

**ECONOMIC AND FISCAL RECONSTRUCTION
ADVISORY BOARD**

**PRELIMINARY REPORT
TO GOVERNOR-ELECT**

Luis G. Fortuño

on

FISCAL RECONSTRUCTION

December 19, 2008

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A. INTRODUCTION

Governor-elect Luis G. Fortuño, Esq., appointed the Economic and Fiscal Reconstruction Advisory Board (the “Board”) with a mandate to evaluate Puerto Rico’s precarious fiscal situation and provide its recommendations on measures that should be implemented to alleviate the current crisis. See Appendix A of this report for a description of the Board.

Appendix B contains a table that includes the financial data obtained by the Board on both revenues and expenditures of the central government for the current fiscal year and the projections made by the Board of revenues and expenditures for the next 4 years, assuming a scenario where no measures for fiscal reconstruction are implemented. It is important to note that, due to time constraints and the scope and reliability of the information made available to the Board, the projections of revenues and expenditures represent the best estimate of the Board, based on the data obtained. Furthermore, the Board understands its projections to be reasonable.

Without doubt Puerto Rico is undergoing one of the worse economic and fiscal crises in its history. The global economic and financial crisis, the local economic recession of the past three years, the long trajectory of government spending in excess of its revenues and the use of non-recurring funds or financing to pay for recurring expenditures (an extraordinary remedy no longer available) have combined to place Puerto Rico’s government in a critical position that requires the implementation of severe and immediate measures to address this situation.

B. ECONOMIC AND FINANCIAL ENVIRONMENT

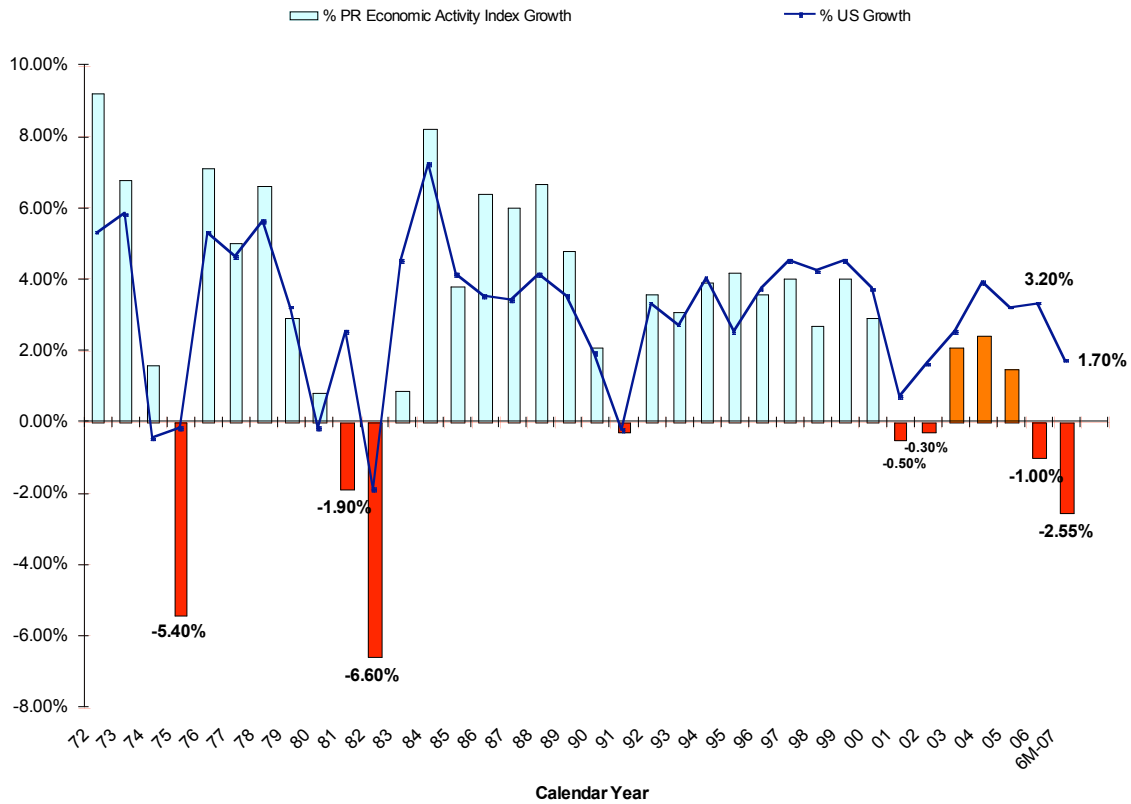
1. Global Economic and Financial Situation.

According to the World Bank, the ongoing recession in the United States, Europe and Japan threatens to be the worst since the Great Depression of the 1930s. This institution warns that after registering 2.5% in global growth for 2008, 2009 could be the first year since 1982 in which global trade declines, with an estimated contraction of 2.1%.

It is projected that the economy of the United States will contract by almost 1% during fiscal year 2009. In 2010, U.S. growth is expected to be just 0.02%, increasing to 2.52% in 2011.

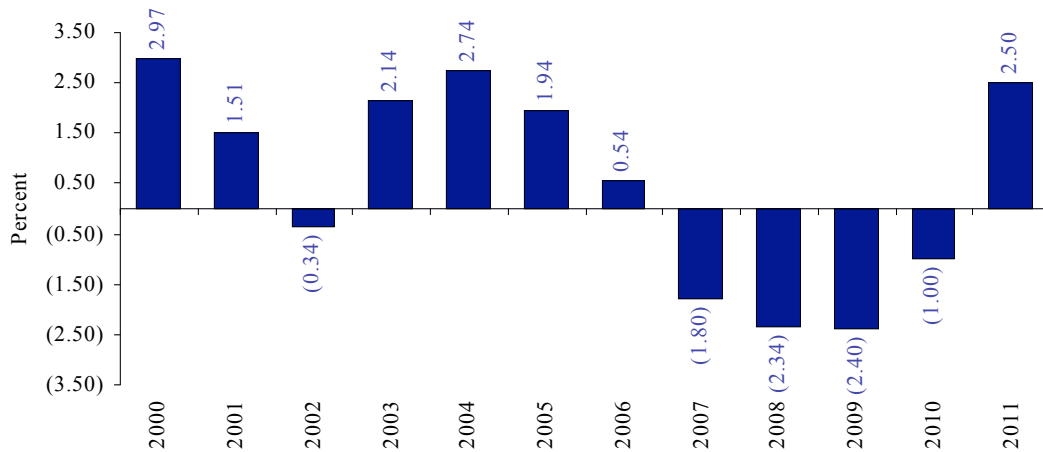
2. Puerto Rico’s Economic Situation.

Over the past 12 years, the economy of Puerto Rico has experienced a massive overheating during which the economic structure was not altered, the risks of industrial concentration were not minimized (primarily in the pharmaceutical industry), operational costs were not reduced, and Puerto Rico’s relevance on a global scale did not improve. The excess of pro-cyclical investment had similar effects to those in the United States, resulting in excessive leveraging of household finances, now vulnerable to declines in real estate values, mortgages with balances that are higher than the value of the property, and declines in the solvency of households as an economic unit.



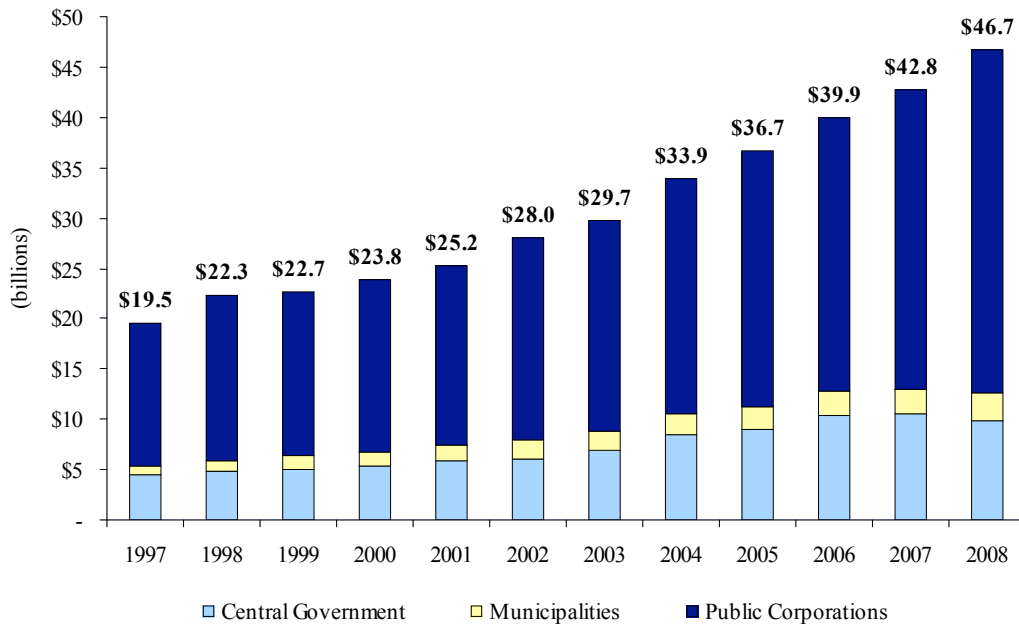
Puerto Rico's economy has been in a recession for the past 3 years, but contrary to previous recessions, ours is of local origin (it was not until 2008 that the United States' economy entered into a period of recession). It is expected that the local recession will continue throughout fiscal year 2010 and there will be no recovery until 2011, when the projected growth is estimated at 2.50%.

