. We also acknowledge that these measures and their macroeconomic impact have to be evaluated with much care before being implemented. Nevertheless, we remain convinced that, given the adverse circumstances prevalent in the global economy, the government cannot further delay taking aggressive steps to ensure that there is a probability of returning the government to solvency and restoring its fiscal health. Taking such steps is necessary to return Puerto Rico to a path of economic growth.

B. ECONOMIC AND FINANCIAL ENVIRONMENT

- The economy of Puerto Rico has been in a recession for the last three years. This recession is expected to continue through fiscal year 2010, and a recovery is not expected until 2011, when growth is projected at 2.50%.

- Puerto Rico's public debt has grown at a faster rate than the growth of its economy, reaching $46.7 billion in 2008. A significant part of the debt issued since 2001 has been used to refinance debt service and pay for operational expenses and projects that had little economic development impact.

- The credit rating of Puerto Rico's general obligation bonds has decreased significantly over the last eight years, falling to Baa3 as determined by Moody's and BBB-, according to Standard & Poor's, the lowest investment-grade rating. An additional downgrade of just one notch, to Ba1/ BB+, in the credit ratings for general obligation bonds would place Puerto Rico below the minimum investment-grade category. This would dramatically reduce the universe of investors willing to buy Puerto Rico bonds and limit our ability to obtain temporary relief to restore our economy, which would force the government of Puerto Rico to implement more drastic measures immediately.

- The United States, Europe and Japan entered into a recession in 2008 that threatens to become the worst since the Great Depression of the 1930s.

- As a result of the financial crisis in the United States, the volume of municipal bond issuances has decreased substantially. Those that have been completed are for states and jurisdictions that have credit ratings that are far superior to those of Puerto Rico. The market for securities having Puerto Rico's current rating is completely closed.

C. BUDGET AND STRUCTURAL DEFICIT

- In recent years, the central government has operated with a structural deficit of around $1 billion, according to official figures. This deficit has been covered with non-recurring revenues, such as GDB loans, bond issuances, debt refinancing and sales of real estate, among others.

- The official budget for fiscal year 2009 projected revenues of $8.488 billion and expenditures of $9.484 billion. It was expected that the estimated deficit of around $1 billion would be covered through funds advanced by GDB, payable from the sale of accounts receivables of the Secretary of the Treasury.

- The Council projects that the deficit for fiscal year 2009 will be approximately $3.2 billion. Collections have fallen approximately $685 million below the budgeted amounts as a result of the recessionary situation and expenditures have outpaced the budget by around $765 million. The sale of the Treasury Secretary's accounts receivables never materialized, which means that, for now, the central government will not be able to pay off its $1 billion loan with GDB. The government has more than $750 million in accounts payable to suppliers.

- Following an analysis of the trends that will impact government revenues and expenditures, the Council estimates that, if drastic measures are not taken, the budgetary gap will remain at more than $3 billion for the next 4 years.

- Revenues will continue to feel the impact of the recession or will reflect very modest economic growth, while important sources of revenue for the government, such as the taxes paid by pharmaceutical companies and revenues from excise taxes on rum will be reduced dramatically as a result of the expiration of patents on drugs manufactured in Puerto Rico and the relocation of the production of Captain Morgan outside of Puerto Rico.

- If measures are not taken to control expenses, they will grow at a higher rate than revenues, due mainly to the effects of inflation, increases resulting from collective bargaining agreements, and even higher deficits in the area of health.

D. FISCAL SITUATION OF OTHER STATES AND MEASURES THEY HAVE ADOPTED

- Although Puerto Rico's fiscal situation is not unique, in relative terms—43 of the 50 states of the United States face or expect to face budget deficits during the remainder of fiscal year 2008-09, as well as 2009-10—the extent of Puerto Rico's problem is far greater. The projected deficit for 2010 for New York, currently the state in the most precarious situation, stands at 22% of its revenues, compared to Puerto Rico's 39%. The relative position of Puerto Rico is even worse if we take into account that credit ratings for bonds of other states are between 5 and 9 categories higher than those of Puerto Rico.

- Many states have already implemented drastic measures to close their budget gaps, such as levying additional taxes, cutting expenses in the areas of health and education, reducing the number of public employees and/or working hours, and adjusting their compensation and benefits.

E. RECOMMENDATIONS

- The extent of the budget deficit and the need for liquidity in the government of Puerto Rico require immediate actions that have a significant impact both in terms of increasing revenues and reducing expenditures. Several of the recommendations submitted by the Council are temporary measures meant to address the urgency of the General Fund's liquidity and cash flow issues. Permanent measures have the objective of eliminating the structural government deficit.

- Temporary measures to increase revenues:

  - Tax Credit Moratorium: We recommend a two-year suspension on new tax credits, until the benefit of these tax credits is evaluated to determine whether they are justified in light of the economic activity they generate. We further recommend that any provision included in current laws that provides for a tax credit for financial loss when an economic activity is not successful be suspended. Finally, we also recommend the new Secretary of the Treasury make a priority of determining the precise fiscal impact of each of the laws that grant these credits and that, as part of this task, he establish the goal of reaching a $150 million in savings based on the revision.