Puerto Rico Real Gross National Product Growth



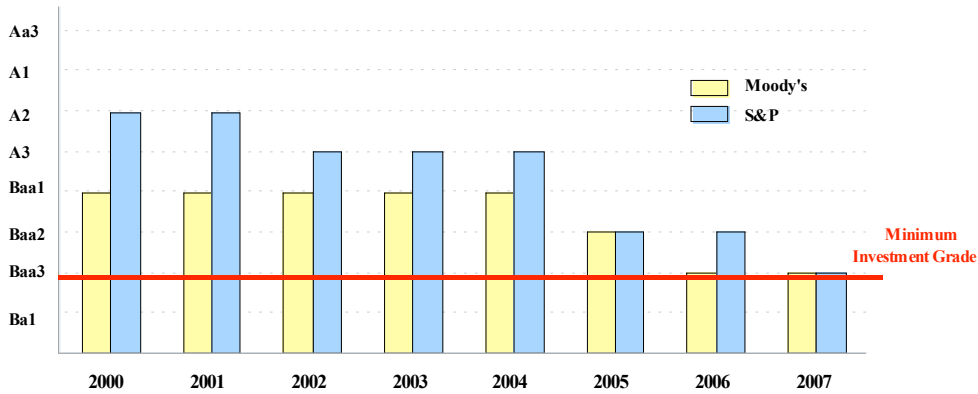
3. Central Government's Public Debt.

Puerto Rico's public debt has grown at a higher pace than the growth of the economy. The compounded annual growth rate was 6.6% for the fiscal period from 1997 to 2001; 9.8% for the overheating period from 2001 to 2005 and 8.3% from 2005 to 2008. In absolute terms, over the past 11 years, public debt has increased from \$19.5 billion to \$46.7 billion. A significant portion of the debt issued after 2001 has been used to refinance the debt service, pay for operational costs, and for projects with little impact on economic development.

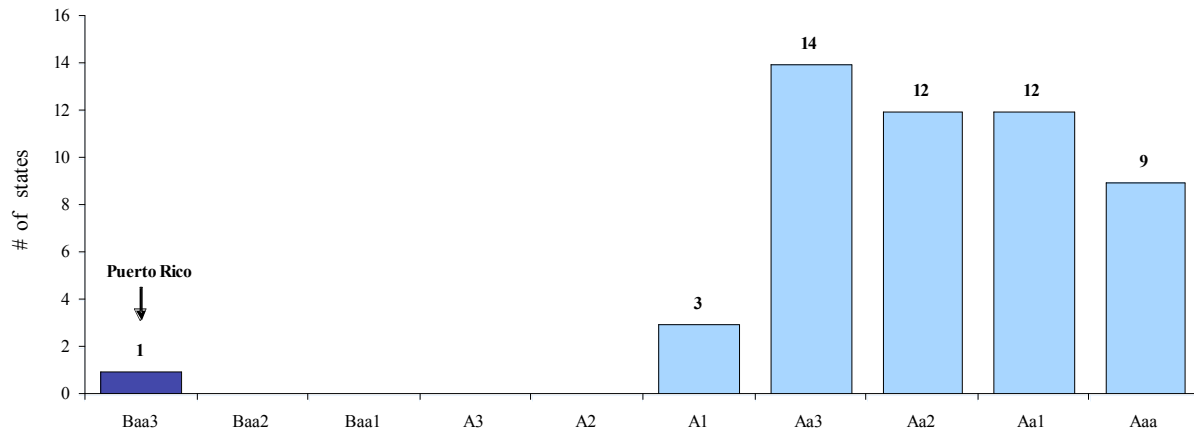


4. Credit Ratings.

The credit ratings for Puerto Rico's general obligation bonds have declined significantly over the past 8 years, falling to Baa3 by Moody's and BBB- by S&P, the minimum investment grade rating.



As shown in the table below, all state issuers in the United States have credit ratings that are higher than those of Puerto Rico.



5. Impact of a Downgrade in Credit Ratings.

An additional downgrade of just one notch, to Ba1 / BB+, in the credit rating for general obligation bonds would place Puerto Rico below the minimum investment grade category and dramatically reduce the universe of investors willing to buy Puerto Rico bonds. Therefore, maintaining and improving the credit rating must be one of the goals for the incoming administration's decision-making process. Losing the minimum investment grade credit rating would severely restrict access to the municipal bond market, to which we have had uninterrupted access the past three decades. As discussed in the following section, access to the bond market during the current crisis is extremely difficult, even for issuers with credit ratings that are superior to Puerto Rico.

A downgrade in Puerto Rico's credit ratings would have the following consequences:

- (i) The market demand to invest in Puerto Rico government bonds would become almost non-existent.

(ii) Assuming buyers exist, the size of bond issues would be reduced from the usual of approximately \$500-\$600 million per bond issue to only about \$100-\$250 million per bond issue.

(iii) The interest rate at which the government of Puerto Rico borrows money would increase substantially, since bonds would be considered “junk.”

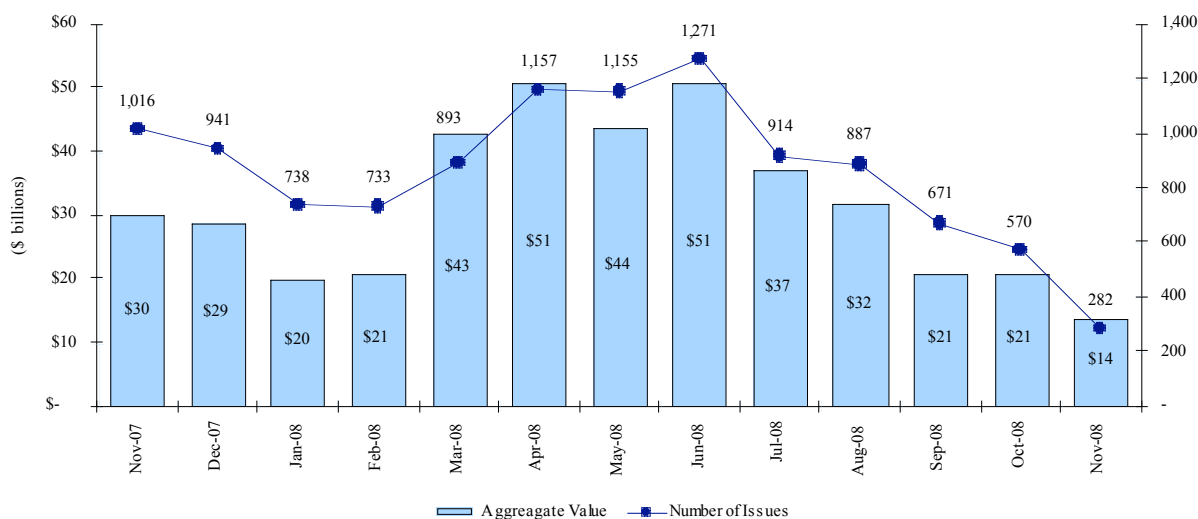
(iv) In the local market, mutual funds, which have been the largest bond investors, would be prohibited from acquiring such bonds.

Finally, a downgrade in the credit rating of Puerto Rico bonds would hamper the temporary relief needed to help restore our economy, forcing the government of Puerto Rico to immediately implement more drastic measures.

6. Municipal Bond Market.

As a result of the financial crisis in the United States, the factors that over the past four years allowed the government of Puerto Rico to postpone assuming responsibility over its spending or impose fiscal controls are no longer present (among them, easy access to the credit markets, insurance for bonds and low interests rates.) In addition, credit ratings agencies are stricter than ever before.

In recent months, municipal bond issues have declined dramatically. In June 2008, 1,271 municipal bond issues were placed, with an aggregate value of \$51 billion. This amount decreased to 282 issues, with an aggregate value of \$14 billion in November 2008.



The yields on 30-day municipal bonds with the highest classification increased to a record of 5.58%, which is 176% higher than the cost of issuing Treasury bonds with the same maturity, according to data released by Bloomberg and Municipal Market Advisors. The yields for 30-day bonds classified as AAA have increased 73 basis points compared to the previous year.

One of the factors that have dramatically affected the municipal bond market has been the financial deterioration of bond insurers. As a consequence, the few municipal bond buyers have concentrated their investments in issuers that enjoy credit ratings of AA and AAA. As mentioned

earlier, Puerto Rico's credit ratings are the lowest within the category of investment grade. Under the current market conditions, there is no demand for bonds in this category.

7. Financial Situation of Main Public Corporations.

Several public corporations are facing serious fiscal challenges. These corporations currently have very reduced liquidity, limited access to financial markets and a restricted or non-existent capacity to issue bonds. In general, the source of their weak financial position is their lack of controls over spending. The financial situation of the Highways and Transportation Authority requires immediate attention.

a. Highways and Transportation Authority (PRHTA). PRHTA does not have sufficient income to pay for its operational expenses and its capital investment program. PRHTA's deficit at the close of FY 2009, in operations (\$65 million) and the spending portion that is capitalized (\$125 million), will be approximately \$190 million and could reach \$250 million in the coming years if drastic measures are not promptly implemented. Operational subsidies for the *Tren Urbano* and *Metrobus* reduce PRHTA's revenues by \$114 million annually. To manage this situation it is imperative that PRHTA:

- (i) Implement a plan to reduce in operational expenses;
- (ii) Significantly reduce its Capital Investment Plan;
- (iii) Create a new capital investment structure such as public-private partnerships (PPP); and
- (iv) Cover, at least in part, the operational subsidies of the *Tren Urbano* and *Metrobus*.

b. Ports Authority (PRPA). PRPA does not have sufficient revenues to meet its aggregate debt service of \$624 million and finance its capital investment plan of \$816 million, only 15% of which is expected to be financed from internal revenues. Its network of regional airports generates losses and users of its facilities represent a concentration of risks. To heal its finances, PRPA must substantially reduce its operational expenses. The implementation of public-private partnerships for many of its operations would be one of the measures to evaluate, with the goal of reducing the principal amount of the debt.

c. Public Buildings Authority (PRPBA). PRPBA is one the public corporations that has been most affected the by the central government's fiscal crisis. As a result of the structural deficit, rent payments included in the central government's budget have been substantially reduced. For fiscal year 2009, the largest part of the assigned rents will be used for debt service payments, with just \$23 million remaining to manage operational expenses. In fiscal year 2008, operational expenses reached \$166 million.

d. Electric Power Authority (AEE by its Spanish acronym). The economic stability of the AEE is threatened by the combination of the high cost of providing services, reduced demand for power and reduced liquidity. The reduced demand will impact its collections and the capacity to meet its debt service, which translates into additional pressure to increase basic rates. Projections for fiscal year 2012 assumes a rate increase that, when combined with the contraction in the pharmaceutical industry, will lead to a decrease in demand for AEE services. Therefore, the payment capacity on AEE's debt service is directly tied to a reduction in its

operational expenses. Credit rating agencies have further indicated that under a weak economic scenario, an increase in short term financing on the part of AEE would cause a downgrade in their bond ratings. Its liquidity depends on the payment of account receivables from all government entities, which have reached approximately \$360 million.

e. Aqueduct and Sewer Authority (PRASA). The long-term financial viability of the PRASA depends on its ability to increase its revenues. The estimates for increasing future revenues prepared for bondholders assume an increase in sales volume and rate adjustments. However, PRASA's operational expenses have been impacted by increases in the costs of electricity and fuel. Its capacity to issue bonds for future investment depends on the success of their net income projections and controls on spending.

8. Financial Contingencies.

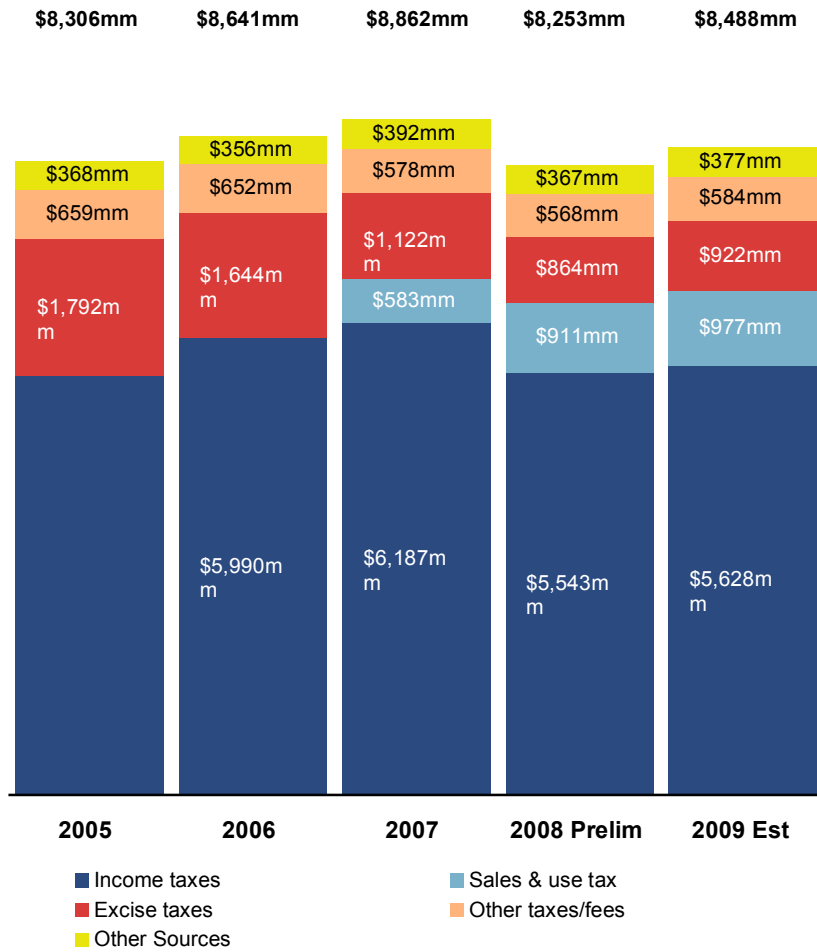
In recent years, the central government and certain public corporations entered into interest rate swap agreements known as "basis swaps," which allowed these entities to receive initial payments that were used, in the case of the central government, to balance part of the budget deficit. These agreements require that, under certain market conditions, the contracting governmental entity deliver to the counterparty government securities or cash to satisfy collateral requirements for future payments that the government entity must make under the contract. Due to irregularities in the financial markets generated by the global crisis, several Puerto Rico governmental entities, including the central government, have been obligated to deliver collateral to comply with these contractual obligations. We understand that the Government Development Bank (GDB) has advanced \$238 million from its \$1 billion line of credit, initially intended to finance the budget deficit for fiscal year 2009, to allow the central government to comply with this collateral obligation, further reducing the funds available to cover the deficit. Should interest rate irregularities in the markets continue or worsen, Puerto Rico will find itself obligated to increase the amount of collateral delivered to these counterparts, further aggravating the government's financial situation.

C. BUDGET AND STRUCTURAL DEFICIT

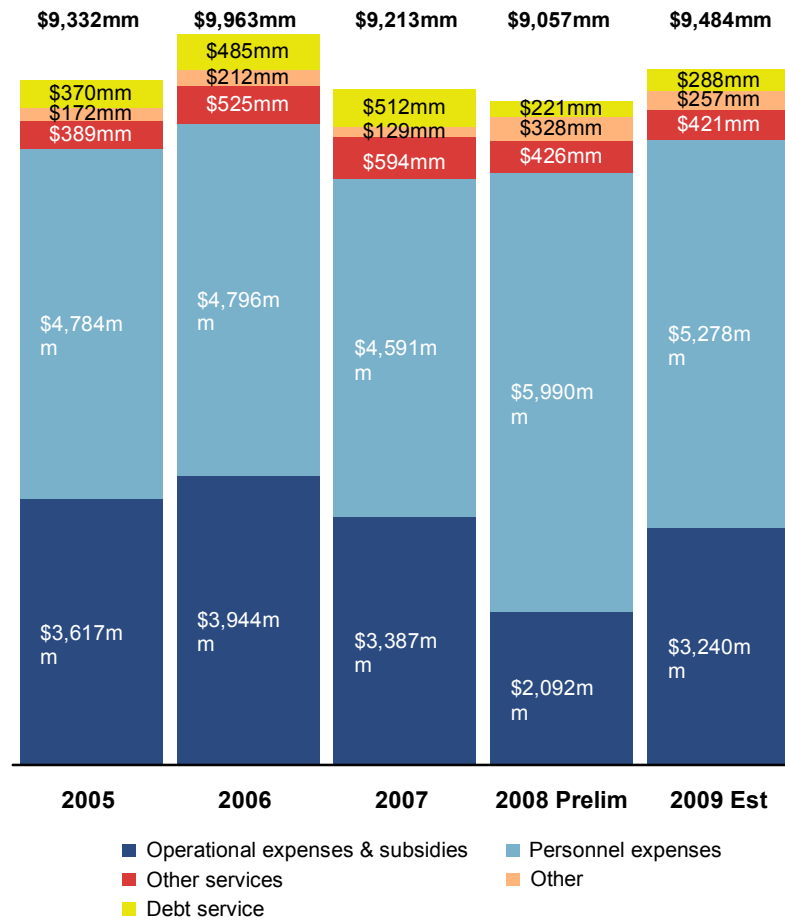
1. Background – History of Structural Deficits.