  - A surtax of 5% on corporations: As an emergency measure and consistent with the objective that all sectors share equitably the burden of addressing the crisis, we recommend the imposition of a 5% surtax on taxable corporations.

  - Individual income surtax: We recommend the imposition of a 5% surtax on the income of taxpayers whose gross adjusted income exceeds $100,000, for tax years 2009, 2010 and 2011.

  - Revision of the real estate property tax-exemption and imposition of a surtax: We recommend that new legislation is enacted that: (i) beginning with fiscal year 2009-2010, establishes a mechanism to gradually adjust the level of exemption on real estate property, so that the exempt amount decreases by $1 for every $1 of appraised value of the property that exceeds the $15,000 base amount, and (ii) imposes a state tax on the value of the property for which the exemption is lost, equivalent to the tax imposed by the municipality (for fiscal year 2007-08, applicable tax rates ranged between 7.8% and 10.23%). We further recommend the imposition of a state surtax equal to 100% of the amount of the tax paid on the property due to the gradual adjustment to the exemption previously described, such surtax would be in effect for fiscal years 2009-2010 and 2010-2011 and would go into the General Fund.

  - Tax on cellular phone communications: We recommend the imposition of a special levy of 1 cent per minute of voice communication through cellular telephones. This measure would not apply to data or text communications and we recommend that it remains in effect until fiscal year 2012.

- Permanent measures to increase revenues:

  - Increase of gasoline tax: We recommend increasing the tax on gasoline from $0.16 to $0.40 per gallon and that this additional revenue remain in the General Fund to help reduce the structural deficit.

  - Increase the crude oil tax: We recommend fixing the tax rate on crude oil at $6.00 per barrel in order to return the rate to 1999 levels and thus counter the effect of the reduction in revenues from this tax in recent years. We propose the increase in revenues resulting from this tax raise remain in the Highways and Transportation Authority and for it to be applied exclusively to pay for the operational losses of the Tren Urbano.

  - Cigarette tax: We recommend an increase of fifty cents per pack in the cigarette tax. This increase, in addition to raising funds for the government in the short term, would also have a positive effect in the medium- and long-term health of the population.

  - Excise tax on alcoholic beverages: We recommend an increase in excise taxes on spirits, beer and wine.

  - Voluntary compliance and improved enforcement: We recommend establishing a voluntary tax payer compliance program—which could include unreported income, as well as the Sales and Use Tax (SUT), income taxes, payroll taxes and any other debt—pursuant to which the tax payer would be allowed to pay off his/her tax debt without paying accumulated interests or penalties. Once the first phase of the voluntary compliance program is completed, the Department of the Treasury should establish a vigorous and sustained auditing program using currently available mechanisms.

  - Improved collection and oversight of the SUT: First, we recommend simplifying the SUT by making it truly uniform. Second, we recommend centralizing SUT administration and collection in order to ease the auditing and oversight process, which would allow for a larger portion of transactions to be captured. Third, we recommend a review of the rules regarding SUT deposits to harmonize them with those related to salary withholding, thus accelerating the receipt of funds into the Treasury accounts. Finally, in order to block the inappropriate use of the resale items exemption certificates, we recommend replacing the current exemption with a credit equal to the SUT paid by the reseller against the reseller's SUT deposits to the Treasury.

- Reappraisal of real estate properties: We recommend adjusting and updating prospectively the values of real estate properties to bring said values to current levels, and implementing this measure together with tax rate cuts. The revenue increase would be directed into the General Fund.

- Self-imposed appraisals in the case of corporations: Many corporations, especially manufacturing companies–particularly in the pharmaceutical industry–that have expanded their operations in Puerto Rico over the years do not have all their properties appraised. We recommend that they be allowed to self-impose the real estate property tax based on the value of their property on the books. Revenues raised by this measure would benefit municipalities.

- Revise the alternative minimum tax: We recommend that the income subject to the alternative minimum tax include all income items (except interest over Commonwealth and federal government obligations and exempted income that originates from injury, disability or inheritance), so that all such income is taxed at a minimum rate of 20%. Furthermore, we recommend prohibiting the use of tax credits to pay for the alternative minimum tax.

• Temporary measures to reduce expenses:

  - Shortened work day: After receiving input from several groups, and acknowledging the impact that this measure would have on the more than 80,000 potentially affected employees, we believe that it is not appropriate at this time to include this measure among the Council's final recommendations. We understand, however, that shortening the work day as a temporary measure should be considered to protect jobs in an agency or a group of agencies where consolidation of functions is taking place.

  - Moratorium of economic clauses in collective bargaining agreements: We recommend the implementation of a two-year moratorium on salary increases stipulated on economic clauses in collective bargaining agreements, until the beginning of fiscal year 2011-2012.