In recent years, the central government has operated with a structural deficit of approximately \$1 billion, according to official figures.

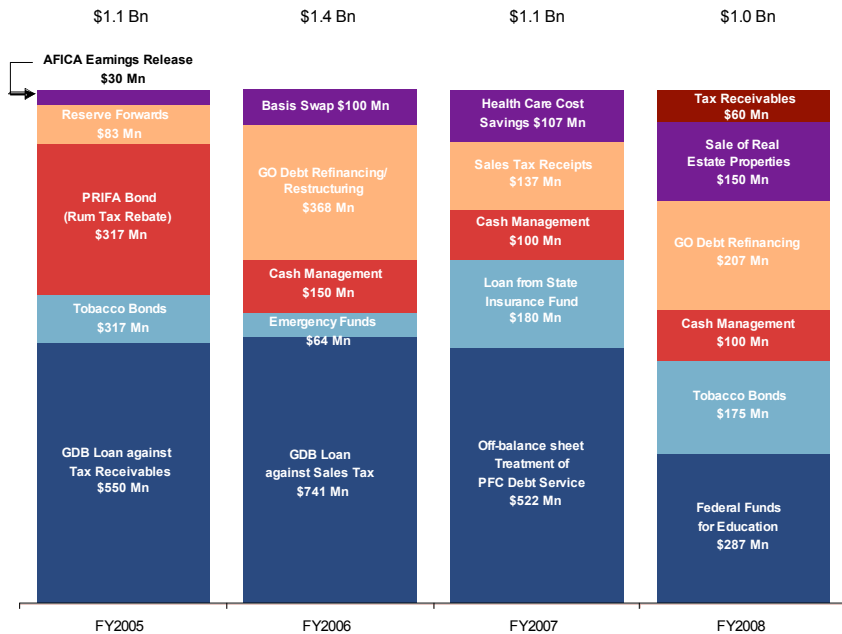
Over the past 4 years, General Fund revenues have remained practically static, averaging about \$8.5 billion.



Expenditures, however, have averaged \$9.5 billion.



The operational deficit has been covered by non-recurring revenues, such as loans from the GDB, issuance of debt, debt refinancing, and property sales, among others.



2. Forecasted Budget Deficit for 2008-2009.

The budget for fiscal year 2008-2009 assumed revenues of \$8.488 billion and \$9.484 in expenditures. It was expected that the \$1 billion deficit would be covered by a credit facility of the Government Development Bank payable from the Secretary of the Treasury's account receivables.

The Board projects that revenues for fiscal year 2008-09 will be approximately \$7.8 billion, which is 8% less than initially budgeted, due to the following reasons:

- Less revenues derived from taxes on income due to the economic recession, particularly in the corporate tax sector,
- Erosion in sales tax (IVU) collections due to the decrease in the volume of retail sales, also a result of the economic recession, as well as the temporary suspension of the sales tax during the month of September, and
- The effect of the proliferation of tax credits, which would further reduce revenues.

On the other hand, the Board forecasts that expenditures for fiscal year 2008-09 will reach approximately \$10.25 billion, 8% higher than projected, mainly due to:

- A \$500 million deficit in the health reform program, according to data obtained from the transition process and information received by the Board,
- Other agency deficits that reach approximately \$100 million,
- Unbudgeted increases in debt service.

The proposed sale of accounts receivables by the Secretary of the Treasury did not materialize, which means the central government cannot pay off the \$1 billion loan obtained from the BGF.

The situation is further aggravated when we take into consideration that the government has over \$750 million in accounts payable to suppliers. This translate into a budget deficit of approximately \$3.2 billion for fiscal year 2008-09

	Budget 2008/2009	Forecast 2008/2010
A. Revenues		
1. Forecasted/base revenues	\$8,488	\$8,488
2. Change in recurring revenues (excluding sales tax and pharma)		(410)
3. Change in sales tax collections		(77)
4. Pharma		0
5. Impact of reduction of rum excise tax		0
6. Estimated impact of tax credits		(200)
Sub-Total	\$8,488	\$7,801
B. Recurring Expenses		
1. Forecasted/base expenditures	\$9,484	\$9,484
2. Inflation on operational expense base		0
3. Impact of collective bargaining agreements		0
4. Health care reform deficit		500
5. Other deficits		100
6. Increase in debt service		115
7. Increase in other debt service		50
Sub-Total	\$9,484	\$10,249
C. Annual Operational Deficit	(\$996)	(\$2,448)
D. Accounts Payable	0	(750)
E. Operational Deficit	(\$996)	(\$3,198)
F. Advances on Tax Account Receivables	996	1,000
G. Cash Deficit	\$0	(\$2,198)

3. Forecasted Budget Deficits for the Periods of 2009-10 to 2012-13.

After analyzing the trends that will impact the government's revenues and expenditures, the Board projects that, unless drastic measures are taken, the budget gap will remain at more than \$3 billion over the next 4 fiscal years.

a. Projected revenues.

Revenue projections are based on the following assumptions:

(i) General Fund revenues, excluding the sales tax and revenues obtained from pharmaceuticals, will grow at a nominal rate of 2% in fiscal year 2009-10 and 4% in subsequent years.

(ii) Revenues from the sales tax will grow at a nominal rate of 2% in fiscal year 2009-10 and 4% in subsequent years. It is important to highlight that, in both instances, these rates of growth are nominal, which do not take into consideration the impact of inflation.

(iii) Revenues from the pharmaceutical industry will continue to decline as patents for the products manufactured expire and are not substituted with new products.

(iv) Revenues from the rum excise tax will continue to decline in fiscal years 2011-12 and 2012-13, due to the loss of excise taxes attributable to Captain Morgan's rum production relocating outside of Puerto Rico.

(v) In recent years a number of tax credits have been issued. The Treasury Department has indicated it does not have information available that would allow it to estimate the impact some of these tax credits will have on future revenues, particularly credits provided under Act 212 for Urban Renewal. Nonetheless, based on the information available, we consider it prudent to include a possible impact of \$200 million annually.

b. Projected expenditures.

Expenditure projections are based on the following assumptions:

(i) To estimate the impact of inflation on operational expenses (excluding payroll and debt service), we applied a rate of 2% in fiscal year 2009-10 and 4% in subsequent years.

(ii) Given that the Board was unable to obtain the estimates of increases under collective bargaining agreements, we assumed a 6% increase in payroll expenses for the four years as provided by the contracts.

(iii) We estimate the deficit at ASES, which currently reaches \$500 million, will increase approximately 7% a year, using an expenditure base of \$2 billion during the current fiscal year.

(iv) We assumed the additional deficit of \$100 million in other agencies would remain in subsequent years.

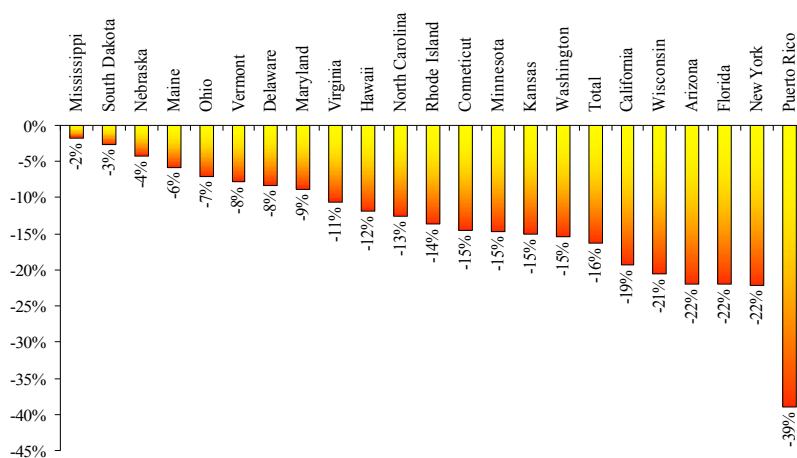
(v) Debt service will increase to approximately \$340 million beginning in fiscal year 2009-10 and will remain at that level during the years included in this analysis.

c. Projected deficit. According to estimates of the Board, the fact that revenues will grow at a slower rate than expenditures will result in a continued deficit that will drain public finances for the foreseeable future at a rate of \$3 billion a year.

	Budget 2008/2009	Forecast 2008/2010	2009/2010	2010/2011	2011/2012	2012/2013
A. Revenues						
1. Forecasted/base revenues	\$8,488	\$8,488	\$8,488	\$8,488	\$8,488	\$8,488
2. Change in recurring revenues (excluding sales tax and pharma)		(410)	(282)	(19)	253	537
3. Change in sales tax revenues		(77)	(59)	(22)	16	56
4. Pharma		0	(8)	(30)	(165)	(246)
5. Impact of reduction of rum excise		0	0	0	(120)	(120)
6. Estimated impact of tax credits		(200)	(200)	(200)	(200)	(200)
Sub-Total	\$8,488	\$7,801	\$7,939	\$8,216	\$8,272	\$8,515
B. Recurring Expenses						
1. Forecasted/base expenditures	\$9,484	\$9,484	\$9,484	\$9,484	\$9,484	\$9,484
2. Inflation (on operational expense base)		0	34	69	72	75
3. Impact of collective bargaining agreements		0	276	290	305	320
4. Health care reform deficit		500	640	790	950	1,122
5. Other deficits		100	100	100	100	100
6. Increase in debt service		115	340	340	340	340
7. Increase in other debt service		50	100	100	100	100
Sub-Total	\$9,484	\$10,249	\$10,974	\$11,173	\$11,351	\$11,541
C. Annual Operational Deficit	(\$996)	(\$2,448)	(\$3,035)	(\$2,957)	(\$3,079)	(\$3,026)
D. Accounts Payable	0	(750)	0	0	0	0
E. Operational Deficit	(\$996)	(\$3,198)	(\$3,035)	(\$2,957)	(\$3,079)	(\$3,026)
F. Advances on Tax Account Receivables	996	1,000	0	0	0	0
G. Cash Deficit	\$0	(\$2,198)	(\$3,035)	(\$2,957)	(\$3,079)	(\$3,026)

D. FISCAL SITUATION IN OTHER STATES AND MEASURES ADOPTED

The fiscal situation that Puerto Rico is currently undergoing is not unique – 43 of 50 states in the United States have or project budget deficits in fiscal year 2008-09 and for 2009-10. These deficits have been provoked or aggravated by the decline in state revenues, resulting from an economic slowdown and the financial crisis. However, in relative terms, the seriousness of the problem in Puerto Rico is far greater. The estimated deficit in Puerto Rico for fiscal year



2009-10 is 39% of the revenues for fiscal 2008-09, a considerably higher proportion than other states facing the same budgetary problems.

Puerto Rico’s relative position is even more precarious if we take into consideration that the bond ratings for these jurisdictions are between 5 and 9 grades above Puerto Rico’s, which at BBB-, is positioned at the lowest level of the so-called “investment grade.”

Although the alternative to turn to the municipal bond markets in order to temporarily finance budget deficits under current conditions is difficult, it is much easier for states to access these bond markets than it is for Puerto Rico. The consequences of a downgrade in credit ratings for these states would not be as negative as it would be for Puerto Rico. A downgrade in Puerto Rico’s credit rating would put our bonds to the level of “junk” and would mean the nearly complete loss of access to the bond market, a catastrophic event to the financial management of the government, its capital improvement programs, and the quality of our infrastructure.

Although the gravity of their budget deficits and the consequences of these are not as grim in other states as they are in Puerto Rico, many states have already undertaken dramatic measures to close the budget gap, such as raising taxes, reducing spending in health and education, reducing the labor force and making adjustments in compensation and benefits for public employees. The table below presents, as an example, the measures taken or proposed by the states of California and New York.

California	New York
<p><i>Increase in revenues</i></p> <ul style="list-style-type: none"> • Temporary increase in sales tax (from 5% to 6.5%) for a 3 year period • Expand the sales tax to cover services that were previously exempt • Impose an “Oil Severance Tax” to producers in the state • Increases in the alcohol tax 	<p><i>Increase in revenues</i></p> <ul style="list-style-type: none"> • Increase in tuition rates at state universities • Increase the contributions by public employees to health insurance premiums and Medicare • Increase special excise tax on alcohol and luxury items
<p><i>Reduction in expenditures</i></p> <ul style="list-style-type: none"> • Cuts in education • Cuts in health benefits • Reduction in funds for state universities • Reduce the work week for public employees • Elimination of 2 holidays and overtime paid to employees who work on holidays 	<p><i>Reduction in expenditures</i></p> <ul style="list-style-type: none"> • Reduce agencies expenditures by 10.35% • Cuts in education • Cuts in healthcare (Medicaid refunds) • Negotiated with the unions so as not to grant the 3% salary increase and defer 5 days of salary • Elimination of cash payments for vacations • Freezing aid to municipalities at current levels

Appendix C includes an article by the “Center on Budget and Policy Priorities,” which discusses the current fiscal situation in the states and the measures they are adopting.

CREATION AND STRUCTURE OF ADVISORY BOARD

On November 10, 2008, the Governor-elect of Puerto Rico, Luis G. Fortuño, Esq., created the Economic and Fiscal Reconstruction Advisory Board, which is made up of 14 private citizens.

The Governor-elect commissioned the Board to evaluate the current situation and present long, medium and short-term recommendations on three specific topics: (i) Fiscal reconstruction, (ii) Public-private partnerships, and (iii) Economic reconstruction.

The members appointed by the Governor-elect are:

Mr. Richard L. Carrión	Board President; Chief Executive Officer, Popular, Inc.
Mr. Alejandro Ballester	President of Ballester Hermanos, Inc.
Mr. Rodolfo A. Colberg	Business Consultant; Managing Partner, Ernst & Young Puerto Rico LLC (1989-2008)
Mr. Atilano Cordero Badillo	President, Supermercados Grande/Empresas Cordero Badillo
Mr. Gilberto Del Valle	Partner, Deloitte & Touche LLP
Mrs. Daneris Fernández	Vice President, Merck; President, Pharmaceutical Industry Association
Mrs. Teresita Fuentes	Partner, Ernst & Young Puerto Rico LLC; Deputy Secretary, Internal Revenue Service (1993-1996)
José Ramón González, Esq.	President, Puerto Rico Government Development Bank (1986-1989)
Mr. William Lockwood Benet	President, Puerto Rico Government Development Bank (2005); Vice President, PR Government Development Bank (1989-1993)
Mr. Luis Miranda	Chief Executive Officer, Universal Group
Manuel R. Pietrantoni, Esq.	Partner, Pietrantoni, Méndez & Álvarez LLP
Marcos Rodríguez-Ema, Esq.	President, Puerto Rico Government Development Bank (1993-1998)
Xenia Vélez Silva, Esq.	Senior Tax Counsel, McConnell Valdés LLC; Treasury Secretary (1997-2000)
Mr. José R. Vizcarrondo	President, Desarrollos Metropolitanos

The Governor-elect appointed Mr. Richard Carrión, as President of the Board and designated Marcos Rodríguez-Ema, Esq. and Manuel Pietrantoni, Esq. as Executive Director and Secretary, respectively.

To structure the tasks of the Board, committees were established for each one of the topics requested by the Governor-elect and a member of the Board assigned to a minimum of two, out of the three, committees:

	Economic Reconstruction	Fiscal Reconstruction	Public-Private Partnerships
Mr. Richard Carrión	x	x	x
Mr. Alejandro Ballester	x		x
Mr. Rodolfo A. Colberg		x	x
Mr. Atilano Cordero Badillo	x		x
Mr. Gilberto Del Valle		x	x
Mrs. Daneris Fernández	x		x
Mrs. Teresita Fuentes	x	x	
José Ramón González, Esq.	x	x	
Mr. William Lockwood Benet	x	x	
Sr. Luis Miranda	x		x
Manuel Pietrantonio, Esq.	x	x	x
Marcos Rodríguez-Ema, Esq.	x	x	x
Xenia Vélez Silva, Esq.	x	x	
Mr. José Vizcarrondo	x		x

Following the mandate of the Governor-elect and the philosophy of the Board of not generating additional studies, and instead taking advantage of the work done by the different groups, the Board analyzed proposals by such organizations as the Association of Certified Public Accountants of Puerto Rico, the Food Marketing Industry and Distribution Association (MIDA by its Spanish acronym), the Construction Advisory Council, Puerto Rico Bankers Association, the Alliance for the Economic Development of Puerto Rico and Citizens Agenda from El Nuevo Día. Furthermore, the Board invited several companies working with municipal bond issues, advisors to public-private partnerships, people familiar with our budget, consultants in the areas of the public health insurance program, economists and non-profit organizations, all of which possess extensive expertise in fiscal and economic areas, to present their recommendations to the Board.

The Board's analysis and the recommendations presented in this report have been enhanced by all this information and the Board greatly appreciates the work of all the people who collaborated with this effort.