• Permanent measures to reduce expenses:

  - Hiring freeze, ban on creation of new job posts (except for relocated personnel) and the elimination of vacant posts: We recommend not creating new posts and not replacing employees who resign, retire or leave their job post.

- Reduce transitory, irregular and appointed (*de confianza*) employees: We recommend that 33% of all transitory, irregular and appointed (*de confianza*) job posts be eliminated.

- Employees hired after July 1, 2008: We recommend that all job posts of new employees that were filled after July 1, 2008 be eliminated.

- Eliminate cash payment of excess accumulated sick days and vacation time: As a transitory measure and in order to relieve the government's cash flow situation, we recommend the balance in sick day leave accumulated up to December 2008 be paid off through compensatory time, instead of cash. For the subsequent years, we recommend passing legislation that eliminates the accumulation and liquidation of sick leave in excess of 90 days and of vacation time in excess of 60 days.

- Fiscal responsibility measures to reduce 10% of government agencies' general expenditures: We recommend that, until the process of analyzing and implementing a reorganization of the Executive Branch is completed, every agency generate savings of not less than 10% of its general operating expenses budget for the second semester of fiscal year 2008-2009 and that it maintain such savings in subsequent years.

- Reorganizing the Executive Branch: We recommend consolidating certain agencies to generate savings of at least 10%. We further recommend that the Office of Management and Budget (OMB) immediately begin a revision of all government programs (zero-base budgeting) to determine whether such programs meet their objectives and constitute a prudent use of the resources of the people of Puerto Rico.

- Reduce allocations to the Legislature: We recommend that, consistent with the agencies within the central government, the Legislative Assembly implement fiscal responsibility measures and generate savings to reduce its expenses by at least 10%.

- Reduce political parties' funding: We recommend eliminating the Electoral Fund and the Matching Fund during election year, which would save the government as much as $28 million. Whether it is desirable to have the government contribute annually to sustain political parties in Puerto Rico should also be analyzed.

- Reduce the General Fund's allocation to municipalities: Given the severity of the financial crisis of the General Fund and acknowledging the improved financial capacity of municipalities since the implementation of the SUT, we recommend eliminating the participation of municipalities in the revenues of the Lottery and that their allocation from the General Fund be reduced from 2.5% to 1.5%, beginning in Fiscal year 2009-2010.

- Reduce the Puerto Rico Health Insurance Administration's deficit: We recommend the creation of a working group or advisory board on public health with the pertinent expertise to achieve the highest efficiencies possible within a term of between 6 and 12 months, and pursue significant structural changes within a term of between 18 and 24 months. In response to the current and projected fiscal reality of the General Fund, and absent significant increases in the federal funds allocated to the Puerto Rico health program, we recommend that General Fund allocations to such program be limited to no more than a specified percentage of recurring revenues (20% until fiscal year 2011 and 18% in following years).

- Financial Measures:

  - Restructuring the debt service: Acknowledging the current limitations of the market, we recommend studying the possibility of refinancing bonds that mature in fiscal years 2009 and 2010 in order to generate temporary relief in servicing the debt during the period of fiscal adjustment.

  - Sale of securities deposited in the Infrastructure Development Fund (IDF): We recommend the sale of the securities deposited in the Corpus Account of the IDF and that the proceeds of the sale be used to pay for the bonds that said securities support, to deposit $300 million in the Corpus Account and to invest said funds in an Investment Contract with GDB, so that this principal grows to $1.0 billion by 2040; and using the net proceeds resulting from this operation, to cover the operational expenses of the government in 2008-09 and to capitalize GDB.

  - Monetization of the Lottery: We recommend monetizing the future revenues of the Lottery through a pledge of additional revenues to be earned through new games, such as "instant games."

  - COFINA: We recommend allocating an additional 1% of the SUT revenues to COFINA, in order to issue bonds that allow for the refinancing of most of the remaining extra-constitutional debt, which would also free up GDB's loan capacity; financing the fiscal year 2009 budget deficit in the long term; and paying for an economic reconstruction program.

- The Council acknowledges the importance of placing the government in a position to pay at least $750 million in overdue payables to suppliers and nonprofit organizations that provide services to or for the government. Therefore, we recommend that these payments be made using funds from these recommended financing measures.

- We recommend that the government of Puerto Rico direct efforts to secure an equitable participation in the program of federal measures that will soon be launched by the Obama Administration. At this time, it is impossible to determine how broad that non-recurring support might be or when it would be received. However, notwithstanding the receipt of federal aid, it is critical that the government begins to address the structural deficit with the measures for increasing revenues and controlling expenses included herein in order to restore our central government to fiscal health.

- We recommend that the Governor adopt a structure of task forces or advisory councils to support the implementation of these measures. These task forces/advisory councils would be comprised of advisors and professionals external to the government, on a voluntary basis, who would work as teams with key individuals within the particular agencies. Such task forces should have within its members the necessary technical expertise and they should be supported by government personnel, or consultants, who will provide the analytical and project management capabilities that are essential to achieving their objectives, while adhering to established budgets and schedules.