Appendix B

TABLE OF ESTIMATED REVENUES, EXPENDITURES

	Budget 2008/2009	Forecast 2008/2010	2009/2010	2010/2011	2011/2012	2012/2013
A. Revenues						
1. Forecasted/base revenues	\$8,488	\$8,488	\$8,488	\$8,488	\$8,488	\$8,488
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6. Estimated impact of tax credits		(200)	(200)	(200)	(200)	(200)
Sub-Total	\$8,488	\$7,801	\$7,939	\$8,216	\$8,272	\$8,515
B. Recurring Expenses						
1. Forecasted/base expenditures	\$9,484	\$9,484	\$9,484	\$9,484	\$9,484	\$9,484
2. Inflation (on operational expense base)		0	34	69	72	75
3. Impact of collective bargaining agreements		0	276	290	305	320
4. Health care reform deficit		500	640	790	950	1,122
5. Other deficits		100	100	100	100	100
6. Increase in debt service		115	340	340	340	340
7. Increase in other debt service		50	100	100	100	100
Sub-Total	\$9,484	\$10,249	\$10,974	\$11,173	\$11,351	\$11,541
C. Annual Operational Deficit	(\$996)	(\$2,448)	(\$3,035)	(\$2,957)	(\$3,079)	(\$3,026)
D. Accounts Payable	0	(750)	0	0	0	0
E. Operational Deficit	(\$996)	(\$3,198)	(\$3,035)	(\$2,957)	(\$3,079)	(\$3,026)
F. Advances on Tax Account Receivables	996	1,000	0	0	0	0
G. Cash Deficit	\$0	(\$2,198)	(\$3,035)	(\$2,957)	(\$3,079)	(\$3,026)

ARTICLE

**“STATE BUDGET TROUBLES WORSEN,”
CENTER ON BUDGET AND POLICY PRIORITIES**

Updated December 10, 2008

STATE BUDGET TROUBLES WORSEN

By Elizabeth McNichol and Iris J. Lav

States are facing a great fiscal crisis. At least 43 states faced or are facing shortfalls in their budgets for this and/or next year. States are currently at the mid-point of their fiscal year — which started July 1 in most states — and are in the process of preparing their budgets for the next year. The outlook for state budgets remains grim.

Over half the states had already cut spending, used reserves, or raised revenues in order to adopt a balanced budget for the current fiscal year — which started July 1 in most states. Now, their budgets have fallen out of balance again. New gaps have opened up in the budgets of at least 37 states plus the District of Columbia after they struggled to close the largest budget shortfalls seen since the recession of 2001. And these problems are expected to continue into next year.

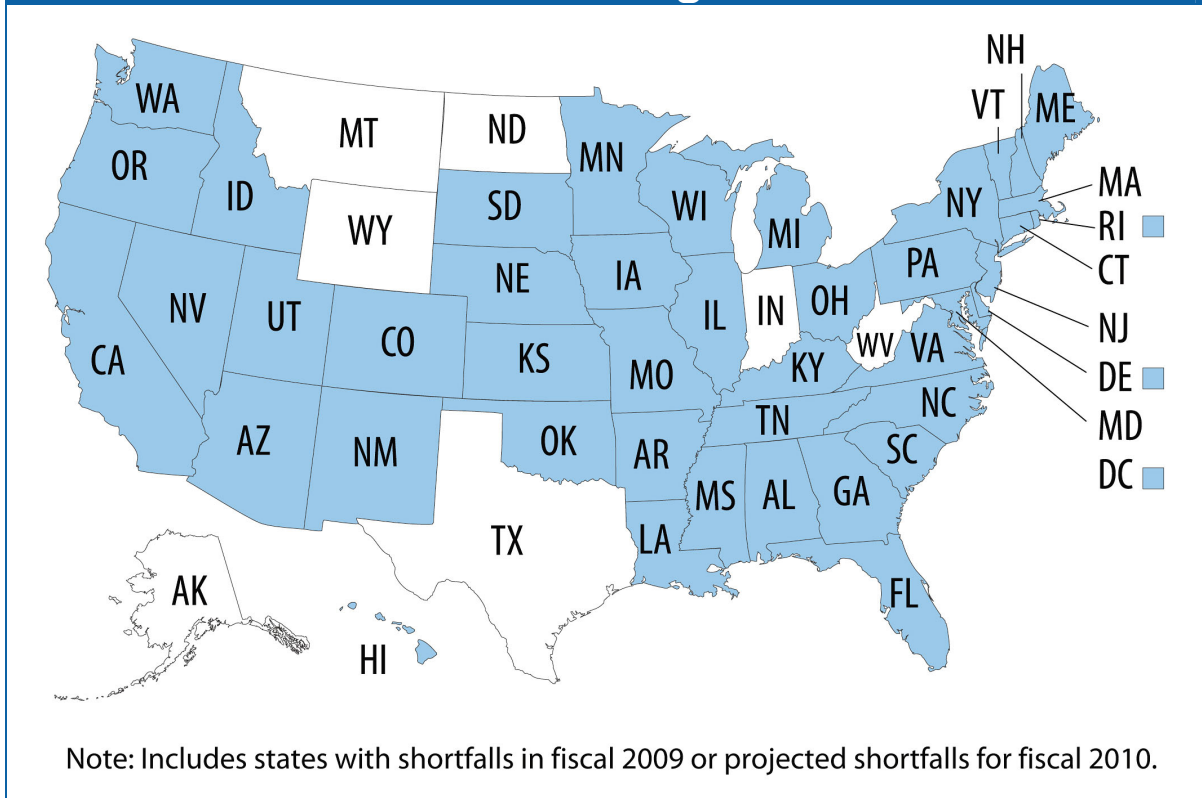
Current estimates are that mid-year gaps total \$31.2 billion — 7.2 percent of these states' budgets — but they will almost certainly widen as the continuing economic turmoil causes revenues to come in below estimates in more states.

The 37 states facing mid-year fiscal year 2009 shortfalls are **Alabama, Arizona, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Kansas, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, and Wisconsin.** In addition, the **District of Columbia** faces a

STATE FISCAL STRESS DEEPENS

- In total, 43 states are facing fiscal stress in their FY2009 and/or FY2010 budgets. Because economic conditions remain unsettled, it is highly likely that budget gaps will grow.
- New mid-year shortfalls have opened up in the budgets of at least 37 states and the District of Columbia. Estimates of these mid-year gaps total \$31.2 billion.
- Budget shortfalls are already projected in 28 states for the upcoming fiscal year. Initial estimates of these shortfalls total over \$60 billion. When all states make projections, shortfalls are likely to exceed \$100 billion.
- This new round of shortfalls is in addition to the budget gaps of \$48 billion that had to be closed in 29 states in their FY2009 budgets.

**FIGURE 1:
43 States Face Budget Shortfalls**



budget shortfall. These budget gaps are in addition to the shortfalls that these and other states faced as they adopted their budgets for the current fiscal year.¹ At that time, 29 states faced a total of more than \$48 billion in combined shortfalls.²

In general, states closed these budget gaps through some combination of spending cuts, use of reserves, or revenue increases when they adopted a fiscal year 2009 budget.

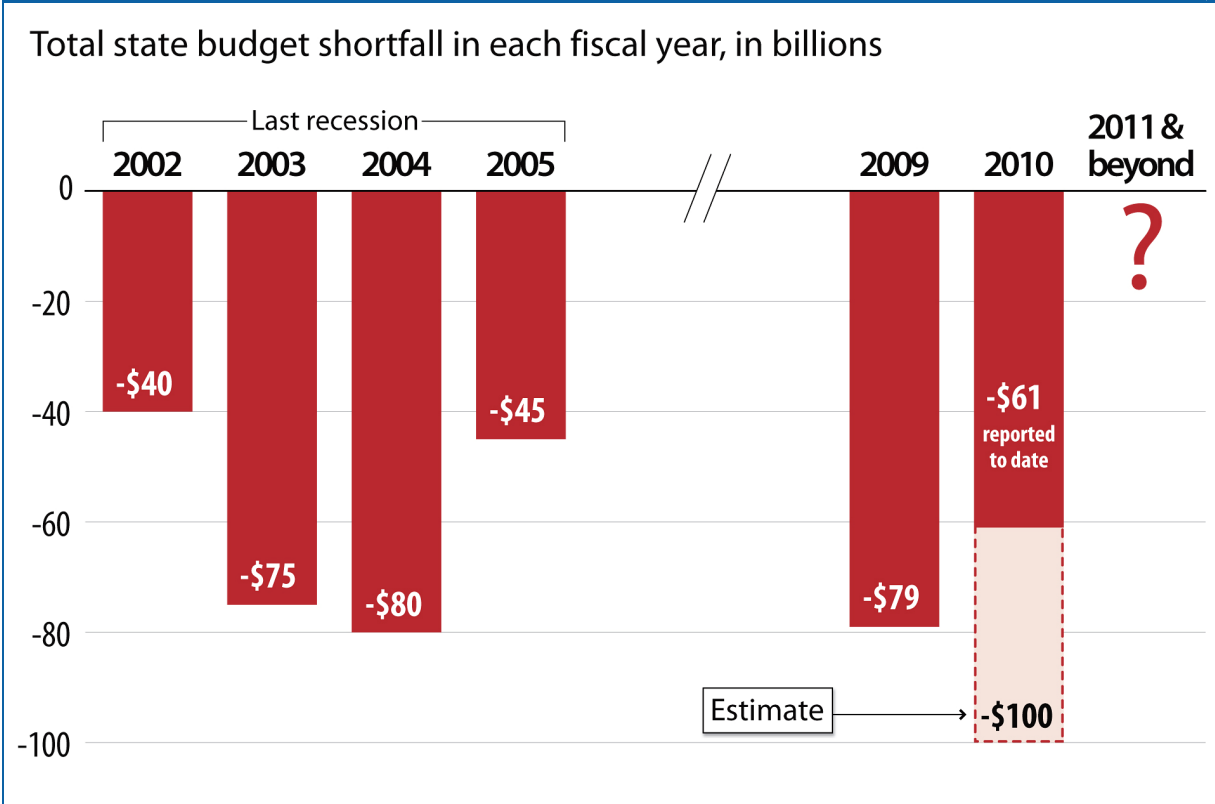
The states' fiscal problems are likely to continue for some time. At least 28 states have looked further ahead and prepared projections of revenues and/or spending for fiscal year 2010 and beyond that foresee continued fiscal distress. These 28 states include **Alabama, Arizona, California, Connecticut, Delaware, Florida, Hawaii, Idaho, Kansas, Louisiana, Maine, Maryland, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Mexico, New York, North Carolina, Ohio, Oregon, Rhode Island, South Dakota, Vermont, Virginia, Washington, and Wisconsin.**³ These gaps total more than \$60 billion — 16 percent of budgets — for the 21 states that have estimated the size of these gaps.

¹ Of these states Colorado, Hawaii, Idaho, Kansas, Missouri, New Mexico, North Carolina, Oregon, Pennsylvania, South Dakota, Utah, and Washington did not also face shortfalls before adopting FY2009 budgets.

² For more detail see the Appendix of this paper and 29 States Faced Total Budget Shortfall of At Least \$48 billion in 2009 available at <http://www.cbpp.org/1-15-08sfp.htm>.

³ The list of states at risk for budget problems in fiscal year 2010 is very likely larger than these 28 states. Most states do not regularly prepare projections of the amount of spending that would be needed to maintain existing services in future

**FIGURE 2:
How Bad Will It Get?**



Moreover, this recession is more severe than the last recession, and thus state fiscal problems are likely to be worse. For instance, unemployment, which peaked after the last recession at 6.3 percent, has already hit 6.7 percent, and many economists expect it to rise much further, which will reduce state income taxes and increase demand for Medicaid and other services. And with consumers' reduced access to home equity loans and other sources of credit, sales taxes are also likely to fall more steeply than they did in the last recession. These factors suggest that state budget gaps will be larger than in the last recession. Based on past experience and the depth of this recession it appears likely that all but a handful of states will face shortfalls in fiscal year 2010 and these deficits will end up totaling over \$100 billion.⁴

In addition, it may be particularly difficult for states to recover from the current fiscal situation, suggesting that there will be multi-year fiscal distress. Housing markets may be slow to fully recover; the decline in housing markets has already depressed consumption and sales taxes as people refrain from buying furniture, appliances, construction materials, and the like. Property tax revenues are

years — current services spending — so it is difficult to determine whether projected revenues are sufficient to cover the future cost of existing programs.

⁴ The projected budget shortfalls for fiscal year 2010 do not include the effects of a second stimulus package. If states received fiscal aid these shortfalls would be smaller. In addition if economic growth was significantly better than projected next year as a result of stimulus efforts, state revenue collections would likely be higher than projected although it is difficult to know when that effect would first be felt.

TABLE 1: STATES WITH MID-YEAR FY2009 BUDGET GAPS

	Size of Gap	Percent of FY2009 General Fund
Alabama	\$458 million	5.5%
Arizona	\$1.2 billion	11.9%
California	\$8.4 billion	8.3%
Colorado	\$99 million	1.3%
Connecticut	\$392 million	2.3%
District of Columbia	\$131 million	2.1%
Delaware	\$152 million	4.2%
Florida	\$2.1 billion	8.2%
Georgia	\$2.5 billion	11.7%
Hawaii	\$232 million	4.0%
Idaho	\$131 million	4.4%
Illinois	\$2.0 billion	7.0%
Kansas	\$137 million	2.1%
Kentucky	\$456 million	4.9%
Maine	\$140 million	4.6%
Maryland	\$513 million	3.4%
Massachusetts	\$1.4 billion	5.0%
Minnesota	\$426 million	2.5%
Mississippi	\$24 million	0.5%
Missouri	\$342 million	3.8%
Nevada	\$536 million	7.3%
New Hampshire	\$50 million	1.6%
New Jersey	\$1.2 billion	3.7%
New Mexico	\$253 million	4.2%
New York	\$1.5 billion	2.7%
North Carolina	\$800 million	3.7%
Ohio	\$1.2 billion	4.2%
Oregon	\$142 million	2.1%
Pennsylvania	\$565 million	2.0%
Rhode Island	\$372 million	11.4%
South Carolina	\$554 million	8.1%
South Dakota	\$27 million	2.2%
Tennessee	\$700 million	6.2%
Utah	\$354 million	5.9%
Vermont	\$63 million	5.2%
Virginia	\$974 million	5.7%
Washington	\$413 million	2.7%
Wisconsin	\$346 million	2.5%
TOTAL	\$31.2 billion	7.2%

Note: An entry of "DK" in Size of Gap means that an estimate of the size of the projected gap in that state is not yet available.

also beginning to be affected, and local governments will be looking to states to help address the squeeze on local and education budgets. And if the employment situation continues to deteriorate, income tax revenues will weaken and there will be further downward pressure on sales tax revenues as consumers become reluctant or unable to spend.

TABLE 2: STATES WITH PROJECTED FY2010 BUDGET GAPS		
	Size of Gap	Percent of FY2009 General Fund
Alabama	DK	
Arizona	\$2.2 billion	21.9%
California	\$19.5 billion	19.3%
Connecticut	\$2.5 billion	14.5%
Delaware	\$304 million	8.3%
Florida	\$5.6 billion	21.9%
Hawaii	\$682 million	11.9%
Idaho	DK	
Kansas	\$959 million	15.0%
Louisiana	DK	
Maine	\$177 million	5.8%
Maryland	\$1.3 billion	8.8%
Minnesota	\$2.5 billion	14.7%
Mississippi	\$87 million	1.7%
Missouri	DK	
Nebraska	\$152 million	4.3%
Nevada	DK	
New Mexico	DK	
New York	\$12.5 billion	22.2%
North Carolina	\$2.7 billion	12.5%
Ohio	\$2.0 billion	7.1%
Oregon	DK	
Rhode Island	\$450 million	13.7%
South Dakota	\$32 million	2.7%
Vermont	\$94 million	7.8%
Virginia	\$1.8 billion	10.6%
Washington	\$2.3 billion	15.4%
Wisconsin	\$2.9 billion	20.5%
TOTAL	\$60.8 billion	16.3%

Note: An entry of "DK" in Size of Gap means that an estimate of the size of the projected gap in that state is not yet available.

Although fiscal year 2010 does not start until July 2009 in most states, the effects of these upcoming problems are likely to be felt sooner. For example, the governor of New York called legislators into a special session in August to make budget cuts designed to reduce projected fiscal year 2010 budget gaps and Maryland has cut spending this year in part to address projected gaps for the next year.

The vast majority of states cannot run a deficit or borrow to cover their operating expenditures. As a result, states have three primary actions they can take during a fiscal crisis: they can draw down available reserves, they can cut expenditures, or they can raise taxes. States already have begun drawing down reserves; the remaining reserves are not sufficient to allow states to weather a significant downturn or recession. The other alternatives — spending cuts and tax increases — can further slow a state's economy during a downturn and contribute to the further slowing of the national economy, as well.

Some states have not been affected by the economic downturn but the number is dwindling. There are a number of reasons why. Some mineral-rich states — such as New Mexico, Alaska, and Montana — saw revenue growth as a result of high oil prices. However, the recent decline in oil prices has begun to affect revenues in some of these states. The economies of a handful of other states have so far been less affected by the national economic problems.

In states facing budget gaps, the consequences sometimes are severe — for residents as well as the economy. Unlike the federal government, states cannot run deficits when the economy turns down; they must cut expenditures, raise taxes, or draw down reserve funds to balance their budgets. As a new fiscal year begins in most states, budget difficulties are leading some 25 states to reduce services to their residents, including some of their most vulnerable families and individuals.⁵

For example, at least 17 states have implemented or are considering cuts that will affect low-income children's or families' eligibility for health insurance or reduce their access to health care services. Programs for the elderly and disabled are also being cut. At least 15 states are cutting medical, rehabilitative, home care, or other services needed by low-income people who are elderly or have disabilities, or significantly increasing the cost of these services.

At least 16 states are cutting or proposing to cut K-12 and early education; several of them are also reducing access to child care and early education, and at least 21 states have implemented or proposed cuts to public colleges and universities.

In addition, at least 20 states have proposed or implemented reductions to their state workforce. Workforce reductions often result in reduced access to services residents need. They also add to states' woes by contracting the state economy.

If revenue declines persist as expected in many states, additional budget cuts are likely. Budget cuts often are more severe in the second year of a state fiscal crisis, after reserves have been largely depleted and thus are no longer an option for closing deficits. The experience of the last recession is instructive as to what kinds of actions states may take. Between 2002 and 2004 states reduced services significantly. For example, in the last recession, some 34 states cut eligibility for public health programs, causing well over 1 million people to lose health coverage, and at least 23 states cut eligibility for child care subsidies or otherwise limited access to child care. In addition, 34 states cut real per-pupil aid to school districts for K-12 education between 2002 and 2004, resulting in higher fees for textbooks and courses, shorter school days, fewer personnel, and reduced transportation.

Expenditure cuts and tax increases are problematic policies during an economic downturn because they reduce overall demand and can make the downturn deeper. When states cut spending, they lay off employees, cancel contracts with vendors, eliminate or lower payments to businesses and nonprofit organizations that provide direct services, and cut benefit payments to individuals. In all of these circumstances, the companies and organizations that would have received government payments have less money to spend on salaries and supplies, and individuals who would have received salaries or benefits have less money for consumption. This directly removes demand from the economy. Tax increases also remove demand from the economy by reducing the amount of money people have to spend.

⁵ For more detailed information see *Facing Deficits, Many States are Imposing Cuts that Hurt Vulnerable Residents* <http://www.cbpp.org/3-13-08sfp.htm>.

The federal government — which can run deficits — can provide assistance to states and localities to avert these “pro-cyclical” actions.

States Have Restrained Spending and Accumulated Rainy Day Funds

Many states have never fully recovered from the fiscal crisis in the early part of the decade. This fact heightens the potential impact on public services of the deficits states are now projecting.

State expenditures fell sharply relative to the economy during the 2001 recession, and for all states combined they remain below the FY2001 level. In 18 states, general fund spending for FY2008 — six years into the economic recovery — remained below pre-recession levels as a share of the gross domestic product.

In a number of states the reductions made during the downturn in education, higher education, health coverage, and child care remain in effect. These important public services were suffering even as states turned to budget cuts to close the new budget gaps. Spending as a share of the economy declined in FY2008 and is projected to decline further in FY2009.

One way states can avoid making deep reductions in services during a recession is to build up rainy day funds and other reserves. At the end of FY2006, state reserves — general fund balances and rainy day funds — totaled 11.5 percent of annual state spending. Reserves can be particularly important to help states adjust in the early months of a fiscal crisis, but generally are not sufficient to avert the need for substantial budget cuts or tax increases.

Federal Assistance Needed

Federal assistance can lessen the extent to which states take pro-cyclical actions that can further harm the economy. In the recession in the early part of this decade, the federal government provided \$20 billion in fiscal relief in a package enacted in 2003. There were two types of assistance to states: 1) a temporary increase in the federal share of the Medicaid program; and 2) general grants to states, based on population. Each part was for \$10 billion. The increased Medicaid match averted even deeper cuts in public health insurance than actually occurred, while the general grants helped prevent cuts in a wide variety of other critical services. The major problem with that assistance was that it was enacted many months after the beginning of the recession, so it was less effective than it could have been in preventing state actions that deepened the economic downturn. The federal government should consider aiding states earlier, rather than waiting until the downturn is nearly over.

Moreover, it seems increasingly likely that this recession will be more severe than the last recession, and thus state fiscal problems may be worse. For instance, unemployment, which peaked after the last recession at 6.3 percent, has already hit 6.7 percent, and many economists expect it to rise much further, which will reduce state income taxes and increase demand for Medicaid and other services. And with consumers’ reduced access to home equity loans and other sources of credit, sales taxes are also likely to fall more steeply than they did in the last recession. These factors suggest that a new round of fiscal relief should be larger than was enacted in 2003.

TABLE 3: SIZE OF TOTAL FY2009 BUDGET GAPS				
	Gap before budget was adopted	Additional mid-year gap	Total	Total Gap as Percent of FY2009 General Fund
Alabama	\$784 million	\$458 million	\$1.2 billion	15.0%
Arizona ¹	\$1.9 billion	\$1.2 billion	\$3.1 billion	30.8%
Arkansas	\$107 million		\$107 million	2.4%
California	\$22.2 billion	\$8.4 billion	\$30.6 billion	30.3%
Colorado		\$99 million	\$99 million	1.3%
Connecticut	\$150 million	\$392 million	\$542 million	3.2%
Delaware	\$217 million	\$152 million	\$369 million	10.1%
District of Columbia	\$96 million	\$131 million	\$227 million	3.6%
Florida	\$3.4 billion	\$2.1 billion	\$5.5 billion	21.5%
Georgia ¹	\$245 million	\$2.5 billion	\$2.7 billion	12.9%
Hawaii		\$232 million	\$232 million	4.0%
Idaho		\$131 million	\$131 million	4.4%
Illinois	\$1.8 billion	\$2.0 billion	\$3.8 billion	13.4%
Iowa	\$350 million		\$350 million	5.5%
Kansas		\$137 million	\$137 million	2.1%
Kentucky	\$266 million	\$456 million	\$722 million	7.8%
Maine	\$124 million	\$140 million	\$265 million	8.6%
Maryland	\$808 million	\$513 million	\$1.3 billion	8.8%
Massachusetts	\$1.2 billion	\$1.4 billion	\$2.6 billion	9.2%
Michigan	\$472 million		\$472 million	4.8%
Minnesota	\$935 million	\$426 million	\$ 1.4 billion	7.9%
Mississippi ¹	\$90 million	\$24 million	\$114 million	2.2%
Missouri		\$342 million	\$342 million	3.8%
Nevada	\$898 million	\$536 million	\$1.4 billion	19.6%
New Hampshire	\$200 million	\$50 million	\$250 million	8.0%
New Jersey ¹	\$2.5 billion	\$1.2 billion	\$3.7 billion	11.4%
New Mexico		\$253 million	\$253 million	4.2%
New York	\$4.9 billion	\$1.5 billion	\$6.4 billion	11.4%
North Carolina		\$800 million	\$800 million	3.7%
Ohio ¹	\$733 million	\$1.2 billion	\$1.9 billion	6.8%
Oklahoma	\$114 million		\$114 million	1.7%
Oregon		\$142 million	\$142 million	2.1%
Pennsylvania		\$565 million	\$565 million	2.0%
Rhode Island	\$430 million	\$372 million	\$802 million	24.5%
South Carolina	\$250 million	\$554 million	\$804 million	11.7%
South Dakota		\$27 million	\$27 million	2.2%
Tennessee ¹	\$468 million	\$700 million	\$1.2 billion	10.4%
Utah		\$354 million	\$354 million	5.9%
Vermont	\$59 million	\$63 million	\$122 million	10.0%
Virginia	\$1.2 billion	\$974 million	\$2.2 billion	12.8%
Washington		\$413 million	\$413 million	2.7%
Wisconsin	\$652 million	\$346 million	\$998 million	7.1%
TOTAL	\$47.6 billion	\$31.2 billion	\$78.8 billion	12.9%

¹Only the low end of the estimated FY09 gap for these states — ones that provided a range of estimates — is shown in this table. For more detail see *29 States Faced Total Budget Shortfall of At Least \$48 billion in 2009* available at <http://www.cbpp.org/1-15-08sfp.htm>.

TABLE 4 – SOURCE OF MID-YEAR FY2009 & FY2010 GAP ESTIMATES

State	Source
Alabama	Executive budget office, press reports of education fund shortfall
Arizona	Joint Legislative Budget Committee
California	Legislative Analyst's Office
Colorado	Governor's office
Connecticut	Office of Fiscal Analysis
Delaware	DEFAC revenue report
District of Columbia	Chief Financial Officer
Florida	Revised revenue projections
Georgia	Georgia State University revenue projections
Hawaii	Council on Revenue forecast
Idaho	Revised revenue projections
Illinois	Governor's office
Kansas	Legislative Research Department
Kentucky	State budget director
Louisiana	State budget director
Maine	Revenue Forecasting Committee
Maryland	Legislature's projection
Massachusetts	Governor's office
Minnesota	Management and Budget forecast
Missouri	Governor-elect's office
Mississippi	Governor's proposed budget
Nebraska	Tax Rate Review Committee
Nevada	Board of Examiners
New Hampshire	Budget Director
New Jersey	Governor's office
New Mexico	Revised revenue projections
New York	Division of Budget
North Carolina	North Carolina Budget and Tax Center
Ohio	Office of Budget and Management
Pennsylvania	Governor's office
Rhode Island	Press reports of House Finance Committee presentation
South Carolina	State Budget and Control Board
South Dakota	Governor's proposed budget
Tennessee	Press reports of State Funding Board meeting
Utah	Governor's special session call
Vermont	Revised revenue projections
Virginia	Governor's office
Washington	Legislature's projections
Wisconsin	Governor's office

For source information for the original shortfall estimates, see *29 States Faced Total Budget Shortfall of At Least \$48 billion in 2009* available at <http://www.cbpp.org/1-15-08sfp.htm>.